Box 1.1

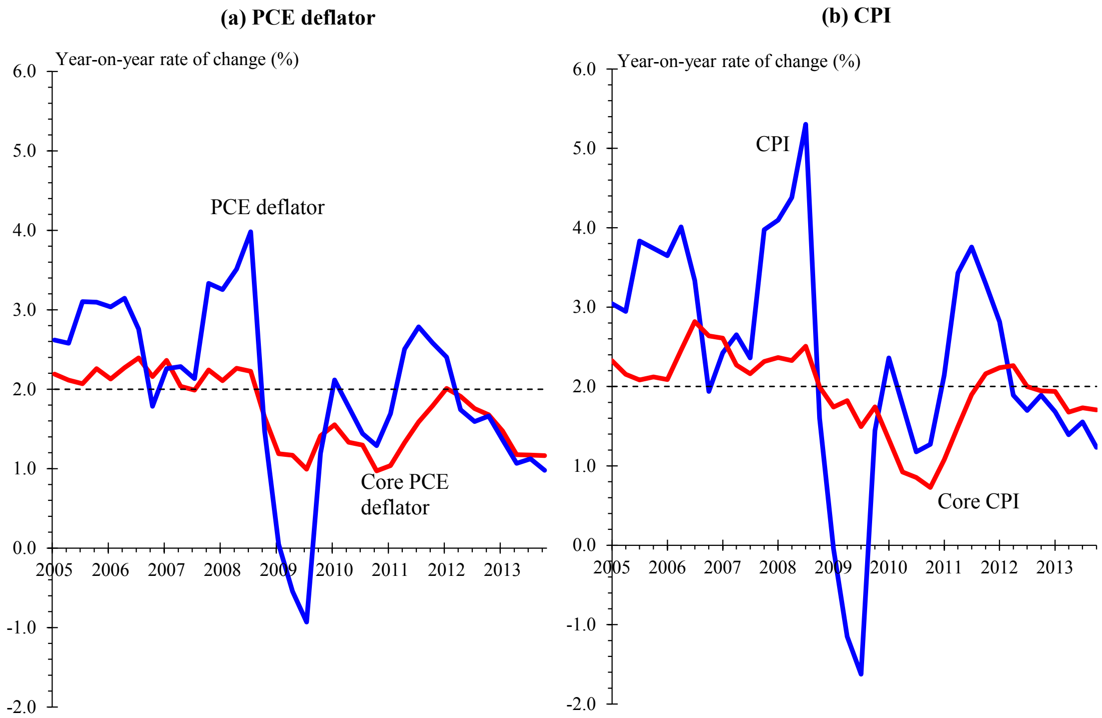
Recent inflation situation in the US

The future path of the US monetary policy is a key source of uncertainty facing the global economy. This note discusses the recent inflation trend in the US, which matters because, together with the range of labour market indicators, it drives the US Federal Reserve (Fed)'s policy, under the dual mandate of the Fed to maximise employment and maintain price stability.

The Fed's recent policy statements reveal its concern on the ongoing low inflation. Indeed, the increase in the personal consumption expenditures (PCE) deflator, the Fed's preferred measure of inflation, has been running below the policy target of 2% since 2012 (***Chart 1a***). Core PCE inflation, which excludes the more volatile food and energy components and hence serves as a better guide for policy decision, has likewise been subdued. The consumer price index (CPI) also showed similar movements (***Chart 1b***). Conceivably, the low inflation stemmed from the great recession of 2008-2009, which slowed income growth and dampened consumption demand. The IMF estimated in April 2014 that the slack in the US economy would remain significant in 2014, with an output gap amounting to 3.3% of the GDP.

Analysed by the aggregate components of the PCE deflator, the price increase for the services component averaged 3.3% per annum during 2005 to 2008, more than offsetting the average annual 1.6% price decline for durable goods, thereby supporting the core PCE inflation at 2.2% per annum before the great recession. However, during 2009 to 2013, the price increase for services averaged 1.9% per annum, while prices of durable goods deflated further, resulting in an average annual rate of only 1.5% for core PCE inflation.

Chart 1 : Inflation as measured by the PCE deflator and CPI

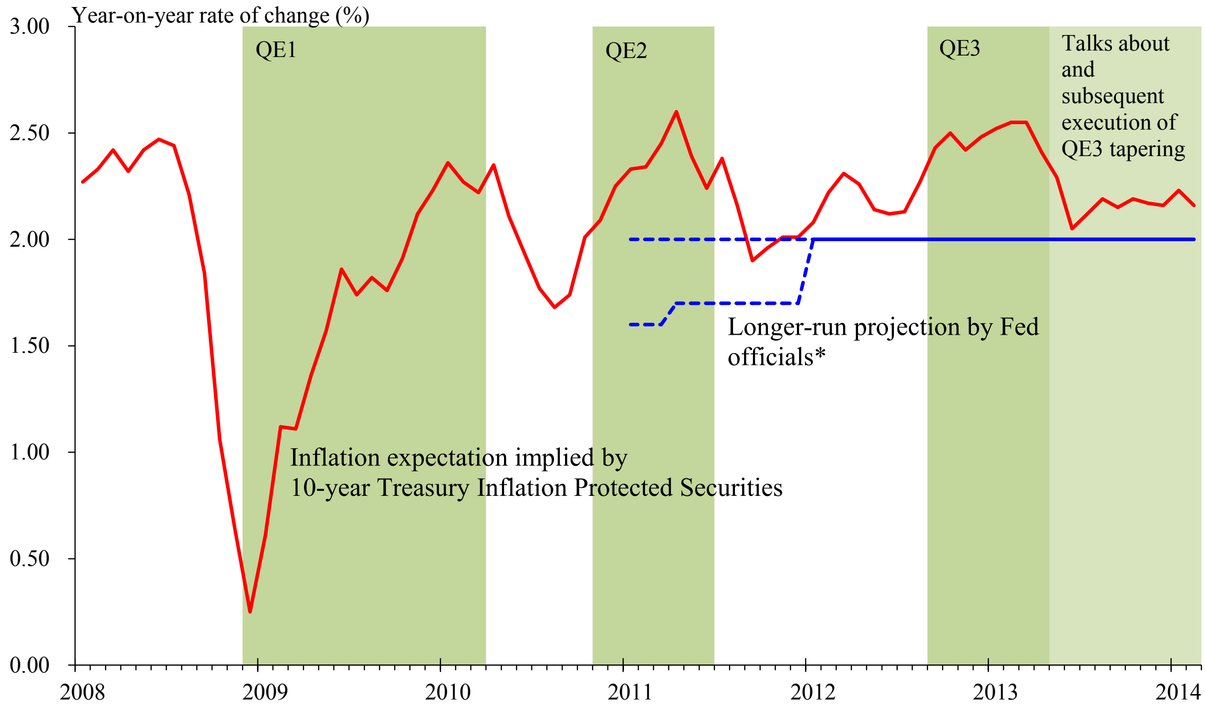


Box 1.1 (Cont'd)

Within the services component, housing, healthcare, and financial services and insurance are the three largest sub-components, accounting for around 60% of total services consumption. They have shown varied price trends recently, with inflation of healthcare and financial services and insurance moving down, and that of housing picking up. In the period ahead, cost-cutting efforts by healthcare providers may continue to rein in healthcare inflation, while housing rents may see slower increase as well given that housing supply has been rising while demand is overcast by the looming monetary tightening.

Notwithstanding these trends, the Fed still expects inflation to move towards 2%. Since January 2012 the Fed's projection of longer-run PCE inflation has remained at 2% (***Chart 2***), partly reflecting its judgement that the ongoing monetary stimulus would strengthen the economic recovery and help lift inflation. The implied inflation rate derived from the yields of Treasury Inflation Protected Securities (TIPS), a gauge of expected inflation, has been largely consistent with the Fed's view (***Chart 2***). Indeed, inflation expectation is seemingly affected by the Fed's policy, as evident by pick up in TIPS implied rate in periods with quantitative easing.

Chart 2 : Longer-term inflation expectation



Notes : (*) Projections by the Fed prior to 2011 are not available. Projections in 2011 consisted of a range whilst later ones consisted of a point only.

In sum, with the TIPS implied rate hovering around 2.2% since mid-2013, the longer-term inflation expectation is still well anchored at around the Fed's inflation target, lending support to the continuation of the Fed's asset purchase tapering. However, should the actual inflation rate stay low in the period ahead and even drive down longer-term expectation, the Fed might need to slow down, or even reverse, its unwinding of monetary stimulus, given its mandate to maintain price stability. With the far-reaching implications of inflation developments in the US, it is worthwhile to monitor the situation closely.