Low rates setting HK up for eventual market fall

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In my *Concrete Analysis* piece in April, I clearly underestimated the impact of the subprime mortgage meltdown and its effects on the broader credit markets. Estimates of the expected credit losses attributable to the subprime mortgage market have grown appreciably in recent months.

A recent Goldman Sachs research note estimates the potential losses at US$400 billion, or three times the size of the savings and loan crisis in the United States in the 1980s. While the loss in absolute terms may not seem very large given the size of the US financial markets, the amount of leverage related to investors holding mortgage-backed securities should not be underestimated.

Goldman estimates that if leveraged investors write off US$200 billion to US$400 billion of aggregate credit losses, the reduction in overall lending could be as high US$2 trillion. In addition, the spillover impact of the credit markets is unprecedented.

In the past six months, the US asset-backed commercial paper market has shrunk nearly 25 per cent (more than US$400 billion) and several central banks including the Federal Reserve have injected billions of dollars to provide liquidity into the uncertain money market system. These factors all together are most likely to drag the US economy into a recession. The real question is how long the economic downturn will last.

In Hong Kong, the markets have been relatively immune from the global contagion, as the credit and mortgage markets continue to perform well. However, in September, interest rates in Hong Kong began to decline again with the best lending rate falling 75 basis points.

On the surface, this may be viewed as good news, but does Hong Kong really need lower interest rates at this point of its economic cycle? Hong Kong's economy has been very robust since the Sars epidemic. The economic facts are clear: GDP growth is strong, unemployment continues to fall, and the overall business confidence is high.

Most importantly, inflationary pressure is increasing with real interest rates expected to fall into negative territory, according to a UBS Global Economic Research report on Monday. Ultimately, most market professionals would agree that lower real interest rates would only further fuel an already strong property market (from January to September, property transactions rose more than 45 per cent year on year in terms of dollar volume.)

Recently, there has been renewed discussion on the effects of Hong Kong's fixed exchange rate system. Under the system, there is little disagreement that asset prices of residential property, equities and other

financial investments will adjust by more than the value of the asset itself – in other words, overshoot. Why? The currency peg does not allow the Hong Kong dollar to adjust itself along with asset values.

More importantly, the fixed exchange rate system links Hong Kong's monetary policy to the US. While the Federal Reserve is grappling with the ongoing problems relating to the subprime mortgage market by aggressively lowering interest rates, Hong Kong's market is buoyant and actually does not need the macroeconomic boost of lower interest rates. In fact, most would agree that Hong Kong's recent economic cycles were no longer highly correlated to the US but rather more closely aligned with the mainland.

What would be the market implications of lower interest rates in Hong Kong during an already strong economic cycle and the eventual market correction?

One would only need to look back to 1997, when Hong Kong was awash with excess liquidity and property prices were rising exponentially.

In the intervening years from 1997 to 2003, residential property prices fell nearly 75 per cent from peak to trough. No other Asian country suffered a price drop of such magnitude and, in Hong Kong's case, the price plunge left nearly 50 per cent of homeowners in negative equity. Even today, there are still thousands of families in negative equity, as public data does not include borrowers who have also opted for top-up financing (or second mortgages).

Hong Kong does not have a subprime mortgage problem and should distance itself from any market that does. Nevertheless, Hong Kong is forced to follow the US economic cycle of lower interest rates, which is likely to result in excessive property price inflation and to overshoot on the upside.

Does Hong Kong really want to fall into the same price trap when property prices will also inevitably overshoot on the downside during the next economic downturn and create new negative equity homeowners?

Written by Leland Sun, Chairman of Pan Asian Mortgage Company Ltd.