Box 1
Depreciation of the Japanese yen and its impacts on Taiwan's economy

Since Shinzo Abe resumed the position as Prime Minister of Japan on 26 December 2012, his administration has actively adopted loose fiscal and monetary policies geared toward jolting the country out of its decades-long deflationary malaise. With the step by step implementation of various revival policies, the value of the Japanese yen dropped. This box will explore the major causes that led to the latest depreciation of the Japanese yen and its economic and financial impacts in Asia and Taiwan.

1. Abe's economic policies and changing domestic and international environments pushed the yen down

After taking office, Prime Minister Abe vigorously advanced new economic policies. Prompted by these policies and other concurrent factors, such as the gradually stabilizing economies of the US and the euro area, lasting merchandise trade deficits in Japan, and massive yen sell-off by international investors, the yen began to weaken.

1.1 Abe's assertion of economic policies is conducive to yen depreciation

Abe's administration launched a three-pronged economic plan, namely an accommodative monetary policy, an expansionary fiscal policy, and a growth strategy that encourages private sector investment, which are collectively dubbed "Abenomics." Major policy measures under implementation are as follows:

1.1.1 Expanding public expenditure

The administration put forth a hefty package of Emergency Economic Stimulus Measures worth 20.2 trillion yen (US$227 billion), of which 10.3 trillion yen will be put in broad categories of government spending with a focus on infrastructure.

1.1.2 Easing monetary policy

The newly appointed BOJ Governor Haruhiko Kuroda, who has been in office since 4 April 2013, announced at his first monetary policy meeting that, in order to achieve the 2% inflation target as early as possible within a two-year timeframe, the BOJ would conduct a quantitative and qualitative monetary easing policy, changing the target of open market operations from the uncollateralized overnight call rate to the monetary base. Within two years the monetary base and holding of long-term Japanese government bonds (JGBs) and ETFs will double from their original amounts to 270 trillion yen, 190 trillion yen and 3.5 trillion yen, respectively. Additionally, the outstanding balance of Japan Real Estate Investment Trust (J-REITs) holdings will increase by the amount of 60 billion yen to 0.17 trillion yen.

Expansionary quantitative easing (QE) pushed down long-term rates and the yield on ten-year JGB hit a new record low of approximately 0.32% on 4 April 2013. International investors successively shorted the yen and, meanwhile, carry trades (i.e. borrowing the yen at a low interest rate in order to invest in another currency that is likely to provide a higher return) resurged, triggering the yen's further depreciation.

1.2 Gradually stabilizing economies of the US and the euro area precipitated the yen's slide against the US dollar

Positive signs of economic recovery in the US began to appear from September 2012. Many leading indicators, such as property prices and the unemployment rate, continued meliorating. Economic and financial conditions in the euro area also stabilized progressively after the European Central Bank's announcement of the Outright Monetary Transactions (OMT) policy. These factors caused an upsurge in financial markets as investors bought back the US dollar and the euro as investment positions.

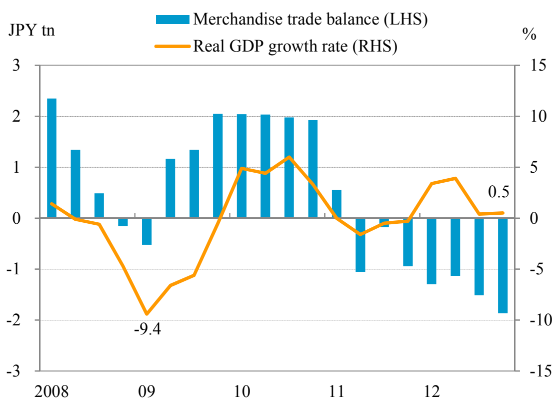
1.3 Expanding merchandise trade deficit in Japan exacerbated the yen's depreciation

Japan has posted seven consecutive quarters of merchandise trade deficits since 2011 Q2 (Chart B1.1), representing the longest period since 1985. Combined with its lackluster economic growth, the situation intensified the trend of yen depreciation. The major factors causing the expansion of Japanese trade deficits are as follows:

(i) Short-term factors: global economic slowdown and huge fuel imports due to the shut-down of nuclear power plants after the devastating earthquake and tsunami in Fukushima in March 2011.

(ii) Long-term factors: Corporates' offshore production and sliding competitiveness in niche products, such as motor and engineering

Chart B1.1 Merchandise trade balances and real GDP growth rates in Japan



Source: Ministry of Finance and Cabinet Office, Japan.

industries, as well as the structural shift stemming from reducing demand for nuclear power.

2. Yen depreciation would benefit Japanese export competitiveness but could destabilize the exchange rates of emerging Asian economies

2.1 Yen depreciation would be conducive to Japanese export competitiveness

The yen's real effective exchange rate dropped 17.6% between October 2012 and March 2013 (Chart B1.2), which helped raise the relative advantage in its export prices and hence benefited export competitiveness. Owing to its increase in the exportation of organic compounds and motor components, the annual growth rate of overall exports reached 6.4% in January 2013, the first positive growth seen in the most recent consecutive eight months. However, it subsequently decreased to 1.1% in March 2013 as exports to Mainland China and the European Union (EU) slipped.

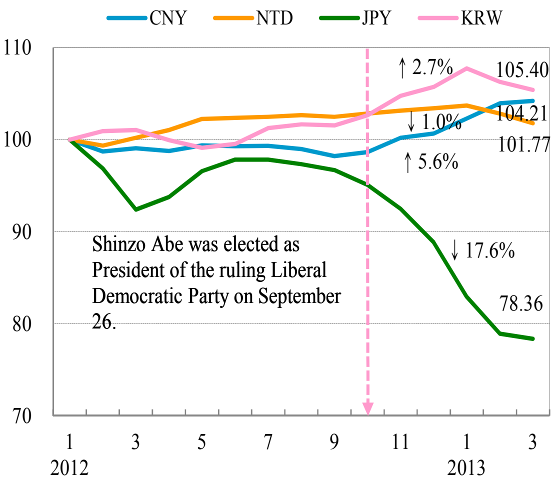
2.2 Yen depreciation could impact the South Korean economy because of their export structure similarities

Among major economies in Asia, Japan and South Korea are most similar in the type of exports. Therefore, South Korea's exports are most likely to be hurt most by the yen's depreciation, particularly in the shipping, steel and motor industries. Thus, competition between Japan and South Korea will be stiffer. After the latest G20 meeting, the Bank of Korea expressed its hope for Japan not to weaken the yen intentionally and that it would keep a close watch on the impacts of Japan's stimulus measures on the South Korean economy.

2.3 Yen depreciation could destabilize the exchange rates of Asian economies

Due to the yen's depreciation, Southeast Asian countries can perhaps benefit from increasing demand for their raw materials and intermediate goods or products driven by the expansion of Japanese

Chart B1.2 The change in real effective exchange rates in Asia



Notes: 1. January 2012 = 100.
2. ↑ and ↓ represent appreciation and depreciation, respectively. % refers to the rate change between October 2012 and March 2013.

Source: BIS effective exchange rate, broad indices.

exports. Among these countries, Thailand's economic outlook, which may benefit from being part of the production supply chain of the Japanese motor industry, could be optimistic. However, Asian countries, taking into account their high degree of export competitiveness, might be prompted to adopt responsive measures to stabilize their exchange rates in the case of excessive fluctuations in the yen-dollar rate.

3. Impacts on the economy and finance in Taiwan

3.1 Massive international hot money flowed in and out of the local foreign exchange market, affecting the stability of the NT dollar exchange rate

With international hot money veering into Asia, the net inflow of foreign capital increased in 2012 Q4, exerting appreciating pressure on the NT dollar.

3.2 Yen depreciation can help decrease Taiwan's trade deficits with Japan and reduce production costs

As Japan is the number one source of imports and the fourth-largest export destination for Taiwan, a huge bilateral trade deficit with Japan has persisted for a long time. In 2012, Taiwan's imports from Japan (about US$47.6 billion) were much higher than its exports to Japan (about US$18.9 billion.) At the same time, the weight of yen-denominated imports was also larger than that of exports. Thus, when the yen's value falls versus the US dollar, the decreased value of imports, converted into US dollars, will be larger than that of exports in the short run. Under this situation, Taiwan's trade deficit with Japan is expected to narrow temporarily. Chemicals and machinery, two major imports from Japan that constitute a hefty portion of Taiwan's trade deficits, will benefit more from the yen's depreciation.

3.3 The purchasing power of Japanese visitors to Taiwan will decrease while that of Taiwanese to Japan will increase

The yen's depreciation will lessen the incentives and consumption ability of Japanese visitors to Taiwan. On the contrary, the number of Taiwanese tourists to Japan will rise because of the increase of their purchasing power.

3.4 Yen depreciation could dampen the investment intentions of Japanese corporations in Taiwan, but will be helpful for Taiwanese enterprises hoping to buy Japanese technology

Japanese corporations, in order to reduce costs and diversify risks, have been actively investing in Taiwan. Coupled with the close network between the two countries in terms of industrial clusters development and the improved cross-strait relationship, Japanese investment in Taiwan rose steadily in recent years. Although the latest yen depreciation could affect their intentions to invest in Taiwan, corporations' long-term investments generally focus on future returns, and the appreciation or depreciation of currencies is not the only reference indicator. Furthermore, the yen's depreciation can raise the relative purchasing power of the NT dollar, which is beneficial for Taiwan's enterprises to engage in direct investment in or purchase technology from Japan.

3.5 The costs of imports from Japan are expected to decline but the impact on consumer prices will be minimal

Even though the yen's depreciation can help reduce the costs of imports, the merchandise imported from Japan largely arises from derived export demand, including key components and capital equipment. Therefore, the impact of the yen's depreciation on domestic consumer prices will be limited. Moreover, price rigidity normally exists in the adjustment process of commodity prices. Following the yen's depreciation, the level of price reduction for consumer goods in the short term probably won't be noticeable. However, in the case where the yen continues depreciating, domestic enterprises would face rising pressures to lower their commodity prices.