○ Presentation (Delivered at the Seminar of Monetary Management organised by the Hong Kong Monetary Authority on 18-19 October, 1993, Hong Kong)

# NON-MONETARY ECONOMIC ADJUSTMENTS

# UNDER THE LINKED EXCHANGE RATE SYSTEM

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I am honoured to be invited by the Hong Kong Monetary Authority to join a distinguished panel of speakers to express my views on the theory and practice of monetary management in Hong Kong. I suspect, however, that as the final speaker on a panel scheduled as the last event of this Seminar, there will be little left about the subject of monetary management that has not been said and is still worth saying. I have therefore chosen to speak on the non-monetary aspects of the economic adjustment in Hong Kong. The key economic issue is the adjustment to a continuous real positive shock. The adjustment process is determined by the constraints imposed by a small open economy operating a currency board type monetary arrangement. Since 1983 the Hong Kong dollar has a unified exchange rate with the U.S. dollar. Such an arrangement limits the range of policy choices that are open to the monetary authority.

## Real Changes in the Economy

Hong Kong is experiencing a massive real positive shock due partly to the opening of China. This has presented Hong Kong manufacturers with opportunities to engage in outward processing and other forms of investment activities in south China at an unprecedented scale. It has allowed productivity of our tradeable goods sector to increase at a much faster rate than our non-tradeable goods sector. A massive structural adjustment is taking place in Hong Kong to re-deploy resources. There are two processes in operation and they are best illustrated with reference to two diagrams given below.

The first process is associated with productivity gains and can be shown diagrammatically in Figure 1. The horizontal axis depicts the volume of tradeables and the vertical axis the volume of non-tradeables. The curve XX depicts the production possibility frontier, where P is the production point and C is the consumption point given the linked exchange rate, e, and the relative price between tradeables, PT, and non-tradeables, PN. Points P and C have been drawn to coincide with each other depicting a long run equilibrium situation where the amount of tradeables produced is the same as the amount that is consumed so that there is balance in the balance of trade.

Figure 1

The positive productivity shock shifts the production possibility frontier from XX to X'X' in a manner that shows the relative greater increase in productivity of tradeables. Given the same relative price line(=ePT/PN), production moves from P to P' and consumption moves from C to C'. There is now an excess supply of tradeables (i.e., a balance of trade surplus) and an excess demand for non-tradeables. Since the exchange rate is not free to adjust under the linked exchange rate. As a consequence, the price of non-tradeables rise relative to tradeables. The resulting relative price will in the long run shift move production and consumption to points P'' and C''. The interim surplus in the balance of trade is now eliminated.

The second process is associated with income gains from investments outside Hong Kong. Given that the returns to investment in China accrue largely to Hong Kong residents, their income will rise faster than domestic output. This increases consumption spending and therefore raises the demand for non-tradeables. Figure 2 shows that while gross domestic product of Hong Kong is reflected by the budget line II, the gross national product is reflected by the budget line I*I*. The preferred consumption point $C^{o}$ is unattainable and also implies an excess demand for non-tradeables. The relative price of non-tradeables will therefore rise further until equilibrium is attained with production occurring at point P* and consumption at point C*. An important point to note is that the final long run equilibrium position due to income rising faster than output implies a chronic balance of trade deficit, which is of course financed by capital inflows.

Figure 2

The structural change in Hong Kong is the result of both a production possibility frontier shift effect and a budget line shift effect. While the strength of the first effect may be self-limiting since there are bounds to outward processing, the second effect can continue for as long as entrepreneurs and managers use Hong Kong as an entrepot for trade and base for investments in China. Both effects imply a movement of resources from the tradeable to the non-tradeable sector. The enormous pressure on domestic resources in the non-tradeable sector causes measured inflation rates in Hong Kong to be much higher than inflation rates in most of our trading partners. It is well known that capital is the most mobile resource, but land and labour is less so. This economic force propels wages to increase in labour markets and asset prices to escalate in property and stock markets. Given the very large scale of structural adjustment that has to take place the role of policy in facilitating the adjustment is worth examining.

## The Role of Monetary Policy

It has often been observed that because nominal interest rates cannot deviate significantly from levels in the United States under the linked exchange rate arrangement, therefore, the key tool for monetary management is no longer effective. What is often omitted with this observation is that the usual goal of interest rate management is to achieve macroeconomic stabilization over the business cycle. What Hong Kong is experiencing now, however, is a permanent change that is not cyclical in nature.

Cyclical fluctuations are essentially temporary changes. The goal of stabilization policy in managing business cycles is to shift resources intertemporally or over time. The aim is to encourage supply and discourage demand during an economic boom and vice versa. Whether this can be done effectively is at the heart of the macroeconomic stabilization policy debates on the choice between rules versus discretion.

A monetary arrangement that permits the implementation of internal price stability as the main macroeconomic objective and one aimed at external price stability will imply different adjustment processes. In the face of a temporary positive shock, the demand for internal price stability can be met by reducing inflationary pressures through an appreciation of the currency. This will have the desired deflationary effect in the short run. Unfortunately such a monetary arrangement will likely give to the monetary authority a considerable degree of discretionary power at its command. Whether the monetary authority will be able to the do the "right" thing at the "right" time becomes uncertain and markets will respond to this increased uncertainty and the market may perhaps indulge in speculative endeavours to out guess the monetary authority's actions. If the monetary authority has to be made accountable in a highly politicized manner the level of uncertainty will become even greater.

By contrast a monetary arrangement whose aims is focused on exchange rate stability as in the linked exchange rate regime is characterized more by rules and has therefore a higher degree of certainty. There are obvious tradeoffs between alternative arrangements. Most speakers at this conference have indicated a preference for maintaining the linked exchange rate regime for Hong Kong. As a believer of rules rather than discretion, I agree with their preferences.

## Policies to Facilitate Market Adjustments

Let us now return to the current economic boom in Hong Kong. I have suggested that Hong Kong is experiencing a permanent structural transformation. Such changes require a permanent redeployment of resources from one sector of the economy to another. Whether the process of adjustment takes place through a change in domestic prices or the exchange rate the final equilibrium deployment of resources will be the same and so will be the fall in relative price between tradeables and non-tradeables in terms of domestic prices or foreign prices. The adjustment process, however, will have different implications for different sectors of the economy and groups of individuals. In particular, individuals with assets at the beginning will experience a windfall gain and those who have invested in skills in the declining sectors will experience a reduction in their economic rents. This can be socially and politically troublesome.

The economic process of resource redeployment is also a major task, but will be facilitated by greater reliance on market forces and where necessary to ensure that artificial impediments to the proper operation of market forces be removed or reduced. The relevant policies include the following:

1. Avoid social legislation that reduce labour market mobility. While labour market interventions in Hong Kong are quite modest by comparison with other countries, it is worth noting that the structural changes in Hong Kong are so massive that a far greater degree of flexibility is called for. Long term severance pay legislation enacted earlier as an alternative to a retirements benefit scheme does not enhance labour market mobility. Compulsory retirement schemes and health insurance schemes that are tied to jobs reduce labour market mobility; they should be avoided. Intrusive legislation to mandate equality of pay and work conditions between men and women not only fail to improve economic opportunities for women, they have well known undesirable effects on labour mobility and labour market segregation. Expanding employment opportunities to guest workers and a more liberal immigration policy have obvious advantages in increasing the supply of scarce skills in demand; and in some cases may even be more cost effective than investing in the training and retraining of the labour force where long lags are clearly in operation.

2. Asset price inflation is part of the adjustment process. Socially, the rise cost of housing in the property market may be politically alarming and therefore has to be addressed publicly. Speculators have been universally identified as the culprit, but this is a red herring. The present approach is to suppress price increases by choking off demand in the banking system through rationing scarce Hong Kong Dollar mortgage loans. These measures will succeed in slowing down price increases by raising the effective cost of acquiring properties, but it will not reduce the underlying demand pressure. At worst it will exacerbate the inequality of wealth created by asset inflation by making it more difficult for the have-nots to become the haves. Eventually, the market will search for alternatives to bank financed Hong Kong Dollar mortgage loans, but the solution may take time and would require the creation of new financial arrangements.

Another solution is to increase the effective supply of housing. This can be achieved through a great variety of means: increasing the supply of land, changing plot ratios, facilitating the redevelopment of urban areas, and altering land use. Another helpful initiative which will alleviate the unfortunate social consequences of asset price inflation is to privatize the existing public housing stock. This will make available to more than a third of the population a genuine and transferrable asset that can serve as a hedge against inflation, thereby making the adjustment to a high inflation environment less painful for many households. The measure would also greatly increase efficiency in the housing market.

## Why Does Pedagogy Matter?

No monetary authority, however independent or autonomous, can be completely insulated from political pressures. For this reason developments and policies outside the monetary area can be consistent with or in conflict with the goals of the monetary authority. If the goal is to stabilize the external price, this goal would be more acceptable if the public does not have to pay a heavy cost to achieve this goal. Unfortunately as in most cases, the benefits of the present monetary and exchange rate arrangement are diffused throughout the whole population, but the harm of asset price inflation and labour market adjustment are borne mainly by a minority that can be politically vocal. The non-monetary issues are likely to be outside the prerogative of the monetary authority, but they have a bearing on the tradeoffs that the monetary authority would have to face. For this reason, no monetary authority can afford to ignore such developments. On the other hand, to involve itself in politics can be just as suicidal for it compromises the authority's autonomy and independence. Pedagogy may well be an essential and necessary exercise.