

Inflation in Hong Kong, SAR - In Search of a Transmission Mechanism

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Summary

The focus of this study is the determinants of inflation in Hong Kong since the establishment of the currency board arrangement in October 1983. Our starting point is the conventional view that domestic inflation will be determined mainly by external factors in a country with a currency board. In the Hong Kong context, it is often argued that consumer price inflation in the United States is an adequate proxy for these external factors.

Our empirical evidence shows that CPI inflation rates in foreign countries do not provide an adequate description of inflation dynamics in Hong Kong. This is particularly the case if one looks at only the United States, but it holds more generally also for multilateral indices of foreign inflation.

In order to investigate the transmission mechanism more fully, we estimate inflation equations based both on traditional and more recent Phillips curve models. The recent models have two distinguishing features that we incorporate in the empirical specification; they allow forward-looking price expectations to play a role in price setting decisions, and they incorporate the possibility of sluggish price adjustments to changes in production costs. When we estimate a New Phillips curve model for the GDP deflator, a significant forward-looking component to expectations is identified. In addition, the estimates reveal that prices are relatively flexible in HK, with adjustments taking place almost twice as fast as in the United States judging by the estimates obtained in Gali and Gertler (1999). Finally we find that import prices and property rental rates appear to be important components of marginal cost of production alongside wages.

More traditional versions of the Phillips curve also fit the data quite well in Hong Kong. Even in this traditional specification, however, measures based on changes in production cost outperform measures of excess demand as forcing variables.

Having found that production costs are important for inflation is not the end of the story, however. To have a full explanation of the inflation process we need to have explanations for the driving forces behind changes in the cost of main factors of production, in particular wages and rental rates. This remains for future research.