Overview of White Paper on International Economy and Trade 2007

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Business corporations not only in Japan but in the rest of the world have increasingly intensified their global economic activities in recent years through goods and services trade and direct investment. The White Paper on International Economy and Trade 2007 analyzes global economic activities of Japanese companies, centering on East Asia, and puts forth a set of proposals on future policies to be taken by Japan.

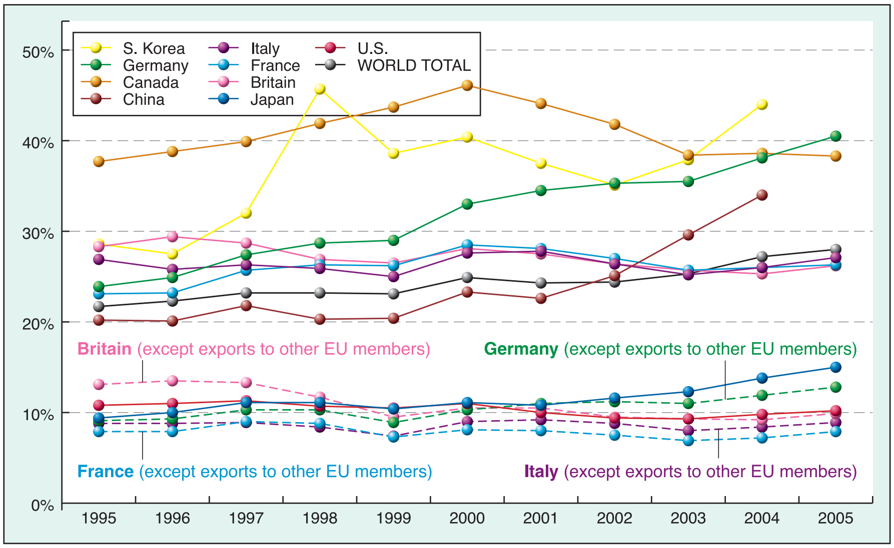
1.Japan Boosting Presence in World Economy

Promoting efficiency of economic activities by boosting trade

Japan's 2006 exports and imports both hit all-time annual highs amid continuing global economic recovery, among other factors. Exports surged 14.4% over 2005 to ¥71,630.9 billion and imports leaped 18.9% to ¥62,166.5 billion. Japan's dependence on exports, as seen in the ratio of exports to the country's nominal gross domestic product (GDP), reached 16.1% in 2006 – the highest level since the end of World War II. Behind this were such factors as global market expansion led by East Asia, an increase in key parts and materials supplied by Japanese corporations to their overseas subsidiaries and affiliates, and enhancement of Japanese firms' export competitiveness attained through cost-cutting efforts and technological improvements.

However, as *Chart 1* indicates, Japan's export dependence (in terms of the GDP ratio) is sharply lower than the average of about 28% in the whole trading world. In general, such a ratio of advanced countries tends to be lower than the global average. But the figure for Japan is much lower than those of Canada and South Korea, although it is gradually exceeding those of US trade and the European Union's extra-region trade. Japan's self-sufficiency in natural resources and energy remains low while Europe enjoys great benefits through intraregion trade between countries with different economic environments and industrial structures. Considering these factors, Japan is required to make more efforts to expand its size of trade to a level topping that of other advanced countries and also to sophisticate and make more efficient its industrial structure through trade.

Chart 1 Trends in major countries' export dependence



Source : *World Development Indicators (World Bank), Direction of Trade Statistics (IMF)*

It is generally pointed out that the principle of comparative advantage can be singled out as the significance of free trade. Under this principle, each country can specialize in the production of goods where it boasts relatively high production efficiency, thus enjoying greater benefits from an exchange of necessary goods through trade than when one country produces all goods domestically. Such specialization in production on the basis of the principle of comparative advantage leads to economies of scale and improvement in productivity. At the same time, consumers can enjoy the advantage of obtaining wider options through trade in the purchase of lower-priced goods and services of higher quality.

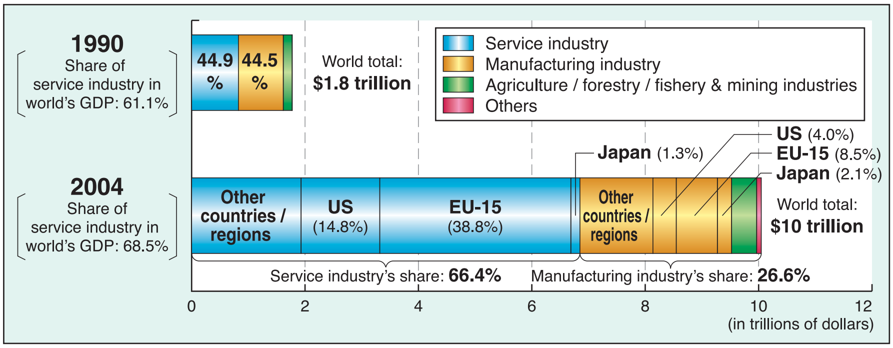
Japan's trade balance is expected to follow a different trend in the future from the current pattern of chronic black-ink figures amid the aging of the population coupled with the dwindling birthrate. Regardless of the trade balance trend, however, it is fully possible for Japan to boost its overall trade value. And, there is much room for the country to expand its trade further and to pursue advantages such as improved efficiency through trade.

Promoting efficiency of economic activities by boosting investment

Japan's economic globalization is reflected in its outgoing and incoming investment, and in the expansion of profits from such investment. As for investment income, returns on securities investment expanded thanks to such factors as greater interest earnings from mid- and long-term bonds against the backdrop of increased outstanding investment and higher money rates worldwide. In addition, returns on direct investment also increased, reflecting brisk earnings posted by overseas subsidiaries and affiliates of globalized Japanese businesses. As a result, Japan's investment income surged 24.1% in 2006 to ¥19,283.1 billion from the year earlier. Of the total, income from direct investment jumped 21.9% to ¥4,082.7 billion, accounting for about 21% of the total.

Breaking down Japan's income balance to confirm its structure, we find the ratio of the country's income receipts to its nominal gross national income (GNI) at 3.1% and that of payments 0.8% in 2005. In comparison, similar ratios came to 15.0% for receipts and 12.7% for payments in Britain; 6.2% and 5.8% in Germany; 5.9% and 5.4% in France; and 3.8% and 3.7% in the United States, all in 2005. Japan ranks at the lowest level among the world's seven most advanced countries in both receipts and payments. This shows that Japan's income balance is large in net terms but that both receipts and payments are small in size. Receipts and payments in the income balance are closely linked with the size of external direct investment and of incoming direct investment, respectively. An expansion in these direct investments helps promote economic efficiency and vitality through such factors as the introduction of new technology and management know-how and a variety of competitions between businesses at home and abroad. In this sense, it is important for Japan to take active measures toward expanding external direct investment and inbound direct investment. Japan's balance of payments surplus is expected to shrink in the long run due to several factors, including a decline in the country's savings rate caused by the aging population and low birthrate. Under such circumstances, Japan is required to boost its total trade value, continue to pursue not only foreign currencies but overall benefits of trade, and make active efforts to improve its international business environment toward liberalization and facilitation of trade and investment so as to further promote efficient economic activities and improve productivity, provide benefits to consumers, and chalk up payments surpluses as long as possible.

Chart 2 World's foreign direct investment



Source : *World Investment Report 2006 (UNCTAD); Balance of Japan's external assets / liabilities (Finance Ministry / Bank of Japan); data from Bureau of Economic Analysis, US Department of Commerce and EUROSTAT*

2. Global Evolution of Service Industry

Progress in globalization of service industry

Amid a steady rise in the weight of services in the world economy led by the United States and Europe, the global service industry is rapidly boosting its overseas presence, mainly through direct investment. *Chart 2* indicates that the balance of the world's external direct investment sharply increased to $10 trillion in 2004 from about $1.8 trillion in 1990, while the service industry's share in the balance rose to 66.4% in 2004 from 44.9% in 1990. This shows that moves toward globalization through direct investment were more active in the service sector than in the manufacturing industry in recent years. Service industries increasing their direct investment sharply are business-oriented services and finance. Transportation, warehousing, communications and commerce also posted gains. In addition, the hotel and food service industries also saw their direct investment increase. This indicates that a wide range of service industries made external direct investment actively. This trend was spearheaded by business-oriented service firms which strengthened their overseas presence to meet increased demand from manufacturers which had, ahead of the service sector, promoted globalization efforts through goods trade and direct investment.

Amid rising demand for services in the world, including Asian countries, sophisticated use of information technology (IT) and institutional improvement in the business environment in various countries and territories are believed to have helped boost the service sector's overseas presence. However, the Japanese service sector's outstanding external direct investment accounts for only 1.3% of the world total, falling far behind other advanced countries in terms of overseas evolution.

To materialize sustainable growth and strengthen international competitiveness of the Japanese service sector which falls behind its US and European counterparts in terms of overseas investment, it is essential for the Japanese service sector to increase its direct investment remarkably and thus challenge overseas markets aggressively, improve its global service-providing capability and acquire economies of scale through an expansion of the corporate size. As a solution to achieve the goal, it is important for Japanese service companies to improve productivity, judging from the recent trend that an increasing number of companies with higher productivity are launching overseas operations. They are also required to pursue multiple management innovations such as promotion of operating efficiency and addition of higher value by creating new business ventures.

Low productivity in Japan's service sector

Let's break down real increases in the value added in Japan's service sector into two factors – labor input (with the number of employees, total hours worked and the quality of labor taken into account) and labor productivity. No industry improved productivity at the same time as it increased labor input. In contrast, US labor productivity improved in almost all industries. Even some industries improved productivity at the same time as they increased labor input. This shows the US service sector as a whole improved efficiency. *(Charts 3* and *4)*

Contribution from IT capital insufficient in Japan

One of the factors behind the above-mentioned low labor productivity in the Japanese service sector is that IT investment has not fully led to an improvement in productivity. *Chart 5* (on the next page) compares changes in the ratio of IT capital stock to the total capital stock in Japan and the United States. The US ratio went up more than 1.5 times to 18.8% in 2005 from 12.2% in 1998 before the IT bubble boosted economic activity. This clearly shows that the United States has accelerated the accumulation of its IT capital stock. On the other hand, the accumulation of IT capital stock has been sluggish in Japan's service sector, with the ratio of its IT capital stock standing at 8.5%. As a result, the gap between Japan and the United States has been widening rapidly.

Need to improve market climate to raise entry rate as metabolic function

Economic reinvigoration requires frequent entry of creative new businesses, effective use of management resources such as personnel, equipment and funds, and creation of value added. To continue giving business operators such incentives, a healthy market environment must be established by such means as relaxation of regulations to help activate new business entries not only at home but from overseas through inbound direct investment.

The entry rate in Japan's service sector was 5.67% in fiscal 2005, way behind the US rate of 11.47% in 2003. New entrants are said to have fresh business models not held by conventional firms and also are relatively high in productivity. Therefore, the low entry rate indicates that the mechanism of productivity improvement does not work fully in Japan's service sector as a whole. One of the factors that curb new entries is the existence of a variety of regulations, including entry restrictions. Some of the regulations are imposed from the viewpoint of maintaining safety and health, environmental preservation and fair trade. But there remain old-fashioned regulations that were really necessary at the time of introduction but are now being questioned due to changes of the times. Regulations that work to curb new entries into the service market should be eased or abolished after their necessity and rationality are reviewed.

3. Establishing an Open, Seamless Economic System

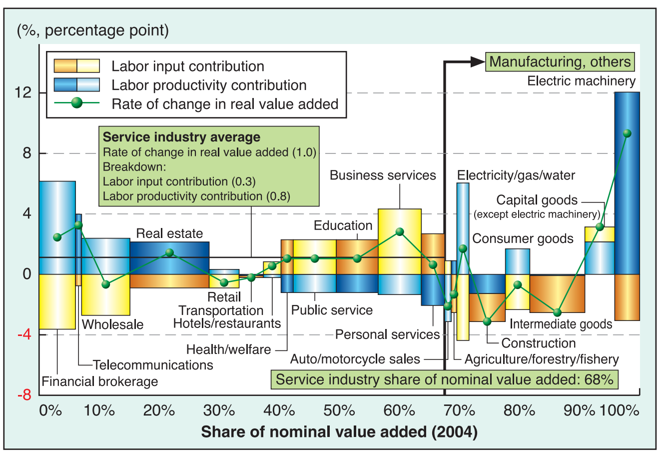
Japan faces a variety of mid- and long-term issues such as the shrinking population, restraints from environmental and energy factors, and intensified international competition. To achieve sustainable growth under the circumstances, Japan is required to promote innovations in various fields and raise productivity of its economy by acquiring management resources and know-how across national borders through such measures as improvement of its market environment designed to actively accept inbound direct investment.

In addition, it is also important for Japan, which has built up business networks mainly in Asia, to maintain and develop the multilateral trade framework under the World Trade Organization (WTO) and to promote international economic partnerships, including the proposed East Asian economic partnership agreement (EPA).

For expansion of inbound direct investment

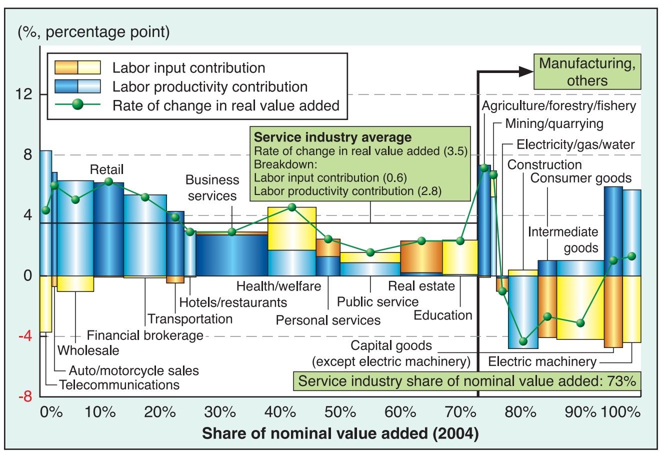
As one of the measures to revitalize innovations, Japan is required to actively introduce various excellent resources (personnel, funds, technology, management capabilities, etc.) from abroad and utilize them. Direct investment in Japan from abroad is expected to offer a

Chart 3 Industry-wise share in nominal value added & rate of change in labor productivity in Japan (based on 2000-04 average)



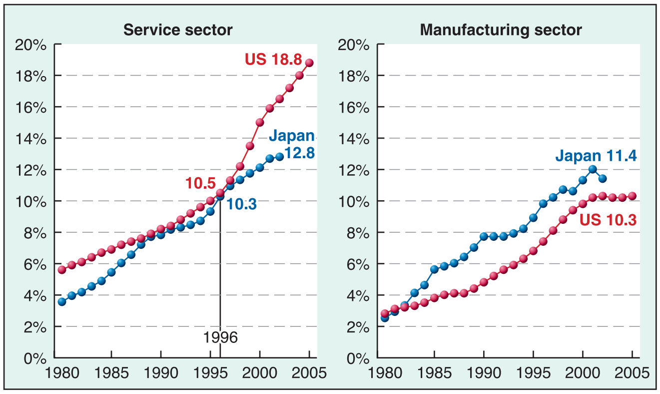
Source : *EU KLEMS project database*

Chart 4 Industry-wise share in nominal value added & rate of change in labor productivity in US (based on 2000-04 average)



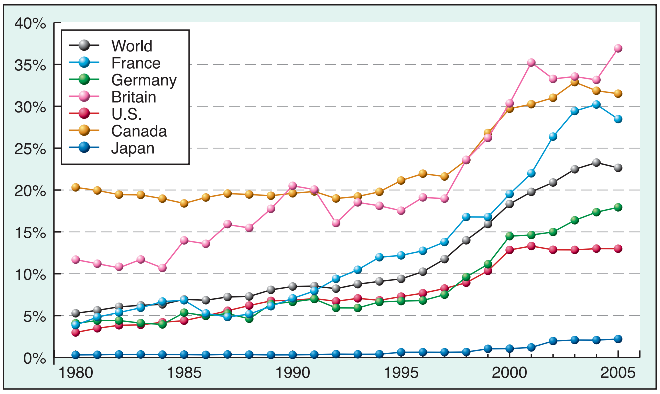
Source : *EU KLEMS project database*

Chart 5 IT capital stock ratio to total capital stock in Japan & US



Source : 2006 database by Research Institute of Economy, Trade & Industry; US Department of Commerce's Bureau of Economic Analysis

Chart 6 Ratio of inbound direct investment balance to nominal GDP



Source : World Investment Report, UNCTAD

chance to achieve the goal. *Chart 6* compares the share of Japan's incoming direct investment balance in GDP with similar figures for major advanced countries in Europe and North America. It shows that Japan remains at a low level of about 2.4%, far below those of the other economic powers. On the other hand, Japan's rate of return on external direct investment is higher than those of the United States and European countries. Therefore, if overseas investors become aware that Japan is a highly profitable market, it can be said there is room for foreign direct investment in Japan to increase. Japan is required to make aggressive efforts to further expand such investment.

There are two prominent types of inbound direct investment – the so-called greenfield investment and M&A (corporate mergers and acquisitions). M&A deals account for about 78% of the world's total incoming direct investment as of 2005. However, the share of M&A in Japan's inbound direct investment is not so high, although the number of M&A cases has been increasing in recent years. M&A is advantageous in that existing management resources can be used. It is also believed to bring about such benefits as achievement of economies of scale through restructuring of corporate organizations, an increase in research and development investment, and promotion of efficiency in such aspects as expansion of sales networks. It is thus important to improve domestic institutional systems to help smoothen M&A deals in Japan.

Moreover, Japan also needs to simplify various procedural requirements and improve convenience at windows for such procedures, further improve its infrastructure and reduce business costs to promote foreign direct investment in the country. By taking such measures, Japan will be able to make its market more attractive for foreign businesses and help them find benefits in concluding various relationships with Japanese companies.

Toward an enhanced partnership in East Asia

An economic bloc is being formed effectively in East Asia, with a high level of growth and brisk economic activity going on in an integrated form within the region. However, from the viewpoint of international comparison, East Asia needs to take more measures to improve its business environment in terms of tariff levels yet to be lowered, remaining investment regulations, and insufficient protection of intellectual property rights.

To continue sustainable growth, East Asia is required to improve its trade and investment environment as a whole. But this is not enough. East Asia needs to establish a wide range of institutional systems that will help countries in the region, which are at different stages of economic development, utilize their own advantages and achieve development by jointly tackling the region's common issues such as energy and intellectual property protection.

Based on these points, Japan has proposed concluding an "East Asian economic partnership agreement" among 16 countries in the region – the 10 members of the Association of Southeast Asian Nations (ASEAN) plus Japan, China, South Korea, India, Australia and New Zealand. Japan has also proposed establishing an "East Asian version of the Organization for Economic Cooperation and Development (OECD)." These concepts are supported with two pillars – liberalization of trade and investment and improvement of various institutional systems, and promotion of cooperation and correction of gaps within the region. Japan intends to utilize its accumulated knowledge and expertise in the fields of technological cooperation and the training of industrial human resources to help promote economic partnerships in the East Asian region. Partnerships among countries at the different stages of economic development are expected to function as building blocks in promoting trade negotiations under the WTO. It is important for Japan to maintain and develop the WTO-led multilateral trade framework, utilize multilayer forums such as the East Asian EPA and the Asia-Pacific Economic Cooperation (APEC) grouping, and help improve the international business environment that should be open in nature and also well balanced. JS