ECONOMIES

A rap from the guiding hand

The Hongkong authorities show they are prepared to exert pressure on interest rates

By Anthony Rowley

Hongkong: The hand of government was clearly detectable in the unexpected decision announced on November 7 to raise interest rates for the second time in two weeks, and by a substantial margin. If not exactly a slap in the face for the private banking cartel, which has traditionally fixed rates (usually on the basis of a belated reaction to events rather than a move in anticipation of them) the official intervention certainly represented a rap on the knuckles.

It was also a further small nail in the coffin of "economic liberalism" in Hongkong in that it appeared to recognise the need for an officially-guided policy on interest rates if the classical "adjustment mechanism" is to operate effectively through the exchange rate.

A good deal more than economic principles and the relative merits of *laissez-faire* and *dirigiste* policies is at stake. Official concern appears to have been mounting quite rapidly in recent weeks over the outflow of funds from Hongkong, the weakness of the colony's currency and the manifest over-heating in certain sectors of the economy.

Against this background, and the failure of the banking system to boost interest rates voluntarily in line with external movements and with the need to temper the property market boom in particular, it was inevitable that the prospect of greater official "suasion" over interest rates (REVIEW, Sept. 22) would become a reality.

The major US dollar support package announced on November 1 (*page 75*), which directly raised the US discount rate to 9.5% and indirectly caused New York prime to rise to 10.75%, obviously forced the hand of Hongkong to some extent over its moves several days later.

Even so, the 1.5-point jump in Hongkong prime (best lending) rate to 8.75% was of a magnitude which clearly suggests that the monetary authorities were pressurising the banks to make up for lost time and previous tardiness over raising rates.

There is still a two-point gap between US and Hongkong lending rates, but of even more significance is the wider gap between the new Hongkong deposit rates, agreed on the same day as the prime rise, and Eurodollar and Asiadollar deposit rates or US deposit rates. Hongkong's new deposit rates (effective, like the prime change, from November 9) are 6.75% for 12-month money, 5.25% for six months, and 4.5% for three months, seven days, call and savings deposits.

With the key 90-day Eurocurrency deposit rate now at about 11.75%, the incentive for a further flow of funds out of the Hongkong dollar and into US dollar or other currencies is obviously as great as ever. Even though no official figures are available to quantify this outflow, officials are concerned about it and Citibank estimates a net placement of HK$3.76 billion abroad between April and August of this year.

The still yawning gap between lending rates and interbank rates in Hongkong is also of continuing concern to perhaps all but the major domestic banks.

On November 9, inter-bank bid rate was about 11.5%, reflecting the heavy demand for money in Hongkong, particularly for the property sector. Banks' average liquidity is admittedly high (46.48% on September 30) but it is distributed unevenly throughout the system and resides mainly with the big domestic banks who are sellers of money to the foreign banks in the interbank market. Demand in the foreign-exchange swap market (where foreign banks swap US dollars for HK dollars) as well as in the overnight and call money markets has forced up rates to record levels. With all banks wanting to maintain high liquidity in anticipation of Chinese New Year monetary demand – a major demand factor just now – rates in the inter-bank market are unlikely to decline until next February at least. The Mass Transit Railway Corporation is also a net taker of funds in the money market.

Apart from the squeeze on borrowing banks, the more worrying aspect of Hongkong's cheap money policy so far this year is its impact on domestic demand which has helped push the trade deficit to a record HK$6 billion (US$1.28 billion) in the first nine months and (along with currency outflows and heavy purchases of gold via the US dollar) seen the HK dollar fall by 11.5% this year on an index basis.

A large component of this domestic demand is accounted for by construction. Bank loans to this sector were a substantial factor behind the dramatic rise in the money supply – up 29.7% at the end of September over a year previously on the narrower M1 basis and by 30.1% on the broader M2 basis.

Demand on the construction sector, which has shown itself in a 20% rise in the value of building mortgages during the first eight months of this year – demand which is "highly interest-rate sensitive" – is also a factor behind the "concealed inflation" Hongkong is experiencing at present and which is not reflected in the inflation rate of about 6% as measured by the cost-of-living index. Construction costs are probably running at five times that rate of inflation.

It remains to be seen whether the Hongkong interest rate rises (which were immediately followed by a 1.5 point rise to 11.5% in two banks' mortgage lending rates) will temper the construction and land boom anything like so effectively as it cooled the stockmarket in the first three days after the announcement (the Hang Seng Index dropped by a full 83 points, or 13%) or whether it will temper overall domestic loan demand, up 35% at the end of August. The hike is, however, a sign that the Hongkong authorities now recognise that, as one economist put it: "There is no point in having an open-ended economy without some stabilising factor" – interest rates – and that they are prepared to act upon that realisation through pressure on the bank cartel. ◼

[illegible]

(HK$ million)	Sept. 30, 1977	Sept. 30, 1978	% change
Number of licensed banks	74	80	
LIABILITIES			
Deposits	49,411	64,605	+ 30.7
Amount due to banks abroad	34,243	41,152	+ 20.2
Other liabilities	10,043	13,593	+ 35.3
TOTAL	93,697	119,350	+ 27.4
ASSETS			
Amount due from banks abroad			
Demand and short-term claims	26,974	36,166	+ 34.1
Time deposits	4,916	8,550	+ 74.0
Loans and advances			
Hongkong	33,759	46,476	+ 38.0
Abroad	17,269	16,444	— 7.8
Investments			
Hongkong	3,466	4,060	+ 17.1
Abroad	74	121	+ 64.0
Other assets			
Hongkong	4,906	6,437	+ 31.2
Abroad	1,446	178	
Cash	887	918•	+ 3.5
TOTAL	93,697	119,350	+ 27.4
Average liquidity during month	44.2%	46.48%	

Haddon-Cave winds up debate

(Cont'd from Page 1)

and the severity of the average trade balance — likely to be of the order of $7 billion in 1978 — can be diminished."

He said for as long as interest rates remain relatively low and the banks and deposit-taking companies continue to accommodate the demand for loans, the excessive growth rate of domestic demand is being encouraged.

"It is in this context that the growth of the money supply has been such a matter of concern in recent weeks," he pointed out.

Mr Haddon-Cave said the growth rate of the money supply — of which the broader definition includes currency in circulation and all bank deposits in the hands of the public — has recently been so fast as to indicate an excessive growth rate of domestic demand.

For example, he said, in the three months ending September 30 this year, compared with the three months ending June 30, the growth rate of bank loans to manufacturing fell from 14.4 per cent to 1.6 per cent, a sharp fall even allowing for seasonal factors.

But it increased from 5.3 per cent to 11.4 per cent for transport and transport equipment, from 14.1 per cent to 20.6 per cent for building and construction and from five per cent to 12.2 per cent to individuals for private and business purposes, "obviously in part for speculative activities in the stock and property markets".

The latter activities are also being financed by credit made available by deposit-taking companies, frequently on lower margins than in the past and this has been a factor in the volatility of the stock market in recent weeks.

He said the best lending interest rate has now been increased four times this year.

He said the two recent increases were consistent with the requirements of this developing situation.

Thus, in the 6½ months, the best lending rate has been increased by 84 per cent and many bank customers will now be paying rates of 10 to 11 per cent and even higher.

Whether lending rates will have to be raised again in the near future, Mr Haddon-Cave said, remains to be seen, but he expects to see over the next few months a dampening down of the demand for loans and thereby a slowing down of the growth rate of the money supply.

In due time he has no doubt that the exchange value of the Hongkong dollar will strengthen.

"I would hope, in particular, that the demand for loans for property development and for speculative property purchases will be dampened down with a beneficial effect on the rate at which prices are presently increasing," he said.

Under the present floating exchange rate regime, the Financial Secretary said Hongkong needs to have some means of protecting the economy from internally generated inflationary pressures.

Mr Haddon-Cave

The whole question of the determination of interest rates, he said, must obviously be given further thought.

Referring to direct measures which might be used to restrain the growth of the money supply, he said he does not expect, at present, that such measures will have to be invoked and, before using them, he would have to satisfy himself that they would be equitable and predictable in their effect.

He predicted that the rate of increase in the general price level and the consumer price index this year will not exceed six per cent, while the increase in the prices of investment goods this year will be about eight per cent.

The unit value index of imports of raw materials and semi-manufactures was only 1.1 per cent higher in the first eight months of this year than in the same period last year.

This represents a sharp deceleration compared with the increase in the whole of last year over 1976 of 3.2 per cent and in 1976 over 1975 of six per cent.

The nominal average daily wage rates, including fringe benefits, for manufacturing workers were eight per cent higher in March this year than in September last year which may be compared with an average half-yearly increase in the previous 18 months of 5.7 per cent.

Mr Haddon-Cave said prima facie evidence that profit margins are being squeezed as a result of these wage increases is provided by the relatively small movement in the unit value index of domestic exports.

On other matters, Mr Haddon-Cave said the call by Mr James Wu for the establishment of a largely Government-financed research council to study social, economic and technological problems, should be left to be examined by the industrial development sub-committee of the Advisory Committee on Diversification.

He drew the advisory committee's attention to Mr Allen Lee's plea for an industrial development council.

Mr Lee said this council should plan and co-ordinate all activities related to industrial development.

"To my dismay," Mr Haddon-Cave said, "he even hinted that the Government's establishment of the advisory committee indicated that the 'Government will probably take an active role in directing (industrial diversification)'.

"The Government had no such preconceived notions in mind when the advisory committee was established — as the terms of reference make quite clear."

He said he would need powerful arguments to be persuaded that the policy of leaving the commercial decision-making process to individual businessmen, a policy which has proved to be remarkably successful in achieving a steady growth momentum, should now be abandoned.

On water charges, Mr Haddon-Cave repeated his warning that an updating and restructuring exercise is inevitable.

He expressed surprise that Mr Allen Lee misinterpreted the Governor's reference to the implications for the level of water charges of the new contract for water supplies from China, which will not in itself require increased charges to consumers.

"But the need for conservation remains as strong as ever and a deficit overall remains in the accounts and is projected to persist.

"So we are now working on the final details of a new and very carefully designed tariff which seeks to reconcile fiscal, social and economic considerations and which will be introduced, I hope, some time next year," he said.

On the management of public finances, the Financial Secretary assured Miss Lydia Dunn that the Government is mindful of its responsibilities "in the way it manages its own affairs and, in particular, in the way it controls the growth of public expenditure."

In this connection, he said he intends to stick by the present framework within which budgetary and fiscal policies are constructed.

Earlier, replying to points raised by Mr David Newbigging, Mr Haddon-Cave said surveys of important service industries are now in hand.

He said he thinks Mr Newbigging exaggerated the extent to which the tourist industry contributes to Hongkong's external earnings.

Mr Haddon-Cave said although expenditure by tourists is of the order of $4 billion, such a figure representing about 7.5 per cent of GDP in current price terms, this does not necessarily mean that "the tourist industry...contributes 7.5 per cent of our GDP."

The reason for this, he said, is that the goods and services consumed by tourists have a high import content so that domestic income generated, in terms of value added in producing them, is less than is implied by the figure of total expenditure.