Box 2.1

Recent economic policy in Japan and its impacts on the Hong Kong economy

Japan has experienced slow economic growth and persistent deflation for a prolonged period. To revitalise the economy, the Japanese authorities under the leadership of Prime Minister Shinzo Abe put forward an ambitious policy approach, popularly known as the "three arrows" of "Abenomics", comprising bold monetary easing, a flexible fiscal policy and a growth strategy.

1. **Bold monetary easing**
   The Bank of Japan (BoJ) overhauled its monetary policy framework this year, introducing an "open-ended asset purchasing method" with a view to achieving an inflation target of 2% in two years. Under the new framework, the BoJ set out a sizeable asset purchase programme in April, aimed to double the monetary base by 2014 and expand the purchases to cover longer-dated government bonds and other risk assets.

2. **Flexible fiscal policy**
   The Diet approved a JPY 13 trillion supplementary budget in February, amounting to 2.7% of GDP，so as to complement monetary easing and bring an end to deflation. However, Japan's government is already running a high fiscal deficit, with gross public debt at about 230% of GDP, the highest among OECD countries. To arrest the swelling public debt, the government decided in October to raise the sales tax rate, from the current level of 5% to 8% in April 2014 and further to 10% in October 2015, accompanied by a JPY 5 trillion stimulus package to alleviate the adverse impacts.

3. **Growth strategy**
   To bolster Japan's competitiveness, the government in June proposed a growth strategy outline, laying out such goals as entering the Trans-Pacific Partnership (TPP) negotiations, raising the female labour participation rate, reviving private investment through tax incentives and establishing National Strategic Special Zones. However, specific measures in many areas remain to be formulated.

The first two arrows of "Abenomics" were shot in the first half of the year and received positively by the market. Japanese stocks rose, while long-dated government bond yield fell. Yet the most prominent effect was a sharp depreciation of the yen spurred by aggressive monetary easing. While the yen regained some ground after the US Federal Reserve's signal at mid-year to taper in due course, it still slid by 16% against the US dollar during the first nine months of the year, or by around 15% on a real effective exchange rate basis.

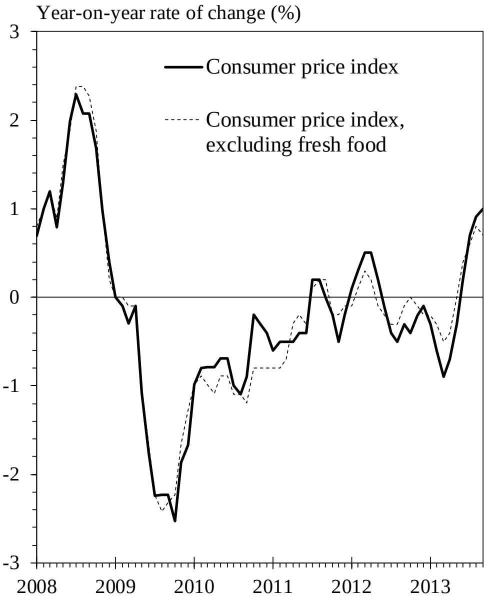
Japan's economy, buoyed by the reflationary policies, also showed some improvement. Real GDP exited contraction and posted visible sequential growth in the first half of the year, driven mainly by stronger consumer spending on wealth effects. Consumer price inflation, notched up by higher imported energy prices following a weaker yen and stabilising trends in other major components, has also turned positive since June 2013 (***Chart 1***).

However, the longer-term growth sustainability is still an open question. The improvements brought by monetary easing and fiscal stimulus could only be extended by the follow-through of structural reforms, whose details have yet to be formulated and debated. Besides, the planned sales tax increases and possibly further fiscal adjustments to fix its public finance could restrain the growth pace of the economy. The task of raising growth potential will further be complicated by the acute energy and demographic challenges.

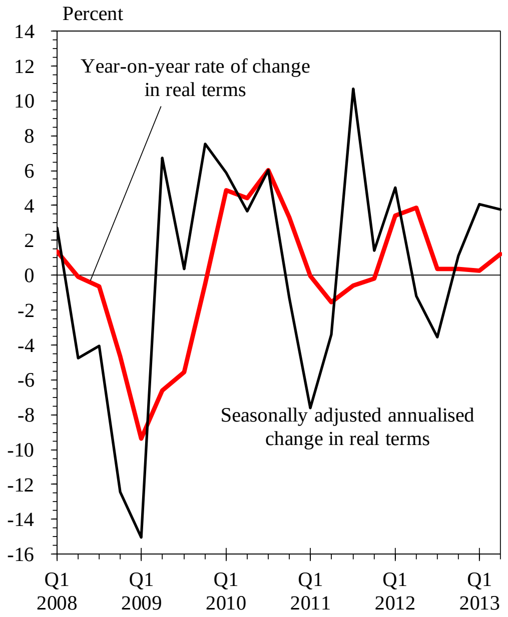
Box 2.1 (Cont'd)

Chart 1 : The Japanese economy showed some improvement in 2013

(a) Consumer price inflation



(b) Real GDP growth



The impacts of Japan's new policy on the Hong Kong economy have been more discernible through its effects on external trade and travel services emanating from a weaker yen. Specifically, in the first nine months of the year, Hong Kong's exports of goods to Japan declined by 6.3% in volume terms over a year earlier, while the number of Japanese visitors to Hong Kong fell visibly by 22.1%. It appeared that the large depreciation of the yen following the launch of "Abenomics" had dampened Japanese demand for goods imports and travel services. However, Hong Kong's import volume of Japanese goods stayed on a downtrend over the same the period, falling by 7.2%, possibly reflecting sluggish re-export trade involving Japan. In contrast, the number of Hong Kong visitors to Japan surged by 49.5% over the period, though this was partly distorted by the low base in 2012. On the price front, prices of imports from Japan posted a 2.0% year-on-year decrease in the first nine months of the year, partly contributing to Hong Kong's subdued imported inflation.

As for capital flows, Japan's new round of monetary easing has not yet ignited a new wave of hot money pouring into Asia. In fact, the improved economic prospects have led to more capital flows into rather than out of the Japanese economy. According to statistics from Japan's Ministry of Finance, in the first eight months of the year, portfolio investment in Japan recorded a net inflow of JPY 21.5 trillion, reversed from a JPY 6.1 trillion net outflow in 2012.

In sum, despite some positive outcomes from Japan's recent policy efforts, the longer-term effectiveness is still unknown, depending on the success of planned structural reforms. As the second largest Asian economy, a stronger Japan emerging from comprehensive reforms could certainly render benefits to the region, including Hong Kong. But before that happens, the uncertainty arising from its monetary easing and the uneven progress of its structural reforms could heighten the volatility of the yen and the regional financial markets, with possible spill-over to Hong Kong. The Government will monitor the situation closely.