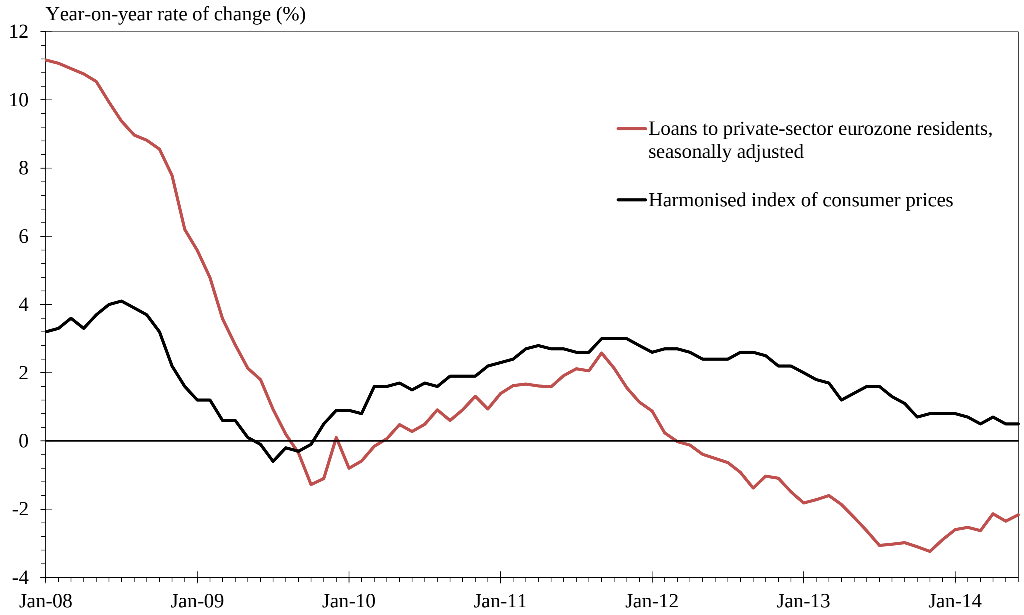
Box 1.1

Recent monetary easing in the eurozone

The eurozone, being still troubled by the deep-seated structural economic problems, has been a weak spot in the global economy. The economy expanded slowly at a quarterly rate of 0.2% in the first quarter, and recent economic indicators continued to signal a weak and unsteady recovery in the second quarter. Along with the lack of growth momentum, credit dynamics in the region have been weak and inflation has stayed uncomfortably low (***Chart 1***). Loans to the private sector have been on the decline, reflecting weak demand for credit amid deleveraging and the banking sector's impaired balance sheet. Deflation lingered in such eurozone members as Cyprus, Greece and Portugal. The disinflationary pressures may hurt investor sentiment and increase real debt burden, thereby adding headwinds to the structural adjustment efforts by the public and private sectors. Indeed, the risks of a prolonged period of low inflation were highlighted by the Eurosystem staff macroeconomic projections in June, which forecast that inflation in the eurozone would likely remain at low levels in the near term, before rising only gradually in 2015 and 2016.

Chart 1 : Credit dynamics and inflation in the eurozone remained subdued



Against this background, the European Central Bank (ECB) announced on 5 June a combination of measures to provide additional monetary policy accommodation and to support lending to the real economy. Among them, the policy refinancing rate was reduced by 10 basis points to 0.15%, while the deposit facility rate was lowered to below zero (-0.1%). Starting from September 2014, a series of targeted longer-term refinancing operations (TLTROs) would be successively rolled out, with a view to support lending to households and non-financial corporations by providing banks with low-cost funding[(1)]. In addition, the ECB would intensify preparatory work related to outright purchases in the asset-backed securities (ABS) market, aimed at enhancing the functioning of the monetary policy transmission mechanism further.

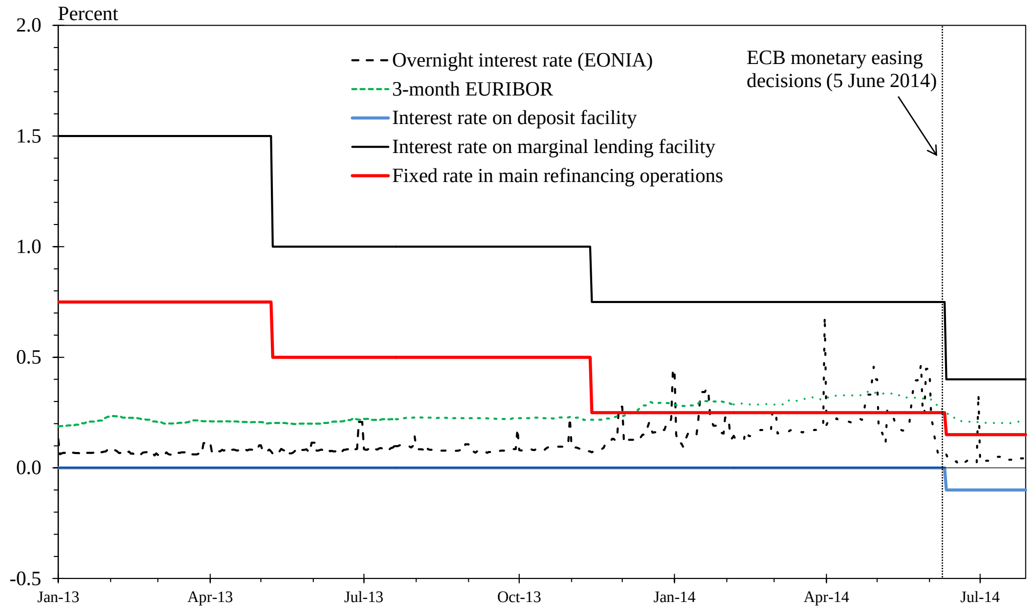
---

(1) According to the ECB's President, the TLTRO has an initial allowance of about €400 billion, and the overall take-up by banks could reach a maximum of €1 trillion. For details, see the transcript for the press conference held after the ECB meeting on 3 July (http://www.ecb.europa.eu/press/pressconf/2014/html/is140703.en.html).

Box 1.1 (Cont'd)

Following the ECB's latest round of monetary easing, short-term money market interest rates, including the overnight interest rate (Euro Overnight Index Average, or EONIA) and the three-month Euro Interbank Offered Rate (EURIBOR), moved lower (***Chart 2***). Benchmark government bond yields of higher-rated eurozone member states fell, while the euro also weakened somewhat in June and July on a nominal effective exchange rate basis.

Chart 2 : Money market and ECB interest rates



Looking ahead, the weak recovery of the eurozone, along with high unemployment rate and low inflation, will continue to pose a drag to the global economy. Furthermore, the recent default incidence related to the parent company of a major Portuguese bank was also a timely reminder of the weakness in some parts of the financial and monetary systems of the eurozone. In sum, the ECB is likely to adopt a highly accommodative policy stance for an extended period of time.

The ECB's latest monetary easing can potentially create spill-overs to the rest of the world, given the large size of Europe's financial system and its tight integration with the global economy. The provision of low-cost funding via TLTROs, in addition to the outright ABS purchase programme (if implemented), will result in substantial expansion of the ECB's balance sheet and huge liquidity in the European banking system. Coupled with lower eurozone bond yields, capital could be encouraged to flow to emerging markets in search of yield. As a result, and also considering the uncertainties over the US Fed's future pace of monetary policy normalisation, capital flows to emerging market economies may turn increasingly volatile, to the detriment of global financial stability. A possible weakening of the euro exchange rate vis-à-vis the US dollar and Asian currencies may also pose uncertainties to Hong Kong's external trade performance. The Government will closely monitor the latest developments on the external front, and stay alert to the risks arising from the highly accommodative global monetary environment.