Economic Analysis

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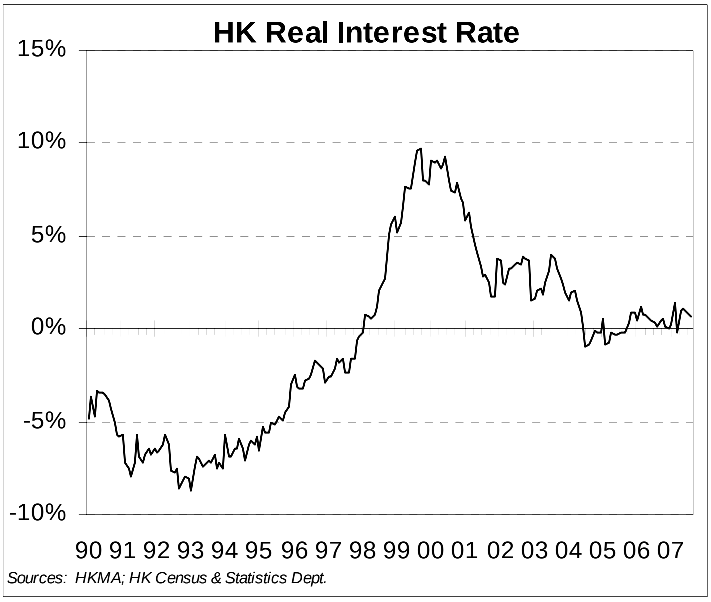
The Return of Negative Real Interest Rates

During the first eight months of 2007, the composite consumer price index (CPI) rose at a benign 1.5% average annual rate. Due to various Government measures, including the rates concession and the public housing rental reduction, the cost of housing has grown by an annualised average of only 0.9% since April. Without the relief measures, the housing component, which makes up 30% of the index, would have risen by some 4.8%. By the time when the rates waiver expires, the housing component is expected to return to its natural level. This will easily push the annual increase in the composite CPI beyond the 3% mark.

This potential upsurge in inflation is causing jitters in Hong Kong, as the U.S. Federal Reserve – which broadly determines Hong Kong interest rates under the linked exchange rate system – is in a rate cutting mood. With bank savings rates in Hong Kong heading towards 2% or lower, and inflation heading higher, negative real interest rates are set to return.



Sources: HKMA; HK Census & Statistics Dept.

A devastating negative real interest rate in the 1990s…

For those who lived through it, the impact of Hong Kong's bout of negative real interest rates in the 1990s still leaves a strong memory. Negative interest rates not only severely eroded purchasing power, they fostered the subsequent asset bubble. However, one cannot hastily draw a parallel between the situation then and now, as the objective situation is different. In the 1990s, negative real interest rates were largely structurally driven.

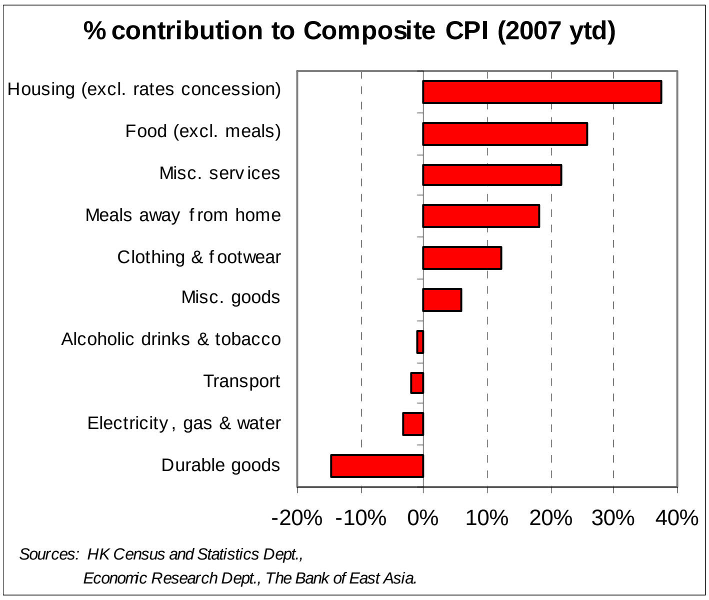
On the back of the strong economic fundamentals entering the 1990s, unemployment rate was under 2%. Land supply was dictated by the Sino-British Declaration, and could not be adjusted to meet rising demand. The resulting property bubble spurred demand for labour, especially in the construction and property-related sectors.

The prolonged period of high growth coupled with full employment resulted in double-digit nominal wage growth. This triggered wage-led inflation and subsequently an inflationary spiral. Throughout the early 1990s, the annual increase in CPI remained at a stunning 9%. At the same time, a series of rate cuts by the U.S. Federal Reserve shaved the HKD savings rate to 1.5%. This translated into real interest rates ranging from -6% to -8%.

The perilously low level of real interest rates fuelled a race to acquire assets. People diverted their cash holdings to other types of investments such as equities and properties, hoping for better returns. Others borrowed heavily, to take advantage of rising values. The excessive zest for asset investments severely aggravated the economic bubble at the time.

…which should remain subdued today

The situation is much different today. The economy has just emerged from an extended downturn, and memories of the multi-year deflationary spiral are still fresh in investors' minds. The economic recovery has a solid foundation, built on sustained growth in both the Mainland and the United States.



During the first eight months of this year, the housing component (netting out the rates concession) contributed nearly 40% of the increase in prices. Food prices (excluding meals bought away from home) accounted for another 26%, driven by the Mainland's double-digit growth in food costs. The higher food prices also drove up the cost of meals bought away from the home, accounting for a further 18% of the increase in prices.

However, today's abnormally high food prices are unlikely to persist. Food prices on the Mainland are highly volatile. A double-digit year-on-year increase in food prices was last seen in 2004; then, the rise in food prices slumped to an annual rate of less than 1% within one year. Moreover, the recent upsurge in meat and poultry prices was mainly driven by a nationwide shortage of pork following an outbreak of "blue ear" disease and a rapid rise in the cost of feed grain. Since food is a necessity, the Mainland government is highly determined to bring prices under control, and the current anomaly should be corrected soon. It is therefore expected that food prices will cease to be a driver of the inflationary environment in Hong Kong.

Looking forward, the inflationary environment will remain demand-driven. The vibrant stock market and expected upward wage adjustments will continue to support a positive wealth effect and underpin domestic demand. This will provide wholesalers and retailers higher bargaining power, and lead to price increases. On the other hand, the housing component will remain a potent force, given its sizable weight in the Composite CPI and the recent upward trend of rents.

Nevertheless, price increases should be kept in check. The likely slowdown of the United States economy will cast some uncertainties over our external trade. This will in turn help contain the local inflationary environment.

Moreover, compared to the 1990s, our economy is still far from reaching full employment. The current unemployment rate, above 4%, still has generous room to decline before it matches the level of the 1990s. Pressure from wage-led inflation should be limited.

Inflation in Hong Kong is thus expected to hover to around 3% to 4% in 2008, staying significantly lower than the 9% level seen in the early 1990s. Meanwhile, given the inflationary concerns expressed by the Federal Reserve, the magnitude of rate cuts in the next twelve months should be at most 100 basis points. This will possibly bring the Hong Kong savings rate down to around 1%, keeping the real interest rate around -2% to -3%.

Booster for the properties rather than stocks

A negative real interest rate environment often leads to a rise in demand for assets, in order to preserve purchasing power. However, the moderate negative real interest rate environment we can expect is likely to exert a more significant impact on the property market than on equities. This is because the stock market has already been hitting new highs and recording heavy turnover, even before the emergence of negative real interest rates. Participation in the stock market has never been higher, and people are investing because of the buoyant returns, rather than due to any urgency to protect purchasing power. The impact of negative real interest rates on an already vibrant stock market should therefore be minimal.

However, the impact on the property market is likely to be considerably stronger. Over the past twelve months, the monthly mortgage payments have declined by some 2%, while the rents have risen by some 13%. These movements should have resulted in an increase in property transactions. The memories of the post-1997 housing crash appear to be casting a very long shadow over potential homebuyers and investors.

Looking forward, the positive wealth effect from the macroeconomic environment, including the upswings in stock returns and wages, should lead to a comeback in buyers' confidence and give the property market a forceful boost. With benchmark rates under downward pressure, mortgage costs will likely trend lower. Coupled with the rising rental trend, a trend that is expected to accelerate further from the 11.4% increase seen in the past three months, current tenants will be motivated to consider buying instead of renting. The property market is therefore expected to demonstrate solid momentum heading into 2008.

Conclusion

Although a negative real interest rates environment is set to return, the extent is likely to be kept at a moderate -2% to -3% as inflation should remain contained. Instead of the drastic economic impact seen in the 1990s, the mild scenario this time should help sustain domestic consumption and investment activities. In the face of the global credit crunch and spillover effects from a slowing U.S. economy, negative real interest rates will give the domestic economy a timely and healthy boost.