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Labour Cost and Deflation

Gloomy 2001

The Hong Kong economy is suffering from a two-pronged attack: a global downturn and an upsurge in structural unemployment. The sudden acceleration of events after the terrorist attacks in the US could not help but create an extra sense of gloom and doom. Faltering consumer spending in the US has hit Hong Kong's trade business, with exports to the US slumping 9.1% in the first ten months of this year. However, thanks to resilient demand from China and Japan, total exports of good managed to fall by a lesser 4.8% during the same period[i].

As the effects of the Fed's aggressive interest rate cuts and the government's generous stimulus package surface, the US economy is expected to recover in the second half of 2002. In addition, China's entry to the WTO and the ensuing flourish in investment will provide some breathing space for Hong Kong. However, the pace of Hong Kong's recovery is uncertain, as the local economy is still haunted by persistent deflation.

Cost adjustment

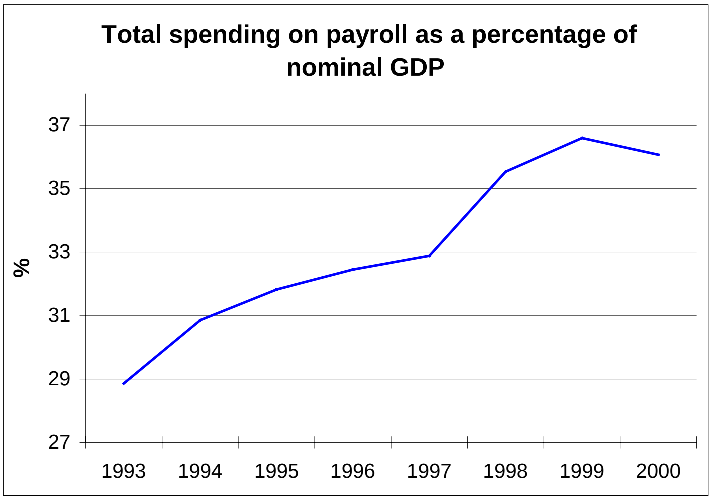
The bubble economy of the mid-1990s transformed Hong Kong into a very expensive city in which to do business, leading to increasing complaints from the business community regarding the high cost structure. The Asian Financial Crisis eventually burst the bubble economy in 1997, starting a market correction process and putting the upward trend of prices into reverse. Under the Peg regime, price adjustment is the main way to resolve the imbalances in the economy. For example, the cost of property has dropped significantly, with a 37% fall in office rents and 55% drop in residential prices since 1997. Entrepreneurs have to endure a narrower profit margin, if there is any at all. The cost of capital has also dropped, as banks have had to accept a squeeze in interest margins in face of dwindling loan demand. In contrast, however, wages have displayed rigid resistance to downward pressures.

Rising labour costs

Labour cost is a function of wages and size of the workforce. The constraints of employment contracts and the adverse effect on morale make companies unwilling to pursue the option of cutting wages. Nominal wages have actually increased by 8.6% since 1997, while consumer prices have dropped 7.0 % over the same period[ii]. In short, while isolated cases of wage reductions have made the headlines, overall wages have in fact risen over the past four years.

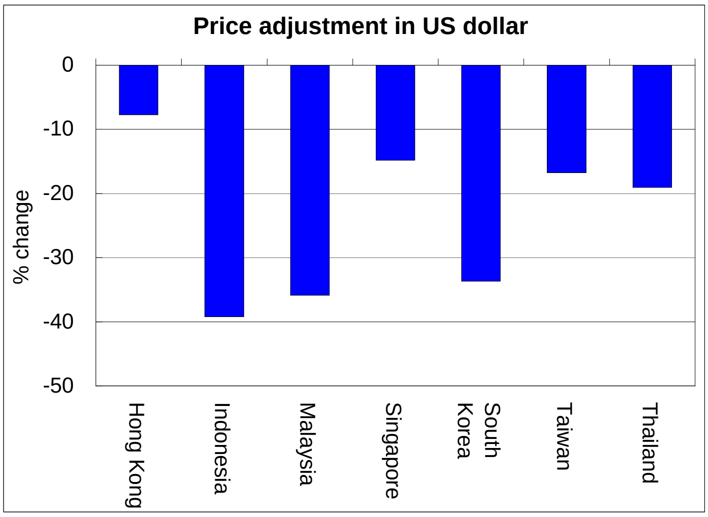
Facing a squeeze in profit margins and being unable to lower wages, companies have to streamline their operations, resorting to layoffs to bring down overall labour costs. In many cases, companies have simply opted to relocate part or all of their operations to places where costs are lower. This contributes to a higher level of unemployment. The jobless rate was 2.2% in 1997, but has since climbed to 5.5% in October.

Despite the rise in unemployment, layoffs have so far been ineffective in cutting labour costs. The total spending on payroll rose 5%[iii] from 1997 to 2000, while total non-labour costs dropped by 8.8% during the same period. As a result, the percentage share of total labour cost to nominal GDP jumped from 32.9% in 1997 to 36.1% in 2000. Hong Kong's rigid labour cost has been an important factor slowing our process of regaining cost competitiveness.



Domestic sectors -Vicious cycle

Despite the plunge in property prices and the deep discounts offered by retailers, our price adjustment process has lagged behind that in neighbouring economies. Hong Kong consumer prices in US dollar terms have dropped by 7.7% since 1997, compared to the respective declines of 14.8% in Singapore and 16.8% in Taiwan. A recent survey showed that Hong Kong is the most expensive place in which to operate a business among the four Asian Dragons.[iv] This suggests that the fall in other prices has not been enough to compensate the relatively static labour cost.



The relatively high cost structure makes Hong Kong less attractive to foreign firms and continues to put pressure on the profit margins of firms operating in the territory. This suppresses demand for labour and keeps the unemployment rate high. The lingering threat of unemployment in turn undermines people's confidence, discouraging them from consuming and investing. This feeds back into the deflation spiral, where firms are forced to cut prices and factor prices move lower due to the weaker demand. In conclusion, domestic prices and the employment market will continue to suffer in the coming year.

Outlook for 2002

Compounded with the weak external demand in the first half, the already high unemployment rate will move even higher, possibly passing the 6.4% recorded in the last recession. The situation is expected to improve in the latter part of the year, following the anticipated US recovery, but the high unemployment rate will keep deflation alive for at least another year. Consumer prices are expected to fall by 1.0% in 2002. This would make the domestic sector the last to recover from the downturn. Although deflation and high unemployment give a negative note to the economic outlook for 2002, the adjustment process underneath is crucial in restoring Hong Kong's competitiveness and attractiveness in the long run.

Private consumption is projected to drop by 0.5% in 2002. A rebound in the US economy in the latter part of the year would offset part of the contraction of Hong Kong exports in the first half. For the full year, exports are forecast to drop by 0.6%, while import would drop by 0.7%. However, better performance in the property market and new business opportunities following China's accession to the WTO will be able to compensate for the weakened investment demand in the exports sector, leading to a growth in investment of 2.3%. Overall, a recovery in the second half will balance out a difficult first half, and real GDP growth in Hong Kong is projected to be 0% in 2002.

Forecast of Major Indicators (%)

	Real Growth Rate	
	2001@	2002@
1. Domestic Sector		
Private Consumption Expenditure	1.5	-0.5
Government Consumption Expenditure	3.0	4.3
Gross Domestic Fixed Capital Formation	1.0	2.3
2. External Sector		
Total Exports of Goods	-2.7	-0.6
Domestic Exports	-15.0	-6.0
Re-exports	-1.1	0
Imports of Goods	-2.5	-0.7
Exports of Services	2.8	1.7
Imports of Services	0.5	1.1
3. Real Gross Domestic Product	0	0
@ BEA Economic Research Forecasts		

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[i] Hong Kong Monthly Digest of Statistics
[ii] Hong Kong Annual Digest of Statistics
[iii] Hong Kong Annual Digest of Statistics
[iv] Economist Intelligence Unit (EIU)