Box 7.1

Unit cost analysis and consumer price inflation

Over the past year or so, there have been increasing concerns about the resurgence of cost-push inflation stemming from the surge in rentals for newly leased retail premises and office space. Now that the Hong Kong economy has completely shrugged off its earlier sluggishness and is now on a full-fledged upswing, it is generally believed that local producers and retailers will be more inclined to pass any cost increases onto the retail price level alongside the broader return of pricing power, thereby pushing up overall consumer prices.

Nevertheless, despite two consecutive years of very robust economic growth, consumer price inflation, though creeping up, has remained modest and well contained, which appears to be quite contradictory to the above argument. This suggests that some important elements in business operations might have been overlooked. Indeed, what matters more to business operators should be unit operating cost, i.e. operating costs per unit of real output or real sales revenue, instead of merely total operating costs, the former being the key determinant of profitability. In other words, productivity of factor inputs such as labour and land (retail premises/office space) also features prominently in the business cost formula. Since the distinct rise in business costs over the past two years has been well underpinned by the concurrent pick-up in overall economic activity and business turnover, the increase in business costs, if reckoned on a per unit cost basis, is actually not that considerable as to push up inflation significantly.

With reference to international statistical practices, the two most prominent components of business cost for the economy as a whole, viz. unit rental cost and unit labour cost (URC and ULC) can be proxied as follow:

URC = (Area of occupied retail premises[#] $\times$ *8-quarter moving average rental index for retail premises)* $\div$ *Real consumption expenditure in the domestic market*

ULC = (Nominal index of payroll per person engaged $\times$ *Total employment)* $\div$ *Real GDP*

As shown in part (a) of Diagram 7.3, both URC and ULC actually rose markedly in 1998, largely attributable to the sharp contraction in economic activity and business turnover during the Asian financial turmoil. Such surge in unit business costs could rather be interpreted as a signal of the need for downward cost adjustment to restore competitiveness, through a combination of reduction in operating scale (e.g. retrenchment of employees and scale-down of unprofitable retail premises), wage cut, and a decline in rentals. That both URC and ULC eased back in the ensuing years actually reflected the speedy adjustment process undergone by the Hong Kong economy in the aftermath of the Asian financial turmoil, being a manifestation of our flexibility and resilience to adverse shocks.

Note: (#) Derived from end-year stock and vacancy data for retail premises published by the Rating & Valuation Department (RVD).