

論 説

A Perspective on Japan's Current Account and
Industrial Shift in the Post-3.11 Era

Ryohei NAKAGAWA

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INTRODUCTION

Since the collapse of bubble economy of the late 1980s, Japanese economy has been stagnant for two decades, although there was a time of continuous low-level growth, thanks to external demand in the mid-2000s. Domestic demand has been weak, deflationary trend has been lingering, and amount of public debt has been accumulating to over 200% of GDP, according to the IMF's World Economic Outlook data. Political leadership remained in limbo, where prime ministers change yearly after Shinzo Abe since 2006, lacking policy continuity along with political populism that bypassed fundamental problem-solving. In the aftermath of the Great East Japan Earthquake and tsunami that occurred on March 11, 2011 (3.11), and the following devastating accident of Fukushima Daiichi nuclear power plant of Tokyo Electric Power Company, the mood toward economic reforms finally seems to have momentum, although capacity to deliver the reforms by the incumbent government of the Democratic Party of Japan (DPJ) is unclear, and the opposition parties, as well as insurgent factions within the DPJ, may undermine the reforms.

Among the future concerns of the Japanese economy, this paper examines the possibility of whether its current account, one of the indicators that Japan has been constantly in surplus for decades, may turn into deficit by 2020. It will also provide some policy and business recommendations to avoid turning into current account deficit.

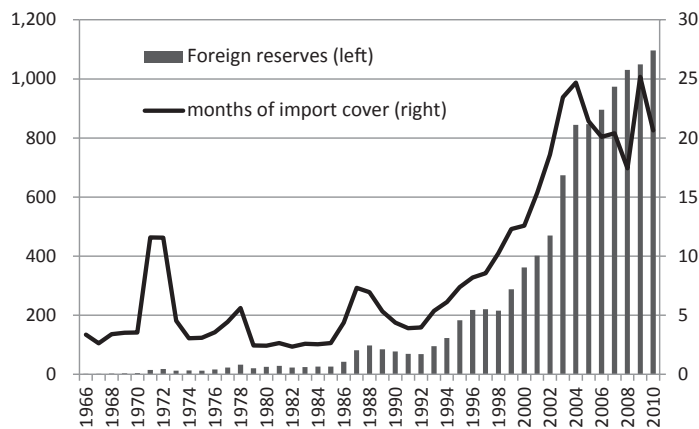
Will current account deficit be critical for Japan?

Keeping current account surplus may not be a necessity for all the economies, as nearly a half of all the countries run current account deficit anyway, and not all the economies that run continuous deficit become insolvent. The United States, as being a country of a key currency, is an example of such cases. Current account deficit of the U.S. has been financed by strong capital account net inflow, particularly in its portfolio investments. For the case of Japan, however, it cannot expect strong net inward investment, either as foreign direct investments (FDIs) or portfolio investments. Japanese companies' FDIs overseas have been much stronger compared to foreign companies' inward FDIs, and inward portfolio investment has also been weak, partly because the Japanese yen is not a key currency and therefore countries do not have strong incentive to accumulate their foreign reserves in the yen.

Another aspect on Japan's necessity to keep its current account surplus is that because the Japanese archipelago lacks almost any kind of natural resources and thereby the country mostly relies on imports, it needs to accumulate certain degree of foreign reserves.¹⁾ Historically speaking, Japanese people may have strong sympathy with this argument, as the country militarily sought for fuel supplies toward the World War II that ended up in misery. However, partly due to currency interventions, Japan's international reserves are very high, second only to that of China, at over US\$1 trillion at end-2010 and have over 20 months of import coverage, securing the country's high liquidity position (**Figure 1**). Nevertheless, demand of fossil fuel by Japan's power plants have increased significantly after 3.11, due to difficulty in running existing nuclear power plants. Therefore, keeping current account surplus would make stronger sense for Japan in the future.

More importantly, the problem lies in the relationship of current account deficit and public finances. Japanese economy's overall excess savings (current account surplus), have been covering its fiscal deficit.²⁾ However, if its current account will turn into deficit (lower savings rate), the Japanese government will need to finance its fiscal deficit from overseas, therefore the funding and defaulting risks will be much higher than today, where postal insurance, postal bank, other domestic banks, insurers and private companies are supporting the Japanese government bonds (JGBs). Current account deficit or fiscal deficit (or heavy debt obligation) alone would not be a fatal problem. The worst case scenario is that the Japanese economy could fall into "twin deficit," as both deficits will create severe vicious cycle and abrupt credit uncertainty. The recent credit uneasiness of Greece and Italy are the symptoms that Japan should avoid, because " (s) hould JGB yields increase, they could initiate an adverse feedback loop from rising yields to deteriorating confidence,

Figure 1. Japan's Foreign Reserves (in US\$ billion) and Months of Import Cover



Source: Naikaku-fu Seisaku-Tokatsu-Kan Shitsu (The Cabinet Office, Bureau of Director-General for Policy Planning) (2011). "Nihon Keizai 2011-2012" (The Japanese Economy 2011-2012). Annex. Long-term statistics.; Author's calculation.

diminishing policy space, and a contracting real economy.”³⁾

With the above considerations, current account deficit will be critical for Japan and is worth analyzing its countermeasures.

Meanwhile, one may also argue that constant current account surplus, or positive savings-investment ratio, may also mean lack of strong domestic demand, which has been weak for two decades indeed. Analysis on savings-investment balance will be conducted on a separate occasion. Household savings rate is decreasing in Japan due to rapidly aging population and may impact Japan's savings-investment balance, therefore possibly putting downward pressure on overall current account in the future.

ANALYTICAL FRAMEWORK

1. Characteristics of Japan's current account and its components after the collapse of bubble economy (period after 1990) will be investigated. Additionally, because direct investment-related income transfers from abroad is becoming significantly important, the trend of outward FDIs will also be investigated.
2. Provide future observations and recommendations through matrix analysis, putting current account components, as well as outward FDIs, in vertical axis and major impacting factors in horizontal axis.⁴⁾ In the past few years, there are multiple events in Japan and in the world that may impact the country's economy and its current account significantly.

These factors include:

<Abrupt Factors>

- The worldwide economic downturn after the subprime mortgage bubble collapse and the following sovereign debt and financial crisis in Europe
- The 3.11 Great East Japan Earthquake and tsunami
- Fukushima Daiichi nuclear power plant accident, change in energy supplies and energy price hike

<Continuous Factors>

- Demographic crunch: Decreasing population and increasing elderlies
 - Fierce manufacturing competition among Japan, South Korea, China, and other Asian economies
 - Super strong yen
 - Further globalization and regional integration
3. Conclusion on whether Japan's current account would turn into deficit by 2020. Additionally, business and policy recommendations will be provided in order to avoid overall current account deficit.

Analysis to continue

This paper constitutes the first part of the two-volume analyses whether Japan's current account could turn red by 2020. In line with this paper on current account and industrial shift, analysis on future of current account balance from the savings-investment

balance approach is to be presented on the next occasion.

LITERATURE REVIEW

Views that Japan's current account balance may become deficit in the future

There are various literatures that discuss expected decrease in Japan's current account surplus.

Japan Center for Economic Research (2011) approaches from energy supply shift from nuclear to fossil fuel and increase in fuel prices in explaining the possibility of Japan's current account turning into deficit by 2020, even assuming that there will be certain degree of renewable energy development by then.⁵⁾ The report can be a warning that policies and strategies to fight the current account turning red are urgently needed to be set and implemented. Indeed, Japan's electricity suppliers increased their fuel imports, particularly liquefied natural gas (LNG), in the period of April-September 2011 by 660 billion yen, or by 37%, compared to the same period in the previous year.⁶⁾ Although such a trend is expected to continue for years to come, energy-related factors are not the only ones impacting Japan's future current account account balance. This paper will approach from a more comprehensive and multi-factor views.

Japan Research Institute (2011) provides warning that current account may turn into deficit by 2020, given an assumption that household savings rate may also turn red by then.⁷⁾ It argues that corporate sectors' high savings rate may be able to cover the negative savings rate of public sectors. However, it also points out that if corporate savings will be accumulated due to stagnant domestic and outward foreign investments, companies may lose competitiveness and potential growth opportunities at the same time. This paper will provide recommendations for the Japanese companies not to be trapped into such symptoms.

Sangyo Kozo Shingikai (2011) calculated two types of future scenario, "growth" and "hollowing-out," of the Japanese economy, and indicated that the country's current account would turn to deficit by 2020 in the "hollowing-out" scenario, while the surplus may even increase in the "growth" scenario.⁸⁾ The "hollowing-out" assumption is based on halving the automobile production by 2020 without strong new industries blooming, while the "growth" scenario is based on booming of three key industries, namely healthcare/nurturing, new energy and "creative", with strong inward and outward investments. Although Ministry of Economy, Trade and Industry has its own interest to address industry-friendly policies, the material's assumption and outcome are indicative and have some similarities to the observation in this paper, particularly in enhancing stronger services sectors and foreign direct investments.

Although he does not provide any date of Japan's current account balance turning deficit, Charles Yuji Horioka (2009) indicates that, along with quantitative analysis on the relations of aging society and Japan's balance of payments, Japan would not face any difficulty because capital inflows from high savings rate countries would finance it, even if Japan's savings-investment balance turns negative and current account will turn into deficit. At the same time, however, Horioka points out the risk of Japan's current account

deficit impacting on embedded problem of public finances.⁹⁾ International Monetary Fund (2011) raise concern about imbalance of a high corporate saving rate, a very low household saving rate, and negative government saving rate, without referring to the risk of IMPACTING on public finances, while emphasizing the risk of large fiscal imbalances and abrupt JGB yield hike.¹⁰⁾ While Horioka (2009) and International Monetary Fund (2011) consider fiscal impact only as a sideline effect, this paper takes it as the key and critical issue to be considered.

Prescriptions for Japan's economic recovery

With extensive analyses, as usual, including the post-3.11 recovery, prices, public finances, international trade, innovation and entrepreneurship, the 2011 white paper on the economy and public finance by Cabinet Office (2011-A) concludes with three key recommendations to achieve "crisis-resilient economy". Those are; 1) developing flexible supply chains through innovation; 2) maintaining "strong public finances, strong social security," and 3) importance of creating intangible assets.¹¹⁾ The so-called "just-in-time" manufacturing supply chain systems exposed their vulnerability in the aftermath of the 3.11 and the Thai monsoon flood in November 2011, while there is no doubt that one of the most pressing issues of the Japanese economy is public finances. Meanwhile, the recommendations of this paper finds a common ground in the first and third points of the white paper on creating intangible assets, while improving Japan's public finances is an obvious necessity.

Takemori (2011) stressed that, at the very last section in his conclusion, exporting capability will still be the key toward recovery in the foreseeable future, as Japan's energy almost totally relies on supplies from overseas, and the country will need to increase its import further.¹²⁾ Although Takemori's argument clearly holds truth, it is too simple and overlooks the situation of Japan's deteriorating terms of trade and does not foresee the risk of decreasing merchandise export after the earthquake. Indeed, as of December 2011, Japan's merchandise trade balance is expected to turn into deficit in 2011 for the first time in the past 31 years.¹³⁾

Despite the fact that the book was written before 3.11, the grief over Japan's current society and the ideal world that Jinno (2010) contemplates and conceives provide various interesting insights to how Japan's future should be designed. Such insights include his emphasis on the necessity of shift from "industrial society" to "intellectual society," which coincides with one of the recommendations in this paper to strengthen services sectors.¹⁴⁾ However, Jinno emphasizes so much on "sharing" that he assertively regards market economy as greed and claims that all the people engaging in the same type of labor should also "share" the same wage level, overlooking difference in productivity of each individual and incentive mechanism of wages.¹⁵⁾ With such a proposition, it is questionable if people can be innovative enough to create "intellectual society" from the current stage, even though higher financial incentives do not always provide stronger productivity or creativity.

Characteristics of this paper

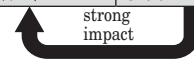
As noted above, existing analyses of future current account balance are either from the savings-investment approach or secondary outcomes from other research purposes, as long as the author explored. Savings-investment balance is supposed to match a country's current account balance in an identity equation, and both sides of the equation influence each other. Yet this equity equation does not reflect causal relationship from one to the other, therefore both savings-investment balance and each component of current account need to be investigated in order to avoid Japan's future current account deficit.

The feature of this paper is that, by regarding Japan's possible current account deficit as a critical risk in conjunction with severely deteriorating public finances, it pursues to provide future observations and recommendations through a matrix analysis so that the country would be able to develop concrete countermeasures.

OBSERVATIONS

Chart 1. Assumption of Effects

	Subprime Bubble Collapse & European Crisis	3.11	The Fukushima Accident, Energy Supply Shift & Energy Price Hike	Demographic Crunch	Fierce Manufacturing Competition	Strong Yen	Further Globalization & Regional Integration
Goods Trade	<ul style="list-style-type: none"> Downward pressure due to weaker demand overseas. 	<ul style="list-style-type: none"> Short-term downward pressure due to temporary break in supply chains. 	<ul style="list-style-type: none"> Downward pressure due to higher fuel imports to compensate nuclear power. Downward pressure due to energy price hike. Downward pressure due to weakening terms of trade. Downward pressure due to loss of Japan's brand image. Medium term upward pressure due to overseas demand in renewable energy-related exports. 	<ul style="list-style-type: none"> Upward pressure due to shrinking domestic market. Upward pressure to seek new business opportunities overseas. 	<ul style="list-style-type: none"> Downward pressure due to stronger price competition. Downward pressure due to weakening terms of trade. 	<ul style="list-style-type: none"> Downward pressure due to higher export price in foreign currencies. 	<ul style="list-style-type: none"> Almost neutral (both gross goods import and export may increase).
Services Trade	<ul style="list-style-type: none"> Downward pressure due to weaker demand overseas. 	<ul style="list-style-type: none"> Neutral. 	<ul style="list-style-type: none"> Slight on-off downward pressure due to decrease in tourists from abroad. Otherwise neutral. 	<ul style="list-style-type: none"> Upward pressure to seek new business opportunities overseas. 	<ul style="list-style-type: none"> Neutral. Larger gross inflows and outflows related to patents. 	<ul style="list-style-type: none"> Downward pressure due to decrease in the yen value revenue. Slight downward pressure due to decrease in tourists from abroad. 	<ul style="list-style-type: none"> Neutral for the time being (both gross services import and export may increase). Larger gross inflows and outflows related to patents.
Dividend Income from Abroad	<ul style="list-style-type: none"> Slight downward pressure due to lower dividends in business operations overseas. 	<ul style="list-style-type: none"> Slight downward pressure due to temporary break in cross-border supply chains in manufacturing. Neutral in the services sectors. 	<ul style="list-style-type: none"> Neutral. 	<ul style="list-style-type: none"> Medium-term upward pressure due to increasing business operations overseas. 	<ul style="list-style-type: none"> Medium-term upward pressure due to increasing business operations overseas. 	<ul style="list-style-type: none"> Upward pressure due to production shift to overseas. Downward pressure due to decrease in the yen value dividend income. 	<ul style="list-style-type: none"> Slight upward pressure even both gross inflows and outflows increase, as income balance has always been in surplus.
Outward FDI	<ul style="list-style-type: none"> Slight downward pressure due to the impact of the crisis on Japanese companies. 	<ul style="list-style-type: none"> Slight upward pressure to create alternative supply options in the medium-long term. 	<ul style="list-style-type: none"> Upward pressure due to decreasing inward FDI. Upward pressure due to renewable energy-related investments overseas. 	<ul style="list-style-type: none"> Upward pressure to seek new business opportunities overseas. 	<ul style="list-style-type: none"> Upward pressure due to increasing business operations overseas. 	<ul style="list-style-type: none"> Upward pressure due to increasing overseas business operations and cross-border M&As. 	<ul style="list-style-type: none"> Upward pressure, as opportunities of Japanese companies overseas are more than foreign companies in Japan.



Whether Japan's current account may become deficit by 2020

Merchandise trade

Merchandise trade has been in decreasing trend overall throughout 1990s and 2000s, as shown in **Figure 2**, and went into red in 2011, first time since 1980, when energy prices soared after the Iranian Revolution.¹⁷⁾ Despite the series of factors that hampered Japanese companies' exports in 2011, such as the strong yen, the 3.11, deteriorated brand image due to the Fukushima accident, the Thai flood and weaker demand in Europe, the overall trend is expected to continue in the foreseeable future, say by 2020.

The 3.11 and the flood in the industrial complex in Thailand cut off Japanese manufacturers' chains of product supply, chiefly in automobile and electronics industries. As so-called "just-in-time" supply system exposed its vulnerability by confronting various uncertainties in 2011, companies are rushed to prepare alternative sources of semi-product suppliers, both domestically and internationally. At the same time, companies could also coordinate and share common standards for some parts of their products with their peer companies in order to prepare for unexpected halt in the flow of manufacturing.

Due to the accident of the Fukushima Daiichi Nuclear Power Plant, most of the operations of nuclear power plants in Japan have been suspended until there are clear signs of green light, therefore the country needs to import more fossil fuels to substitute impotent nuclear power supplies. According to an estimate by Cabinet Office (2011-B), Japan's urgent need in importing more fossil fuels will push up import prices and thereby the terms of trade will deteriorate further by 0.15 percentage points, and the real GDP would fall by 0.39-0.6 percentage points, due to lower productivity in the electricity generation sector.¹⁸⁾ These figures suggest that there is urgent need in much more research and development in the energy efficiency area, such as distribution of renewable energy-related products, formulating smart grid and mini grid structures, unifying electric frequency both in the eastern and western Japan, developing efficient system of energy conversions, etc.

One of the fundamental factors of Japan's decrease in manufacturing trade surplus is that Japanese manufacturers' competitive edge has been challenged by South Korean, Chinese and other Asian manufacturers. Competition has become intense year by year, as the gap between relative technological advantage and price competitiveness has been narrowing down.

Additionally, due to the strong yen and higher import prices driven by recent energy price hike, the terms of trade for Japanese companies are also deteriorating. Cabinet Office (2011-B) explains that as import prices has been increasing and export prices decreasing, the terms of trade index has been falling for a quarter century since the third-quarter in 1986, reaching 50% as of the third-quarter in 2011.^{19), 20)} Japanese manufacturers, particularly the automobile and auto-parts industries, experienced production location shifts to the United States after the Plaza Accord in September 1985, when the yen started to rise rapidly against the dollar. In the mid-1990s, they also experienced another massive production shift to the ASEAN countries to hire relatively low-cost workers, driven by the so-called "super *endaka* (strong yen)". Given the current

historic-high yen, at least nominally versus the dollar, this time manufacturers would shift not only their production bases but also their marketing, research and development and other functions to overseas in order to fully engage in local markets, fight against the risks and to seek for higher profitability.

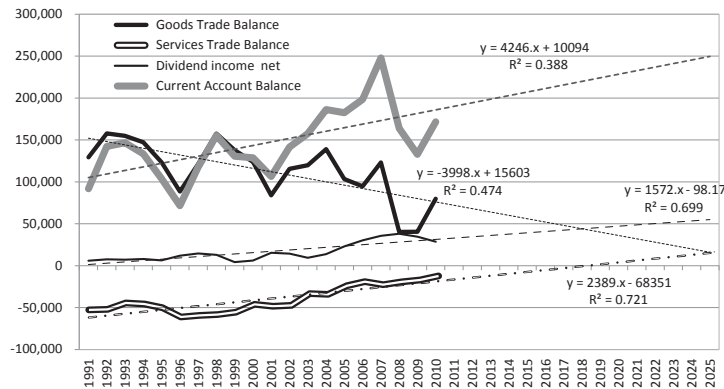
As shown in **Figure 2**, merchandise trade balance has been almost in tandem with the overall current account balance until around 2000, but started to diverge thereafter. Such trend is an indication that other components of current account started to play important roles after around 2000, namely services trade and income from abroad.

Services trade

Services trade has been in deficit throughout the period of 1990s and 2000s, as seen in **Figure 2**, mostly due to larger number of Japanese people travelling overseas compared to foreigners coming to Japan, Japanese companies' large air and ocean transportation payments to foreigners and foreign insurance operations in Japan. However, the services balance has been increasing and is gradually approaching zero, mainly owing to stronger air and ocean transportation receipts, more foreigners travelling to Japan and increasing royalties and license fee receipts (**Figure 3**).

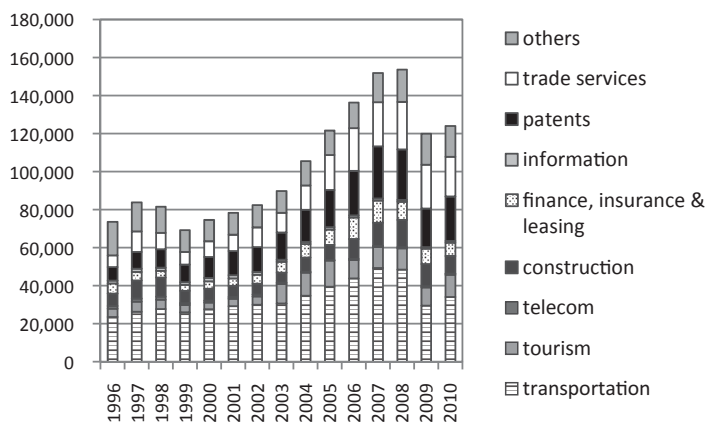
International Monetary Fund (2011) provides recommendation for Japan's services sectors to improve their productivity, emphasizing needs of “ (r) egulatory reforms that lift barriers to entry in key service industries (medical care, education, transport, utilities) ; policies that encourage competition, including through antitrust violations; broader trade and financial liberalization (snip) ; and weaker restrictions on inward FDI (e.g., lower equity restrictions and easing merger and acquisitions rules) ; would strengthen competition and raise productivity in insulated industries.” ²¹⁾

Figure 2. Japan's Current Account Balance, Goods & Services Trade Balances and FDI-Related Income from Abroad (in 100 million yen) ¹⁶⁾



Source: Ministry of Finance, Japan, Balance of Payment Statistics.; Author's calculation.

Figure 3. Japan's gross services exports (in 100 million yen)



Source: Bank of Japan, Long-Term Statistics Website; Author's calculation.

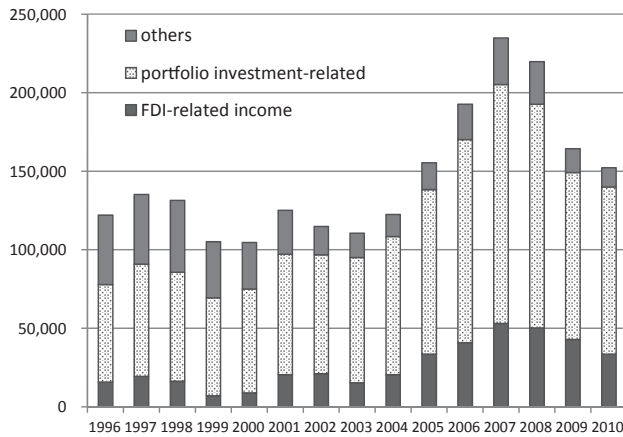
This suggestion is also persuasive from the point of view of currency strategy. According to Cabinet Office (2011-B), real effective exchange rates of the countries whose non-manufacturing sectors have relatively lower productivity compared to manufacturing sectors tend to appreciate, regardless of the conditions of their terms of trade. Therefore, raising productivity of services sectors will help the economy to be more robust against currency fluctuations. For the case of Japan, although there are more people employed in the non-manufacturing sectors and creating more added value compared to manufacturers, average labor productivity is actually lower than manufacturers.^{22), 23)}

Incomes related to intellectual property rights and other intangible assets will also play significant roles. Cabinet Office (2011-A) explains the importance of innovative technology and knowledge through innovation that would further push up the profitability of Japanese companies, both in manufacturing and services.²⁴⁾ While many conventional Japanese companies' research and development operations have been stand-alone, internationally-recognized companies tend to collaborate and cooperate with companies, research institutions and scholars overseas.

Income from outward FDIs

Income balance overall has been increasing significantly throughout the 1990s and 2000s, surpassing the trade balance (both goods trade and the sum of goods and services) in the mid-2000s. Portfolio investment-related income accounts for almost 70% of the total gross income from abroad, reflecting the Japanese government's large foreign reserve holdings, such as in the form of U.S. Treasury Bills (**Figure 4**). Meanwhile, the amount of FDI-related income is increasing and is becoming considerable enough to play an important role in maintaining Japan's current account surplus, despite temporal decrease due to global financial crisis since 2008. Japanese companies are expected to expand their business operations to overseas, particularly to the Asian neighbors, due mainly to

Figure 4. Japan's gross income receipts (in 100 million yen)



Source: Bank of Japan, Long-Term Statistics.

shrinking domestic market, the strong yen and price competition with companies of these economies.

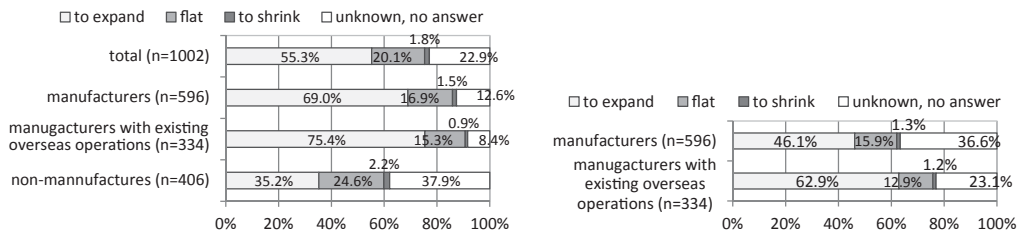
One of the popular stereotypes of “Japanesenesses” is that companies are impotent to be able to challenge uncertainties after experiencing sluggish time in the 1990s. “In fact, Japan has historically punched below its weight in cross-border M&A. Last year, it accounted for just 3.4 per cent of deals. Its biggest share, in 2008, was only 6.6 per cent. In the 1980s, Japanese companies, buoyed by a booming domestic economy, snatched up assets around the world, generating fodder for countless books on how Japan would take over the world,” as Financial Times (2011) describes.²⁵⁾ Takeda (2005) also lamented that after the surreal bubble economy, “most of Japanese industries and business people are petrified and got into the syndromes of ‘paradise lost’ and ‘paradigm lost.’ (snip) Therefore, Japanese companies need to reevaluate and regain the three core principles of ‘the triple S’s,’ namely faith (*shinnen*), trust (*shinrai*) and perseverance (*shimbo*), in order to survive in the ever-challenging and competitive global market.”²⁶⁾

Why should Japanese companies go overseas then? This question can be approached by Frank Knight’s definition of “risk” and “uncertainty,” where “risk” is something measurable about future that insurance products can hedge, while “uncertainty” is a non-quantitative one. And Knight argues that “(i) t is the ‘true’ uncertainty, and not risk, which forms the basis of a valid theory of profit.”²⁷⁾ In other words, in the long-run, companies can only make profit by challenging uncertainties. Starting new business operations overseas is an uncertainty overall, while there are many risk factors within the project that can be hedged by insurance or by any other measures. A study in Cabinet Office (2011-A) suggest that higher the percentage of outward FDI within outward overall investments, a country tends to have higher profitability of outward FDI (correlation observed between the FDI ratio and FDI profitability), which also backs up the Knightian uncertainty theory.²⁸⁾

While Japanese people perceive that there are only few opportunities around them and they assume their capabilities to start new businesses are extremely low compared to any other countries around the world, according to a survey by Global Entrepreneurship Monitor,²⁹⁾ Japanese companies are finally challenging uncertainties and exploring business opportunities worldwide. On the back of such trend is that Japanese people realized, or knew already but convinced after around 2000, that going overseas would be much more efficient than opening new operations domestically. **Figure 5** clearly shows that many Japanese companies, particularly manufacturers, plan to expand their overseas operations within three years.

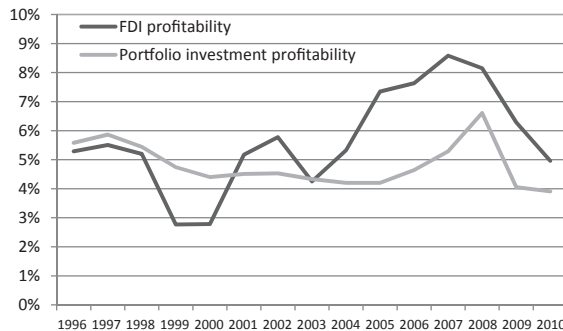
The characteristics of the change is that, in addition to existing operations in matured markets, such as North America and Europe, companies are challenging even stronger uncertainties in developing economies, thereby increasing their profitability overseas. While, operation income of Japanese listed companies decreased from 5.5 trillion yen in the fiscal year of 2000 to 3.8 trillion yen in 2010 domestically (31% decrease), it increased from 500 billion yen to 1.9 trillion during the same period in Asia (280% increase), or from 700 billion yen to 2.6 trillion yen in “developing countries” overall (271% increase).³⁰⁾ **Figure 6** shows that FDI profitability has been increasing during the 2000s, despite the contraction after the global financial crisis after 2008.

Figure 5. Survey: Japanese companies’ prospects for overseas revenue (left) and production (right) (% of consolidated accounts)



Source: Japan External Trade Organization (JETRO), *Heisei 22-nendo Nihon Kigyo no Kaigai Jigyo Tenkaini Kansuru Anketo Chosa (The Fiscal Year 2010 Survey on Japanese Companies’ Overseas Operations)*, pp.49, 52.

Figure 6. Japan's outward investment profitability (in 100 million yen)³¹⁾



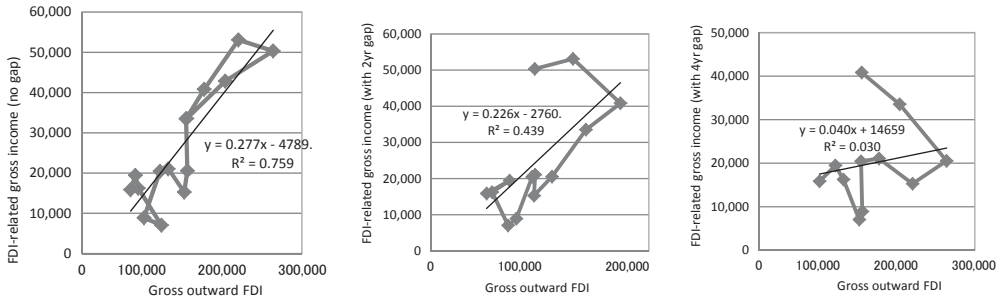
Source: Bank of Japan, Long-Term Statistics Website; Author's calculation.

Indeed at the micro-level, such tendency can be clearly observed. Although 2011 was a tough year for Japanese companies, particularly for manufacturers and those who experienced direct impacts from the Great East Japan Earthquake and the flood in Thailand, such as Toyota and Canon, more than half of Japan's listed companies are expected to mark higher profit (by ordinary profit-basis) in the fiscal year ending March 2012, largely driven by services sectors and companies that absorb demands from emerging markets. Companies expected to record historic high profit in the services sectors include Oriental Land Co. that runs Tokyo Disney Resort, an electric appliance distribution giant Yamada Denki Co. and an IT and communication conglomerate Softbank Corporation, while those absorbing strong demands from emerging economies include an industrial machinery manufacturer Fanuc, a household care products manufacturer Unicharm Corporation and a plant engineering JGC Corporation.³²⁾ Such a trend proves that a number of Japanese companies are already challenging new opportunities internationally.

For Japan's current account to maintain its surplus, and at the same time for Japanese companies to be profitable, sustainable outward FDI is one of the most important factors, as it is the source of future income. Then the question is how Japanese companies would maintain or accelerate their momentum of outward FDIs. Regarding Japanese companies' overseas investment decision-making, Chan, Makino and Isobe (2006) suggest that there is strong tendency of "herd behavior," that is, FDI decisions are in many cases influenced by their competitors' behaviors, rather than their own investment experiences in the past. Such behavior would reduce the uncertainties of new operation in destination economies, although it would not create unique competitive edge as an individual company.³³⁾ Additionally, although FDI income is a dividend from investments in the past, **Figures 7 and 8** indicate that there is no strong significance in causal relations, such as "they receive because they invested in the past," but rather as "they invest because other companies also invest, or it is profitable at the time."

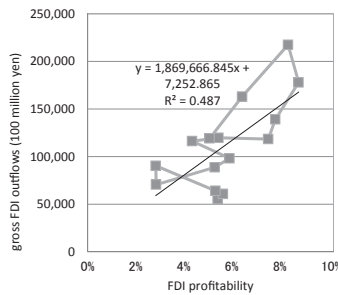
The above observations imply that for individual companies, it is important not only to

Figure 7: Outward Gross Direct Investment versus FDI-related Gross Income, 1996-2010 (100 million yen) : No gap (left) ; two-year gap (middle) ; four-year gap (right)³⁴⁾



Source: Bank of Japan, Long-Term Statistics Website; Author's calculation.

Figure 8: FDI profitability versus gross FDI outflows, 1996-2010 (100 million yen)



Source: Bank of Japan, Long-Term Statistics Website; Author's calculation.

follow other examples because other companies may imitate as well, but to challenge what other companies are not doing.³⁵⁾ This way companies may be able to generate profit in the long-run by challenging the “Knightian uncertainties,” although there are also chances of making losses by challenging it. For the economy as a whole, such “herd behaviors” denote that the momentum of outward FDIs can be accelerated and create booms, while in other cases companies may stop investing or divest simultaneously and create busts once significant uncertainties can be observed at investment destinations, thereby cause or deepen notorious financial crisis. Therefore, getting rid of such “herd behaviors” may benefit individual companies while at the sametime avoid risk of creating bubble for the economy as a whole.

CONCLUSION AND BUSINESS/POLICY RECOMMENDATIONS

Even though Japanese technology still holds certain degree of advantage in terms of their pure excellency, manufacturers have been gradually losing their competitive edges

during the 1990s and 2000s, due to various factors, including fierce price competitions with Chinese, South Korean and other companies in emerging markets, the super strong yen and increasing energy prices, thereby weakening Japan's condition of terms of trade. Additionally, the impact of America's subprime bubble collapse in 2007-2008 suddenly spread around the world and decreased global demand. On top of that in 2011, the East Japan Great Earthquake and tsunami hit the northeastern Japan's coastal area along the Pacific, which prompted the accident in Fukushima Daiichi nuclear power plant. Facing such challenges, certain degree of vulnerabilities, if not fundamental, of the Japanese manufacturing characteristics, such as the "just-in-time" supply-chain system and the weakening terms of trade, were exposed.

The question of this paper was to clarify if there will be significant negative impact on Japan's current account balance, which is believed to turn into deficit by 2020, according to some analyses. Due to the fiasco in the Japanese public finances, current account deficit will be critical and needs to be avoided so as not to be trapped into the "twin deficit." Putting aside the savings-investment balance analysis, which will be conducted on a separate occasion, increasing services exports and income from overseas, particularly in FDI-related income, are expected to cancel off the decreasing merchandise export to a considerable extent, given Japanese companies' changing attitudes toward international business operations, both in manufacturing and non-manufacturing sectors.

Business and policy recommendations

Through the analysis in this paper, the following policy and business recommendations are provided in order to avoid Japan's current account to turn into deficit:

- 1) Expand their business operations abroad and set policies to enhance it: Although Japanese companies have certain degree of technological advantages, foreign companies can catch up quickly through reverse engineering and their own research and development activities. Japanese companies are recommended not only to continue their own research operations, which is obviously important to produce inimitable and profitable goods, but also to put more resource in improving their marketing and design functions, particularly marketing in foreign economies. The recent strength of Samsung of South Korea evolved from emphasizing such activities. Non-manufacturing sectors can also enjoy benefit of higher profitability in the growing emerging market. As Cabinet Office (2011-A) concludes, the benefit of opening up the economy is in improving its productivity.³⁶⁾
- 2) Improve risk management skills: To reduce the degree of uncertainties in foreign markets, managing various types of risks will be an important skill for Japanese companies. These risks include operation risks, such as preparing alternative supply-chain options or sharing common standards for some parts of their products with peer companies, credit risks, including understanding financial risks of business partners and macroeconomic and political risks in the destination countries, and compliance and reputation risks that are becoming increasingly important when doing business across cultures.

- 3) Enhance profitability in the productive services sectors and deregulate: Having stronger services sectors and embracing the growing markets overseas will help companies to be more profitable and for the economy as a whole to increase its current account balance and GDP. Additionally, raising productivity of services sectors will help the yen to depreciate, according to Cabinet Office (2011-B), thereby also impacting current account positively.³⁷⁾ The government should relax regulations in order to boost fair competition and put more resources in educating young people with special skills, which may also increase employment flexibility among industries. As Cabinet Office (2011-A) indicates, countries with higher degree of entrepreneurship tend to have higher labor productivities.³⁸⁾ In turn, productive services sectors would also impact the Japanese economy to recover from the deflationary environment.
- 4) Reduce “herd behaviors:” As described in the previous section, “herd behaviors” can sometime be risk-hedging because there are already existing examples of uncertainty challengers, which also means that profitability would be smaller. It is important not only to follow former examples because other companies may imitate as well, but to challenge what other companies are not doing.³⁹⁾ For the economy as a whole, such “herd behaviors” would simply enhance over-competition and reduce profitability, as well as imply the possibility of FDI booms and busts, which would deepen the risk of financial crisis.

NOTE

- 1) Takemori (2011), p.191.
- 2) Domestic savings > Domestic Investment + Fiscal Deficit.
- 3) International Monetary Fund (2011), p.2.
- 4) Income from cross-border portfolio investments (mainly U.S. Treasury Bills) and current transfers (mainly development aids to overseas) are not investigated, because their key determinants are mostly unrelated to this paper’s analysis.
- 5) Japan Center for Economic Research (2011), p.1.
- 6) Nihon Keizai Shimbun (2011-A).
- 7) Japan Research Institute (2011), p.5.
- 8) Sangyo Kozo Shingikai (2011), p.9.
- 9) Horioka (2009), pp.300-305.
- 10) International Monetary Fund (2011), p.2.
- 11) Cabinet Office (2011-A), pp.286-289.
- 12) Takemori (2011), pp.191-199.
- 13) Nihon Keizai Shimbun (2011-B).
- 14) Jinno (2010), pp.56-61, 93-96.
- 15) Ibid., pp.154-156, 159-162.
- 16) Trendlines were derived from the twenty-year period of 1991-2010. Diffusing extended trendlines were shown for reference only and do not necessarily reflect this paper’s standpoints.
- 17) Nihon Keizai Shimbun (2011-B).
- 18) Cabinet Office (2011-B), pp.56-60.

- 19) Ibid., pp.24-25.
- 21) Terms of trade = (Export price index / Import price index) × 100.
- 21) International Monetary Fund (2011), p.19.
- 22) Cabinet Office (2011-B), p.37.
- 23) Average in 2000-2009, GDP/Number of Employees = Manufacturers: 10.54 million; Non-Manufacturers: 8.13 million
- 24) Cabinet Office (2011-A), pp.184-196.
- 25) Financial Times (2011).
- 26) Takeda (2005), pp.34-35.
- 27) Knight (2006), pp.19-20.
- 28) Cabinet Office (2011-A), pp.146-148.
- 29) Global Entrepreneurship Monitor (2010), p.18. Japan's "Perceived Opportunities" = 5.9 (ave. 33.4 in "innovation-driven economies"), "Perceived Capabilities" = 13.8 (ave. 44.4 in "innovation-driven economies").
- 30) Nihon Keizai Shimbun (2011-C).
- 31) FDI and portfolio investment-related income / stock of FDI and portfolio investment.
- 32) Nihon Keizai Shimbun (2011-D). The article also provides examples of companies that have inimitable technologies and hold significantly high market shares in certain fields, such as Toray, Nidec and Kuraray.
- 33) Isobe, Makino and Chan (2010), pp.121-122.
- 34) As for the two-year (middle) and four-year (right) gap analyses, income receipts (*Y-axis*) are hypothetically delayed after their investments (*X-axis*), assuming that local operations' income should be generated few years after their initial investments. By comparing the differences in r^2 , only small significance is observed as the gap goes wider, indicating that companies' investment decisions are not necessarily strongly driven by their past investment experiences.
- 35) Isobe, Makino and Chan (2010), p.122.
- 36) Cabinet Office (2011-A), pp.194-195.
- 37) Cabinet Office (2011-B), p.37.
- 38) Cabinet Office (2011-A), pp.201-202.
- 39) Isobe, Makino and Chan (2010), p.122.

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A Perspective on Japan's Current Account and Industrial Shift in the Post-3.11 Era (NAKAGAWA)

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日本の経常収支と 3.11 後の産業構造の変化に関する一考察

現在、日本の製造業の技術的優位は一定程度保たれてはいるが、1990年代から2000年代にかけて、多くの日本企業はその販売競争力を失ってきている。その要因として挙げられるのが、中国・韓国や他の新興国企業との激しい価格競争、超円高、資源高に伴う交易条件の悪化などである。2008年のリーマン・ショック以降の世界的な経済停滞や昨今の欧州危機などに伴う海外の需要停滞の中、更に2011年3月、東日本大震災と津波、そしてそれに伴う福島第一原子力発電所の事故が起きた。

これらの状況を受け、本稿では将来の日本の経常収支が著しく悪化してゆく危険がないかどうかを検証し、そうならないためにビジネスおよび政策としてどう対応すべきかの提言を行った。今後本稿とセットで貯蓄投資バランスによる分析を別途扱うが、本稿における経常収支諸項目の分析によれば、将来のサービス貿易および所得収支の増加が商品の貿易収支の減少を少なからず相殺することが見込まれる。今後はとりわけ直接投資の報酬分の流入が増えてゆくことが予想され、このことは日本の製造業およびサービス業が海外展開に対して積極化していることに裏付けられている。経常収支赤字化を防ぐためのビジネスや政策面での提言として、1) 企業は今後積極的に国際展開を試み、政府はそれを政策的に支えること、2) 国際展開するにあたり、各種リスク管理体制を整備して不確実性に備えること、3) 生産性の高いサービス業の収益性を高め、そのために新規参入や起業に関わる規制緩和で政策的に支えること、4) 日本企業が「群れる習性」を改めることで、個社別には収益率を向上させ、経済全体にとっては資本の一斉引上げなどの金融危機の要因を回避すること、を挙げる。

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