Chapter 4 Towards Building an Open and Seamless Economic System

For Japan to respond to the increasing weight of its international economic activities, and to strengthen its abilities for future sustainable growth, it needs to become a more open and attractive country, in addition to the development of a seamless international business environment with stronger cooperation between Japan and East Asia. Based on the previous analyses, this chapter discusses specific efforts towards building an open and seamless economic system.

Section 1 Increasing weight of Japan's international economic activities (as a new trade and investment powerhouse)

In recent years, companies from many countries including Japan are becoming increasingly active in the global economic activities through trade in goods and services, and direct investment, etc. It is thought that this advancing globalization is further increasing the international economic activities, bringing greater impacts on Japan's economy. In this section, the relationship between increased international economic activities of Japanese companies and Japan's economy is outlined to investigate the relationship between globalization and economic growth.

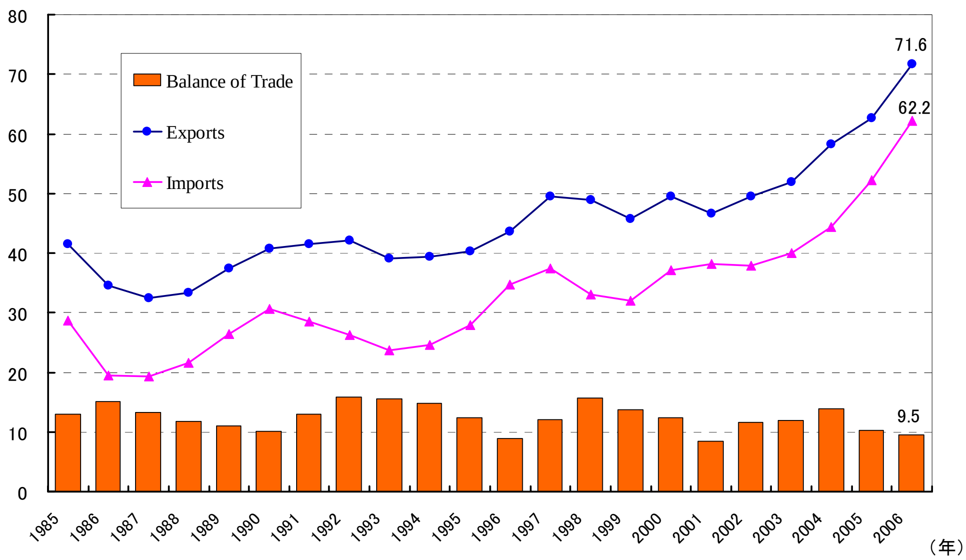
1. More efficient economic activities through expansion of trade

(1) The amount of Japan's foreign trade reaches historic high

In a background of continuing recovery of the global economy, the value of Japan's 2006 exports was ¥71,631 billion (14.4% growth over the previous year) with imports of ¥62,167 billion (18.9% growth) as both exports and imports reach historic highs (Figure 4-1-1). Japan's 2006 trade surplus fell by 8.4% to ¥9,464 billion. This reflects that although prices of primary products such as crude oil fell in the year's second half, the full year average rose over the previous year, so import growth exceeded export growth, shrinking the trade surplus.

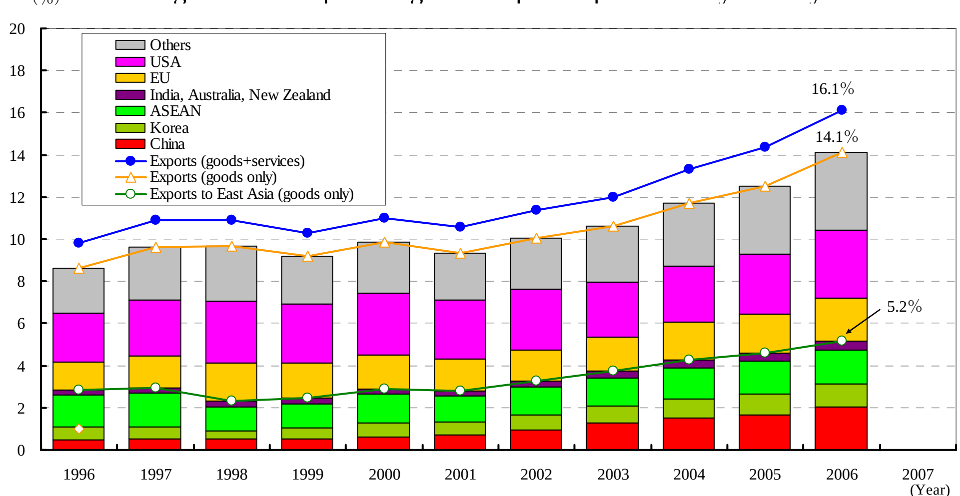
Not only in 2006, but in recent years the weight of international economic activities has been increasing for the Japanese economy and Japanese companies. Japan's export dependency (the ratio of goods and services exports to nominal GDP) peaked in 1984 at 14.9%, and has been fluctuating around 10% since then, but has been consistently rising since 2001, reaching 16.1% in 2006, its highest postwar level (Figure 4-1-2). Looked at by country, exports to China and East Asia are growing. From 2000 to 2006, over 50% of goods export growth went to East Asia, as goods exports to East Asia grew to 5.2% of nominal GDP. The background factors of Japan's growing exports include the growth of East Asian and world markets, growing supply of major parts and materials to overseas subsidiaries of Japanese companies, strengthened export competitiveness of Japanese companies through cost reductions, and improved technical strength, etc. On the other hand, the imports are growing along with the exports, and although slight fluctuations in the trade balance can be seen since 1985, Japan is recording about a ¥10 trillion annual trade surplus each year.

Figure 4-1-1 Changes in exports and imports of Japan



Source: *International Balance of Trade Statistics* (Ministry of Finance/Bank of Japan)

Figure 4-1-2 Japan's degree of export dependence by country

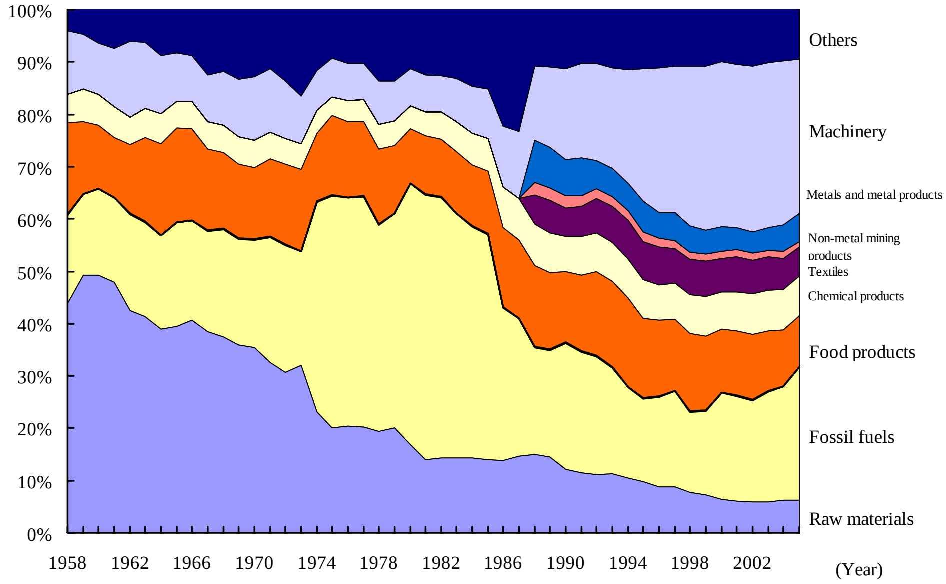


Notes: 1. Degree of export dependence=Total export volume (Balance of international payments base) / nominal GDP
2. Figures for 2007 are an extrapolated estimate based on government outlook for FY2007, based on 2006 figures.
Source: *National Statistics,* (Cabinet Office); *Balance of Payments* (Ministry of Finance/Bank of Japan).

(2) Japan receives benefits of free trade

In order to see the impacts of this growing trade on Japan, looking back on Japan's trade structure in the past, Japan received a wide range of benefits through free trade from after the war until recently. Japan relies on overseas markets for the majority of its natural resources and energy, so securing stable natural resources and energy is necessary and essential to maintain consumption for people's lives. Also, to obtain foreign currency required for these imports, Japan achieved a remarkable development through processing trade, or the exportation of manufactured products. Transport equipment and electronic goods have a growing share of Japan's exports, with a shift from labor intensive products to higher value added products. Also, obtaining natural resources and energy comprised an extremely large share of Japan's imports, with crude fuel comprising about 60% of the value of Japan’s imports until the mid 1980s. However, over the long term, the share of crude fuel has been in a declining trend to 30% - 40% since the mid 1990s, while the share of industrial product imports has shown growth (Figure 4-1-3).

Figure 4-1-3 Changes in proportion of product imports to Japan (by type of product)

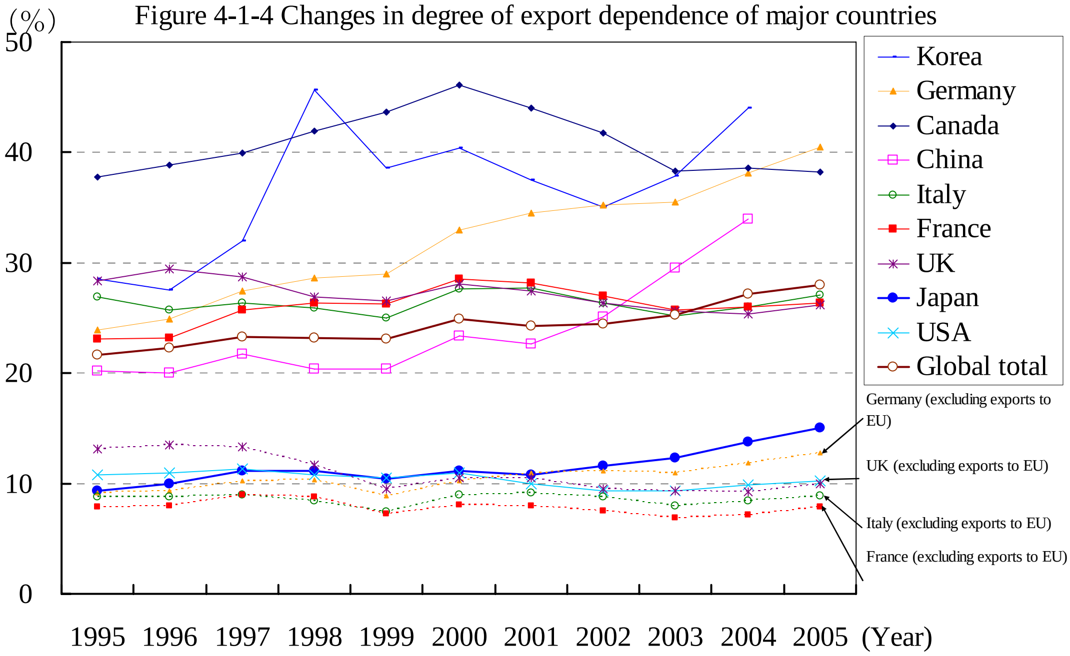


Source: JETRO website.

It is generally pointed out that the significance of free trade is that each country specializes in a production of goods for which they have relatively high production efficiency. By exchanging the necessary goods through trade, each country is able to obtain more benefits than if all goods are produced domestically, utilizing the theory of comparative advantage. This specialization of production which utilizes comparative advantage leads to a higher productivity through economies of scale. By trading, the consumers can also obtain the benefits of greater selection of quality goods and services at lower prices. One can say that in recent years, through greater exports and imports of both goods and services, securing overseas markets, and the use of excellent foreign products, countries are achieving the development of competitive industries, a higher productivity for their overall economies, and greater consumer benefits.

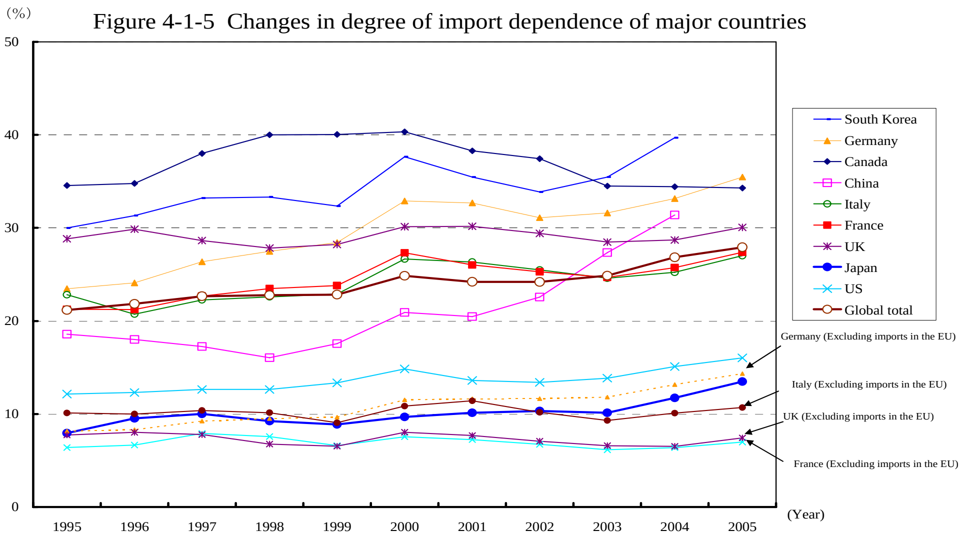
As mentioned above, Japan has steadily expanded the volume of its trade in recent years, but Japan’s trade as a percent of nominal GDP is far lower than the global average for total trade (about 28%). In general, there is a tendency for developed countries to have a lower ratio than the global average for total trade. Although Japan is steadily exceeding the ratios for foreign trade of the U.S. and Europe’s trade outside of the European region, Japan’s ratio is far lower than that of Canada and South Korea (Figures 4-1-4 and Figure 4-1-5). Considering Japan’s low self sufficiency in natural resources and energy, and that Europe obtains large benefits from intra-regional trade between countries with a different economic environment and industrial structures, Japan needs to achieve a higher trade level than the other developed countries, and an even more advanced and efficient industrial structure through trade. Japan’s trade balance as a share of nominal GDP has been in a stable surplus of about 2% since the late 1990s, so while balancing exports and imports, Japan has increased trade and recorded a stable trade surplus (Figure 4-1-6). Japan's future trade balance trend may change from this stable surplus amid Japan's low birthrate and aging society. Regardless of its trade balance situation, it is thought that there is a sufficient possibility of growth in the total trade value, and there is plenty of room for Japan to increase its trade even more, and pursue the benefits of higher efficiency through trade. It is thought that by increasing the amount of trade and raising productivity of the overall economy, it will be more possible to increase the economic growth and maintain the trade surplus.

Figure 4-1-4 Changes in degree of export dependence of major countries



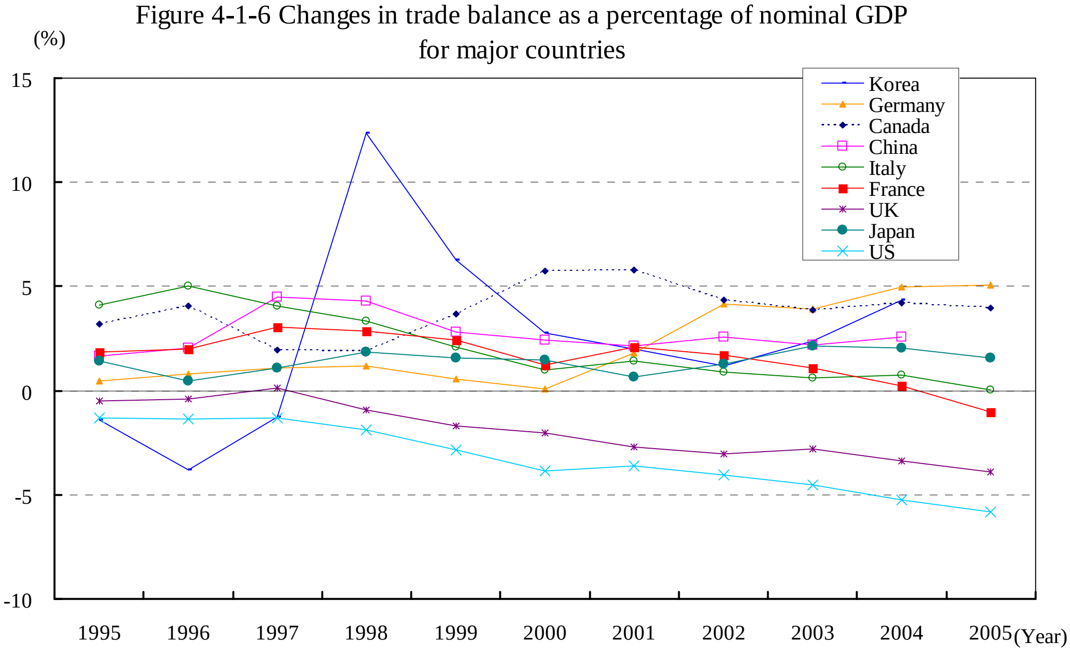
Notes: 1. Degree of export dependence=Total export volume (Balance of international payments base) / nominal GDP
2. For EU countries the degree of dependence is calculated excluding the export of goods to other EU members from the total export volume figure.
Source: *WDI* (World Bank); *DOT* (IMF).

Figure 4-1-5 Changes in degree of import dependence of major countries



Notes: 1. Degree of import dependence=Total import value on goods and services (Balance of international payments base) / nominal GDP
2. The degrees of import dependence for EU member countries given above are reference lines calculated by deducting imported goods within the EU from the total import value of goods.
Source: WDI (World Bank); DOT (IMF)

Figure 4-1-6 Changes in trade balance as a percentage of nominal GDP for major countries



Notes: Trade balance as a percent of nominal GDP=(export value-import value) / (nominal GDP).
Source: WDI (World Bank). Value of imports and exports based on balance of international payments.

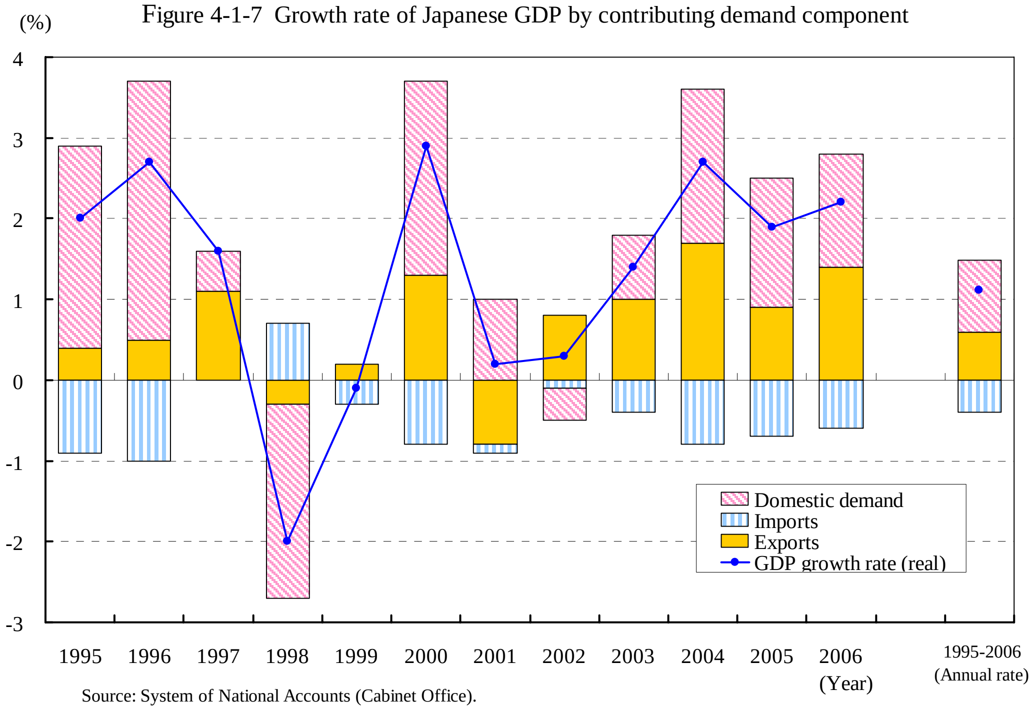
(3) The impacts of increased trade on the domestic economy

Next, the impacts of this increased trade on Japan's economy will be analyzed from the microeconomic aspect. The 2006 real GDP growth rate was 2.2%,[1] achieving seven consecutive years of positive growth, with the economy in recovery since 2002.[2] In order to investigate the role of trade in this GDP growth, the contributing factors are broken down into domestic demand, exports, and imports. The exports (goods and services) contributed about 66% of the growth from 2002 to 2006, and about 52% from 1995 to 2006 (Figure 4-1-7). The import growth accompanying the economic growth showed a negative contribution to the GDP growth (about 32% from 2002 to 2006, and about 28% from 1995 to 2006), but this was greatly exceeded by the contribution ratio of exports. The exports also had a large impact on the capital investment. Industries such as electronic goods and autos with a large share in the total capital investment also comprised a large percentage of the export sales, so it is clear that the export growth of these industries stimulates the capital investment (Figure 4-1-8). In fact, in the overall economy, the annual export growth has been positive since 2002, and the capital investment has also been in recovery except for some slow periods (Figure 4-1-9). Thus the

[1] Values based on the second early report.
[2] This shows the recovery period in the Basis Judgment (Kicho Handan) of the Monthly Economic Report, and does not show the official government Economic Expansion Period. To confirm an accurate economic expansion period, it is necessary to wait for the Reference Date to be established by the Economic Conditions Trend Indices Research Society (Keiki Doukou Shisuu Kenkyukai), held at the Economic and Social Research Institute, Cabinet Office.

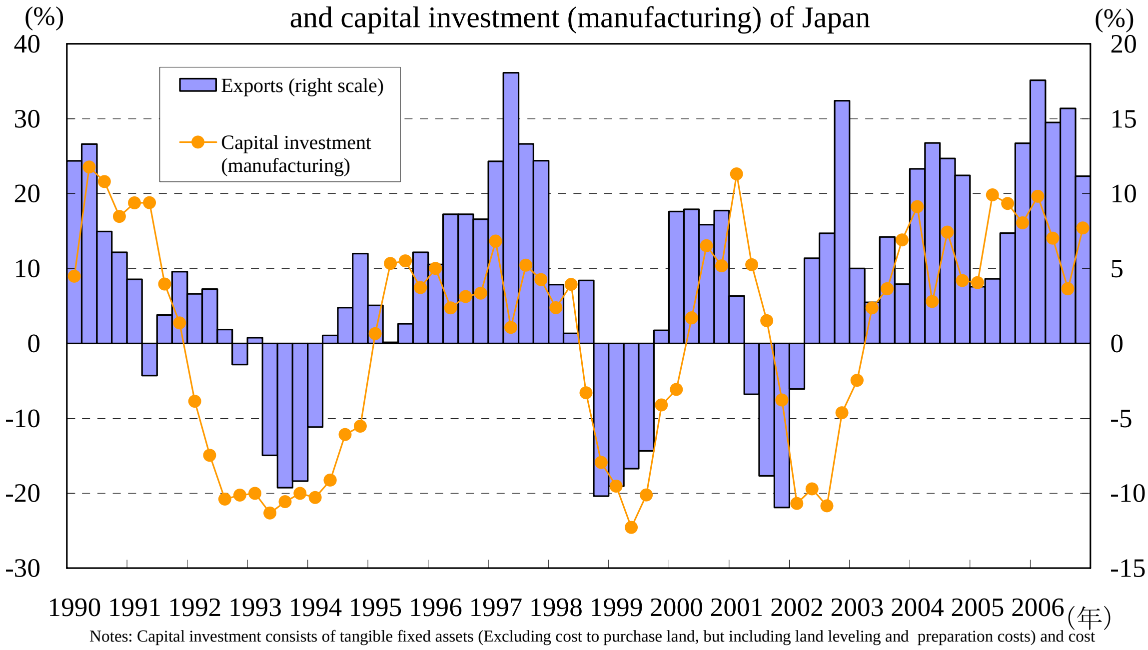
growth of exports is directly and indirectly pulling the domestic economy into recovery.

Figure 4-1-7 Growth rate of Japanese GDP by contributing demand component



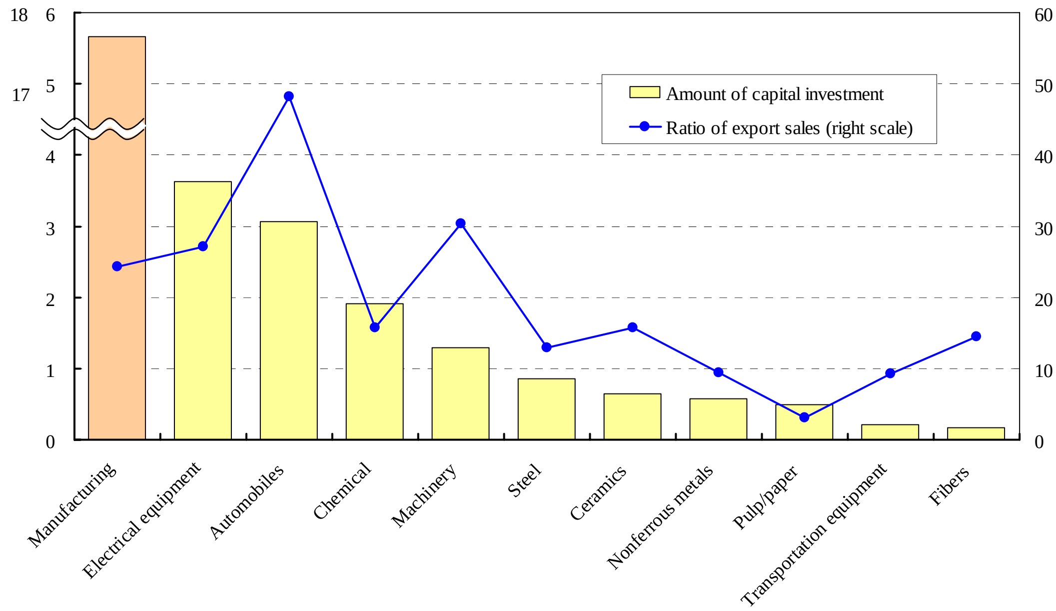
Source: System of National Accounts (Cabinet Office).

Figure 4-1-8 Changes (compared to same term of previous year) in exports and capital investment (manufacturing) of Japan



Notes: Capital investment consists of tangible fixed assets (Excluding cost to purchase land, but including land leveling and preparation costs) and cost for software creation.
Source: Trade Statistics; Company Statistics Seasonal Report (Ministry of Finance)

Figure 4-1-9 Capital investment and export sales ratio of Japan by industry (FY2005)



Notes: 1. The export sales ratio was created based on data from Nikkai NEEDS.
2. Plant and equipment investment consists of tangible fixed assets (Excluding cost to purchase land, but including land leveling and preparation costs) and cost for software creation.
Source: Company Statistics Seasonal Report (Ministry of Finance); Nikkei NEEDS

2. More efficient economic activities through expansion of investment

(1) Japan's income balance reaches new historic highs

Globalization of the Japanese economy is shown by the expansion of inward and outward investment and its profit. Regarding income receipts, the growing investment balance, rising global interest rates, etc., led to growing interest receipts from mid and long term bonds, which was the main factor in growing receipts from securities investment earnings. In addition, reflecting factors including favorable results of overseas subsidiaries of Japanese companies which have moved forward with globalization, direct investment earnings receipts also increased, with a dramatic increase in 2006 income receipts to ¥19,283 billion (24.1% over the previous year), an historic high.[3] On the other hand, income payments also grew firmly due to factors such as securities investment earnings for Japan, reaching ¥5,537 billion (33.2% growth). As a result, Japan's income surplus in 2006 reached ¥13,746 billion (20.8%),[4] an historic high (Figure 4-1-10).

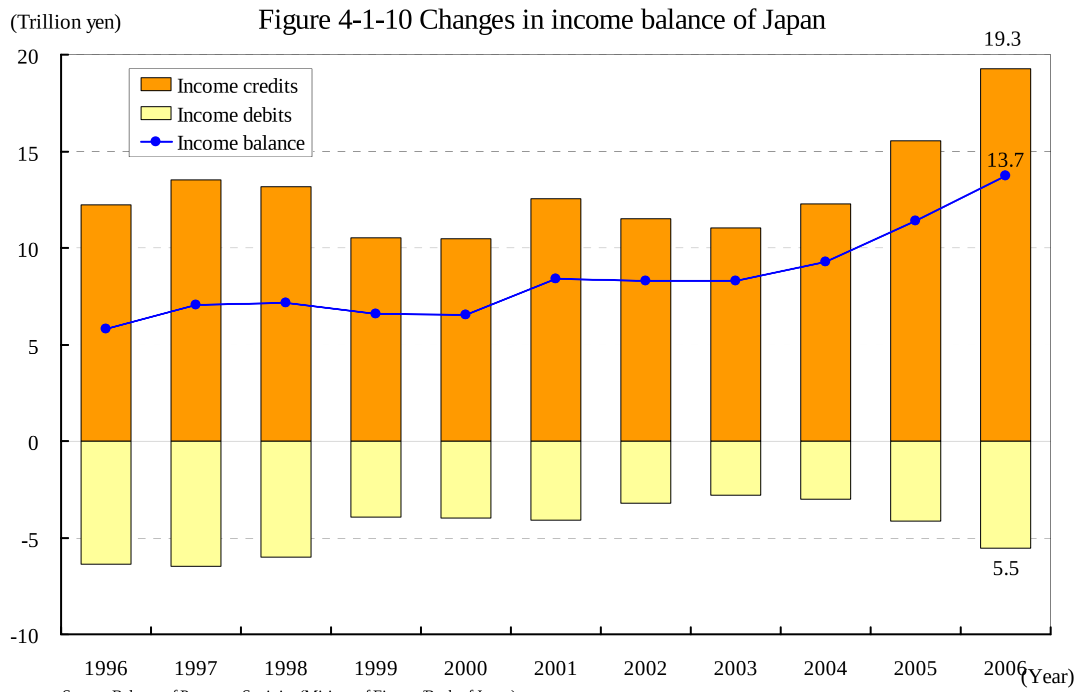
As a result of this favorable increase in its income balance, Japan's income balance first exceeded its trade balance in 2005, and the current account balance, which shows the total of the trade balance and income investment, grew 8.7% over the previous year in 2006, reaching an historic surplus of ¥19,849 billion. Many years of current account surpluses led to accumulation of net foreign assets,

[3] Compared with years since 1996, when the methods of recording derivative transactions were implemented.

[4] Data on receipts and payments for income which are announced on a monthly basis are totaled to calculate annual basis figures, so the total does not match the income balance.

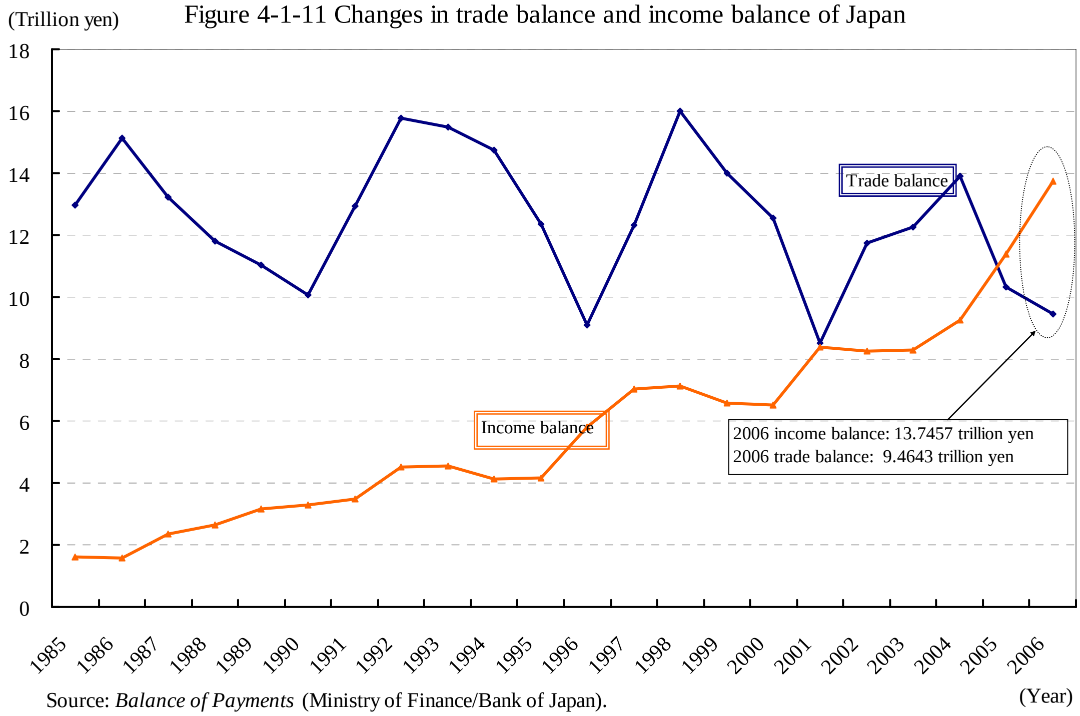
which combined with a low yen to create continuing growth in the income surplus, and the income balance comprised a larger share of the current account balance in 2006.

Figure 4-1-10 Changes in income balance of Japan



Source: Balance of Payments Statistics (Ministry of Finance/Bank of Japan)

Figure 4-1-11 Changes in trade balance and income balance of Japan



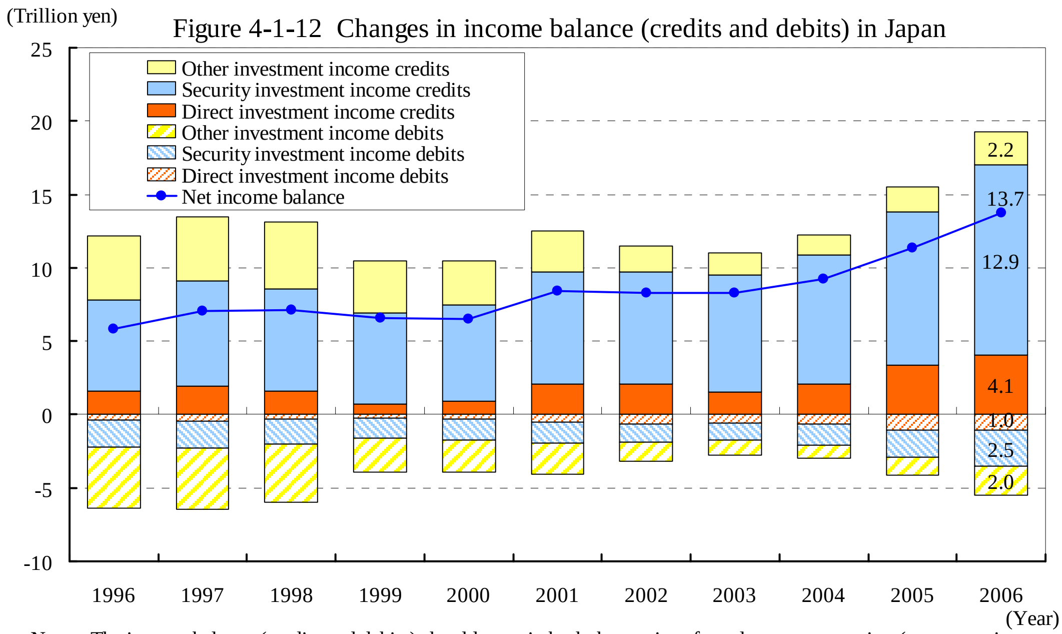
Source: *Balance of Payments* (Ministry of Finance/Bank of Japan).

(2) Vigorous investment activities due to advancing overseas business expansion

Supporting this growing income surplus, in addition to the growing receipts from securities investment earnings, were the growing profits recorded by overseas subsidiaries accompanying the progress in overseas business expansion of Japanese companies (Figure 4-1-12). Among income receipts, receipts from direct investment earnings were ¥4,083 billion (growing 21.9% over the previous year), growing to comprise about 21% of income receipts. Also, looking at the relationship between the income balance (flow) and net foreign assets (stock), Japan increased its net foreign asset balance through its exports of goods, securities investment, overseas business expansion of Japanese companies, etc., as mentioned above, and earnings from these resources contributed to recording income surpluses (Figure 4-1-13). Japan's net foreign asset balance reached about ¥215 trillion at the end of 2006, showing consistently strong growth.

Looking at the activities of overseas subsidiaries of Japanese companies, which are greatly contributing to growth of receipts from direct investment earnings, fiscal 2004 ordinary income grew to an historic high of ¥6,115 billion, with dramatic growth of 31.0% over the previous fiscal year (Figure 4-1-14). Looking at the balance of payments of overseas subsidiaries of Japanese companies by region, in FY2004 Asia generated the largest profits (¥2,204 billion), with the highest net income/net sales (4.3%) due to factors like the economic boom in Asia. It is clear that Asian subsidiaries are the main source of earnings in overseas activities of Japanese companies (Figure 4-1-15).

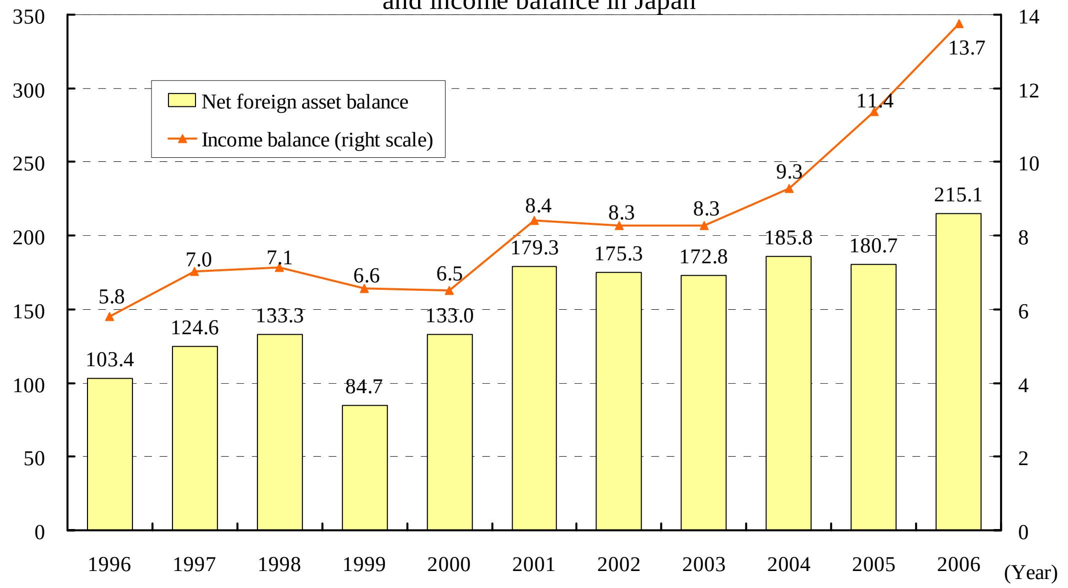
Figure 4-1-12 Changes in income balance (credits and debits) in Japan



Notes: The income balance (credits and debits) should contain both the receipt of employee comensation (compensation received by residents and workers earned overseas) and the payment (payment of compensation by residents to non-residents and workers). However, it was omitted here because the share was less than 0.5% for each year.

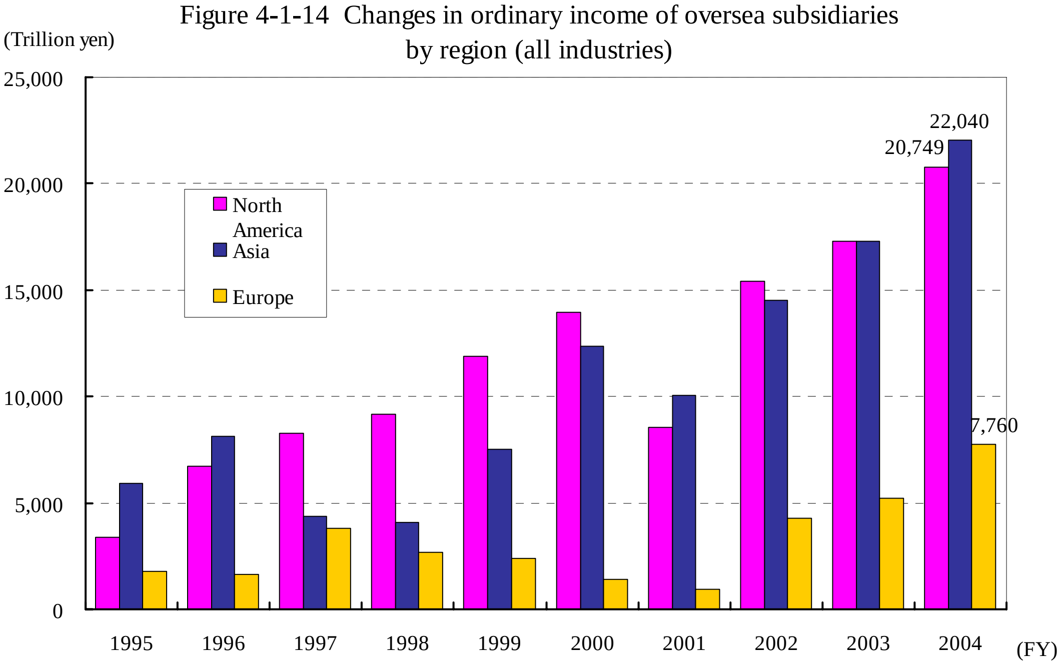
Source: *Balance of Payments Statistics* (Ministry of Finance/Bank of Japan)

Figure 4-1-13 Relationship of net foreign asset balance and income balance in Japan



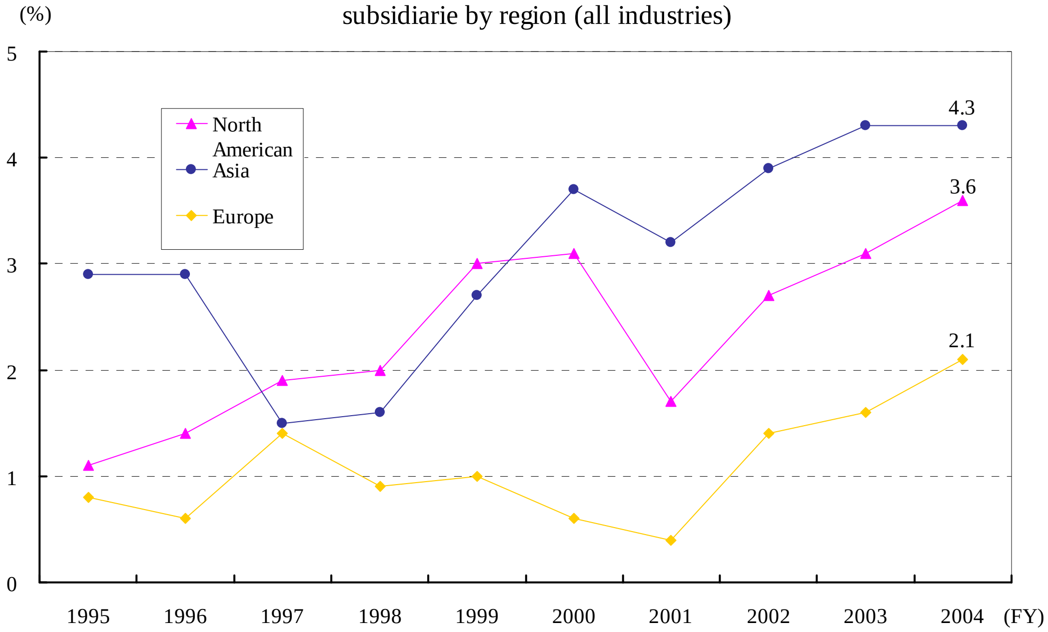
Notes: The 2006 net foreign asset balance is a primary estimation value.
Source: *Balance of Payments Statistics*; *International Investment Position* (Ministry of Finance/Bank of Japan)

Figure 4-1-14 Changes in ordinary income of oversea subsidiaries by region (all industries)



Source: *Survey of Overseas Business Activity* (Ministry of Economy, Trade and Industry)

Figure 4-1-15 Changes in ratio of ordinary income sales by oversea subsidiarie by region (all industries)



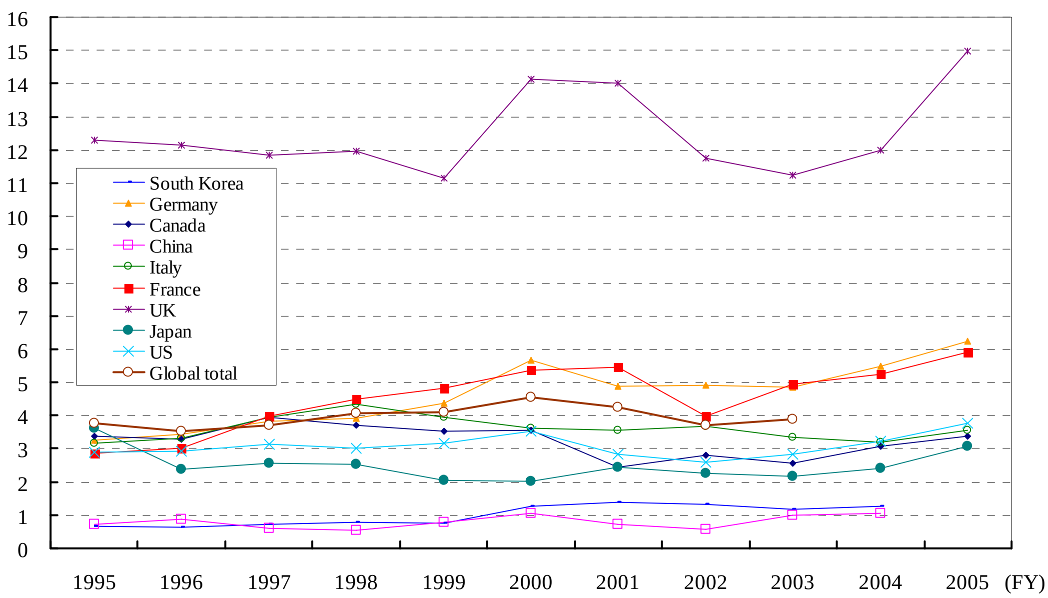
Source: *Survey of Overseas Business Activity* (Ministry of Economy, Trade and Industry)

(3) Structure of Japan's investment activities

To check the structure of Japan's income balance, breaking down the income balance into receipts and payments as percentages of nominal GNI gives 3.1% for receipts/GNI, and 0.8% for payments/GNI (2005). In contrast, the UK has 15.0% receipts and 12.7% payments, Germany 6.2% receipts and 5.8% payments, France 5.9% receipts and 5.4% payments, U.S. 3.8% receipts and 3.7% payments (all in 2005). All of these are higher than Japan, which has the lowest receipts and payments among these seven developed countries (Figures 4-1-16 and Figure 4-1-17). Japan has a large net balance, but has the characteristic of small receipts and payments. Also, receipts and payments of income balance are closely related to the sizes of outward FDI and inward FDI, respectively. Japan's outward FDI balance and inward FDI balance as percentages of nominal GDP are low compared to the U.S. and European countries, and this gap with U.S. and European countries is growing even more in recent years (Figure 4-1-18). This growth in these direct investments contributes to the activation and improvement of their economic efficiency through the introductions of new technologies and business know-how, the variety of competition from domestic and foreign companies, etc. Thus it is important for Japan to make active efforts towards increasing outward and inward FDI. These efforts are described in detail in Section 3 and Section 4.

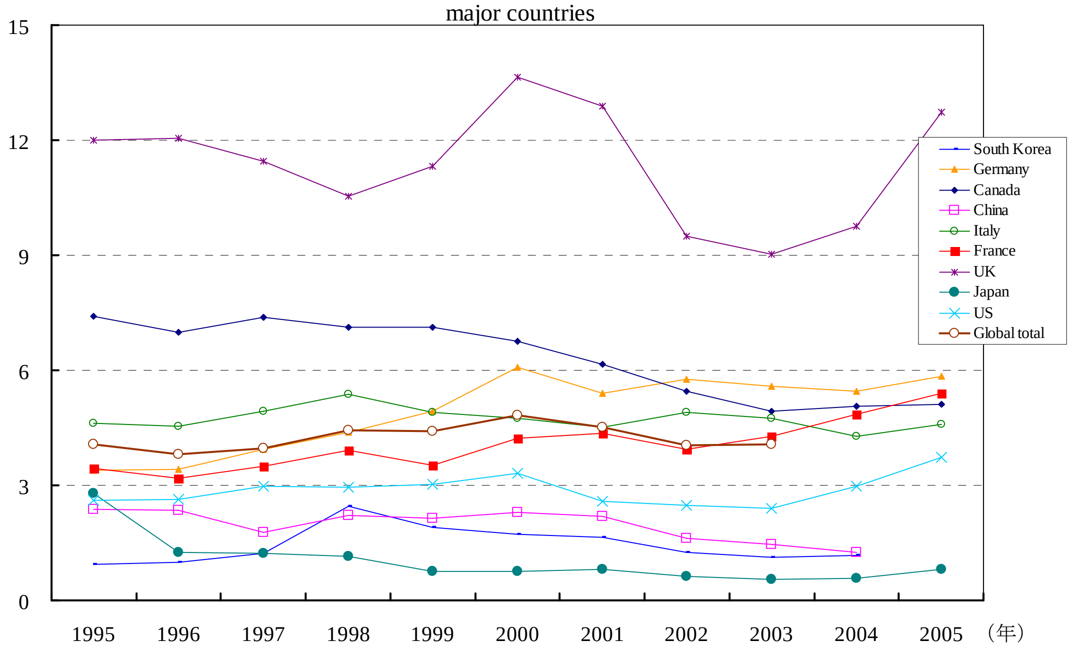
Figure 4-1-16 Changes in ratio of ordinary income sales by oversea subsidiaries by region (all industries)

(%)



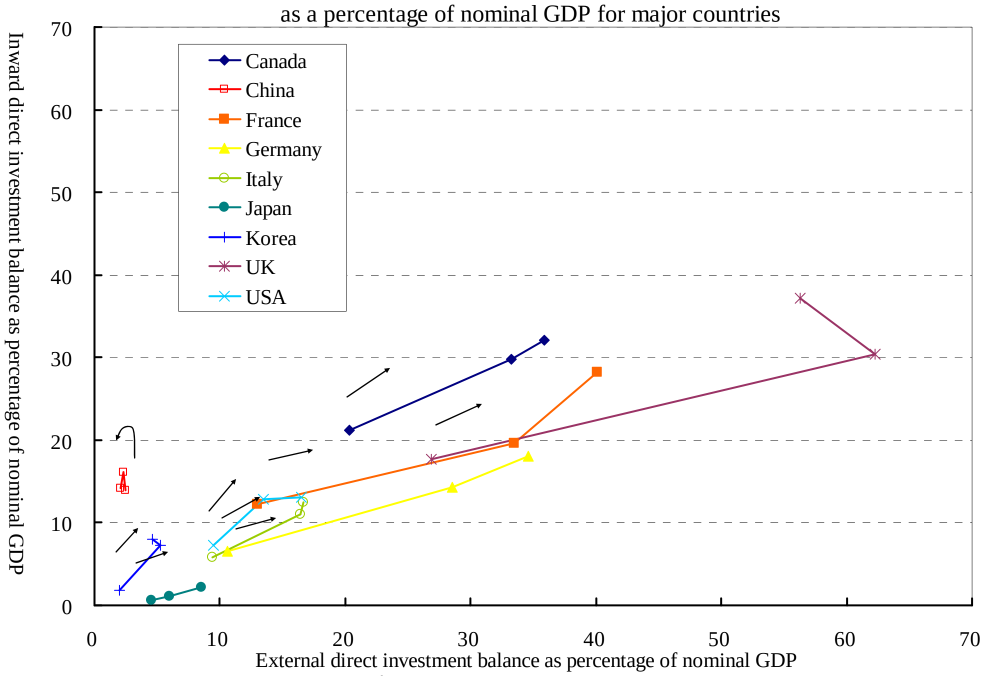
Source: *Survey of Overseas Business Activity* (Ministry of Economy, Trade and Industry)

(%) Figure 4-1-17 Changes in income balance (debits) as a percentage of nominal GNI of major countries



Source: *WDI* (World Bank)

Figure 4-1-18 Changes in inward and external direct investment balance as a percentage of nominal GDP for major countries

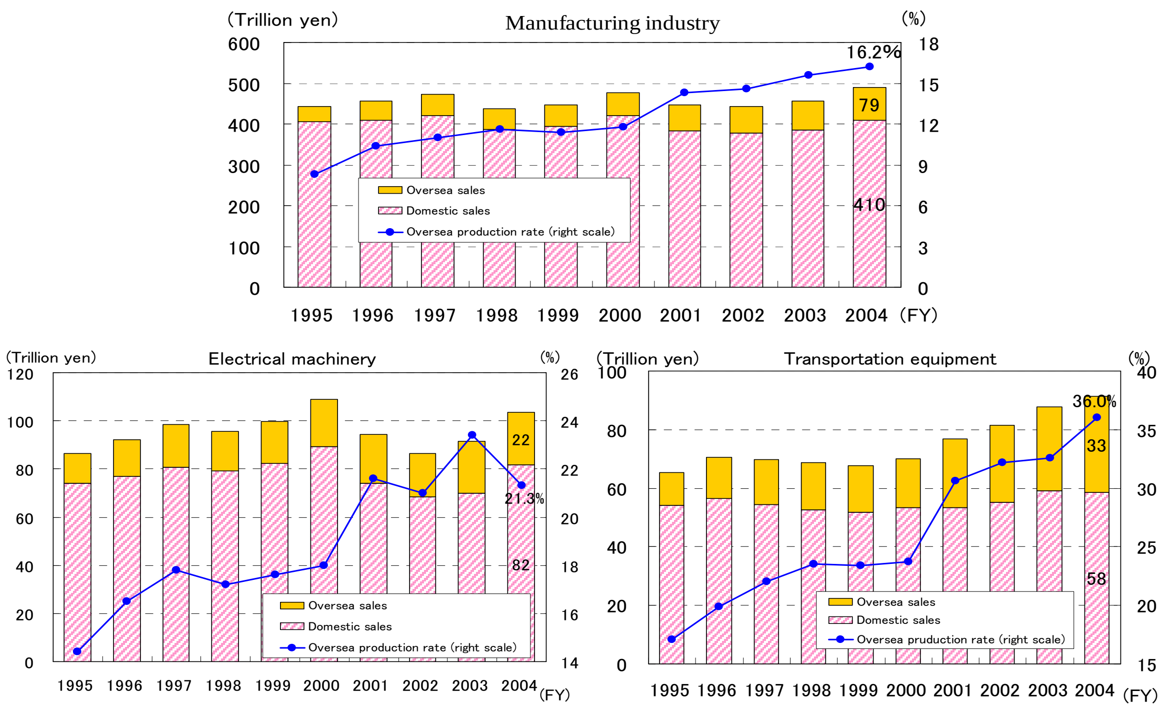


Notes: For each country the arrow shows the change in results from 1995 to 2000 to 2005.
Source: *WDI* (World Bank); *World Investment Report 2006* (UNCTAD).

[Column 12] Impacts of growing overseas-related business activities on domestic business activities

By increasing direct investments overseas, overseas business activities of Japanese companies have become more active, with a greater share of their business. Sales of the Japanese manufacturing industry (total sales of Japanese domestic corporations and Japanese overseas subsidiaries) were about ¥490 trillion in 2004. Of that, the sales of overseas subsidiaries were about ¥80 trillion, reaching an historic high of 16.2% of the total sales. Two industries have been pushing forward with the development of overseas business networks: transport equipment (36.0%), and electric machinery (21.3%) in recent years: transport equipment (36.0%), and electric machinery (21.3%). These industries have resulted in a growing share of sales by overseas subsidiaries (Column Figure 12-1).

Column Figure 12-1 Changes in ratio of sales to production in oversea subsidiaries



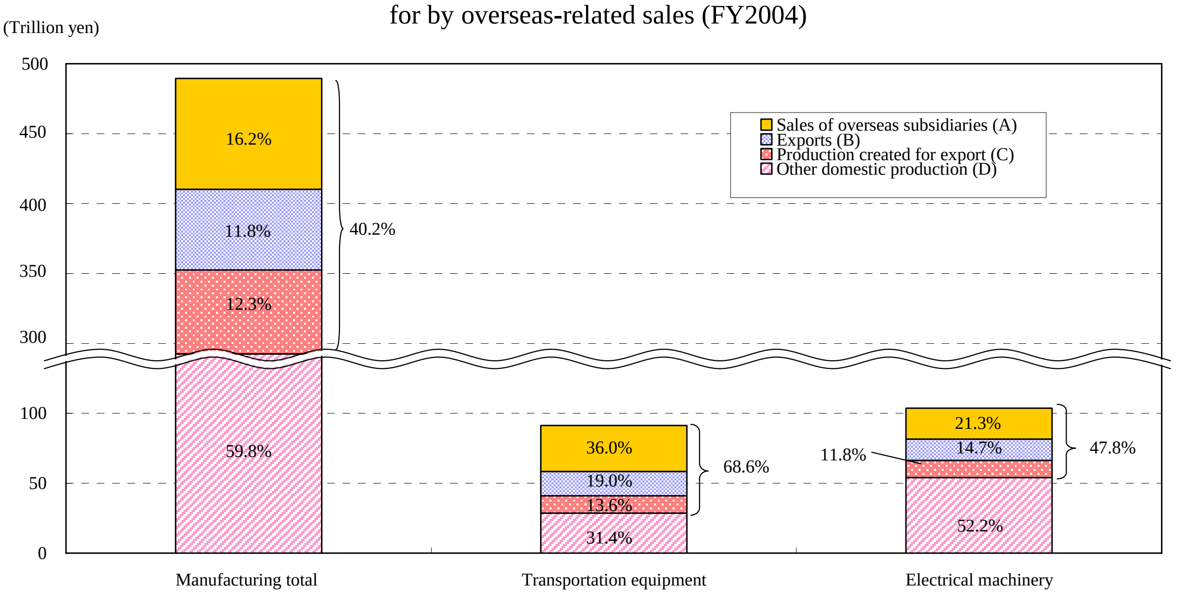
(Notes) 1. Calculated by overseas production ratio = sales by oversea subsidiaries /(sales by oversea subsidiaries＋Japanese domestic corporations)×100

2. "Electronic machinery" includes "telecommunication machinery."

Source: *Survey of Oversea Business Activity* (METI), *Survey of Corporate Enterprises* (MOF)

The growing weight of foreign economic activities by Japanese companies goes beyond the increasing percentage of sales by overseas subsidiaries. Out of the domestic corporate sales by Japan's domestic manufacturing industry, the sales of products destined for overseas markets, and the sales of parts and raw materials input for production to export can be regarded as the sales to satisfy overseas demand. Thus for Japan's overall manufacturing industry, the overseas related sales were calculated by a total of: (a) The sales of overseas subsidiaries, (b) The exports by domestic corporations, and (c) The domestic production induced by exports (using an input-output table). This gives the result that out of about ¥490 trillion of FY2004 sales by Japan's domestic manufacturing industry, about 40% (about ¥197 trillion) is comprised of the overseas related sales [the total sales of overseas subsidiaries (about ¥79 trillion), the exports (about ¥58 trillion), and the domestic production induced by the exports (about ¥60 trillion yen)].[5] Industries with ratios of overseas related sales above the manufacturing industry average are transport equipment (about 69%), and electric machinery (about 48%), so it is clear that much of the sales are directly or indirectly brought about by the overseas demand (Column Figure 12-2).

Column Figure 12-2 Proportion of total sales of Japan's manufacturing industry accounted for by overseas-related sales (FY2004)



Notes: 1. "Sales of overseas subsidiaries (A)" is the reported sales of local affiliates as gathered in a survey on overseas business activities.
2. "Exports (B)" is calculated from the total export volume in national economic statistics. However, as national economic statistics by economic sector are only publicized per each calendar year, the total export volume for FY2004 was broken down into a comparative composition by industry for CY2004.
3. "Production created for export (C)" =[(domestic corporate sales balance) - (B)] × (proportion of production created for export by Japanese manufacturing industry). "Other domestic production (D)" = (domestic corporate sales balance) - (B) - (C). However, domestic corporate sales balance uses the balance of sales figure gained from the business outlook survey and the production promotion effect of products for export is gained from the simplified extended inter-industry tables.
4. Overseas-related sales for individual industries do not factor in the production ripple effect on other industries caused by the industry in question's overseas activities. "Exports" also includes exports to overseas subsidiaries. For both domestic and overseas cases there is a possibility that calculations include some overlap in final goods and raw material sales. "Electrical machinery" includes "information and communications equipment."
Source: *Basic Survey of Overseas Business Activities, Simplified Extended Inter-Industry Tables* (METI); *Business Outlook Survey* (Ministry of Finance); *National Statistics* (Cabinet Office).

3. Building a new "trade and investment powerhouse"

As seen above, the weight of international economic activities in Japan's economy is steadily growing in recent years, with growing exports, imports, income receipts and payments. Also, the income account surplus from the trade surplus, direct investment and securities investment leads to the growing current account. The current account increases the net foreign asset balance, which further increases the income account surplus. This mechanism is working continuously. However, by international standards, one certainly cannot say that Japan has sufficient trade or income receipts and payments. Due to the declining savings rate from factors such as the low birthrate and aging society,

[5] It is important to note the possibility that exports to overseas subsidiaries may be included in exports from Japan, and there may also be duplicate recording of domestic and overseas sales of finished products and raw materials. However, even if one makes a similar calculation of (overseas subsidiary sales) minus (supplies from Japan), the overseas related sales ratio of Japan's manufacturing industry becomes about 38%, resulting in only a small difference.

Japan's current account surplus is forecast to shrink over the long term. In this environment, to promote even more efficient economic activities, to raise productivity, to bring benefits to consumers, and to ensure the surplus for as long as possible, the following efforts become essential: (a) Increase total foreign trade and pursue the benefits of bilateral trade, both imports and exports, not only for the purpose of acquiring foreign currency, (b) Raise productivity by acquiring new technologies and business know-how through greater inward FDI and outward FDI, (c) Make improvements in the international business environment towards liberalization and facilitation of trade and investment, thereby making Japan both a "foreign trade country" and an "investment country."