White Paper on International Trade 1989
— Rapid Progress in Structural Adjustment —

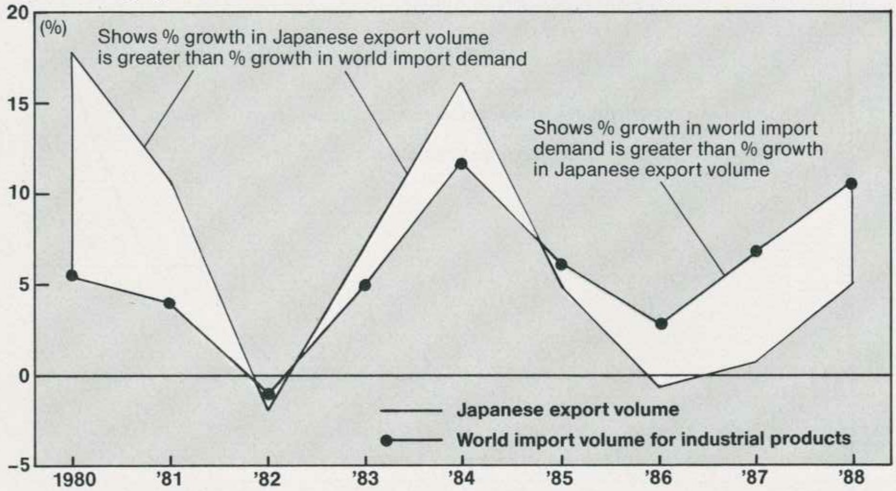
By Hiromichi Aoki

The Japanese economy expanded strongly in 1988, with business investment and consumer spending interacting to provide the main impetus for growth. While external demand contributed negatively to GNP growth for the third straight year, the contribution of internal demand increased even further.

With internal demand supporting steady expansion, the economy posted real GNP growth of 5.7% for the year. Industrial production expanded rapidly in virtually all sectors, significantly boosting corporate earnings. Prices remained stable, and the employment situation improved.

The earnings position of Japanese corporations has recovered markedly since fiscal 1987, particularly in the manufacturing sector. This is attributable not only to the positive impact on costs of a stronger yen and cheaper oil, but also to companies' efforts to restructure their operations, including shifting their focus to the domestic market, developing higher value-added products and promoting rationalization. Earnings in manufacturing, which dropped 16.8% in fiscal 1986 from the preceding year, increased substantially in fiscal 1987 and 1988 as domestic sales expanded amid a continuing decline in the ratio of exports to total production. Spurred in part by technological innovations, the manufacturing industry geared its production increasingly to domestic demand and diversified into nonmanufacturing fields.

Fig. 1 Changing Global Demand for Industrial Products and Japanese Export Volume



Note: Year-on-year % change
Sources: International Trade, GATT; Trade Statistics, Ministry of Finance

Exports and imports trend

The total value of Japan's exports stood at ¥33.9 trillion in 1988, up 1.9% from the year before for the first year-to-year gain in three years. On a dollar basis, exports were up 15.6% at $264.9 billion. Export volume expanded by 5.1%, faster than in 1987.

In addition to the price factor, the expansion of Japan's domestic economy has worked to reduce export volume in recent years. At the same time, however, the robust growth of world demand due to the steady recovery of the global economy has helped keep volume up more than it might have been otherwise (Fig. 1).

Exports of capital goods increased in 1988, reflecting the worldwide investment boom and the expansion of overseas production by Japanese makers. Expanded production abroad leads over the short term to expanded exports of the machinery, equipment and other capital goods required by new plants and factories. Over the long term, however, the overseas production is expected to reduce the trade surplus through production substitution and expanded imports of products made overseas by Japanese industries.

Japan's export structure is changing in the direction of greater sophistication—namely, the export of higher value-added products. This trend is evident not only on a broad, sector-by-sector basis but also within individual industries. It is also affecting individual products.

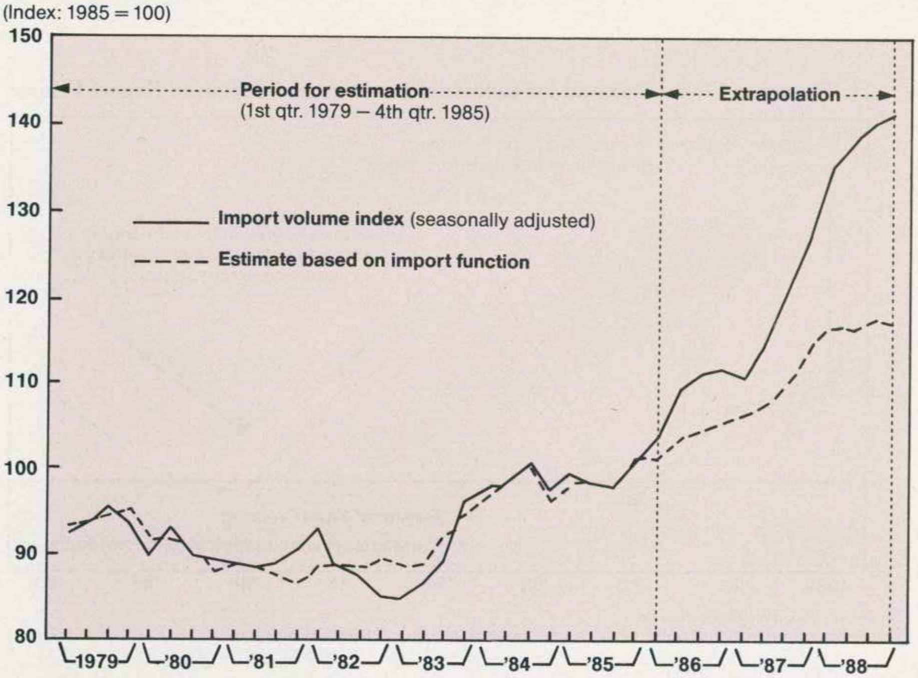
These moves, coupled with the expansion of Japan's imports, are contributing to the international intra-industry division of labor. It is essential that Japan continue to promote exports in a balanced manner while remembering the need to improve the economic welfare of other countries.

Japan's imports reached ¥24.6 trillion in value in 1988, up 10.4% for the first two-digit increase in eight years. In dollar terms, imports totaled $187.4 billion, up 25.3%. Consumer goods continued to register high rates of growth, while imports of capital goods and foodstuffs also accelerated, further broadening the base of import demand.

Manufactured goods accounted for 49.0% of Japan's total imports in 1988. The expansion of manufactured imports has caused actual import volume to deviate widely upward from estimates arrived at using the standard import function. This, too, would suggest that the nation's import structure has changed in recent years (Fig. 2).

The exchange rate shifts since the fall of 1985 have affected both exports and imports. The impact has differed by sector, however. In the case of exports, most

Fig. 2 Deviation of Japanese Import Volume from Estimates Based on Standard Import Function



Note: Import volume function was estimated for 1979 through 1985. For 1986 and after, the actual economic values for each of the independent valuables were extrapolated into the function.

Sources: Price Index Monthly Report, Bank of Japan; Trade Statistics, Ministry of Finance; National Economic Accounts

of which are generated by a relatively small number of major corporations, structural change was relatively rapid during the yen's appreciation. In the case of imports, however, many more companies and organizations are involved, while import products cover a broadening spectrum of both consumer and manufacturing demand. Given the lack of exposure to such fundamental change in the nation's import trade, it has taken until now for conditions conducive to structural adjustment to appear. Further progress is expected in the future.

Japan's economic entities, having overcome the recession caused by the yen's appreciation, are now seeking to make positive use of the high yen rate to share new business opportunities. In 1988, managements in the manufacturing and distribution industries initiated moves to use more imports. Foreign companies also markedly expanded their direct investment in Japan in response to growing demand for imported products. Imports are permeating the Japanese consumer market as consumer attitudes toward foreign goods change. A number of factors lie behind these changes, including increased real income due to the rising yen and falling oil prices, and diversifying demand. In addition, personal imports–foreign goods purchased directly from abroad by individual consumers–are on the rise.

In the manufacturing industry, moves are afoot to take advantage of cheaper imports by substituting intermediate goods for crude raw materials. At the same time, companies are seeking to capitalize on the high yen by importing finished goods produced overseas by Japanese companies, or by foreign manufacturers on an OEM (original equipment manufacturer) basis. Manufacturers are also importing foreign products for sale through their own domestic distribution networks. Major retail businesses, too, are getting directly involved in the import business. "Develop and import" schemes to help foreign companies create products geared to the Japanese market are making especially notable progress.

These moves to expand imports still have a long way to go. The exchange-rate gains resulting from the yen's rise have not been sufficiently passed on to consumers and users, and it is important to continue to reduce the price disparities between Japan and other major countries. It is also important to promote the rationalization of Japan's distribution system, and relax government regulations to further enliven the nation's import market.

Producing abroad

Japan's direct investment abroad has increased rapidly in recent years, particularly in the manufacturing sector ($47 billion in fiscal 1988, up 40.9% over the year before). At the same time, the business strategies of Japanese corporations are shifting from export-oriented production to production outside of Japan. There are even moves to set up overseas R&D centers for product development and basic research geared to local market needs. The thrust of business strategy is thus changing from a "linear internationalization" centered on the home country to a "multidimensional internationalization" aimed at raising the overall efficiency of corporate groups through the intra-company division of labor.

Direct investment abroad involves not merely transfers of capital but, more importantly, an integrated transfer of such management resources as technology, know-how and talent. Direct investment in foreign countries thus brings various benefits to the local economy, including job creation, technology transfers and the development of local enterprises through the purchase of locally produced raw materials and parts. Japanese corporations place orders with local enterprises on a long-term basis providing them with information and even technical personnel. By doing so, they help find and develop local enterprises capable of supplying raw materials and parts on a stable basis.

In order to contribute to the long-term development of local enterprises, Japanese corporations need to do more to localize their operations and promote exchange with local economies (Table 1). In addition, the Japanese government needs to create an environment conducive to freer reciprocal investment by, for example, dealing positively with TRIM (trade-related investment measures) negotiations under GATT.

Relations with the U.S. and the EC

The U.S. economy has a structure predicated on excess demand, including the budget deficit. This must be corrected if U.S. external imbalances are to be alleviated (Fig. 3). In addition to such macroeconomic demand management, efforts are also required at the microeconomic and business management levels.

U.S. productivity, for instance, has been rising since the start of this decade. In industries such as electric machinery and transportation equipment, which have a large weight in trade, however, the production base is not sufficiently strong to meet total demand. For this reason, such industries have a structural dependence on imports. Moreover, investment in new production capacity accounts for only a relatively small proportion of total plant and equipment investment. As a result, the supply-demand gap in manufacturing has narrowed rapidly in recent years.

In the management arena, an orientation toward short-term earnings, lack of interest in exports and a focus on mergers and acquisitions (M&A) activity with heavy overtones of a money game have retarded long-term research and development and caused a shortfall in equipment investment. All this has inevitably weakened American industry. In order to correct the nation's external imbalances, American corporations will have to reexamine the long-term implications of their business strategies.

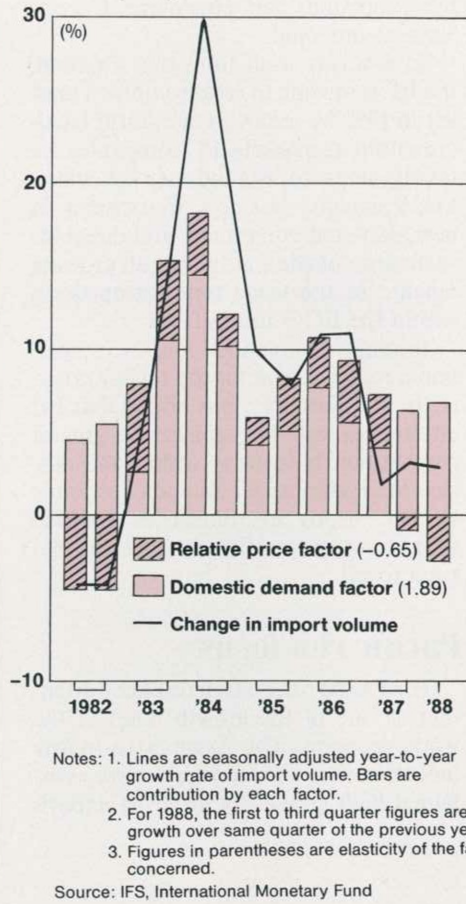
Japanese direct investment in the United States has increased markedly in recent years, especially in the manufacturing sector. Growth has been especially striking in electrical machinery, transportation equipment and general machinery. Japanese direct investment is playing a complementary role in strengthening America's industrial base, and is expected to help over the long term in reducing U.S. external imbalances. Japanese direct investment accounts for only a small proportion of M&A in the United States. By contrast, the construction of new manufacturing facilities and the expansion of existing facilities–investments with a powerful positive effect on the local economy–claim a major share. Thus Japanese direct investment in the United States is creating stable jobs and helping

Table 1 Delegation of Authority in Overseas Subsidiaries of Japanese Corporations and Japanese Subsidiaries of Foreign Enterprises

(%)

	Management of wholly owned overseas subsidiary		Management of foreign-affiliated enterprise in Japan		
	Japanese parent company	Overseas subsidiary	Overseas parent company	Subsidiary in Japan	Japanese parent company
Decisions on marketing strategy	43.3	56.7	10.2	80.3	9.5
Decisions on production and inventory volumes	32.8	67.2	2.9	92.6	4.4
Decisions on supply sources for raw materials and parts	24.4	75.6	7.4	86.7	5.9
Decisions on product specifications	61.7	38.3	22.2	74.1	3.7
Decisions on sales price	36.1	63.9	5.2	87.3	7.5
Decisions on promotion and performance rating systems	21.8	78.2	1.4	84.2	14.4
Plant and equipment investment plans	82.6	17.4	48.4	41.8	9.8
Research and development plans	85.5	14.5	29.9	64.6	5.5
Appointment of officers	95.9	4.1	53.5	22.8	23.8
Decisions on dividend payouts	89.3	10.7	46.4	39.3	14.3
Decisions on long-term fund raising, including capital expansion	92.7	7.3	50.0	33.3	16.7

Fig. 3 Factors Contributing to Change in U.S. Import Volume



Notes: 1. Lines are seasonally adjusted year-to-year growth rate of import volume. Bars are contribution by each factor.
2. For 1988, the first to third quarter figures are growth over same quarter of the previous year.
3. Figures in parentheses are elasticity of the factor concerned.

Source: IFS, International Monetary Fund to improve production management in U.S. manufacturing.

These contributions have been welcomed by many Americans, but there is also growing concern over such investment as well. Japanese corporations must make further efforts to promote localization in harmony with the U.S. economy and society and win acceptance as good "corporate citizens."

Looking back at developments since the formation of the European Economic Community in 1958, it is clear that inter-regional trade has been given greater priority in Europe than external trade, particularly in the 1960s. The tariff union resulted in a rapid increase in trade among EC member states, but by the same token, this reduced their competitive opportunities vis-à-vis countries outside the Community. The relative lack of competition with non-EC countries, coupled with lagging structural adjustments, have weakened the international competitiveness of the Community as a whole. Investment in growth industries has stagnated, and employment problems go unsolved.

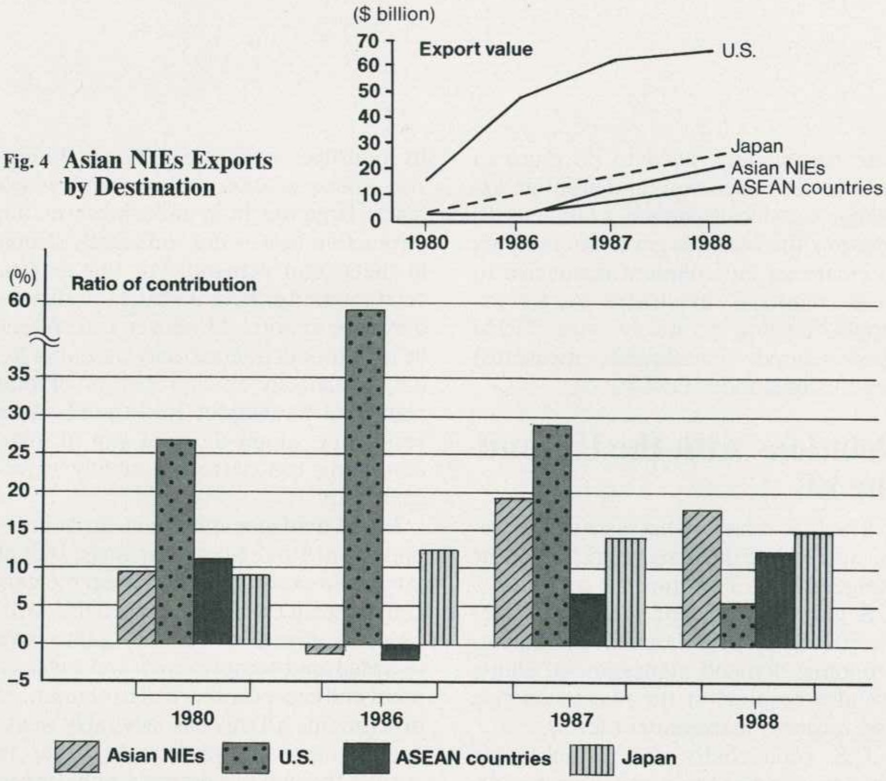
To extricate itself from this situation, the EC is moving to create a unified market in 1992 by removing non-tariff barriers within its markets. EC companies are taking steps to expand market share. M&A activity, business investment in new plant and equipment, and direct investment outside the EC are all growing rapidly. At the same time, competition within the EC is intensifying.

To make this planned market integration a real occasion for the revitalization of the EC economy, it is hoped that EC enterprises will be exposed to greater competition both from within and outside the region under an open economic system. Strong EC industries oriented toward corporate efficiency are the desired result.

Pacific rim focus

The Pacific rim is attracting keen attention as one of the growth poles of the world economy. The Asian NIEs (newly industrializing economies) have sustained high growth by fostering export-

Fig. 4 **Asian NIEs Exports by Destination**



oriented industries. Now, however, the wave of industrialization is spreading rapidly to ASEAN countries and China.

The Asian NIEs are now seeking to change their growth pattern to one led by domestic demand in response to the revaluation of their currencies, rising labor costs, intensifying trade friction with the United States, and other factors contributing to the deterioration of their export environment. In fact, the Asian NIEs have already reached a point where their domestic economies depend increasingly on the growth of internal demand, and their industrial structure is becoming increasingly sophisticated. Together with Japan, they are contributing to the growth of the ASEAN countries through serving as a market and expanded direct investment.

The expansion of Japan's imports and the growth of the NIEs' markets in Asia is prompting rapid change in the regional trade structure. In the past, Asian nations have depended heavily on exports to the United States. The new pattern gives further impetus to self-sustaining growth in Asia (Fig. 4). Furthermore, this structure is becoming more multilayered, as a result of the formation of parts supply networks among ASEAN states.

Japan ought to make wide-ranging contributions to the stable development of the Pacific rim. More specifically, Japan needs to firmly maintain an open and free trade system, open its domestic market wider to foreign goods through the sustained expansion of domestic demand, and promote cooperation with other Asian nations in the areas where they are weakest, such as capital, technology, talent and other management resources, as well as physical infrastructure.

Changes in exchange rates are giving impetus to the global adjustment of economic imbalances. Japan is making steady progress with structural adjustments, hinging on import expansion and direct investment abroad. The Pacific rim region, centering on Asian nations, with their competitive trade order, is fast becoming a key growth pole of the world economy amid moves toward protectionism and regionalism. From this point of view the white paper stresses the importance of pursuing open trade and enhancing the dynamism of competition.

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