Structural Changes in Japanese Economy

As Seen from Balance of Payments Data

By Naoyuki HARAOKA

Japan's economic news media have come to frequently use such terms as structural changes and structural reforms of the Japanese economy. In my private opinion, the frequent and easy use of those terms has apparently caused the misunderstanding that structural changes and reforms of the Japanese economy could be achieved in a short period. Essentially, the economic structure of a country should be considered from a medium- to long-range perspective spanning a period of 10 to 20 years. It is not the sort of thing that can be realized this year or next. As this is most clearly showcased in Japan's balance of payments statistics, this author would like to take this occasion to introduce it.

Japan's current account surplus increased 16.1% in fiscal 2007 through March 31, 2008, from the previous year to ¥24,550 billion, hitting a record annual high for the fifth straight year, according to figures released by the Finance Ministry. The data also show that Japan's income account surplus rose 17.6% from the previous year to ¥16,760 billion, which is larger than the country's surplus in the balance of goods and services trade. The income account covers earnings from Japanese investments overseas (income from direct investments abroad, such as dividends from overseas subsidiaries, and from portfolio investments overseas, such as receipts of stock dividends and bond interest). The balance of payments statistics clearly show that Japan has come to post profits mainly from investments overseas rather than from exports.

Chart 1 indicates changes between fiscal 1985 and fiscal 2007 in Japan's balance of payments on current account, which comprises the goods trade, services trade, income and transfer accounts. The transfer account covers Japan's grant aid to foreign countries, contributions to international organizations, and workers' remittances. Japan's current account surpluses are on the increase as a whole. Goods trade surpluses are on the decline, while services trade deficits have started to decrease, partly because the patent royalty balance has turned to the black in recent years (as indicated in *Chart 2*). As mentioned above, Japan's income account surplus showed a 10-fold increase in the past 20 years. These are remarkable changes in current account statistics. In fiscal 2005, Japan's income account surplus exceeded that in the trade balance. Such a structural change in the country's balance of payments was brought about by increases in direct and portfolio investments overseas matching progress in economic globalization. *Chart 3* indicates solid rises in earnings from direct and portfolio investments abroad.

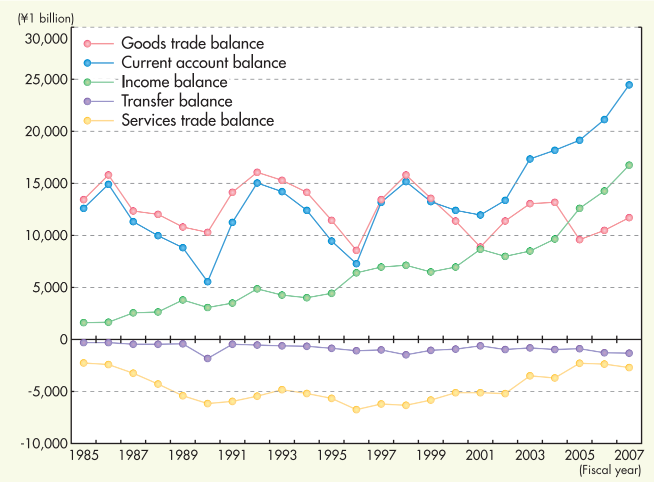
The Ministry of Economy, Trade and Industry (METI) has conducted an annual survey on overseas business activities by Japanese corporations. The Survey of Overseas Business Activities covers Japanese direct investments abroad, notably data on economic activities by overseas subsidiaries of Japanese corporations. In addition to the income account swing from deficit to surplus, the survey is another indicator that mirrors a structural change in Japan's balance of payments brought about by an increase in direct investments overseas, which also symbolizes a maturation of the Japanese economy.

Specifically, *Chart 4* shows a consecutive rise in the overseas production ratio, or the share of sales by overseas subsidiaries in the total sales of Japanese corporations. This clearly indicates that direct investments overseas have gained more importance for the Japanese economy. A regional breakdown shows a remarkable rise in Asia's importance for overseas production by Japanese corporations. This may impact Japan's trade balance in three different ways. One is an increase in exports to Japan from overseas subsidiaries. The second is a rise in exports from Japan of materials, parts and others that are necessary for overseas production. The third and last one is a decrease in exports of final products from Japan that corresponds to an increase in overseas production. It is still unclear which factor – reduced exports or increased imports – would work favorably or unfavorably in Japan's trade balance. But longer overseas production would generally reduce the need to procure materials and parts from Japan, making the effect of an import increase greater than that of an export decrease and working to drive the country's trade balance toward the red.

In recent years, the share of final products in Japan's total imports

CHART 1

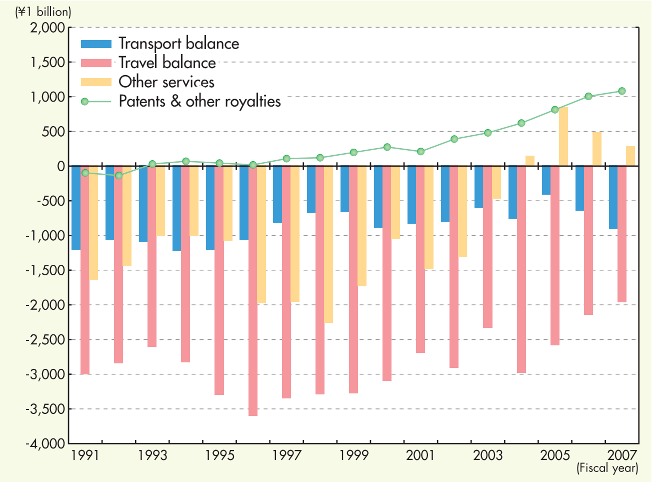
Trends in Japan's balance of payments



Source : "Japan's Balance of Payments Statistics," Finance Ministry

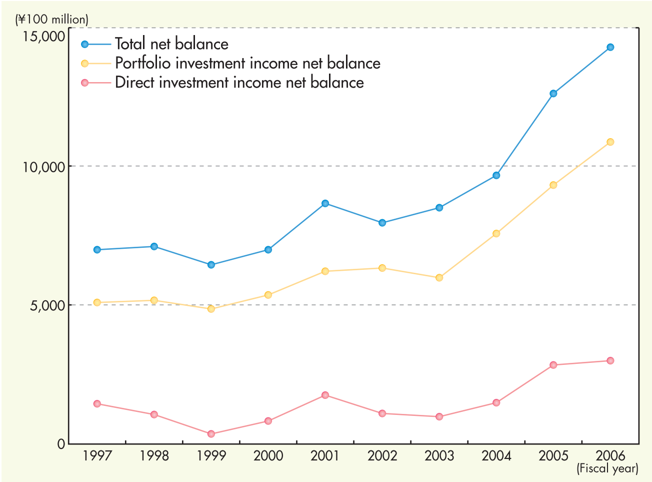
CHART 2

Balance of services trade by item



Source : "Japan's Balance of Payments Statistics," Finance Ministry

CHART 3
Japan's income balance



Source : "Balance of Payments Quarterly (Oct.-Dec. 2007)," International Department, Bank of Japan

has been on the rise, topping the 60% mark. This may be one piece of the evidence that supports this theory. When the ratio remained in the 30-40% range, this figure was used as evidence of Japan's closed economic structure and as one of reasons justifying the arguments by the "revisionists" that Japan is a special country to be treated differently from free-market economies. It also caused a series of trade disputes with Japan's key trade partners. A recent rise in the share of final products in Japan's imports means that Japan is also one of ordinary countries in the world. According to the METI survey, sales to Japan by overseas subsidiaries in the manufacturing sector in fiscal 2006 hit an all-time high of ¥11.4 trillion, up 22.8% from the previous year. Those sales accounted for 18.1% of Japan's total imports, representing a 1.4 percentage-point increase from fiscal 2005. By region, sales from Asia took the lion's share of 82.5% as shown in *Chart 5.*

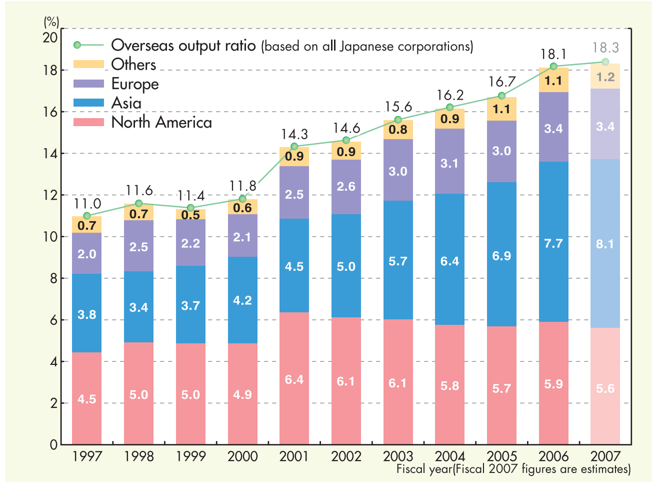
Let us look into decisive factors behind Japanese investments overseas. The survey shows that nearly 70% of Japanese corporations on an all-industry basis singled out brisk or potentially large local demand for their products. Less than 10% of the respondents cited industry development or protection policies by foreign governments. This indicates Japanese corporations have taken their investment decisions basically in line with market mechanisms.

We can thus explain in terms of a particular stage of economic development that a structural change takes place in a country's balance of payments as a corollary to the functioning of market mechanisms. It is the "stage theory of economic development," which says that a country's balance of payments structure changes in stages in line with its economic development.

Under this theory, a developing country running deficits in the balance of goods and services trade and on income account – hence a deficit in its current account balance as well – will be able to post trade surpluses in line with its economic development and progress in its industrialization, as is the case for Japan's economic development. Trade surpluses increase sharply as a country gains export competition. Its income account remains in the red at first but swings to the black as its overseas investments expand, helping to post large surpluses in the current account balance. A country in such a stage is called an "immature creditor nation." Many say Japan had long been in that stage.

But Japan's goods and services trade surpluses are on the decrease, as mentioned earlier. In addition, a large part of Japan's current account surplus comes from income account surpluses caused by earnings from investments overseas. This may show that

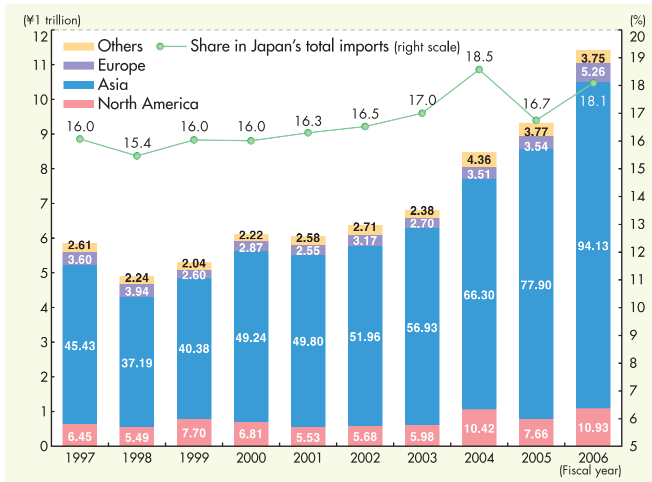
CHART 4
Trends in percentage of overseas output by region
(based on data for all Japanese manufacturers)



Note: Overseas output ratio (based on all Japanese corporations) = (Sales by overseas subsidiaries <manufacturing>) / (Sales of overseas subsidiaries <manufacturing>) + (Total sales by parent corporations <manufacturing>) X 100*
The fiscal 2007 estimate for the overseas output ratio based on all Japanese corporations was worked out by the Finance Ministry.

Source : "Financial Statements Statistics of Corporations by Industry," Finance Ministry

CHART 5
Trends in sales by overseas subsidiaries & their share in Japan's total imports



Source : "Survey of Overseas Business Activities," Ministry of Economy, Trade & Industry

Japan is turning into a "mature creditor nation." However, Japan cannot be called a fully mature creditor nation in its true sense because such a country is deep in the red in the balance of goods and services trade. We can say that Japan faces a major turning point in terms of its balance of payments toward becoming a mature creditor nation.

The next stage of a mature creditor nation is a credit-withdrawing nation whose goods and services trade deficits top income account surpluses, turning its current account balance into the red. The United States is in this stage.

This is reflected in a decline in Japan's household savings rate in recent years. That rate remained more than 10% in the early 1990s but fell to 3.2% in fiscal 2006. If the rate should fall further due to the aging of its population, Japan may see signs of shifting to a mature creditor nation in terms of the savings-investment disequilibrium that mirrors the macroeconomic aspect of the current account imbalance. JS

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