

Seventh Meeting of the Economic and Employment Council

Agenda Item 5 : Rising Rents and the Hong Kong Economy

Introduction

Property rentals have been rising since late 2003, in tandem with the economic recovery and the revival of the property market. According to statistics of the Rating and Valuation Department (R&VD), by July 2005, flat rentals have already rebounded by a cumulative 22% from the trough in September 2003. Similarly, rentals of office space and retail premises have also risen back distinctly, by 37% and 19% respectively from their troughs in 2003. There is concern from the community that the significant rise-back in rentals would lead to a resurgence in inflation, undermine profitability of businesses, and hamper the recovery in the economy. This paper examines these issues in the context of the long-term trends of property rentals in relation to the economic growth.

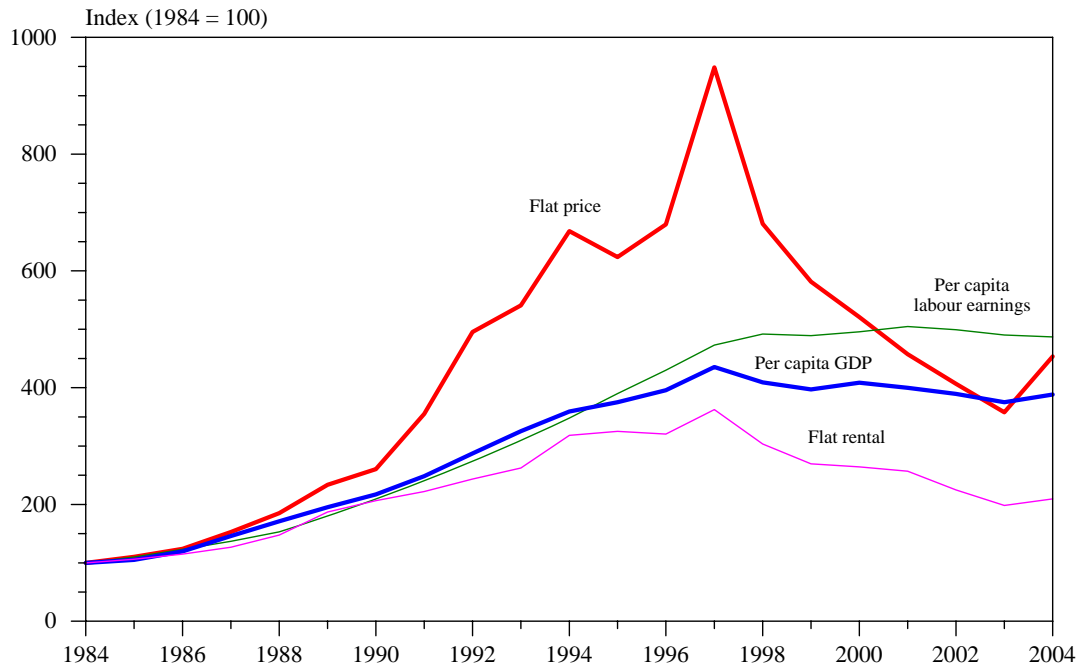
Property market as an integral part of the economy

2. From a macro perspective, the property market is an integral part of the market economy and in this context, property market performance can be seen as one manifestation of the state of the economy, in just the same way as share prices, trade performance, unemployment rate, wages, or inflation are. By the same token, property rentals, as a measure of the return or yield from investment in property, is just one form of return on capital, akin to dividend earned on holding stocks and shares, or interest on bonds or bank deposits.

3. Analysing the relationship between property rentals and the economy over the past two decades, between 1984 and 1997, flat rentals were indeed on an almost uninterrupted rise, by an average of 10.4% per annum. But per capita GDP rose even faster, by 12.0% per annum, and even more so for per capita labour earnings, by 12.7%. This suggests that the surge in flat rental actually went in tandem with, and was well supported by, improved incomes as the economy boomed. Moreover, the significant rise-back in rentals over the past two years has also to be seen in conjunction with the marked decline in flat rentals since late 1997, which precipitated to a cumulative fall-off of 45% between 1997 and 2003, far more distinct when matched against the cumulative decline of

14% in per capita GDP over the same period (*Chart 1*). The analysis clearly suggests that while the property market shows considerable volatility from year to year, in the long run property prices and rentals basically move in tandem with the economy.

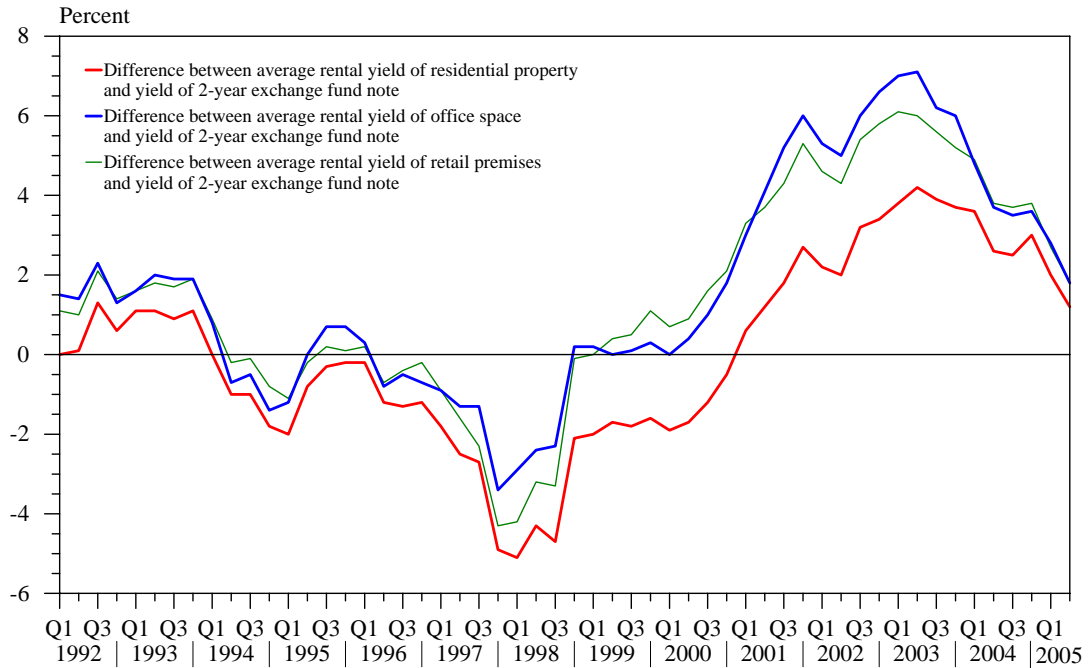
Chart 1
Flat price and rental vs per capita GDP and labour income



4. From another perspective, it can be shown that the current rental yield still stands at a reasonable level, which suggests that the current state of the property market as a whole remains healthy. The spread of rental yield and yield of 2-year exchange fund note, which reflects the risk premium for holding a rental property, moved to negative territory during the property market booms in 1994-95 and 1996-97. The negative spreads mainly reflected investors' optimism on further capital gains by holding the property. As flat prices fell by a larger extent than flat rentals amidst the property market downturn, the spread rose back to positive territory since 2001. Although the spread narrowed again along with the current recovery of the property market, the spread still stands at a reasonably healthy level of around 1-2 percentage points (*Chart 2*).

Chart 2

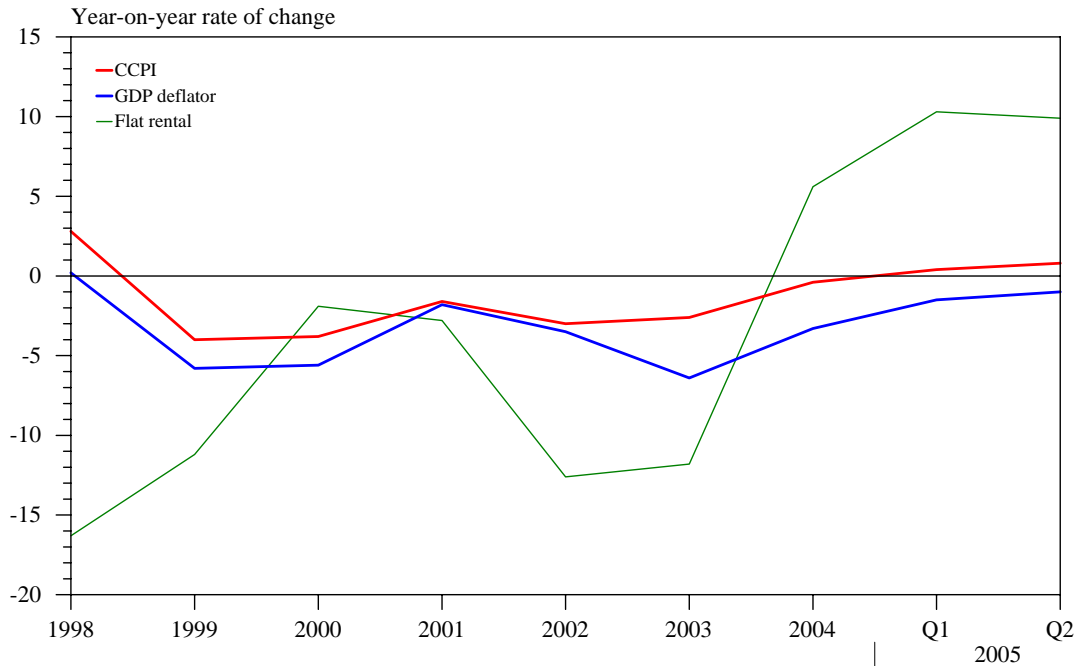
Difference of rental yield and exchange fund note yield



Impact of the recent surge in rentals on the economy

5. So far, there are little signs that the increase in property rentals has contributed to any surge in inflation as the feeding-through to the retail price level has not been significant. The GDP deflator and the domestic demand deflator remain soft, suggesting that overall price and cost pressure on the economy remains modest (*Chart 3*). While consumer price inflation is likely to creep up over the course of this year, it is still expected to be modest, and within the range of what most economists would regard as healthy inflation.

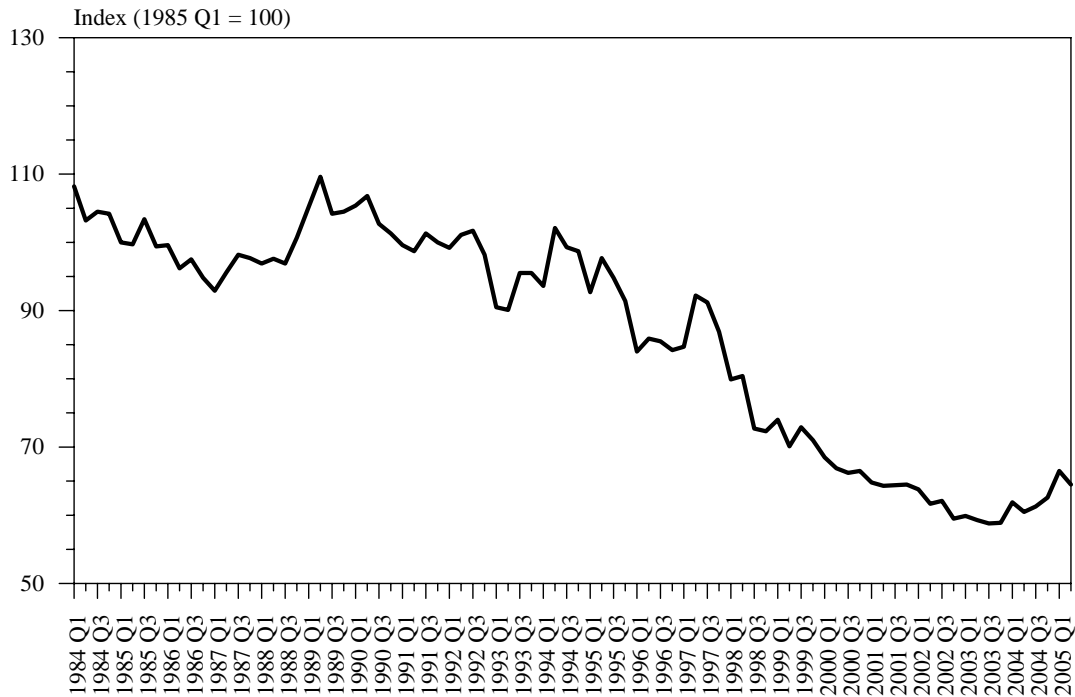
Chart 3
CCPI, GDP deflator and flat rental



6. There is also a worry that sharp increase in property rentals in Hong Kong may undercut the competitiveness of Hong Kong to foreign companies as a place of doing business. This would indeed be a valid concern if the surge in property rentals goes way beyond what our households can support in terms of rental affordability, and what our businesses can support in terms of earning capacity or income prospect. But this does not appear to be the case up to now.

7. Taking residential properties as an illustration, notwithstanding the significant rebound in flat rentals, affordability of tenants in the second quarter of 2005 is still better than any time during the entire period during 1984-1999 (*Chart 4*). This suggests that the recent bounce-back in flat rental has been well supported by improved job and income prospect, and in this context, it should be seen as no more than a catch-up consequential to the sharp fall-off in the earlier years. Furthermore, as the economic recovery deepens, employment income can be expected to improve further, which should in turn underpin tenants' affordability to rent.

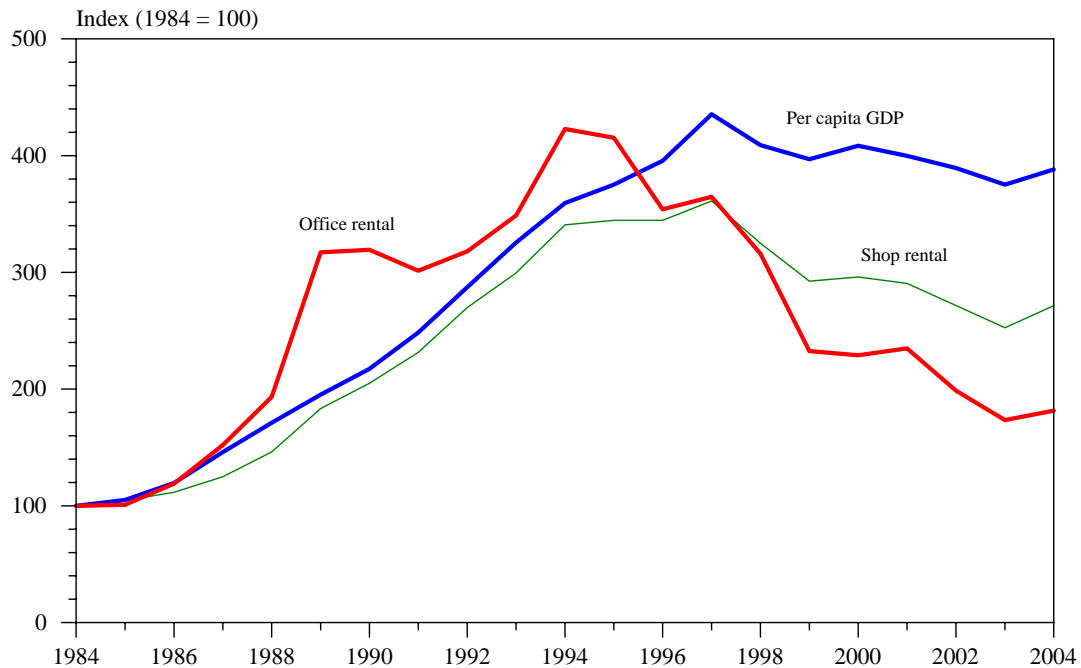
Chart 4
Affordability index of households to rent a 50m² flat



Note : A fall in affordability index indicates an improvement in affordability.

8. Similarly, the same is true for office and shop rentals. More specifically, between 1984 and 2004, office rentals have risen by a cumulative 82% and shop rentals by 171%, but they were both considerably smaller than the corresponding growth of 288% in per capita GDP, or that of 387% in per capita labour earnings (*Chart 5*). Thus, again, the strong pick-up in office and shop rentals of Hong Kong since late-2003 can be seen as largely a reflection of the upbeat business prospect and higher expected earning capability of businesses in Hong Kong as the Hong Kong economy enters a cyclical upturn. Indeed, despite the surge in rentals since late 2003, the number of regional headquarters and regional offices in Hong Kong have risen to new highs in 2005.

Chart 5
Office and shop rentals vs per capita GDP



9. Yet admittedly, in the short-run, the negative impact of rising rentals would be more noticeable at the micro level. Some service sectors, particularly retail trade and restaurants, for which rent expense accounts for a larger percentage of the operating cost, will feel more of the pinch. To the extent that the operators cannot pass on the rent cost increase in full to consumers amidst keen market competition at the retail level, there will be profit squeeze, which will be particularly pronounced for those operators already with low profit margin. Nevertheless, granting that the rise in rental cost is driven up primarily by improved sales or business, the increase in operating cost on a per dollar of output basis may not be as marked as it appears to be, as *Charts 6 and 7* show.

Chart 6
Unit rental cost of the retail trade sector

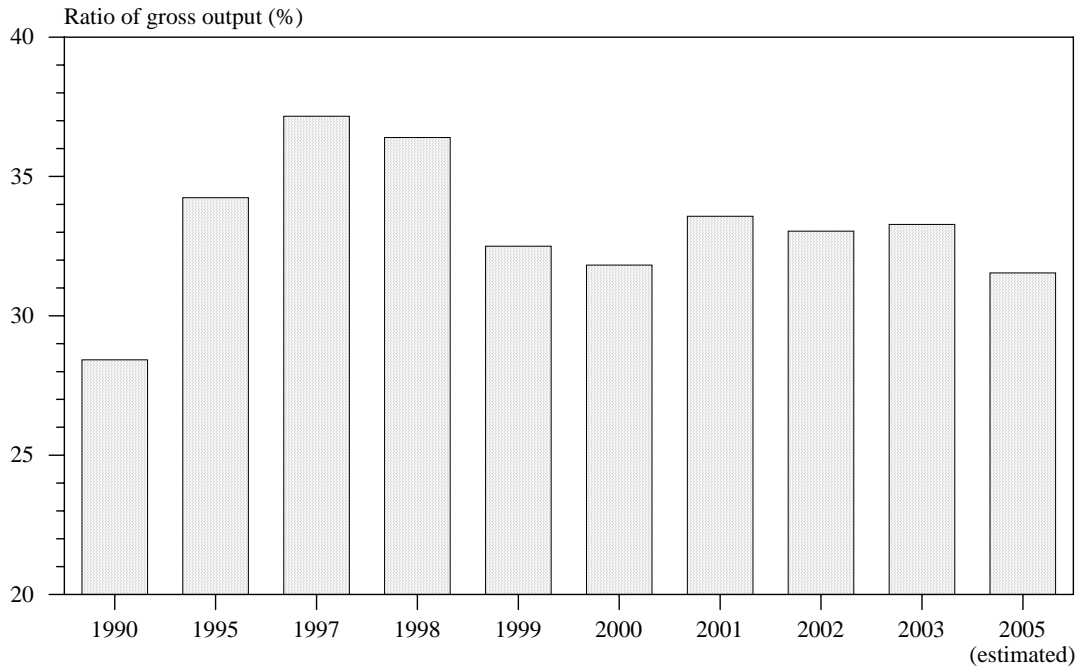
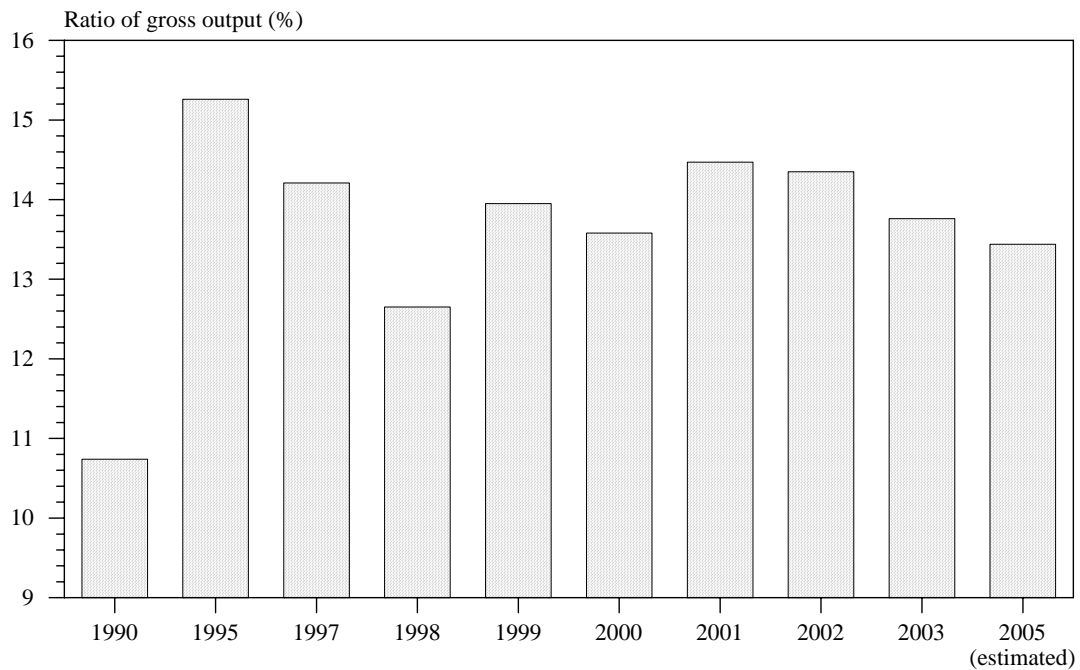


Chart 7
Unit rental cost of the restaurant sector



10. Moreover, the fact that some tenants in the prime shopping/business districts are being displaced by new tenants who are able to pay higher rental may not necessarily be bad for the economy as a whole. Arguably, these are normal market activities, and the play-out of market forces actually ensure that the scarce resources, shop or office premises in prime locations in this case, would go to users who value them most.

Rent and rates as a % of total operating cost by sector

<u>Economic activities</u>	<u>2002</u>	<u>2003</u>
Manufacturing	2.2	2.1
Retail trade	38.0	38.3
Wholesale and import/export trade	6.5	6.4
Restaurants	14.5	14.0
Hotels	6.9	6.4
Transport and storage	4.7	4.7
Communications	6.0	5.4
Financing and insurance	6.6	6.0
Real estate	3.9	4.2
Business services	6.2	5.9
Overall economy*	7.6	7.5

Note : (*) It refers to all economic activities but excludes community and social services provided by the government and non-profit institutions, and ownership of premises.

Concluding remarks

11. The current levels of home purchase and rental affordability suggest that in overall terms, the recent surge in property price and rental in the past two years or so are largely a result of improved income prospect and hence they are generally in line with the economic fundamentals. The Government will continue to keep in view developments in the property market, and will carry through its housing policies and take necessary actions to foster a healthy development of the market.

Economic Analysis Division
Economic Analysis and Business Facilitation Unit
Financial Secretary's Office
October 2005