

## Box 2.1

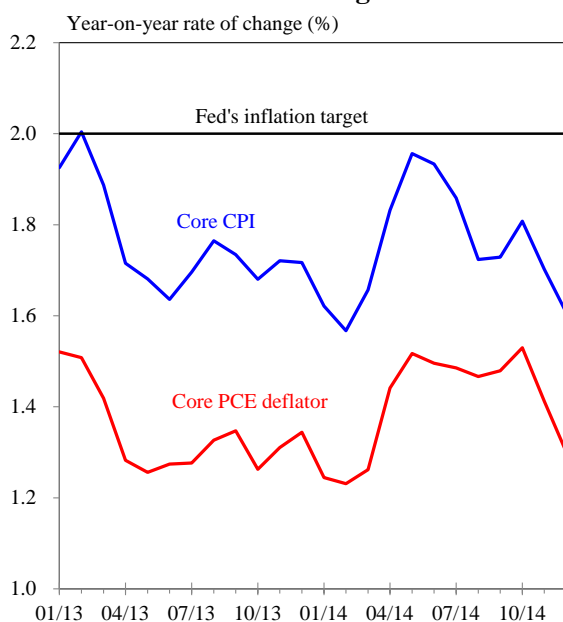
## Deflation risks in selected economies

Global inflation followed an easing trend in 2014 amid the disappointing recovery pace of the global economy. Indeed, some economies have seen persistently low inflation or on the brink of deflation. By denting investment sentiment, delaying consumption and increasing real debt burden, deflation can lead an economy into prolonged recession, particularly when central banks are running out of conventional stimulus tools. Furthermore, different inflation trends across regions will result in varying central banks' policy actions, risking increased volatility in the global financial and exchange rate markets. The global inflation situation therefore warrants concern. This note attempts to examine the latest inflation trends in selected economies, including the US, the eurozone, Japan and the rest of Asia.

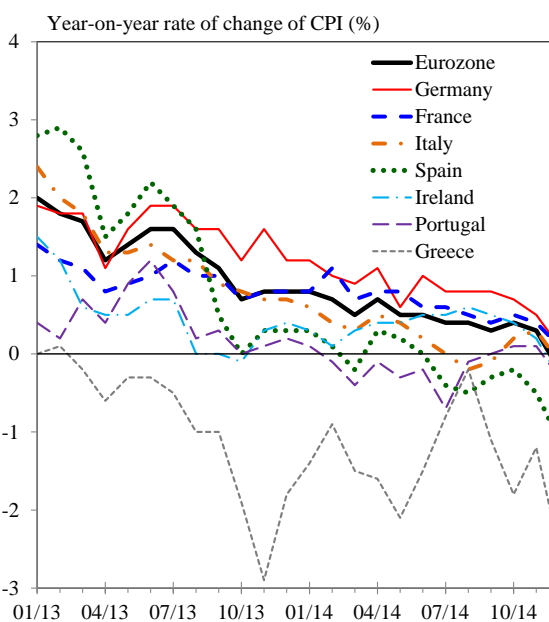
In the US, the Fed ended its asset purchase programme in October 2014 alongside stronger growth momentum. Yet, the path to normalising interest rates is still contingent on incoming data. While unemployment improved visibly, wage pressures have stayed unusually modest and housing market recovery has also been slow. In December, inflation rates in terms of the core personal consumption expenditures (PCE) deflator and core consumer price index (CPI) were just 1.3% and 1.6% respectively, still below the Fed's 2% target (*Chart 1*). Yet, deflation risk in the US should be less of a concern given the economy's improved outlook.

By comparison, deflation risk is more acute in the eurozone. Consumer price increases have been deviating notably from the European Central Bank (ECB)'s mandate of keeping inflation close to 2%. Excluding food, alcohol and tobacco, and energy prices, the eurozone's flash estimate of core CPI inflation stayed subdued in January, at 0.6%, amid the lack of growth momentum and elevated unemployment rate in the region. The headline rate even dropped to -0.6% due to the plunge in energy prices. Certain weaker eurozone members, including Spain and Greece, have already been experiencing deflation. Germany's inflation also unexpectedly eased in the recent past, despite its relatively resilient economic fundamentals (*Chart 2*).

**Chart 1 : US price indicators still below Fed's inflation target**



**Chart 2 : Deflation risks in the eurozone have risen**



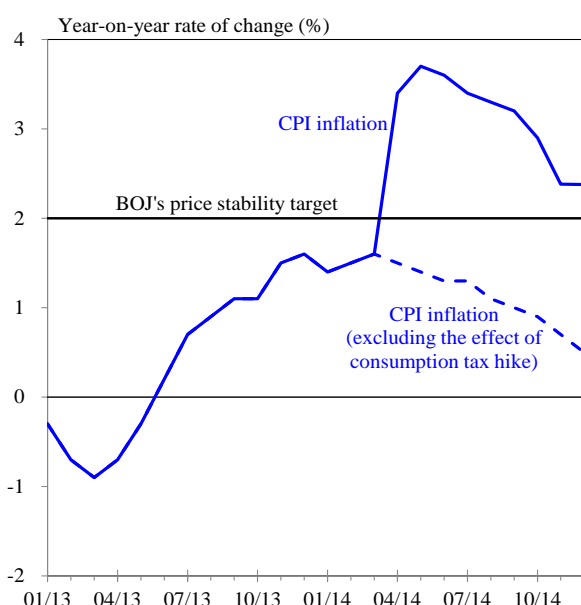
**Box 2.1 (Cont'd)**

To reinvigorate the economy and bring inflation back to the target, the ECB cut its key interest rates to record lows in June and September 2014, and started its covered bond and asset-backed securities purchase programmes since October. However, these measures failed to reverse the course of the region's inflation. On 22 January 2015, the ECB announced further easing measures, and expanded its purchase programmes for asset-backed securities and covered bonds. It remains to be seen whether this can fend off deflation risk.

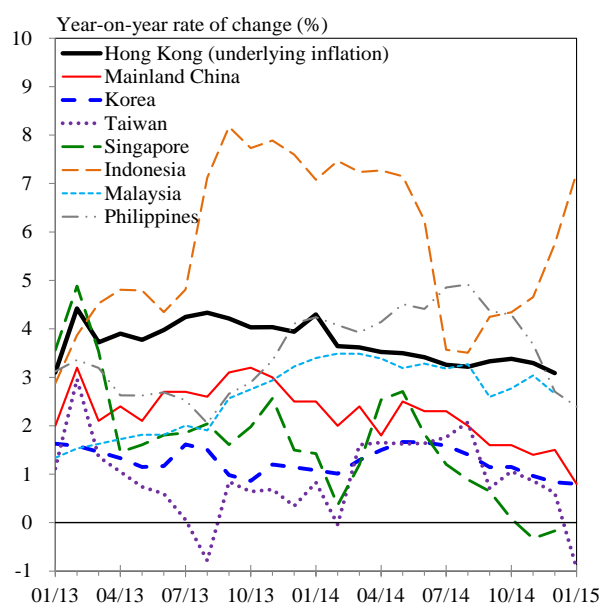
In Japan, the fight against deflation by means of “Abenomics” has also run into difficulties, with consumer price inflation easing again in recent months. Apart from the recent plunge in oil prices, also accountable were the waning effects of the expansionary macroeconomic policies launched since 2013 as well as the weakened demand following the consumption tax hike in April 2014, which led Japan's economy into recession in the second and third quarters of 2014. The Bank of Japan (BOJ) rolled out further monetary easing measures in late October in an attempt to ward off deflation risk and revive the economy. Japan's inflation was 0.5% in December after excluding the effect of the consumption tax hike, well below the BOJ's target of attaining 2% inflation (**Chart 3**).

As to other Asian economies, inflationary pressures in most of them have also been receding along with the recent declines in commodity prices and the sluggish global economy (**Chart 4**). In the Mainland economy, while producer prices have been falling, consumer price inflation still registered a mild increase, albeit easing further. Also, Singapore's negative headline inflation rates in November and December were due mainly to temporary factors. Compared to the eurozone economies, most Asian economies have relatively sound fundamentals and continue to sustain solid expansion, and therefore the risks of falling into the deflationary trap should not be significant.

**Chart 3 : Japan's underlying inflation is still below BOJ's target**



**Chart 4 : Inflation in many other Asian economies has also eased in recent periods**



In sum, the deflation risks in economies across the globe are uneven, with the threats to the eurozone and Japan being most severe. The recent oil price slump also complicated the picture. Hong Kong's underlying inflation is currently around 3% and deflation risk is low. However, the unevenness of deflation risks in major economies would reinforce the trend of varying monetary policies among them, with potential destabilising repercussions on global financial and exchange rate markets. We need to closely monitor these developments.