Box 1.1

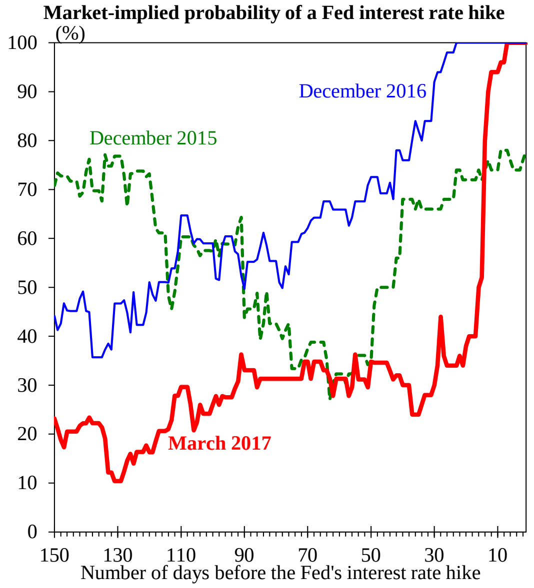
The US interest rate outlook

Following the interest rate hike in December 2016, the US Federal Reserve (Fed) raised the target range for the federal funds rate by another 25 basis points to 0.75-1.00% in March 2017, marking the third increase since December 2015. While the Fed kept the federal funds rate unchanged in its latest Federal Open Market Committee (FOMC) meeting in early May, the interest rate normalisation process in the US is expected to continue in the coming years, though the pace would hinge on the developments of the US economy. Considering that the US interest rate is highly relevant to the Hong Kong economy, this note briefly examines the uncertainties surrounding the US interest rate outlook.

Swings in market perceptions on the Fed's future interest rate actions could bring about significant shifts in the direction of capital flows and heighten volatility in global financial and foreign exchange markets, especially against the backdrop of deepening policy divergence among major central banks. While many regarded the rate hike in March 2017 as widely expected at the time it was announced, market participants only priced in a probability of around 40% for a March rate hike in late February, notwithstanding generally positive incoming economic data. It was after Fed officials had signalled an interest rate hike could come as early as March that the market priced in a considerably higher probability for an upcoming interest rate move (***Chart 1***). Similar observations can be drawn when the same analysis is performed on the two other interest rate hikes earlier on. These showed the potential extent of uncertainty when predicting US interest rate movements as purely deduced from analysing financial market data.

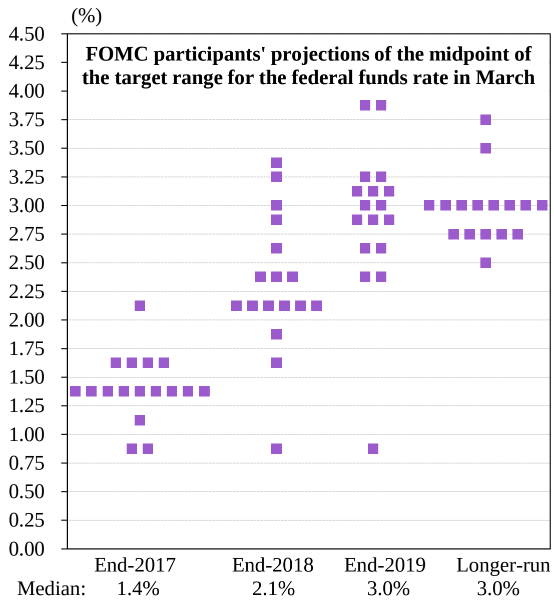
Another perspective to look at the US interest rate outlook is from the projections of the Fed. ***Chart 2*** shows the extent of disparity between the federal funds rate projections of individual FOMC participants in their meeting in March this year. While the median and mode of their projections both pointed to two more interest hikes of 25 basis points each this year, the extent of variability became much larger at end-2018 (from 1.50-1.75% to 3.25%, if removing the extreme values) and at end-2019 (from 2.25-2.50% to 3.25%, if removing the extreme values). On the other hand, it is worth noting that, despite the great variability in the expected interest rate paths of the FOMC participants in the coming two to three years, most of them considered that the US federal funds rate should be around 3.0% in the longer run, i.e. around 2 percentage points higher than the current level.

Chart 1 : Expectations in the financial markets for an interest rate hike only aligned with the Fed shortly before the FOMC decision



Source: Bloomberg's federal funds futures pricing.

Chart 2 : Notable disparity between the expected interest rate paths of the FOMC participants in 2-3 years' time



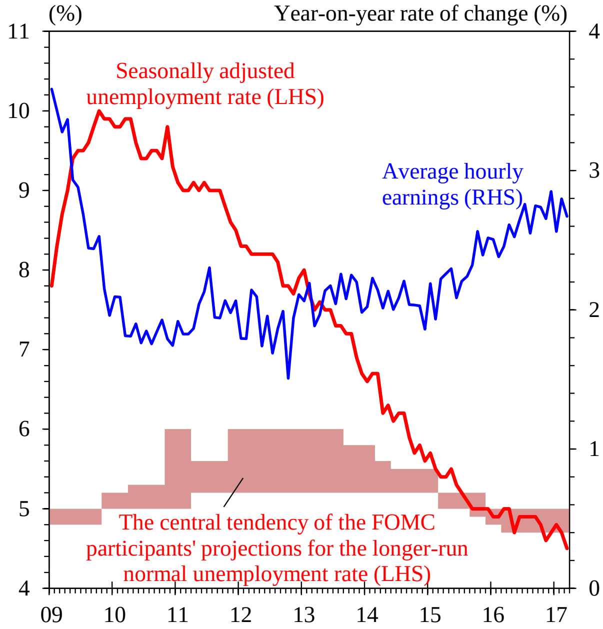
Box 1.1 (Cont'd)

Although there appears to be uncertainty about the pace of interest rate hikes down the road, the US economy's solid progress towards the Fed's dual mandate of maximising employment and maintaining stable prices will provide support for the interest rate normalisation process to continue. In particular, the US labour market has improved significantly and is in the vicinity of fulfilling maximum employment, supported by continued expansion of the US economy. Nonfarm payroll employment gains were solid, averaging 187 000 per month in 2016 and 178 000 per month in the first quarter of 2017. The unemployment rate trended lower to 4.5% in March, slightly below the central tendency of the longer-run normal level projected by the FOMC participants. Alongside a tighter labour market, average hourly earnings growth accelerated gradually from 2.4% year-on-year in the first quarter of 2016 to 2.7% in the first quarter of 2017 (***Chart 3a***).

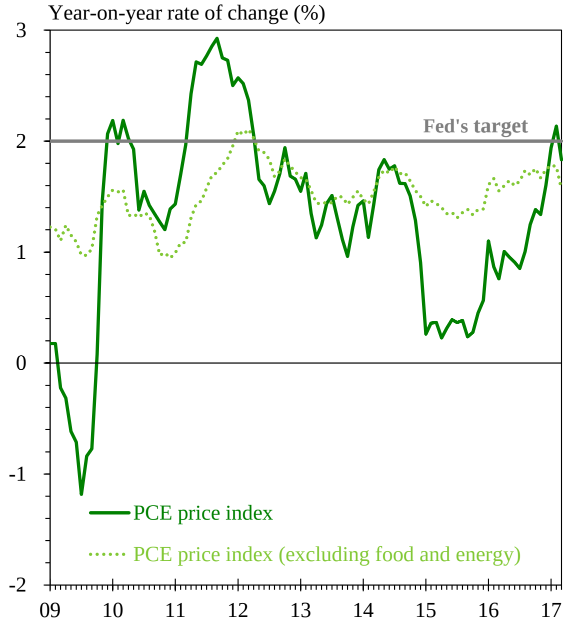
As for prices, personal consumption expenditure (PCE) inflation, the Fed's preferred measure, has moved closer to the Fed's 2% target, picking up progressively from 0.9% in the first quarter of 2016 to 1.4% in the fourth quarter and to 2.0% in the first quarter of 2017, on the back of the oil price recovery, while core PCE inflation averaged 1.7% in the first quarter of 2017 (***Chart 3b***).

Chart 3 : The US economy's solid progress towards the Fed's objectives for monetary policy will provide support for further interest rate normalisation down the road

(a) The labour market continued to improve



(b) PCE inflation has picked up



It is widely expected that the US economy will see slightly faster growth going forward. In April, the IMF projected the US economic growth to be 2.3% in 2017 and 2.5% in 2018, representing a pick-up from the 1.6% growth in 2016. Firmer economic expansion in the US, coupled with a further strengthening in labour market conditions, should help support a sustained pick-up in wage growth, which would in turn exert upward pressures on inflation. Hence the possibility of a faster pace of interest rate increases should not be ruled out.

Box 1.1 (Cont'd)

However, the still-evolving policy developments under the new US administration have complicated the US economic outlook and the Fed's course of monetary policy. On one hand, the proposed tax reforms and infrastructure spending plans, and initiatives to review financial regulations, if implemented in a timely manner, could provide a stronger impetus to US growth. Yet the sustainability of US long-term fiscal position could limit the availability of policy space. On the other hand, there are concerns about a possible rise in protectionist sentiment and the potential adoption of more inward-looking trade policies. The movements of the US dollar will also complicate the inflation picture. How the new administration's set of economic policies will ultimately impact on US growth and inflation, and hence the interest rate outlook, remains to be seen.

Another dimension of the Fed's monetary policy normalisation that deserves a close watch is the eventual scale-back of the Fed's balance sheet. In its May policy statement, the Fed once again indicated that the current reinvestment policy of longer-term asset securities is anticipated to continue until the normalisation of interest rates is well under way to help keep financial conditions accommodative. That said, according to the minutes of March's FOMC meeting, most participants judged that a change to the Fed's current reinvestment policy (implying a scale-back in the Fed's balance sheet) would likely be appropriate later this year, though the timing is still uncertain and would depend on economic and financial conditions. Given the various uncertainties surrounding the issue, market speculations about the Fed's preferred size and composition of its balance sheet as well as the appropriate timing to start its scale-back might affect financial and liquidity conditions in the period ahead.

While there are uncertainties surrounding the Fed's timing and pace of future interest rate hikes and hence risks of increased financial market volatility, Hong Kong is capable of navigating through capricious global financial conditions and of handling massive capital flows, thanks to our strong economic fundamentals and robust financial system. The Government will continue to closely monitor the US economic and monetary policy developments and their possible impacts on the Hong Kong economy.