The Changing Structure of Japan's Balance of Payments—Implications of the Shrinking Trade Surplus in Goods and Services

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1. Introduction

In the past, Japan's balance of payments has been characterized by a persistent and large trade surplus, with the deficit in services (such as travel, for instance) being eclipsed by a huge merchandise (goods) trade surplus.

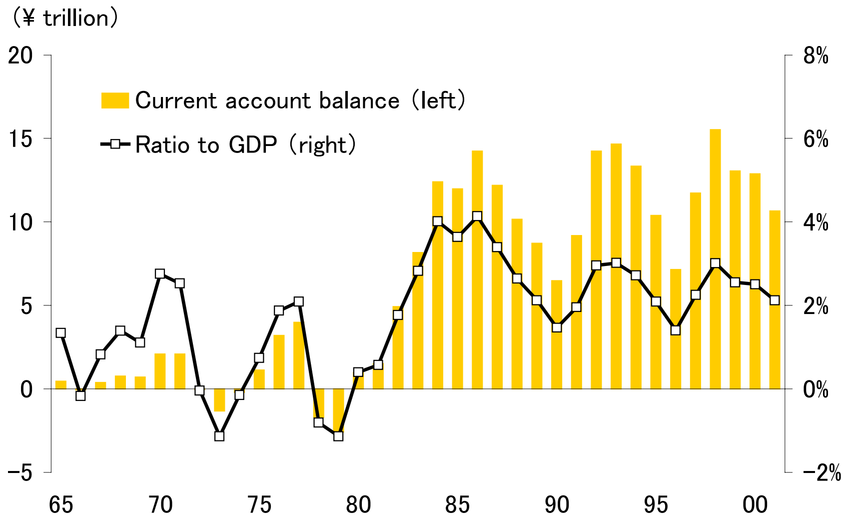
However, after reaching 9.5 trillion yen in 1998, the trade surplus plunged for three straight years, dropping to 7.4 trillion yen in 2000, and again by half to 3.2 trillion yen in 2001. Compared to a dip in the services deficit to 5.3 trillion yen, the merchandise trade surplus plummeted to 8.5 trillion yen in 2001 (from 16 trillion in 1998) due to sluggish export growth amid relatively steady import growth. In particular, a flood of imports from China has expanded Japan's bilateral trade deficit with that country to a hefty 3.3 trillion yen.

The most commonly used measure of the balance of payments is the current account balance, which includes the balance of trade in goods and services, net income balance for investment and labor income, and current transfer balance.

Following World War II, as Japan grew internationally competitive and mounted a successful export drive, the current account balance became consistently positive around 1970. Despite a brief period of deficits due to the two oil shocks, the current account remained large and positive from the 1980s, to the point of exacerbating trade friction with Japan's trading partners.

For the world as a whole, the balance of payments is zero by definition, with surpluses in some countries being offset by deficits in others. Whether a particular country is in surplus or deficit does not necessarily indicate that country's economic health. However, since a persistent deficit must be financed with foreign currency reserves or capital inflows from abroad, current account trends are a major concern of international financial markets and economic policymakers.

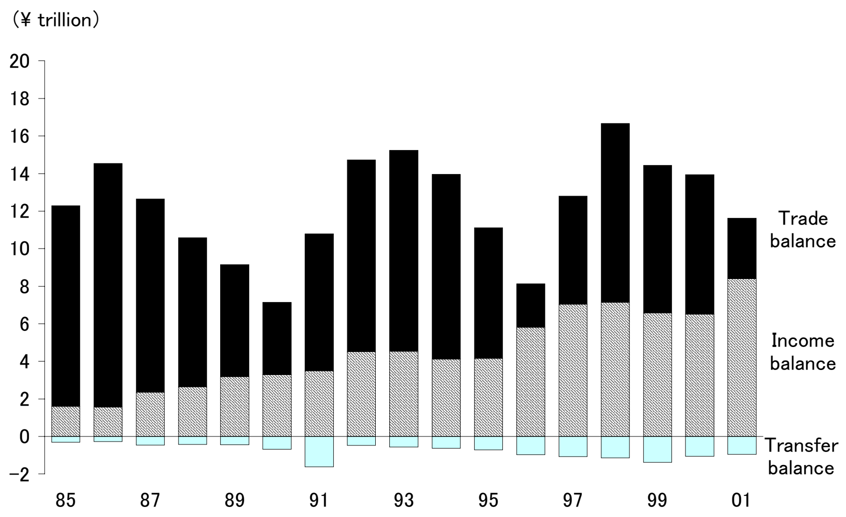
Figure 1　Current Account Balance



Source: Ministry of Finance, *Balance of Payments*.

Despite the 3.2 trillion yen decline in Japan's trade balance in 2001, the current account surplus declined by only 2.2 trillion yen to 10.7 trillion yen mainly because another major component of the current account—the income surplus—grew from 6.5 trillion yen to 8.4 trillion yen. The growing size of the income surplus, which now almost rivals the trade surplus, is indicative of major structural changes occurring in Japan's balance of payments.

Figure 2　Composition of the Current Account Balance



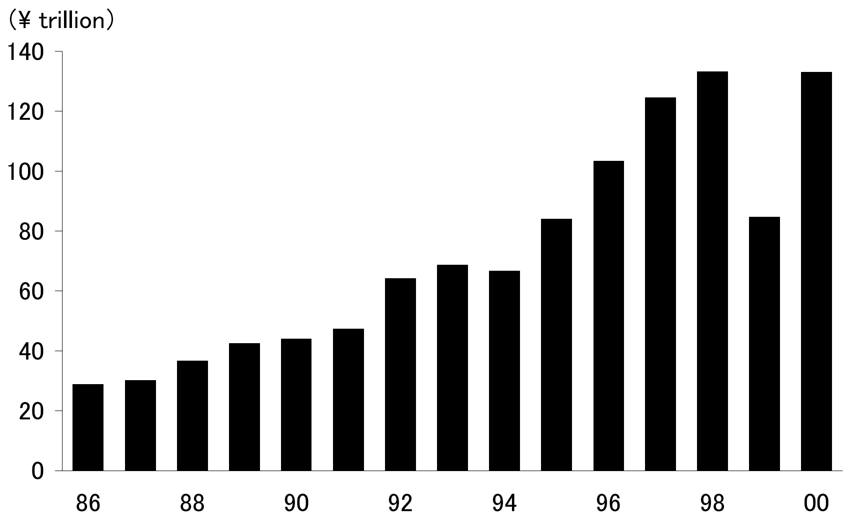
Source: MOF, *Balance of Payments*.

2. Growth in Net Foreign Assets

Japan owns foreign assets in other countries, and other countries also own assets in Japan. A current account surplus implies that foreign assets acquired by Japan in that year exceed foreign assets acquired by other countries, such that Japan's net foreign assets have grown. While the yen value of foreign assets fluctuates based on the exchange rate and other factors, the persistent current account surplus implies that net foreign assets owned by Japan have continued to grow. Indeed, Japan's net foreign assets expanded from 29 trillion at the end of 1986 to 133 trillion yen in 2000.

Japan's foreign assets consist of: (1) direct investment by Japanese companies in local subsidiaries abroad, (2) portfolio investment in foreign stocks and bonds, (3) international loans, and (4) foreign currency reserves. Since the late 1980s, a major reason Japan's foreign assets have grown is the increase in direct investment during the bubble era, prompted by: (1) the strong yen following the 1985 Plaza Accord, which hurt export profits, and (2) strong earnings growth, which encouraged companies to expand their presence abroad. After the bubble economy collapsed, poor earnings reduced the risk tolerance of Japanese companies, causing direct investment to slow down, while monetary easing reduced interest rates to new lows, expanding the spread between domestic and foreign interest rates and stimulating investment in foreign securities. As for stock investment, while Japan continued to invest in foreign stocks, foreign investment in Japanese stocks was even greater, and the result has been a continual net decline.

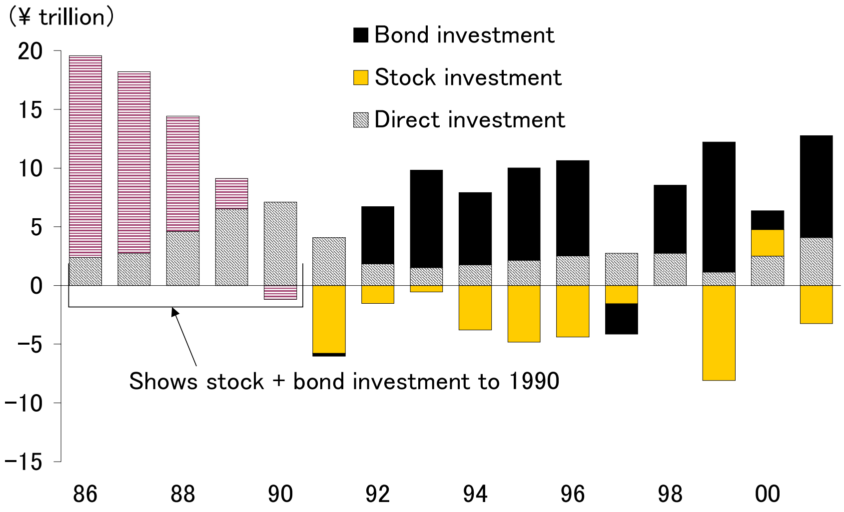
Figure 3 Net Foreign Assets of Japan



Source: MOF, *International Investment Position of Japan*.

Despite fluctuations due to interest rate and exchange rate trends every year, income from foreign assets has grown over the long term. The income surplus, which stood at only 1.6 trillion yen in 1986, grew to 8.4 trillion yen in 2001. In the future, if Japan's foreign stock and bond holdings continue to grow, dividend and interest income will also increase. As long as the current account balance remains positive and net foreign assets continue to grow, the income surplus will keep expanding as well.

Figure 4 Composition of Net Foreign Assets (Japan)



Source: MOF, *Balance of Payments*.

3. Effects of the Growing Income Surplus

Ever since Japan began consistently posting current account surpluses in the mid 1970s, economic policies have struggled with the problem of alleviating trade friction and the strong yen. Trade disputes date back to when the current account balance was still negative, starting with textiles in the 1960s, and followed by steel, automobiles, and semiconductors. However, as the current account surplus surged in the 1980s, economic friction intensified with other countries, who viewed the problem not on the level of individual products and industries, but as a fundamental problem with the structure of Japan's economy. Friction was most severe with the U.S., who at the time was struggling with twin deficits in the federal budget and current account.

Japan's economic friction with its trading partners tends to heat up depending on the other country's economic condition. For Japan, a trade surplus in goods and services implies that domestic production exceeds domestic demand. But for Japan's trading partners, the corresponding trade deficit implies that despite a healthy domestic demand, domestic production is being partly crowded out by imports. Any resulting increase in unemployment creates political pressure to curb the rather visible Japanese imports.

The severity of economic friction depends not only the level of the current account surplus but on its composition—whether the surplus derives from the trade balance, or from income balance components such as direct investment and portfolio investment.

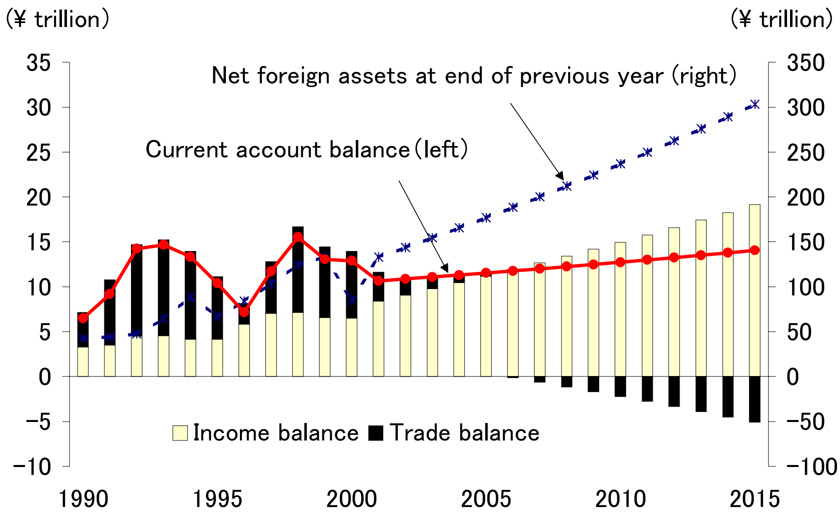
With respect to the income balance, income from direct foreign investment signifies economic activity by Japanese companies abroad, which helps create local jobs, while asset income from foreign portfolio investment does not affect the employment situation abroad. Thus for Japan, compared to a worsening trade surplus, an income surplus does not aggravate unemployment abroad, and is thus less likely to cause trade friction.

However, a persistent current account deficit nonetheless reduces foreign currency reserves, increases foreign ownership of government bonds, and encourages acquisitions by foreign companies. This can cause national emotions to flare up, as happened in the U.S. when Japan went on a buying spree and snapped up U.S. companies and real estate properties. While many economists see no problem with a current account deficit, governments tend to shun a growing current account deficit on the basis that interest payments on bonds owned by foreigners represents income flowing out of the country.

But income surplus or not, other nations will not necessarily tolerate Japan's growing current account surplus forever. We simulated the growth of net foreign assets, assuming for simplicity that the current account surplus remains at 2.1% of nominal GDP (the level in 2001), and that the return on net foreign assets also remains at the 2001 level. If increased each year by the amount of the current account surplus, net foreign assets will expand from the present 26% of nominal GDP to 34% by the end of 2006, while the income surplus alone will reach 2.1% of nominal GDP. Since we assume limited growth for the current account surplus, the growing income surplus entails that the trade surplus will decline and eventually turn negative.

The assumption of the current account surplus remaining at 2.1% of nominal GDP may seem causally flawed and unrealistic. But for the exchange rate to remain stable, a suitable capital outflow must accompany the growing current account surplus. Exchange rate risk could restrain outward direct and portfolio investment below this level. If the supply of foreign currency generated by the current account surplus significantly exceeds foreign currency demand for outward investment, the yen will appreciate unabatedly. From the perspective of the trade balance, an overvalued yen will automatically depreciate as falling exports and rising imports reduce the current account surplus.

Figure 5 Possibility of a Trade Deficit in 2006



Sources: MOF, Balance of Payments, and *International Investment Position of Japan.*

But as foreign assets accumulate year after year, the resulting growth in income surplus will sustain the current account surplus and strong yen, ravaging the trade surplus. Japanese companies will lose competitiveness not only in the export market but the domestic market. As a result, the trade surplus will gradually diminish, eventually turning to deficit.

The phenomenon in which foreign assets accumulate to the point of altering the structure of the current account is not peculiar to Japan, but long studied in economic theory linking the balance of payments structure to stages of economic development. Moreover, Japan's population structure is also predicted to change due to rapid aging, resulting in a declining labor force and reduction in household savings. Thus not only will Japan enter a stage of lower international competitiveness, but the aging population will curtail productivity and export capacity as well, causing the trade balance for goods and services to turn negative.

Figure 6 Economic Development Stages and the Balance of Payments Structure

Stage of development	Economic circumstances	Trade account	Fiancial account	Capital account	Current account
Debtor nation					
1st stage	Economy developing; not yet competitive	−	−	+	−
2nd stage	Become competitive; start paying foreign debt	+	−	+	−
3rd stage	Paying foreign debt; positive current account	+	−	−	+
Creditor nation					
1st stage	Debt payments end; capital export begins	+	+	−	+
2nd stage	Economy matures; negative trade balance	−	+	−	+
3rd stage	Foreign assets are consumed	−	+	+	−
Net debtor nation	Become net debtor again	−	−	+	−

Note: Shows how a country's balance of payments changes with each stage of economic development.
Source: *Fiscal 1984 White Paper on Trade*.

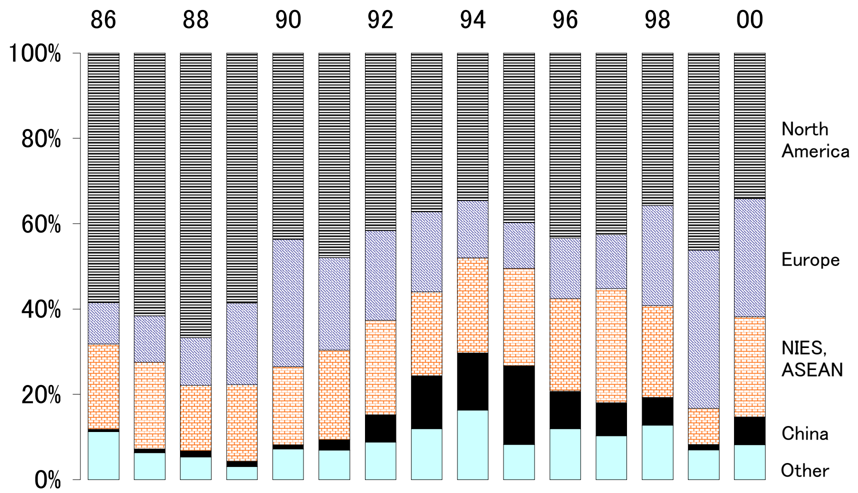
4. Perspectives on Deindustrialization

Under the postwar Breton Woods regime, the exchange rate remained fixed at 360 yen to the dollar for several decades. When the U.S. abandoned the gold standard in 1971, the exchange rate appreciated to 308 yen, raising concerns of deindustrialization that have lingered around ever since. In particular, the yen's surge following the Plaza Accord damaged export profitability, and propelled manufacturers to set up operations in Asia's NIES countries, where labor was cheap. Not only was export production transferred out of Japan, but Japanese automakers even began reverse-importing products into Japan.

Looking at Japan's industrial structure in terms of employment, since 1970 the manufacturing sector has accounted for a declining percentage of employment, while that of the tertiary sector has risen. Manufacturing employment, which comprised 24% of employment in the 1980s, was hit especially hard by the collapse of the bubble economy, and fell to 20.0% by 2001. However, this type of shift in employment from manufacturing to the service sector is shared by industrialized economies in general.

Another often cited problem is the decline in domestic production because production is transferred overseas. Companies generally move production abroad for two reasons: (1) to take advantage of lower costs in developing countries, and (2) to alleviate trade friction with industrialized countries by manufacturing products locally. During the 1980s, Japan expanded direct investment in industrialized countries to circumvent trade disputes; for example, voluntary export restraints in the U.S. prompted Japanese automakers to set up plants in North America.

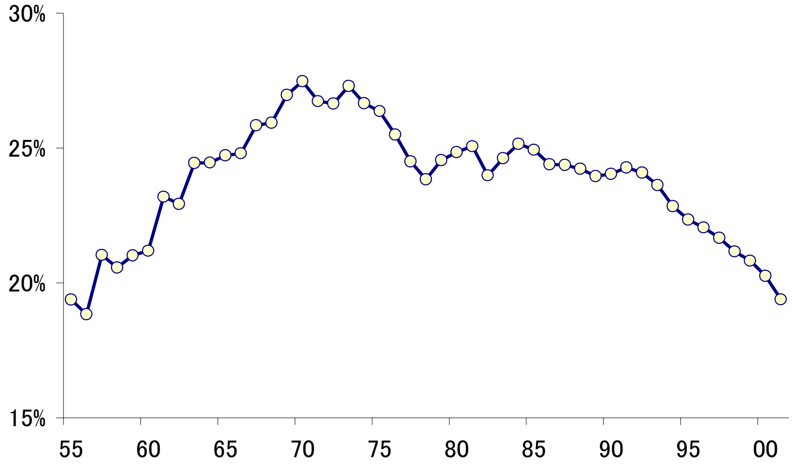
Figure 7　Foreign Direct Investment by Region (Manufacturing)



Source: MOF, *Foreign Direct Investment.*

Although concerns of deindustrialization strengthened as the post-Plaza Accord exchange rate surged past 200 yen, the percentage of employment in manufacturing barely budged during the bubble period of the late 1980s. The decline in manufacturing employment in the 1990s thus created the illusion that deindustrialization was accelerating, when in fact the bubble's collapse had simply triggered structural adjustments in a delayed reaction from the 1980s.

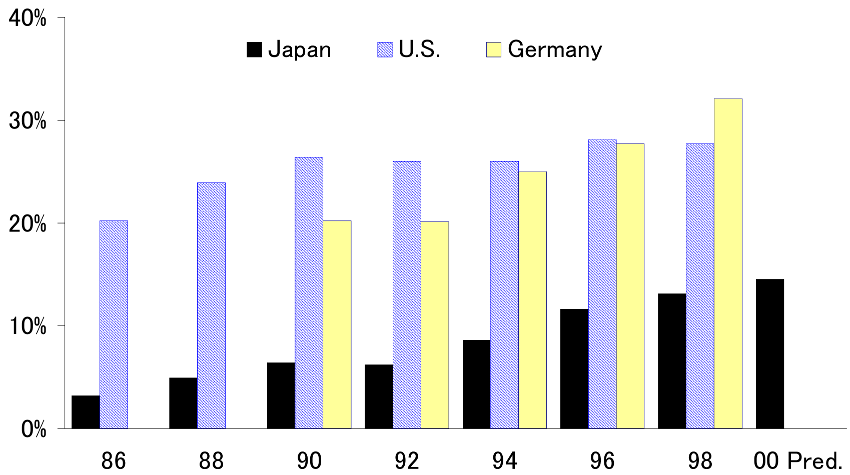
Figure 8　Percentage of Employment in Manufacturing



Source: MPMHAPT, *Labor Force Survey*.

Japan's overseas production ratio is rising, and should continue to rise considering that it remains low compared to the U.S. and Germany. Thus as companies continue to transfer production abroad, further declines in domestic manufacturing employment appear inevitable.

Figure 9　Overseas Production Ratios of Japan, U.S. and Germany



Source: Ministry of Economy, Trade and Industry, *Summary of the Overseas Business Activities Basic Survey.*

The impact of foreign direct investment and a rising overseas production ratio on Japan's exports is complex. Capital goods exports increase during the construction phase of overseas plants. Once overseas production begins, exports of finished products from Japan decline, but exports of components increase. Indeed, at this point exports may well be greater than if production had remained at home. Trying to prevent deindustrialization by restraining overseas production may thus subvert the intended effect.

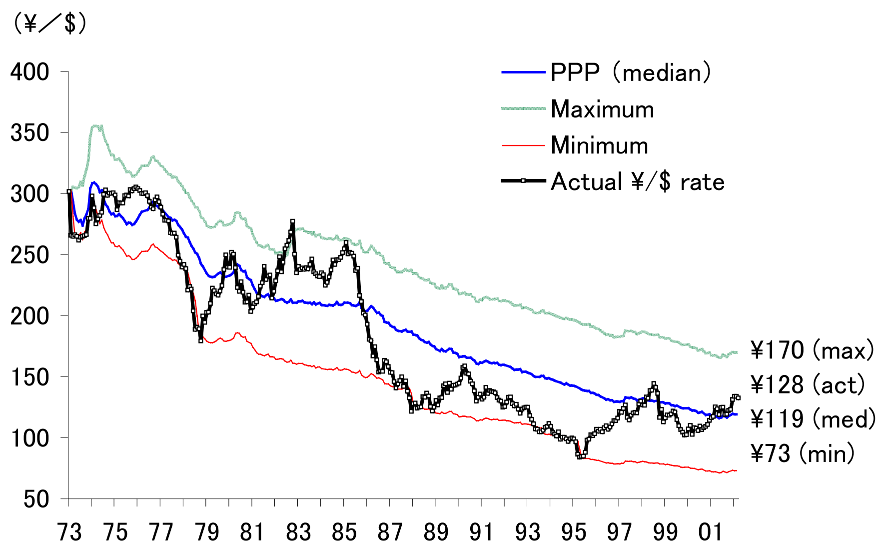
According to the development theory of balance of payments, a current account surplus accompanied by a trade deficit can result in more business failures, more unemployment, and more income disparities. However, striving to enhance export competitiveness may only be a temporary solution. This is because a shrinking trade deficit and expanding current account surplus implies accelerated growth in net foreign assets and an expanding income surplus, causing the yen to appreciate further.

Since the late 1990s, the exchange rate has hovered near the center of a band of purchasing power parity values thought to cause long-term equilibrium in the trade balance for goods and services. Recently, due to massive monetary easing, the exchange rate has drifted toward the weak yen side of the band. However, this may indicate the risk of a stronger yen as the economy recovers and domestic interest rates return to normal levels. One scenario for economic recovery calls for drastically depreciating the yen through BOJ purchases of foreign denominated assets and monetary easing. While this approach may produce short-term results, a weak yen cannot be sustained in the long term due to the increase in foreign assets and resulting growth in income surplus. While economic recovery is anticipated in fiscal 2002 led by exports to the recovering U.S. economy and a weak yen, external demand cannot be relied on for a sustained economic expansion over the long term.

The burgeoning income surplus and shrinking trade surplus suggests that Japan, as one of the world's few creditor nations, cannot rely on export led growth indefinitely. Exports and imports each account only for approximately 10% of GDP. To make the economy more efficient, it is more important to improve the efficiency of industries and companies not related to trade, rather than those involved in trade.

The primary requirement for sustained growth is not to enhance export competitiveness, but to change the economic structure to one led by domestic consumption. And considering the substantial foreign assets earned from trade and amounting to almost 30% of GDP, another major issue for the economy is for financial institutions to enhance their asset management capability so as to maximize asset income.

Figure 10　Purchasing Power Parity and the Actual Exchange Rate



Source: NLI Research Institute.