Structural Changes & Prospects for Japan's Current Account Balance

Author
Yoichi Matsubayashi

By Yoichi Matsubayashi

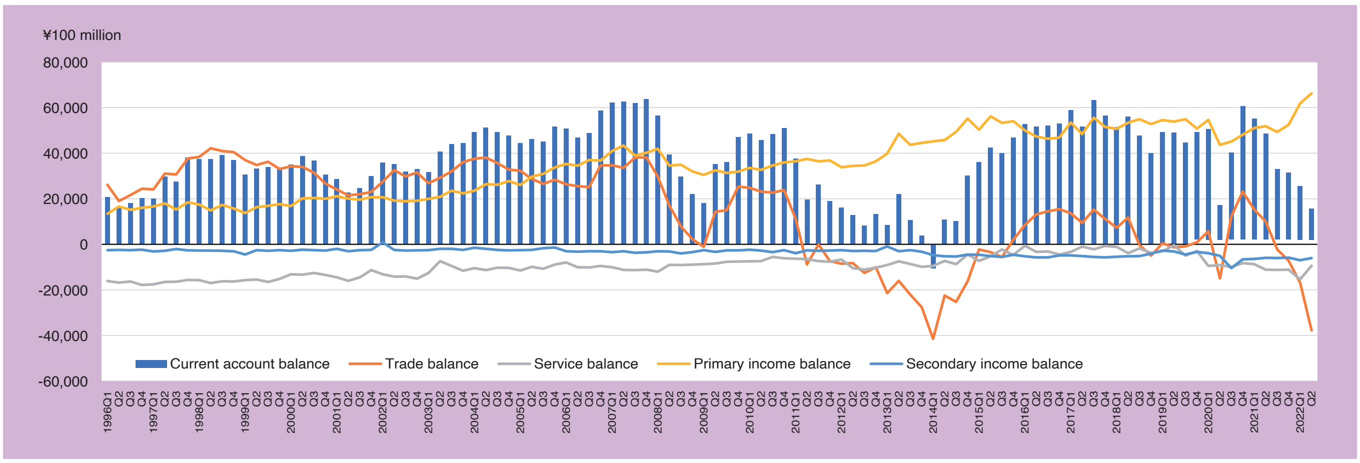
The Worsening of the Current Account Balance

The August preliminary figure of the current account balance published in October 2022 by the Ministry of Finance was 589 trillion yen, which is the lowest figure for August since 1985, when comparisons first became possible. The largest factor behind the shrinking of the current account surplus is the expansion of the trade balance deficit. The preliminary figure for August was a deficit of 2.49 trillion yen, which represents an increase in deficit of about 1 trillion yen compared to the same month in the previous year. The main causes for this are the depreciation of the yen and the increase in import values caused by the soaring prices of resources, while the fact that export values are not increasing in spite of the depreciation of the yen is another factor. The current account balance gives an overall indication of Japan's external earning power, and it is an extremely important economic indicator not only of the short-term changes in Japan's economy, but also from the long-term viewpoint of growth and development. Accordingly, in this paper I take an overarching view of a relatively long span of changes in Japan's current account balance, and look at the structural changes that have arisen from the first half of the 2010 decade. Also, I try to place recent developments in the context of a longer time horizon of more than a century. Through these kinds of consideration, we should be able to survey future trends in the current account balance and look at the prospects for the characteristics of Japan's economy.

Trends in the Current Account Balance from the Second Half of the 1990s

Chart 1 shows the current account balance from the first quarter of 1996 until the second quarter of 2022, and the trends in the elements that comprise it. The amount of surplus in the current account balance has been increasing from the latter half of the 1990s up until 2007. Some factors behind this increase are the facts that the trade balance was steady and had a tendency toward a surplus, while the primary income balance (such as the interest and dividends arising from foreign investment) was on an increasing trend. As a result of the global finance crisis sparked by the Lehman Shock in 2008, international trade shrank drastically globally, then from 2008 to 2009 the trade balance worsened, and the current account balance also dropped to the level below 2 trillion yen. Thereafter, although the current account balance showed signs of improvement, as a result of the 2011 Great East Japan Earthquake trade transactions decreased, the trade balance moved to a deficit, and the current account balance also decreased drastically. From mid-2014, there was a move to a positive direction, but a dramatic expansion in the

CHART 1
Trends in current account balance
1985Q1 - 2022Q2



Source: Balance of Payments Statistics, Ministry of Finance trade surplus could not be felt, and from 2017 onwards the trend to a decrease continued, with the deficit still being maintained. Meanwhile, the income balance has also steadily increased since the global financial crisis, with the increase being especially prominent since about 2012. Since around 2011, trends in the current account balance reflect both the tendency to a worsening of the trade surplus and the trend towards an increase in the income balance, in combination.

Subsequently, the current account balance from 2021 on has steadily shrunk drastically, in particular because of the considerable worsening of the trade balance experienced. Moreover, although it may not be clear in the graph, since the second half of the 1990s, the service balance deficit has shown a trend toward improvement. In particular, once we entered the 2010s, the deficit dramatically decreased, and from 2016 to 2017 we entered a state where a balance of close to zero was achieved. However, with the spread of the new coronavirus from 2020, leading to the curtailing of foreign tourists entering Japan, the deficit has been increasing.

From this viewpoint, there is a strong possibility that the current account balance of Japan gave rise to structural changes from around 2011 to 2012. Specifically, there are three points: 1) the steady worsening of the trade balance, 2) the dramatic increase in the primary income balance, and 3) the sustained improvement of the services balance. In order to deeply consider the structural changes of the current account balance that occurred in the first half of the 2010s, it is essential to look closely at each of its features. Below we consider the state of the trade balance and the income balance, which showed particularly substantial changes.

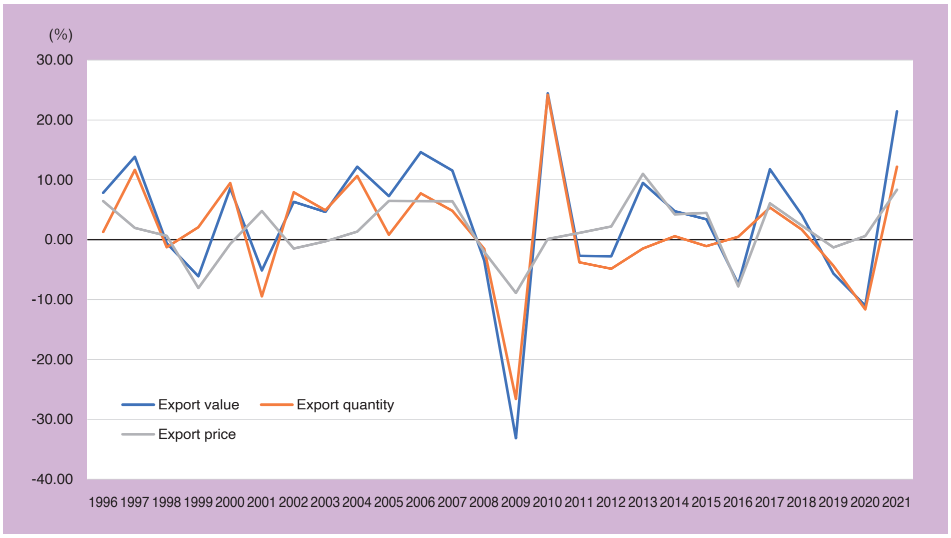
Changes in the Trade Balance

In order to look deeply at the characteristics of the structural changes in the trade balance, it is useful to closely observe export and import trends, which comprise the trade balance. *Chart 2* and *Chart 3* show the value, quantity and price indices of exports and imports, compared to the previous year. In regard to the export value indices, there was a period from the latter half of the 1990s to the latter half of the 2000s when the rate of increase was above 10%, which was in accordance with the changes in the quantity exported. However, once the 2010s were entered, there were hardly any cases of the export value amount exceeding 10%. The slowing of the increase in the export quantity also came to have only a slight connection with the export value, with the changes in the export value being brought about by changes in the export prices.

Meanwhile, the changes in the import value consistently have a

CHART 2

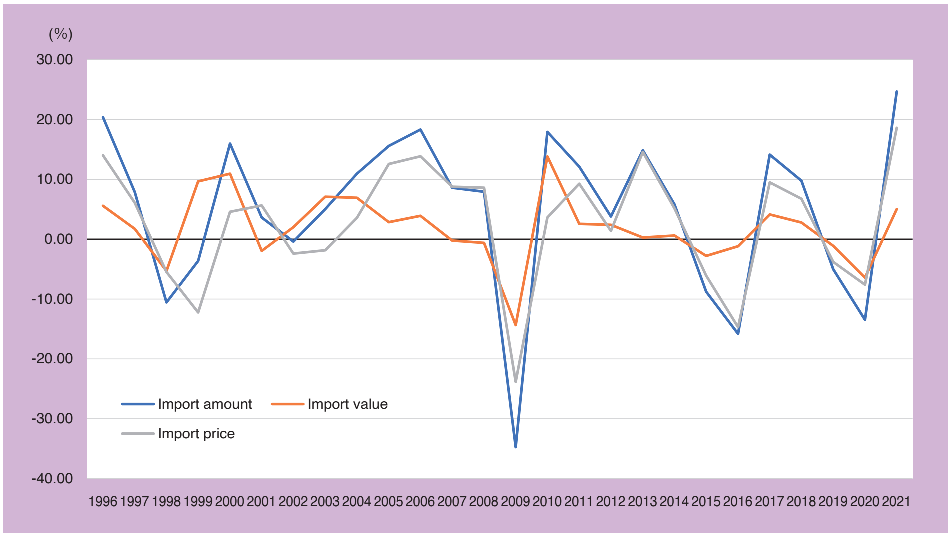
Changes in exports



Source: Trade Statistics, Ministry of Finance

CHART 3

Changes in imports



Source: Trade Statistics, Ministry of Finance strong relationship with changes in import prices, with the rate of increase in the import quantity being generally steady, and no changes being seen from the pivotal point of about 2010. Based on the above observations, the structural changes in the trade balance that arose in around 2011 constituted a major causal factor in the softening of the increase in the export value, in accordance with the sluggishness of the export quantity.

In 2011, following the Great East Japan Earthquake, there was a curtailing of the supply chains and the rapid appreciation of the yen. Also, economic decline in countries continued after the global financial crisis. Because of these factors, exports decreased dramatically. However, another important element was that Japan's export competitiveness was on a decreasing trend, which began to become considerably more pronounced in the 2010s.

In the 2013 White Paper on International Trade, Japan's share of the global export amount is calculated in detail. If we compare the values for 2000 and 2011, the figures are as follows: general machinery 11.5%→8.5%, automobiles 16.1%→11.9%, electromechanical 12.8%→6.5%, and precision machinery 17.7%→9.1%, showing major drops in Japan's share in machinery-related areas. Furthermore, comparing trade specialization coefficient, a substantial drop is seen in electromechanical 0.41→0.17 and precision machinery 0.42→0.29. In these ways, in Japan in around 2011, along with various short-term factors such as the Great East Japan Earthquake, the sudden high yen, and the global economic recession, there was the multiplying effect of mid- and long-term elements such as the trend toward a decrease in export competitiveness. It is probable that the decrease in exports became sustained and as a result the path towards a trend to a worsening of the trade balance was followed.

Changes in the Investment Balance

Next I will look at the characteristics of the structural changes in the investment balance. *Chart 4* shows trends in the primary income balance. As we saw in *Chart 1*, since the second half of the 1990s the investment balance has been on an increasing trend. Observing closely, we can see that although for several years following the 2008 Lehmann Shock, there was a deadening in growth, and from around 2012 it began to substantially increase. Moreover, from 2021 to the most recent time also, a dramatic increase has been seen; this has its cause in the current rapid depreciation of the yen.

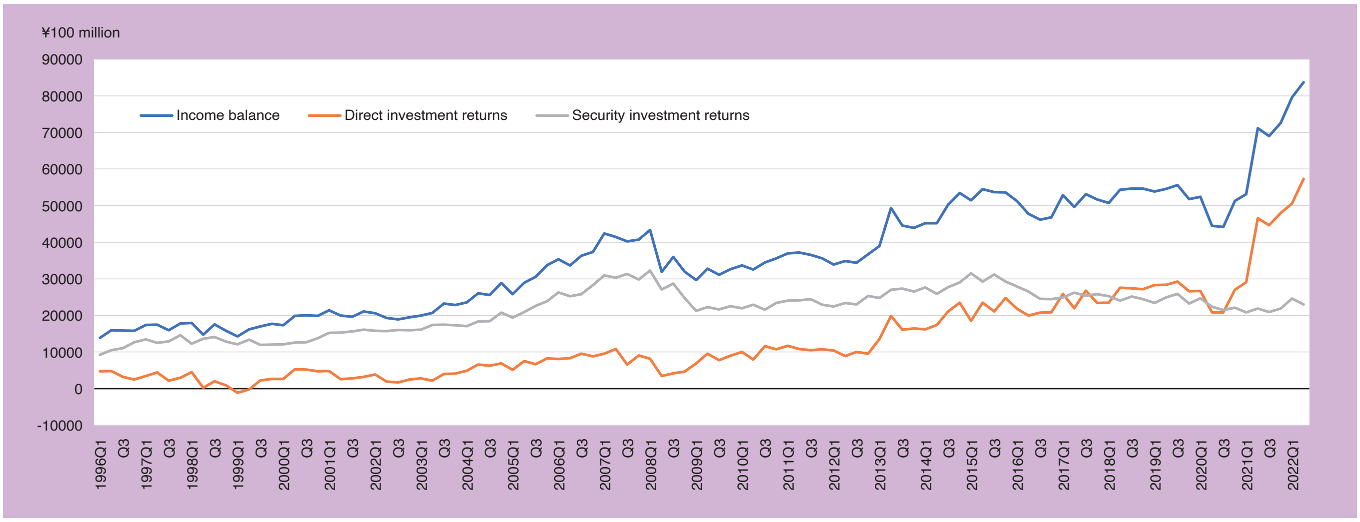
In order to analyze the causes behind the changes around 2021 in *Chart 4*, we added security investment returns and direct investment returns, which are both major structural factors in the income balance. Until the Lehman Shock, securities investment income had been gradually increasing but thereafter it changed to a decreasing trend. Meanwhile, the direct investment income showed a consistent increase, with the increase being prominent from around 2012. A background factor to this is the activation of external investment resulting from the drop in the expected profit of domestic capital, and from the appreciation of the yen. Further, recently the ratio of M&A in direct investment is beginning to increase. It is possible that the increase in profits following from the expansion in direct investment is tied to the changes in the income balance from around 2012.

Long-Term Trends in the Current Account Balance

We will now give an overview of the current account balance from a more long-term perspective. *Chart 5* depicts Japan's current account balance as a percentage of GDP for more than a century, from 1885 to 2021. Looking at the roughly 130 years in chronological order, they can be basically divided into three periods:

CHART 4

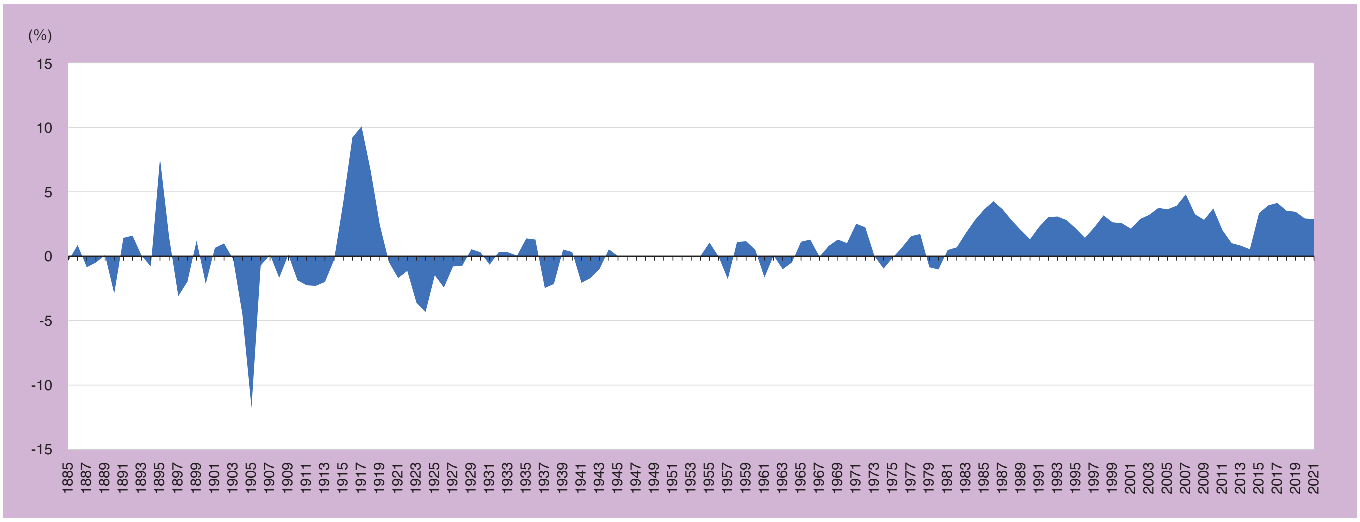
Trends in income balance



Source: Balance of Payments Statistics, Ministry of Finance

CHART 5

Long-term trends in accounts balance, 1885-2021



Source: Ippei Yamazawa and Yuzo Yamamoto (1979), "Long-Term Statistics 14: Trade and Balance of Payments", Toyo Keizai Inc., National Accounts, Cabinet Office

1) the period from 1885 until the end of World War II, 2) the period from the 1950s to the 1970s, and 3) the period from the 1980s until the present.

In the period from 1885 until the end of World War II, several substantial changes can be seen. Each of these was caused by major-scale wars or disasters. Specifically, these were: the current accounts surplus resulting from the compensation received in the Sino-Japan War (1894-1895) (transfer balance surplus); the current accounts surplus coming from the increase in imports of military items in the Russo-Japanese War (1904-1905); and the current account deficit reflecting the drop in exports resulting from the Great Kanto Earthquake (1923). However, excepting the occurrence of the dramatic external imbalance resulting from these kinds of unforeseen events, although there have been many periods of deficit, it cannot be said that a major imbalance has arisen.

We are unable to obtain GDP data for the period from 1945 to 1954 due to the economic confusion following the war. From 1955 onwards, for some time no substantial imbalance can be seen, while the 1950s, 1960s, and 1970s all show a surplus of no more than 1%. Expressed differently, it can be surmised that the 30 years from the 1950s to the 1970s were a period of comparatively short-term changes. Once we enter the 1980s, the situation changes dramatically.

In 1980 the surplus was about 0.7% but in only seven years it reached a level more than six times that, adding up to a high surplus of about 4.5% as a share of GDP. This trend rapidly decreased from 1987 onwards, but the average value for the 1980s was 2.3%. In the 1990s also, the surplus tendency showed no changes, with the average value (2.3%) showing no difference from that of the 1980s. The surplus trend continued in the 2000s, and at the peak (2007) there was a surplus of about 4.8%, the highest level since the 1980s. However, on entering the 2010s the situation changed considerably, with the surplus beginning to shrink. After the 2011 earthquake, we see a trend towards an increase again, but from 2017 on, the downward trend continues.

In regard to long-term trends in the current account balance, the "the balance of payments stages hypothesis" concept is well-known. This hypothesis was advocated by Geoffrey Crowther and Charles Kindleberger in the 1950s, and considers changes in the current account balance associated with a country's economic development by means of the savings investment balance framework.

In Stage I (immature debtor country), since there is little producible wealth in one's own country and there is no option but to import from other countries, the trade and service balances show a deficit. Further, since there are low income and insufficient savings, it is necessary to procure the capital necessary for industrialization from overseas, so the interest payments on this capital increase, and the income balance also goes into a deficit. Thereafter, as the trade and service balances move to a surplus along with the development of industrialization, there is a transition to Stage II (mature debtor country).

Through the increase in the acquisition of capital from overseas resulting from economic development, the income balance deficit expands. As economic development progresses further, imports expand, the trade and services balance surpasses the income balance deficit, and the accounts balance goes into a surplus, transitioning to Stage III (debt repayment country). Then the maintenance of the account balance surplus surpasses the external assets, and the nation shifts to Stage IV, where the income balance surplus is maintained (immature creditor country).

Although the income balance surplus is maintained, along with the maturing of the economy, imports from emerging market countries begin to increase, and then the trade and services balance starts to gradually decrease, leading to a shift to Stage V (mature creditor country). Then, as this trend progresses further, the trade and services balance surplus exceeds the income balance deficit, and there is a transition to Stage VI (creditor country), where the accounts balance has changed to a surplus *(Table)*.

The table depicts a summary of these processes. In the 1984 Economic White Paper, the current account balance of Japan extending to over one century is classified in accordance with the balance of payments stages hypothesis. From 1970 to 1983, when the above White Paper was compiled, the *Table* indicates that Japan was an "immature debtor country". In regard to a transition to the Stage V mature creditor country, although the time of transition is not definitely determined, in the 2006 Economic White Paper it was forecast that Japan would likely transition to a fully mature creditor nation.

Let us consider the state of the balance of payments in 2021. As can be understood from the compilation in the *Table*, the trade and services balance changed to a deficit, while the income balance surplus exceeded it; a current account surplus arose, and Japan's economy was then in the vortex of being a mature creditor power.

TABLE

The balance of payments stages hypothesis & the economy of Japan

Stage	Stage of development	Trade and services balance	Income balance	Accounts balance	Capital (finance) balance	Economy of Japan
I	Immature debtor country	↓	↓	↓	↑	1868-1880
II	Mature debtor country	↑	↓ ↓	↓	↑	1881-1914 1955-1964
III	Debt repayment country	↑ ↑	↓	↑	↓	1919-1920 1965-1969
IV	Immature creditor country	↑	↑	↑ ↑	↓ ↓	1970-1983
V	Mature creditor country	↓	↑ ↑	↑	↓	2021 Trade and services balance: -¥2.5 trillion Income balance: + ¥18.0 trillion Current account balance: + ¥15.4 trillion Capital balance: - ¥10.7 trillion
VI	Creditor country	↓ ↓	↑	↓	↑	

Source: G. Crowther (1957), "Balance and Imbalance of Payments", Harvard University, Cambridge, MA.

Then, as I mentioned at the start of this paper, Japan's immediate current account balance worsened considerably, and there was steadily growing concern that there might eventually be a deficit. This state of affairs means a transition to the Stage VI creditor country, in the stage theory of economic development. In such circumstances, the key as to whether or not a transition to Stage VI occurs is the trend toward an increase in the import amount and the expansion of the trend to a trade balance surplus, resulting from the lengthening of the soaring prices of resources. If the soaring of the import mineral prices is not something transient, but rather a sustained element, not only the trade and services balance of Japan's economy but also the current account balance will change to a deficit. At the same time, through the enduring of the deficit, there is the possibility of transitioning to a creditor country. This point is highly significant, not only in regard to Japan's current account balance but also in overviewing Japan's macro-economy as a whole.

Current Account Balance & Future of Japan's Economy

As I said earlier, the current account balance has the meaning of being a comprehensive index of a country's external earning power. Accordingly, the beginning of a transition to a deficit in a country's current account balance has also begun to hold the possibility that the country's overall economic power, and even confidence in its currency, are undergoing changes. Here we can understand the concept of confidence in a currency from the three aspects of price stability, interest stability, and exchange rate stability. When we consider that the nearest asset to currency in a national economy is government bonds, we could hold the view that confidence in government bonds could also waver.

There is also the opinion that, since close to 90% of Japan's government bonds are held by domestic investors, there is a low possibility that confidence in them will drop. Nevertheless, there is a need for concern that, along with the growing dependence on procurement of foreign funds in the flow aspect of moving to a deficit in the current account balance, private financial assets will shrink, and in the event that a situation is realized where changes in the stock aspect of a closing in on the balance of the government debt accelerate, the possibility of a drop in confidence is by no means small. In any event, before a drop in confidence becomes apparent, it is essential that a solid strategy in regard to Japan's external earning power be developed.

Japan has an inherent advantage in manufacturing and technology. At the same time as "earning through investment" utilizing the large amount of external assets that have been built up through past current account balances, the strategy of "making money with goods" should be combined with the creation of high value-added export products to restore industrial competitiveness. The most pressing issue for the Japanese economy today is to deeply conceive of the sources of earning power based on a long-term perspective, rather than to dwell on the fluctuations in the current account balance. JS

Yoichi Matsubayashi, Ph.D., is a professor of the Graduate School of Economics at Kobe University. His main subject is International Macroeconomics.