

## CHAPTER 7 : PRICES

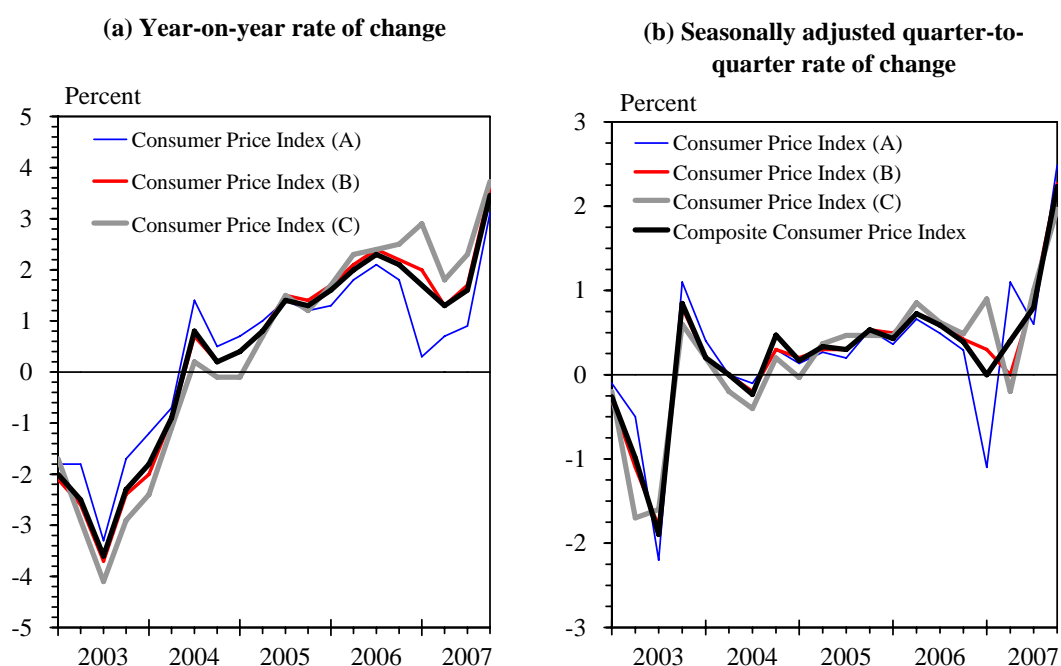
### *Summary*

- *Consumer price inflation in 2007 averaged at 2.0% in terms of the Composite CPI, the same as in 2006. Discounting the effects of the public housing rental waiver in February and the rates concession in the second and third quarters of the year, the underlying consumer price inflation for 2007 as a whole was 2.8%, which was still rather moderate when viewed against the strong economic upturn over the past few years.*
- *Inflation pressures picked up in the second half of 2007, mainly due to higher food prices brought about by the global food inflation. The strong domestic demand, appreciation of the renminbi, weakening of the US dollar, and resurgence of international oil prices also contributed.*
- *Local business cost pressures were still largely contained in 2007. Unit labour cost continued to be kept down by rapid productivity growth, while unit rental cost remained in check, despite rising shop rentals, thanks to the rapid expansion in business volume.*
- *Looking ahead, the high food and oil prices, renminbi appreciation and weakening of the Hong Kong dollar will continue to exert pressures on prices from the external front. On the domestic front, rising private housing rentals may pose an upside risk to inflation. Also, the vibrant business activities and tightening labour market will likely further push up wages, and office and shop rentals. Yet the sustained labour productivity growth should provide some cushioning effect. Also, the measures announced in the 2007-08 Policy Address and the 2008-09 Budget will help lower the cost of living of the community and push down somewhat the headline inflation.*

## Consumer prices

7.1 Continuing the upward trend in 2005 and 2006, the underlying inflation pressures continued to climb up over the course of 2007, reflecting the robust domestic demand as well as stronger external cost pressures. While the headline consumer price inflation for 2007 as a whole, as indicated by the *Composite Consumer Price Index (CCPI)*<sup>(1)</sup>, at 2.0%, was the same as that for 2006, the former number was lowered by the public housing rental waiver in February 2007 and the rates concession in the second and third quarters of the year. Taking away the effects of these measures, the underlying consumer price inflation for 2007 was 2.8%, which was still rather moderate taking into consideration the robust economic growth for four consecutive years. Local business cost pressures were kept largely in check in 2007. Wages rose moderately during the year, and the impact on business costs was much alleviated by rising labour productivity. Likewise, the impact from the rise in commercial rentals was to a large extent diluted by rapid expansion in business volume.

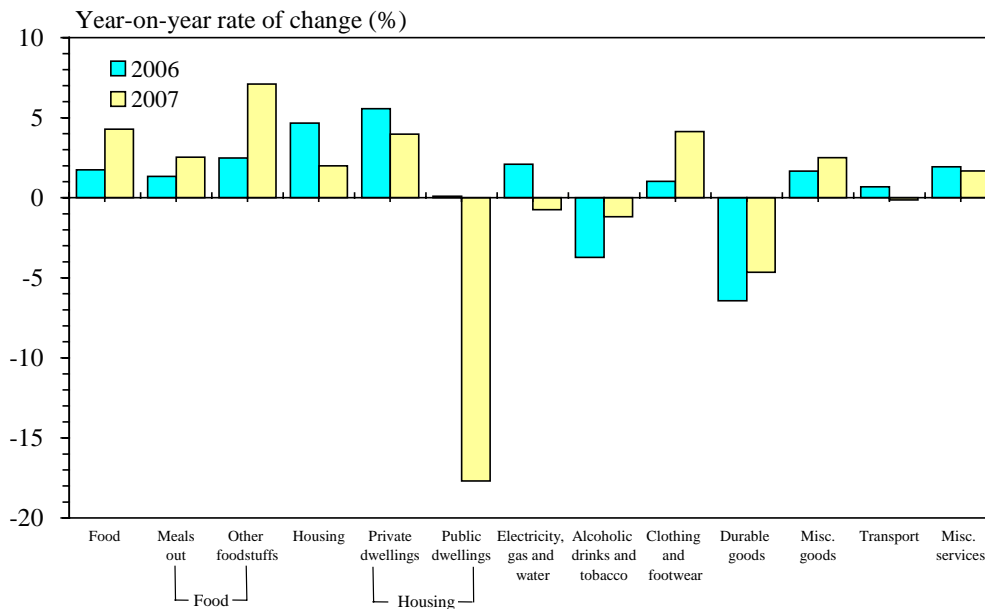
**Diagram 7.1 : Consumer price inflation climbing up in 2007**



7.2 The underlying consumer price inflation climbed up from 2.5% and 2.4% in the first and second quarters respectively to 2.7% in the third quarter, and notably further to 3.5% in the last quarter. The pick-up of the inflation rate in the second half of 2007, amidst strong consumption demand, was mainly caused by surging food prices stemming from the global food inflation, appreciation of the renminbi and weakening of the US dollar. The resurgence

of international oil prices from September 2007 and higher housing costs also contributed. In 2008, inflationary pressures are expected to persist, as the high food and oil prices, renminbi appreciation and weakening of the Hong Kong dollar will continue to exert pressures on prices from the external front. On the domestic front, the upward trend of private housing rentals deserves close monitoring. Also, due to the vibrant business activities and tightening labour market, there will likely be some further build-up of pressures on wages and commercial rentals. Yet the sustained labour productivity growth should mitigate the rising price pressures to some extent.

**Diagram 7.2 : Inflation pressures climbed up during 2007, with more distinct increases in food prices**



**Table 7.1 : Consumer Price Indices**  
(year-on-year rate of change (%))

|      |        | <u>Composite CPI</u> | <u>CPI(A)</u> | <u>CPI(B)</u> | <u>CPI(C)</u> |
|------|--------|----------------------|---------------|---------------|---------------|
| 2006 | Annual | 2.0                  | 1.7           | 2.1           | 2.2           |
|      | H1     | 1.8                  | 1.6           | 1.9           | 2.0           |
|      | H2     | 2.2                  | 1.9           | 2.3           | 2.4           |
|      | Q1     | 1.6                  | 1.3           | 1.7           | 1.7           |
|      | Q2     | 2.0                  | 1.8           | 2.1           | 2.3           |
|      | Q3     | 2.3                  | 2.1           | 2.4           | 2.4           |
|      | Q4     | 2.1                  | 1.8           | 2.2           | 2.5           |
| 2007 | Annual | 2.0                  | 1.3           | 2.2           | 2.7           |
|      | H1     | 1.5                  | 0.5           | 1.7           | 2.3           |
|      | H2     | 2.5                  | 2.0           | 2.7           | 3.0           |
|      | Q1     | 1.7                  | 0.3           | 2.0           | 2.9           |
|      | Q2     | 1.3                  | 0.7           | 1.3           | 1.8           |
|      | Q3     | 1.6                  | 0.9           | 1.7           | 2.3           |
|      | Q4     | 3.5                  | 3.1           | 3.6           | 3.7           |

**Table 7.2 : Composite Consumer Price Index by component  
(year-on-year rate of change (%))**

| <u>Expenditure component</u>               | <u>Weighting (%)</u> | <u>2006</u> | <u>2007</u>  | <u>2007</u>  |              |              |              |
|--|----------------------|-------------|--------------|--------------|--------------|--------------|--------------|
|  |                      |             |              | <u>Q1</u>    | <u>Q2</u>    | <u>Q3</u>    | <u>Q4</u>    |
| Food                                       | 26.94                | 1.7         | 4.3          | 2.9          | 2.8          | 4.8          | 6.7          |
| <i>Meals bought<br/>    away from home</i> | <i>16.86</i>         | <i>1.3</i>  | <i>2.5</i>   | <i>1.8</i>   | <i>2.0</i>   | <i>2.6</i>   | <i>3.7</i>   |
| <i>Other foodstuffs</i>                    | <i>10.08</i>         | <i>2.5</i>  | <i>7.1</i>   | <i>4.4</i>   | <i>4.1</i>   | <i>8.2</i>   | <i>11.6</i>  |
| Housing <sup>(a)</sup>                     | 29.17                | 4.7         | 2.0          | 2.2          | 1.0          | 0.7          | 4.2          |
| <i>Private dwellings</i>                   | <i>23.93</i>         | <i>5.6</i>  | <i>4.0</i>   | <i>5.6</i>   | <i>2.0</i>   | <i>2.3</i>   | <i>5.9</i>   |
| <i>Public dwellings</i>                    | <i>2.49</i>          | <i>0.1</i>  | <i>-17.7</i> | <i>-31.7</i> | <i>-10.5</i> | <i>-17.8</i> | <i>-10.8</i> |
| Electricity, gas and water                 | 3.59                 | 2.1         | -0.7         | -1.3         | -2.2         | -2.7         | 3.4          |
| Alcoholic drinks and tobacco               | 0.87                 | -3.7        | -1.2         | -3.9         | -0.1         | -1.1         | 0.5          |
| Clothing and footwear                      | 3.91                 | 1.0         | 4.1          | 7.2          | 3.9          | 3.7          | 2.0          |
| Durable goods                              | 5.50                 | -6.4        | -4.7         | -5.8         | -4.6         | -4.2         | -4.0         |
| Miscellaneous goods                        | 4.78                 | 1.7         | 2.5          | 2.8          | 1.8          | 2.1          | 3.4          |
| Transport                                  | 9.09                 | 0.7         | -0.1         | -0.6         | -0.5         | -0.1         | 0.7          |
| Miscellaneous services                     | 16.15                | 1.9         | 1.7          | 2.2          | 2.2          | 1.3          | 1.0          |
| All items                                  | 100.00               | 2.0         | 2.0          | 1.7          | 1.3          | 1.6          | 3.5          |
|  |                      |             | (2.8)        | (2.5)        | (2.4)        | (2.7)        | (3.5)        |

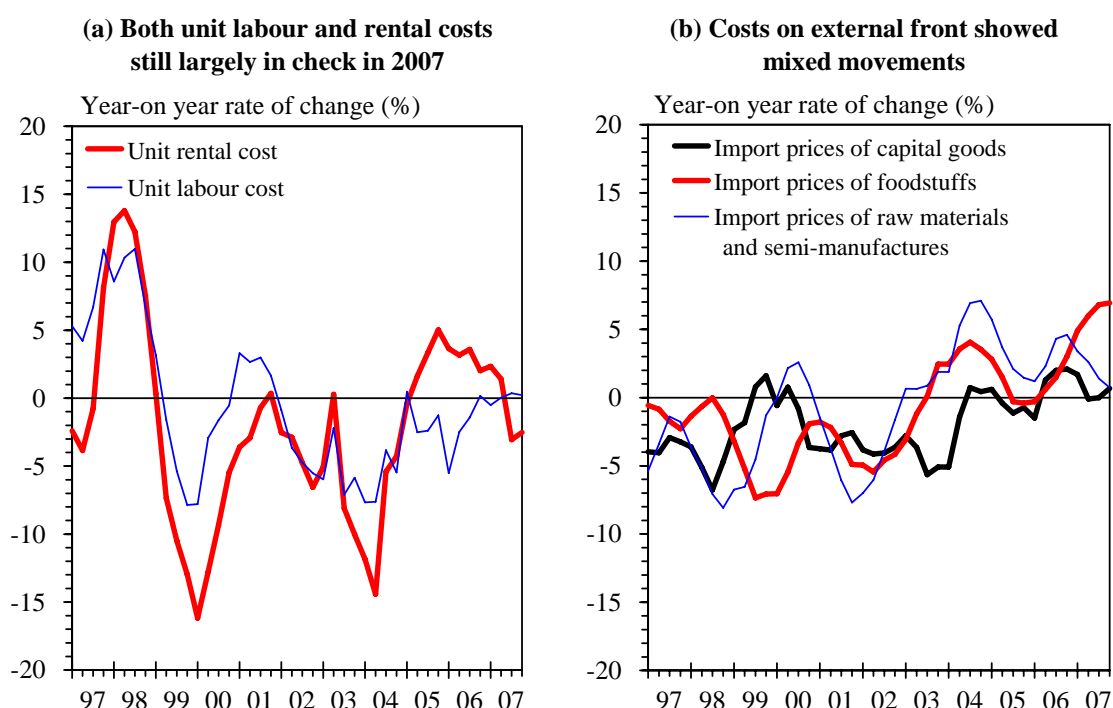
Notes : (a) The housing component covers rents, rates, Government rent, maintenance costs and other housing charges. Its sub-components on private and public dwellings as presented here, however, cover rents, rates and Government rent only. Hence, the combined weighting of private and public dwellings is slightly less than the weighting of the entire housing component.

( ) Underlying inflation rate after taking out the effects of the public rental waiver in February and the rates concession in the second and third quarters of 2007.

## Costs of factor inputs

7.3 Along with the strong economic upturn, there have been increasing pressures on wages and rentals. However, the *unit labour cost*<sup>(2)</sup> was still rather stable in 2007, thanks to the offset to higher wage costs by the sustained growth in labour productivity. As to *rental costs*, all business-related rentals on new leases, those for office space in particular, rose notably in 2007. Yet, on a per unit rental cost basis, the rise was so far contained due to rapid business expansion.

**Diagram 7.3 : Costs of factor inputs**



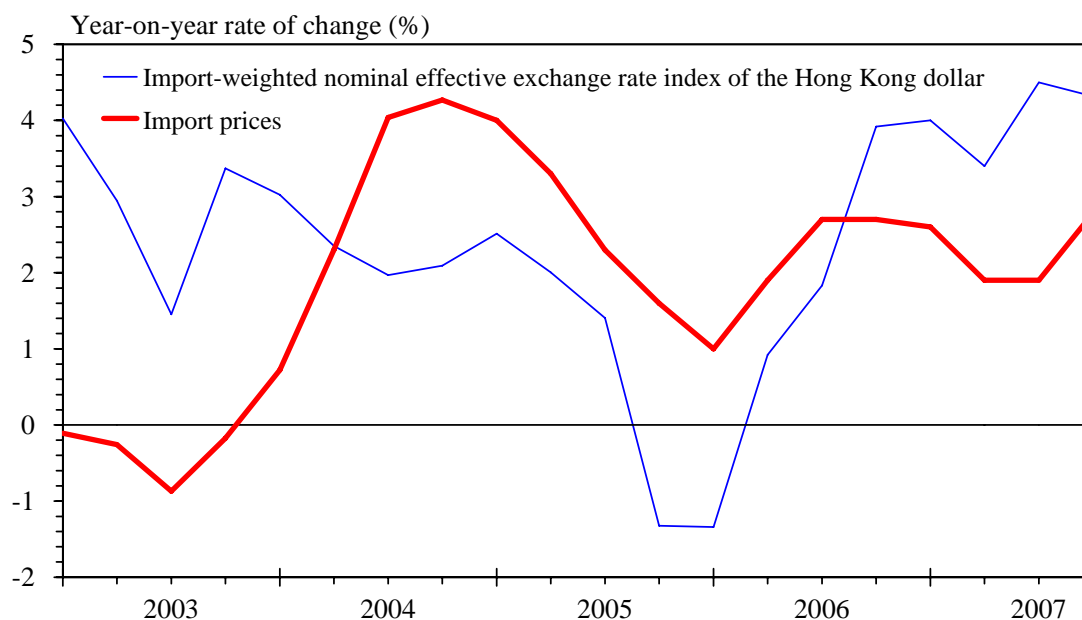
7.4 Despite the weakening of the Hong Kong dollar, the increase in import prices in overall terms remained moderate in 2007. Yet prices of different end-use categories showed very divergent movements. The import prices of *foodstuffs* went up notably over the course of the year due to inflation in food prices in the Mainland and other major source countries including Australia, Thailand and the US. Import prices of *fuels* shot up in the second half of the year along with the resurgence in international crude oil prices. The pick-up in prices of *consumer goods* was relatively milder thanks to the still moderate increases in prices of consumer goods from major sources including the Mainland and Japan. While these import prices which are more relevant to consumer price inflation saw faster increases, import prices of *raw materials* rose only modestly and those of *capital goods* were rather stable.

**Table 7.3 : Prices of imports by end-use category  
(year-on-year rate of change (%))**

|      |        | <u>Foodstuffs</u> | <u>Consumer goods</u> | <u>Raw materials</u> | <u>Fuels</u> | <u>Capital goods</u> | <u>All</u> |
|------|--------|-------------------|-----------------------|----------------------|--------------|----------------------|------------|
| 2006 | Annual | 1.2               | 0.5                   | 3.2                  | 16.6         | 1.1                  | 2.1        |
|      | H1     | 0.2               | 0.3                   | 1.8                  | 27.5         | *                    | 1.5        |
|      | H2     | 2.3               | 0.7                   | 4.4                  | 7.6          | 2.1                  | 2.7        |
|      | Q1     | -0.3              | 0.5                   | 1.2                  | 32.4         | -1.5                 | 1.0        |
|      | Q2     | 0.6               | 0.1                   | 2.3                  | 23.7         | 1.3                  | 1.9        |
|      | Q3     | 1.5               | 0.4                   | 4.3                  | 13.6         | 2.0                  | 2.7        |
|      | Q4     | 3.0               | 1.1                   | 4.6                  | 2.0          | 2.1                  | 2.7        |
|      | 2007   | Annual            | 6.2                   | 3.3                  | 2.0          | 11.2                 | 0.5        |
| H1   | 5.4    | 2.8               | 3.0                   | 0.3                  | 0.7          | 2.2                  |            |
| H2   | 6.9    | 3.7               | 1.1                   | 22.2                 | 0.3          | 2.3                  |            |
| Q1   | 4.9    | 2.3               | 3.4                   | 1.9                  | 1.7          | 2.6                  |            |
| Q2   | 6.0    | 3.2               | 2.6                   | -2.0                 | -0.1         | 1.9                  |            |
| Q3   | 6.8    | 3.4               | 1.4                   | 7.9                  | *            | 1.9                  |            |
| Q4   | 6.9    | 4.0               | 0.7                   | 37.1                 | 0.7          | 2.8                  |            |

Note : (\*) Change of less than 0.5%.

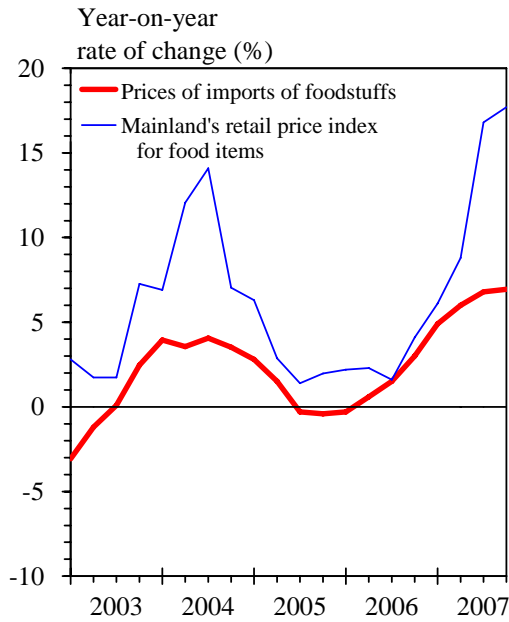
**Diagram 7.4 : Import prices rose moderately further along with the weakening of the Hong Kong dollar**



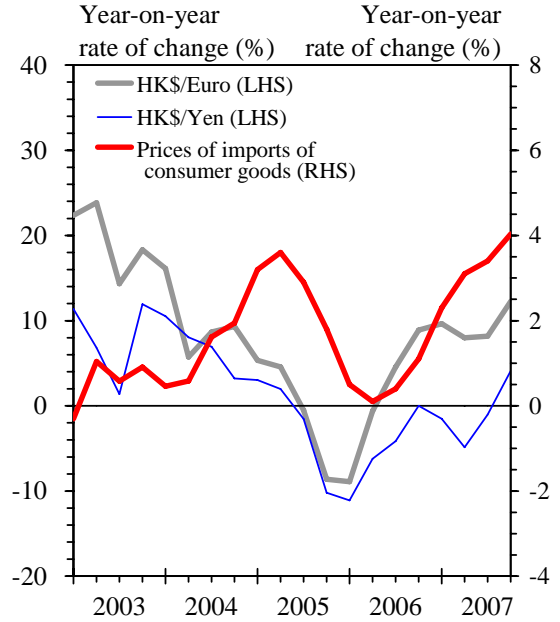
Note: The nominal EERI in this graph is inverted in scale for easier comprehension. An increase in the nominal EERI indicates weakening of the Hong Kong dollar.

## Diagram 7.5 : Prices of imports by end-use category

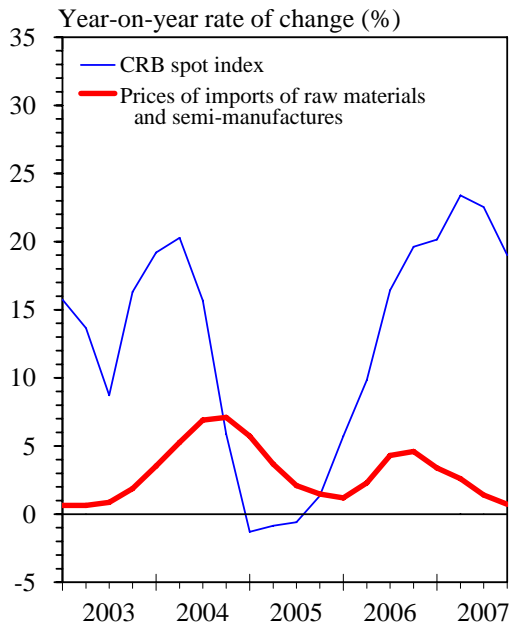
**(a) Import prices of foodstuffs rose distinctly**



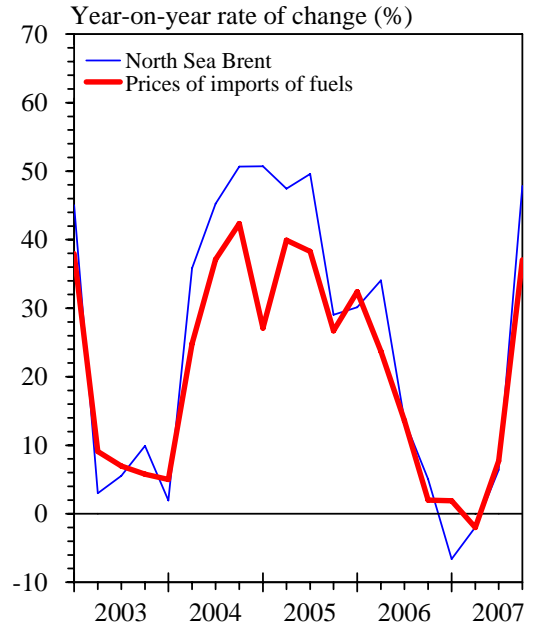
**(b) Import prices of consumer goods picked up moderately**



**(c) Import prices of raw materials saw mild increases**



**(d) Fuel prices shot up in the second half of 2007**



## Output prices

7.5 Output prices of the local manufacturing sector, as measured by the *Producer Price Index*<sup>(3)</sup>, picked up modestly in the first three quarters of 2007. For the service sectors, output prices generally remained in check or even declined, reflecting the competitive business environment and the sustained growth in productivity. The only exception was the hotel sector, which saw a further sharp rise in prices, in tandem with the vibrant performance of inbound tourism during the year. The persistent decline in the output prices for the telecommunications sector reflected the keen competition and continued technological advancement in the sector. More recently, output prices of land transport and marine transport tended to rise amidst elevated fuel costs.

**Table 7.4 : Producer Price Indices for the local manufacturing sector and selected service sectors (year-on-year rate of change (%))**

| <u>Industry group</u>                   | <u>Annual</u> | <u>Q1</u> | <u>2006</u><br><u>Q2</u> | <u>Q3</u> | <u>Q4</u> | <u>Q1</u> | <u>2007</u><br><u>Q2</u> | <u>Q3</u> <sup>@</sup> |
|---|---------------|-----------|--------------------------|-----------|-----------|-----------|--------------------------|------------------------|
| Manufacturing                           | 2.3           | 2.0       | 2.4                      | 2.6       | 2.0       | 2.5       | 2.6                      | 2.5                    |
| Selected services sector <sup>(#)</sup> |               |           |                          |           |           |           |                          |                        |
| Hotels and boarding houses              | 10.3          | 10.1      | 9.2                      | 9.2       | 12.5      | 8.4       | 9.2                      | 10.1                   |
| Land transport                          | *             | 1.0       | 0.6                      | -0.2      | -1.2      | -0.8      | -0.4                     | 0.2                    |
| Maritime transport                      | -1.9          | -3.6      | -3.4                     | -1.8      | 1.1       | 1.8       | -0.8                     | 0.7                    |
| Air transport                           | -1.1          | 0.2       | -0.5                     | -1.1      | -3.0      | 0.8       | 1.4                      | -0.5                   |
| Telecommunications                      | -6.1          | -7.5      | -6.3                     | -4.0      | -6.7      | -3.4      | -3.8                     | -2.6                   |
| Miscellaneous communications services   | 0.4           | 1.5       | 1.4                      | 1.3       | -2.6      | -0.3      | -0.7                     | -0.4                   |

Notes : (#) Producer Price Indices for the other service sectors are not available, due to the difficulties involved in defining and delineating the various types of services and hence in measuring their respective price changes. This is particularly so for such sectors as banking and insurance, where the producers often do not charge their customers explicitly.

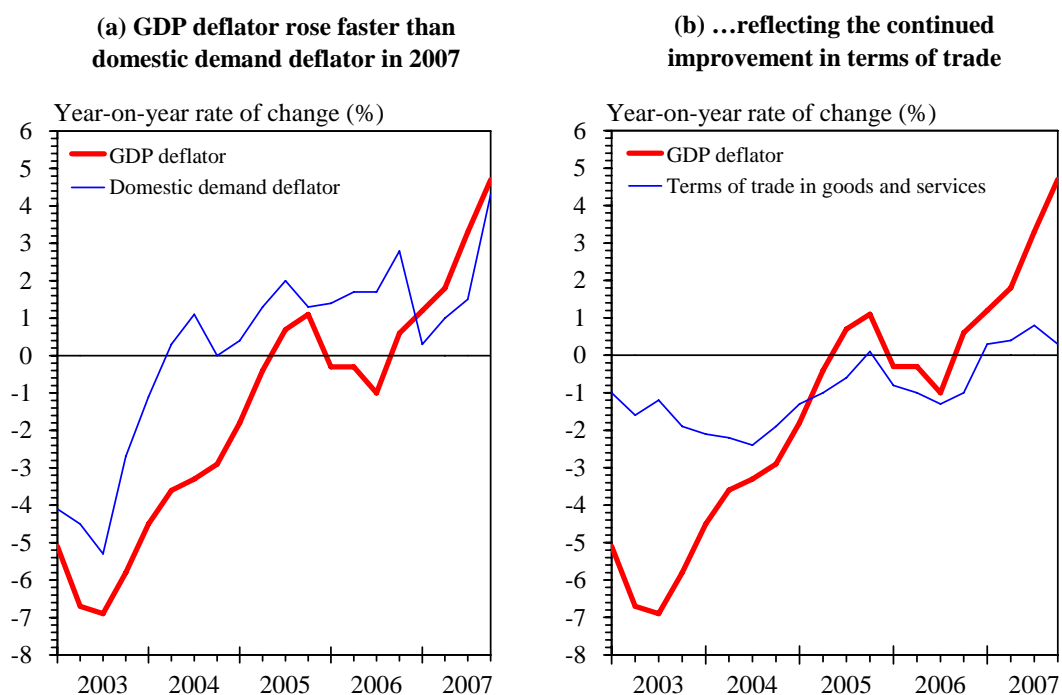
(\*) Change of less than 0.05%.

(@) Provisional figures.

## GDP deflator

7.6 After declining marginally in 2006, the *GDP deflator*<sup>(4)</sup>, a broad measure of overall changes in prices of the economy, rose moderately in 2007, by 2.8% over a year earlier. This was mainly because the *terms of trade*<sup>(5)</sup>, which has a prominent impact on the GDP deflator given the sheer size of trade in the Hong Kong economy, improved during the year as export prices rose slightly faster than import prices. Taking out the trade components, the *domestic demand deflator* picked up by 1.9% on average in 2007. The increase was faster in the second half of the year, in line with the rising trend of consumer prices.

**Diagram 7.6 : GDP deflator**



**Table 7.5 : GDP deflator and the main expenditure component deflators  
(year-on-year rate of change (%))**

|  | <u>2006</u>               |                       |                       |                       |                       | <u>2007</u>               |                       |                       |                       |                       |
|--|---------------------------|-----------------------|-----------------------|-----------------------|-----------------------|---------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|  | <u>Annual<sup>#</sup></u> | <u>Q1<sup>#</sup></u> | <u>Q2<sup>#</sup></u> | <u>Q3<sup>#</sup></u> | <u>Q4<sup>#</sup></u> | <u>Annual<sup>+</sup></u> | <u>Q1<sup>#</sup></u> | <u>Q2<sup>#</sup></u> | <u>Q3<sup>#</sup></u> | <u>Q4<sup>+</sup></u> |
| Private consumption expenditure        | 1.3                       | 1.5                   | 1.4                   | 0.7                   | 1.6                   | 3.8                       | 1.9                   | 2.3                   | 3.9                   | 6.6                   |
| Government consumption expenditure     | 1.2                       | 1.0                   | 1.4                   | 1.3                   | 1.2                   | 3.3                       | 1.3                   | 4.0                   | 3.9                   | 4.0                   |
| Gross domestic fixed capital formation | 4.2                       | 1.3                   | 3.6                   | 6.0                   | 5.8                   | -4.3                      | -4.3                  | -4.9                  | -6.7                  | -1.5                  |
| Total exports of goods                 | 0.3                       | -1.2                  | 0.1                   | 0.6                   | 1.2                   | 2.1                       | 2.3                   | 1.7                   | 1.7                   | 2.5                   |
| Imports of goods                       | 2.1                       | 0.6                   | 2.1                   | 2.7                   | 2.8                   | 1.6                       | 2.1                   | 1.2                   | 0.9                   | 2.3                   |
| Exports of services                    | 3.6                       | 3.6                   | 4.0                   | 3.6                   | 3.3                   | 2.7                       | 2.9                   | 2.2                   | 2.6                   | 3.1                   |
| Imports of services                    | 0.8                       | -0.3                  | 0.4                   | 1.1                   | 1.7                   | 2.9                       | 2.3                   | 2.5                   | 2.9                   | 3.7                   |
| <b>Gross Domestic Product</b>          | <b>-0.3</b>               | <b>-0.3</b>           | <b>-0.3</b>           | <b>-1.0</b>           | <b>0.6</b>            | <b>2.8</b>                | <b>1.2</b>            | <b>1.8</b>            | <b>3.3</b>            | <b>4.7</b>            |
|  |                           | <b>(-0.3)</b>         | <b>(0.1)</b>          | <b>(*)</b>            | <b>(0.7)</b>          |                           | <b>(0.5)</b>          | <b>(0.9)</b>          | <b>(1.3)</b>          | <b>(1.9)</b>          |
| Total final demand                     | 1.2                       | 0.2                   | 1.1                   | 1.3                   | 2.0                   | 2.1                       | 1.8                   | 1.5                   | 1.8                   | 3.2                   |
| Domestic demand                        | 1.9                       | 1.4                   | 1.7                   | 1.7                   | 2.8                   | 1.9                       | 0.3                   | 1.0                   | 1.5                   | 4.3                   |

Notes : Figures are subject to revision later on as more data become available.

Figures in brackets are the seasonally adjusted quarter-to-quarter rates of change.

(#) Revised figures.

(+) Preliminary figures.

(\*) Change of less than 0.05%.

## Notes :

- (1) The Consumer Price Indices (A), (B) and (C) are compiled by reference to the average expenditure patterns for different groups of households as obtained from the Household Expenditure Survey. Then, by aggregating the expenditure patterns of all the households covered by the above three indices, a Composite CPI is compiled.

The expenditure ranges of the households covered in the 2004/05-based CPIs are shown below:

|        | <u>Approximate proportion of households covered</u><br>(%) | <u>Average monthly expenditure range during Oct 2004 to Sep 2005</u><br>(\$) |
|--------|--|--|
| CPI(A) | 50   | 4,000 to 15,499  |
| CPI(B) | 30   | 15,500 to 27,499   |
| CPI(C) | 10   | 27,500 to 59,999   |

The weightings of the various components in the 2004/05-based CPIs are as follows:

| <u>Expenditure Component</u>                       | <u>Composite CPI (%)</u> | <u>CPI(A) (%)</u> | <u>CPI(B) (%)</u> | <u>CPI(C) (%)</u> |
|--|--------------------------|-------------------|-------------------|-------------------|
| Food   | 26.94                    | 32.10             | 27.32             | 20.41             |
| <i>Meals bought away from home</i>                 | 16.86                    | 18.63             | 17.65             | 13.74             |
| <i>Other foodstuffs</i>                            | 10.08                    | 13.47             | 9.67              | 6.67              |
| Housing  | 29.17                    | 30.54             | 27.70             | 29.66             |
| <i>Private dwellings</i>                           | 23.93                    | 22.07             | 23.89             | 26.11             |
| <i>Public dwellings</i>                            | 2.49                     | 6.18              | 1.25              | --                |
| <i>Maintenance costs and other housing charges</i> | 2.75                     | 2.29              | 2.56              | 3.55              |
| Electricity, gas and water                         | 3.59                     | 4.84              | 3.37              | 2.45              |
| Alcoholic drinks and tobacco                       | 0.87                     | 1.35              | 0.79              | 0.42              |
| Clothing and footwear                              | 3.91                     | 2.81              | 4.28              | 4.67              |
| Durable goods                                      | 5.50                     | 4.01              | 5.67              | 6.99              |
| Miscellaneous goods                                | 4.78                     | 4.68              | 4.76              | 4.91              |
| Transport  | 9.09                     | 8.07              | 9.05              | 10.35             |
| Miscellaneous services                             | 16.15                    | 11.60             | 17.06             | 20.14             |
| All items  | 100.00                   | 100.00            | 100.00            | 100.00            |

- (2) Unit labour cost represents the labour cost per unit of output produced. It is distinct from the nominal wage index in that it will discount the effect of labour productivity growth in arriving at the labour cost measure. Technically, it refers to the product of the nominal index of payroll per person engaged and the total employment, divided by the real GDP.
- (3) The Producer Price Index is designed to reflect changes in the prices of goods and services received by local producers. Producer prices refer to the transacted prices, net of any discounts or rebates allowed to the buyers. Transportation and other incidental charges are not included.
- (4) The implicit price deflators of GDP and its main expenditure components are derived by dividing GDP at current prices by the corresponding volume estimates. The rate of change in the GDP deflator may differ substantially from that in the Composite CPI over the same time span. The Composite CPI covers consumer price inflation in particular. Yet the GDP deflator is a much broader measure of inflation for the entire economy, and takes into account all the price changes related to consumption, investment, exports and imports. Also, the rate of change in the GDP deflator may differ appreciably from that in the total final demand deflator, depending on the movements in the prices of final demand and imports. Likewise, the rate of change in the GDP deflator may differ appreciably from that in the domestic demand deflator, depending on the movements in the prices of imports and exports.
- (5) The terms of trade is defined as the ratio of the prices of total exports to the prices of total imports.