

# Adding up the inflation rate

**INFLATION** is running at nearly 14 per cent in Hongkong. But what exactly does that figure measure? **JILL MCGIVERING** looks at the government decisions which are made in determining the Consumer Price Index, the measure of the territory's cost of living.

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**F**IVE years ago the mythical "average" Hongkong household happily saved up for manual sewing machines and pianos and spent a few spare dollars on anti-mosquito coils. Today such purchases are consumer dinosaurs.

Instead Mr and Mrs Average rush to the check-out with a basket laden with microwave ovens, personal computer accessories, compact disc players and electronic organs.

Keeping track of spending habits in "average" families is a first step in the complex process of establishing Hongkong's Consumer Price Index (CPI), the basis of monthly bulletins on the territory's cost of living and inflation levels.

CPI homework starts at the grassroots when every five years 5,000 local households complete detailed personal diaries to see what and how they spend in a given fortnight.

Their answers form the Household Expenditure Survey (HES), a prototype of "average" consumer spending, tabulated into various sectors from food and housing to services.

CPI figures are deducted from this model spending pattern, fixed for five years from one HES survey to the next. Each month, researchers gather 40,000 price quotations to find what today's prices are and what they tell us about Hongkong's evolving cost of living, whether we're falling behind, and how much we should be battling for at annual raise time.

But is this method serving Hongkong's best interest? Don't some governments fiddle the figures for the benefit of consumers and financial markets alike?

Unlike many countries, Hongkong does not publish one overall CPI index, showing total urban inflation across all households. In the name of accuracy, figures are split into three separate indices, two provided by government and the third by the Hang Seng Bank. Each deals with a different income band and tells a slightly different story.

CPI (A) covers 50 per cent of the territory's ur-

ban households, in the monthly income bracket \$2,500 to \$9,999. CPI (B) monitors a more affluent group, 30 per cent of the urban population, earning between \$10,000 and \$17,499 a month.

The Hang Seng CPI spans 10 per cent of households in the \$17,500 to \$37,499 monthly income range. The remaining 10 per cent is lost in high or low earning extremes.

According to Dr Yu Ching Jao, reader in economics at the University of Hongkong, the considerable differences in Hongkong spending habits between income ranges probably does justify three separate CPI indices.

"If all people in Hongkong had more or less the same spending habits, it would be useful to construct a simple CPI for the whole population," he says. "But as long as there are marked differences, separate indices are more useful."

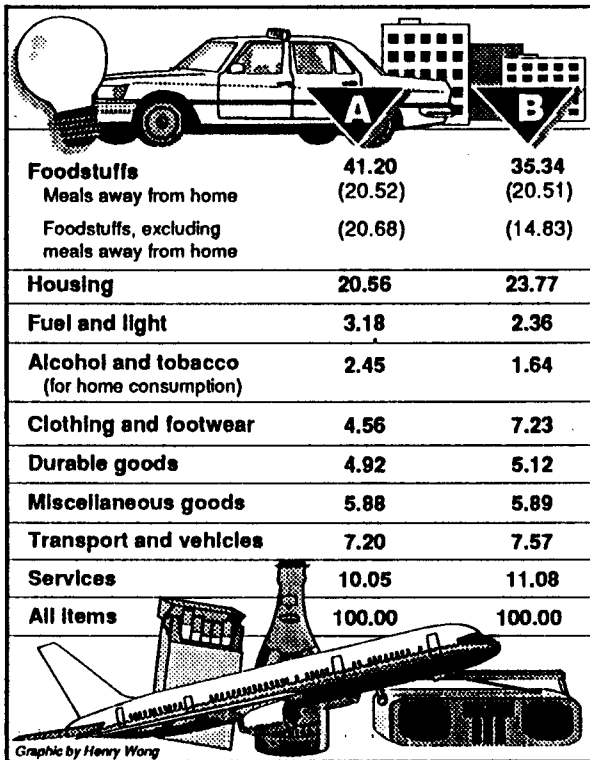
The US, by comparison, publishes one consumer price index for all urban consumers, plus one specialised CPI index focusing on urban wage earners and clerical workers.

In the UK, the retail price index (RPI) is a single measure covering almost all households, with the exclusion of pensioners and the top and bottom few per cent of earners.

Elley Mao, principal economist at the Economic Services Branch of the Government Secretariat, points out that with the level of discrepancy from one income group to another, the creation of a single CPI would make consumer data indistinct.

"It would be too gross if we had just one CPI," she says. "For people in the upper band, you would expect the spending pattern and basket of goods would be very different from those in lower bands."

"Presumably you can produce an overall figure but the fact is we believe since CPI (A) represents 50 per cent of urban households, that should be relatively representative in itself."



Figures, based on spending diaries from sample households in the latest Housing Expenditure Survey, show average proportions of spending on various consumer categories.

CPI (A) shows figures for 50 per cent of local urban households in the monthly salary range of \$2,500 to \$9,999. CPI (B) covers the 30 per cent of urban households with higher monthly income range, \$10,000 to \$17,499.

Durable goods category includes furniture, electrical goods, crockery and hardware, watches and sports goods.

Miscellaneous includes medicines, books and newspapers, cosmetics and toiletries, jewellery and toys and hobbies. Services range from school and medical fees to entertainment, postal and telephone charges.

But the way Hongkong's CPI system measures the housing component is its most controversial aspect. Hongkong adopts the "rental equivalent approach". Where respondents are owner-occupiers, the researchers calculate a fictitious rent for the property.

Here too the practice diverges from the UK where a direct measure of home ownership is built in through the inclusion of mortgage interest rates.

"Their argument is that home ownership constitutes an investment and reflects an acquisition of assets which is not necessarily the equivalent of the service of the accommodation you consume," says Ms Lily Ouyang Fong, Senior Statistician (Price) in the Government's Census and Statistics Department.

As rents normally follow property trends, both approaches should yield more or less the same results in the long term. But in the short term there may be sharp moves and differences between the two.

"Both the US and a number of other European countries also use the rental equivalent approach," says Ms Mao. "With the mortgage payment approach the CPI tends to fluctuate with every change in interest rates."

"Also if you used the mortgage approach, what would happen to those flats in which the owner has already redeemed the mortgage through many years of repayment? Do you assume the rental for those flats is zero?"

The counter argument is: does the exclusion of mortgage rates make the

CPI less sensitive to changes in property prices and interest rates?

"It's one of these situations where there's no completely satisfactory answer," says Alan McLean, chief economist at the Hongkong and Shanghai Bank.

"It depends to some extent what the average household pays: rent or a mortgage. In Hongkong's CPI (A) probably almost 50 per cent of the people live in public housing so it would be nonsensical to have an index where the housing cost component is related to the cost of a mortgage."

Accuracy versus resources creates another debate. In Hongkong, the HES is only updated once every five years. Are we missing something?

Since consumer spending habits inevitably change over time, affected by shifts in personal income, consumer fashion and individual changes in lifestyle or taste, any changes in consumer habits which take place between the five-year surveys fail to be accounted for.

The US rebases its CPI every 10 years. So does Australia. Singapore like Hongkong rebases every five years, New Zealand every three and Canada every four.

But in the UK, rebasing comes at the beginning of every calendar year. Hongkong would benefit from following suit with more regular updating to ensure greater accuracy, argues Dr Jao.

"The problem is whether the Government is willing to spend that much more in resources for this kind of statistical data," he says, "but it probably would be better to revise the HES more frequently than every five years."

Changes in consumer spending profiles are so slight, argues Ms Ouyang, that accuracy is not impaired by five yearly surveys.

"The HES composition only fades out very gradually, the majority of the things - clothes, food -

are still there," she says. "Change is so slow and the effects so minor that in terms of the whole basket, precision is still preserved."

As well as the inevitable extra cost, more HESs would also make comparisons between figures from one year to the next more confusing, adds Mr McLean.

Whether every five years or every year, the nature of CPI findings make them inevitably retrospective. The index can never be instantly responsive to changes as they happen nor predict change but only record movements historically on a framework which is itself constantly being outmoded.

Is there any other domestic system which would work better? There might be, suggests Dr Jao, if research resources were no obstacle.

"The CPI is always open to criticism; that it's not comprehensive enough, not reliable enough," he says.

"Theoretically, one could construct a really comprehensive index which included everything, even wealth and assets, stocks and shares and real assets like real estate. That could better reflect the true level of inflation in Hongkong."

But despite the endless debate about methodology, decimal point accuracy in inflation remains meaningless to the average consumer on a practical basis, says Mr McLean.

"I bet if you took three or four items at random out of the basket of goods and asked consumers what it cost now and what it cost a year ago, 99 per cent of them wouldn't know the answer," he says.

"I think by and large we're pretty well served in Hongkong by the CPIs, despite the fact everybody feels that they understate the nature of inflation. That's human nature."