Box 6.1

Analysis of unit labour costs in different economic sectors

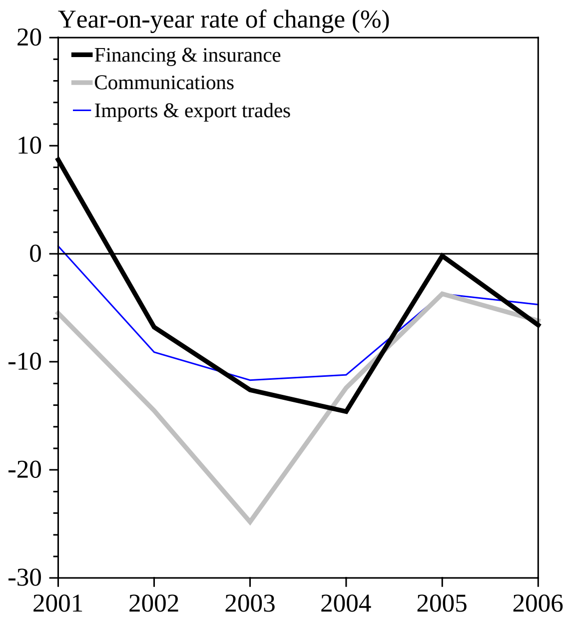
Since the return to positive inflation in late 2004 amidst the strong economic upswing, consumer price inflation has been creeping up at a moderate pace. This high-growth-low-inflation era is the best performance in our recent history. Such a benign inflation despite the strong economic growth in Hong Kong was largely a result of the persistently declining unit labour cost over the past five years, which in turn was driven down by the distinct labour productivity growth in Hong Kong. This article analyses the movements of unit labour costs in individual sectors to examine whether the decline in unit labour cost is a broad-based phenomenon.

Unit labour cost is defined as the share of labour cost per unit of output. In this analysis, total labour cost in the selected economic sectors is based on the total nominal payroll as obtained by multiplying the per capita nominal payroll index with the total employment in the respective sectors. The output in individual sectors is measured by the value added in 2000 constant prices compiled under the GDP production based framework. Unit labour cost in a specific sector is thus calculated as the ratio of total labour cost in that sector to its output.

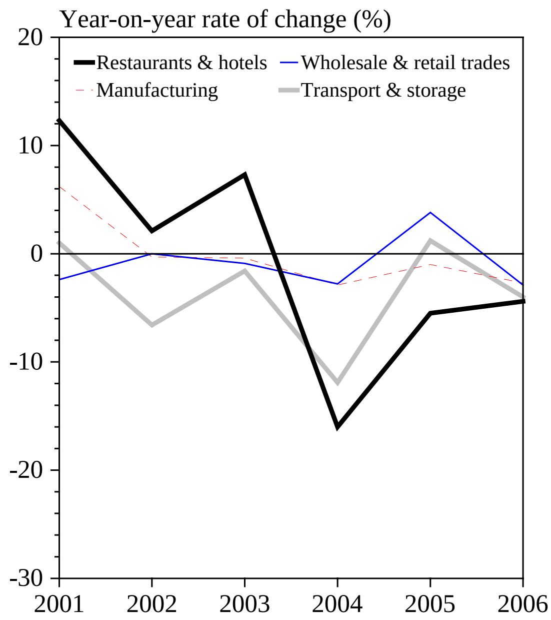
The year-on-year rates of change of unit labour costs in some major economic sectors from 2001-2006 are presented in Chart 1.

Chart 1 : The year-on-year rates of change of unit labour costs in major economic sectors

(a) Financing and insurance; communications; and import and export trades showed sharper falls in unit labour costs over the past 6 years



(b) while wholesale and retail trades; restaurants and hotels; manufacturing; and transport and storage showed smaller declines



Box 6.1 (cont'd)

A number of salient features stand out from the sectoral analysis of the trends in unit labour cost :

(1) Unit labour cost has shown a broad-based decline in all sectors since 2002, one exception being "restaurants and hotels" which saw further growth in unit labour cost until the sharp fall in 2004. The high unit labour cost in the restaurant sector during 2001-03 in fact signified the need to scale back on the size of workforce in that sector when restaurant business went down along with the cyclical downturn at that time, more so in 2003 when business was severely hit by the outbreak of SARS.

(2) Despite the rise-back in wages and per capita payrolls in all sectors since 2005, unit labour costs continued to decline across-the-board in general from 2005 through to the first quarter of 2007. Analysed by individual sectors, the decline in unit labour cost was particularly sharp in booming sectors like "financing and insurance", "communications" and "import and export trades". It is interesting to note that the increase in per capita payroll in "financing and insurance" was actually very distinct at 5.5% in 2005 followed by an even stronger rise at 10.0% in 2006, the fastest amongst other sectors last year. This tied in well with the buoyant job market in the financing and insurance business, with unemployment rate of only 2.0% and vacancy rate of 2.7% for 2006 as a whole. But with the payroll rise more than compensated by an even faster productivity growth, this sector actually saw the largest decrease in unit labour cost amongst the major sectors.

(3) Similarly, the decline in unit labour cost in "communications" was mainly a reflection of the very rapid growth in labour productivity bolstered by fast technological advancement in that sector. The same is observed for "import and export trades" over the same period.

(4) As such, increasing payroll cost is not a cause for inflation concern if it is well matched by vibrant business and productivity growth. While the rapid productivity growth in recent years was partly driven by technological advancement and an on-going capital deepening process, a larger part of it was due to the significant upgrading of the quality of our workforce, thanks to education and experience accumulation of the workers themselves.

(5) Just as high unit labour cost can be a warning of the poor performance in business and the need to cut cost in order to restore profitability, declining unit labour cost signals the need to increase manpower in the sector to gear in with the anticipated rise in output. The broad-based decline in unit labour cost suggests that while economic activity in all sectors has continued to thrive, so far it has not yet generated significant cost pressures to undermine the competitiveness or profitability at the macro economy level, nor at the individual sector level.