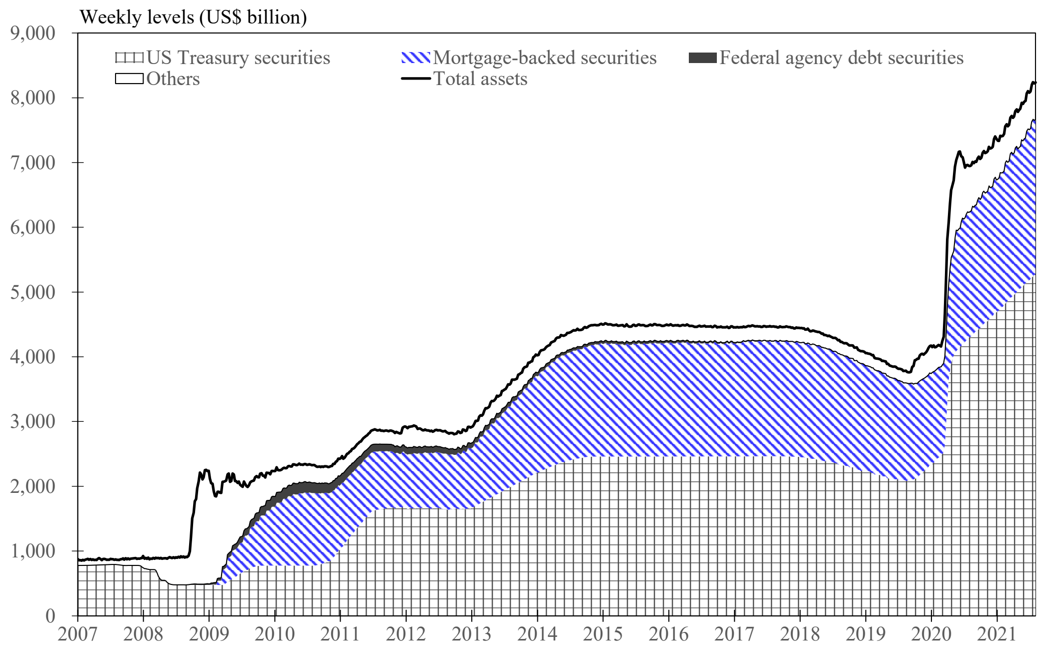
Box 2.2

Recent economic and monetary policy developments in the US

The US economy fell into a deep recession in the second quarter of 2020 due to the COVID-19 pandemic. Thanks to strong fiscal and monetary support, the US economy showed a sharp initial rebound in the third quarter of 2020 and gathered further steam entering 2021 alongside the rollout of mass vaccinations. Reflecting the sharp pick-up in demand amid economic reopening, supply constraints as well as an exceptionally low base last year, the US core inflation surged in the past few months, triggering concerns that the US Federal Reserve (Fed) may begin to adjust its ultra-loose policy stance earlier than previously anticipated. This box article examines developments in the US economy and monetary policy since the onset of the COVID-19 pandemic and their potential implications for the global and local economy.

The outbreak of the COVID-19 pandemic in early 2020 dealt a severe blow to the US economy. To curb the spread of the virus, stringent measures such as lockdowns and stay-at-home orders were imposed, resulting in an unprecedented economic contraction. To alleviate the economic pains and ensure stability and liquidity in financial markets, in March 2020 the Fed slashed the target range for the federal funds rate twice by a total of 150 basis points to an ultra-low level of 0.00%-0.25%. The Fed also restarted the quantitative easing programme through purchasing Treasury securities and agency mortgage-backed securities at no less than US$120 billion per month. As of 4 August 2021, the Fed's balance sheet scaled up visibly to US$8,235 billion, almost doubled the pre-pandemic level of US$4,159 billion at end-Feb 2020 and surpassed its previous peak of US$4,516 billion on 14 January 2015 by 82% (***Chart 1***).

Chart 1 : The Fed's balance sheet scaled up visibly after the outbreak of the pandemic



Note: Latest position as of 4 August 2021.
Source: Federal Reserve Bank of New York.

Box 2.2 (Cont'd)

Apart from rate cuts and quantitative easing, the Fed announced in late August 2020 a revised Statement on Longer-Run Goals and Monetary Policy Strategy. Average inflation targeting is adopted under the new framework, which means that following a period of inflation running below the long-run goal of 2%, the Fed will allow inflation to stay moderately above 2% for some time before adjusting its policy stance. Moreover, the Fed emphasised that its policy decisions will hinge on the "shortfalls" of employment from its maximum level, rather than the "deviations" from its maximum level, reflecting its view that a robust job market can be sustained without causing runaway inflation. With the Fed taking a more tolerant stance on inflation, the market generally expected a longer period of near-zero interest rates and easy financial conditions.

Thanks in part to the very accommodative monetary environment, the US economy has staged a notable rebound, with real GDP in the second quarter of 2021 (advance estimate) already surpassing its pre-pandemic level despite the uneven pace of recovery across sectors[(1)]. On the labour market front, the unemployment rate likewise fell considerably from the high of 14.8% in April 2020 to 5.9% in June 2021, but was still above the level of 3.5% in February 2020. Non-farm payroll employment, at 145.8 million in June 2021, was still 6.8 million lower than the level in February 2020 (***Chart 2a***). This suggested that more time is needed for the labour market to fully recover.

Chart 2a : Non-farm employment still fell short of the pre-pandemic level

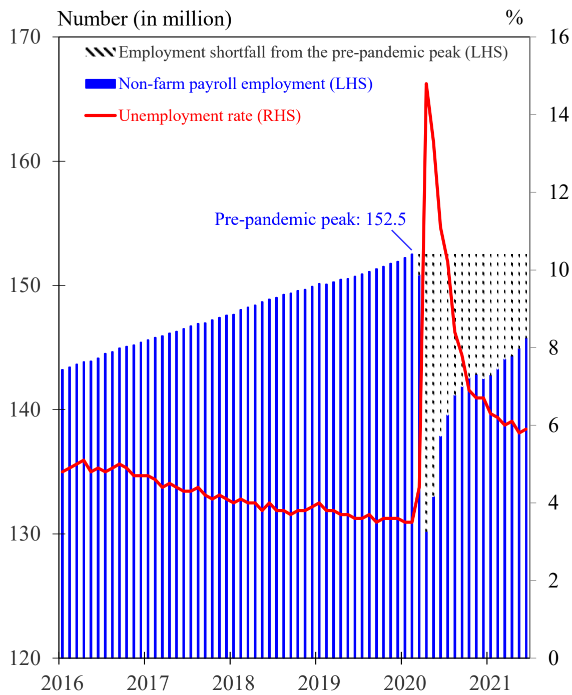
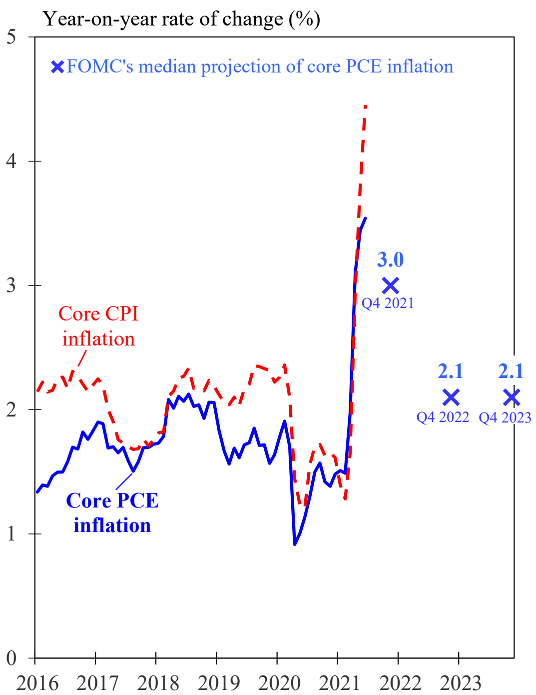


Chart 2b : FOMC's participants expected the recent surge in inflation to be transitory



Sources: US Bureau of Labour Statistics, Bureau of Economic Analysis and Federal Reserve.

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(1) Based on the detailed GDP data for the first quarter of 2021 (the latest), activity levels for sectors hard hit by the pandemic such as arts, entertainment, and recreation, and accommodation and food services were still noticeably below those in the fourth quarter of 2019 by 34.6% and 19.9% respectively.

Box 2.2 (Cont'd)

Notwithstanding the uneven recovery and the still substantial slack in the labour market, various measures of US inflation rose markedly in recent months and surprised the market. Core PCE inflation (excluding food and energy) picked up sharply from 1.5% in February to 3.5% in June. Core CPI inflation also accelerated to 4.5% in June (***Chart 2b***), the highest in almost 30 years. This reflected both surging demand amid reopening of the US economy and the supply bottlenecks, though a low base of comparison last year also contributed. There were heightened concerns that the strong monetary and fiscal support may have increased the risk of overheating in the US economy and pushed up inflation pressures.

In June 2021, participants of the Federal Open Market Committee (FOMC) meeting expected the recent surge in core PCE inflation to be transitory, with the median projection showing an ease-back in core PCE inflation to 2.1% in the fourth quarter of 2022 (***Chart 2b***). Meanwhile, a majority of participants expected the Fed would only start to raise interest rates in 2023, albeit earlier than that projected in March. In mid-July, Fed Chair Powell reiterated that he expected inflation to moderate after staying elevated in coming months. But he also added that the Fed would be prepared to adjust the stance of monetary policy if inflation was moving persistently beyond the Fed's target. In late July 2021, the Fed decided to keep the interest rate target unchanged and maintain the pace of asset purchases at no less than US$120 billion per month. Powell added that the timing of any change in the pace of asset purchases will depend on the incoming data, and advance notice will be provided before making such changes.

However, if US inflation continues to surprise the market on the high side, this may deepen market concerns about high inflation and drive up longer-term inflation expectations which have been well-anchored over the past decade or so. Indeed, the Beige book released in mid-July revealed that many business contacts of the Fed expected further increases in input costs and selling prices in the coming months, and expressed uncertainty or pessimism over the easing of supply constraints. Gauges of short-term and longer-term inflation expectations also generally rose on entering 2021[(2)], though the latter were often below the former, implying some abatement in inflation beyond the short-term. Given the dual mandates of achieving maximum employment and stable prices, the Fed would face a trade-off between curbing inflation and creating jobs. If the longer-term inflation expectation shifts to a level much higher than the Fed's target, the Fed may have to withdraw monetary support earlier than currently expected, potentially restraining economic and employment growth.

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(2) For example, according to the Survey of Consumer Expectations conducted by the Federal Reserve Bank of New York, the median one-year and three-year ahead inflation rose to 4.8% and 3.5% respectively in June, up by 1.8 and 0.5 percentage points compared to end-2020 levels. Results of the University of Michigan's Survey of Consumers suggested that the expected year-ahead inflation rate was 4.7% in July 2021, substantially higher than 2.5% in December 2020, whereas the expected inflation rate for the next five years averaged 2.8% in July 2021, up from 2.5% in December 2020. According to the Second Quarter 2021 Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, the median 5-year headline CPI and PCE inflation forecasts were 2.4% and 2.2% respectively, up from 2.0% and 1.8% in the fourth quarter of 2020. The 5-year breakeven inflation rate implied by US Treasury securities rose to around 2.5% of late, up from below 2% in early 2021.

Box 2.2 (Cont'd)

Yet, tapering of asset purchases and eventual unwinding of monetary accommodation need to be handled with care. Market speculations about the future path of the Fed's monetary policy may trigger a revaluation or sell-off of risky assets and intensify global financial market volatility with repercussions on investment and economic sentiments. Emerging market economies with weaker fundamentals could also face higher risks of capital outflows and currency depreciation, adding headwinds to their economic recovery.

The timing of the Fed to withdraw its monetary support is still highly uncertain, as it would hinge on the actual progress of the US economic recovery and the outturn of inflation. The market currently expects that the process of unwinding will likely be gradual. Under the Linked Exchange Rate System, Hong Kong interest rates cannot deviate substantially from their US counterparts, suggesting that any US interest rate normalisation will likely entail upward pressures on local interest rates. That said, Hong Kong has strong economic fundamentals as well as a sound and resilient financial system, capable of handling massive capital flows and volatile global financial conditions. The Government will closely monitor the US monetary policy developments and stay vigilant to their possible impacts on the Hong Kong economy.