## **Chapter 2** Boosting Growth Potential by Incorporating Global Growth

As a result of resource price rises and the yen's depreciation, Japan suffered its largest-ever trade deficit in 2022. This chapter will show that increases in import prices of mineral fuels accounted for most of the deficit and that reducing the dependence on mineral fuels is an important challenge for strengthening the trade structure as well.

The chapter will also show that while the yen's depreciation provides good export opportunities, Japan has been unable to increase export income by taking advantage of it with respect to some items but that there may be room for increasing income regarding those items by revising unit prices.

It will also show that companies' overseas expansion contributes not only to profits, employment, and productivity but also to the domestic economy from the viewpoint of promoting exports from regions and that the government will strenuously promote the overseas expansion of companies, including startups.

The chapter will also show that as "internal internationalization" is also important for enhancing Japan's global competitiveness, the government will promote foreign direct investments in Japan and step up efforts to attract highly skilled foreign professionals.

## Section 1 Japan's current account balance and its implications

## **<u>1. Current account balance trend</u>**

First, let us look at the current account balance trend since the 1990s. Figure II-2-1-1 shows the current account balance trend since 1996. Until the first half of the 2000s, the trade surplus underpinned the current account surplus. However, since the second half of the 2000s onwards, following the global financial crisis, the primary income surplus, rather than the trade surplus, has underpinned the current account surplus. In other words, the Japanese economy has been undergoing a structural shift in the way of earning income from exporting domestically produced goods to repatriating profits from Japanese companies' overseas business bases.



Source: Balance of Payments (MOF), Balance of Payments Related Statistics (Bank of Japan).

#### 2. Trade balance trend

Next, let us take a close look at breakdowns of the current account balance in detail. First, we will look at the trade balance trend since 2000. Figure II-2-1-2 shows the trade balance trend since 2000 by main product item and by import/export. Although electrical machinery continued to make positive contributions to the trade balance until the first half of the 2000s, its contributions have become smaller since the 2010s. Meanwhile, mineral fuels have consistently made negative contributions to the trade balance, and their contributions have become larger since the second half of the 2000s. Figure II-2-1-3 shows a breakdown of changes in the trade balance compared with the level in 2000 by main product item. In the cases of transport equipment and machinery, their positive contributions to the trade balance have been increasing as a trend since 2000, while in the cases of mineral fuels and electrical machinery, their negative contributions have been expanding as a trend.

According to Figure II-2-1-4, which shows the trade balance trend by major region since 2000, Japan has maintained trade surpluses with United States, the NIEs3, Hong Kong and India, but its trade deficits with the Middle East, Oceania, and China have been expanding as a trend.

Figure II-2-1-5 shows the top 10 major region-product pairs in terms of positive contribution to the change in Japan's trade balance from the first half of the 2000s (the average for 2000-2004) to the second half of the 2010s (the average for 2015-2019) and the top 10 major region-product pairs in terms of negative contribution. Trade in transport equipment with a broad range of regions made positive contributions, as did trade in chemicals and machinery with Asia. On the other hand, trade in mineral fuels with other regions (mainly Oceania) and the Middle East made particularly large negative contributions, and trade in electrical machinery with China also made large negative contributions.

Figure II-2-1-6 shows changes in electrical machinery imports from China classified by product item compared with 2000. Telephony and telegraphy made the largest negative contribution. Presumably, the main reason is that although domestically manufactured mobile phones used to be supplied to the Japanese market, the supply in Japan has been substituted mostly by imports from China.



Source: Trade Statistics of Japan (MOF).

# Figure II-2-1-3. Changes in trade balance by main product item in Japan compared with the level in 2000



Source: Trade Statistics of Japan (MOF).



Figure II-2-1-4. Changes in trade balance (by major region)

Source: Trade Statistics of Japan (MOF).





Source: Trade Statistics of Japan (MOF).





Source: Trade Statistics of Japan (MOF).

#### 3. Service balance trend

Next, let us look at the service balance trend since 1996. Figure II-2-1-7 shows changes in the service balance, services exports, and services imports by type of service. Although Japan has consistently recorded service deficits, travel-related services exports increased from 2014 onwards, making positive contributions to the service balance. However, because of the tightening of border control measures due

to the COVID-19 pandemic, travel-related services exports have declined steeply since 2020. Meanwhile, the charges for the use of intellectual property have made position contributions to the service balance since the middle of the 2000s. On the other hand, in recent years, the negative contributions of research and development services, other business services, including professional and management consulting services, and telecommunications, computer, and information services have been increasing as a trend.

By region, trade with China has made positive contributions to the service balance mainly because of the travel balance surplus (Figure II-2-1-8). On the other hand, the negative contributions of trade with the United States and the EU have been increasing as a trend against the backdrop of the expansion of imports of telecommunications, computer, and information services. Since 2019, the negative contribution of trade with the ASEAN has been increasing against the backdrop of the expansion of imports of other business services.



Figure II-2-1-7. Changes in service balance

Source: Balance of Payments (MOF), Balance of Payments Related Statistics (Bank of Japan).



Figure II-2-1-8. Changes in service balance by region

Source: Balance of Payments (MOF), Balance of Payments Related Statistics (Bank of Japan).

## 4. Primary income balance trend

Finally, we will look at the primary income balance trend since 1995. Figure II-2-1-9 shows year-onyear changes in the primary income balance by type of income since 1995. Japan has consistently recorded primary income surpluses. Until the 2000s, securities investment income receipts accounted for most of the surplus, but since the 2010s, the contribution of direct investment income receipts has increased, indicating that the globalization of Japanese companies' manufacturing and sales bases have positively contributed to Japan's current account balance in a stable manner. Figure II-2-1-10 shows the trend in direct investment income receipts by region since 2014. The value of income receipts from Asia (excluding China), including the ASEAN, was the largest, followed by the values of income receipts from the United States and from China. According to Figure II-2-1-11, which shows the ratio of direct investments withdrawn to direct investments implemented, around 60 to 70% of the direct investments implemented in European countries and the United States have been withdrawn, while the withdrawal ratio is only around 30% in China.

In view of the above, medium- to long-term changes in Japan's income earning power can be summarized as shown in the table below (Table II-2-1-12). The next section will focus on the current state of the trade balance, identify the vulnerabilities of the trade balance, and explore ways of enhancing Japan's income earning power in a stable manner.



Figure II-2-1-9. Changes in primary income balance in Japan

Source: Balance of Payments (MOF), Balance of Payments Related Statistics (Bank of Japan).



Figure II-2-1-10. Changes in Japan's direct investment income receipts by region

Source: Balance of Payments (MOF), Balance of Payments Related Statistics (Bank of Japan).

Figure II-2-1-11. Changes in the ratio of direct investments withdrawn to direct investments implemented



Source: Balance of Payments (MOF), Balance of Payments Related Statistics (Bank of Japan).

Item	Characteristics of the changes
Entire current account balance	Japan's earning structure was based on the trade balance before the early 2000s, but it changed to one based on the primary income balance after the late 2000s.
Trade balance	The trade balance maintained a trade surplus before the early 2000s, but the surplus narrowed dramatically due to the global financial crisis in 2008, and then it began to recover. However, it turned into a trade deficit after the Great East Japan Earthquake in 2011, and the trade balance remained sluggish after that. The structural background to this was largely due to the expansion of mineral fuel imports and the decline in the surplus in electrical machinery. The decline in the surplus in electrical machinery is largely due to the expansion of from China, especially telecommunications equipment. The surplus in semiconductors etc., which are components of electrical machinery, was maintained, but the surplus has been trending downward. Going forward, domestic manufacturing bases will be reinforced to maintain and strengthen supply chains, and the surplus is expected to improve.
Service balance	Before the COVID-19 pandemic, the travel balance contributed to the reduction of the deficit in service balance, but this effect was gone due to the stricter border control to address the pandemic. Currently, the surplus in travel balance is recovering backed by the easing of the border control. In addition, the surplus in the charges for the use of intellectual property remains stable. Meanwhile, in recent years, the negative contributions of R&D services, other business services, including professional and management consulting services, and telecommunication, computer and information services have been increasing.
Primary income balance	Before the 2000s, a surplus in the primary income balance was largely dependent on the surplus coming from investments in securities, but after the 2010s, the surplus coming from direct investment expanded and it bolstered the surplus in current account balance instead of the trade balance. Regional differences were seen in the withdrawn of FDI funds. In Europe, the U.S., and ASEAN, the withdrawal ratios of the funds were 60-70%, while in China, it remained only around 30%.

 Table II-2-1-12. Change in Japan's income earning power seen from current account balance