QNB Economics
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Monetary tightening in Hong Kong and Singapore

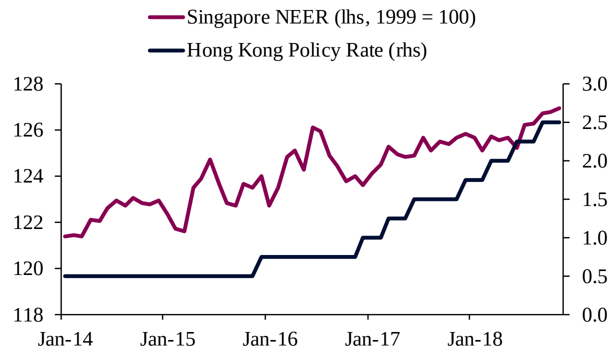
Despite external headwinds associated with weaker global growth, slower trade growth and higher uncertainties in global trade and investment policies, both Hong Kong and Singapore are in a process of monetary policy tightening. Our analysis delves into the different driving forces behind recent policy moves by the Hong Kong Monetary Authority (HKMA) and the Monetary Authority of Singapore (MAS).

The Hong Kong economy is extremely open to trade and capital flows, with external trade in goods and services equivalent to 375% of GDP. This makes it important to maintain a stable exchange rate. In fact, the monetary policy objective is to stabilize the nominal exchange rate against the USD, anchoring inflation expectations while reducing foreign exchange (FX) risks to exporters, importers and international investors. The HKMA mandate is to secure the Linked Exchange Rate in which the Hong Kong dollar (HKD) is fixed at 7.85 per unit of USD. This is operated through a currency board, i. e., a FX regime in which both stocks and flows of the monetary base have to be fully backed by FX reserves.

Under a currency board, domestic interest rates are expected to be broadly aligned with interest rates prevailing in the country of the anchor currency. In the case of Hong Kong, this means that monetary policy is mostly passive and interest rates follow the US monetary policy cycle. As the US Federal Reserve hiked short-term interest rates by 25 basis points (bps) three times so far this year, the HKD has been under pressure and the HKMA had to intervene and use the official FX reserves to purchase local currency. Therefore, excess liquidity in HKD has declined from USD 23 Bn at the start of the year to around USD 10 Bn in recent weeks. This has so far pushed the base rate up by 75 bps and has contributed to narrow the 12-month USD Libor – HKD Hibor differential to around 35 bps from around 60 bps early in 2018.

By cooling down the local housing and equity markets, tighter financial conditions generate a wealth effect that weight on domestic demand. However, in the absence of more significant external shocks, this should not cause disruptions as monetary conditions are still supportive and growth is robust. Unemployment is at a 20 year low of 2.8% and inflation is moderate at 2.7%.

Hong Kong Policy Rate and Singapore SGP NEER



Sources: Bloomberg, QNB Economics analysis

Singapore is also extremely open to trade and capital flows, with external trade in goods and services equivalent to 234% of GDP. While this makes FX stability important, inflation is also a key target. The management of the exchange rate is of paramount importance for monetary policy in Singapore. The MAS estimates that FX changes have twice the impact on the economy as interest rates. The value of the Singapore dollar (SGD) is allowed to fluctuate within a band (currently estimated to be +/- 2%) against an undisclosed basket of currencies – also known as the nominal effective exchange rate (NEER).

In April and October 2018, the MAS has decided to tighten policy by increasing the slope of the SGD NEER from the flat path that has been in place over the last two years. While the MAS does not explicitly announce the slope of the SGD NEER policy band the market consensus is that it has been set at an appreciation slope of 1.0% per annum. At its semi-annual monetary policy statement on 12th October, the MAS also noted that the width of the policy band and the level at which it is centred will continue to be unchanged.

The MAS moves this year express the beginning of a gradual normalization process in monetary policy as the economy continues to expand, resulting in a tighter labor market while inflation is projected to rise modestly in the near term before stabilizing at just below 2%. Economic activity is above potential as seasonaly adjusted GDP growth was 4.7% y/y in Q3 2018.

In short, monetary policy is being tightened in both Hong Kong and Singapore. While in Hong Kong the process is driven by US policy rates and the requirements of the currency board, in Singapore recent moves rather reflect a relatively hawkish assessment on inflation.

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