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Japan's Changing Economic Structure

By Ariyoshi Okumura

Nearly two years have passed since the Plaza Accord of September 1985 set the stage for readjustments in the exchange rates of major currencies. The yen has since appreciated 70% against the dollar, surging from the ¥240 level to the ¥140 level. This has crimped the international competitiveness of the Japanese economy and has created serious problems for a wide range of industries.

Yet the primary objective of the exchange rate adjustment—correcting the trade imbalances among major countries—has yet to be achieved. The U.S. trade deficit widened from $124.4 billion in 1985 to $144.3 billion in 1986. The deficit still remains disturbingly high. The Japanese trade surplus, meanwhile, expanded from $56 billion to $92.7 billion in the same period. Although it is finally showing signs of shrinking, it also remains disquietingly large (Fig. 1). The rapid appreciation of the yen has had a deflationary impact on the economy, appearing in deteriorating corporate income and rising unemployment.

Restructuring in progress

In the long run, the changes in exchange rates should promote economic restructuring and help correct trade imbalances. In the shorter term, however, such imbalances can widen under the impact of the so-called J-curve, as recent trade statistics amply demonstrate. Yet the yen has already appreciated sufficiently to force structural reforms in the Japanese economy. In fact, such changes are already taking place.

The continued enormous trade surplus may lead some to conclude that Japan's economic structure has not changed at all. But a closer look at both exports and imports reveals that significant change is clearly under way.

For one thing, the export volume has dropped significantly. It has declined substantially in such areas as textiles and steel. The expansion of dollar-denominated exports on a value basis reflects the markups in dollar prices triggered by the yen's rise. In fact, however, the yen went up so fast that exporters did not have time to mark up their prices sufficiently to fully absorb the impact of higher exchange rates. As a result, total yen-denominated exports shrank as much as 15% on a value basis in fiscal 1986 April 1986 to March 1987, causing a marked deterioration in export earnings.

Total imports, meanwhile, dropped 2% in value in fiscal 1986, chiefly because of lower prices for oil. But imports of manufactured goods expanded markedly. Textiles imports were up 29% over the previous year, chemicals 20% and machinery and equipment 19%. Thus the trade structure is beginning to change—even if these changes have not yet shown up in the balance of trade.

Japan's GNP grew only 2.6% in real terms in the year ended March 1987, the lowest rate of growth in 11 years. This was due primarily to a sharp drop in external demand, namely, a contraction of exports, and expansion of imports. Domestic demand alone expanded 4.3% for the highest increase in several years. The main thrust for economic growth came from internal demand (Table 1).

The appreciation of the yen is also prompting corporations to restructure their operations in order to stay competitive in world markets. First, they are updating their overseas strategies. Japan's direct investment abroad jumped to $22.4 billion in 1986 from $12.2 billion in 1985. Japan is now investing more abroad in annual terms than any other country. In the first half of the 1980s, most of the investment went to the United States to avert trade frictions. At the time, the yen was still undervalued. Now, while investment in the United States is expected to continue to expand, the emphasis is shifting to newly industrializing countries (NICs) in Asia.

The wage gap between Japan and these Asian NICs has widened as a result of the strong yen. The average per hour wage in Japan, calculated at the prevailing exchange rate, is eight times higher than in South Korea, six times higher than in Taiwan and five times higher than in Singapore. It is only natural that Japanese corporations should seek to take advantage of this cheap labor as a key part of their overseas investment strategies. In fact, many are shifting production to South Korea, Taiwan and other countries.

Second, Japanese enterprises are using more imported components, now that foreign-made finished products and parts can be purchased at much lower cost than before. By incorporating these low-cost imports into their products, they can make them more competitive price-wise. But what is most significant about these moves is that overseas suppliers are no longer regarded simply as sources of cheaper goods but as partners in corporate development. These partnerships are being maintained through various forms of cooperation, such as technology transfers and capital subscriptions.

These changes in Japanese corporate strategy make it increasingly likely that a significant portion of export production will move overseas, and that imports of foreign products and parts will increase rapidly. This is an inevitable process that the Japanese economy must go through if

Fig. 1 Balance of Payments of Japan and the United States ($ billion)

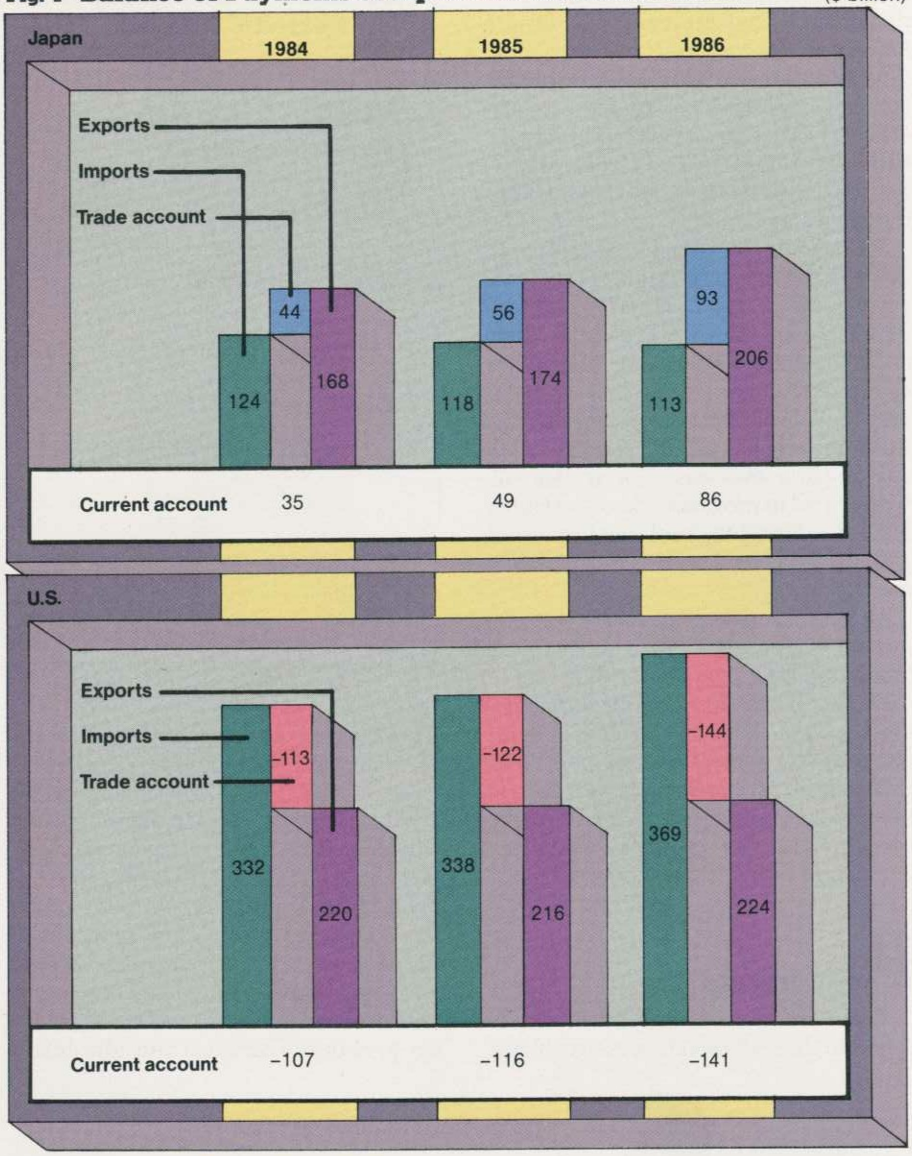


Table 1 Japan's Real Growth Rate (%)

	FY 1984	FY 1985	FY 1986
Domestic demand	3.9	3.7	4.3
Overseas demand	48.8	19.9	-36.6
GNP	5.1	4.3	2.6

it is to make itself more compatible with the international economy and ensure long-term coprosperity. At the same time, however, such economic restructuring, unless carried out smoothly, could also lead to declines in industrial activity, such as the loss of jobs and a drop in output caused by overseas relocation of domestic production.

Production is already being pared down in the industries hit hardest by the yen's surge. Large numbers of workers have been forced out of work in the steel and shipbuilding industries, which played leading roles in Japan's postwar growth. Subcontractors, too, are suffering from moves by parent companies to source parts overseas. Nor is that all. Many firms in provincial export-oriented industries have gone bankrupt because of a sharp drop in demand and plunging market prices.

During the past year, nearly 400,000 jobs have been lost in the manufacturing industries, with the jobless rate rising to 3.2%, the highest since records started being kept and published in 1953. Unemployment is reaching serious proportions, particularly in provincial areas where manufacturing plants and factories are concentrated. The "hollowing out" of regional economies is a distinct possibility.

Table 2 Effect of Emergency Economic Package in Expanding Domestic Demand

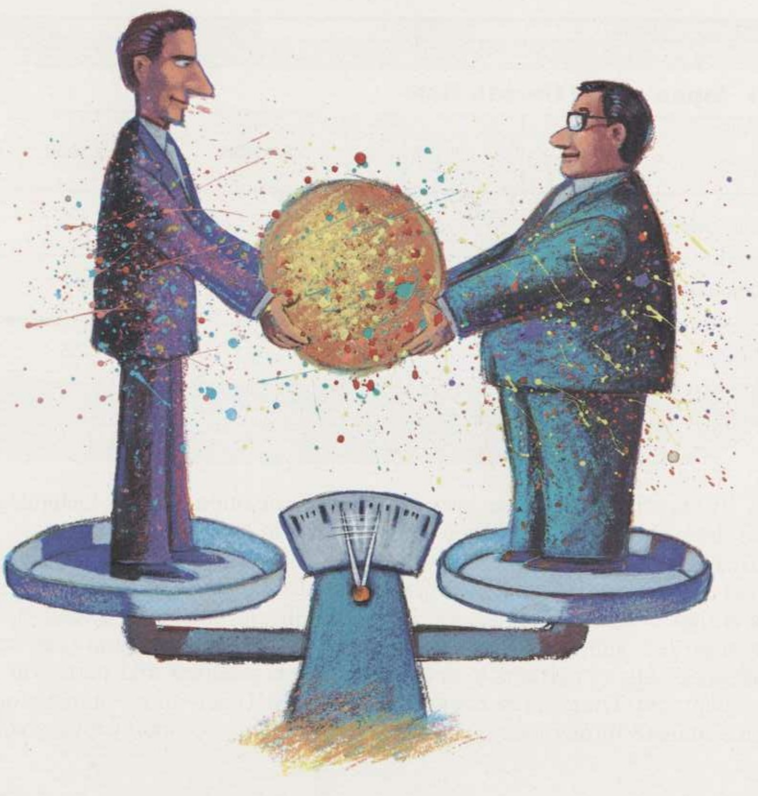
(%)

	Tax cut	Public works spending	Total
Individual consumption	0.4	0.3	0.7
Housing investment	0.2	0.9	1.1
Equipment investment	0.2	1.2	1.4
Public investment	–	11.9	11.9
Exports, etc	–	–	–
Imports, etc	0.4	0.7	1.1
Real GNP	0.2	1.3	1.5

Note: Projected on the basis of the Industrial Bank of Japan's short-term macro model.

Policy changes

There are limits to how much can be achieved through economic restructuring that relies only on the upward adjustment of the yen rate, and there are negative effects as well that might otherwise be avoided. Further jumps in the yen's value would only accelerate the economic slowdown in Japan, making it all the more difficult for the country to contribute to the world economy. In addition, a further fall in the value of the dollar would not only weaken international confidence in the U.S. currency but also increase inflationary pressures. Exchange rate adjustment has reached a point where it could start having highly adverse effects.



In the final analysis, trade imbalances should be corrected on a longer-term basis through policy coordination among the leading industrialized countries. In fact, there is already a broad consensus on this score among them, as was agreed upon in a series of international conferences leading up to the Venice economic summit in last June.

In Japan, there is also a public consensus that the nation must change its economic structure in order to achieve harmonious development as an integral part of the international economy. In this respect, the new Maekawa report, published by the Economic Council, a key government advisory body, in April 1987, makes three essential points. First, Japan should make it a national goal to steadily reduce the current account surplus; second, the structure of the Japanese economy should be changed to one based on domestic demand; and third, achievement of equilibrium in external balances will lead at the same time to a higher quality of life at home.

Government policy is changing in line with these recommendations. Particularly important are the steps being taken to expand domestic demand and liberalize the domestic market.

A set of emergency economic measures announced by the government are aimed at significantly expanding domestic growth in fiscal 1987. This program reflects the agreements on policy coordination reached at a series of international conferences held since 1986, including meetings of the G-5 and G-7 nations and the summit of the seven industrialized nations in Venice. It exceeds, both in scale and substance, any previous set of stimulative measures taken in recent years.

The package, worth about ¥6 trillion (about $40 billion at the rate of ¥150/$), is the largest ever. It includes about ¥5 trillion in measures related to public investment, including nearly ¥1 trillion in housing-related investments and not less than ¥1 trillion in personal income and other tax cuts. These measures required a bold decision on the part of the government, given the enormous budget deficit. Japan has indeed made a clear-cut policy change in favor of expansion led by domestic demand.

The stimulus program will not only contribute to international economic cooperation but should also help the Japanese economy out of its slump. It is estimated that the GNP growth rate for fiscal 1987 will rise by an additional 1.5 points or so, thus moving the domestic economy gradually toward recovery (Table 2).

For these reasons, the package deserves to be well received both as a positive manifestation of external economic policy and as a necessary response to the domestic economic slowdown. In view of the still large budget deficit, however, it is hoped that the private sector will step in to take the lead in fiscal 1988 and beyond, with the government performing a supportive role. This is an essential condition for sustainable expansion in domestic demand.

The export dependence (exports/GNP) of the Japanese economy is relatively low−13% in fiscal 1986, the second lowest figure among the industrialized nations after the United States. In that sense, the Japanese economy can be said to be already oriented toward internal demand. There is, in fact, wide scope for domestic growth, especially considering the stimulative effects of the higher yen, the strong demand for residential construction and the continuing need for infrastructure projects. It is quite possible for Japan to maintain respectably strong long-term economic growth by tapping this vast potential demand at home, even without much growth in exports. With the yen's appreciation as the lever, the Japanese economy is already moving in this direction.

Major changes are also under way in the area of market liberalization. Residual import restrictions on industrial products have been completely lifted, and Japan's average industrial tariff is now the lowest in the world. Japan is the only country that has no import duty on cars. Yet while Japan has the most open market system in the world as far as industrial products go, the fact remains that the market is still seen by foreign firms as less open than it should be. Limited market access, the complicated distribution structure and uncompromising consumer attitudes toward quality are cited among the perceived barriers.

Efforts are being made to improve the situation. However, it must be recognized that certain access problems exist in every national market. Many foreign products hold a large share of the Japanese market, thanks to sales promotion efforts by the foreign firms involved. Sales of foreign goods in Japan are likely to expand markedly now that the strong yen has made imports much cheaper, and Japan is stepping up efforts to increase industrial imports through further tariff cuts and other measures.

Market-opening moves are not confined to industrial goods; they are gaining momentum as well in banking and other services. There has been marked progress in financial liberalization in recent years. Further deregulation is expected here and in other fields, giving foreign industrial corporations and financial institutions greater access to the Japanese market.

The Japanese agricultural market is still less open than the markets of the United States and other industrialized countries. Agriculture, which involves employment and political problems, is more or less protected in the United States and European Community member states as well. Yet Japan, with its low level of food self-sufficiency, has adopted strongly protectionist policies in order to secure stable food supplies. The priority now given to correcting the trade imbalance, however, has spurred feelings that drastic action is needed to open up the farm market as well. The government is considering easing residual restrictions on agricultural imports and cutting tariffs. In addition, it is planning to reduce farm subsidies to bring domestic prices for agricultural produce closer to international levels.

Direction of Japan's economy

Japan's economic structure is changing markedly as business adapts to the strong yen. At the same time, the government is pursuing policies aimed at making the Japanese economy more compatible with that of the rest of the world. These moves are expected to gain momentum and could bring major structural changes in the economy within the next several years.

The trade picture is also expected to change dramatically as increasing production by Japanese companies in the United States, Europe, Asia and other regions and growing imports of manufactured goods accelerate the international division of labor between Japan and other countries. Full-fledged economic development in neighboring Asian countries will also contribute to the international division of labor. As a result, Japan's trade surplus will likely shrink gradually in the years ahead.

In the adjustment process, industries that have lost their comparative advantage will go into decline. The result will be higher unemployment and stagnation in regional economies. Restructuring is a process that will also involve a great deal of pain. Yet the Japanese economy must face it, and indeed, is already moving in this direction.

International cooperation

International cooperation is essential to the smooth restructuring of the Japanese economy and the stable development of the world economy. Restructuring is a common challenge for Japan and other nations. The difficulties it presents will be no less challenging in the United States, which faces the urgent double task of cutting its deficits and strengthening its industrial competitiveness. Under such circumstances, it is likely that the interests of Japan and the United States will at times clash. Intensified trade friction between the two countries could cause major swings in the yen-dollar exchange rate and add to protectionist pressures. Either development would hinder the orderly restructuring of the Japanese economy. The economies of the two countries would suffer all the more given the close relations between them in trade, finance and other fields, and the growing integration of their economies through the mutual entry of industrial corporations and financial institutions into their markets.

The success or failure of economic reform in Japan, the United States and other major countries will determine the future of the world economy. At times such as these, it is essential to maintain closer international cooperation for the coordination of economic policies and the stabilization of exchange rates. ●