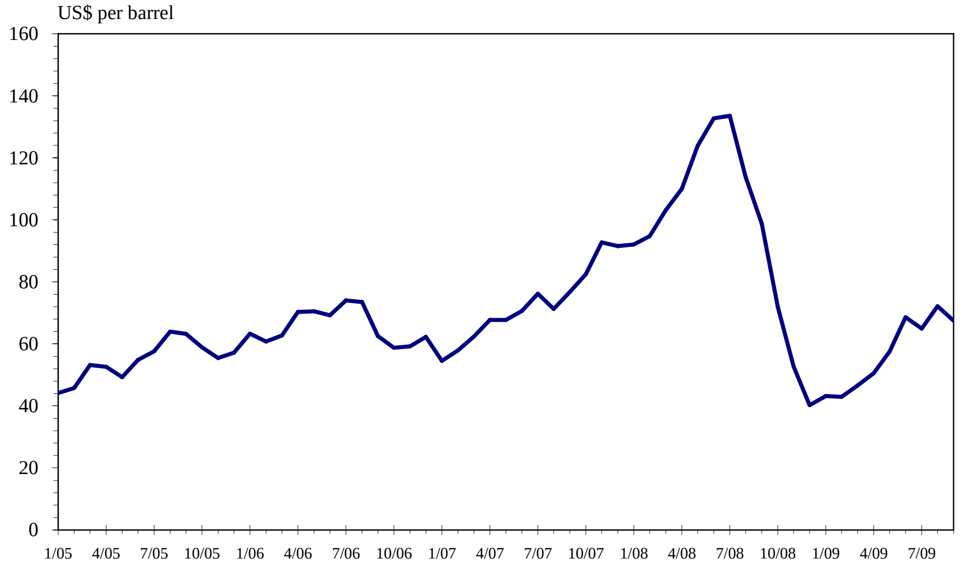
Box 6.1

Impact of recent oil price movements on consumer price inflation

International oil prices, like many other commodity prices, are usually volatile, and sensitive to changes in economic climate. Since the late 1990s, crude oil prices had been on an uptrend amidst large fluctuations, as a result of the fast growing demand from the emerging economies and the tight demand-supply balance. Despite the slowdown in the major advanced economies since early 2008, crude oil prices ran up further and reached a historic high in July 2008, before the correction set in. The outbreak of the global financial tsunami and the subsequent global synchronised recession also accelerated the fall in oil prices. The spot price of Brent crude oil, for instance, plummeted within six months from its peak of around US$145 per barrel to a trough of less than US$40 per barrel in December 2008. Crude oil prices then rebounded notably since March this year as global economic outlook improved. Over the past several months, oil prices fluctuated at around US$70 per barrel, with a further advance to around US$75 towards the end of October.

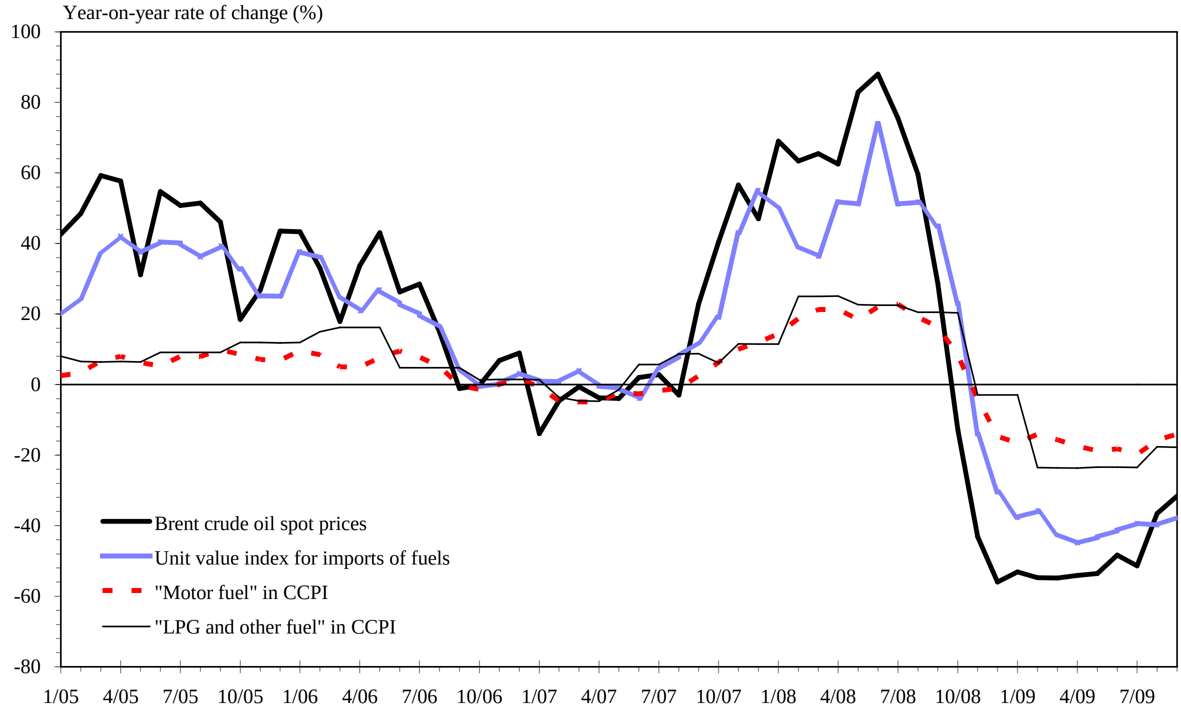
Chart 1 : The spot price of Brent crude oil (monthly average)



The prices of several items in the consumer price indices, such as "motor fuel" and "LPG and other fuel", are directly affected by or closely related to the movements of oil prices. These items together, however, have a small combined weighting of 0.89% in the Composite CPI. The changes in crude oil prices affect the import prices of fuels, which in turn lead to the adjustments in the prices of the fuel-related items at the consumer level. Past experience, as indicated in ***Chart 2***, suggests that crude oil prices, import prices of fuels and the prices of fuel-related items at the consumer level tend to move broadly together. Nevertheless, as illustrated in ***Chart 2***, the prices of fuel-related items at consumer level usually exhibit a much smaller degree of fluctuations than crude oil prices and import prices of fuels, mainly because the purchase costs of fuels only make up a fraction of the retail prices of the fuel-related products for final consumption. Other factors also account for the incomplete feed-through of the changes in crude oil prices to the local consumer prices of the fuel-related items: (1) exchange rates of Hong Kong dollar against the currencies of the import sources; and (2) movements in refinery and production costs as reflected by differences between prices of crude oil and refined oil products.

Box 6.1 (Cont'd)

Chart 2 : Movements of fuel-related consumer prices, import prices of fuels and international oil prices



Given the highly service-oriented nature of the Hong Kong economy, the direct impacts of oil prices on consumer prices are usually not significant. In the second quarter of 2008, when the underlying Composite CPI inflation rate was 5.7% and oil prices had significant increases over a year earlier, the contribution from the fuel-related products to the inflation rate was just 0.19 percentage point.

As oil prices were still notably lower than their year-ago levels in the third quarter of 2009, the contribution of fuel-related items to consumer price inflation had turned negative. Yet with the underlying inflation rate coming down to very low levels, at -0.3% in the third quarter, the negative contribution from the fuel-related items to consumer price inflation, at -0.18 percentage point, became relatively more evident.

The risks of a sustained price surge from current levels should be largely contained by large excess capacity and high inventories, unless there is a significant change in the oil market outlook. If crude oil prices are to stay at the recent levels of US$70-80 per barrel in the coming months (the IMF assumed a simple average price of US$76.5 per barrel in 2010 for UK Brent, Dubai and West Texas Intermediate crude oil in its latest World Economic Outlook), they will be notably higher than the year-ago levels and the contribution of fuel-related items to consumer price inflation will likely turn from negative to positive, reducing to some extent the deflationary pressure in the economy.