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Structural Inflation

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The present inflation in Hong Kong has both internal and external causes. Until the mid--1980s, Hong Kong's inflation was largely imported. In recent years, however, two new structural factors have become an important source of inflation: labour shortage and emigration. Labour shortage was created by the reduced flow of immigrants from China after the touch base policy was terminated in 1980, while the number of emigrants leaving Hong Kong rose from 19,000 in 1986 to 42,000 in 1989.

The Law of One Price implies that in an open economy like Hong Kong's, movements in the price of tradeable goods and services cannot deviate from world prices. The contribution of external inflation to domestic inflation depends on how open the economy is. Since trade with the rest of the world dominates the Hong Kong economy, the distinction between tradeable and non- tradeable is often unimportant. Consequently, movements in the price of tradeable goods and services in Hong Kong will be very similar to movements in the general price level. This was indeed the case until the mid-1980s, but since then, the general price level has risen faster than the price of tradeable goods and services. This phenomenon is new to Hong Kong.

The labour market became increasingly tight over time, and wages began to escalate. Since Hong Kong manufacturers are predominantly exporters, they could not shift the burden of wage increases onto foreign customers. The employment share of the manufacturing sector in the economy began to decline from 40 percent in 1980 to 29 percent in 1989. The opening of China provided an opportunity for manufacturers to relocate their plants to China.

Unlike manufactured products, most services are consumed locally. Wage increases could therefore be passed onto local customers. For this reason, the price of tradeable goods compriseding primarily of of manufactured products began to lag behind consumer prices in the mid-1980s.

The rapid growth of service industries in the economy during the 1980s is partly a result of the inability of the manufacturing sector to compete for workers in a tight labour market. This is substantiated by the more rapid increase of overall wages relative to manufacturing wages after the mid- 1980s. The rising emigration rate of managers and professionals due to political uncertainty has also reduced labour productivity. This further fuelled wage increases. The rising incidence of labour unrest in the public and quasi-public sectors is a manifestation of the same set of problems. Since wage increases in these sectors are uniformly adjusted, the bargaining process becomes excessively tedious, and there will be aggrieved parties at the end. Employees in certain services would seek to reduce workloads and improve working conditions as alternatives to wage increases.

Inflation since the mid-1980s cannot be attributed to external factors alone and cannot be solved by standard macroeconomic policy instruments. Pegging the interest rate at a level above the world rate will only alter the composition of assets held by the public in their portfolios, and can at most have only short-term effects. Revaluating the Hong Kong dollar will reduce the amount of imported inflation in the short run, but it will also lead to a further deterioration in the competitiveness of the manufacturing sector and will accelerate structural inflation. The only effective means of tackling structural inflation has to focus on providing long-term solutions for a tight labour market.