

# White Paper on International Trade 2002

## Part I: Review the Old, Learn Anew

By Hisatake Masato

Japan seems to have lost its way recently. In particular, many people regard the development of neighboring East Asian countries, especially China, as a threat to Japan. In actual fact, however, this development can be either a threat or an opportunity; it all depends on us. But where do our feelings of uneasiness come from? The fundamental source of anxiety is our lack of self-reliance. Japan has certainly never closed its doors completely on outside cultures, technologies, or systems. On the contrary, we have always embraced outside influences, and over time, made them into something of our own. We haven't just copied or borrowed wholesale. Neither have we only rejected. Taking in, digesting and assimilating ideas from abroad has always been Japan's greatest strength. Japan cannot maintain this merit without the notion of independence. Now

we seem to be losing this ability due to several factors. In the background of this lack of self-reliance, Japan appears to be showing an inability to think logically and make sound judgments.

The onset of deep awareness of one's own problems often triggers feelings of despair, regardless of whether the problems are of an individual, a business, a region, or a nation. But it is also impossible to reach inside and tap into one's inner strengths until this awareness sets in.

With these thoughts in mind, this year's *White Paper* addresses Japan's directionless times by devoting Part I (chapters I and II) to some historical fact finding. We will take an open-minded look at what has been happening in East Asia and Japan. In the *Analects of Confucius*, the great thinker urges us to "review what we have learned, and learn anew." This ancient

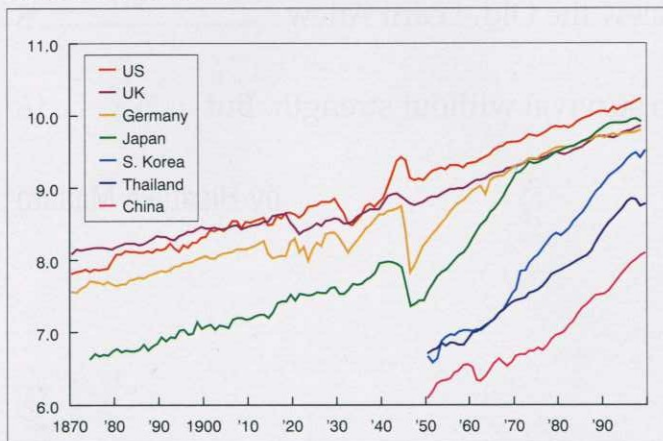
"wisdom of the Orient" will guide us through Part I.

### What Has Been Happening in East Asia and Japan?

What has been happening in East Asia's and Japan's economic sphere? As we will describe in Chapter I, the following three phenomena have surfaced to the foreground.

First, we are witnessing the possible emergence of a new group of developed economies in East Asia. It is impossible to say whether today's rapid growth could continue, for a number of challenges loom on the horizon, but if countries in East Asia can take the bull by the horns and resolve these issues as they arise, East Asia may well emerge in the first half of the 21st century as a developed economic region on a par with Europe and North America.

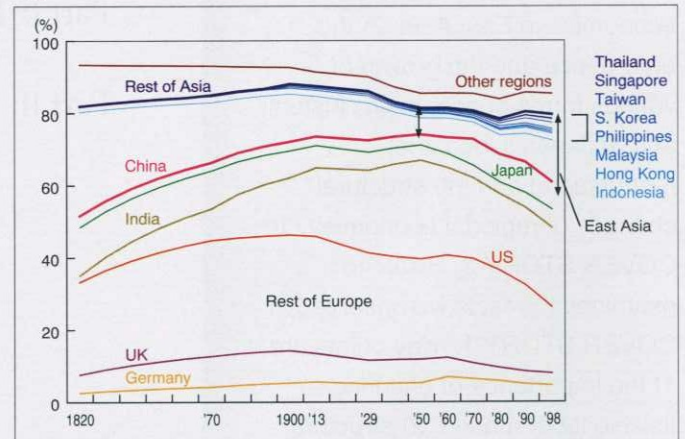
Figure 1 Per capita GDP



Note: The above figures for per capita GDP represent natural logarithm values (1990 international Geary-Khamis dollars).

Sources: 1. Figures to 1949 from *Monitoring the World Economy, 1820-1992*, Angus Maddison, 1995, OECD  
2. Figures for period since 1950 from *The World Economy: A Millennial Perspective*, Angus Maddison, 2001, OECD

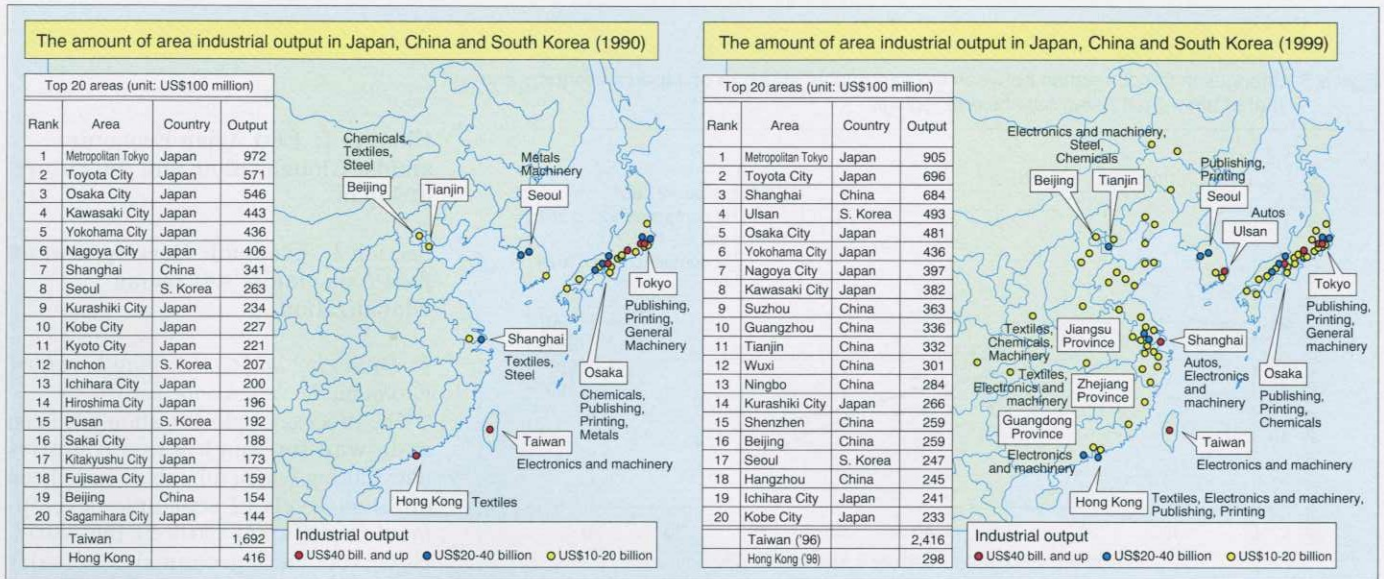
Figure 2 Share of World GDP



Note: GDP figures in 1990 international Geary-Khamis dollars. Statistics for different countries and regions are not available across the board in all the same years. For the sake of convenience, only years for which statistics exist for all countries and regions have been plotted on the graph (1820, 1870, 1900, 1913, 1929, 1950, 1960, 1970, 1980, 1990, and 1998). The points on the graph have been arbitrarily connected using straight lines.

Sources: (1) Figures to 1949 from *Monitoring the World Economy, 1820-1992*, Angus Maddison, 1995, OECD  
(2) Figures for period since 1950 from *The World Economy: A Millennial Perspective*, Angus Maddison, 2001, OECD

Figure 3 Comparison (1990 vs. 1999) of area industrial output in Japan, China and South Korea



Note: The industrial output rankings are not completely precise because "city" is defined here in administrative, rather than geographic, terms. Nevertheless, it is still possible to make comparisons between 1990 and 1999, and we can see the progress of industrialization in many East Asian cities. Source: Statistics from the various national governments

(Figure 1)

One factor behind the deepening of economic relations within East Asia is the fact that the region's share of global gross domestic product (GDP) has been on the rise since about 1950, which is a turning point in history. (Figure 2)

Secondly, in conjunction with East Asia's economic growth, economic activity has undergone geographic

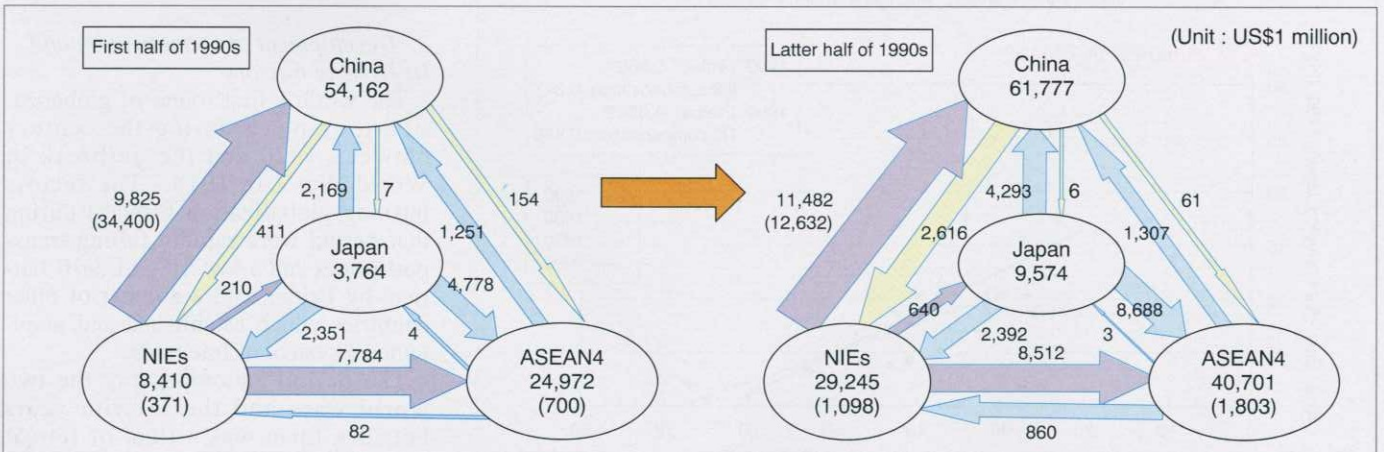
agglomeration, leading to the emergence and the growth of various forms of economic clusters. Competition and linkage are taking place in tandem, and in parallel. (Figure 3)

Third, economic development in East Asia is closely tied to Japan's industrial restructuring and the structural changes of regional economies. Japan is witnessing the third round of post-war

regional economic restructuring. Since the latter half of the 1970s, when the second cycle occurred, the most notable features of structural economic change in Japan have been an increasingly prominent service sector and overseas transference of production bases.

The following is an overview of chapters I and II.

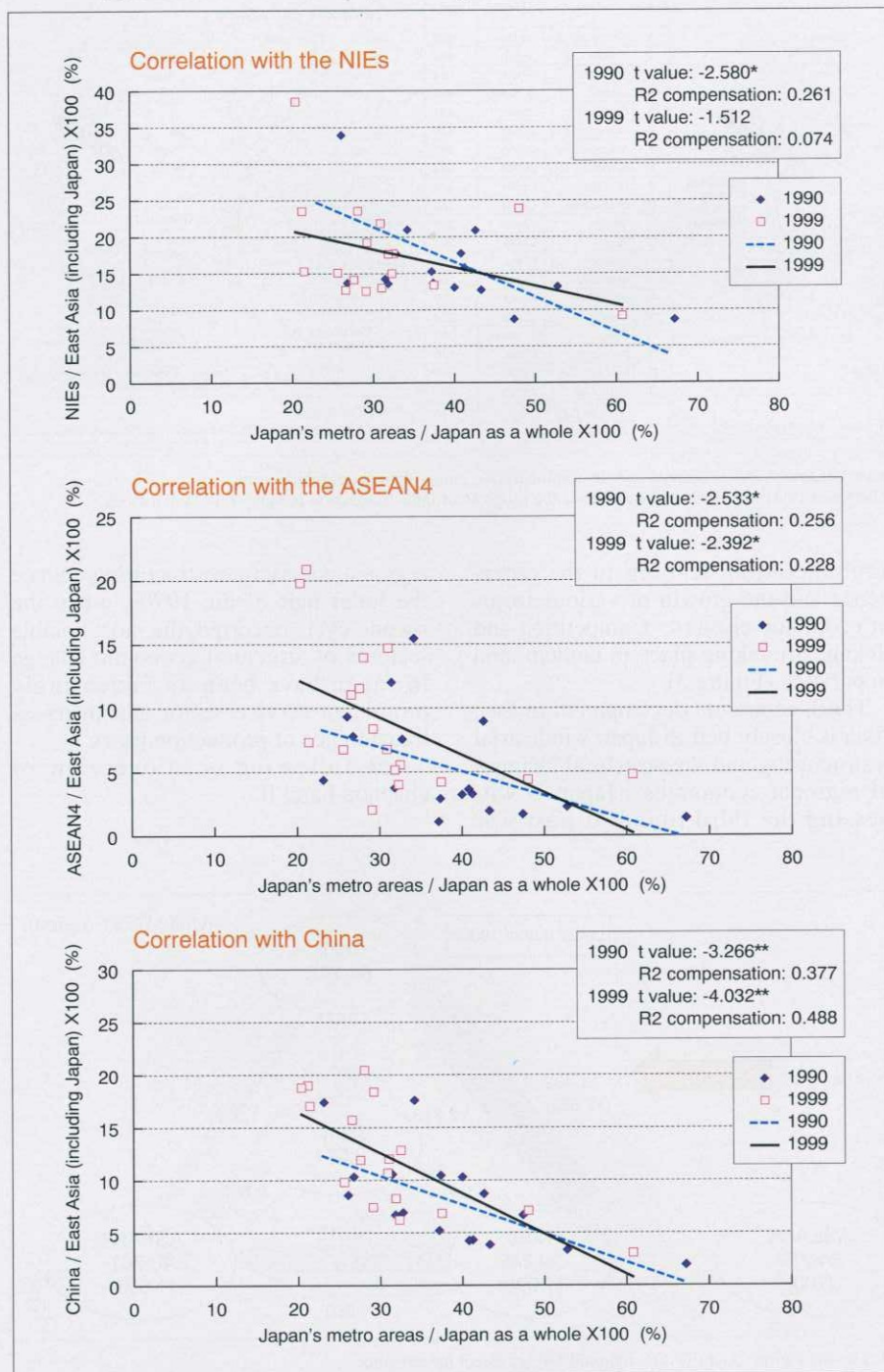
Figure 4 Direct investment trends within East Asia



Notes: 1. The above diagrams are based on statistics (provided by the various countries) on inbound foreign direct investments. 2. Figures for the first half of the 90s are annual averages for the years 1990-94. Figures for the latter half of the 90s are annual averages for the years 1995-99. 3. Numbers within the circles indicate total amount of inbound foreign direct investments. 4. Figures for the NIEs/ASEAN 4 inside parentheses indicate foreign direct investments received from other NIEs/ASEAN 4 nations. 5. Figures for Japan are based on notifications (¥100 million and up). Figures for Hong Kong are based on utilized investments. Singapore's are for pledged investments. Figures for other countries indicated approved investments. For this reason, the amount of inbound investment in Japan and Hong Kong may be underestimated in these diagrams. 6. Hong Kong investments in China are not included in China's figure for investments from NIEs. Instead, they are shown in parentheses under the arrow from NIEs to China.

Source: Institute for International Trade and Investment, *Statistics on the Direct Investments of the Major Nations of the World*

Figure 5 Changes in the correlation between the geographic structure of Japan's economy and that of other East Asian nations and regions



Key: 1: Publishing & Printing, 2: Transportation machinery, 3: General machinery, 4: Electronics & Machinery, 5: Precision machinery, 6: Metal products, 7: Metals, 8: Chemicals, 9: Plastics, 10: Rubber products, 11: Textiles, 12: Apparel, 13: Petroleum and coal products, 14: Paper and paper products, 15: Foods, beverages, tobacco, 16: Kilnware and stone masonry, 17: Others

Note: With the t values, double asterisks indicate that 1% is significant, while a single asterisk indicates that 5% is significant.

Source: Compiled by Fujita and Hisatake (1998) based on documents from the Cabinet Office (Annual Report on National Accounts; Annual Report on Prefectural Accounts) and UNIDO (ISD)

## Chapter I. East Asian Economy amidst Globalization, and the Future of Japan

### Section 1. Economic Development in East Asia amidst Advancing Globalization

#### 1. Diverging and Converging Levels of Economic Development

The process of globalization has been underway for roughly two centuries now, during which time there have been different levels of economic development in different parts of the world. However, among countries actually involved in the process of globalization, we see convergence. One could think of this trend as the establishment and expansion of a “convergence club.” Reviewing the historical record, we find that as levels of economic development converge, the developed nations being caught from behind carry out various reforms designed to ensure sustained growth, thereby continuing to grow and advance to new levels of development. As globalization advances, the important question for Japan, as a member of the “convergence club,” is how to carry out reforms that will lead to sustained growth.

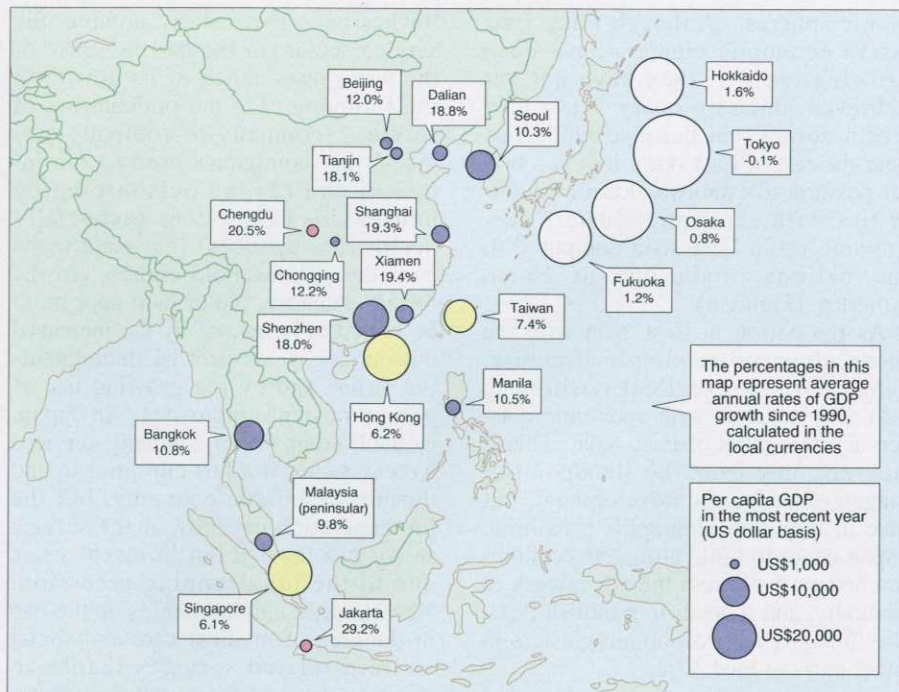
#### 2. Development of Globalization and Its Driving Factors

The world's first round of globalization took place during the century between 1820 and the outbreak of World War I in 1914. The factors pushing globalization forward during that period were rapidly falling transport prices and a lowering of tariff barriers by Britain and a number of other countries which established and maintained a system of free trade.

The period encompassing the two world wars and the interim years between them was a time of retreat from globalization – a time when many types of barriers were erected to restrict migration, trade and capital flows. Economic blocs formed and grew during this period.

The period beginning with the end of World War II and continuing to the present day has brought a second glob-

Figure 6 Annual East Asian per capita GDP growth in the 1990s



**Note:** Figures for different countries and regions represent different years, as follows: Manila, Hong Kong, Taiwan, Singapore: 2000, China, Jakarta, Malaysia (peninsular), Seoul: 1999, Japan: fiscal 1999, Bangkok: 1997. The percentages below the place names represent average annual rates of GDP growth since 1990, calculated in the local currencies. The circles associated with the place names are color-coded to indicate different rates of average annual per capita GDP growth. The four colors represent: less than 5%; 5.1-10%; 10.1-20%; over 20%.

**Sources:** Statistics from the various countries

alization boom. This time, the factors pushing globalization forward have been the galloping pace of advances in transportation and communications, and systemic progression leading toward the current development of a multilateral trading system and various economic tie-ups. The development of better shipping methods via air and sea, rail and communications networks extending to every corner of the globe, and rapid advances in information technology have diversified shipping methods in recent years and lowered the cost of transportation and communication. In addition, a consensus arose after World War II that the lack of international systems for managing trade and economic relations had fueled the growth of protectionism and economic blocs during the period between the two world wars. This consensus has been a driving force in the post-war efforts to build such systems, under

which the amount of trade in goods and services, as well as foreign direct investment, have soared.

### 3. Convergence and Deepening Relationships in East Asia

The levels of economic development of East Asian countries have basically been rising and converging throughout the past several decades. Not only have per capita GDP figures in countries around the region been rising and converging, but economic structure has also been evolving in the direction of greater sophistication. One reason for the convergence has been the deepening of economic relationships in both trade and investment within the region. (Figure 4) Closer trade relations and expanded investment are pushing countries and regions throughout East Asia toward a more sophisticated economic structure and a horizontal division of labor among regions, thereby contribut-

ing to convergence and progress within the region.

For Japan, the entry of other East Asian countries into the "convergence club" makes it necessary, just as it earlier became necessary for Europe and North America, to restructure its economy and remake itself in order to seek further growth.

## Section 2. Changes in the Geographic Structure of the Japanese Economy, and Competition and Linkage between Economic Clusters in East Asia

### 1. The Dynamics of the East Asian Economic Cluster

The convergence of levels of economic development in East Asia is part of the process of economic cluster. In China, which is experiencing sustained economic growth, industry is becoming concentrated in its coastal areas. In countries like Malaysia and Thailand, the growing economic cluster in each country is supporting their industrial development.

At the same time, competition and linkages are being formed simultaneously between the various economic clusters of East Asia. Competition between economic clusters is becoming more intense not only in the manufacturing sector, but in efforts to acquire information and knowledge bases as well. At the same time, however, companies from Japan and other countries invest in economic clusters throughout East Asia, and in so doing, they create linkages between Japan and the economic clusters of East Asia. Thanks to linkages of this sort, a division of labor is springing up among these economic clusters, and the various economic clusters are developing their own unique characteristics.

### 2. Industrial Restructuring and Changing Economic Clusters in Japan

Industrial restructuring in Japan is closely intertwined with the process of geographic regrouping of the domestic economy. Japan has gone through two cycles of industrial restructuring and geographical regrouping of the domes-

tic economy since World War II. It appears that it is now entering into a third such cycle. After the second cycle, the transition of economic activities spread beyond Japan's borders, and furthermore, to other parts of East Asia. This trend has promoted the development of economic clusters throughout the East Asian region.

In the third cycle, we have witnessed changes in the relationship between the geographic structure of Japan's economy and that of East Asia as a whole. Industries agglomerated in Japan's major metropolitan areas used to hold a huge competitive edge over their East Asian counterparts, but in the current cycle, Newly Industrializing Economies (South Korea, Taiwan, Hong Kong and Singapore) are becoming more competitive in the same industries. (Figure 5)

### 3. Features of Economic Clusters in Japan, and Linkages among Different Economic Clusters

One feature of economic clusters in Japan is a high degree of diversity. That is, they are not specialized industrial clusters, but Japan's economic clusters are multi-faceted and include many different industries and companies concentrated, above all, in large urban areas forming diversified eco-

nomie spheres. Although other East Asian economic clusters have been growing rapidly, they have not yet achieved much diversity. It is also worth noting that because Japan lies near the rest of East Asia, it is in a better position to establish closer economic ties with economic clusters now growing up in East Asia compared to the nations of Europe or North America. (Figure 6)

As the nation in East Asia with the most advanced economic structure, Japan is in an excellent position to establish linkages with economic clusters in other parts of East Asia. This is true not only from the standpoint of stages of economic development, but also in terms of geographic proximity. Japan needs to build attractive economic clusters that stress the advantages of diversity, and it needs to establish flexible linkages with economic clusters in other parts of East Asia.

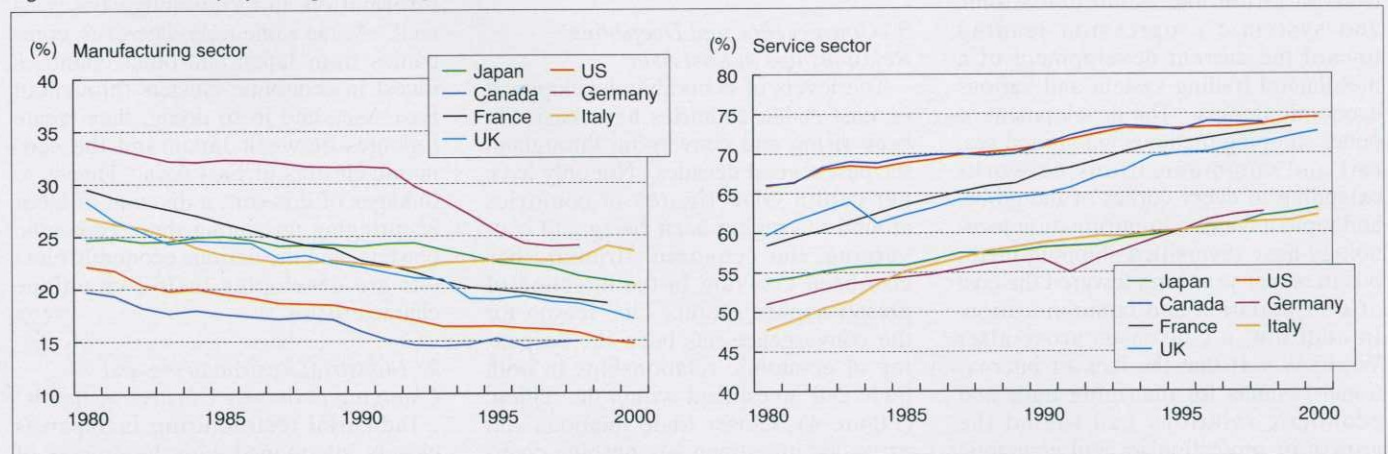
### Section 3. Growth of the Service Sector in Developed Countries

In all developed countries, the service sector accounts for a growing percentage of economic activity and employment. (Figure 7) In the United States, where growth of the service sec-

tor has been particularly notable, the service sector (in the narrow sense of the term) owes much of its growth to the following: (1) the outsourcing of services (company-to-company services) that companies used to run in-house; and (2) the outsourcing by households of services (especially health care services) that used to be considered household chores. In the former category, the growth appears to be fueled in large part by the increased outsourcing of services by manufacturing firms, and by the growing use of non-permanent employees. In Japan, as well, company-to-company services were growing at a fast clip prior to and during the bubble economy, but the job-generating capacity of the service sector has leveled out in recent years due to the long-running recession. Nevertheless, employment is on the rise in the area of medical care and social welfare-related services thanks to growing demand for nursing care services created by the aging of Japan's population.

As service sectors around the world continue to grow, the percentage of economic manufacturing activity in Japan is falling, causing many people to worry that Japan is losing touch with its "manufacturing" traditions. On the

Figure 7 Share of employment generated by manufacturing and services in developed countries since 1980



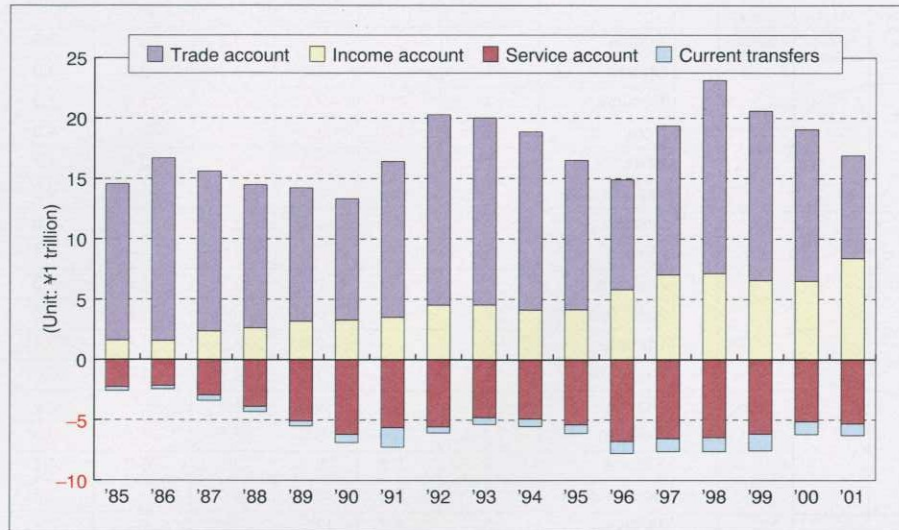
Note: 1. Data for Germany up to 1990 are only for the former West Germany. Data for Germany from 1991 onward are for the unified Germany.

2. Data for France represent numbers of employees rather than workforce percentages.

3. The service sector as referred to here includes: wholesaling and retailing (including restaurants and hotels); transport and communications; finance, insurance and real estate; and area, social and individual services.

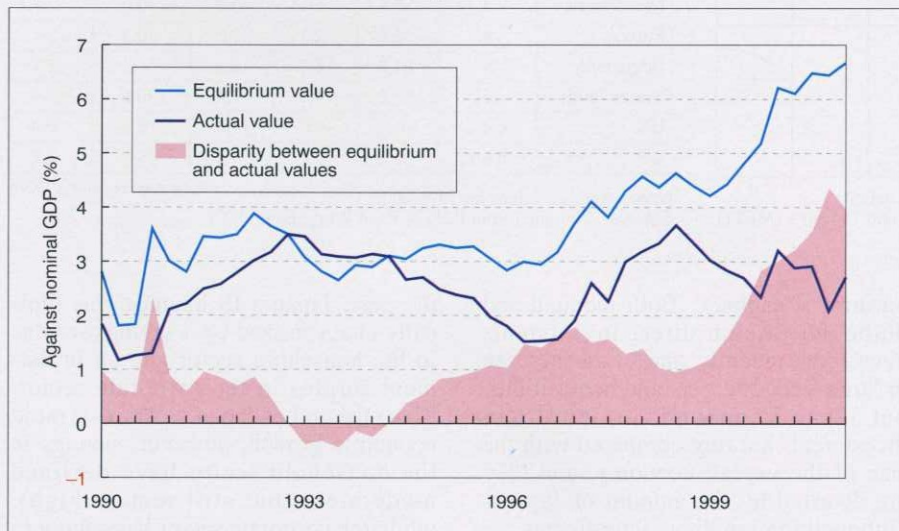
Source: Compiled from OECD, *Labour Force Statistics*

Figure 8 Balance of payments (by category) since 1985



Source: Bank of Japan, *Balance of Payments Statistics*

Figure 9 Nominal current account balance against GDP



Source: Compiled from Cabinet Office, *National Economic Accounts* and other materials

other hand, there is not actually an either/or trade-off between manufacturing and services. Consider the following two factors: (1) Revival of the U.S. economy has not been fueled solely by growth of the service sector. Rather, it has been the result of a growing interdependence between the manufacturing and service sectors. (2) Within the manufacturing sector, firms have been diverting more and more company

resources away from processing and assembly, and toward highly profitable marketing and after-sales services, which amounts to the integration of services and manufacturing. Given these factors, it would seem that there is less and less need to discuss the service and manufacturing sectors as if they were mutually exclusive categories.

Today, technological progress continues apace and increased efficiencies

are being achieved in specialties across the board. Against this backdrop, if Japan's economy is to retain its vitality and achieve further growth, it will have to continue moving toward greater "selectivity and concentration" on Japan's traditional strengths – the manufacturing sector's superior production technology and marketing strategies, while it moves on to establish strong ties with the service sector, which is exhibiting increased specialization and growth. Also, Japan's service sector needs to provide services not just to our domestic manufacturers, but to overseas individual users and firms as well.

## Chapter II. What the Balance of Payments Tells Us about Japan's Economy

### Section 1. Trends in Japan's Balance of Payments

#### 1. Trends and Features of Japan's Current Account Balance in 2001

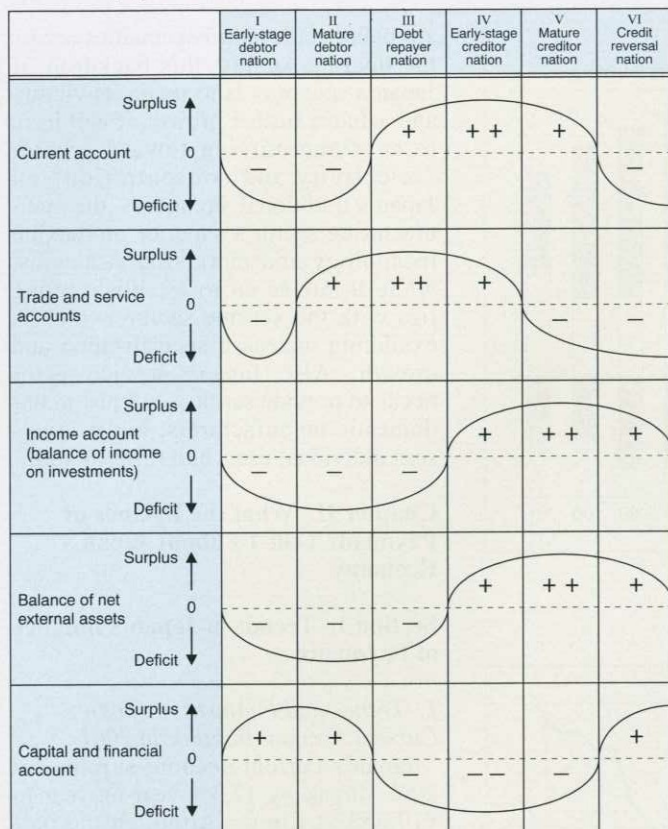
Japan's current account surplus for 2001 shrank by 17.3% year-on-year to ¥10.6523 trillion. Although the balance on income recorded a sharply expanded surplus, this was more than offset by a dramatically reduced trade surplus brought on by an export slump caused by the global economic recession. (Figure 8)

Previous reductions in Japan's current account surplus were due to import growth brought on by increased domestic demand, which reduced our trade surplus. This time, however, domestic economic doldrums led to a sluggishness in imports at the same time that global economic recession also depressed exports. Thus shrinking the current account surplus.

#### 2. Current Account Trends by Category, and Capital and Financial Account Trends

The trade account surplus shrank in 2001, mainly due to a decline in exports, causing some to worry that Japan's exports had become structurally less competitive. However, Japan was not the only country to see lower exports and a smaller trade account sur-

Figure 10 Typical stages of a country's balance of payments structure



Note: Plus signs (+) denote a surplus, and minus signs (-) a deficit  
 Source: Compiled by the Ministry of Economy, Trade and Industry (METI) using data from the Bank of Japan (2001)

Table 1 Recent balance-of-payment structures and levels of economic development in different countries

	Development level	Current account	Trade and service accounts	Income account	Net external assets	Capital and financial account
Austria	1	-2.5	-0.9	-0.8	-16.5	2.5
Spain	1	-1.0	-0.2	-1.3	-19.6	2.0
Portugal	1	-7.3	-9.6	-1.3	-21.8	8.3
Peru	1	-4.8	-3.8	-2.8	-47.7	4.3
Chile	1	-3.5	-0.9	-3.3	-22.9	4.7
Argentina	1	-3.8	-1.5	-2.4	—	4.3
Brazil	1	-3.7	-1.6	-2.3	—	3.8
Mexico	1	-2.5	-0.8	-3.0	—	2.1
Australia	1	-4.3	-1.1	-3.2	-51.9	4.3
New Zealand	2	-6.2	0.1	-6.9	-83.0	5.5
Canada	2	-0.3	2.9	-3.3	-31.9	-0.1
Denmark	3	0.9	3.7	-2.1	-21.1	-0.0
Norway	3	5.1	8.0	-1.0	—	-3.8
Sweden	3	2.5	6.0	-2.1	-35.8	-0.8
Finland	3	5.6	8.1	-2.1	-95.6	-4.1
South Korea	3	3.2	3.7	-1.0	—	-2.3
Malaysia	3	4.7	12.3	-5.6	—	-4.7
Thailand	3	4.1	5.8	-2.1	-40.8	-1.6
Italy	3	1.5	3.1	-1.1	0.9	-0.5
Japan	4	2.4	1.3	1.3	22.9	-2.6
Netherlands	4	5.1	6.1	0.7	-0.8	-2.3
France	4	2.2	2.7	0.6	10.4	-2.4
Singapore	4	21.4	16.7	6.1	—	-22.1
Switzerland	5	7.8	4.8	7.1	126.8	-10.4
UK	6 → 1	-0.4	-1.0	1.1	-10.6	0.4
US	6 → 1	-2.8	-2.2	-0.0	-15.0	3.2

Note: Average values for 1996-2000  
 Source: Compiled from IMF, IFS and World Bank, WDI  
 (Percentage of nominal GDP)

plus. The same two things occurred in the major nations of East Asia due to the global economic recession.

Due primarily to a huge deficit in the tourism account, the service account has run a deficit of several trillion yen since the 1990's. On the other hand, the deficit in the category of patent and other royalties has shrunk in recent years thanks to increased royalty income.

The income account surplus has been growing at an accelerating rate since the 1990's due to the accumulation of external assets, and it is comparable in size to the trade account surplus. Much of the income account surplus is generated by income from securities investments, a reflection of the continuing accumulation of overseas securities investments.

Reflecting the current account surplus, Japan's capital and financial account continues to show a deficit (i.e.

outflow of capital). Both inbound and outbound foreign direct investments have risen recently due to an increase in large-scale mergers and acquisitions, but Japan's inbound foreign direct investments are tiny compared with the size of the overall economy, and they are dwarfed by the amount of Japan's outbound foreign direct investments.

## Section 2. Evaluation of Changes in the Current Account Balance

### 1. The Japanese Economy and IS Balance Trends

From a macroeconomic viewpoint, "current account" refers to the gap between savings and investment. The current account balance reflects changes in savings and investment activities, changes in population composition, shifts in the budget balance and other mid to long-term factors. In

the past, Japan's IS balance was typically characterized by a savings surplus in the household sector and an investment surplus in the corporate sector. Since the end of Japan's period of rapid economic growth, however, savings in the household sector have declined moderately (but still remain high), while the corporate sector has swung to a savings surplus, reflecting lower plant and equipment investment. As a result, the private sector's savings surplus has been expanding since the 1990's. In the public sector, the government's fiscal deficit expanded during the first half of the 1990's, due in part to decreased tax revenues and increased social security outlays. However, in recent years the fiscal deficit has been shrinking and the public sector's investment surplus has stopped expanding and started shrinking. The combined effect of all these factors is an

overall national IS balance that, at this point in time, shows no clear-cut tendency in any particular direction.

## 2. Viewpoints Regarding Changes in the Current Account

The recent contraction of Japan's current account surplus has mainly been the result of falling exports brought on by the global economic recession (Figure 9), which is a short-term factor.

Long-term change in Japan's current account balance is determined to a considerable degree by the IS balance, especially by investment trends. An upturn in domestic investment acts to reduce the current account surplus. Conversely, a downturn in domestic investment results in the expansion of the current account surplus. If, as a result, the economy was to weaken, domestic and inbound foreign investment would decline, giving rise to worries about export competitiveness. When domestic firms increase their foreign investments, these investments

eventually affect the current account balance through changes in exports and imports. Accordingly, when thinking about the state of the Japanese economy, there is no need to pay much attention to changes in the current account surplus, especially during short-term changes.

## 3. Evaluation of the Level of the Current Account Balance, and Economic Revitalization

Some people worry about the shrinking current account surplus, but in fact, there is no observable relationship between the level of the current account balance, the unemployment rate and international competitiveness. To achieve economic development in the future, Japan will need to stimulate increased investment, which is the prime mover of economic growth. It is also important that our government builds a more attractive investment environment, improves the image held overseas concerning the Japanese economy, and establishes international trust toward our economy.

## Section 3. Japan's Economic Development and Our International Balance of Payments in the Future

### 1. Stages of Economic Development and International Balance of Payments

When we examine an individual country's economic development and changes in the structure of its international balance of payments over time, we generally see the following progression: early-stage debtor nation → mature debtor nation → debt repayer nation → early-stage creditor nation → mature creditor nation → credit reversal nation. (Figure 10, Table 1)

The structure of Japan's international balance of payments has followed precisely this pattern. While Japan's trade and service account surpluses are shrinking, our income account surplus and net external assets are on the rise. We are now making the transition to a mature creditor nation, as the United Kingdom and the United States have done previously. (Table 2)

### 2. Mid to Long-Term Current Account Forecast, and a Look at Some Outstanding Issues on Japan's Agenda

If we regard Japan as being in the midst of a transition to a mature creditor nation, its shrinking current account surplus should not be seen as a problem for the time being. But if Japan's economy is to remain strong, there are many points that we must consider in relation to the maintenance of export competitiveness, development of the service sector and the domestic and overseas investment activities of Japanese enterprises. The international community must have trust in our economy and see it in a favorable light; otherwise, the flow of inbound investment and capital will weaken, as will our economic strength and international competitiveness.

Several things must be done. First, it is important that Japan keep producing internationally competitive export products. Japan's exports have been growing with its effort to change the structure of export items, branching out into new fields while transferring the production of low-end exports to overseas manufacturing bases.

Second, in the service sector as well, Japan must branch into next-generation areas where it can be internationally competitive.

Third, to achieve a stable income account in the future, Japan needs to make good use of its external assets and take an active approach to its investment activities by keeping close track of the changes in the global profit structure and profitability of various industries.

Fourth, Japan needs to build an attractive investment environment for both international and domestic firms. In other words, we need to carry out domestic reforms.


It is necessary for the Japanese economy to continually come up with new sources of income of the sort described above. To build up an environment that is conducive to the achievement of this goal, we must carry out economic reforms and promote innovation throughout the entire economy. 

Table 2 Net external assets of various countries, Dec. 31 2000

Country	Balance	Percentage of nominal GDP
	(Unit: US\$1 billion)	(%)
Japan	1,158	25
Switzerland	297	124
Germany	69	4
Belgium	61	25
France	60	5
Italy	44	4
Iceland	-5	-60
Denmark	-27	-17
Austria	-32	-17
New Zealand	-39	—
Portugal	-39	-38
Netherlands	-42	-11
Greece	-47	-42
Sweden	-59	-26
Spain	-114	-21
Canada	-162	-24
Finland	-181	-151
UK	-184	-13
Australia	-208	-53
US	-2,187	-22

Source: Compiled from IMF, *IFS*