Box 1.1

The US Federal Reserve's conditional timetable for tapering asset purchases

The Federal Open Market Committee (FOMC) of the US Federal Reserve (the Fed) began its third round of quantitative easing (QE3) in September 2012 by buying agency mortgage-backed securities (MBS) at a pace of US$40 billion per month. In December 2012, the Fed expanded its purchases by also taking up longer-term Treasury securities at a pace of US$45 billion per month, and tied its forward rate guidance to developments in unemployment rate, near-term inflation projection and longer-term inflation expectation.

FOMC members, though mostly approved of the effectiveness of the open-ended program in easing financial conditions and helping economic recovery, held diverse views on the potential costs and risks arising from the additional purchases[(1)]. As the US economy continued to recover at a moderate pace despite the drag from fiscal adjustment in the first half of this year, there were increased discussions on the possibility of scaling down QE3[(2)].

On 19 June 2013, after the FOMC meeting, Fed Chairman Bernanke put forward the conditional timetable for tapering asset purchases[(3)]. In essence, if the incoming data are broadly consistent with FOMC's forecast, the Fed would moderate the pace of its asset purchases in measured steps later this year, resulting in an end to QE3 around mid-2014. According to the FOMC's projections in June, the US unemployment rate was expected to come down gradually to 7.2-7.3% in 2013 Q4 and 6.5-6.8% in 2014 Q4 and the US economic growth to pick up to 2.3-2.6% year-on-year in 2013 Q4 and further to 3.0-3.5% year-on-year in 2014 Q4, while inflation would move closer to the 2% target.

As expectations on the prospect of QE3 began to shift, global financial markets saw notable gyrations in recent months, especially during May and June. The yield on 10-year US Treasury bond, albeit still close to its historic low, has increased by around 1 percentage point since early May, alongside rebounds in other longer-term rates (***Charts 1a and 1b***). Global equity and commodity prices (***Charts 2a and 2b***) as well as exchange rates have also turned more volatile.

At the current juncture, there is still much uncertainty surrounding the materialisation of the Fed's conditional timetable. Inflation in the US has been subdued and is likely to be less of a concern in the near term (***Chart 3a***). However, it remains to be seen whether the job gains would be large enough to bring down the unemployment rate (***Chart 3b***) and whether the private sector demand would strengthen to offset the fiscal drag and result in faster GDP growth in the coming quarters as forecast by the FOMC. Specifically, the recent rises in long-term interest rates, including the mortgage rates, may restrain the pace of the US housing market recovery as well as business investments going forward. The outlook for the US economy will also hinge on how the euro debt crisis will evolve and whether the emerging markets will maintain their growth momentum in the coming quarters.

---

(1) See, for example, the minutes of the FOMC meeting in September 2012, when QE3 was first launched (http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20120913.pdf).

(2) See, for example, the minutes of the FOMC meeting in March 2013, in which several FOMC members already opined that asset purchases could be reduced over the course of the second half of 2013 (http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20130320.pdf). Also, Fed Chairman Bernanke, during his Testimony to the US Congress on 22 May, already indicated that the Fed could slow down the purchases should the economic improvement sustain (see the archive of the hearing at http://www.jec.senate.gov).

(3) For details, see the transcript for the press conference held after the FOMC meeting in June 2013 (http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20130619.pdf).

Box 1.1 (Cont'd)

Chart 1 : Longer-term US Treasury yields picked up in recent months on the market expectation of potential asset purchase tapering

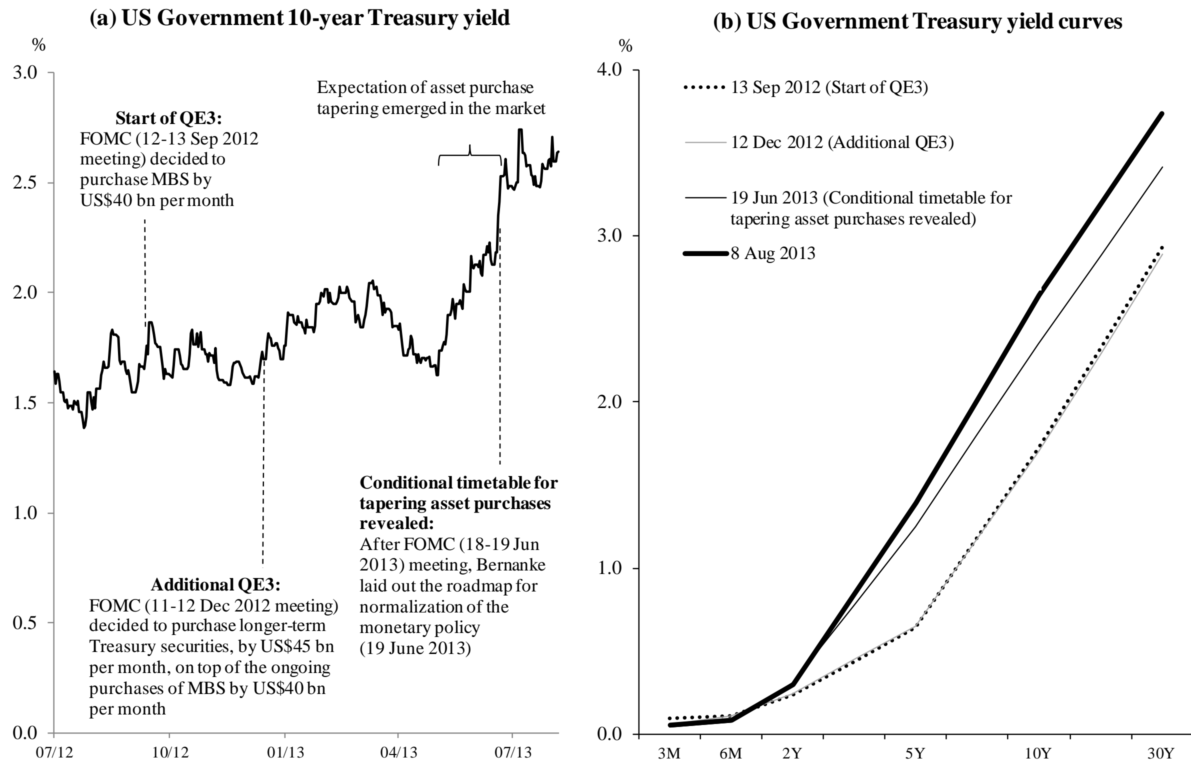
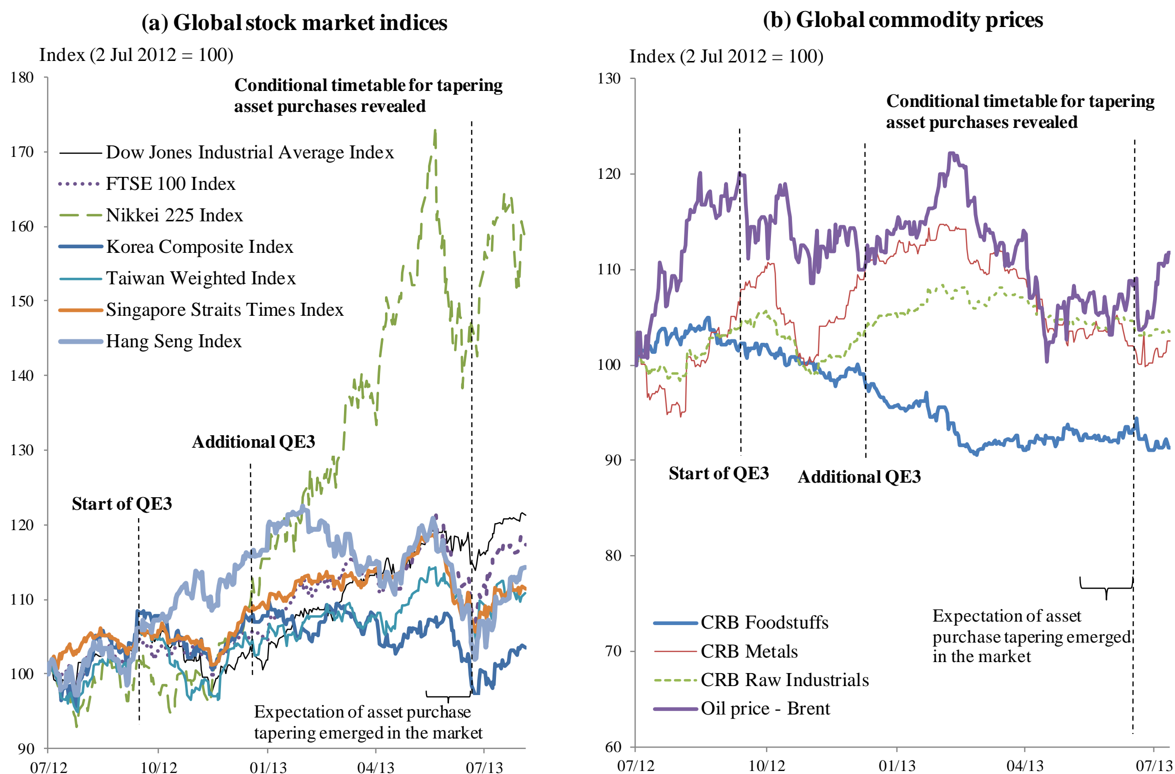
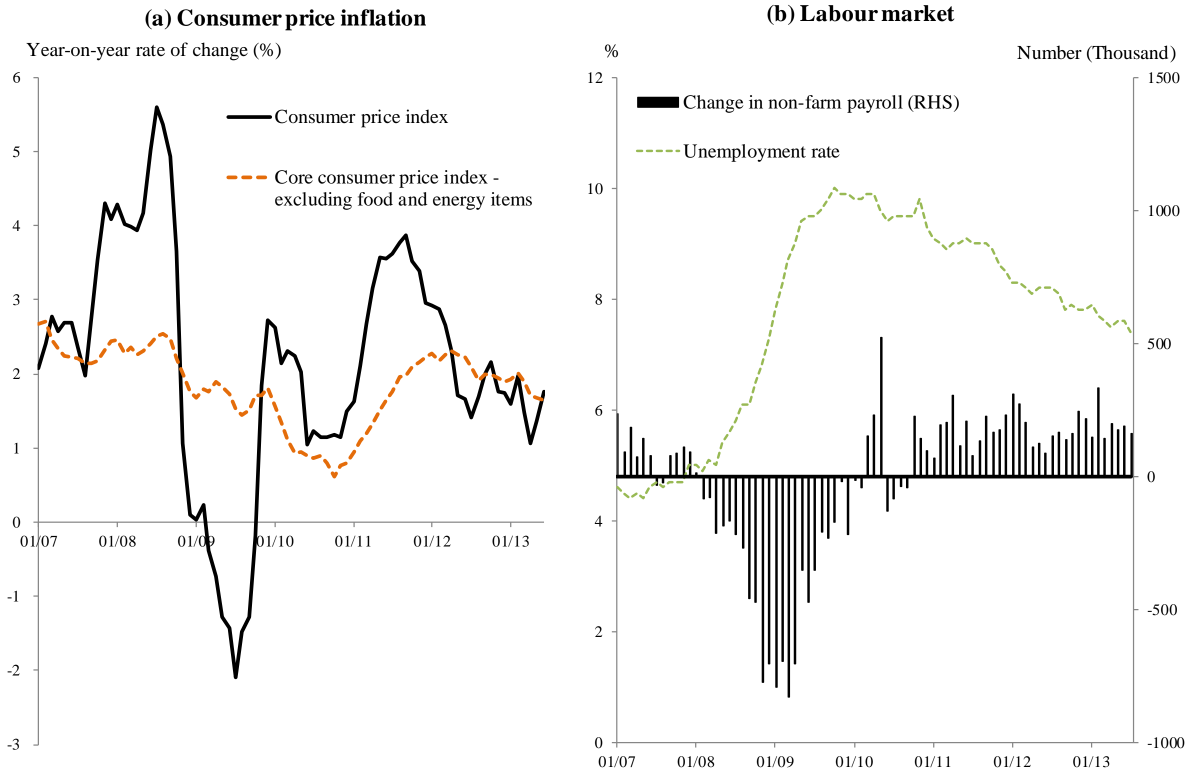


Chart 2 : Global stock and commodity prices saw notable gyrations of late



Box 1.1 (Cont'd)

Chart 3 : Recent developments of inflation and labour market conditions in the US



The Fed's several rounds of massive QE measures since the outbreak of global financial crisis in 2008 had quadrupled the size of its balance sheet by July 2013 (***Chart 4***). Even if the conditional timetable can be materialised, the Fed's balance sheet would continue to increase until its asset purchases come to an end in mid-2014. Fed Chairman Bernanke also indicated that the Fed would likely maintain unprecedented stimulus with a record-high balance sheet and near-zero target interest rate even after the Fed stopped asset purchases[(4)]. In other words, the global liquidity glut and low interest rate environment, created by the major central banks, including the Fed, the European Central Bank and the Bank of Japan, and being the major drivers behind cross-border capital flows and elevated asset bubble risks in some economies, would likely last for an extended period of time.

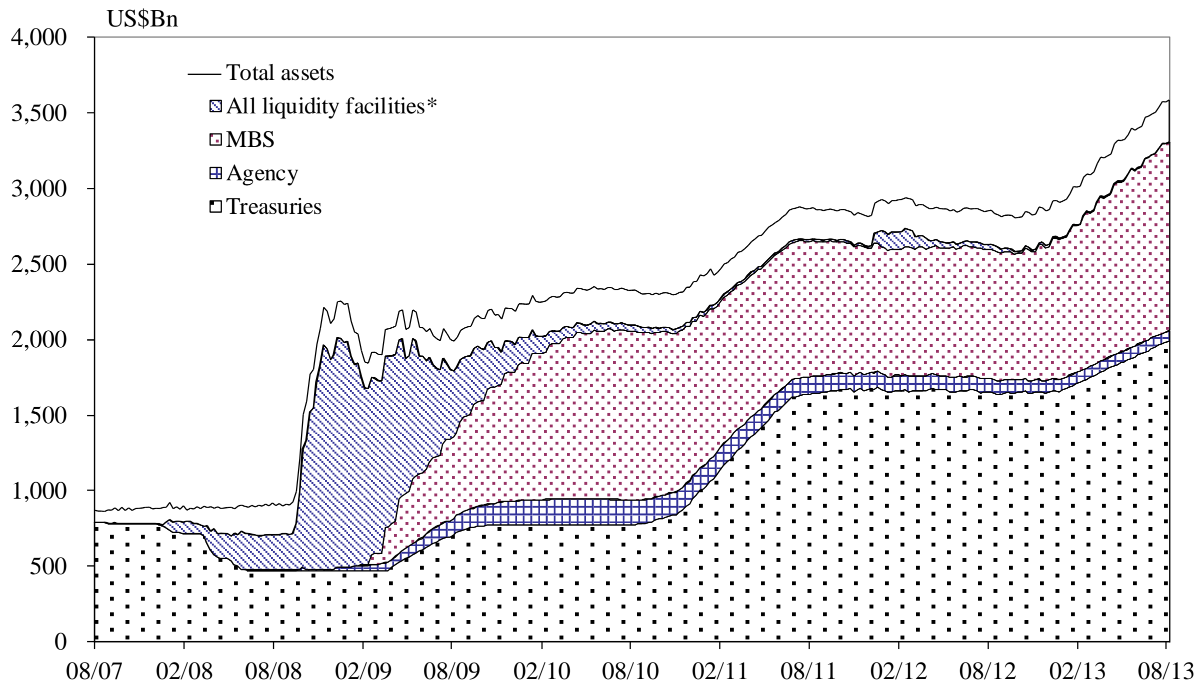
As far as Hong Kong is concerned, our small open economy is susceptible to the ebb and flow in global economic and financial conditions. There is much uncertainty about the Fed's imminent tapering of asset purchases, and also about when the various major central banks would eventually exit from their unconventional monetary policies. Market sentiments would be easily swung by incoming economic data and changes of policy actions by central banks, leading to heightened volatility in global financial, commodity and foreign exchange markets. Asian and emerging economies, including Hong Kong, may experience significant capital flow reversals, increasing the interest rate risks faced by investors and causing larger-than-desirable asset price fluctuations.

---

(4) See, for example, the testimony presented by Fed Chairman Bernanke to the US Congress on 17 July 2013 (http://www.federalreserve.gov/newsevents/testimony/bernanke20130717a.pdf).

Box 1.1 (Cont'd)

Chart 4 : Changes in the Fed's balance sheet since the global financial crisis



Note : (*) All Liquidity Facilities include: Term Auction credit; primary credit; secondary credit; seasonal credit; Primary Dealer Credit Facility; Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility; Term Asset-Backed Securities Loan Facility; Commercial Paper Funding Facility; and central bank liquidity swaps.

While Hong Kong's financial sector is more than capable of handling the massive capital inflows and outflows day in and day out, the local regulatory bodies have implemented various prudential measures to mitigate systemic risks and keep the financial system sound and resilient. Both supply-side and demand-side measures have also been implemented to contain the housing market bubble risks and to ensure its healthy and stable developments. The Government will stay vigilant to the developments in the external environment and roll out additional measures to safeguard Hong Kong's macroeconomic and financial stability as and when appropriate.