Box 1.2

The US Federal Reserve's third round of quantitative easing (QE3)

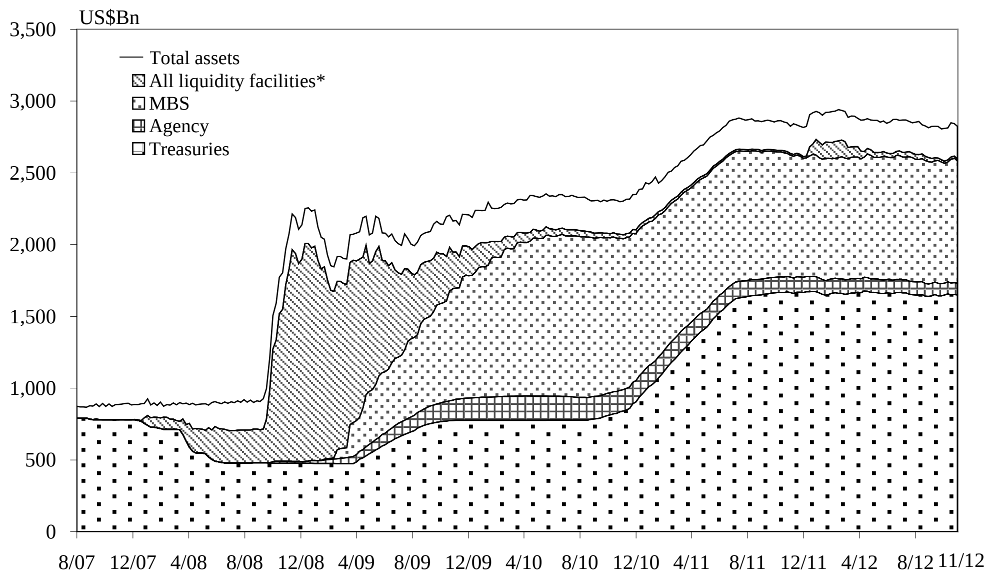
The US Federal Reserve (the Fed) announced on 13 September 2012[(1)] that it would purchase additional agency mortgage-backed securities (MBS) at a pace of US$40 billion per month, in a context of price stability, until the labour market conditions improve substantially. This new round of asset purchase action is commonly called QE3. Meanwhile, the Fed also anticipated its policy rate to stay at exceptionally low levels at least through mid-2015.

The Fed has employed a number of unconventional monetary policy measures over the past several years to contain the global financial crisis (see ***Box 2.1*** of the ***2010 Economic Background and 2011 Prospects***). As seen from ***Chart 1***, the various asset purchase programmes undertaken by the Fed, including the previous two rounds of QE, have resulted in a significant expansion of the Fed's balance sheet. Indeed, the size of its balance sheet before the announcement of QE3 was already more than tripled its pre-crisis level at mid-2007. Going forward, the Fed's balance sheet, the MBS portion in particular, can be expected to continue to balloon.

The effectiveness of QE is an issue of hot debate in the US, given the possible longer-term undesirable consequences in terms of higher inflation risk, resource misallocation, and moral hazard. Furthermore, regardless of whether QE3 is effective in achieving the Fed's objectives, its potential negative external side effects have already aroused much criticism from the emerging markets.

The previous rounds of QE in the US (similarly for QE in the EU and Japan), while reducing the systemic risk in the financial markets and pains of the Great Recession of 2008-09, has resulted in a global liquidity glut, which triggers greater volatility in cross-border fund flows, thereby heightening the risks of asset market exuberance and inflation in economies where fundamentals are relatively sound. The impacts on Hong Kong and other Asian economies have also been highly visible.

Chart 1 : Changes in the Fed's balance sheet since the global financial crisis



Note : (*) All Liquidity Facilities include: Term Auction credit; other loans; Commercial Paper Funding Facility; outstanding principal amount of loans to American International Group, Maiden Lane LLC, Maiden Lane II LLC, Maiden Lane III LLC, and TALF LLC; and central bank liquidity swaps.

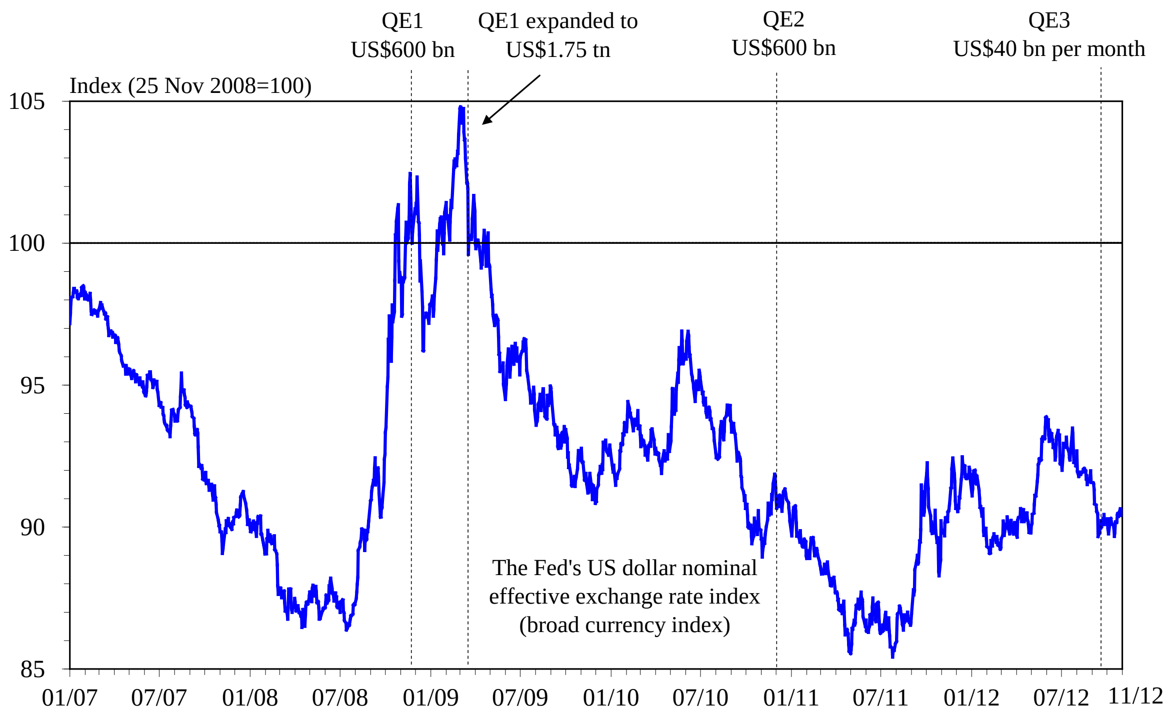
(1) FOMC statement: http://www.federalreserve.gov/newsevents/press/monetary/20120913a.htm.

Box 1.2 (Cont'd)

QE3, unlike the previous two rounds of QE, is open-ended and does not have a target size. As such, its cumulative side effects on Hong Kong and other Asian economies can potentially be substantial, although its effects at the current initial stage may still be not so evident.

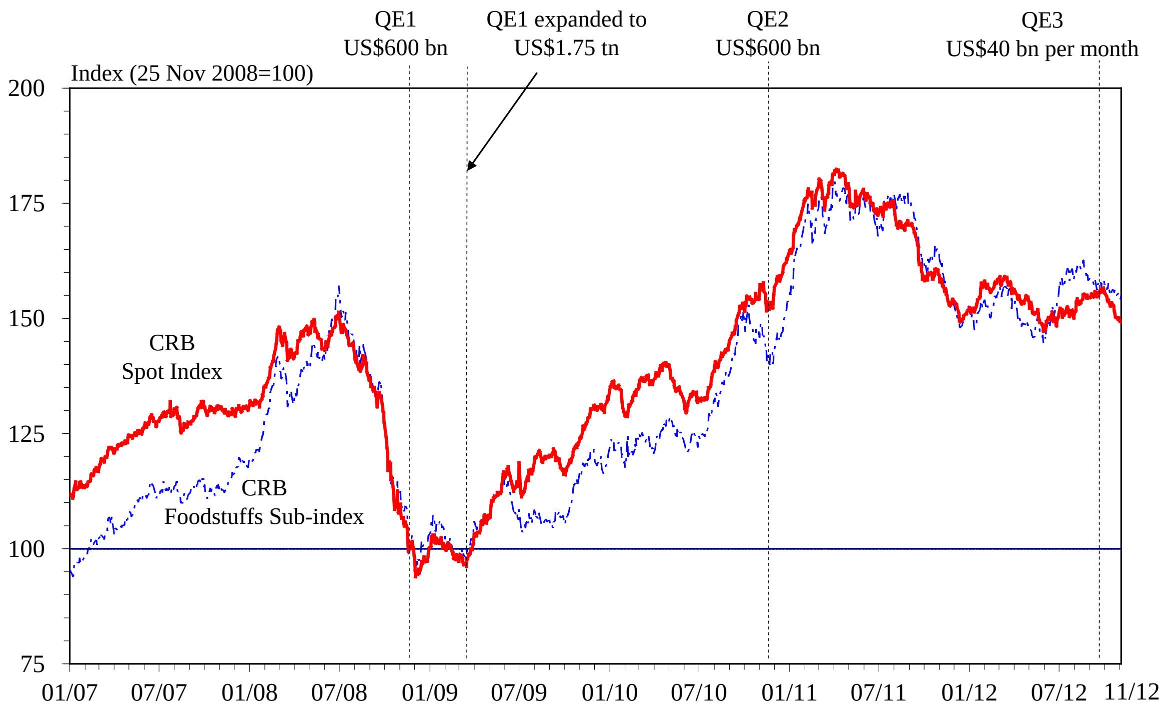
The highly accommodative monetary policy stance adopted by the Fed has resulted in heightened volatility in the US dollar exchange rate and global commodity prices. As illustrated in ***Chart 2***, the US dollar had been rather volatile since the announcement of QE1 in November 2008. Comparing October 2012 with November 2008, the US dollar nominal effective exchange rate index fell by about 10%. Over the same period, global commodity prices, using the CRB spot index as an indicator, rose by almost 50% cumulatively (***Chart 3***). As regards QE3, its immediate impact on global commodity prices has been mixed up till now, yet its longer-term impact remains to be seen. In particular, a resurgence in global commodity prices could pose upside risks to imported inflation in Hong Kong beyond the short term, and is a development to watch over closely.

Chart 2 : Movement of the US dollar exchange rate following announcements of QE programmes



Box 1.2 (Cont'd)

Chart 3 : Movements of world commodity prices



One of the intentions of the Fed's QE3 is to reflate asset prices, including housing prices, stock prices and other financial asset prices in the US. However, the resultant ultra-abundant liquidity and ultra-low interest rate environment are not exactly what Hong Kong needs now. The Government has reiterated its grave concern about the developments in the local property market, given the almost uninterrupted rally cumulating to a 107% increase in housing prices from the 2008 trough. While the local property market developments have also to do with the underlying demand-supply conditions, particularly the tight supply situation, the Fed's QE3 and its anticipation to keep interest rate low through mid-2015 would inevitably increase the risk of housing market exuberance further, thereby posing an on-going risk to Hong Kong's financial and marco-economic stability. A further side effect is the consequential surge in housing rentals and hence local inflation.

The advent of QE3 may also result in a fresh round of significant capital inflows into Hong Kong and other regional economies. Indeed, the Aggregate Balance of the local banking system increased in October for the first time since September 2009. In mid-September, in response to QE3, the Hong Kong Monetary Authority introduced the fifth round of tightening measures for property mortgage loans. In October, the Government also rolled out further measures to stabilise the housing market. Given the potential destabilising consequences of QE3 on the Hong Kong economy, the Government will continue to monitor the situation closely and take appropriate measures to safeguard Hong Kong's macroeconomic and financial stability as and when necessary.