

White Paper on International Economy & Trade 2016 — Japanese Trade Policy in the Opacity of the Global Economy

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Introduction

The outlook for the global economy appears increasingly opaque as the United Kingdom's decision to leave the European Union falls on a world weighted down by excess capital stock in China and fretting over the possibility of an economic slowdown in the United States. The Japanese economy in particular faces an increasingly harsh environment. The yen has turned a corner on the foreign exchange market and is now trending upward, leaving the future of a cheap yen, considered a pillar of Abenomics, in uncertainty. Although the level of corporate profits remains high, they are showing signs of stalling. Ordinary profits for January-March 2016 fell 7% from the previous quarter, and 9% year-on-year according to the Financial Statements Statistics of Corporations by Industry. The business conditions diffusion index in the Bank of Japan's Tankan survey indicates that business sentiment among businesses of all sizes in all industries has become subdued, both for now and looking toward the future.

The diminished expectations of economic growth amid a declining, aging population, the persistently low productivity of a labor force that fails to fully utilize information technology and other innovations, slow-to-improve childcare conditions, and the anxiety of the working population over the future of the Japanese economy all weigh heavily on it, weakening private sector demand for both consumption and investment. There is an urgent need to develop new markets overseas through trade and investment and to discover as-yet untapped demand at home if Japan is to boost its potential growth rate by enhancing its productivity and innovative powers.

The 68th *White Paper on International Economy and Trade* was published in June 2016. This article will discuss prescriptions for reviving the Japanese economy through trade policy while following the outline of the White Paper. First it will explain developments in the Chinese economy. Although increased investment in China and elsewhere sustained the global economy during an economic crisis even as developed economies faltered, economic growth led by capital investment generated excessive debt, and excessive production capacity is also becoming obvious. The current state of trade in services will then be mentioned. At 126 trillion yen, Japan's current account balance in 2015 returned to pre-financial crisis levels. Although 60% of income consisted of exports of goods, economic growth is now led by investment and service exports. Thus, the urgency of increasing trade in services that draws on

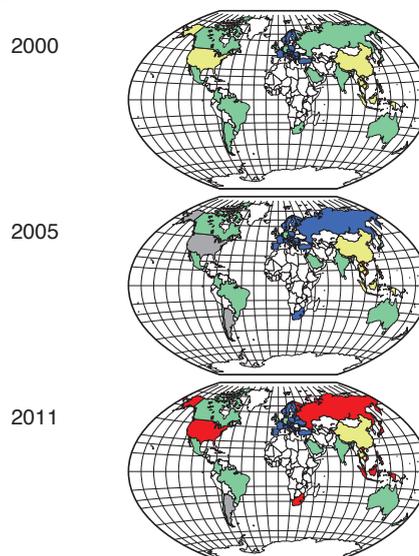
Japanese strengths will be discussed. Sections on inbound tourism, an area of trade in services that is showing particularly robust growth, and the challenges in expanding exports by small, medium and mid-tier enterprises as well as government policy in the era of the fourth industrial revolution, will follow. The performance of such enterprises from the perspective of energizing local economies with a focus on manufacturing exports will then be taken up, and the final section will emphasize the importance of the Trans-Pacific Partnership and other economic partnership agreements and the desirable orientation of Japan's trade policy in light of the recent political situation in the United States and Europe.

State of Emerging Economies

The global economic crisis that hit in the fall of 2008 has been the catalyst for a major change in the economic relationship among emerging economies. The rapid growth of the emerging economies and the deepening of the global value chain has enhanced the presence of China in production. *Chart 1* shows that the largest exporting country in terms of value added with regard to final

CHART 1

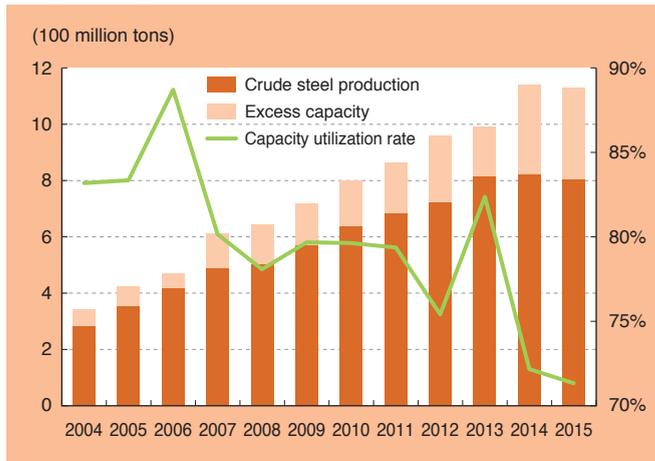
Largest exporter in terms of value added as proportion of final demand in each country



Source: *White Paper on International Economy and Trade 2016*, METI

CHART 2

China's crude steel production capacity & utilization rate



Source: White Paper on International Economy and Trade 2016, METI

demand in each country is shifting from the US, Europe and Japan to China. The largest exporting country in terms of value added means the country that is generating the largest amount of value added for final demand in any other country (other than that country itself). Take the US, for example. The nominal share of imports by country shows that China overtook Japan in 2002. By 2006, China passed Japan in imports in terms of value added. You can see that the time has passed when Japan was effectively providing value added by supplying parts and components and by providing licenses to China.

China played a significant role as the engine of the global economy in the post-financial crises touched off by the Lehman bankruptcy by expanding investment and other means even as the developed economies decelerated. But taking on the double burden of excessive debt and excessive production capacity in that process led to the deceleration of the Chinese economy that we are witnessing today.

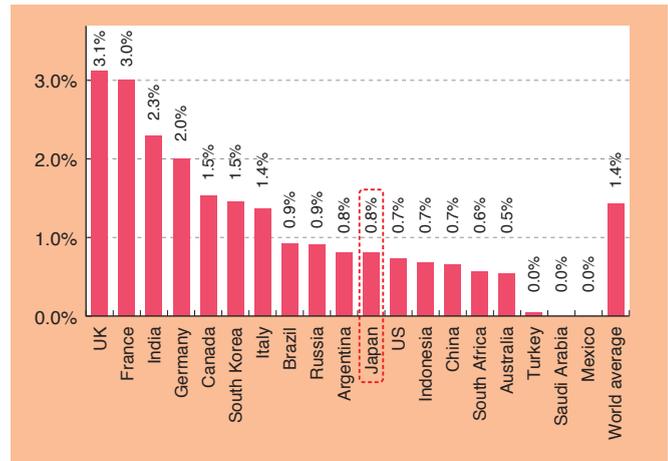
The gap between actual production and its capacity is evident in the steel and iron and chemical sectors. As [Chart 2](#) shows, the production of raw steel is increasing at a lower rate than production capacity, with the result that the capacity utilization rate is trending down to approximately 70% as of 2015. The producer price and export price declines have led to concerns on overseas dumping. Indeed, the number of antidumping duties imposed and safeguard measures being triggered have been on the rise since the turn of the century, mainly in iron and steel products. Some 15 years since China's accession to the World Trade Organization (WTO), its efforts to gain "market economy status" are now the focus of controversy. This is an important issue in gauging the extent to which China's excessive production will affect the global economy going forward, since market economy status will make anti-dumping findings more difficult.

State of Trade in Services

As the role of services in industrial activities increases with the

CHART 3

Ratios of professional service exports to GDP for G20 countries (2014)



Source: White Paper on International Economy and Trade 2016, METI

growth of the global economy, the proportion of services in international trade is also rising. Since services now account for 70% of Japan's GDP, it is important to deepen our understanding of services in international trade. This year's White Paper on International Economy and Trade highlights "professional services" such as research and development services and specialized consulting services, and discusses where Japan is positioned regarding their export and the challenges ahead.

As [Chart 3](#), which gives the ratios of professional services to GDP for the G20 member countries, shows the ratio is high in industrialized economies such as the UK (3.1%) and France (3.0%), but India also shows a high level of communication, computer and information service exports (2.3%), largely as a consequence of the high level of outsourcing consignment activities in the IT sector.

The Japanese ratio for professional services is low, at 0.8%. However, research and development services are rapidly on the rise, showing potential for future growth. One important issue going forward is the extent to which accurate and comprehensive statistics on trade in services can be secured as data exchange and commercial transactions over the Internet grow.

Further Efforts to Become "Tourism-Oriented Country"

Some 19.74 million foreigners visited Japan in 2015, surpassing the previous record of 13.41 million visitors in 2014 with a 47.1% increase. This was the third straight year that the record was broken, in the process recording the greatest growth rate since 1964, when records were first taken. Foreign visitors are also spending more while they are travelling in Japan, to the tune of 3.48 trillion yen in 2015, up from 1.85 trillion yen in 2012.

However, there are many countries in the world that have even more foreign tourist visits, earning even more money from them. The number of international tourists is expected to rise from 1.18

billion in 2015 to 1.8 billion in 2030 worldwide. It is necessary for Japan to establish an environment that attracts more tourists in a growing global tourism market and puts the resultant inbound demand to good use in Japan's economic growth.

The White Paper on International Economy and Trade focuses on the relationship between the average length of stay and the amount of expenditures per tourist, and notes that in order to increase international tourism revenues, it is important not only to increase the number of inbound tourists but also to extend their length of stay. The average length of stay in Japan for foreign tourists remains at 6.0 nights, while it is recognized that there is a positive correlation between the distance that foreign tourists travel to come to Japan and the time that they spend here. Thus, there is a need for a strategic tourism policy that takes into account the residential country portfolio of the visitors.

Dealing with Cross-Border Data Transfer

Electronic commerce continues to grow as business activities and our daily lives are increasingly permeated with information and communication technology (ICT). The *E-Commerce Market Survey* published in May 2015, available on METI's website, projected electronic commerce sales for 2015 at 280 trillion yen, up 4% from the previous year.

Foreign vendors have a major presence in electronic commerce. In May 2015, the Organisation for Economic Co-operation and Development (OECD) published its final reports on comprehensive rules for curbing tax avoidance by multinational enterprises that conduct cross-border transactions. One of the focuses of the reports is on international transactions in a digital society. One major change from the pre-digital "analog" society is the availability of highly granular data that can be utilized by businesses generated by the permeation of ever-improving ICT. Browsing and purchasing data are beginning to be linked to each individual consumer for example. This is not limited to the retail business. The quantitative data being accumulated are becoming a useful intangible asset for manufacturers as well.

Linking data into ever greater aggregations creates correspondingly greater value, which is the ICT analog of the network effect. There is some justification for the notion that it is better to allow free circulation of data in order to maximize their potential value.

But there is also much criticism over the cross-border transfer of data. There appear to be three issues here. First is securing employment. The notion is that requiring servers and other equipment to be located domestically generates employment. But increasingly smaller, higher-performing servers mean that the amount of jobs generated by forced localization of data-related facilities is debatable.

The second issue is the treatment of personal information. The idea is that storing personal data domestically will reduce the risk of personal information being leaked. On the other hand, there is the view that whether or not the information is being stored domestically

is meaningless in an era when everyone and everything are connected through the Internet. There is also the need to examine the means of storing personal information from a technical perspective.

The third issue is the implication of the accumulation of data by global platform providers. The accumulation of data by platform providers enhances the quality of the services, bringing major benefits to their users. On the other hand, the possibility cannot be denied that domestic businesses may be placed at a disadvantage in concluding contracts with foreign platform providers as the latter grow more powerful. This problem was illuminated by the lawsuit that a small business and former subcontractor of Apple brought against the latter.

The adoption of rules such as securing the freedom of cross-border data transfer and a ban on forced localization of servers and other computer-related equipment is being considered in order to prevent regulation that impedes electronic commerce. However, such rules could impede the effectiveness of Japanese regulation of global platform providers. There is a need to debate as to how we face up to electronic commerce in the policy domain.

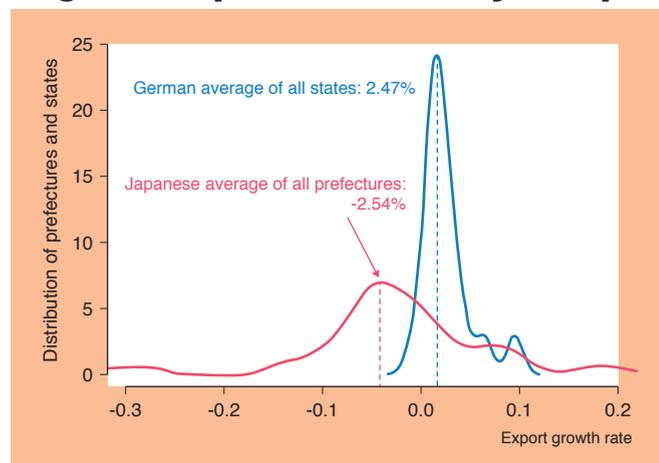
Exports & Regional Economies

As the domestic market shrinks in Japan in an aging society with a declining birthrate, there is a need to seek business opportunities through exports by small, medium and mid-tier enterprises, an issue also important from the perspective of revitalizing regional economies. *Chart 4* shows that Germany has less regional variation in the expansion and contraction of exports than Japan. All German states but one are increasing their exports, and none of them experienced a significant decrease, whereas 33 Japanese prefectures, or 70% of the total, saw their exports decline.

This could indicate the existence of bottlenecks for Japanese small, medium, and mid-tier enterprises in penetrating overseas

CHART 4

Regional exports in Germany & Japan



Source: White Paper on International Economy and Trade 2016, METI

markets. One such bottleneck that has been noted is the lack of suitable exhibition space and international conference facilities and the immature state of the exhibition industry. Germany holds many exhibitions domestically and abroad, including those for small, medium and mid-tier enterprises, providing them with opportunities to negotiate directly with foreign customers. There are relatively few such opportunities in Japan, with the result that such enterprises are often only able to develop overseas markets through trading companies and wholesalers. But the respondents to a questionnaire mainly aimed at manufacturers indicate that trading companies and wholesalers charge high brokerage fees and that it is difficult to agree on production volume, price and other conditions.

The 2016 White Paper points out that there are many non-exporters with high export potential — mainly small, medium and mid-tier enterprises — in the Hokkaido and Koshin’etsu areas and elsewhere. (Here, “non-exporters with high export potential” is defined as business establishments that do not export that have higher productivity (value added per employee) than exporting business establishments.) There is a need to examine more closely the extent to which this “export potential” reflects the true state of small, medium and mid-tier enterprises in Japan, including the appropriateness of using productivity as the yardstick. That said, since such enterprises can no longer survive solely through transactions with conventional large domestic companies, policy measures to provide support for them in the development of their overseas markets should be effective.

Note also that “Out-In” mergers and acquisitions, where overseas companies acquire Japanese companies, are increasing of late, as [Chart 5](#) shows. This indicates that there are many cases where small, medium and mid-tier companies that were unable to penetrate overseas markets despite their technological capacities and also failed to transfer management to the next generation are being bought up by overseas businesses. On one hand, this is a positive inbound investment story. However, this should be kept on the policy

agenda from the perspective of the dynamic generation of innovation, namely, the question of how technological spillover effects and the seeds of new technology can be secured domestically.

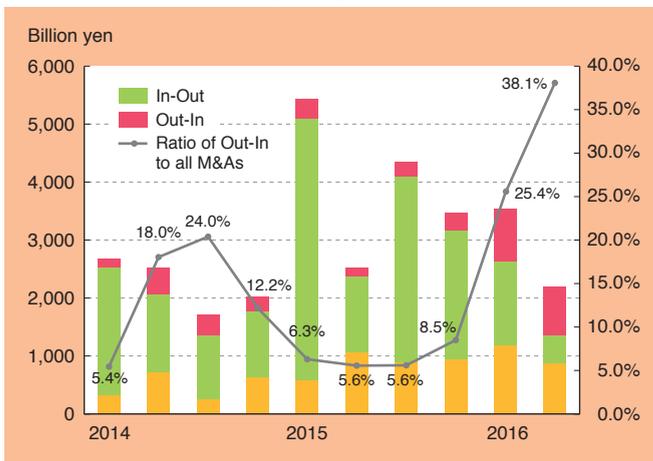
Promoting Economic Partnership Agreements

The Trans-Pacific Partnership (TPP) negotiations, largely concluded last October, officially came to a successful end on Feb. 4 in Auckland, New Zealand, with the signing of the agreement by the 12 ministers representing the contracting parties. The 12 nations will begin domestic ratification procedures with the aim of bringing the TPP into force within two years, an event that will create a colossal free trade area that encompasses 40% of global GDP.

Looking back, we can see that Japan has a long history of trade liberalization. The first post-WW II wave came in the 1960s-70s in the multilateral trade liberalization under the General Agreement on Tariffs and Trade (GATT). The second wave came after the turn of the century in the form of regional trade liberalization through free trade agreements (FTAs) and economic partnership agreements (EPAs) among small numbers of countries, including bilateral arrangements. The final agreement on the TPP can be seen as the crest of this second wave. Its ratification is expected to influence the Regional Comprehensive Economic Partnership (RCEP) negotiations led by China and to be a major driving force for the Free Trade Area of the Asia-Pacific (FTAAP) initiative.

The TPP will create a free, open, and highly foreseeable economic zone in the Asia-Pacific region. As such, its early ratification would be of great significance in countering anti-globalist or protectionist policies. At the same time, it cannot be denied that the path to the TPP’s entry into force is becoming heavily clouded as both Democratic and Republican candidates have expressed negative views on it during the 2016 US presidential primaries. The UK decision to leave the EU, namely Brexit, could also have a material toll on the TPP by raising questions about the value of economic integration. Japan should consider fallback plans in case early ratification becomes difficult, even as it works toward that end. For example, it should take advantage of the momentum generated by the successful conclusion of the negotiations on the Information Technology Agreement to seek early conclusions to the negotiations on the Environmental Goods Agreement and Trade in Services Agreement in the WTO. In any case, we should remember anew that the Japanese economy cannot grow without an outward-looking trade policy. **JS**

CHART 5
“Out-In” M&As (value)



Source: MARR

Hiroshi Ohashi, a professor at the Graduate School of Economics at the University of Tokyo, is a who has published widely in numerous journals, including the Journal of International Economics and the Journal of Industrial Economics. He has been a program director at the Research Institute of Economy, Trade & Industry (RIETI), and served as principal researcher at the Competition Policy Research Center at the Japan Fair Trade Commission. His areas of expertise include international trade and competition policies.