Foreign versus Domestic Factors as Sources of Macroeconomic Fluctuations in Hong Kong

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September 2003

Summary

There can be little doubt that macroeconomic developments in Hong Kong are highly dependent on the evolution of international financial and goods markets. There is not much firm evidence, however, on the quantitative importance of these linkages. For example, it would be useful to know whether foreign influences account for fifty percent or ninety percent of business cycle fluctuations, and whether domestic factors therefore account for half or merely ten percent. The answer to this question is likely to depend on the horizon which one has in mind. External shocks are surely more important in the long run than in the short run, but by exactly how much?

This paper uses a semi-structural vector autoregression approach to estimate the relative importance of domestic and foreign shocks as sources of macroeconomic fluctuations in Hong Kong since the adoption of the currency board. We find that external factors are clearly dominant in the medium to long run. In view of the highly open nature of the Hong Kong economy and the linkages implied by the currency board arrangement, it is perhaps not unexpected. However, that these factors should account for fifty percent or more of unexpected fluctuations in real GDP and the GDP deflator at shorter horizons of one to two years is more surprising, and it is large in comparisons with other highly open small economies.

Even if external shocks are dominant sources of macroeconomic fluctuations, there remain significant short-term influences of domestic variables. For example, in the historical decomposition of the evolution of output growth and inflation we discovered a significant role for domestic factors in the recent recession. Their impact resembles very much those that would be generated by a conventional aggregate supply contraction. A challenge for future research is to identity empirically the exact sources of the domestic shocks.