

White Paper on International Economy & Trade 2012

- Expanding the Frontiers of Growth through Global Linkage

By Policy Planning & Research Division, Trade Policy Bureau, Ministry of Economy, Trade & Industry (METI)

First published on Aug. 15, 1949, the White Paper on International Economy and Trade has been issued every summer since. White Paper 2012 is the 64th edition.

White Paper 2012 analyzes the unsparing trade environment surrounding Japan of late and illuminates the current situation, where in addition to the rise in import prices due to the surge in natural resource prices, factors such as the appreciation of the yen and increasingly severe competition from emerging economies have been depressing export prices. It goes on to point out how important enhancing brand value and other non-price competition factors are to increasing profitability. It also shows how the overseas deployment of business activities by Japanese firms is spreading to services and other non-manufacturing sectors as well as small and medium enterprises and intermediate firms, and uses comparisons with Germany and other countries to point to the importance of taking ever more advantage of growth opportunities overseas.

Global Economy Slow to Recover amid Anxieties

First, an overview of global economic trends. The global economy bottomed out in the spring of 2009 and proceeded on to a gradual recovery path. However, in 2011, the deepening sovereign debt crisis in Europe and the economic slowdown in the US marked the return to a slowdown. Although fears of rapid economic reversal eased up in 2012, the global economy continues to harbor instability while being propped up with policy measures by individual governments.

Emerging economies are also showing some slowdown but continue to maintain high growth patterns, outperforming

developed countries eight-fold in economic growth (as of 2011 Q2). High growth in China and other emerging economies has pushed the share of emerging and developing economies up to 35.3% of global GDP against 64.7% for the advanced economies. In particular, as the EU, which accounts for 25.4% of global GDP in real terms, suffers a recessionary setback, China's presence looms even larger with expectations of its role in supporting global economic growth (Chart 1).

European Economy in Deeper Turmoil with Sovereign Debt Crisis

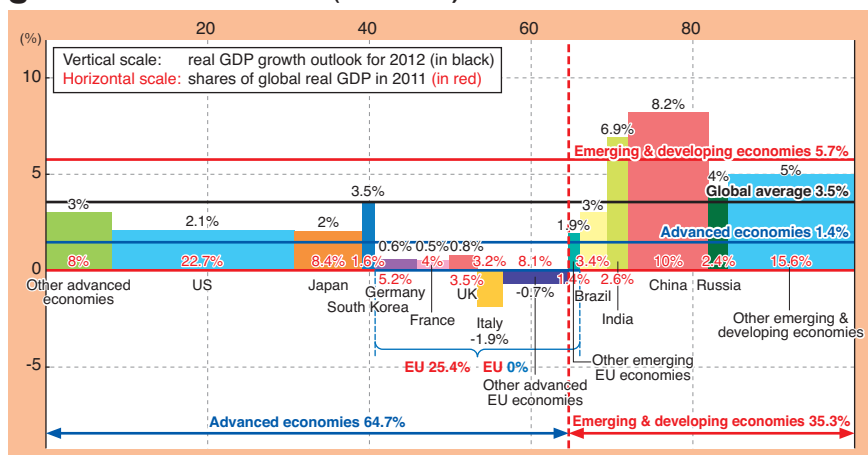
The European economy had been gradually recovering from the drop-off resulting from the worldwide economic crisis in 2008. As the European sovereign debt crisis became evident, however, business sentiment took a turn for the worse; retrenchment by governments aimed at restoring fiscal health as well as other factors reduced demand, and it became clear that the economic trend-line had gone into a stall.

The German economy, however, is chugging along more steadily than other major economies and the unemployment rate there has been trending at an all-time post-reunification low. The European economies are increasingly bifurcating.

One factor supporting Germany's economic competitiveness has been the restraint on labor costs there. A look at the timeline for labor costs per unit — an index that represents how much personnel

CHART 1

National & regional growth rates and global GDP shares (real terms)



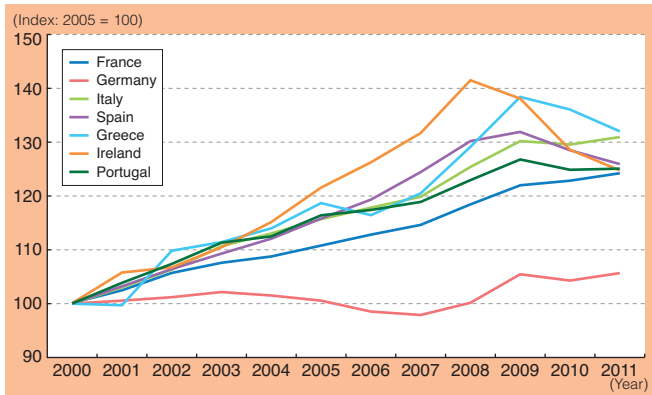
Note 1: Figures for "advanced economies" and "emerging & developing economies" and "...developing economies" are Ministry of Economy, Trade and Industry estimates based on IMF data. No primary data available.

2: Figures standardized to 2010 levels.

Source: Compiled using data from IMF "World Economic Outlook," April 2012

CHART 2

Labor cost trends in key Eurozone countries



Note: Original indexes 2000 = 100, recalculated as 2005 = 100. Forecast for 2011.
Source: Compiled using data from "Eurostat"

expenses are required to produce a single unit of GDP — shows that Germany's numbers have been relatively restrained since 2000, while other EU members have seen 20% to 40% rises over the same period. The Schröder administration came to power in 1998, but its labor market reform really took off after reelection in 2002, when it implemented a series of reforms aimed at making the labor market more flexible, including a cutback on the duration of unemployment benefits and a partial introduction of fixed-term employment. As a result, labor costs were contained, particularly in manufacturing, enhancing the competitiveness of German exports (Chart 2).

Germany's rising export competitiveness is evident from a look at the current account figures of major Eurozone countries. Germany's current account registered deficits in the 1990s but turned to surpluses in the 2000s, which increased continuously up to 2007. France and Italy, on the other hand, went the other way from surplus to deficit, while Spain's deficit kept growing rapidly up to 2007. Germany's surplus and the cumulative deficit of the other three countries have more or less balanced each other out in recent years (Chart 3).

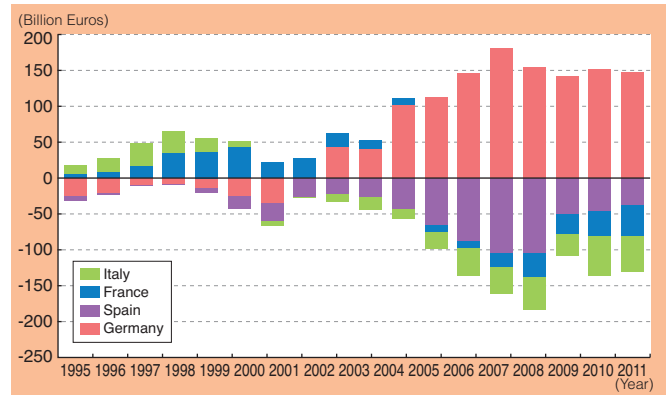
US Economy Trending Firmly but Outlook Clouded

The US economic recovery slowed in 2011 due to such factors as spiking oil prices and the disruption of supply chains caused by the Great East Japan Earthquake, but picked up pace again through the bottom half of the year.

Economic indexes currently indicate a gradual recovery overall, as the labor and housing markets have been showing signs of improvement in 2012, but consumption has yet to show a full-

CHART 3

Current account trends in 4 major Eurozone countries



Source: Compiled using data from "Eurostat"

fledged recovery. Persistently high unemployment rates and sluggish home prices, falling overseas demand due to the knock-on effects of the European sovereign debt crisis and the lower growth rates in the emerging economies, and spiking oil prices are risk factors here. Expectations continue for support from fiscal and monetary policies (Chart 4).

Chinese Economic Growth Still High but Showing Deceleration

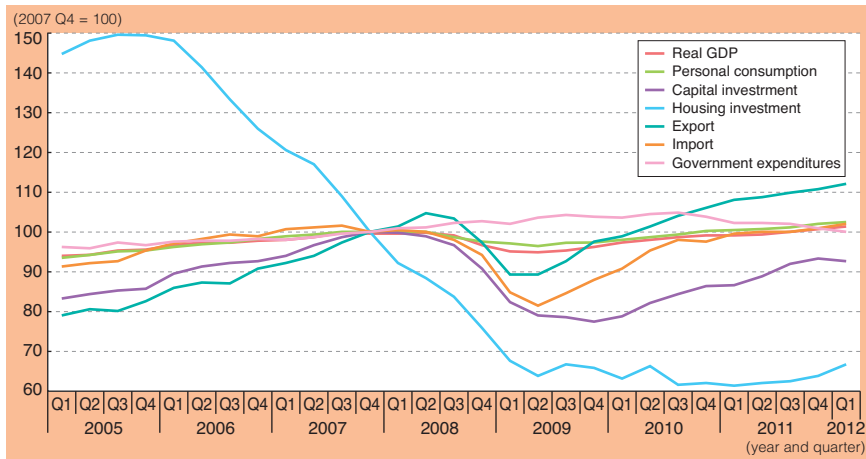
Fighting inflation became the top policy priority for the Chinese economy in 2011, and the Chinese government adopted a tight financial policy. By mid-year, though, exports bound for Europe began to decelerate, leading to a slowdown in economic growth centering on the export-reliant coastal areas. In 2012, the Chinese government has made "stable and faster development of the economy" the top priority and price stability a priority issue, and has emphasized the expansion of domestic demand, consumption in particular. A sudden drop-off in home prices, the debt overhang at the local government level, and decelerating exports due to the European sovereign debt crisis are near-term risks.

Other Asian Economies

Asian economies continued on a gradual recovery path in 2011, but the speed diminished from mid-year due to such factors as the spike in natural resource prices, rising domestic price levels and the tight money policies in response, and declining exports due to the European sovereign debt crisis.

The South Korean economy was no exception, as it too saw its

CHART 4
Real US GDP (2007 Q2 = 100), overall & breakdown by demand



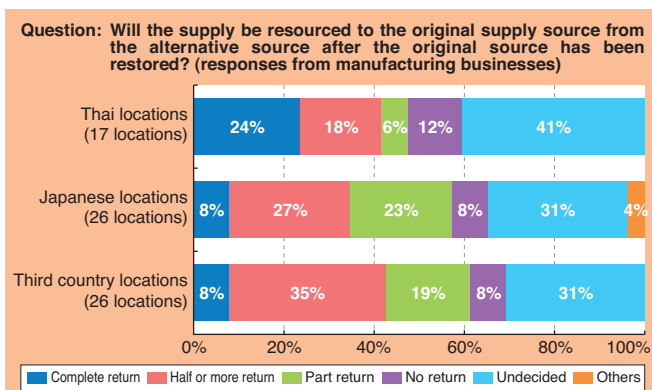
Note: Preliminary results for 2012 Q1.
 Source: Compiled using data from US Department of Commerce, CEIC Database

exports decelerate from mid-year mainly on the European front as the sovereign debt crisis heated up again there. By autumn, European financial institutions and other overseas investors were turning increasingly risk-averse, leading to capital flight from South Korea and other Asian countries, with the rapid fall of the won and declining foreign currency reserves as consequences, while an economic slowdown became increasingly evident. There have been signs of an upturn in some quarters recently, but the South Korean economy overall continues to mark time.

Japan & the International Trade Environment in 2011

Next follows an analysis of Japan's international trade environment in 2011. That year Japan saw a series of events of historical proportions that massively impacted its international

CHART 5
Japanese business response to Thai floods



Note: Totals do not add up to 100 each because of rounding off to the nearest whole number.
 Source: Ministry of Economy, Trade and Industry "Emergency Survey concerning the State of Supply Chain Recovery from the Thai Flooding Damage" (survey conducted late November-early December)

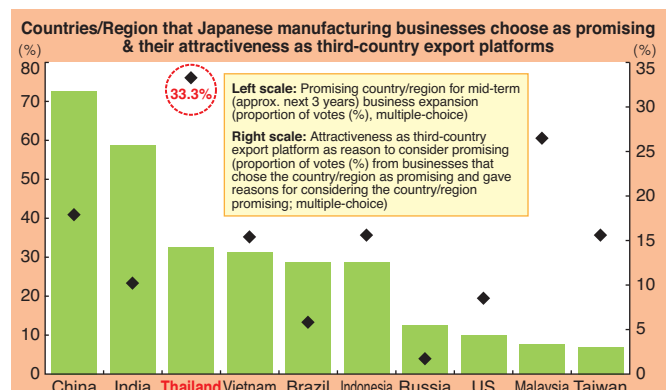
trade environment. The devastation from the Great East Japan Earthquake shattered the global supply chains that Japanese firms had built up over the years, with consequences not only in Japan but worldwide. The yen climbed through the summer months and set a historical high against the US dollar by the end of October. The European sovereign debt crisis further deepened during summer and beyond, leading to the global economic slowdown that put downward pressure on Japanese exports. The massive October floods in Thailand caused major damage to Japanese firms located there and their supply chains. The 2011 Japanese trade balance recorded the first deficit in 31 years,

further stoking fears of an industrial hollowing out.

Japan's Trade & Investment Structure & Its Transformation

Japan's international trade went through a major structural shift in the 2000s. The overseas expansion of Japanese firms has spurred its integration into the international production network, and trade in intermediate products has soared for exports and imports alike. As a result, Japanese exports, historically hovering around 10% of GDP, expanded to around 15%. The "full set" industrial structure of the past has been transformed, and both the intermediate product supply through imports and the production inducement effect of external demand have grown in importance. However, in comparison to Germany, the degree of integration into the international division of labor is still low.

CHART 6
Thailand's attractiveness as investment destination



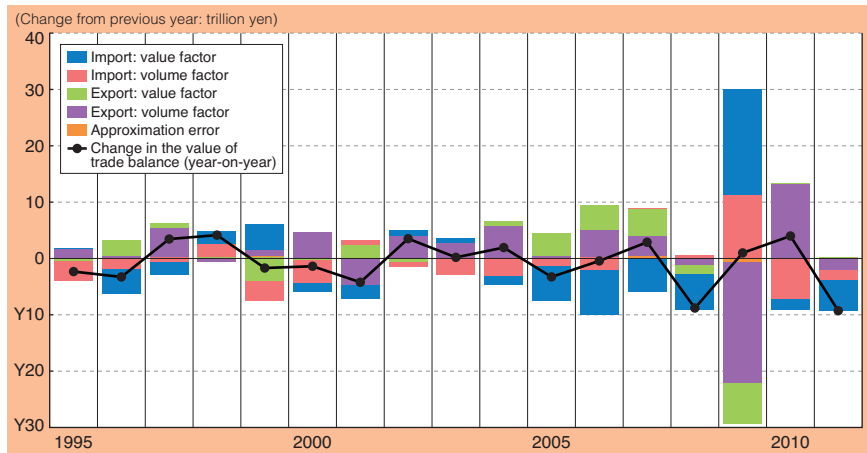
Source: Compiled from Japan Bank for International Cooperation "Survey Report concerning the Overseas Expansion of Japanese Manufacturing Businesses (December 2011)"

CHART 7

Factorial decomposition of Japan's trade balance (year-on-year, 1995-)

The massive Thai floods, together with the great earthquake in March, provided a powerful reminder of the widening scope of the supply chains that Japanese firms have developed and the economic ties between the Japanese economy and the East Asian production network. Although production has returned to pre-flood levels with the rapid recovery of the supply chains, there is a movement to review supply sources from a risk-diversification perspective. According to the "Emergency Survey concerning the State of Supply Chain Recovery from the Thai Flooding Damage" conducted by the Ministry of Economy, Trade and Industry, the Japanese firms who replied that they would make a complete switch back from the alternative supply sources after the original supply sources have recovered from the disaster were in the minority (Chart 5). On the other hand, Thailand's development as a third-country export platform through industrial agglomeration and the expansion of its FTA network has enabled it to maintain its attractiveness as an investment destination, according to the "Survey Report concerning the Overseas Expansion of Japanese Manufacturing Businesses (December 2011)" conducted by the Japan Bank for International Cooperation (Chart 6). Flood control and other efforts to improve the business environment remain important.

Structural Challenges Revealed by 1st Trade Deficit in 31 Years & Yen-Dollar Exchange Rate's Historic High



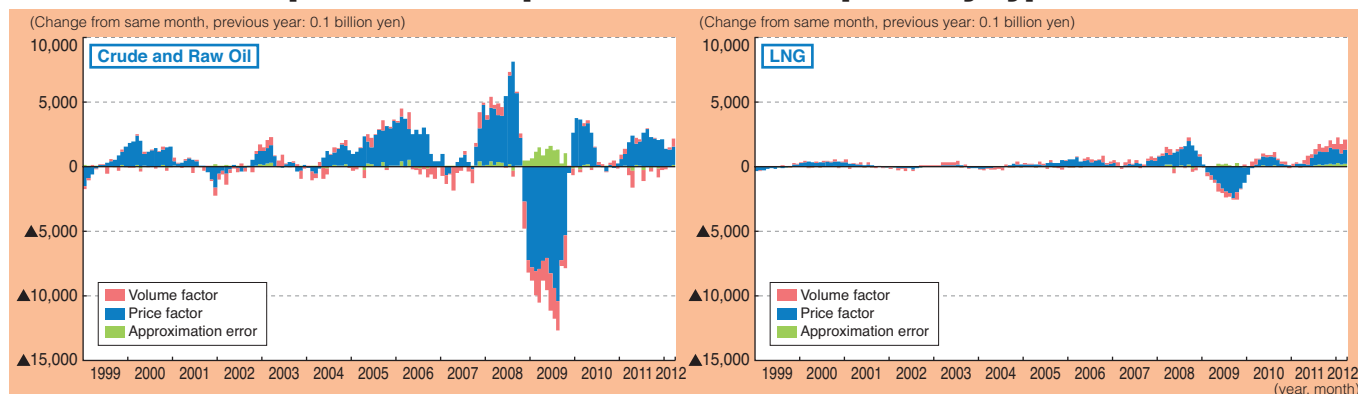
Note: Calculated from volume and price indexes for exports and imports respectively. Source: Compiled from Ministry of Finance "Trade Statistics"

Japan's first trade deficit in 31 years symbolized the severity of its international trade environment in 2011. One half of the deficit was attributable to rising import prices while decreasing export volume and increasing import volume accounted for the other half (Chart 7). Specifically, surging oil prices sparked by the Middle East's political destabilization beginning at the end of 2010 coupled with the increase in LNG imports as a power generation alternative became the main driver of the drift into trade deficit territory, while factors such as supply constraints originating from the huge earthquake, the historical exchange rate high, and the global economic slowdown also contributed to the switchover (Chart 8).

The historical appreciation of the yen in 2011 became one of the causes of worry over the hollowing out of the Japanese economy. This strong-yen phase has not been accompanied by improvements in the terms of trade because of the severity of the rise in import price levels due to surging natural resource prices. The rise in the

CHART 8

Factorial decomposition of Japan's fossil fuel imports by type & value



Note: Commodities classified on the principal commodities basis for the "Trade Statistics." For numbers, fixed results -2011. For 2012 numbers, fixed results for January-February, 9-digit provisional results for March. Calculated from volume and price indexes of the respective commodities.

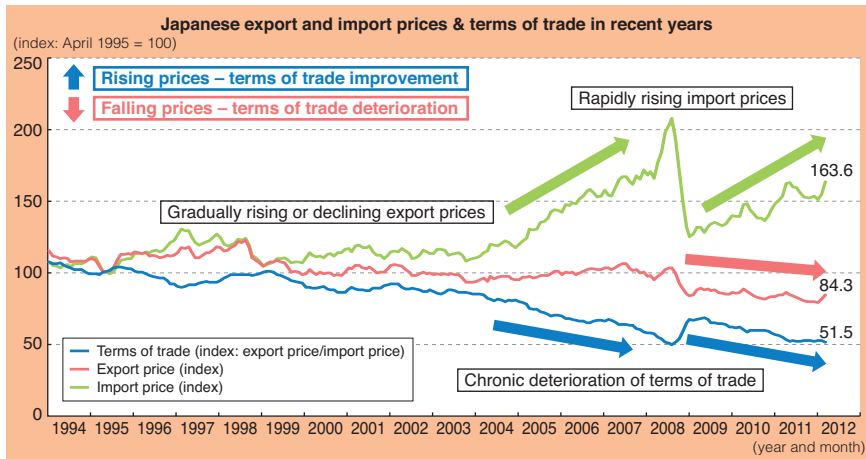
Source: Compiled from Ministry of Finance "Trade Statistics"

Note: Commodities classified on the principal commodities basis for the "Trade Statistics." For numbers, fixed results -2011. For 2012 numbers, fixed results for January-February, 9-digit provisional results for March. Calculated from volume and price indexes of the respective commodities.

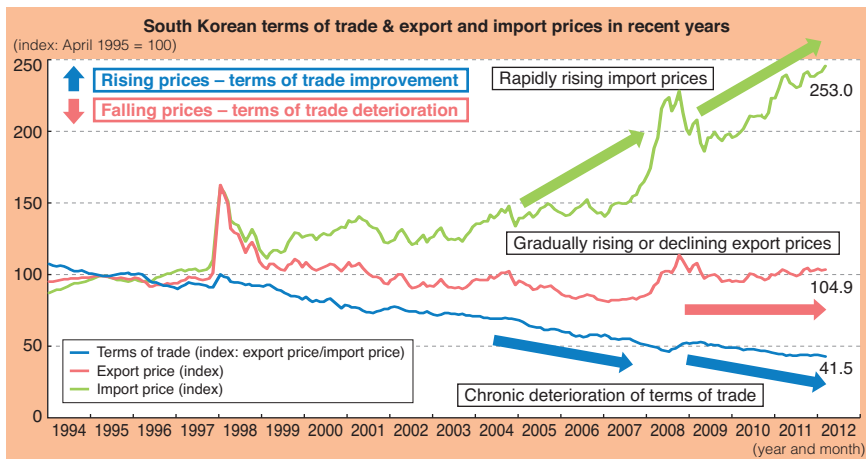
Source: Compiled from Ministry of Finance "Trade Statistics"

CHART 9

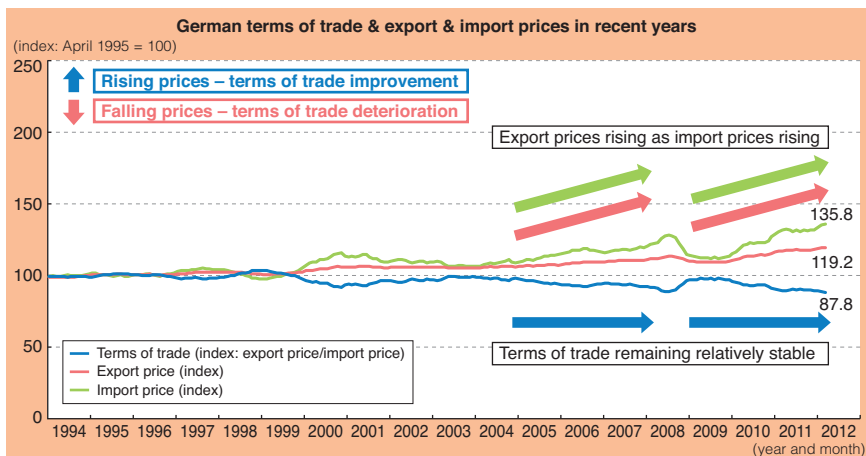
Trends in the terms of trade for Japan, Germany & South Korea



Note: The value for April 1995 is given as 100 in order to make comparisons with previous occasions of yen highs. The most recent value is for March 2012.
 Source: Compiled from Bank of Japan "2005 Base Corporate Goods Price Index"



Note: The value for April 1995 is given as 100 in order to make comparisons with previous occasions of yen highs. The most recent value is for March 2012.
 Source: Compiled from Bank of Korea "Export/Import Price Index" and CEIC Database



Note: The value for April 1995 is given as 100 in order to make comparisons with previous occasions of yen highs. The most recent value is for March 2012.
 Source: Compiled from IMF "Export/Import Price Index" and CEIC Database

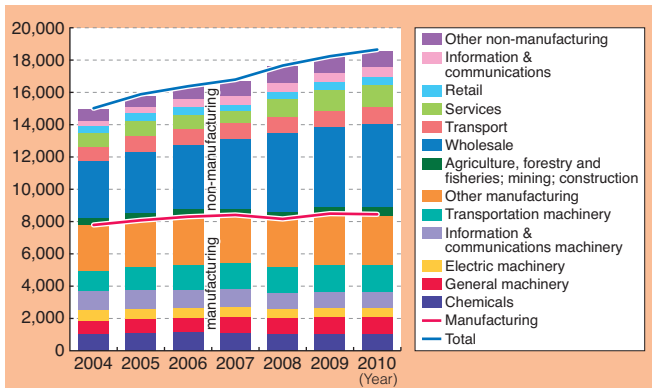
yen exchange rates and deterioration in the terms of trade occurring simultaneously are acting as a massive drag on the profitability of Japanese exporting businesses (Chart 9). The deterioration in the terms of trade is even more evident in South Korea and Korean export prices are showing a marked downturn, indicating that Japanese export businesses are being exposed to severe pricing competition as Japan comes increasingly into rivalries with South Korea and other East Asian countries on the rise. Germany, by contrast, shows both export and import price levels maintaining stability, and exporting businesses have not been exhibiting major dips in profitability. One cause for this appears to be the business strategy adopted by German businesses to maintain reasonable export price levels through technology- and brand-driven differentiation. This reinforces profitability at the individual corporate level, and may also be one factor in building an economic framework that is not buffeted by natural resource price surges and exchange rate fluctuations.

Scope of Expansion of Overseas Business Activities by Japanese Firms & Taking Advantage of Growth Opportunities

The overseas expansion of Japanese firms is beginning to show a breadth that can no longer be seen as the expansion of global supply chains by large manufacturers alone. Small and medium enterprises as well as intermediate firms are also moving forward with exports and overseas direct investment. Non-manufacturing and other sectors once seen as serving domestic demand are exhibiting efforts to actively engage in overseas business activities (Charts 10 & 11). The share of investment in North America and Europe has been declining while investment in China and elsewhere in Asia has been surging. Overseas expansion of wholesale and services as well as the wholesale function of manufacturing firms is becoming evident, reflecting the increasing

CHART 10

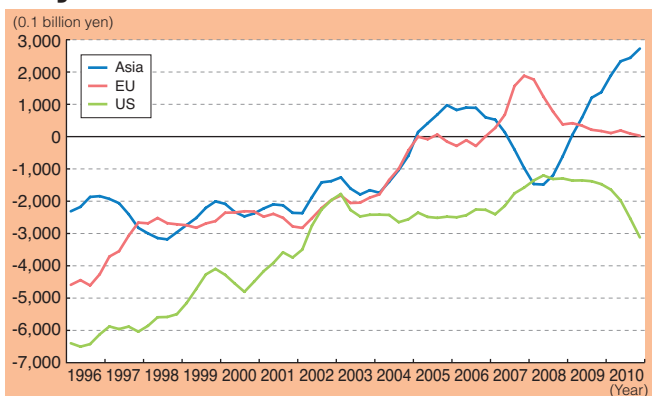
Number of overseas subsidiaries by sector over time



Source: Compiled from "Survey on Overseas Business Activities" (2009) (Ministry of Economy, Trade and Industry), "Economic Census" (2009) (Ministry of Internal Affairs and Communication and Ministry of Economy, Trade and Industry)

CHART 12

Trend in services account vis-à-vis major economies



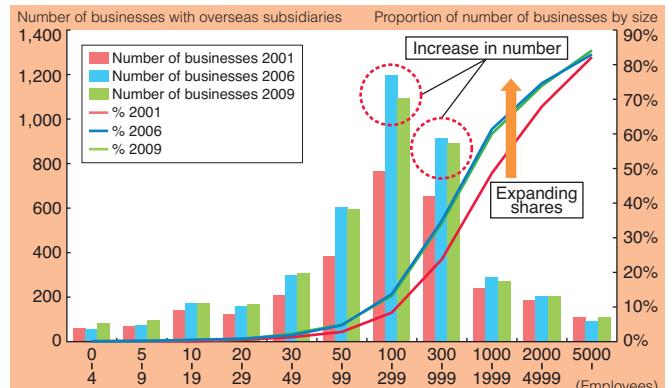
Source: Compiled from "Balance of Payments Statistics" (Ministry of Finance, Bank of Japan)

importance of the Asian market.

In Japan, there is vivid awareness of the domestic business environment's deterioration dubbed the "Six-fold handicap" and Japanese businesses have been seen making moves to strengthen overseas direct investment through mergers and acquisitions and other means. This has led to rising fears of an industrial hollowing out. Generally speaking, the relationship between overseas direct investment and domestic business activities is more often complementary than substitutive, and there is a paucity of clear evidence at this point that overseas direct investment is leading to a decline in domestic production and employment. However, it is necessary to keep in mind that the fears of hollowing out, where domestic business activities are substituted offshore, may become reality if the growth potential of the Japanese economy deteriorates and the shift to new employment opportunities falters. On the other hand, overseas business expansion provides opportunities for raising productivity and promoting innovation in domestic business through more efficient distribution of corporate resources, ripple

CHART 11

Number of firms with overseas subsidiaries (manufacturing; by number of employees)



Source: Compiled from "Establishment and Business Census" (2001, 2009) (Ministry of Internal Affairs and Communication), "Economic Census" (2009) (Ministry of Internal Affairs and Communication and Ministry of Economy, Trade and Industry)

CHART 13

Examples of overseas business expansion in services

Home delivery services

- The number of home delivery items handled in Asia by the Yamato Group recorded a 4.4-fold increase over the FY2010-2011 period. Differentiation has been achieved through frozen and chilled delivery and Japanese services such as payment on delivery and delivery time choice.
- Japanese businesses seeking to expand overseas business operations are also benefiting from the distribution network construction.

Food service industry

- Yoshinoya (over 500 establishments overseas) has achieved differentiation through the safe and secure Japanese cuisine cachet and its own distinct sauce, recipes and the like.
- Mosburger (approx. 300 establishments overseas) has taken features of Japanese cuisine and adapted them to local tastes, while introducing menu items popular there to the Japanese market.

Tourism industry

- The Wakura Hot Spring Kagaya, a Japanese inn in Ishikawa Prefecture, opened in Taipei, Taiwan, in December 2010 with the purpose of providing the same *omotenashi* (traditional Japanese hospitality) available at the Wakura inn in Japan.
- 25% of the Taiwanese guests there have also stayed at the Wakura inn in Japan, creating tourism demand in Japan.

Convenience stores

- The convenience store industry is accelerating overseas expansion. The industry as a whole is expected to have more overseas stores than domestic stores before the end of 2012.
- A uniquely Japanese business model established around "convenience."

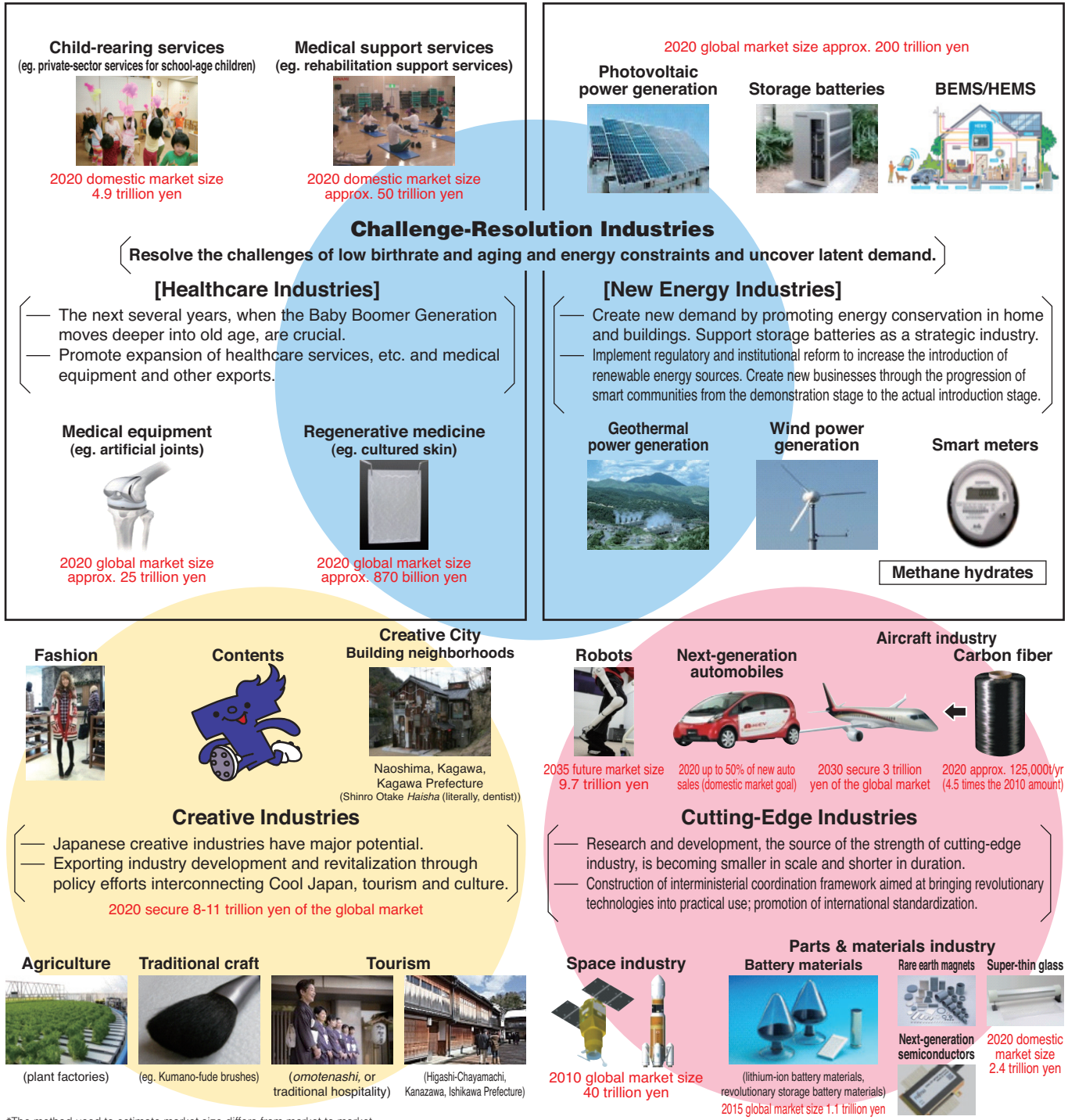
effects of technology and knowhow, rising incentives for research and development, and the like. Further broadening the base of overseas business expansion going forward may create new growth opportunities.

Opportunities for Overseas Expansion of Business Activities in Services

Focusing specifically on services, Japanese service exports and imports are not that large compared to those of other major countries, and the service trade balance has been in deficit. However, there are signs of change, as the deficit has been shrinking and has already turned into a surplus with Asia (Chart 12). There have been cases in recent years where Japanese services have been recognized in overseas markets for their differentiation through distinctly Japanese values. They indicate that there is room to project in overseas markets the intangible values such as knowhow and brands that Japanese service

CHART 14

Three industrial sectors with growth potential



*The method used to estimate market size differs from market to market.

Utilizing Information Technology; Open Access to Public Purpose Data

Strengthening Potential of Small & Medium Enterprises and Microbusinesses

Nurturing Human Capital that Generates Innovation

Supplying Risk Money

industries have nurtured. They also raise the hope of pushing manufactured products up the value chain and reinforcing competitive advantages through the combination of service functions and manufacturing activities (*Chart 13*).

Undertakings by Germany & South Korea Aimed at Improving Business Environment

Enhancing the domestic business environment is essential to taking advantage of overseas expansion of business activities to enhance domestic growth potential. The German and South Korean efforts are useful examples in this respect. Germany, already enjoying the benefits of the single currency risk-free EU market, has helped reinforce the competitiveness of German businesses by undertaking labor market reform, R&D promotion and other measures to enhance the business environment. South Korea has been improving its business environment through such means as lower corporate tax rates, free trade agreements and business startup promotion and has actively supported the domestic industry's movement up the value chain, all the while enhancing its overseas business presence by actively supporting the overseas business activities of their domestic small and medium enterprises as well as big business. Japan is also working to strengthen the competitiveness of its businesses through such means as efforts to improve the business environment through the promotion of economic partnerships, location subsidies, and the like, as well as the five percentage-point reduction of the effective corporate tax rate in the FY2012 tax revision. Nevertheless, there are many things that Japan can learn from the various other efforts being made by other countries.

Establishing a Trade & Investment Environment that Promotes Engagement by Japanese Firms

The enhancement of Japan's trade and investment environment through such means as global and regional rule-making through the promotion of FTAs/EPAs, WTO and the like is essential to securing overseas demand by further strengthening the linkage between the Japanese and global economies.

Support for Overseas Business Activities that Match Changing Needs

With regard to overseas demand, the importance of connecting the growth of other countries to Japanese growth by taking advantage in particular of infrastructure demand in emerging economies in Asia and elsewhere and promoting overseas packaged-infrastructure expansion remains unchanged. In addition, there is hope that expanding "Cool Japan" business activities overseas, drawing on the traditional and cultural cachet that is the

source of Japan's allure, will become a new driver of growth for the Japanese economy.

Recent years have also seen small and medium enterprises increasing their overseas business activities. However, there is a need to enhance supportive measures for lowering the barriers against starting up overseas business activities and to secure and train "global human capital" which is reportedly in short supply.

Urgency of Measures to Reinforce Competitiveness in Attracting Businesses

While expanding growth opportunities overseas, it is also important to strengthen domestic competitiveness in attracting business establishments. To this end, in addition to the corporate tax reduction implemented in FY2012, it is necessary to make efforts to promote location by global businesses and enhance location subsidies with the objective of securing Asian platform functions.

As for mid- to long-term efforts, nurturing challenge-resolution industries (healthcare, childrearing services, medical equipment and devices, energy conservation), creative industries (tourism, culture), and cutting-edge industries (next-generation automobiles, aircraft, aerospace, etc.) is important as they are the new growth areas that will be the main drivers of the Japanese economy of the future (*Chart 14*).

Contemporary Significance of "Trade-based Nation"

"Trade-based nation" — a term often used today — was originally one of the lines of thinking introduced when the direction of post-WW II reconstruction was being debated and was used to stake the claim that "challenges of the national economy should be resolved at the global level." The "challenges of the national economy" change over time. The 1976 White Paper on International Trade — which elaborated on "trade-based nation building" — stated that the "stable development of international trade is essential to pursuing the stable development of the Japanese economy and securing the improvement of the life of the people" and that it "is an imperative to respond dynamically to economic developments in Japan and overseas and... to develop a more sophisticated relationship within the international division of labor. This is the path that trade-based Japan should take."

2011 turned out to be a year of rarely seen severity in the international trade environment. Nevertheless, there is a broadening movement to spread Japanese values overseas through goods and services and take advantage of domestic growth potential. It is our hope that this White Paper will facilitate understanding of the contemporary significance of a "trade-based nation." **JS**