Box 2.1

The increasing monetary policy divergence between major central banks

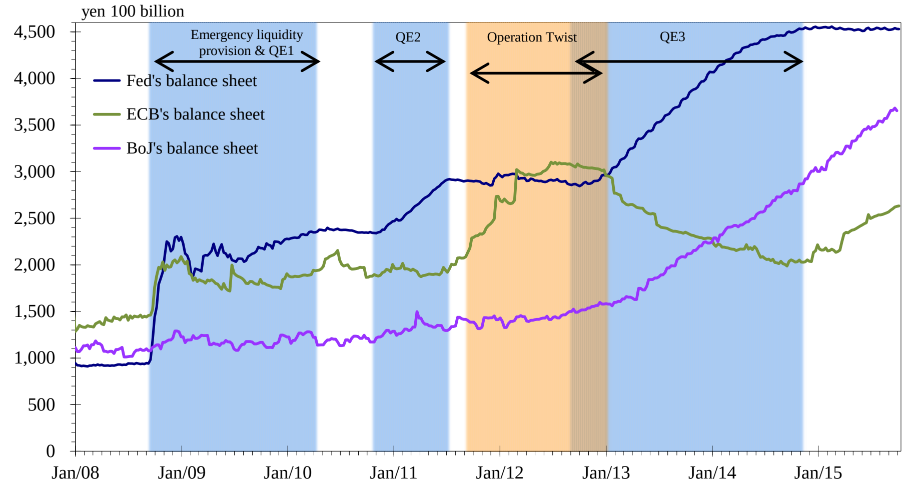
The pronounced divergence of monetary policy stances among major central banks, which has led to a more volatile global financial environment, remains a key source of uncertainty facing the global economy. This note briefly reviews the policy directions signalled by the major central banks.

In the US, the Federal Reserve (Fed) ended its third round of quantitative easing (QE) in October 2014, upon growing signs of economic improvement. Although the US economy hit a soft patch in the first quarter of 2015, the Fed considered the setback to be temporary and removed the reference to "being patient" in beginning to normalise the monetary policy in the Federal Open Market Committee (FOMC) meeting statement in March, signifying that the conditions for an interest rate life-off were increasingly ripe. US economic growth rebounded as expected and the labour market continued to improve in the second quarter.

The US data, however, turned softer again in the third quarter, with moderated GDP growth and slower job gains, although the unemployment rate, at 5.1% in September, was close to the full-employment rate as estimated by the FOMC participants. Besides, inflation pressure and wage growth stayed low. Thus, the Fed continued to keep interest rate unchanged in the FOMC meeting in October. Yet, the accompanying policy statement hinted that the interest rate lift-off may start in December if the US economic recovery continues as expected. Such a signal increased sharply the market expectations for an interest rate lift-off in December.

In contrast to the US Fed's preparation for lifting interest rates, the European Central Bank (ECB) and the Bank of Japan (BOJ) took further steps to expand their balance sheets over the past year (**Chart 1**). Faced with growing deflation risks and sluggish economic growth, and with the scope for interest rate cuts almost exhausted, the ECB launched an expanded Asset Purchase Programme in October 2014 to cover the purchase of covered bonds and other asset-backed securities.

Chart 1 : In contrast to the US Fed's conclusion of its QE programme, the ECB and BoJ are still expanding their balance sheets



The ECB stepped up asset purchases from March 2015 to include euro-denominated investment-grade securities issued by eurozone governments and agencies and European institutions, with the total monthly purchases of public and private sector securities amounting to €60 billion. Since then, economic growth remained modest. Consumer price inflation stayed below target and the flash reading for October was zero, underscoring the deflation risks. While the asset purchase programme was originally intended to be carried out until end-September 2016, the ECB President in the post-meeting press conference in

Box 2.1 (Cont'd)

October indicated that the monetary policy stance needed to be re-examined in December. This raised market expectations for further easing measures to come soon. Apart from the possibility of stepping up the asset purchase programme, the ECB stated that it would deliberate all other instruments available within its mandate, including a further reduction of policy interest rates which had already been reduced to negative unprecedentedly in June 2014.

As for the BOJ, it surprised the market in October 2014 by accelerating the monetary base increase from an annual pace of 60-70 trillion yen to about 80 trillion yen. The BOJ contended that economic growth and inflation had not picked up as expected after a sales tax hike in April 2014. To pre-empt deflation risks, the BOJ announced further steps in January 2015 to stimulate bank lending. While the BOJ kept monetary policy unchanged in its latest meeting at the end of October, it cut Japan's economic growth and CPI inflation projections for this and next fiscal year. Given the consistently low inflation and the fragile state of the economic recovery, the BOJ remains under pressure to further ease monetary policy.

Elsewhere, many central banks in different parts of the world successively cut interest rates thus far this year, including those in the Mainland, Thailand, Indonesia, South Korea, Taiwan, Russia, India, Canada and Australia, with more aggressive cuts for some. On the other hand, the Bank of England (BOE) held the policy rate unchanged at 0.5% in November, but the minutes of the Monetary Policy Committee revealed that one member preferred to hike rate given the concerns about rising domestic cost pressures. Amid the increasing monetary policy divergence, the exchange rate fluctuations were unusually large over the past year or so. By end-October, the Japanese yen and euro against the US dollar both had depreciated by some 20% from mid-2014.

The international financial markets have turned exceptionally volatile, particularly during the summer months this year. Global stock and commodity markets came under severe selling pressure, with visible capital outflows from emerging market economies in August (**Chart 2a & 2b**). Currencies of emerging market economies such as Malaysia, Indonesia, Thailand, Brazil, Mexico and Russia all fell to multi-year lows **(Chart 3)**.

Chart 2a: Global stocks plunged in the summer of 2015

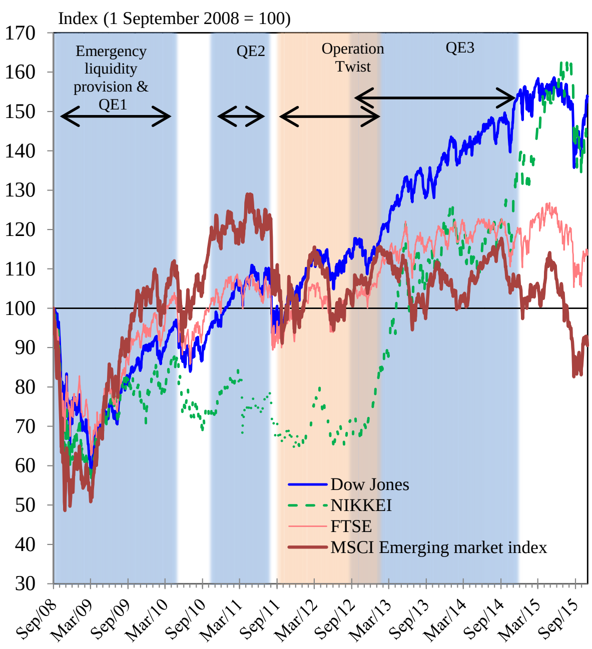
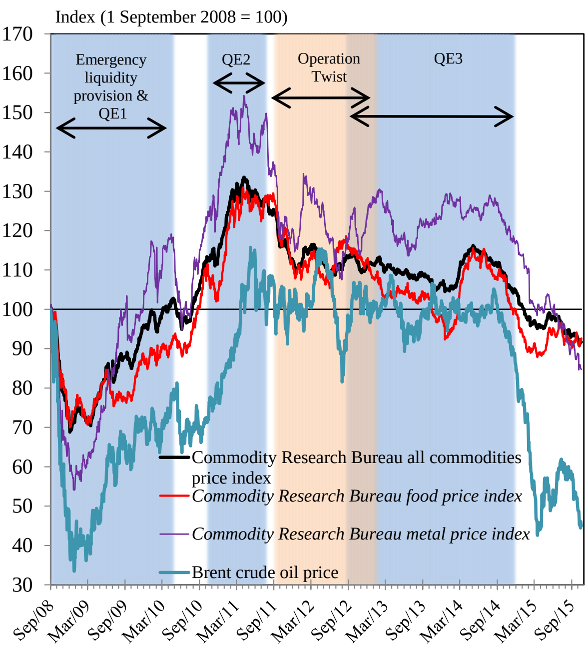
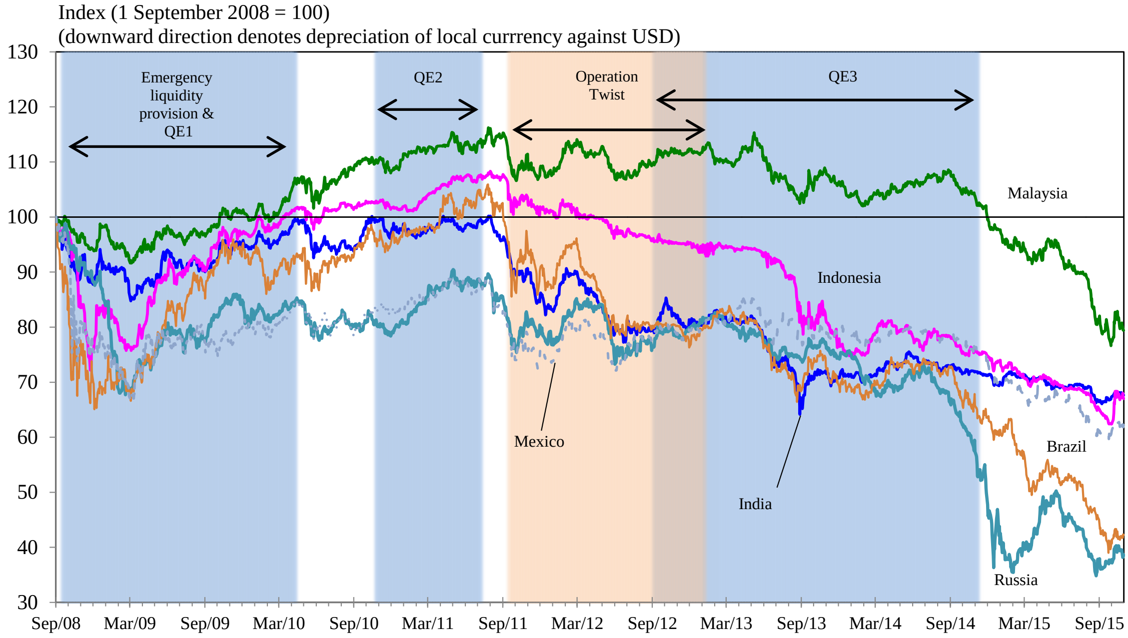


Chart 2b: Commodities prices fell visibly further in 2015



Box 2.1 (Cont'd)

Chart 3: Currencies of many emerging market economies came under pressure in 2015



The monetary policy divergence among central banks is likely to deepen further in the period ahead in the midst of an uneven expansion and shaky recovery of the global economy. The Government will stay vigilant and closely monitor the developments on the international monetary front and their possible impacts on the Hong Kong economy.