SPECIAL REPORT

Japan's Chronic Current Account Surpluses And the U.S.-Japan Economic Relationship
– A Macroeconomic View from Japan –

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My purpose here is, first, to explain that Japan has indeed become an international creditor, as befits the slowdown of its private fixed capital formation and its unusually high rate of private savings.

A second purpose is to relate the net export-led growth of the Japanese economy to deteriorations in the terms of trade, induced by the oil crises, and to the restoration of its position as an international creditor after each oil crisis.

A third purpose is to analyze the unique causal relationship observed in 1983–84 between the huge government deficit in the U.S., high American interest rates, the strong U.S. dollar, and the emerging large current account surpluses of Japan.

Japan as an international creditor

Since World War II, the Japanese economy has experienced several stages in the evolution of its balance of payments.

During 1945–64, Japan was an immature debtor country with current account deficits (Stage I). It was an international borrower, both in flow and stock terms. Then, during 1965–71, Japan became a mature debtor country with both current account surpluses and net payments of investment income (Stage II). In other words, during this period, it became an international lender in flow terms as reflected in current account surpluses, but not yet in stock terms as reflected in net payments of investment income.

Finally, from 1972 to date, Japan has become an immature creditor country with current account surpluses, including net receipts of investment income (Stage III). That is, it has become an international creditor both in flow and stock terms. This period, in which trade surpluses are a dominant factor for persistent current account surpluses, will be followed by Stage IV, where service account surpluses rather than trade surpluses will be a dominant factor for persistent current account surpluses.

These changes in the balance of payments largely coincided with the development of various elements in Japan such as the external trade sector, and the change in the tempo of private capital stock accumulation.

During Stage I, Japanese exports consisted primarily of simple labor-intensive commodities, such as textiles, and of unsophisticated electrical appliances and vessels. In Stage II, medium knowledge-intensive goods, such as sophisticated electrical appliances (e.g., color television sets) and capital-intensive basic commodities (e.g., iron and steel and petrochemicals) dominated the Japanese export sector. In Stage III, automobiles and highly knowledge-intensive industries (e.g., large machinery, turn-key plants, electronics, etc.) have become increasingly important.

The persistent surplus of the current account since 1965 is probably due to changes in the investment ratio to GNP (gross national product) during Stages II and III. During the period 1952–67, total fixed capital formation (including private and public as well as residential construction) accounted for the rapidly increasing share of the nominal GNP, which grew from 20.4% to 32.5%. As mentioned earlier, the Stage I period registered a persistent deficit in the current account. During Stage II, total fixed capital formation as a share of nominal GNP stopped rising, remaining stable at the high ratio of 34–35%. This change in the trend of investment ratio may be consistent with the emergence of current account surpluses. Entering Stage III, a period characterized by the two oil crises and the floating exchange rate, the ratio of total fixed capital formation to nominal GNP has declined to 31–32%, caused mainly by a semi-permanent decline in private expenditure on plant and equipment.

Hence, the persistent surplus in the current account can be accounted for by the rise in the endowment of capital in Japan. If the higher level of capital stock per worker reduces the rate of increase in physical capital stock, the result can be an improvement in the current account, since international capital moves from highly capital-endowed economies to those that are less so. The development of the endowment of capital has been accompanied by the above-mentioned transformation of comparative advantage industries from labor-intensive to capital-intensive and further to knowledge-intensive ones, and the concurrent development of managerial skills. Particularly in Stage III, the rapid development of highly knowledge-intensive industries suggests that Japan is now in a position to transfer not only technology but management know-how in the form of direct investment abroad.

Peculiar characteristics of current account surpluses during the two oil crises

It is rather surprising that over the ten years from 1973 to 1981, the cumulative surplus of Japan's current account was only 0.24% of cumulative GNP (measured at current nominal prices). This ratio can be compared with 0.47% for West Germany and 0.11% for the United States during the same period. This ratio in Japan under both floating exchange rates and the two oil crises was also much smaller than the U.S. ratio of 0.70% during 1960–66 under the Bretton Woods System.

The fact that there were relatively small cumulative current account surpluses after 1973 also nullifies a claim often made by both domestic and foreign economists that the government deficit in Japan has not been large enough to absorb the large

private savings, and that as a result excess private savings have spilled over into large current account surpluses.

The question then arises as to why the Japanese economy is often perceived as relying heavily on rapid export expansion for its growth, despite the relatively small cumulative current account surplus since 1973. This perception has become a strong irritant to Japan's trade partners over the past ten years, as our partners have generally experienced slow domestic growth and rising unemployment.

Unless there are major changes in the external terms of trade (export prices divided by import prices), the magnitude of the current account imbalance should be the same in either nominal or real terms. The period since 1973 has witnessed unprecedented changes in the terms of trade due mainly to the two oil price shocks. This was particularly true for Japan because of its heavy reliance on imported crude oil and the sharp depreciation of its exchange rate due to the oil crisis.

In other words, Japan's surprisingly small cumulative external surplus after 1973 does not necessarily preclude the possibility of an expansion in the export surplus in real terms, given the sharp deterioration of Japan's terms of trade. That is in fact what happened between 1973 and 1982: exports in real terms (at 1975 prices) expanded by 11.6% annually, in sharp contrast to a mere 2.2% annual growth in real imports. Real GNP increased by 4.0% a year during the same period.

This represented an astonishing turnaround in the growth pattern of the Japanese economy. While exports and imports grew in parallel during the high growth period of the 1960s, export surplus-led growth characterized the period after 1973. As noted, this is not reflected in the nominal trade figures; nominal exports grew at nearly the same pace as nominal imports after 1973 (by 15.6% and 13.7% a year, respectively). As a result, the expansion of the nominal external surplus (defined as an excess of exports over imports of goods and services at current prices) accounted for merely 2.0% of the increment of nominal GNP from 1973 to 1982. In sharp contrast, the expansion of real external surplus contributed nearly one-third (32.4%) of the growth of real GNP during the same period. Measured at current prices, the economy registered little export-led growth. But measured at constant prices, extraordinary export surplus-led growth was realized.

A major difference between the high-growth era and the oil-crises era was in the movement of the terms of trade. From 1973 to 1982, Japan's terms of trade deteriorated by 43.3%, whereas they improved slightly during the 1960s. This deterioration was much larger than in West Germany and the United States, where the comparable figures were 7.4% and 24.5%, respectively. The real income loss in Japan due to the deterioration of the terms of trade amounted to 9.1% of real GNP in 1981. In other words, the worsening of the external current account caused by the deterioration of the terms of trade between 1972 and 1981 could be compensated for by exporting real goods and services equal to 9.1% of the 1981 GNP.

As a result, the underlying trend of a persistent nominal current account surplus re-emerged after each oil crisis. However, since maintaining the status of an international creditor, despite the large oil deficits in the current account, has caused a considerable export surplus expansion in real terms, such expansion of the real export surplus resulted in the accusation that the Japanese economy is biased too heavily toward exports.

Relationship between large U.S. government deficit and Japan's large current account surplus

Japan's chronic current account surpluses in normal circumstances imply that it will continue to incur large surpluses in its merchandise trade with the United States. This imbalance arises essentially from two aspects of the structure of Japan's balance of payments—the commodity composition of merchandise trade and the chronic deficit in its services account.

Even if Japan's merchandise trade account were balanced, its large net imports of petroleum and other primary products would have to be offset by similarly large net exports of manufactured goods. Japan is endowed with few natural resources. In 1980, for instance, Japan's net imports of primary products amounted to 10.1% of GDP (gross domestic product), as compared with U.S. net imports of primary products amounting to 1.9%. On the other hand, Japan's net exports of manufactured goods amounted to 9.1% of GDP compared to only 0.5% for the United States. Japan's trade deficits in primary products are incurred not only in mineral fuels (6.7% of GDP in 1980) but also in crude materials (2.2%), and food, beverages and tobacco (1.3%).

This unique structure of trade balances by commodity group tends to be reflected in Japan's trade balances by region. Huge deficits in trade with OPEC countries are offset by large surpluses in trade with the industrialized countries. Similarly, Japan incurs merchandise trade deficits with advanced primary commodity-exporting countries such as Canada, Australia, New Zealand, and South Africa. These deficits are offset by high surpluses in trade with the United States, the European Community, and the newly industrialized countries.

Japan's current account also shows large deficits in trade in services. These deficits are particularly notable in transportation, tourism, licensing, royalties, and management fees. This large deficit in services, as in the primary commodity trade, is financed by a surplus in manufactured exports. In this connection, Japan's current account surpluses with the United States tend to be amplified because Japan incurs relatively small service deficits with the United States. This will continue to be the case if Japan's net investment income continues to grow as a result of increased investments in the United States.

Although Japan's chronic current account surpluses and its implied chronic bilateral trade surpluses with the United States can be justified in terms of economics, the counterpart of such surpluses, namely, the U.S. trade deficit with Japan, is politically unattractive to politicians in the United States. This unattractive external situation will be aggravated, particularly when Japan's actual current ac-

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count surpluses go beyond the normal ratio of, say, 1.5% of its nominal GNP. That concern may become reality in 1983–84. This time, however, the mechanism for enlarging Japan's current account surplus will be totally different from that in the past. That is, Japan's current account surpluses will become intolerably larger in 1983 and 1984 from a political viewpoint, not because of weak domestic demand in Japan but because of the large government deficit in the United States.

In the United States, the federal budget deficit in 1983 and 1984 will account for about 80% of private savings, net of depreciation. Such an unprecedentedly large share held by the budget deficit in the relatively small amount of net private savings has kept real interest rates at a high level, even though monetary policy has become somewhat more accommodating since August 1982. Such high interest rates have led to a flow of world savings into the United States, thus contributing to the very high external value of the U.S. dollar.

This inflow of world savings into the United States—that is, a capital account surplus—can finance part of its large fiscal budget deficit. Without such imports of foreign capital, U.S. interest rates would have been even higher in the past as well as at present. In this sense, a capital account surplus is welcome to the U.S., given the fact that U.S. politicians have chosen to live with the large budget deficit. Nevertheless, the U.S. Congress pays great attention to the current account deficit, and especially to its bilateral trade deficits with Japan, rather than acknowledging such a function of the capital account surplus.

It is illogical to welcome the capital account surplus on the one hand and to criticize the current account deficit on the other. This is because the current account deficit is a counterpart of the aforementioned capital account surplus. The strong dollar, which results from the massive inflow of foreign capital attracted by high dollar interest rates, erodes the international price competitiveness of the American manufacturing service industry sector, thereby worsening the current account situation. Also, as the U.S. economy continues to recover vigorously under the strong dollar, a greater number of Americans, possessing more income from increased production and larger capital gains from the buoyant stock market, make more trips to Europe and buy more video tape recorders from Japan. In fact, during the first half of 1983, domestic demand at 1972 prices increased by US$51.5 billion, one-quarter of which (US$12.8 billion) was drained in the form of an excess of imports of goods and services over exports. Hence, high interest rates and the strong dollar are simply market instruments which transmit part of the large domestic budget deficit into both the external capital account surplus and the current account deficit.

In sum, with only a relatively small amount of net private savings available in the U.S. economy, the huge budget deficit almost simultaneously causes both a high-interest-rate-induced capital account surplus and a strong-dollar-induced current account deficit. It is, therefore, logically impossible to have a large fiscal deficit without having it worsen the current account.

In view of the impending presidential election in November 1984, a new problem arises from the dichotomy in attitudes of U.S. congressmen who have chosen to tolerate the large federal budget deficit but not the current account deficit. Such a dichotomy tends to impede the sustained recovery of the world economy.

The necessary conditions under which the world economy can sustain its recovery are lower U.S. interest rates and freer access to markets in the developed and developing countries. However, the choice of U.S. politicians to tolerate the large federal budget deficit keeps dollar interest rates high, while their criticizm of the current account deficit strengthens protectionism, thus reducing access to international trade markets. Both serve only to obstruct the smooth recovery of the world economy.

In order to avoid such a harmful dichotomy, U.S. government economists should explicitly tell their politicians that, once they have chosen to accept the large budget deficit, the American capital account surplus should be welcomed, since capital inflows can prevent dollar interest rates from going even higher. The current account deficit of the U.S. and the implied large trade deficit with Japan should also be welcomed by the U.S. for exactly the same reason.

We sometimes hear the U.S. administration criticize those countries which complain about the U.S. budget deficit and the excessively strong dollar, claiming that the deficit is helping the U.S. recover, thus pulling the world out of the latest recession. This presumption, however, can hold true only when U.S. politicians also accept the current account deficits, and when high real U.S. interest rates are not exported through weak foreign exchange rates. Excessively high real interest rates simply mean that nominal interest rates are higher than the growth rate of nominal GNP. All economists understand that this relationship between nominal interest rates and GNP will not help the sustained progress of private business fixed capital formation. Since the recovery of private business expenditure on plant and equipment stimulates higher productivity and lower inflation through more productive capacity, world recovery will not be sustainable without such sound business investment. Theoretically, governments of the rest of the world could offset the unfavorable real interest rates by fiscal measures, such as investment tax credit. But, this is again another form of involuntary constraint imposed upon fiscal policy in other countries by the U.S. large budget deficit. ●

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