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The Economic Pulling Power of External Demand
- How Far Can Japan Rely on Exports to Asia? -

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I. An Economic Recovery Dependent on External Demand

1. The Japanese Economy Today

Early in 2002, the Japanese economy moved into a recovery phase on the strength of exports. However, although some areas, such as private capital investment and consumer spending, show positive signs, domestic demand in general continues to stagnate. For the present, the economic recovery is dependent on external demand (exports).

2. Factors Affecting the Future Trend of Exports

Against this background, grounds for anxiety over the future of exports have begun to emerge, including a growing sense of uncertainty as to the outlook of the US economy.

On the other hand, some observers believe the growth of exports to Asia is likely to continue, supported by "self-sufficient" economic growth in the region, typified by the rise of China.

II. Factors Behind the Export Recovery

Let us examine the factors behind the recovery in exports since the beginning of 2002, by sector.

High-tech related exports to Asia have seen rapid growth since the spring, on the strength of a recovery in supply and demand conditions, including expectations of a recovery in the demand for IT and the completion of inventory adjustments following the adjustment of production of IT devices in fiscal 2001.

Exports to Asia of materials such as chemicals and iron & steel have continued to grow steadily, reflecting active investments from Europe and the United States, with a view to developing the Asian markets, as well as growing shift of production bases of Japanese companies to Asia.

Automobile exports to the United States have been firm since the beginning of 2002, reflecting the firm sales performance achieved thanks to promotion campaigns in the US (the reduction or waiving of interest on loans). Nearly 70% of the growth of exports to the United States can be attributed to this factor.

1. Firm High-Tech Exports and Japan's Continued Reliance on the US Market

The recent growth in high-tech exports (semiconductors, etc.) to Asia is due to the fact that the high-tech industries have established a large number of production bases in Asia and that the share of world production commanded by Asia is growing. The share of world sales of semiconductors accounted for by the Asia-Pacific region (excluding Japan) has been rising since the 1990s, and in the first half of 2002 reached 35.9%, well above the 23.5% share accounted for by the United States.

With the shift of production to Asia, in spite of a global decline in demand, high-tech production in Asia is highly likely to hold relatively firm. At least in the short term, therefore, high-tech exports to Asia are likely to hold steady.

However, final demand for high-tech goods in Asia has not grown to the same extent, and the high-tech industries continue to rely on the United States and other regions for final demand. A survey of share of sales by region among final products reveals that in personal computers, for example, the US commands the largest share at 34% (as of the first quarter of 2002), and that the share commanded by the Asia-Pacific region is only half that figure. This is because, as a "market", Asia is still an emerging economy and is still reliant on export demand from the United States.

This is confirmed by the fact that electrical machinery and electronic products are prominent among the range of goods exported by many Asian countries and that (except for trade within Asia), the United States is generally their largest trading partner.

2. Asia Increasingly "Self-Sufficient" but Still Weak in Some Respects

Behind the healthy exports of iron & steel, chemicals, etc., to Asia lies the growth of internal demand in Asian economies such as China and Korea, which, in the short term, is likely to

continue to generate export demand for Japan. Asia has continued to record a high growth. In 2000, the total GDP of the East Asian region had reached 26.0% of that of the United States (as compared to 21.0% in 1990), and internal demand within the region is growing steadily.

An examination of "export cohesion", an indicator of the strength of trade relationships between countries and regions, for the East Asian region reveals that the cohesion of trade within the region exceeds that of trade with the United States or Japan, a sign of growing "self-sufficiency" of economic growth in the Asian region. Thus, the Asian economies have become sufficiently strong to maintain certain growth in spite of the deceleration of the US economy.

However, the ratio of the total GDP of the East Asian region to that of the United States is roughly equivalent to the ratio of Japan's GDP to that of the United States in the early 1970s. In this sense, the "self-sufficiency" of the East Asian region remains weak in some respects.

From another angle, in Asia, ratios of exports to nominal GDP and ratios of exports to the developed nations to nominal GDP held relatively steady throughout the 1990s. Given that the growth of ratios of exports to other countries in the region over this decade was by no means spectacular, that most of the final demand in the electronics sector, which accounts for a large share of Asian exports, came from the developed nations, and that exports to the United States command the lion's share of exports to the developed nations, it may be concluded that the economic structure of East Asia is still dependent on external demand. Moreover, trade within Asia retains a strong flavor of trade in intermediate goods owing to the fact that products whose exports rely on the developed nations (especially the United States) for final demand are manufactured on a cross-border basis.

Given these facts, it is clear that the growth of internal demand in the Asian economies, which is the result of sustained rapid economic growth, is steadily increasing the "self-sufficiency" of the Asian economies. However, as many products still rely on the developed nations for final demand, it is likely that the trend of exports to Asia will still be easily influenced by the trend of the US economy. Thus, while exports of iron & steel, chemicals and other materials from Japan are likely to remain firm in the short term, if the deceleration of the US economy becomes more pronounced, its effects may gradually spread.

III. The Significance of Exports of Capital Goods to Asia

1. Exports of Capital Goods Likely to Remain Steady

Notwithstanding economic trends in the United States and around the world, exports of capital goods to Asia are likely to remain relatively steady. Asia's emerging role as "factory to the world" has generated demand for machinery and components to be used in the establishment of factories and is likely to continue to lead to a rise in exports by Japanese companies, which are highly competitive in the capital goods sector.

The fact that Asia is becoming a "factory to the world" may be seen in the steady growth of direct investment in Asian countries. Attracted by cheap labor and huge potential markets, Japanese direct investment in Asia is growing as a ratio of all direct investment, and the ratio of investment in Asia is also starting to recover as a ratio of direct investment worldwide. Moreover, Asia is still regarded as a promising target for investment in the future, and direct investment in the region is likely to remain firm.

2. The Medium-to-Long Term Impact of Exports of Capital Goods

However, although exports of capital goods are supporting Japan's exports in the short term, they are also gradually increasing Asia's production capacity. In the long term, therefore, exports of capital goods may undermine Japan's production base through the replacement of exports from Japan by local production and a rise in reverse imports to Japan.

Incidentally, estimates based on the assumption that direct investment in Asia, which has recently begun to rise once more, continues and that the sales of local subsidiaries in Asia grow steadily suggest that, as a result of the growth of reverse imports and the replacement of exports from Japan by local production, direct investment in Asia will exert a downward pressure on Japan's trade surplus of between ¥1.3 trillion and ¥3.5 trillion over the next five years. The transfer of production activities to Asia could also exert a downward pressure on the trade surplus equivalent to as much as 50% of the current surplus (on a customs-cleared basis, ¥7.1 trillion as of fiscal 2001).

Of course, this does not mean that the current trade surplus will fall right away. In recent years, the balance on income, which is the "fruit" of past overseas investment, has been rising. The technological balance also shows signs of improving, a fact which will serve to bolster the current trade surplus. If Japan uses its particular technological strengths to create yet more technology-intensive products, it should be possible to build an ideal trade relationship with Asia, through the advancement of industry.

IV. The Trend of the US Economy and its Impact on Exports to the United States and Asia

1. The Trend of the US Economy

The US economy is likely to continue to decelerate as the poverty effect and deterioration in consumer confidence that have accompanied the fall in share prices continue to curb consumer spending. Of course, given that active monetary easing will help to slow the fall in housing prices and that there is still room for a free hand in the management of fiscal policy, the economy is unlikely to crash.

The downward trend of inventory levels having stopped in November 2001, sales of automobiles are sluggish and inventories are beginning to accumulate once more. Although sales recently saw a small upturn, a full-scale recovery is unlikely.

2. The Impact on Japanese Exports

The deceleration of the US economy is likely to affect Japanese exports not only in the shape of a slowdown in exports to the United States, centering on automobiles, but also through a dulling of exports to Asia, centering on high-tech products. Exports of automobiles are likely to slow as sales peak and inventories grow. Other export goods are also likely to suffer the effects of the deceleration of the US economy. The demand for high-tech goods in the United States is likely to remain sluggish next year owing to the rise in diffusion rates of personal computers, etc., and excessive investment in the telecommunications industry among other causes. The Asian high-tech economy, which relies on the United States for final demand, will

likewise slow down, and the growth of Japanese exports to Asia is also likely to see a gradual slowdown.

V. Conclusions and Policy Issues

Given the conditions described above, it is likely that Japan's exports to the United States will gradually slow, at least until the end of 2002. As to Japan's exports to Asia, the high-tech sector, in which Asia is gradually increasing its world share of production is likely to remain firm, while exports of materials and exports of capital goods are both likely to continue to grow, reflecting the growth of internal demand in Asia and the region's emerging role as "factory to the world". Overall, exports should continue to support the recovery of the Japanese economy. In this sense, excessive pessimism with regard to external demand is unwarranted**.**

Looking ahead to 2003 and beyond, exports to Asia, which is gradually becoming more "self-sufficient", are likely to continue to underpin Japan's overall export figures. Needless to say, Asia is not so "self-sufficient" that internal demand alone is enough to support economic growth, and the impact of the deceleration of the US economy will gradually make itself felt in Asia, too. This will lead to a slowing of the growth of Japan's exports not only to the United States but also to Asia, and means that the economic pulling power of exports is likely to see a gradual decline.

In this light, the most pressing issue for Japan is, at any rate, to make the switch from external demand to internal demand, and given that one result of exports of capital goods to Asia is a contraction of Japan's domestic production base, the most important issue for this country is capital investment aimed at strengthening its domestic manufacturing base, which is also an "engine" of the economy in general.

In this sense, the tax reforms that are now being debated must provide incentives to investment by the business sector, not only in the form of an expansion of tax systems to promote research & development, but also through a bold reduction in tax on capital investment. Specifically, the depreciation period for capital equipment should be substantially shortened to allow companies to replace obsolescent equipment with the latest models without delay.

Furthermore, given that expectation of economic growth is the greatest incentive to investment, it is urgent that Japan create a business environment that will encourage companies to move on from a "weeding-out" stage in which they are rationalizing their businesses with a view to improving profitability, to a stage of "growth through concentration" on high-profit business sectors. Specifically, the corporate appetite for investment with a view to developing new industries must be stimulated._Deregulation should be used to encourage companies to enter new business sectors and the government should greatly increase the ratio of its spending that is devoted to supporting the growth of promising industries, for instance, supporting the creation and improvement of the childcare and nursing environments and supporting the commercialization of nanotechnology.