Chapter 3 Strengthening the Competitiveness of the Japanese Service Industry and Global Expansion

This chapter will discuss several issues which should be faced to make Japan's service industries more competitive, by analyzing the current situation of service industries in Japan and the world.

Specifically, it will discuss the following: (1) Amid the progress of the service-based global economy and the advancing global expansion of service industries, Japan's service industries are lagging far behind, (2) Major background factors of the global expansion of service industries - improved IT utilization, deregulation, and improved systems, and (3) The current situation of Japan's service industries from an international perspective, and issues which should be faced to raise productivity.

Section 1 Global expansion of the service industry-the age of global service industries

1. Move towards a service-based global economy, and global expansion of service industries

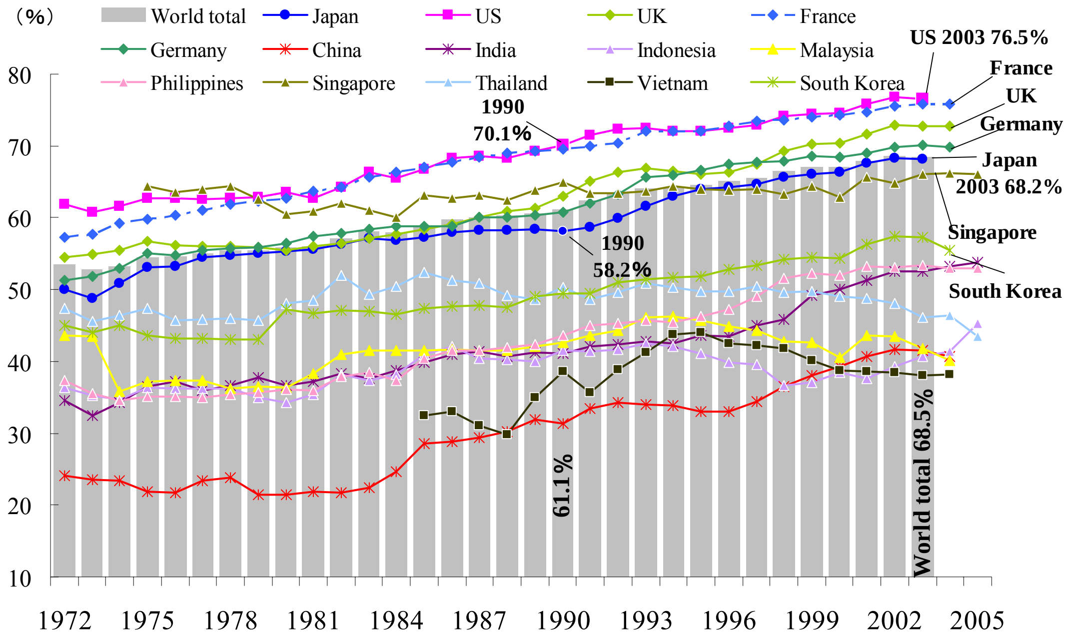
(1) Advancing towards a service-based global economy

The move towards a service-based global economy is steadily progressing. Looking at the global trend of service[1] industries' nominal value added as a share of nominal GDP, it is an almost consistently increasing trend since the 1970s, and the importance of service industries is increasing in the global economy (Figure 3-1-1). In particular, the move towards service-based economies is steadily progressing in the U.S. and Europe, as its share exceeded 70% in the U.S. and France since the first half of the 1990s, while it also reached about 70% in the UK and Germany in recent years. Further, its share is even growing steadily in many East Asian countries, especially in China and India whose share have been growing dramatically since the late 1990s.

Service industry employment is also growing as a share of employment in all industries, with a long term growth trend in the U.S., European and East Asian countries (Figure 3-1-2). Thus the importance of service industries in the overall global economy is forecast to grow even more in the future, in terms of both added value and employment, including in developing countries.

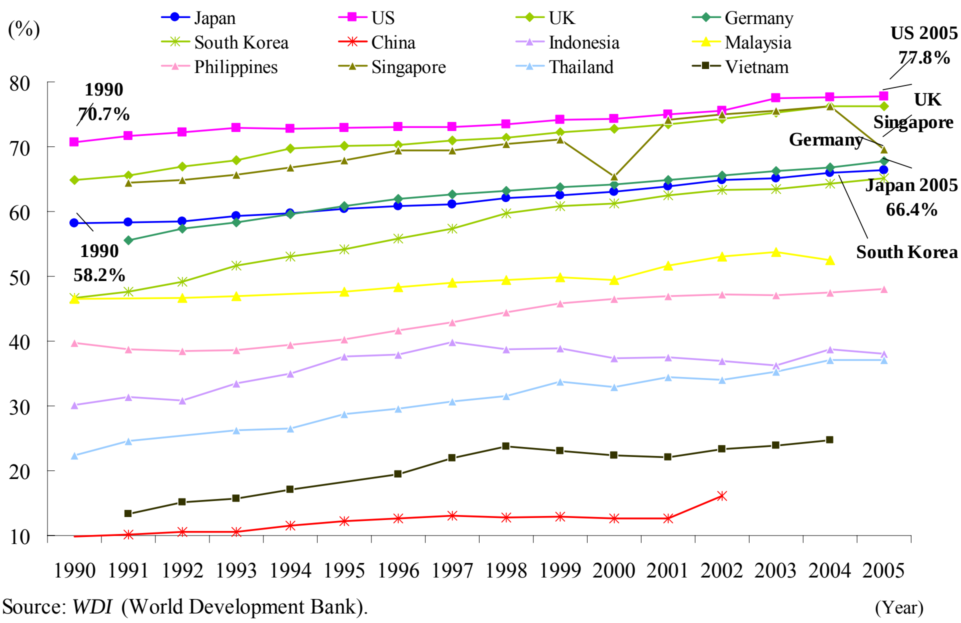
[1] Except where otherwise specified, "service industries" in this chapter indicates industries which correspond to those in the Japan Standard Industrial Classification (March 2002 revision): H (Information and Communications), I (Transport), J (Wholesale and retail trade), K (Finance and insurance), L (Real estate), M (Eating and drinking places, hotel and lodging), N (Medical, health care and welfare), O (Education, learning support), P (Compound services), Q (Services not elsewhere classified).

Figure 3-1-1 Changes in service industries' nominal value added as a share of nominal GDP



Notes: The "World" here refers to "World" in *WDI* (World Development Bank).
Source: *WDI* (World Development Bank).

Figure 3-1-2 Changes in service industry employment as a share of employment



Source: *WDI* (World Development Bank).

(2) Progress of service industries towards global expansion

In recent years, advancing globalization is a characteristic of service industries, which are of steadily increasing importance in the global economy.

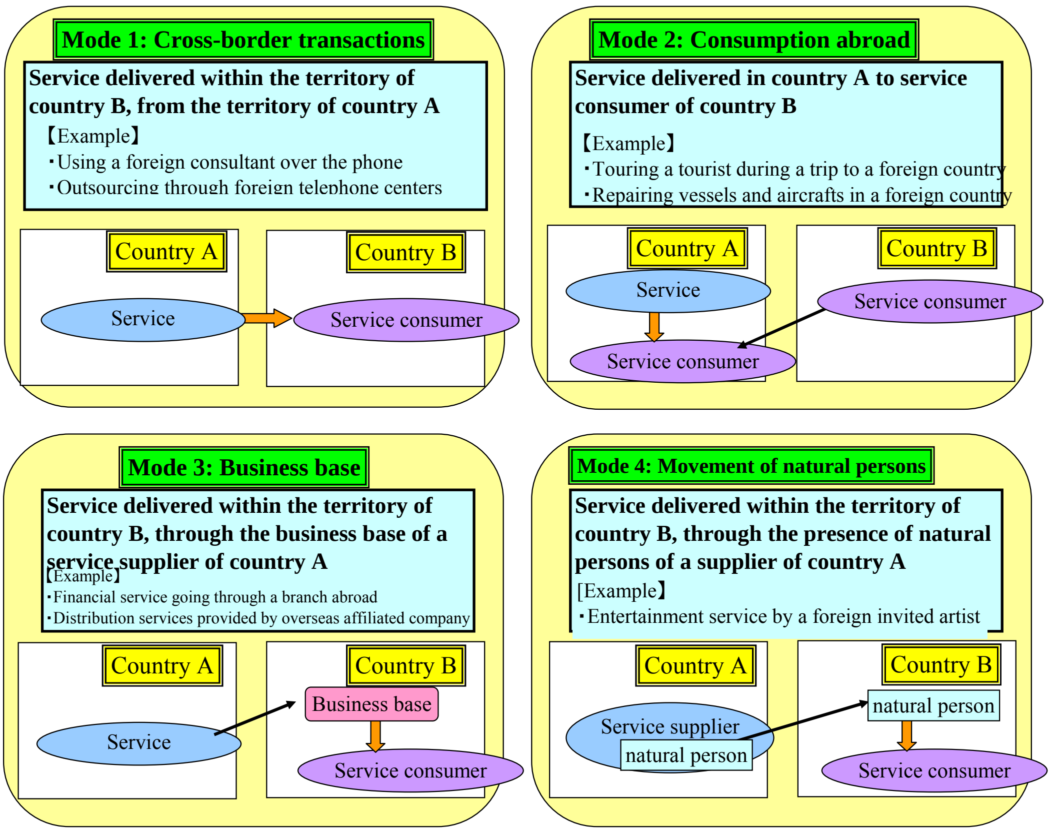
To check how globalization of service industries has actually progressed, We consider the types of international service transactions.

The WTO definition of international service transactions is the most popular. In the General

Agreement on Trade in Services (GATS) which WTO brought into effect in January 1995, services are defined as all services in all sectors, excluding services provided through exercise of government authority. Those transaction types are classified into the following four modes (Table 3-1-3).

Mode 1: Cross-border transactions
(Service delivered within the territory of country B, from the territory of country A)
Mode 2: Consumption abroad
(Service delivered in country A to service consumer of country B)
Mode 3: Business base
(Service delivered within the territory of country B, through the business base of a service supplier of country A)
Mode 4: Movement of natural persons
(Service delivered within the territory of country B, through the presence of natural persons of a supplier of country A)

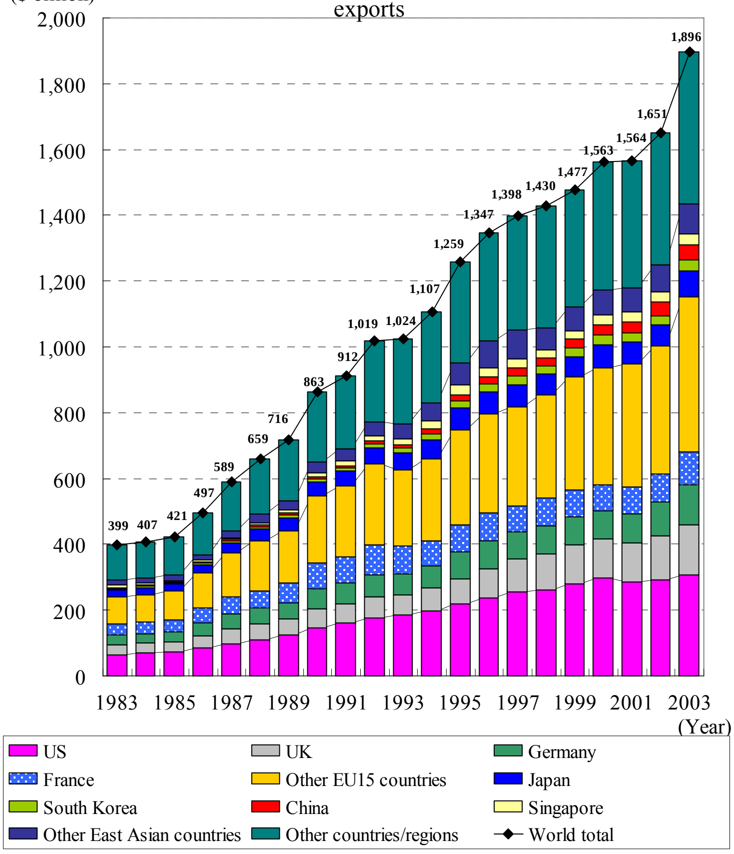
Figure 3-1-3 The 4 modes of service transaction



Notes: 1. The symbols in the figure represent the following.
:movement of people service delivery
2. Service consumer and service supplier indicates a natural person or corporation.
Source: Minisitry of Economy, Trade and Industry

In checking trends in international service transactions by mainly looking at trends in each country's value of service exports[2] which are thought to correspond to Mode 1 and Mode 2 transactions, expansion is seen in each country overall. The export value is particularly large in advanced countries, with the U.S. as the largest. On the other hand, expansion of service transactions is also seen in East Asian countries in recent years, such as China achieving a rapid economic growth, in addition to the service export value growing in Singapore and South Korea where the move to a service-based economy is progressing (Figure 3-1-4).

Figure 3-1-4 Changes in the world's value of service exports



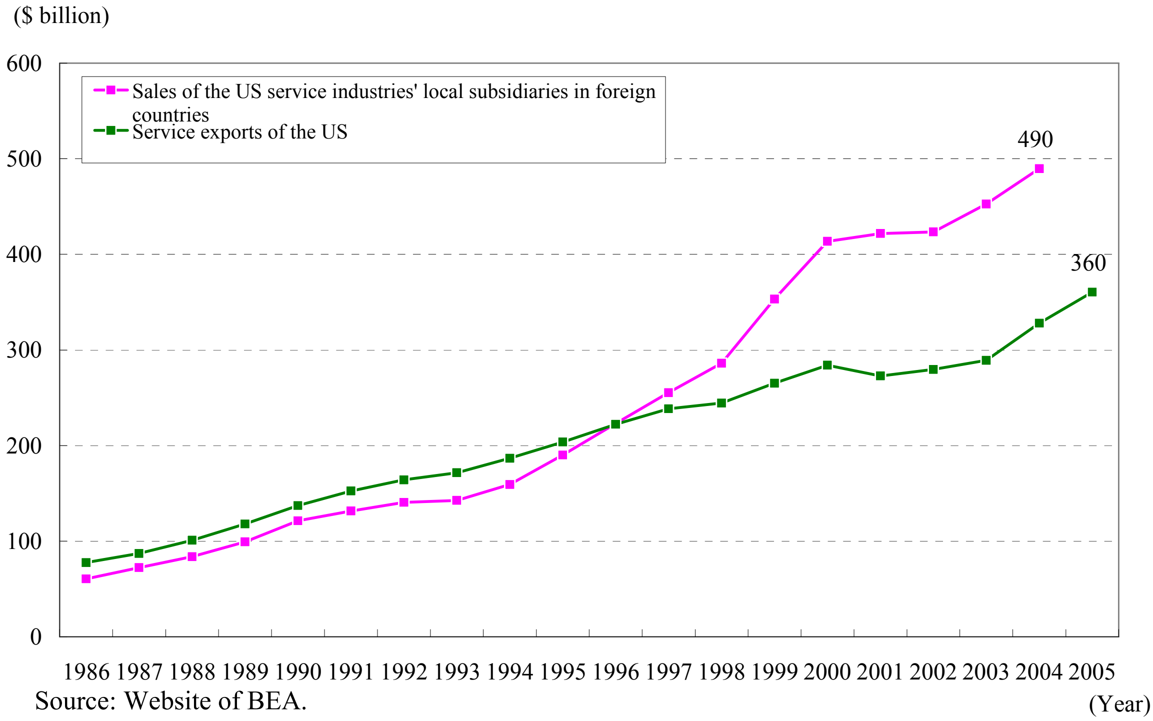
Notes: 1. ASEAN countries refer to Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam. But due to calculation limitations, prior to 1993, Vietnam is not include.
2. Out of the other EU countries, data up to 1994 is missing for Luxembourg.
3. Other countries regions are calculated subtracting the countries and regions noted in the "World" of the *WDI* (World Bank).
Source: *WDI* (World Bank).

For GATS Mode 3 transactions or the services delivered through a business base, its establishment in a foreign country is regarded as a resident of the consuming country in international balance of payments statistics, so only part of these can be measured. Thus for the value of Mode 3 transactions, most are thought to be recorded as sales of local subsidiaries in foreign countries, instead of trade in services in home countries. The U.S. has the largest value of service exports, and is also the main

[2] One can consider that these also correspond to part of Mode 3 and Mode 4.

country which has moved towards a service-based economy. The sales by the local subsidiaries of U.S. companies in foreign countries almost equaled the value of U.S. services exports until the early 1990s. But the sales by the local subsidiaries in foreign countries grew rapidly since the late 1990s, greatly exceeding U.S. service exports since 1997 (Figure 3-1-5). It seems that the global expansion of U.S. service industries shifted from its previous expansion through both service exports and local sales via foreign subsidiaries, to the expansion since the late 1990s mainly through the presence of foreign subsidiaries.

Figure 3-1-5 Changes in international transcation of the US

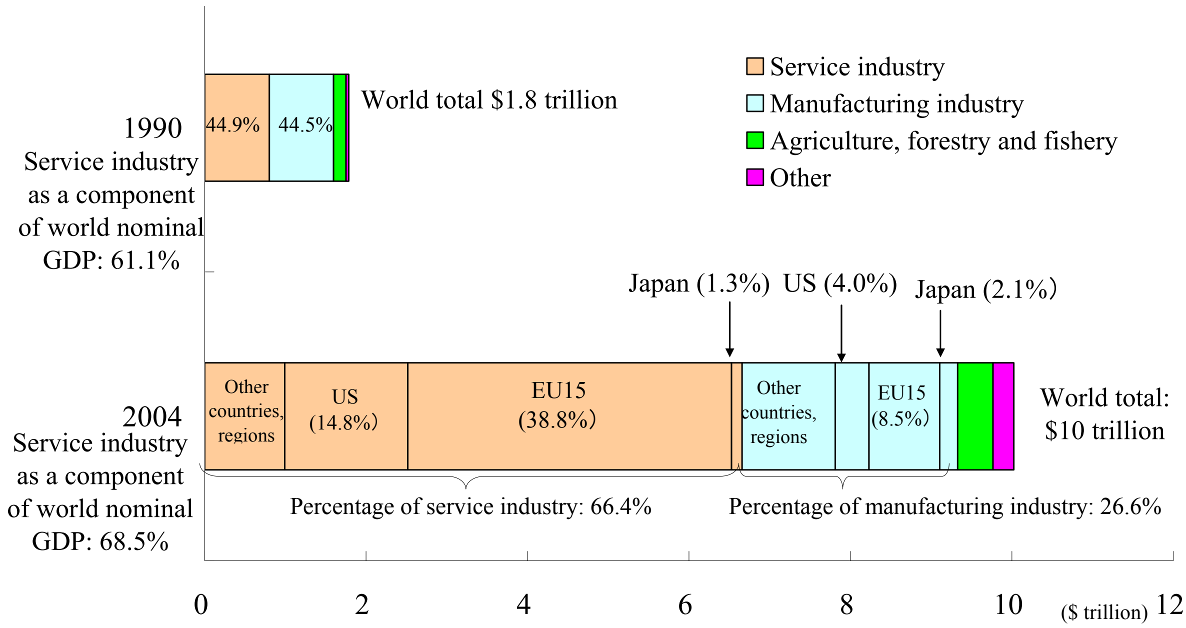


Source: Website of BEA.

Thus, looking at the trends in the balance of global direct investment, amid the rapid growth in the total global balance of foreign direct investment (FDI) from about $1.8 trillion in 1990 to $10 trillion in 2004, the share of service industries in the total global FDI balance jumped from 44.9% in 1990 to 66.4% in 2004 (Figure 3-1-6). The share of service industries' nominal value added in the global nominal GDP expanded from 61.1% in 1990 to 68.5% in 2003, but this is greatly exceeded by the growth in the share of service industries in the global FDI balance. In contrast during this period, the share in the FDI balance by manufacturing industries fell from 44.5% in 1990, to 26.6% in 2004.

In this way, the rapid progress in the global expansion of service industries has resulted in its share greatly exceeding that of manufacturing industries in the total global FDI balance.

Figure 3-1-6 Changes in the world balance of FDI



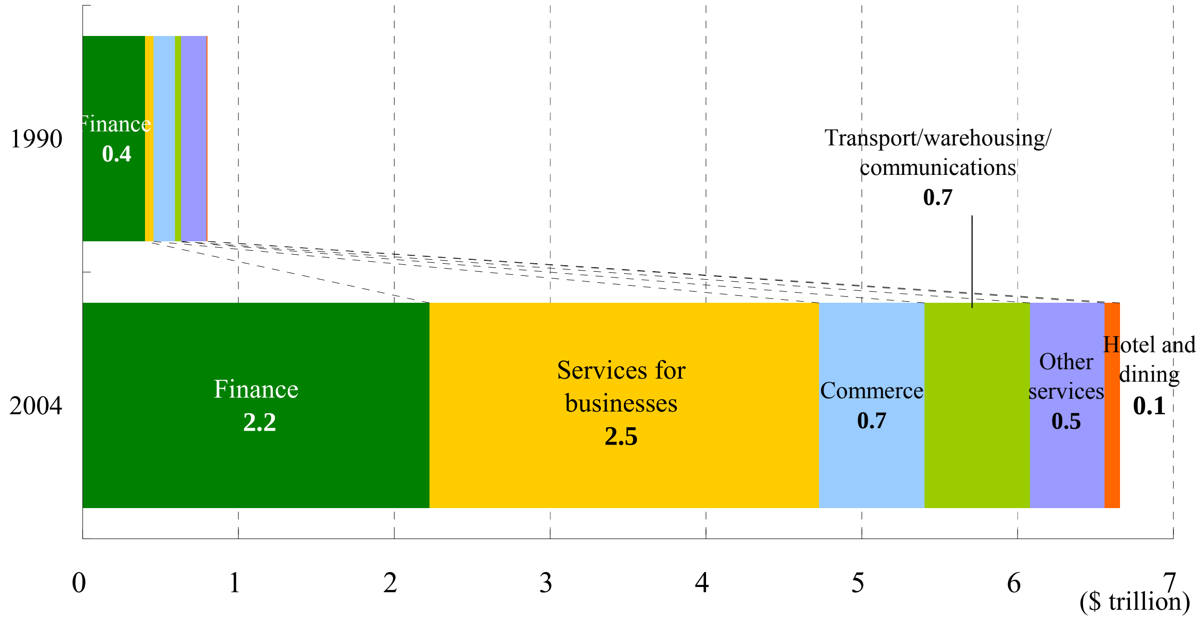
Notes: 1. Because Japan's direct investment balance by industry has been calculated and released since 2005, Japan's data for 2005 has been used.
2. EU15 includes intra-regional investments.

Source: *World Investment Report 2006* (UNCTAD), *Japan's Balance of Payments and International Investment Position* (Ministry of Finance, Bank of Japan), US BEA website, EUROSTAT.

Also, looking at the breakdown of the FDI balance by each service industry, the FDI balances of all service industries are increasing, such as commerce and transport/warehousing/communications (Figure 3-1-7). In particular, there were remarkable growths in finance, services for business,[3] and transport/warehousing/communications. This growth may be due to these industries providing relatively limited services to business compared to the diverse demands of individuals in each country, and their active global expansion aiming at supplying the demands for international services accompanying the global expansion of the manufacturing industries.

[3] Computer related services, research and development, legal, accounting, tax services, consulting, and advertising etc., are included in the services for business.

Figure 3-1-7 Changes in FDI in the world's service industry by each industry



Notes: Services designated as "Other" are the total of public defense, education, health and social services, individual and social services, and other services.
Source: *World Investment Report 2006* (UNCTAD).

(Cross-border M&A – accelerating globalization of service industries)

Cross-border M&A (mergers and acquisitions) greatly increased in the late 1990s (Figure 3-1-8). Behind this trend, there were; an expansion of the regional market and intensification of competition due to the deepened EU regional market integration; introduction of the Euro in January 1999 which led to the removal of currency barriers and expanded the capital markets in the EU region, allowing EU regional companies to expand the capability to raise capital; and deregulation in various countries which dramatically changed the business environment for service industries, such as the passage of the November 1999 Financial Services Modernization Act[4] in the U.S.

Entry into foreign markets through cross-border M&A enables effective utilization of existing business resources of purchased companies, such as consumer recognition, and retail and distribution networks locally established by the purchased company. This is an advantageous point compared to greenfield investing (direct investment in the form of establishing a new factory and corporation). With the emphasis on management speed in recent years, cross-border M&A are becoming an increasingly important management technique.

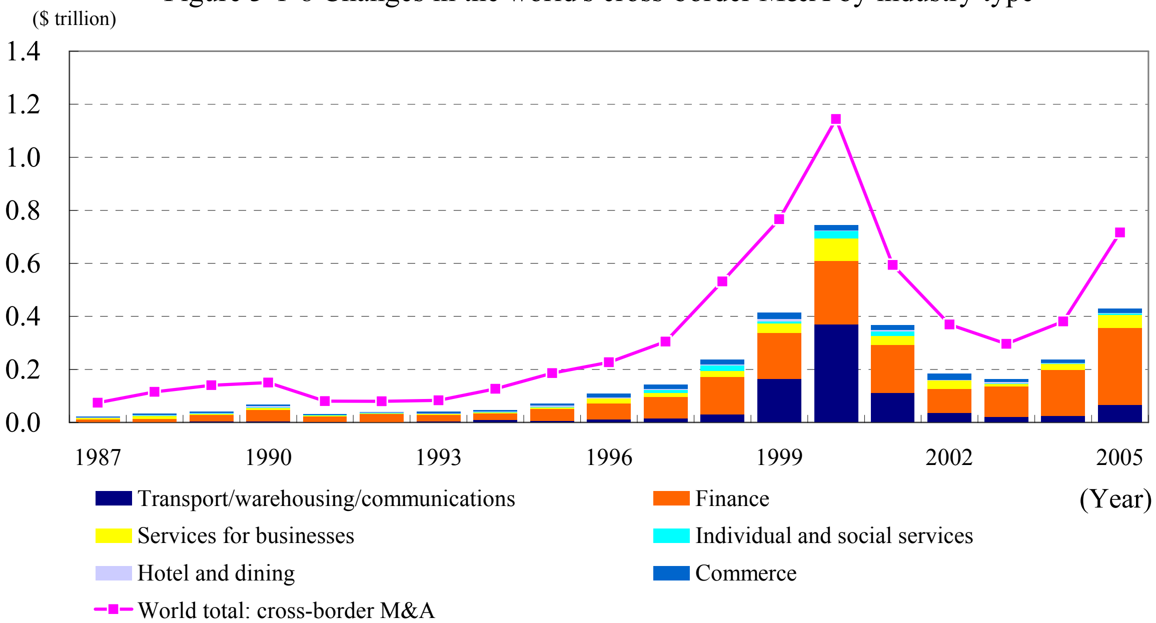
The expansion of cross-border M&A in the late 1990s was seen to be mainly active in the service industries, such as finance and communications. This is thought to have resulted from the need arising for larger companies in the communications sector, in a background of enormous facilities investments and the rapid expansion of mobile telephone markets, due to the advancement in the technology development such as mobile phones and broadband communications. Also, in the finance

[4] Through passage of this law, a legal framework was developed for mutual participation in banking, securities, and insurance business under financial holding companies.

and insurance sectors, the following causes were seen to overlap, resulting in the rapid global expansion of M&A targeting the financial industry: (a) Due to the introduction of the Euro in January 1999, along with the disappearance of the market boundaries of each country's currency, the competition intensified within the financial industry due to the progress in system developments, (b) There was active M&A targeting investment banks, to bring the know-how on intermediation or provision for financial advice for company mergers and acquisitions, (c) Acquisitions of the U.S. financial institutions by the financial institutions in the EU region had increased due to the U.S. deregulation of the Financial Services Modernization Act, etc.

As described above, the changes in the business environment for service industries, such as deregulation and introduction of the Euro, were the contributing factors for active cross-border M&A, pushing forward the globalization of service industries.

Figure 3-1-8 Changes in the world's cross-border M&A by industry type



Notes: Calculations based on industry of the company targeted for takeover.
Source: *World Investment Report 2006* (UNCTAD).

2. Global Expansion of Japan's Service Industry

(1) Japan's service industries are far behind in global expansion

To check the situation of Japan's service industries, service industries' nominal value added as a share of nominal GDP was reviewed. This share was in a consistent growth trend since the 1970s, reaching 68% in 2003, so the service-based economy is also seen to be steadily advancing in Japan (Figure 3-1-1, Table 3-1-9). However, this level is almost the same as the share of service industries in overall global nominal GDP, below the levels of the U.S. in 2003 (77%), France in 2004 (76%), UK in 2004 (73%), and Germany in 2004 (70%).

Table 3-1-9 Service industries' nominal value added as a share of nominal GDP in respective countries (1990, 2004)

(%)

	1990	2004 (2003 for Japan/US)
Japan	58	68
US	70	77
UK	63	73
Germany	61	70
France	70	76
China	31	41
India	41	52
South Korea	50	56
Singapore	—	65
Thailand	50	46
World total	61	68

Source: WDI (World Bank).

Further, looking at the share of service industries in the total FDI balance by country and region, it was 35% for Japan at the end of 2005, an extremely low level compared to the U.S. (74%) and EU15 (76%) in 2004 (Table 3-1-10). Also, even looking at the share of nominal GDP by country and region, it was only 4% for Japan's service industries, far below the UK (36%), France (32%), Germany (27%), and the U.S. (13%).

Table 3-1-10 The share of nominal GDP and total FDI balance by country and region of the FDI of service industries

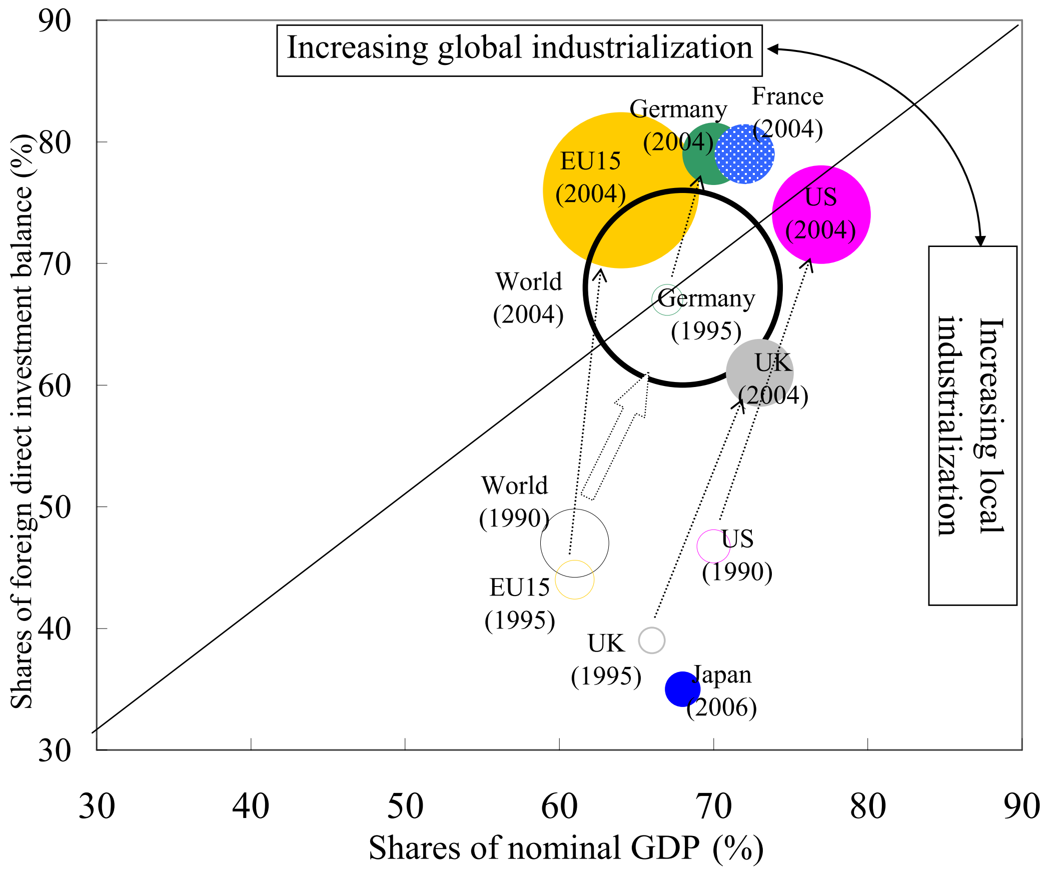
(unit:%)

	Share of overall foreign direct investment balance	Share of nominal GDP
	2004 (2006 for Japan)	2004 (2006 for Japan)
Japan	35	4
US	74	13
EU15	76	—
UK	61	36
Germany	79	27
France	79	32
World Total	68	—

Notes: EU15 includes intraregional investment
Source: *World Investment Report 2006* (UNCTAD)
National Economic Accounting (Cabinet Office,Government of Japan), International Investment Position (Ministry of
Website of BEA, EUROSTAT.

From these facts, it is clear that Japan's move to a service-based economy reflects the international competitive power of Japan's manufacturing industries, but Japan is still lagging compared to other developed countries, and is moreover far behind the global expansion of the U.S. and Europe (Figure 3-1-11).

Figure 3-1-11 Nations' service sectors as components of nominal GDP and of foreign direct investment balance



Notes: 1. The size of the circle indicates the amount of direct investment.
2. Due to data limitations, Japan and US service sectors as components of nominal GDP were calculated based on 2003 data.
3. EU15 includes intra-regional investments.

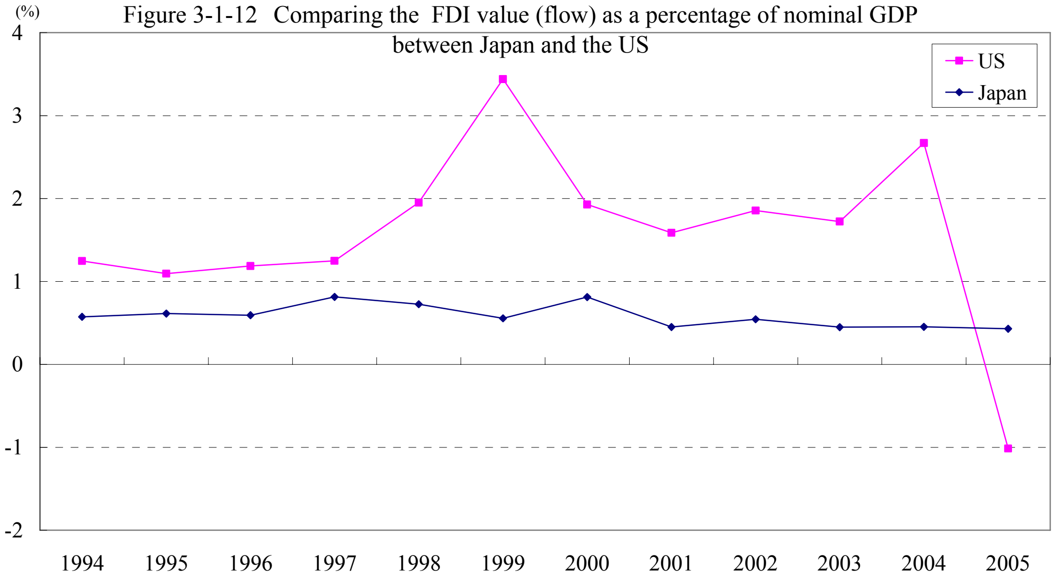
Source: *WDI* (World Development Bank), *World Investment Report 2006* (UNCTAD), *IFS* (IMF), *Japan's Balance of Payments and International Investment Position* (Ministry of Finance, Bank of Japan), US BEA website, EUROSTAT.

Also, looking at the trend in FDI value (flow) by Japan’s service industries as a percentage of nominal GDP compared to that of U.S. service industries, while the value of FDI by Japan’s service industries hovered at a low level about 0.5% even in recent years, the value of FDI by U.S. service industries was 1.0% to 3.5%, far above the level of Japan’s service industries (Figure 3-1-12).[5] It is

[5] For the reasons for the large decrease in U.S. FDI in 2005, refer to Chapter 1, Section 1, footnote 2.

clear that Japan's service industries are steadily falling behind the active FDI of U.S. service industries.

Figure 3-1-12 Comparing the FDI value (flow) as a percentage of nominal GDP between Japan and the US



Notes: 1.The foreign direct investment of Japan is on a FY base. The investment amount during the contract from 1994-2004 (not including the investment recoupment) was recorded, and the acceptance and payment (including investment recoupment) of the capital in 2005 was calculated.
2. US is on a year base, and is calculated by the acceptance and payment of the capital.
Source: *National Economic Accounting* (Cabinet Office, Government of Japan), *International Investment Position* (Ministry of Finance)/(Bank of Japan), website of BEA.

Looking at the share of Japan's service industries in the total global FDI balance, at only 1.3%, it is far below the 14.8% by the U.S. (Figure 3-1-6). This share is even lower than the 2.1% share of the FDI balance by manufacturing industries, which produce a far smaller share of value added in nominal GDP compared to service industries. This contrasts with the 14.8% share by U.S. service industries, far above the 4% share of similar U.S. manufacturing industries, while even in the EU15 the share of service industries reaches 38.8%, greatly exceeding the 8.5% share of similar EU15 manufacturing industries. In this way, compared to advancing global expansion surpassing the speed of domestic growth in developed countries in Europe and the U.S., global expansion by Japan's service industries is far behind.

(2) Service industry trends by industry type

In this way, looking at the share of FDI balance of Japan's service industries by industry type, which still have not reached an appropriate size when viewed internationally, while the financial industry and wholesale and retail industries comprise over 80% of the FDI balance, no shares of other industries reach 10% (Table 3-1-13). For the entire world, service industries for business have the largest share (37.5%), followed by finance (33.5%), commerce (10.2%), transportation / warehousing / communications (10.1%), etc (Table 3-1-14). A characteristic seen in Japan is that while the share of service industries for business (included in "Services (8.6%)" in Table 3-1-13) is relatively small, the share of wholesale and retail industries is relatively large.

Table 3-1-13 FDI in Japan's service industry by industry type (end of 2006)

	Service industry	Finance, insurance	Wholesale, retail	Services	Communications	Real estate	Transportation
Direct investment Positions (100 million yen)	188,752	96,251	59,859	16,223	6,332	5,923	4,164
Composition of service industry (%)	100.0%	51.0%	31.7%	8.6%	3.4%	3.1%	2.2%

Source: *Japan's Balance of Payments and International Investment Position* (Ministry of Finance, Bank of Japan).

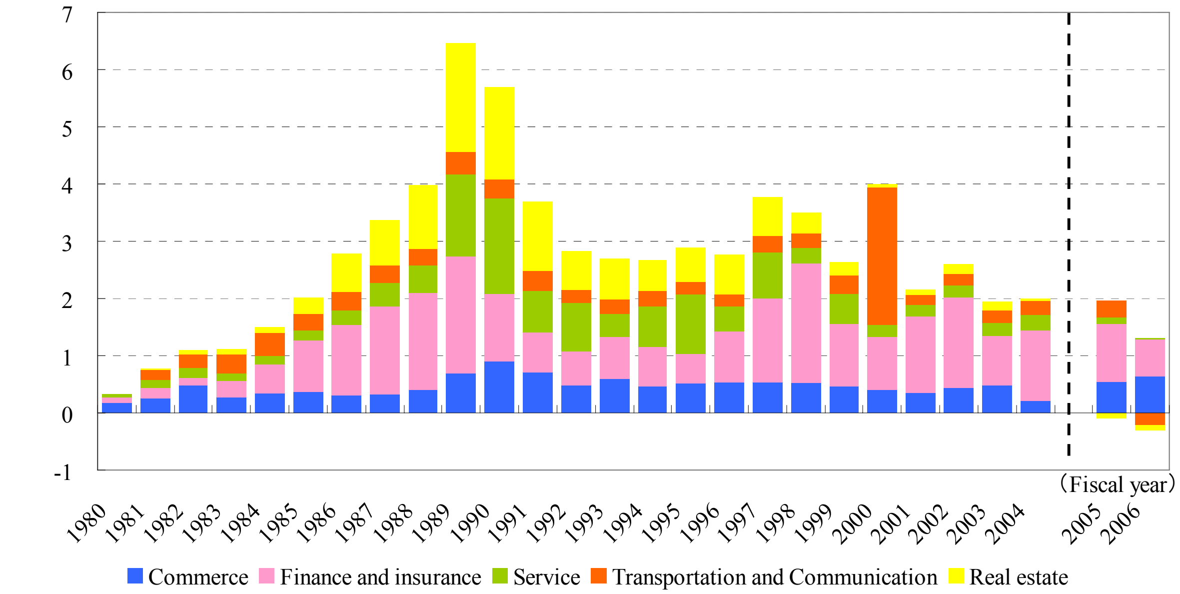
Table 3-1-14 FDI in the world's service industry by industry type (end of 2004)

	Service industry	Services for business	Finance, insurance	Commerce	Transport/ warehousing/ communication	Other service industries	Hotels, Restaurants
Direct investment Positions $ billion)	66,571	24,991	22,273	6,777	6,748	4,804	979
Composition of service industry (%)	100.0%	37.5%	33.5%	10.2%	10.1%	7.2%	1.5%

Source: *World Investment Report 2006* (UNCTAD).

Further, looking at the trends in FDI value (flow) by industry type, total investment value peaked in 1989 at ¥6.5 trillion, decreasing thereafter to about ¥2 trillion since 2001. The real estate industry and other service industries invested large amounts before and after the 1989 peak, falling off thereafter. This contrasts with the growing amounts invested by the finance and insurance industries (Figure 3-1-15). The amounts invested by commerce industries are relatively stable. The above trends resulted in the finance/insurance industries and commerce industries coming to comprise over half the value of FDI by Japan's service industries in recent years, with FDI actually limited to a few industries even in recent years.

Figure 3-1-15 Changes in foreign direct investment (flow) of Japanese industries



Notes: 1. From 1980~2004, the contracted investment (not including the investment recoupment), 2005 and 2006, the acceptance and payment of capital. (including investment recoupment) are displayed.
2. 2005, 2006 Retail and wholesale are presented as commerce.
3. 2005 and 2006 are calendar year figures
4. Prior to 1988, dollar figures were displayed converted into yen.

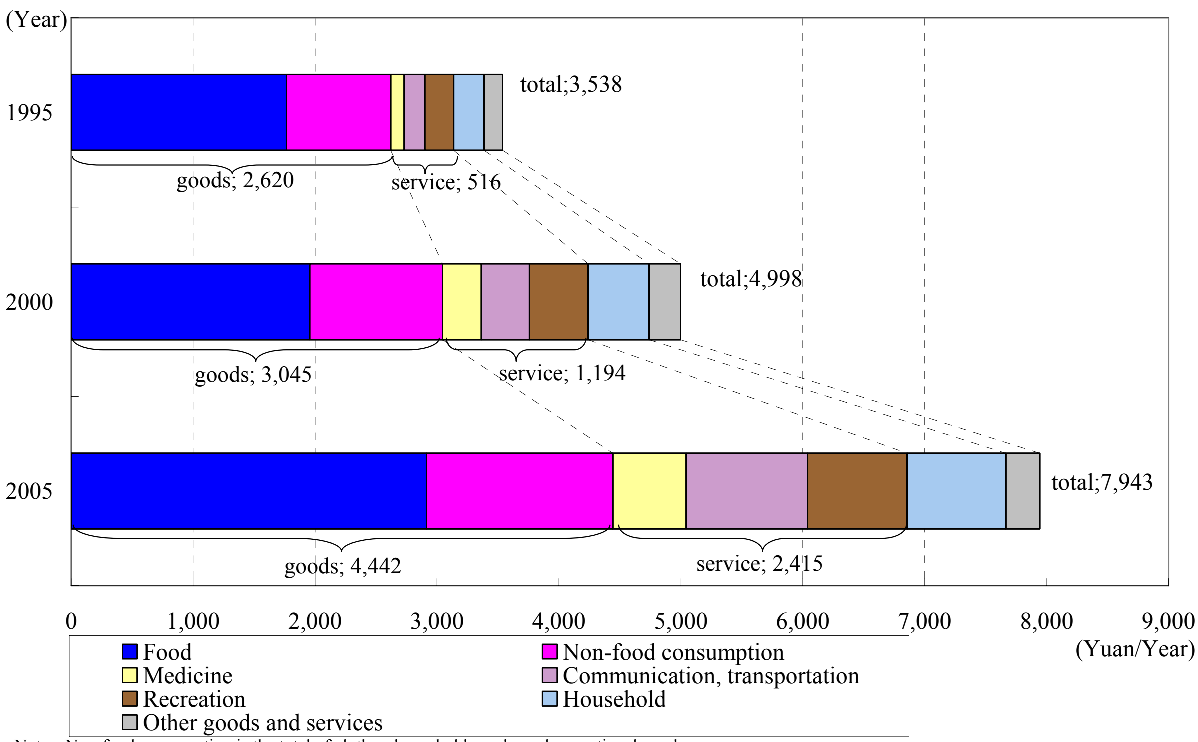
Source: *Foreign and inward direct investment situation* (Ministry of Finance), *International Investment Position* (Ministry of Finance)/(Bank of Japan), Bloomberg..

[Column 8]: Service Industries in East Asia

As described above, East Asia has achieved a high economic growth. Through that process, the income levels in various East Asian countries are rising overall, with growing middle classes,[6] etc.

Looking at the urban consumption expenditures per household in China which has maintained a particularly high per capita real GDP growth rate, the service expenditures such as medical, communications and transport, recreation (travel, etc.) were 2,415 renminbi in 2005, comprising 30% of the total expenditures (Column Figure 8-1). At 4.7 times the expenditures in 1995, demand for the services to individuals is growing rapidly in recent years, far above the 70% increase in goods.

Column figure 8-1 Changes in urban consumption expenditures per household in China by category

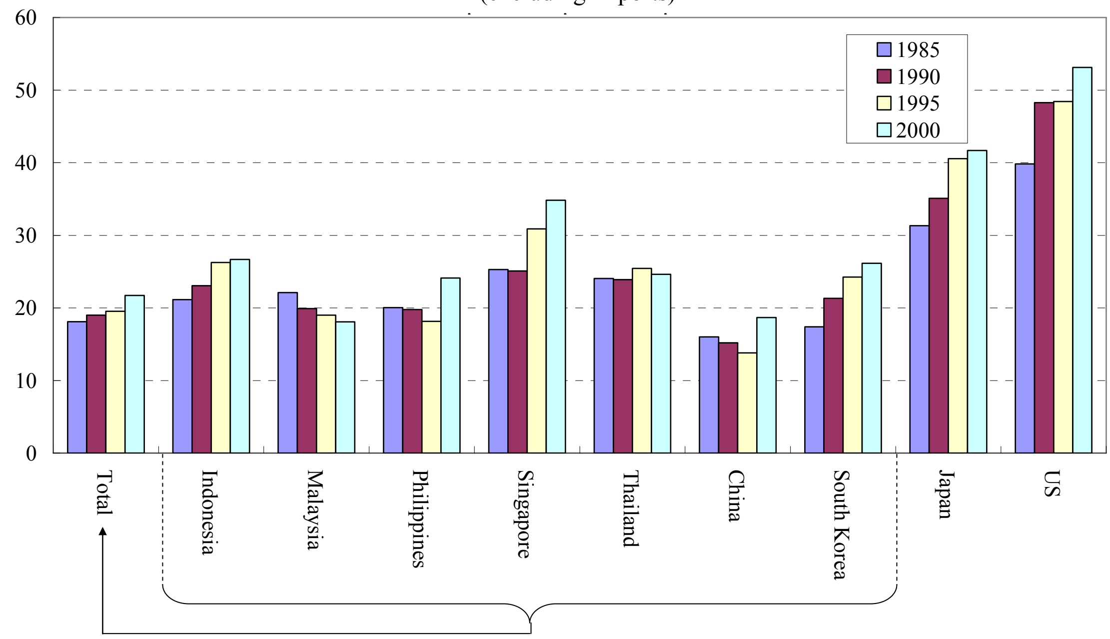


Notes: Non-food consumption is the total of clothes, household goods, and recreational goods.
Source: CEIC Database.

Due to the expanded production volumes of the manufacturing industries in East Asia, along with the construction of efficient production networks and its move toward service-based economies, there is a growing demand for services to business. Although the growth rate of each country varies in terms of its share of the domestic service industries of intermediate input among all industries, the overall growth can be seen in the East Asia region as a whole (Column Figure 8-2).

6 For details, refer to Chapter 2, Section 1.

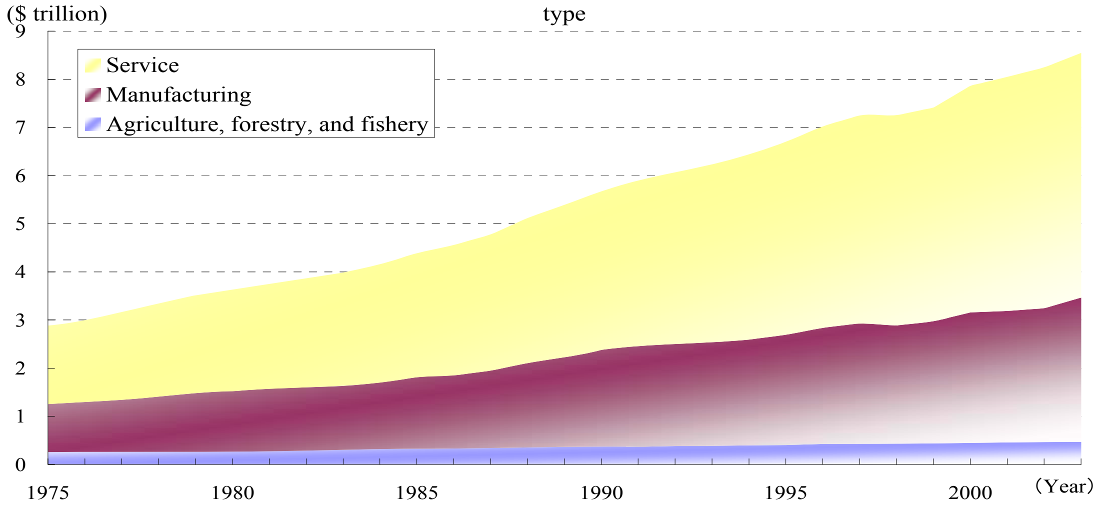
Column figure 8-2 Ratio of intermediate inputs among all industries shared in service industries (excluding imports)



Source: *1985 Asian International Input-Output Analysis* (JETRO Institute of developing countries), *1990 Asian International Input-Output Analysis* , *1995 Asian International Input-Output Analysis* , *2000 International Input-Output Analysis.*

As mentioned above, due to the expanded demand for both services to business and individuals caused by the increase in income growth, the real total GDP of East Asian countries is growing along with their service industries (Column Figure 8-3). This trend is expected to continue from now on.

Column figure 8-3 Breakdown of real GDP in East Asia and Hong Kong by industry type



Notes: 1. Real dollar base (2000 values).
2. Due to calculating limitations, Brunei, Myanmar, and Singapore are not included.
Source: *WDI* (World Bank).