Economic Analysis

October 2002

A Publication of the BEA Economic Research Department

Deflation and Private Consumption

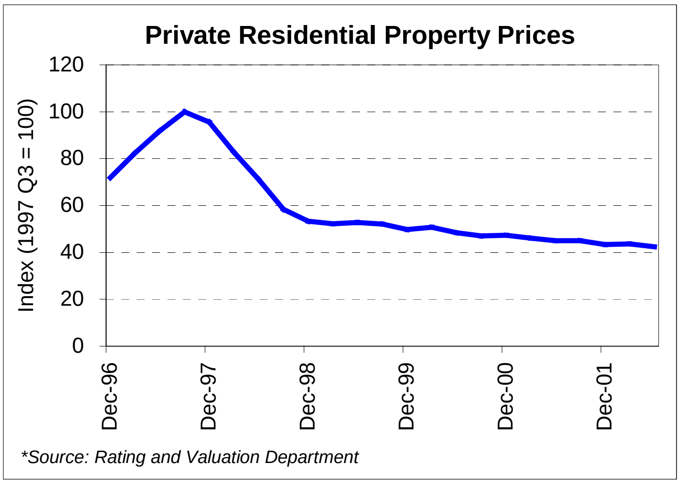
Battered by deflation for four consecutive years, Hong Kong has seen domestic prices drop by an accumulated 12% over that same period. This prolonged fall in prices has been damaging to our economy on most counts. While the magnitude of deflation has been regularly featured in the news headlines, the level of domestic demand is what determines the nature and impact of deflation. Only a substantial strengthening of domestic demand will solve the deflation problem. In this regard, upgrading the quality of the city's consumption could help to stimulate demand.

Main Driver of Deflation: Falling Domestic Demand

Throughout the time that we have been locked in a deflationary spiral, the public's attention has been on the magnitude of the price falls. But this focus could be misleading. For example, the fall in public housing rents, by 11.3% since 1998, is only a transfer of money from government to private hands. Similarly, the government's relief measures on rates and water charges introduced in the 02/03 budget have technically dampened deflation by 1.1 percentage points. Yet no one will argue that these concessions have worsened the deflation problem.

Meanwhile, the fall in prices has partly been cushioned by cheaper imports. Lower import prices for consumer electronics have mitigated some of the pressure on retail profit margins, as retail prices dropped by 16.3% over the past four years. Hence, as long as the fall in prices does not force businesses to reduce payroll and investments, lower prices could be a good thing for consumers and the economy.

In fact, the deflationary spiral arises from contracting domestic demand, and price falls by themselves are the symptom rather than the cause of the adjustment process. Since 1998, both the rising unemployment rate and falling property prices have undermined consumer confidence. The weak domestic demand puts pressure on prices and contributes to the deflation problem. Property prices have dropped by 60% in the past five years. This has sent the net worth of the property holdings of many households into negative territory. The increase in net debt has dampened consumer sentiment and reduced consumers' appetite to spend. This has counteracted the positive effect of the over 25% saving in mortgage payments due to the lower mortgage rate in the past few years.



Businesses are forced to cut prices to stimulate demand. And with costs like rent and wages relatively inflexible, business profit margins have been squeezed. Thus, firms are forced to cut investments and payroll, feeding unemployment. This heightens people's worry about job security and further weakens consumer demand. The vicious spiral further damages our domestic economy.

Ironically, some of the sectors hit hardest are those that have not experienced a steep fall in prices. For example, prices for dining-out have dropped by a relatively modest 3.7% since 1998. However, this is not the result of high pricing power, but the lack of room to cut prices. Sandwiched between weak demand and rigid wage and rental costs, many restaurants do not have the option to slash prices and are forced to close down instead. As a result, the industry unemployment rate surged from 3.2% in 1997 to 11.9% in mid-2002, further hammering domestic demand.

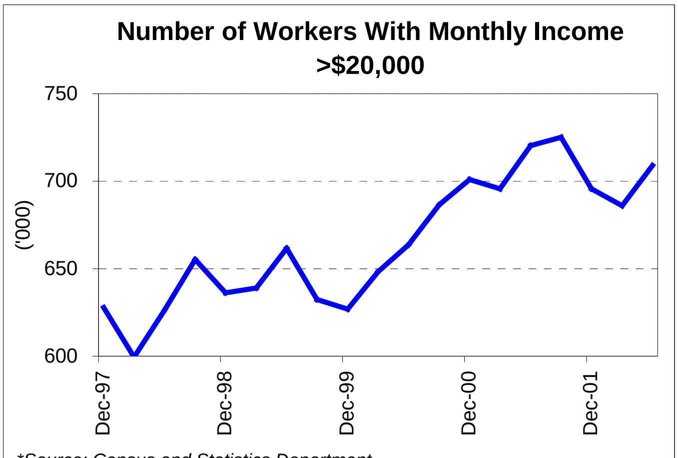
Rising prices in some sectors have also inflicted damage on private consumption. Prices of transportation and textbooks have risen by 1.5% and 16% respectively since 1998. As these items are necessities, consumers have to swallow the higher prices. This eats into the household budget and forces consumers to cut consumption on other items instead.

Hence, we should focus on the strength of domestic demand, rather than on falling prices. The deflation problem could be solved once domestic demand regains vibrancy. Among which, a more stable property market would rebuild consumer confidence. The resulting increase in construction work would also generate more employment for the construction industry and ease the joblessness for the sector.

Quality, Not Price, Should be the Focus

Upgrading and diversifying the range of choice available to consumers could breathe new life into our domestic demand. In a deflationary environment, businesses are very concerned about maintaining turnover, and attempt to stimulate consumption by lowering prices. Suggestions to invest to upgrade or bring innovation to the product line are met with strong resistance.

However, despite the economic downturn and record high unemployment rate, many consumers have not experienced any reduction in their income level. The median monthly household income stayed level at $18,000 from 1998 to 2001. The number of families in the high-income band has held up remarkably well in recent years. For some, spending has been reduced, not because things are not cheap enough, but because the quality is not good enough.



Source: Census and Statistics Department

The willingness of people to spend at fitness and health clubs, and at upmarket coffee shops, in recent years contradicts the theory that people do not have money to spend. These product lines put the emphasis on quality, and their price tags reflect that emphasis. Nevertheless, demand remains strong. This suggests that the potential demand for new and higher quality retail choices has not been fully explored.

Popular leisure activities in our city are largely limited to dining, shopping and karaoke. In recent years, blandness and conformity have pushed out the daring and the innovative. People complain that restaurant after restaurant offers the same formula; that all the shopping centres offer the same range of retail outlets. More choice, rather than more of the same, is one option to stimulate demand.

The spectrum could be further widened by promoting and developing Hong Kong's countryside, waterfronts and local attractions for leisure activity purposes. In this respect, the government can play the role of "market enabler" by upgrading the related infrastructure. This includes building better facilities and other supporting services, and inviting business to repackage and promote these areas to realize optimal public usage. Another area that needs work is the training of our workers in the retail industry.

Enhancing the quality of consumption could boost consumer spending in a significant way. The same rationale could apply to the influx of Mainland tourists, for these visitors shop here as much for the wide choice as for the low prices. Greater attention in this area is necessary if Hong Kong wants to maintain its position as the tourist centre in the region.

Conclusion

Hong Kong requires a strengthening of domestic demand in order to break out of the current deflationary trend. Lingering deflation shifts attention from quality to price, which paradoxically dampens demand in a deflationary environment – there is always the expectation that things will be cheaper tomorrow. Hong Kong is no longer a shopping paradise, with the emphasis on low prices, it once was. According to many international surveys, Hong Kong is also among the most expensive cities to live. To justify the premium, the overall quality of consumption in the city must be enhanced.

There is generally a lack of discussion on the need to fully develop our consumption sector. Perhaps this is partly due to the view that the domestic sector is a less powerful engine of growth than the external sector in a small open economy like Hong Kong. However, if Hong Kong aims to develop into a world city to attract capital, tourists and talents, consumption quality is a key component. Furthermore, the consumption sector employs 40% of our labour force. It is worthwhile to put more effort to build up our domestic consumption sector. This could unlock more consumer spending and generate more jobs than we can expect, helping us to break away from the deflationary spiral.

The viewpoints expressed in the Economic Analysis do not necessarily reflect those of Management of this Bank. Reprinting of any figures or statements contained herein is permitted provided that proper attribution is given to the Economic Analysis and/or the BEA Economic Research Department. Please direct any inquiries to Economic Research Department, Tel: 2842-3488, Fax: 2877-6707, or GPO Box 31, Hong Kong.