



JRI news release

**The Significance of the Sharp Fall in the Current Trade Surplus
— The Importance of Preventing "Undesirable Surplus Shrinkage"
by Breaking Down Japan's High Cost Structures —**

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1. A Sharp Fall in the Trade Surplus

There was a time when the debate centered on how to reduce the surplus, but Japan's current balance of payments has undergone a major change. The current account surplus has declined from ¥15.2 trillion in fiscal 1998 to ¥12.1 trillion in fiscal 2000, and is expected to be around ¥8 trillion in fiscal 2001. The chief reason for this fall is the sharp fall in the trade surplus, which has fallen from ¥16.0 trillion in fiscal 1998 to ¥11.5 trillion in fiscal 2000 and is expected to be around ¥7 trillion in fiscal 2001.

In itself, a shrinking trade surplus is not necessarily a problem. A rise in imports contributes to the economic growth of trading partner countries by offering them an export market, and may even expand the pie of the global economy by encouraging Japan's exports in the areas where Japanese industry has a relative competitive advantage. In domestic terms, an increase in imports of cheap, high quality goods helps to raise real purchasing power. However, the current fall in the trade surplus is not so much a "desirable surplus shrinkage" of this kind as an "undesirable surplus shrinkage" against a background of industrial hollowing-out.

In other words, in the past, Japan's trade surplus used to fall when the domestic economy was in a recovery phase. However, the current shrinkage has coincided with a recession phase. This is partly due to a cyclical fall in exports owing to the slowdown in overseas economies, especially that of the United States, but a more fundamental reason is the hollowing-out of Japanese industry.

2. The Spread of Industrial Hollowing-Out

The spread of industrial hollowing-out in Japanese industry can be seen in the following areas:

(i) A lack of growth in high value added exports

A survey of the composition of Japanese exports reveals that, until the mid-1990s, the proportion of technologically intensive capital goods rose steadily. Over the past few years, however, the proportion of capital goods has peaked, indicating that the speed of technical advance in Japanese industry is slowing.

(ii) The relationship between domestic and overseas production is becoming one of replacement

In the past, the relationship between domestic and overseas production was complementary, but in recent years this relationship has broken down. In other words, while the sales of domestic businesses have stagnated, a rising trend in the sales of overseas subsidiaries is becoming established. This phenomenon coincides with a rise in overseas production ratios, and it may be concluded that the growth of overseas production has led to a fall in domestic production.

(iii) A sharp rise in import penetration

Owing to a sharp rise in the penetration of the Japanese market by imports of manufactured goods, including reverse imports, imports remain firm despite the deterioration of the domestic economy.

(iv) A fall in productivity throughout Japan's economy

Japan's manufacturing base is shrinking in conjunction with the rise in import penetration, but this would not be a problem if it were balanced by increased activity in the non-manufacturing sector, as in the United States. Increased activity in the non-manufacturing sector contributes to growth of the current surplus in the form of a surplus in balance on services. However, the total factor productivity (TFP) of the Japanese economy as a whole is declining, indicating that the increase in activity in non-manufacturing industries has failed to exceed the contraction of manufacturing industries. Moreover, balance on services continues to show a substantial deficit.

As a result of this industrial hollowing-out, exports have, structurally, ceased to grow against the background of a fall in the international competitiveness of Japanese products, and the trend of replacement of domestic production by imports has become established, leading to a decline in the trade surplus. One

factor behind this trend that cannot be overlooked is the rapid rise in the technological standard of Asian products, especially of Chinese products. The existence of a substantial wage gap is a major factor behind the decline in the cost-competitiveness of Japanese products. **In a sense, however, it is the fate of developed nations to be caught up with by newly industrialized nations, and, if anything, the true reason for the rapid contraction of Japan's manufacturing base is its failure to change a high cost structure and inflexible industrial and employment systems, and its slowness to foster new industries and respond to the IT revolution.**

In other words, in spite of the fact that the international industrial map is changing radically as the technological standards in China and other Asian countries rise, Japan has failed to address the high cost structures and systemic inflexibility of its economy, and has been slow to make technological advances in existing industries and foster new industries, so that the rapid shrinking of Japan's trade deficit is nothing less than **a signal that industrial hollowing out has finally become a reality and is increasing in severity.**

3. A Possibility That the Current and Trade Surpluses Will be Eliminated Within Five Years

If Japan continues to procrastinate on breaking down its high cost structures and reducing the inflexibility of its industrial and employment systems, the hollowing-out of its industry will become more severe and, in the near future, it is possible that the country's current surplus will be eliminated. Let us, therefore, attempt to predict when the trade surplus will be eliminated, on the assumption of two

different scenarios (the calculations take no account of exchange rate fluctuation or oil price fluctuation).

Standard scenario:

- Export volume rises at the average rate recorded in the 1990s. The proportion of high value added exports continues to grow. Export growth rate: 3.8%
- Import volume is projected on the assumption that domestic real economic growth continues at the average rate recorded over the past five years (1.1%), and that import penetration rises at the rate recorded over the past five years. Import growth rate: 7.5%

⇒ Trade surplus eliminated in second half of 2007; Current surplus eliminated in first half of 2008.

Pessimistic scenario:

- Export volume rises at the average rate recorded in the 1990s, but the proportion of high value added exports stops growing. Export growth rate: 2.5%
- Import volume is projected on the assumption that domestic real economic growth continues at the average rate recorded over the past five years (1.1%), and that import penetration rises at the rapid rate recorded over the past two years. Import growth rate: 10.9%

⇒ Trade surplus and current surplus both eliminated by end of 2004.

From the perspective of IS balance theory, with economic activity declining against the background of a shrinking current surplus, it is likely that the fiscal deficit will grow due to declining tax revenue, and that the household savings ratio will rise as a result of income decline.

4. What Will Happen When the Current Surplus is Eliminated?

Even if a country's current balance of payments slips into deficit, provided the domestic financial markets are convenient, the structure of industry continues to become more sophisticated, economic growth potential is high, foreign investors continue to channel funds into that country, and exchange rates are maintained, no problems will arise. A typical example is that of the United States in the 1990s, where the existence of a current deficit, if anything, was a sign of the trust of the international community.

In Japan, however, the shrinking current surplus is largely due to industrial hollowing-out, and, given the immaturity of the domestic financial markets, if industrial hollowing-out continues and the current surplus is eliminated, the economy is at risk of collapsing, by the following process:

Stage 1: a Severe "Triple Weakening" (yen, bond prices, share prices)

Investors will forsake Japan and pull their funds out of the domestic financial markets. As a result, share prices will fall, bond prices will fall, and long-term interest rates will rise sharply. Funds will migrate overseas and the value of the yen will fall sharply.

Stage 2: a Decline in the Level of Industrial Activity

The rise in long-term interest rates will lead to a rapid increase in the number of business failures, leading to stagnation in capital investment. It could be argued that, if the yen continues to weaken, Japan will recover its competitiveness but, with the domestic industrial infrastructure already weakened, the foundation of competitive strength itself will already have been destroyed. Once the industrial concentration is dismantled, it will be difficult to induce foreign companies to return to Japan.

Stage 3: Hyper-Inflation

The rapid depreciation of the yen will gradually lead to cost-push inflation, and the rise of inflation will exert a downward pressure on the yen through a reduction in purchasing power parity. If industrial hollowing-out progresses, the weakening of the yen and inflation will become a vicious circle. Hyper-inflation will make it still more difficult to restore normal economic activity.

Stage 4: the Collapse of the National Livelihood

By reducing the opportunities for employment, the contraction of industrial activity will lead to a sharp rise in unemployment, and hyper-inflation will lead to a fall in the real standard of living and social unease.

Stage 5: a Negative Impact on the World Economy

If the GDP of the world's second largest economy continues to shrink on a dollar basis, the deflationary pressure will have an impact on the world economy that it will be impossible to ignore. In particular, given that the bursting of the IT bubble and the war against terrorism are likely to reduce the growth potential of the world economy as compared with the 1990s, the contraction of the Japanese economy will have a serious impact.

5. Preventing "Undesirable Surplus Shrinkage"

(1) The Dubious Efficacy of Protectionist Trade Policies

Even if Japan adopts protectionist trade policies such as the activation of "safeguards", although these may, for a time, provide an analgesic for the pain of business failures and unemployment, in the long term, their efficacy is dubious. Protectionist measures delay the process of structural reform and may, if anything, delay the regeneration of Japanese industry.

(2) Correcting High Cost Structures and Reducing Unit Labor Costs

To halt industrial hollowing-out, Japan must not only make haste in correcting its high cost structures but also needs to give priority to increasing the flexibility of its industrial and employment systems with a view to reducing unit labor costs. As time is running out, administrative streamlining, deregulation and the lowering of public service charges, among other measures, should be pursued as a priority, and every effort should be made to increase the flexibility of its employment and wage systems beyond the framework of conventional ideas, with a view to reducing the cost of labor, which has become a major obstacle to the improvement of cost competitiveness.¹

¹ In conjunction with these efforts, simply buying time through a uniform reduction of wages or employing more workers in the public sector, on the grounds that Japan must "bear the pain for a while", will not be sufficient. Japan must choose its policies on the assumption that the society of the future will be very different from that of today. In other words, structural reform will also require social reform, and there must be a fundamental "change of values". Specifically, Japan should change the combination of the employment model of long-term employment and equal pay and the household model of the man going out to work and the woman doing the housework. With a view to promoting the combination of greater fluidity of employment and performance-oriented employment and both spouses going out to work and sharing the housework, Japan should undertake a complete reform of its employment and social security systems, aiming to (i) achieve a recovery of business vitality through personnel and organizational reform, (ii) maintain incomes on a household basis, and (iii) restore the balance of paid work and housework between men and women.

(3) A Strengthening of the Industrial Base and Fostering of "Human Capital" for the Future

However, **if economic vitality and the standard of living are to be maintained and raised in the medium-to-long term, Japan will need to persevere in its efforts to strengthen the base for the creation of new industries by establishing systems for collaboration between industry and academia, and concentrating fiscal expenditure in key areas of science and technology.** At the same time, it must pursue education reforms and the creation of new vocational retraining systems, and must **foster the "human capital" that will be the fountain of economic growth in the 21st century.** The benefits of these efforts are unlikely to be visible in the short term, but steady perseverance will bear fruit in the coming era of rebirth.

(4) Aiming for "Desirable Surplus Shrinkage"

Even if the efforts described above are successful in preventing industrial hollowing-out and lead to the revitalization of industry, the trade surplus is bound to shrink in the medium-to-long term. This is because the industrialization of China and other Asian countries makes it a "historical inevitability" that a large part of Japan's manufacturing base will be transferred overseas. However, with the technology held by those manufacturing industries that remain in Japan becoming ever more sophisticated, and the potential for the establishment of new businesses growing, it should be possible to strengthen the growth potential of needs-oriented software and service industries. **Consequently, while Japan becomes a major importer with its economy shifting over to a domestic demand-led pattern of growth, exports of technologically advanced products**

will grow steadily, and as international trade expands, it should be possible to achieve "desirable surplus shrinkage" which has been the issue since the publication of the "Maekawa Report".