

# Japan's Current Account – Its Status & Future



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## Foreword

Japan marked two consecutive months of current account deficit last winter. Given that this economy has enjoyed, or sometimes even be criticized for, a stable current account surplus over decades with only a few exceptions, two months of deficit attracted considerable attention in financial markets and business talks. Will the current account deficit continue? What implications does it have for the economy? Does it mean Japanese economic deterioration? This article provides an analysis of the developments in the current account, forecasts from both cyclical/short-term and structural/long-term views, and finally considers the implications.

## Structure of Japan's Current Account

The current account records the balance of economic transactions between one economy and others in terms of goods, services, and investment. The current account balance is more comprehensive than the goods trade balance. The current account is the sum of the balance of goods trade, the service trade balance, and the balances of primary and secondary income.

The goods trade account refers to net exports (i.e., exports minus imports) of goods such as machinery, vehicles, and commodities. The service trade balance is the net balance of transport, travel, and other services such as intellectual property use charges, telecommunications, and financial services. The primary income balance consists of net investment income from direct and portfolio investment activities, while the secondary income balance reflects current transfers free of charge, such as ODAs and remittances.

Japan has had a long history of current account surpluses, but its driver has changed over time (*Chart 1*). Until the early 2000s, the main driver of Japan's current account surplus was the surplus in goods trade. However, since the early 2010s, the primary income surplus has been exclusively supporting the current account surplus, whereas the trade account has basically been balanced. The service trade account has marked a deficit continuously throughout the period, but its deficit size had been trending smaller until the Covid-19 era. The contribution from the secondary income balance is also

structurally negative, but negligible.

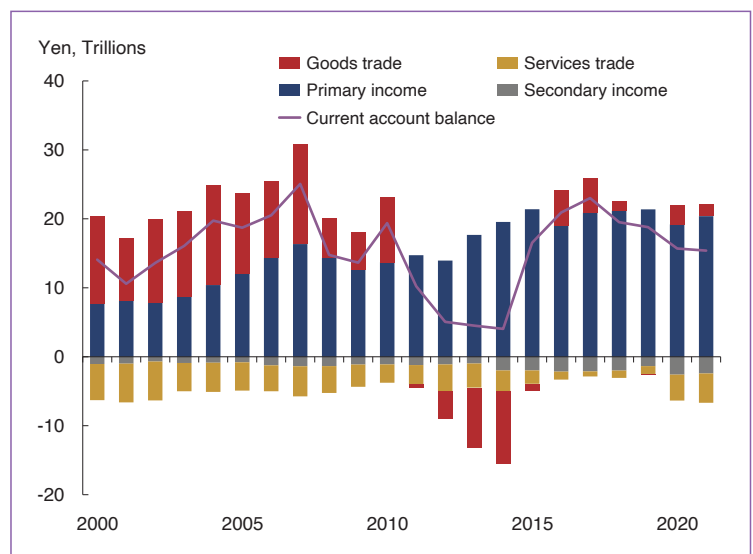
This primary income-led current account surplus structure is quite unique to Japan. For many other major economies, the largest component in the current account is usually the trade balance. For instance, the United States has a current account deficit led by a large deficit in goods trade. The United Kingdom enjoys a sizable service account surplus, while a large goods trade deficit leads it to a current account deficit. For the Eurozone and China, goods trade surpluses drive their current account surplus.

## Two Successive Months of Current Account Deficit

However, Japan's stable current account surplus seems to be at a crossroads recently (*Chart 2*). The current account balance in January was -1.2 trillion yen, the second consecutive month of being in deficit after a -0.3 trillion-yen deficit in December 2021. Since it was the first time for Japan's current account to mark a deficit for two consecutive months since 2014, it attracted attention in the foreign exchange market and served as one of the fundamentals for the yen's depreciation.

CHART 1

## Japanese current account balance, annual



Source: Ministry of Finance, Bank of Japan, Haver Analytics

The breakdown shows that the surplus in primary income was not enough to cover the deficit in the goods and service trade balances. The goods trade deficit expanded, with a significant increase in imports and stagnant exports. On the import side, the import value of commodities rose sharply due to soaring global commodity prices. Imports of pharmaceuticals also increased, amid vaccination needs. On the other hand, a recovery in exports has been delayed with the continuing supply-chain disruptions, particularly in the auto sector. For service trade, evaporation of inbound tourists amid Covid-19 has been causing service exports to deteriorate.

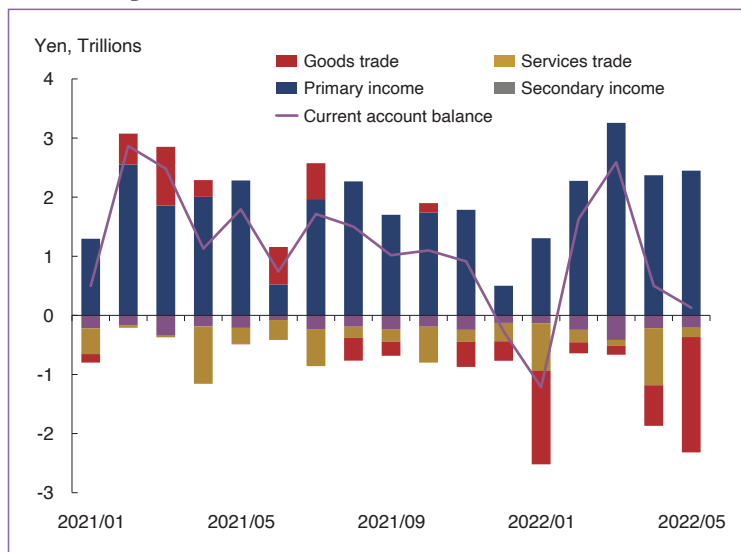
In February, though, a current account surplus returned and has continued until the most recent data in May. A seasonal decline in fossil fuel import volumes contributed favourably, and the improvement in primary income receipts is helping to support the overall account.

### Goods Trade Account Likely to Stay Negative in Coming Months

Against this backdrop, the goods trade balance is highly likely to stay in deficit in the coming months. The largest driver will continue to be soaring commodity prices. Crude oil prices have been fluctuating recently, reflecting factors such as the lockdowns in China, Russian supplies, and the economic outlook in developed economies, but they have remained high at around \$100/bbl. On the export side, given the continued impact of supply-chain disruptions and the downward revisions in auto manufacturers' production plans over the summer, it will take some more months for vehicle

CHART 2

### Japanese current account balance, monthly



Source: Ministry of Finance, Bank of Japan, Haver Analytics

shipping, which represents about 20% of Japan's exports, to recover.

Additionally, service exports are unlikely to recover strongly either. Although the government has reopened Japan's borders to international tourism since June, capping the entry number at 20,000 people per day means that the number of visitors will stay at less than a quarter of that in pre-Covid 2019 at the maximum. Also, even if the government were to eliminate the cap, given that strict restrictions are likely to continue in mainland China, and tourists from there represented 30% of total international tourists and 37% of total international tourist consumption (both in 2019), a full recovery will not take place till China drastically changes its policy.

### Is the J-Curve Effect Still There?

Furthermore, in terms of the balance of trade in goods, the impact of the recent massive depreciation of the yen will not be negligible, given the size of the movement. Although it is true that the trade balance or current account balance could influence the foreign exchange market in turn, I will narrow the argument down to the impact from the foreign exchange market on the trade account given that the exchange market moves more complexly.

In the foreign exchange market, the yen has been depreciating rapidly against the dollar, against the backdrop of the massive increase in commodity prices since Russia's invasion of Ukraine, widened US/Japan interest rate differentials, and the difference in economic and monetary policy outlook between Japan and other developed economies. The yen depreciated to a 24-year low of 135 to the dollar in June, whereas it was around 115 in February. The yen has also depreciated against other main currencies, and the nominal effective exchange rate of the yen, which is its trade-weighted value against other currencies, saw a significant decline of around 10% during this period.

In the theory of the *J-curve effect* in international economics, currency depreciation is thought to work asymmetrically to the trade account over time, just like the shape of "J". On the export side, currency depreciation contributes to an increase in export volumes through enhancing export competitiveness by allowing export companies to cut prices denominated in foreign currencies. Given that it takes a while for businesses to change the prices of their products after currency depreciation, this effect of enhancing exports emerges with lags. On the other hand, on the import side, import prices in one's own currency inflate immediately. As a result, the impact from currency depreciation on the trade balance changes over time, from initial worsening (increase in import prices) to eventual improvement (improvement in export volumes).

However, it is arguable whether the J-curve effect still exists in Japan. As businesses have already shifted to

overseas production from exporting products, except for high-value products, clearly the path through from yen depreciation to export prices is smaller than before. As a result, it is hard to imagine that ongoing yen depreciation will lead to a significant increase in export volumes even with lags.

### Stable Primary Income to Support Current Account

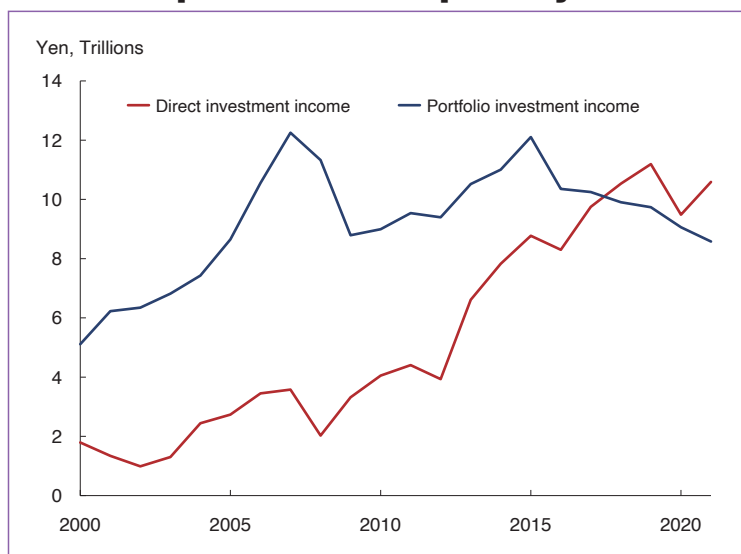
However, I do not believe that Japan has already turned into an economy with a permanent current account deficit structure.

First, it is too early to say that the large deficit in goods trade will persist. In commodity markets, it seems that the situation surrounding the war in Ukraine has already been priced in largely. This implies that it will take additional news for commodities to increase further from now. The increase in medical imports and the slump in auto exports due to supply-chain disruptions are temporary factors, although it could take several more months for them to normalize.

Second, as argued in the previous section, what matters most in Japan's current account recently is the primary income account rather than the trade account. Therefore, it is necessary to have a look at this less-familiar component of the current account.

The source of Japan's primary income used to be exclusively portfolio investment income, mainly from foreign bonds held by financial institutions (Chart 3). Since the 2010s, however, direct investment income has grown as manufacturers enhanced overseas production and non-manufacturers also increased overseas business. As a result, direct investment income and portfolio investment income now each account for about half of the total

CHART 3  
Main components of net primary income



Source: Ministry of Finance, Bank of Japan, Haver Analytics

investment income.

The increase in the amount of assets has contributed to the recent surge in direct investment income. Although portfolio investment assets are still larger than direct investments, direct investment assets tripled over the past 10 years. Indeed, according to UNCTAD, Japan's direct investment outflow was the largest in the world in 2018 and 2019 and was third largest in 2020 after China and Luxembourg, whereas it ranked just 13th in 2000.

Another source of strong direct investment income is its structurally high rate of returns. The return from direct investments has been around 6%-8% recently, whereas the portfolio investment's return is trending downward, to below 3%, partially reflecting the low interest rate trends in developed economies. Direct investment returns are high in investments in Asia. Although there are notable short-term risks such as the economic slowdown in China, stable primary income surpluses will support the overall current account, supported by economic developments in emerging Asia.

In addition, when it comes to the primary income account, it seems that the yen's depreciation is firmly contributing to an improvement in the balance. The primary income surplus for March was a record-high 3.3 trillion yen and April/May was also a robust 2.4-2.5 trillion yen.

### Savings-Investment Balance Determines Current Account

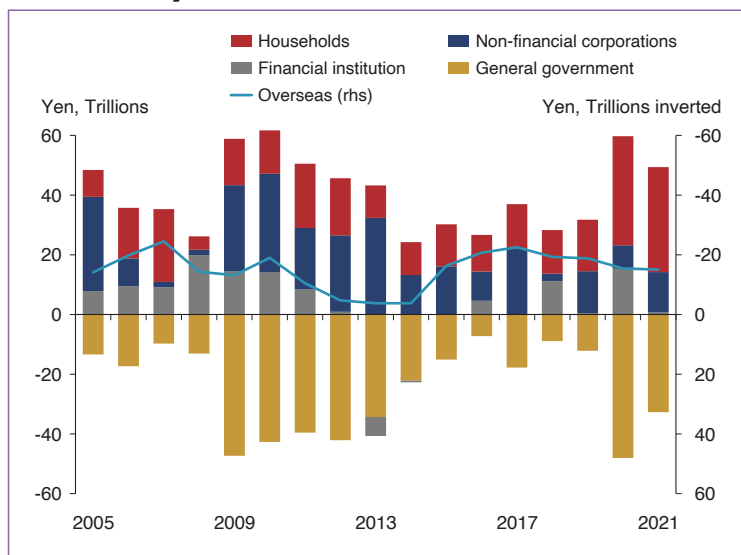
In the long run, the current account balance is thought to be determined by the macro savings-investment balance. If an economy has national savings larger than its investments (net savings / financial surplus), it implies that it has a structural current account surplus, as the overseas sector for the economy is in financial deficit and vice versa.

Japan has structural net savings in the household and corporate sectors which are larger than the net investments in the government sector (Chart 4). Fluctuations in 2020 and 2021 were notable in that the deficit in the government sector expanded significantly due to direct payment programs to households. However, as this deficit was simply covered by an increase in household savings following the worst of the pandemic, its impact was largely netted out. Looking ahead, it is likely that net savings in households and companies will cover the net investment in the government sector, as has been the case in past years.

The most important factor in the outlook for Japan's savings-investment balance is the sustainability of the household sector's excess savings. Generally, the aging of society is thought to lower savings, as the presence of retired households who withdraw savings for consumption increases. In the real world, however, it

CHART 4

## Savings-Investment balance (positive if net saver)



Source: Bank of Japan

could work conversely through an increase in the middle-age generation who aggressively save anticipating retirement, while the younger generation, who invest more in residential property, declines.

Moreover, there would be a non-negligible impact from the improvement in life expectancy and an increase in precautionary savings due to fears over the sustainability of the social security system. In fact, net savings of Japanese households, both in absolute terms and as a percentage of GDP, were larger in the 2010s, when the aging of Japanese society progressed, than in the 2000s. The impact of aging on the balance might not be as large as it appears.

The corporate sector, the other source of net savings, is also unlikely to turn toward net investment anytime soon. Theoretically, free enterprises in a market economy are the ones that conduct capital investments by raising outside funds, and they are often treated as net investors. However, in Japan, facing balance sheet adjustment pressure after the collapse of the bubble economy, the financial crisis in the 1990s and secular stagnation thereafter, companies have kept investments within their cash flows. The corporate sector is now structurally over-savvy. Furthermore, it is highly likely that the importance of maintaining cash has been recognized again by business managers with the Covid-19 turmoil. Additionally, with no change in expectations of continued secular low growth in domestic demand, it is unlikely that companies will rapidly shift to net investments.

On the other hand, structural net investments in the government sector will continue, given that fiscal consolidation is unlikely under

Japan's parliamentary democracy, whichever the ruling parties are. The fiscal measures in response to the Covid-19 crisis will be withdrawn gradually, but it is not realistic to expect that fiscal consolidation will progress significantly anytime soon, particularly with sustained expansion in social security expenditures.

### Theoretical View of the Current Account & Macroeconomy

Traditionally, the development stage theory of Geoffrey Crowther famously provides a theoretical framework connecting economic growth and the structure of balance of payments. According to this theory, the balance of payments, including the current account, shifts in the order of (1) immature debtor, (2) matured debtor, (3) debt reducer, (4) immature creditor, (5) matured creditor, and (6) asset liquidator, depending on the country's stage of economic development, just like a human life cycle.

Looking at the current account balance, an economy experiences a current account deficit at the stage of (1), (2), and (6), whereas it enjoys a current account surplus when it is at (3), (4), and (5) stages. At the initial stage of economic development, a country starts with a current account deficit because it imports more goods from overseas than it exports as its manufacturing ability is limited, and it relies on foreign capital for domestic financing needs.

Subsequently, as its trade balance improves with enhanced export competitiveness, the current account deficit decreases. Once all debts are repaid, not only the trade balance but also the primary income balance turns into a surplus. This is when its current account surplus reaches its peak. Thereafter, as export competitiveness gradually declines, the trade balance deficit increases again, and eventually the trade balance deficit exceeds the primary income balance surplus, and the current account turns into a deficit.

Based on this theory, by simply looking at what happened during last winter, Japan seems to be shifting from the matured creditor stage (5) to asset liquidator (6) in that its trade account deficit is becoming larger than the primary income balance surplus. Based on this theory, the shift in the development stage is irreversible; once Japan turns into a current account deficit, it will persist in the future. Such an argument was widely made in 2012-2013 when Japan saw three consecutive months of current deficit, and today.

But it won't be that easy in the real world. In fact, Harutoshi Oda ("A Contemplation on the Development of the International Payment Pattern of Crowther", *Fukuyama Daigaku keizaigaku ronshu*, 2009) points out that many developed economies did not follow this theory in practice. According to this paper, some economies (Australia, New Zealand, and Spain) maintained a current account deficit for a long time, and others (Canada, Italy, Portugal, and Sweden) go back and

forth between a current account surplus and deficit, rather than shifting as the life cycle goes on.

Particularly, it points out that current account balances of non-industrial export-oriented economies, such as resource rich economies or financial economies, typically do not follow the pattern of development stage theory. It would be more accurate to say that development stage theory is just a guideline. Although Japan has followed the development stage theory largely, it does not necessarily mean that it will continue to do so in the future. To give an example, the existence of a non-negligible services trade income from inbound tourists is not clearly treated in the theory. The size of travel income has little to do with the economic development stage.

In fact, from the view of the savings-investment balance, it can be said that economies in secular stagnation due to society aging run a current account surplus. In the context of secular stagnation, it is widely argued that an increase in life expectancy and a decline in fertility lead to higher net savings through a higher working-age savings requirement and lower demand for housing investment, respectively. Besides, under secular stagnation, companies find it difficult to find investment opportunities as the domestic market shrinks. These domestic excess savings are eventually “exported” to foreign economies via capital outflows. This implies that the aging of the population can boost savings and could lead to a current account surplus.

An Oxford Economics’ global analysis based on demographic change and wealth accumulation also found that the negative impact from demographics on Japan’s current account surplus is limited, even at a horizon of 2050. It appears that there is considerable time for Japan to become a permanent current account deficit economy, leaving aside some short-term fluctuation.

## Implications of Structural Current Account Deficit

So far, we have looked at the structural forces of the current account and found that it is unlikely that the Japanese current account deficit will persist structurally. However, suppose that Japan eventually turns into a chronic current account deficit economy at some point; what kind of problems will emerge?

For an economy with a fixed exchange rate and limited exporting ability, the current account deficit could be a policy constraint. At the time when Japan adopted a fixed exchange rate system, this constraint was famously quoted as the *balance of payments ceiling*. The point of this argument is that a widening current account deficit leads to increased pressure for currency depreciation with an increase in cash outflows, and the authorities need to conduct currency intervention by buying the domestic currency to maintain the fixed rate. Thus, when the economy grows due to an increase in domestic demand, the authorities need to tighten it adversely in order to reduce its current account deficit beforehand, as if the current account deficit were the ceiling for growth.

However, now that Japan has moved to a floating exchange rate regime, there is little need to directly correct the current account deficit immediately. Although the current account balance sometimes attracts attention in the foreign exchange market, as earlier this year, it is not the single factor that determines the exchange rate. In a floating rate regime, there are many other factors which influence exchange rates: price differences, interest rate differences, and market confidence, to name a few.

In fact, as we saw at the beginning, there is little relationship between the current account balance and economic growth in advanced economies. The US and the UK have structural current account deficits, but their growth rates are higher than that of Japan. Even if an economy has an entrenched current account deficit, it can be said to not matter a lot as long as it is stable and sustainable. Rather, if current account surpluses are driven by domestic excess savings, then current account surpluses can be evaluated as a reflection of sluggish domestic demand, in other words, secular stagnation.

Having said that, though the implications of current account deficits for economic growth would not be significant, it does not mean they are entirely without caveats. For an economy with insufficient savings in the government, current account deficits can become a financing constraint for the government as it means that domestic private savings are smaller than the government’s financing needs. For Japan, in turn, it will mean an increased foreign presence in the Japanese government bond market, whereas now foreign investors represent a limited share of 13.6%.

An increase in foreign holdings will mean a change in the structure of the Japanese government bond market. In this regard, Sotaro Kankawa (“Investment Behavior of Foreign Investors in the JGB Market”, Bank of Japan Working Paper Series, 2020) points out that foreign investors behave differently from domestic investors in the bond market. Particularly, they tend to reduce bond purchases during periods of heightened global market uncertainty, whereas such a tendency is not seen among domestic investors. The increased presence of foreign investors could potentially increase volatility in Japanese government bond interest yields, i.e., the government’s financing costs, which could be problematic given the large size of Japan’s debts which have already surpassed 250% of the size of its GDP. JS

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