

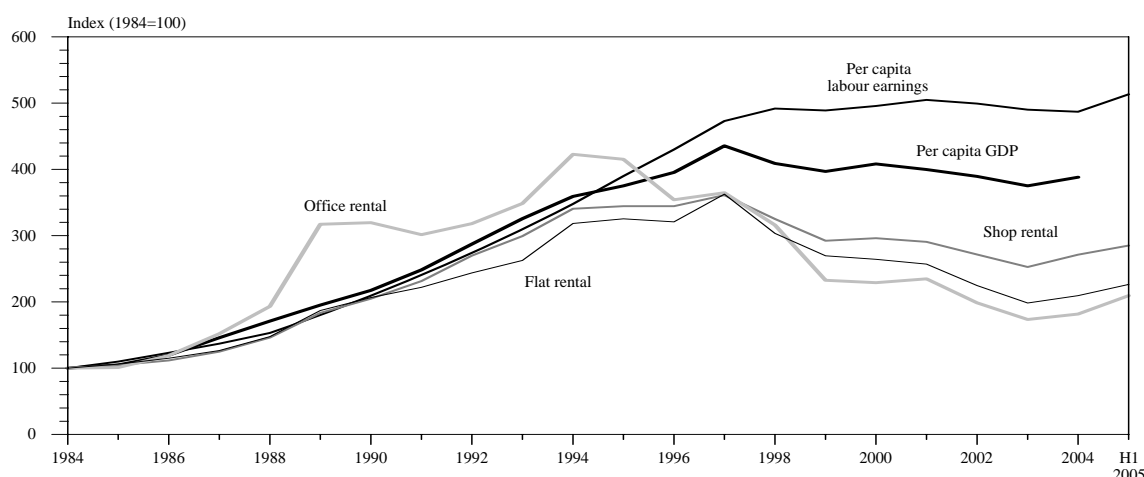
Box 1.1

Rising rentals and the Hong Kong economy

Property rentals have been rising noticeably since late 2003, in tandem with the economic recovery and the revival of the property market. There is concern from the community that the significant rise-back in rentals would lead to a resurgence in inflation, undermine profitability of businesses, and hamper the recovery in the economy. This box examines these issues in the context of the long-term trends of property rentals in relation to economic growth. From a macro perspective, the property market is an integral part of the market economy and in this context, property market performance can be seen as one manifestation of the state of the economy, in the same way as share prices, trade performance, unemployment rate, wages or inflation. By the same token, property rentals, as a measure of the return or yield from investment in property, is one form of return on capital, akin to dividend earned on holding stocks and shares, or interest on bonds or bank deposits.

Analysing the relationship between property rentals and the economy over the past two decades, between 1984 and 1997, flat rentals were indeed on an almost uninterrupted rise, by an average of 10.4% per annum, but per capita GDP rose even faster, by 12.0% per annum, and even more so for per capita labour earnings, by 12.7% per annum. This suggests that the surge in flat rental actually went in tandem with, and was well supported by, improved incomes as the economy boomed. Moreover, the significant rise-back in flat rentals over the past two years has also to be seen in conjunction with their marked decline between 1997 and 2003, by some 45%, far more distinct when matched against the corresponding decline of 14% in per capita GDP. The analysis clearly suggests that while the property market shows considerable volatility from year to year, in the long run property prices and rentals basically move in tandem with the economy.

Property rentals vs per capita GDP and labour income



Box 1.1 (cont'd)

Impact of the recent surge in rentals on the economy

So far, there is little sign that the increase in property rentals has contributed to any surge in inflation, as the feeding-through to the retail price level has not been significant. The GDP deflator and the domestic demand deflator remain soft, suggesting that overall price and cost pressure on the economy remains modest (*Diagram 1.4 and Paragraph 1.5*).

There is also some worry that sharp increases in property rentals in Hong Kong may undercut the competitiveness of Hong Kong as a business hub. This would indeed be a concern if the surge in property rentals goes way beyond what the households can support in terms of rental affordability, and what the businesses can support in terms of earning capacity or income prospect. But this does not appear to be the case up to now. Taking residential properties as an illustration, notwithstanding the significant rebound in flat rentals, affordability of tenants in the second quarter of 2005 is still better than any time during the entire period 1984-1999. This suggests that the recent bounce-back in flat rental has been well supported by improved job and income prospect, and in this context, it should be seen as no more than a catch-up consequential to the sharp fall-off in the earlier years. Furthermore, as the economic recovery deepens, employment income can be expected to improve further, which should in turn underpin tenants' affordability to rent.

Similarly, the same is true for office and shop rentals. More specifically, between 1984 and 2004, office rentals have risen by a cumulative 82% and shop rentals by 171%, but they were both considerably smaller than the corresponding growth of 288% in per capita GDP, or that of 387% in per capita labour earnings. Thus, again, the strong pick-up in office and shop rentals of Hong Kong since late-2003 can be seen as largely a reflection of the upbeat business prospect and higher expected earning capability of businesses in Hong Kong as the Hong Kong economy enters a cyclical upturn. Indeed, despite the surge in rentals since late 2003, the number of regional headquarters and regional offices in Hong Kong has risen to a new high in 2005.

Yet admittedly, in the short run, the negative impact of rising rentals would be more noticeable at the micro level. Some service sectors, particularly retail trade and restaurants, for which rent expense accounts for a large share of the operating cost, will feel more of the pinch, particularly so for those operators with low profit margin. Nevertheless, granting that the rise in rental cost is driven up primarily by improved sales or business, the increase in operating cost on a per dollar of output basis may not be as marked as it appears to be (*Paragraph 6.3 and Diagram 6.3a*).

In sum, the current levels of rental affordability suggest that in overall terms, the recent surges in property rentals in the past two years or so are largely a result of improved income and hence generally in line with the economic fundamentals.