

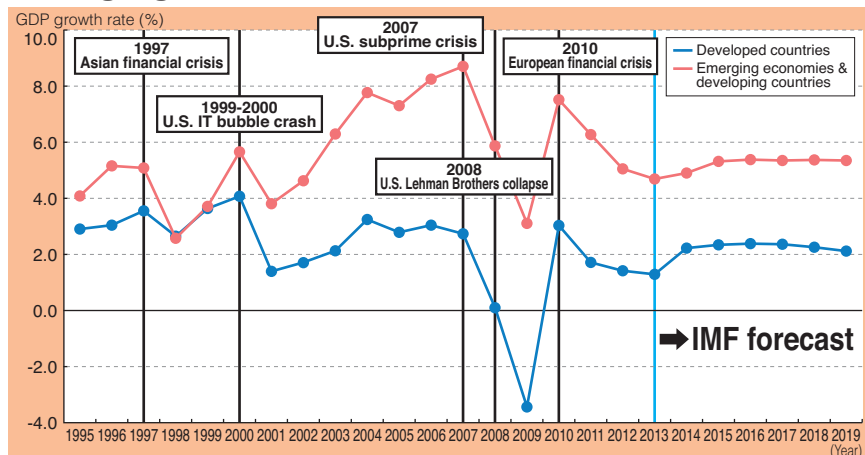
White Paper on International Economy & Trade 2014

By Policy Planning & Research Office, 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 2014 is the 66th edition.

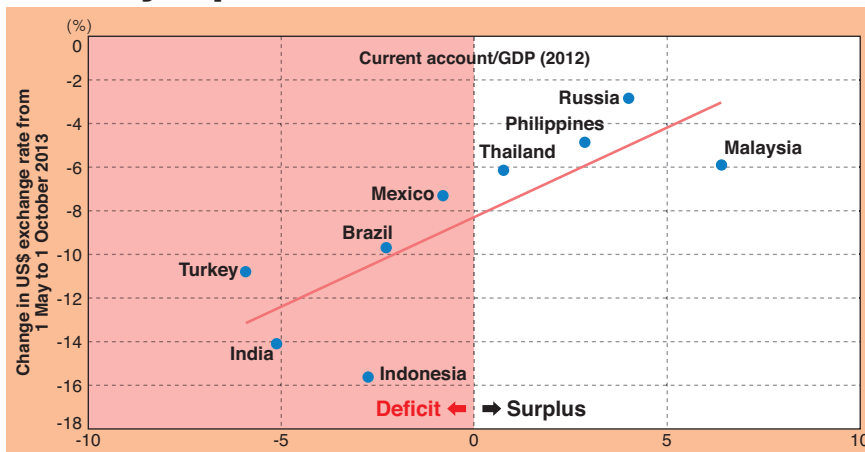
White Paper 2014 analyzes the growth strategies, structural reforms and changes in the economic structures of Europe, the United States, China, ASEAN and other major economies based on the understanding that the importance of economic reform and growth strategies to the stable growth of the global economy has increased. It uses this analysis as the backdrop to an exposition of policy measures aimed at improving the domestic and overseas business environment for Japan. It also conducts an analysis of Japan's trade and current balances in recent years.

CHART 1
GDP growth rates in developed countries & emerging economies



Source: IMF, WEO April 2014

CHART 2
Correlation between current balance/GDP ratio & currency depreciation rate



Source: IMF, WEO April 2013 (current account/GDP estimated for India and Turkey); Thomson Reuters EIKON

1. Trends in the Global Economy & Japan's Trade & Investment

Firstly, an overview is provided of the trends in the global economy and Japan's trade and investment in the aftermath of the global economic crisis.

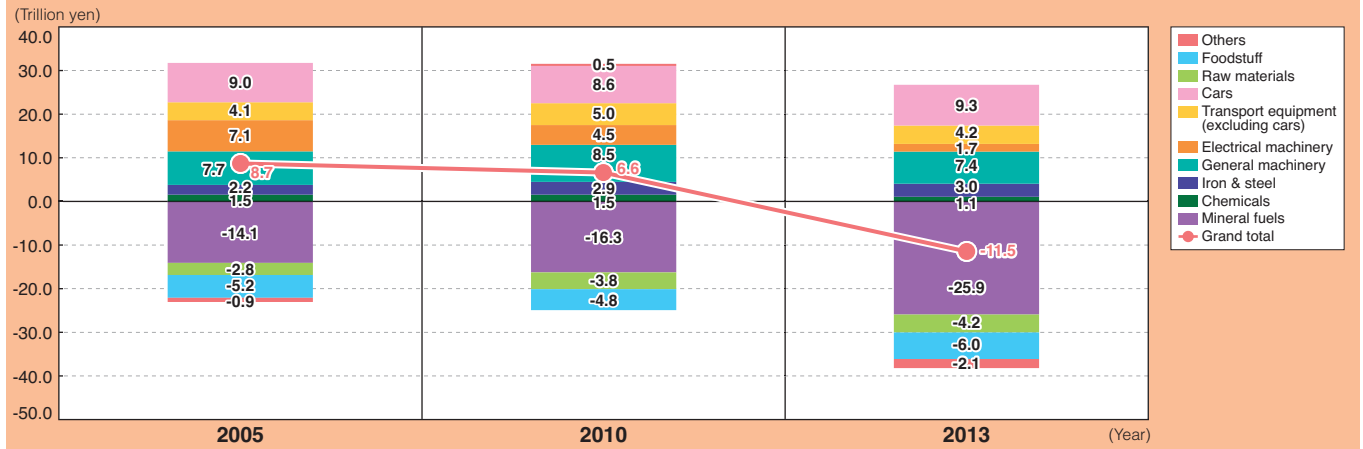
1-1 Trends in the Global Economy

Five years and counting after the global financial crisis ignited by the collapse of Lehman Brothers, the U.S. and other developed countries are beginning to return to growth tracks, but recovery is not so strong compared to past recovery phases (Chart 1). Emerging economies, which have been the driving force of global economic growth following the Lehman shock, show some vulnerability.

The year 2013 was characterized by some turmoil among emerging economies in terms of, for example, capital outflow and falling exchange rates amid expectations regarding the "tapering" of U.S. quantitative easing (Chart 2). This led to reform efforts in India, Indonesia and some other emerging economies aimed at reducing current account deficits, based on the understanding that although the emerging economies in general had become more resilient as a result of their experiences in previous financial crises, there was a need to respond to external shocks not just by defending exchange rates and other responses on the financial front but with reforms aimed at enhancing growth potential.

CHART 3

Comparison of trade balance for major product categories (2005, 2010 & 2013)



Source: Trade Statistics, Ministry of Finance

1-2 Trends in Japanese Trade & Investment

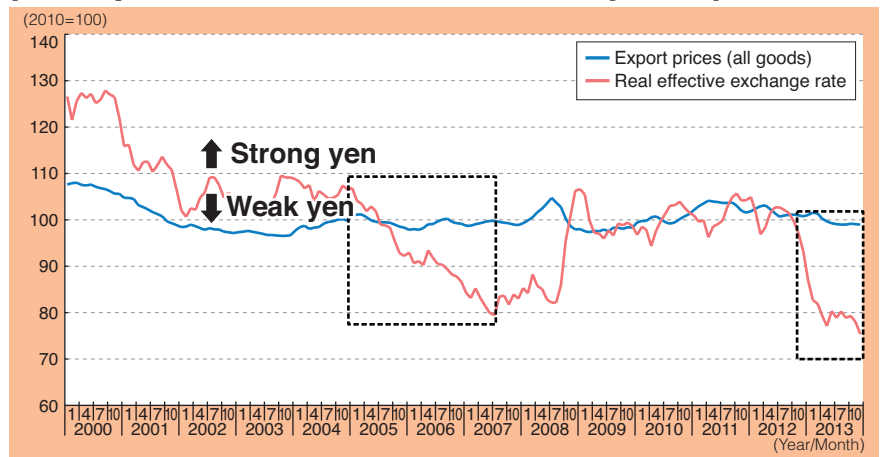
Japan's 2013 current account recorded its largest deficit in history. Although exports increased for the first time in three years as the result of the yen's weakening beginning at the end of 2012, imports increased for the fourth straight year, reaching the highest level in history, mainly as a result of the increase in the value of fossil fuel imports for electricity generation and strong domestic demand. A comparison of the trade statistics figures at the product category level in 2005, 2010 and 2013 shows that the mineral fuels deficit increased substantially while surpluses in general machinery, electrical machinery and the like have been decreasing (Chart 3). Export volume showed weak growth, but was rising gradually from the third quarter on.

Decelerating demand in emerging economies and the reluctance of businesses by varying degrees to lower prices on their foreign currency-denominated exports are two reasons why export volume growth has been weak. A look at exchange rates and export prices since 2000 shows that the overall export price level for all products has not shown much change correlated to exchange rate oscillations regardless of the direction of the yen (Chart 4).

As exchange rates trended towards a weaker yen from November 2012 onward, some businesses have increased export volume because they ① kept prices for their yen-denominated exports steady, resulting in a decline in terms of their local currency values or ② reduced prices denominated in local currencies (Chart 5). On the

CHART 4

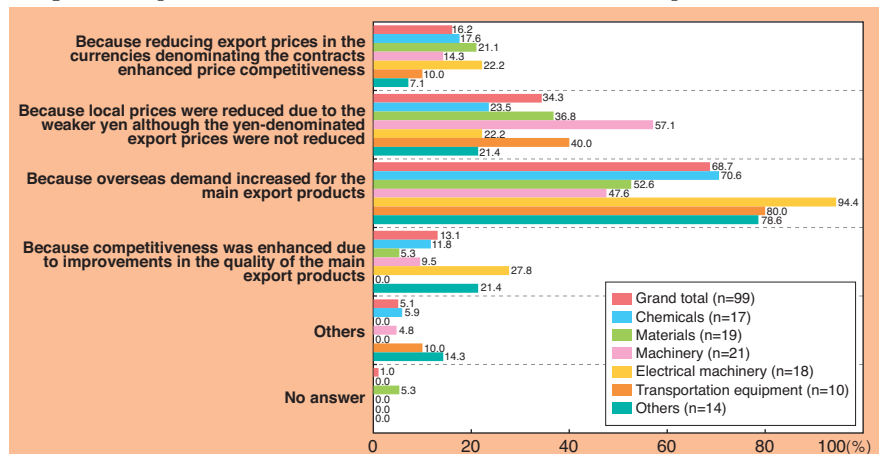
Movement of real effective exchange rate & export prices (for all products on the contract currency basis)



Source: Bank of Japan, Real Effective Exchange Rate and Corporate Goods Price Index (2010 base)

CHART 5

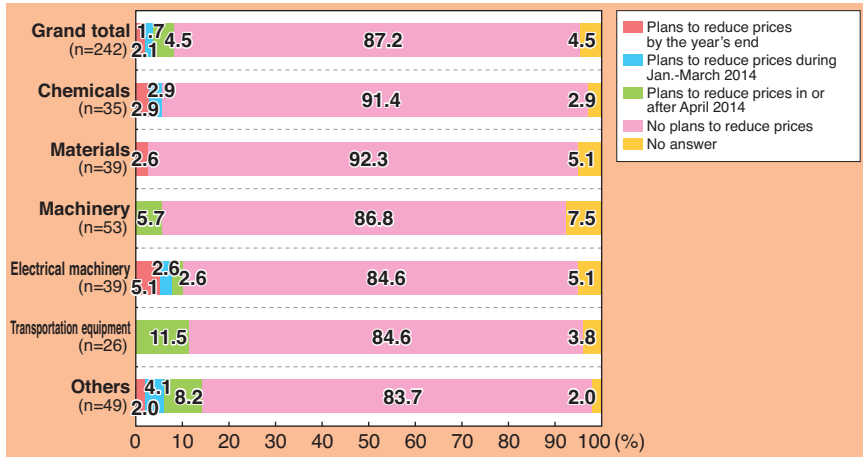
Reasons for the increase of the volume of exports (from November 2012 onward)



Source: Survey & Analysis of the Price-setting Behavior, etc. of Businesses in Response to Exchange Rate Fluctuations, Mitsubishi UFJ Research & Consulting

CHART 6

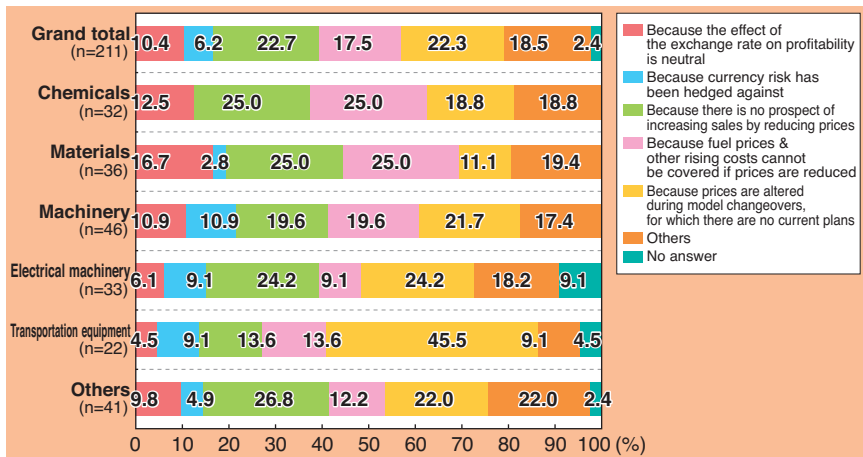
Future policy regarding alteration of export prices of businesses that have yet to do so



other hand, many businesses that had not altered prices stated that they did not have plans to reduce them in the foreseeable future (Chart 6). The main reasons that they gave for being reluctant to reduce prices were that they “cannot expect to increase sales even if prices were reduced” and they “currently have no plans for model changeovers and other occasions that are used to change prices.” It appears that this behavior on the part of businesses is a cause of the weakness in the increase in export volume (Chart 7).

CHART 7

Reasons why there are no plans to reduce export prices



In 2013, Japan registered its smallest current account surplus since 1985 as a consequence of an expanding trade deficit, even though the deficit in services trade shrank and the primary income surplus grew.

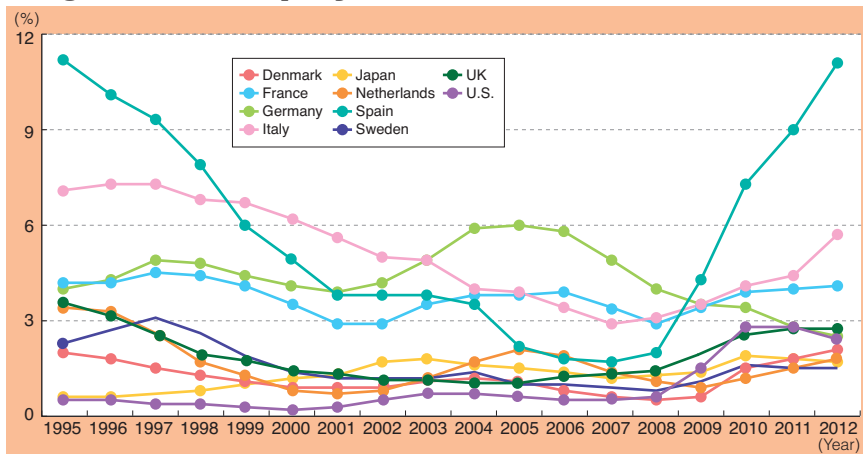
In order for Japan to maintain its current account surplus in the future, it is necessary to continue reducing the services deficit through such means as increasing inbound tourism and intellectual property income, further increasing the income surplus by enhancing the profitability of direct foreign investments, and reducing the trade deficit through such means as reinforcing export competitiveness and securing stable and inexpensive supply of natural resources.

Source (CHART 6 & 7): Survey & Analysis of the Price-setting Behavior, etc. of Businesses in Response to Exchange Rate Fluctuations, Mitsubishi UFJ Research & Consulting

2. The Economic Fundamentals of Various Countries & Their Growth Strategy & Structural Reform Efforts

CHART 8

International comparison of long-term unemployment rates



This section provides an analysis of the growth strategies and structural reform efforts of various countries as well as structural changes in their economies.

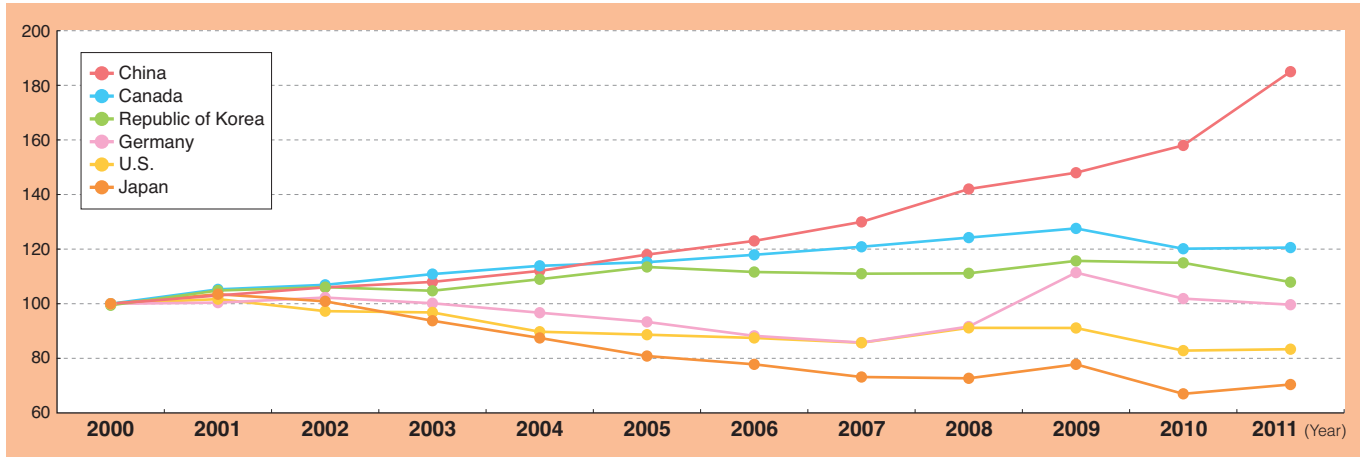
2-1 Labor Market Reform in Europe

Europe is finally showing signs of economic recovery. However, high unemployment persists, posing a structural problem (Chart 8) that lends urgency to the challenge of labor market reform. Southern Europe has been drawing attention to its efforts to make the labor market more flexible, such as relaxing procedures for wage adjustments. Overall, however, the tendency being observed is to emphasize reduction of disparities between regular and irregular workers and proactive

Note: Long-term unemployed = unemployed for 12 months or more
Source: Eurostat data

CHART 9

Comparison of unit labor cost transitions in manufacturing (unit: year 2000=100)

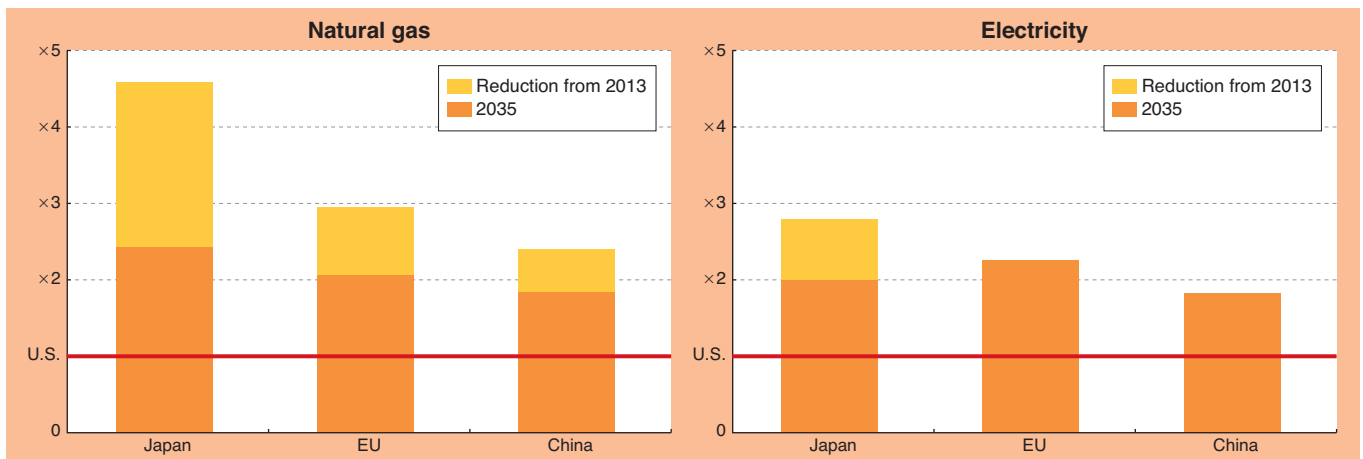


Note: China represented by economy-wide figures

Source: U.S. Department of Commerce Economics & Statistics Administration (ESA)

CHART 10

Ratio of industrial energy prices relative to the U.S.



Source: IEA World Energy Outlook 2013 summary version

labor market policies such as assistance for securing jobs (Table). This is an indication of the importance of the policy mix in the reform package.

2-2 The Manufacturing Renaissance & Reshoring in the U.S., & the Effect of the Shale Revolution

Reshoring, the return to the U.S. of its manufacturing base, focused largely on domestic demand, is occurring against the background of an improving business environment due to shrinking unit labor cost disparities as a result of rising wages overseas and the increased production of domestic shale oil and gas (Chart 9 and 10).

That said, the overseas deployment of U.S.

TABLE

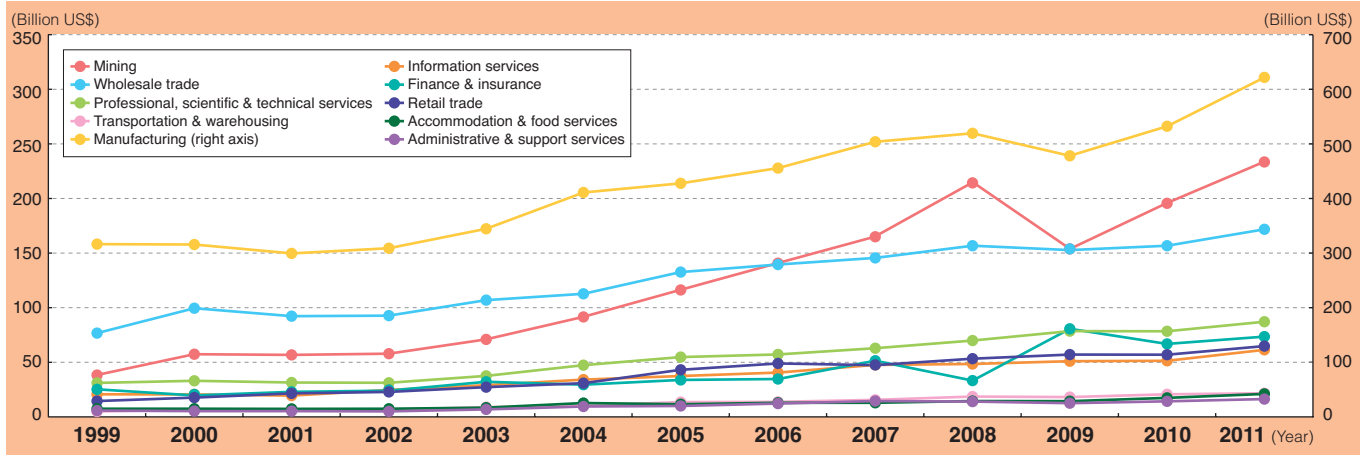
Recent labor market reform in Europe

Purpose	Contents	Country
Stabilizing worker employment; tightening regulation of non-regular employment	Avoiding perpetuation of fixed-term employment (maximum duration, conversion to permanent employment after a fixed period), improving treatment of non-regular employees, raising cost to business of non-regular employment, etc.	Spain 2010, Italy 2012, France 2013, Netherlands 2012 & 2014, Germany 2011, UK 2011
	Protecting rights of cross-border dispatched workers	EU 2014
	Introducing nationally uniform minimum wages	Germany: agreement in April 2014 (to be introduced in stages from 2015 through 2017). (Major countries other than Italy, Sweden and Denmark have legal minimum wages.)
More flexibility in the labor market	More flexibility for wage adjustments	Spain 2012, France 2013
	Relaxing restrictions on discharging regular employees	Spain 2012, Italy 2012

Source: Federation of Private Employment Agencies (Algemene Bond Uitzendondernemingen, ABU, Netherlands); Global Work Place Insider; The International Employment Lawyer; Institute for the Study of Labor (IZA); Department for Business, Innovation & Skills (BIS, UK); Japan Institute for Labour Policy & Training (JILPT); JETRO

CHART 11

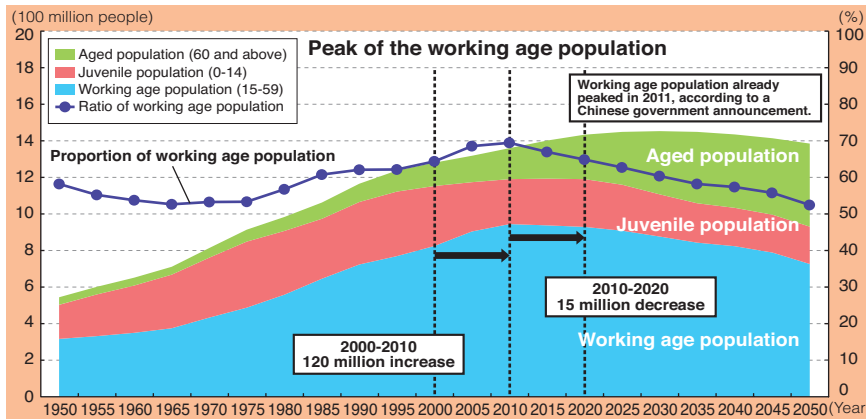
Transition of nominal added-value of American overseas subsidiaries by industry



Note: Depository institutions (banking) not included for 1999-2008
 Source: U.S. Department of Commerce Bureau of Economic Analysis (BEA) statistics

CHART 12

History & outlook for China's demographic composition (by age group)

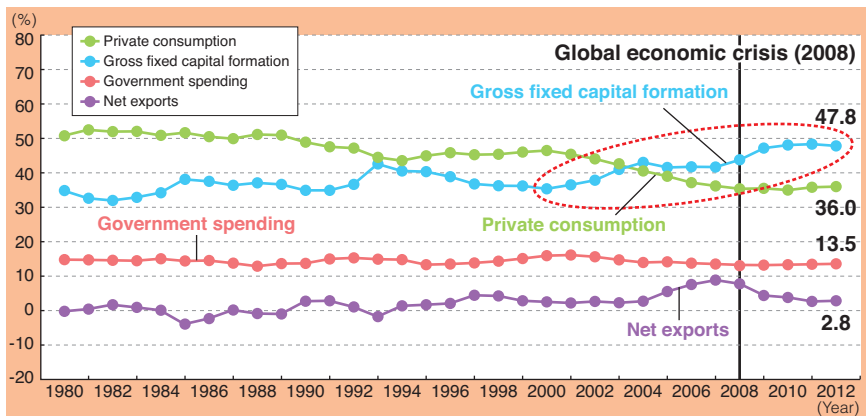


Note: Population estimates by UN, which include high, medium & low cases. The medium case is used in this figure.; In determining the definition of the working age population, the "16-59" used in the Jan. 20, 2014 press release from the National Bureau of Statistics of China was taken into consideration.; According to an announcement from the National Bureau of Statistics of China, the working age population already peaked in 2011, & decreased in 2012 & 2013.

Source: United Nations, World Population Prospects, the 2012 Revision

CHART 13

GDP by demand component



Source: National Bureau of Statistics of China statistics & the CEIC China Premium Database

businesses as a whole remains on an upward trajectory, as value-added, employment, fixed investment and other indexes of their overseas subsidiaries continue to rise (Chart 11).

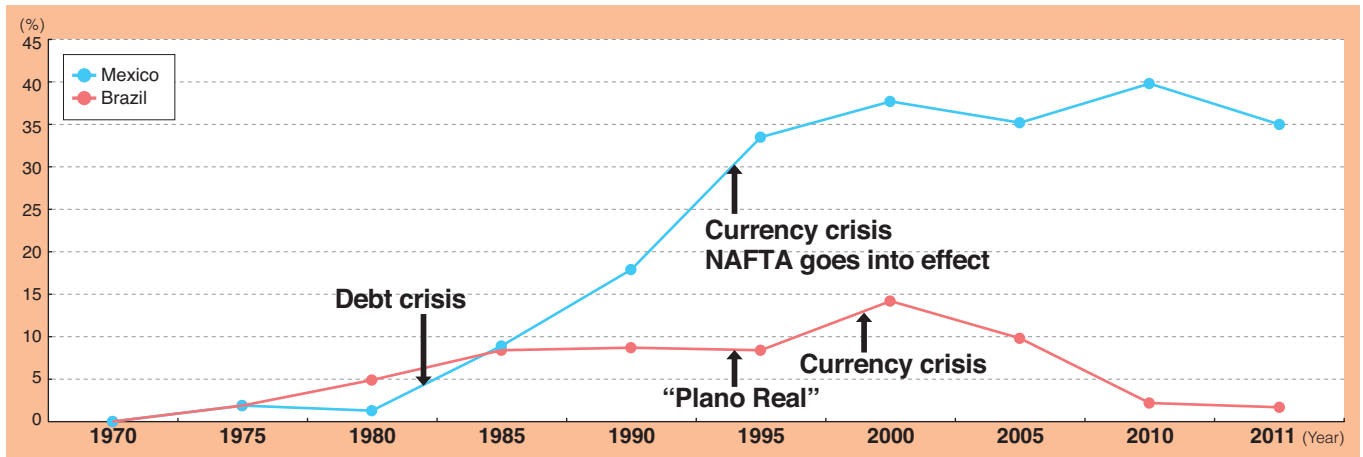
2-3 The Search for New Growth Models (China, ASEAN)

China has averaged nearly 10% annual GDP growth for more than three decades, expanding its presence in the global economy in terms of GDP, trade, foreign exchange reserves and other measures. However, the growth rate has dipped to the 7% range recently as demographics, wage levels and other conditions that supported such exceptional economic growth have been changing, and income disparities and other distortive side effects of economic growth are becoming evident (Chart 12). In order to continue growing against this background, China must grapple with the challenge of structural reform over a wide range of interrelated areas including conversion from its investment-focused growth model, response to the challenges posed by excess production capacity and state-owned enterprises, promotion of industrial structure enhancement, deregulation and financial reform, establishment of a social security framework and resolution of the local government debt issue (Chart 13).

ASEAN has developed an East and Southeast Asia-wide supply chain and achieved export-driven growth based on the competitive edge

CHART 14

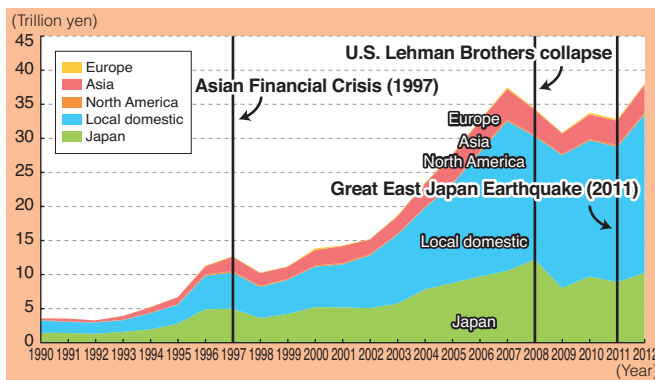
Mexico & Brazil: proportion of manufactured goods in their top-10 export items



Source: Instituto Brasileiro de Geografia e Estatística (IBGE), Instituto Nacional de Estadística y Geografía (INEGI) & CEIC databases

CHART 15

Procurement sources of Japanese subsidiaries (manufacturing) in Asia



Source: METI Basic (Trend) Survey of Overseas Business Activities

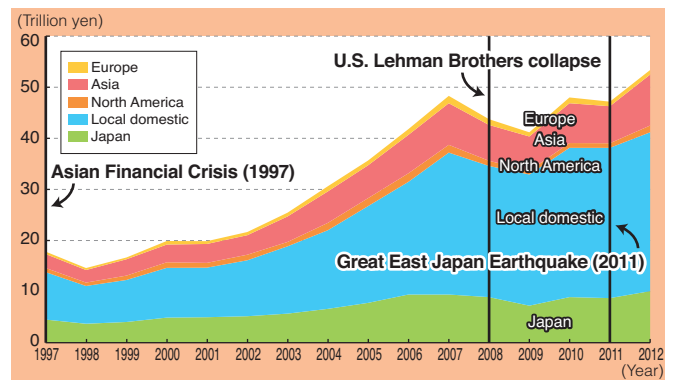
provided by low-cost labor. The major challenges in converting to sustainable growth based on the virtuous circle between the expansion of domestic demand and the enhancement of productivity are the promotion of further liberalization as well as the generation of innovation, infrastructure development, the establishment of an economic institutional framework that supports growth and the like.

2-4 The Growth Strategies of Mexico & Brazil

A look at the respective top 10 export items of Mexico and Brazil since the 1990s shows that Mexico has undergone a massive structural transformation into becoming an exporter of mainly manufactured products while Brazil has maintained an export structure that is centered on raw and processed natural resources and agricultural products, a contrast that has become even more marked in recent years (Chart 14). The background to this is the difference in their growth strategies. Mexico achieved growth as a manufacturing and export platform by promoting deregulation, privatization and other structural reforms while aggressively pushing external liberalization to utilize the benefit of its geographical

CHART 16

Sales of Japanese subsidiaries (manufacturing) in Asia

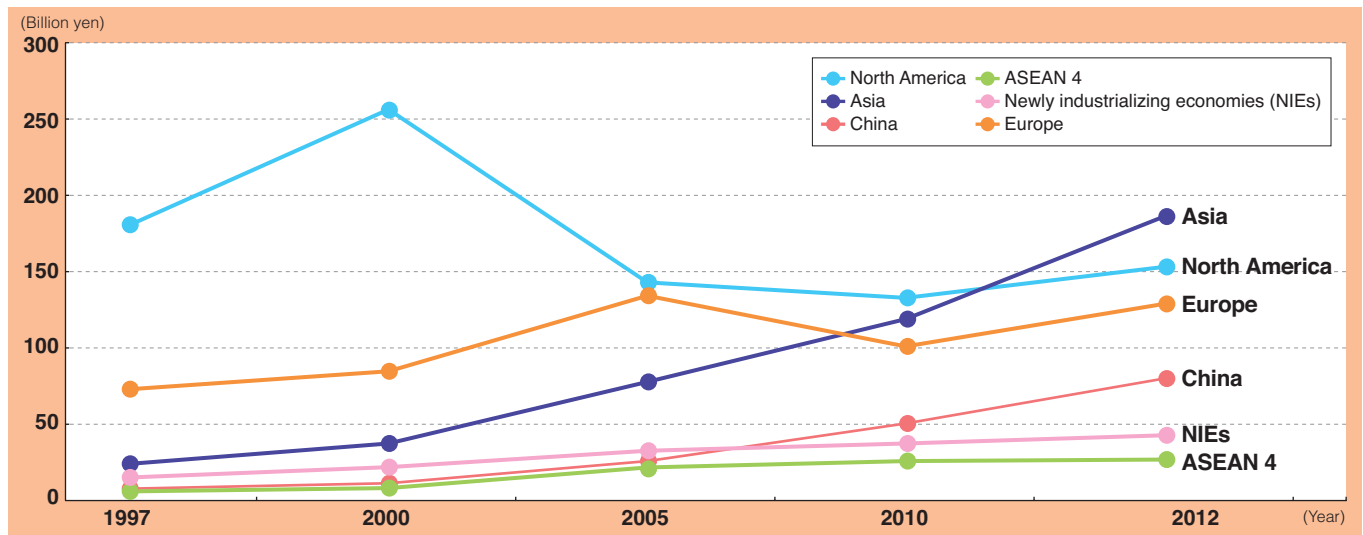


proximity to the U.S. Brazil, on the other hand, while accepting inbound direct investment, has achieved development by enhancing domestic demand by nurturing domestic industries and expanding the middle class, and more recently through natural resource exports, with China as the major destination.

2-5 The Intensification of the Trade & Investment Relationship in East & Southeast Asia

The trade and investment relationship in East and Southeast Asia is undergoing further intensification, and Japanese businesses are increasingly conducting their product development and production on a region-wide basis. To use the sourcing activities of the Asian subsidiaries of Japanese businesses engaged in local production as an example, the proportion of procurement within the host countries is increasing year by year although procurement from Japan is not decreasing (Chart 15). The growth of Japanese business activities in East and Southeast Asia is also visible in the increase of the ratio of local sales by their Asian subsidiaries (Chart 16), as well as in the increasingly vibrant research and development activities there (Chart 17).

CHART 17

R&D expenditures of Japanese overseas subsidiaries (manufacturing)**3. International Engagement by Japan**

This is an exposition of policies that help improve the domestic and overseas business environment for Japan. It is important for Japan in accessing the global market to undertake ① promotion of economic partnerships, ② strategic engagement with emerging economies and ③ incorporation of top-tier human resources and businesses from abroad.

3-1 Promotion of Economic Partnerships

The expansion of free trade and promotion of economic partnerships comprise the central pillar of Japan's international economy and trade policy. It is essential to Japan's future economic growth to incorporate that growth and major markets in the Asia-Pacific region by laying out a global "network of economic partnerships" through the promotion of the Trans-Pacific Partnership (TPP), Regional Comprehensive Economic Partnership (RCEP), a Japan-China-Republic of Korea free trade agreement, a Japan-EU economic partnership agreement (EPA) and other multilateral EPAs. The "Japan Revitalization Strategy" (June 14, 2013 Cabinet decision) has determined that "the FTA ratio (proportion of FTA partners' share of total trade) shall be raised from 19% currently to 70% by 2018," and negotiations continue.

In addition to promoting economic partnerships, it is important to inform companies of the actual benefits of utilizing EPAs. According to the questionnaire, Japanese companies identified the tariff elimination/reduction as the major benefit of the EPA/FTA and there is some gap in knowledge levels among them. They answered that the following information is helpful when they consider utilizing EPAs: Japan's EPA partner countries/regions, specific goods of which the tariff is reduced or eliminated, and the actual value of tariff

reduction, as well as the examples of EPA utilization by other companies. These results of the survey show that providing such specific information may increase further use of EPAs.

3-2 Strategic Engagement with Emerging Economies

Obtaining demand from emerging economies is necessary to generate wealth for Japan by enabling Japanese businesses to capture growing global demand and to build the foundations for promoting exports of finished products and parts and components from Japan.

To this end, in 2013 the Japanese government categorized emerging economies into three groups ("China and ASEAN", "South and West Asia, the Middle East, Russia, and Central and South America" and "Africa") based on the level of economic development, the extent of engagement by Japanese businesses and the competitive environment *vis-à-vis* non-Japanese businesses, and is taking measures accordingly.

3-3 Incorporation of Top-Tier Human Resources & Businesses from Abroad

Promoting inward foreign direct investment, in which Japan falls behind other countries, provides new stimulus for open innovation and it is also important from the viewpoint of revitalization of local economies amid fierce global competition to attract foreign businesses.

To meet the challenge, the Japan Foreign Direct Investment Council is taking the lead in promoting regulatory and institutional reform, taking into account the views of overseas businesses, and attracting investment in collaboration with the Japan External Trade Organization (JETRO), Japanese embassies and consulates and innovative local governments.