The 2015 White Paper on International Economy & Trade

Exports & Investments

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Introduction

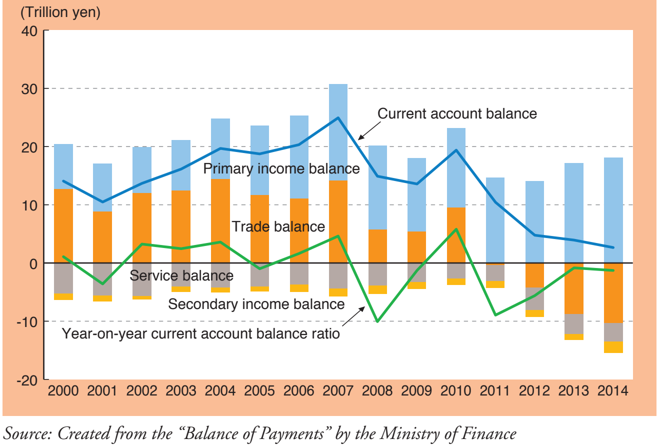
As the administration of Prime Minister Shinzo Abe enters its third year, Japanese policies are slowly shifting away from an emphasis on resolving the lack of demand issue to overcome deflation, to a new stage where measures are required to overcome constraints in supply in a country with a declining population. When the administration first took office in December 2012, measures were implemented to lift demand from the macro-side, with the first arrow of such measures being bold monetary easing, and the second arrow being flexible financial policies. The administration is now executing a growth strategy, the third arrow of the structural reform designed to eradicate the deflationary mindset in business circles and among the general public, and Japan's revival strategy — "Japan is Back" — was revised in the middle of 2015 (June 30). In the meantime, the Abe administration has requested wage increases and rising costs have been passed on to prices, through government-labor-management meetings. In addition, the administration has been undertaking reforms that Japan has long been unable to touch upon since the end of World War II, namely agricultural reforms including the reorganization of Japan Agricultural Cooperatives (JA), and system reforms in energy, including electricity and gas.

As a result, corporate profits are at a historical high, and with these profits leading to higher wages, consumption is finally beginning to pick up. The unemployment rate has gone down to 3%, the effective job ratio is also picking up for the first time in 20 years, and the workforce has increased by 900,000 people. Looking ahead, supply and demand for labor is expected to remain tight, and therefore an exit in the struggle to overcome deflation seems to be near.

Thus, a virtuous cycle is steadily beginning to pick up speed under Abenomics. But as Japan faces a declining population and an ageing society, it needs to cultivate new markets both domestic and abroad, and obtain potential demand in order to achieve sustainable economic growth. The 2015 White Paper, which counts as the 67th in its publication series, categorizes Japan's overseas earning power into three areas and highlights the challenges the Japanese economy is faced with to sustain its growth in the future. This article will introduce the findings of the White Paper based on these three categories — "Export Power", "Attracting Power" (of people and businesses), and "Earning Power" (by expanding overseas) — and discuss the future direction of the Japanese economy.

CHART 1

Trend in current account balance
(2000-2014)



Source: Created from the "Balance of Payments" by the Ministry of Finance

Trends in Current Account Balance

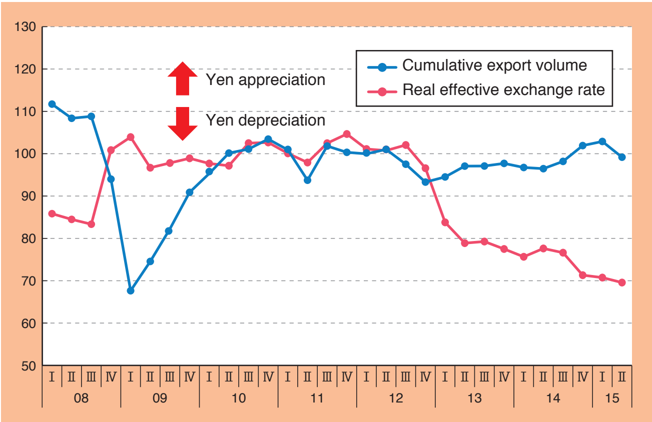
As is well known, the current account balance consists of the trade balance, service balance, and income balance. Although the trade balance in fiscal 2014 marked the largest deficit for Japan, the service deficit declined sharply. In particular, the travel balance deficit was the smallest, backed by the increase in foreign visitors to Japan, and the surplus for intellectual rights fees, which includes royalties from foreign companies, was at a historical high. In addition, with direct investment producing large profits, the (primary) income balance surplus was also at a historical high. As *Chart 1* shows, the percentage of the trade balance was the highest amongst these three components, and therefore Japan's current account balance is in surplus by 2.64 trillion yen, the lowest figure since such data became available in 1985. The recent decline in energy prices since the fall of 2014 will surely have a big impact on the current account balance, and therefore the surplus in the trade balance and the current account balance is expected to expand in 2015.

Analyzing Factors Behind Trade Balance

When considering trends affecting the current account balance, the trade balance has a huge impact. The White Paper on International Economy and Trade follows the trends in export volume of Japanese goods. In looking at the relationship between the export volume and the real effective exchange rate (REER), we can observe an increase in the trade volume from 2000 to 2007 on the back of a weak yen. After the yen appreciated from 2007 to 2012, a major readjustment process to weaken the yen was seen, but the trade volume was slow to reflect that process *(Chart 2)*. The reasons behind the birth of this J-curve effect have not yet been fully presented. The White Paper tries to seek a solution by estimating an export function, which explains what factors influence the volumes of exports from Japan. In addition to the aforementioned real effective exchange rate, the explanatory variables used in the export function were: (1) export demand (total GDP of 26 major trade partners of Japan), (2) high added value of export goods, (3) production capacity of export goods, and (4) foreign inventory

CHART 2

Real effective exchange rate & trends in export volume



Source: Ministry of Finance, Export Volume Index from the Cabinet Office and seasonally adjusted, BIS

investments. Of the four variables, production capacity of export goods was a key variable in assessing Japan's "Export Power". In particular, on the back of economic globalization in recent years, Japan's manufacturing industry continues to rapidly expand its businesses overseas, and with overseas transfer of production infrastructure, concerns over the hollowing out of domestic production bases are rising, but if there are constraints to domestic production capacity it will be difficult for Japan to export, even if overseas demand were to expand. In looking at the results of the export function estimates by the White Paper, one can see that overseas demand factors continued to push the export volume up, except for the quarter after the Lehman Shock. On the other hand, requirements for high value-added exports generally tend to push export volume down. The decline in Japan's exports under the depreciation of the yen after 2011 can be explained by a reduction in production capacity of export goods which lasted from the end of 2011 to 2012, and by the last-minute increase in demand before the hike in consumption tax which caused a temporary decline in the production capacity of export goods. It is especially interesting to note the result which highlights the impact of last-minute demand on export volume, as it matches other last-minute demands which heralded the introduction of new systems. For example, past studies have shown that corporate export behavior which portended the introduction of voluntary export restraints did have a brief, but large, impact on supply and demand in the market ("Anticipatory Effects of Voluntary Export Restraints: A Study of Home Video Cassette Recorders Market", by Hiroshi Ohashi, *Journal of International Economics*, 2002). A more thorough academic analysis into this matter is needed.

Verification of "Export Power"

The White Paper shows that requirements for high added value for exports is the general cause of the decline in export volume. This observation is puzzling. The White Paper analyzes the trends in export volume and in unit prices of major countries by export items for each sector. *Table 1* compares Japanese exports and German exports to China. The reason for comparing Japan and Germany is because like Japan, Germany has high export amounts across many industries. This table provides instances where export volume in the period 2013-14, compared to at least two years between 2005 and 2008, has shown an increase, and has also shown a positive year-on-year growth for more than three years in the five-year period from 2010 to 2014. Results show that the major sectors in Germany have a high percentage of items where both volume and prices have risen. In other words, while some Japanese export items have been absorbed by global demand, the percentage it has acquired in relation to the growing demand has been small compared to Germany, and this has highlighted that the requirements for high added value and volume increase have not been progressing simultaneously.

Verification of "Attracting Power"

With globalization of economies, we are entering an era where competitive countries attract and collect "people, money, goods, and information" and are revitalizing industries. Technological innovation as seen in information and communication technologies has opened doors to an era where the same information can be shared anywhere in the world, and the choices for companies over which city to do business in are expanding. Rapid economic development seen in newly emerging countries, mainly in Asia such as China and India, and the emergence of low-cost airlines has made the transfer of human resources between international cities easier, and has thus intensified competition between the cities, mainly in Asia.

One can see where Japan is positioned amongst the competition between international cities in the Global Competitiveness Report published by the World Economic Forum or the World Competitiveness Yearbook published by the International Institute for Management Development (IMD) *(Chart 3)*. In both of the reports, Japan's ranking is on a rising trend. But if one looks at the individual items such as "cost of industrial electricity" under the assessment item for "Basic Infrastructure" in the IMD rankings, Japan placed 45th (2010), 52nd (2013), and 50th (2014), and has been showing a decline in recent years, also causing a decline in Japan's international competitiveness. The electrical system reform in Japan which consists of three stages has been approved in the Diet, and as the first round of reforms, a new organization which strengthens electricity reliability across regions, the

TABLE 1

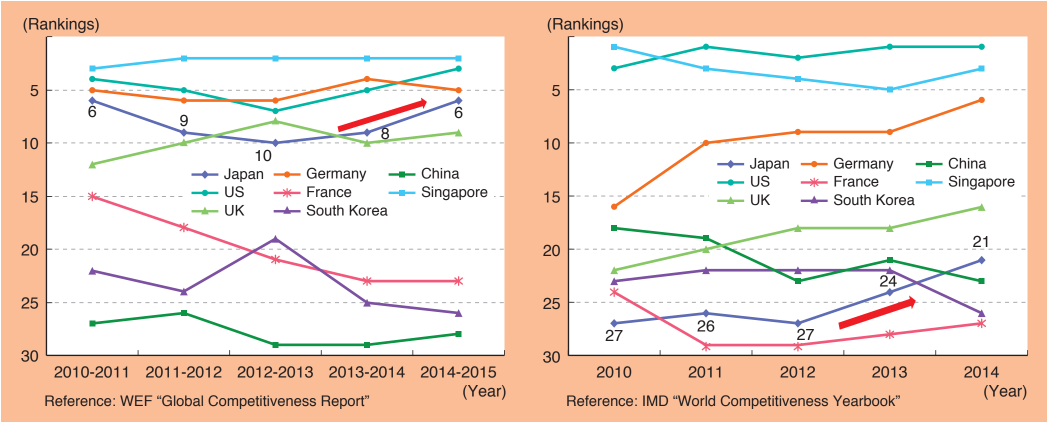
Comparison of trends in exports to China in Japan & Germany (volume, unit price)

Exports to China (major 8 sectors)	Japan (%)						Germany (%)					
	Share of items (volume increased)	Share of items (2014)				Share of items (unit price increased)	Share of items (volume increased)	Share of items (2014)				Share of items (unit price increased)
		Unit price++	Unit price+	Unit price±	Unit price▲			Unit price++	Unit price+	Unit price±	Unit price▲	
Chemicals & plastics	58.9	3.7	37.3	13.7	4.2	72.3	81.4	17.8	29.8	18.3	15.5	60.2
Textiles & textile articles	36.3	3.2	12.2	12.1	8.8	47.8	76.5	7.8	30.3	13.4	25.0	55.7
Iron & steel products	60.1	0.6	15.2	29.9	14.5	34.7	78.8	1.8	27.4	14.0	35.6	36.4
Nonferrous metal	23.6	0.0	3.0	10.7	9.8	31.3	44.7	2.1	28.1	6.6	8.0	75.9
General machinery	48.3	2.1	12.4	8.0	25.8	49.5	70.4	2.8	24.1	7.7	35.8	40.6
Electrical machinery	50.3	4.3	6.3	14.0	25.6	33.1	77.9	4.3	28.0	11.2	34.5	43.1
Precision machinery	41.9	8.4	8.4	4.2	20.8	35.1	84.4	3.5	22.5	16.3	42.1	37.8
Transportation equipment	56.2	1.1	48.5	0.8	5.8	83.8	79.8	0.5	52.5	14.1	12.9	69.0

Notes 1: Underlined items for Japanese unit price increase items show that the numbers are larger than those of Germany.
2: Iron & steel products and nonferrous metal do not include scrap iron. Major transport items are included in transportation equipment, and not in general machinery.
Source: White Paper on International Economy & Trade 2015, Part II, Chapter 1, Section 3, Table II-1-1-3-31, p. 113

CHART 3

Trends in international competitiveness rankings
(left: WEF, right: IMD)



Source: White Paper on International Economy & Trade 2015, Part II, Chapter 1, Section 2, Chart II-1-2-2-15, p. 165

Organization for Cross-regional Coordination of Transmission Operators, was established in April 2015, and electrical system reform is steadily progressing. Japan needs to maintain its efforts to push regulatory reform forward in other industry and business areas, and continue such efforts so that companies choose Japan as a site to do business in, including start-up companies.

On the other hand, in terms of attracting people to Japan, sightseeing visits have been showing a great increase. In 2014, the number of foreign visitors to Japan reached 13.41 million, a historical high, and it is expected that 2015 will show a far greater number than the previous year. In particular, the majority of foreign visitors come from Asia, and for 2014, 80.7% of foreign visitors to Japan came from Asia. In order to attract foreign visitors, Japan has been working on cross-ministry efforts including systems' development, and in addition to active campaigns by the Japan National Tourism Organization and others, easing and exemptions of conditions and paperwork for visa applications have also contributed to promotion of travel to Japan. Promoting the attractions of Japan from diverse angles to other countries by ways of collaboration with government initiatives such as Cool Japan or Visit Japan is also important from a diplomacy perspective.

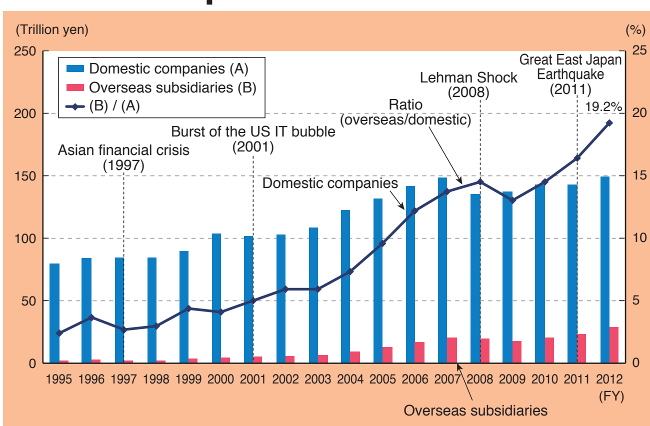
Verification of "Overseas Earning Power" (1): Dividend Payout Ratio

How and where are Japanese companies profiting from selling their products and services overseas? By analyzing the individual reply sheets of the Basic Survey of Overseas Business Activities, the White Paper tries to grasp the relationship between Japan and overseas business activities by region and by industry. Looking at overseas Japanese business activities between 1995 and 2012, the percentage of overseas subsidiaries against Japan-based companies grew two-fold in sales, three-fold in current profits, and eight-fold in retained profits. *Chart 4* shows the retained profits changing at a high level for companies with businesses overseas compared with companies headquartered in Japan.

As the weight of overseas profitability becomes higher, how, then, are domestically headquartered companies profiting? From the perspective of overseas subsidiaries, the following three components contribute to profits of companies headquartered in Japan: (1) procurement of materials from Japan (Japanese exports), (2) dividend payout to Japan (an item of income balance), and (3) payment of royalties to Japan (an item of the service account). These three categories all showed a temporary decrease with the Lehman Shock but have been steadily growing, and especially in terms of ratio, the percentage of dividends and royalties is expanding. Dividends fluctuate by year, but dividend payouts from China and from the US are shown to be on a par in recent years. The White Paper also showed that payout ratios of Japanese companies in China are higher than the average ratio of host nations to Japanese subsidiaries, and also higher than the payout ratio in the US. In terms of the relationship between the payout ratio and corporate profitability, the percentage of dividend paying companies generally tends to go up with a rise in net profit rates, but there seems to be a cap at 10-15%. This shows that dividend payouts are easier to implement with higher profit rates, but that high profit rates do not necessarily lead to dividend payouts, and that dividend payouts are determined by other factors than profit rates. The percentage of dividend-paying companies rises in proportion to the number of years in operation, and the percentage becomes flat around 40% after the years of operation pass 10 years. This shows that for companies to be able to pay out dividends, they need to build a solid organizational and financial base, such as acquiring management know-how and building a trusting relationship with employees and local stakeholders. An assumption can be made that once the years in operation pass a certain number, the companies have the option of retaining the capital locally with their subsidiaries. These analyses provide a new perspective on profit distribution between the

CHART 4

Trends in retained earnings balance at domestic companies & overseas subsidiaries



Note: Domestic companies were compiled from the companies surveyed by the "Basic Survey of Japanese Business Structure and Activities". Retained earnings balance was calculated as accumulated profit.
Reference: Chart was made using findings from the "Basic Survey of Japanese Business Structure and Activities" and "Basic Survey of Overseas Business Activities" published by the Ministry of Economy, Industry and Trade.
Source: White Paper on International Economy & Trade 2015, Part II, Chapter 1, Section 3, Chart II-1-3-1-3, p. 179

Japanese headquarters and the overseas subsidiaries, and it is hoped that a more thorough academic analysis can be provided.

Verification of "Overseas Earning Power" (2): Financial Analysis

The White Paper uses the financial data to analyze the characteristics of how major Japanese and other foreign global companies make profits. Based on the financial data for the eight years from 2006 to 2013, the following companies were extracted for the analysis: top 500 companies in terms of consolidated sales for the most recent 10 months; top 500 companies whose overseas sales ratios are more than 20% of their total sales; and 357 other companies whose overseas sales ratios are more than 20% of their total sales along with other factors. It is important to note that for those sectors with the majority of companies being state-owned (energy, finance, and pubic profit), such companies have been excluded, along with those whose group sales figures for 10 consecutive years were not available.

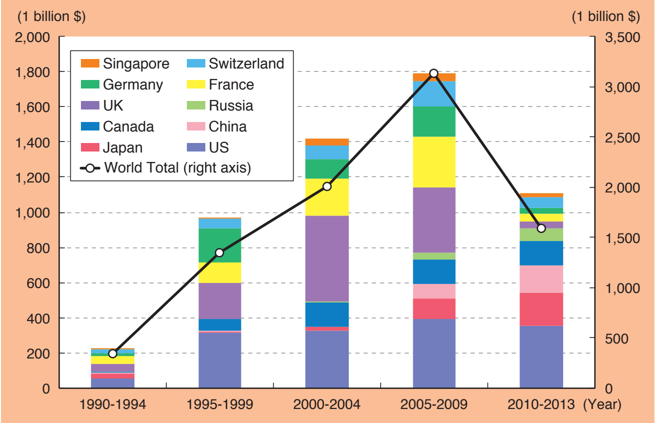
The White Paper looks at changes in sales figures by region under these preconditions. One can see that Japanese companies underperform other foreign companies in all regions (Asia Pacific, North and South America, Europe, Middle East and Africa) in terms of annual average growth rate for sales. In particular, in the Asia-Pacific region where the companies are headquartered, and where the market size is expanding, the annual average growth rate for sales of Japanese companies is 3.6%. In comparison, the growth rates for US companies, European companies, and Asian companies are 11.2%, 10.1%, and 8.5% respectively. This highlights the fact that Japanese companies have been unable to absorb the growth of the Asia-Pacific region.

The White Paper also conducts analysis from a business diversification angle. By calculating the Herfindahl-Hirschman Index which assesses the degree of concentration of business operations, and analyzing the relationship between profitability and the differences in diversification within each company, the results showed that Japanese companies that are engaged in exclusive operations or technical operations tended to outperform foreign companies, but diversified Japanese companies have low growth rates and low profitability. Synergies between multiple businesses, as a result of diversification, have not been fully utilized, and in fact there is a possibility that resources are too scattered and investments are not adequate to switch over to a high growth and high profit strategy. There is also a possibility that businesses are losing their competitiveness as a result of not reviewing their portfolios based on their competitive advantage. On the other hand, US and European companies have successfully directed their economies of scale and diversification to produce high returns, and there is a possibility that large companies which have established a monopolistic status, and newly emerging companies which are expanding their corporate activities in new growth areas, are supporting the growth and profitability of the overall corporate sector. This White Paper provides an important basic analysis on how to conduct future comprehensive analyses of global companies.

Strengthening Global Management Power

In a world where global competition is intensifying and where the proportion of overseas businesses continues to expand, overseas businesses by Japanese companies is manifested not only in green field investments, but also as M&A or acquisitions of existing businesses. While the value of cross-border M&A has decreased in the world since the Lehman Shock, the percentage of M&A by Japanese companies has increased *(Chart 5)*. The White Paper points to two characteristics of the recent changes in globalization of corporate activities. (1) For those businesses with existing business headquarters overseas, deepening of globalization can be seen in expansion of overseas business activities and quick acquisition of overseas markets via M&A. In parallel, overseas expansion for the purpose of acquiring overseas markets, not for cost purposes to look for cheap labor, is seen across all company sizes. (2) In addition to globalization of production and sales, the percentage of companies undertaking research and development overseas is also increasing, and as such, the width of overseas business activities is expanding. In response to the progress in globalization of corporate activities, collecting talent from around the world and promoting diversity in human resources to pursue "domestic globalization" has become a priority. In addition to geopolitical risks, there is a need to correct the perception of risk between the headquarters and the overseas subsidiaries. According to a survey conducted by the White Paper on the corporate headquarters, while 40% of the companies replied that the risk management division is able to effectively manage the subsidiaries, even the small-scale domestic companies, there was a significant portion of companies who replied that they are not able to manage their overseas subsidiaries acquired through M&A, and a very few replied that they are able to manage even the small-scale companies. Demarcation of risks to be managed by the risk management division and the operations division has not been clearly identified, and the lack of arrangement to maintain the independence of foreign entities and uniformly undertake risk management is thought to be a contributing factor. But if the goal is to properly manage risks to create synergies between the domestic headquarters and the overseas business sites, Japanese companies need to transform their management to fit globalization. JS

CHART 5
Cross-border global M&A & percentage for Japan (1990-2013)



Reference: Data from the UNCTA Database
Note: PURCHASER, values are annual cumulative figures.
Source: White Paper on International Economy & Trade 2015, Part II, Chapter 1, Section 3, Chart II-2-3-1-3, p. 269

Hiroshi Ohashi, a professor at the Graduate School of Economics at the University of Tokyo, is a prize-winning researcher who has published widely in numerous journals, including the Journal of International Economics *and the* Review of Industrial Organization. *He has been a faculty fellow and program director at the Research Institute of Economy, Trade & Industry (RIETI), and served as head research officer at the National Institute of Science and Technology Policy in the Ministry of Education, Sports and Technology. His areas of expertise include industrial organization, competition policy and international trade.*