White Paper on International Economy and Trade 2014 Contents

- Japan and the world. Shifting to new growth models -

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Part I　Trends in world economy

■ World economic trends after the global economic crisis

・In the past five years, the world economy faced two serious crises, the global economic crisis and the European debt crisis. Although advanced economies slumped deeply during this period, they displayed strength in 2013. Meanwhile, China and other emerging economies, which have been driving forces of the world economy after the collapse of Lehman Brothers, began to show some signs of vulnerability from 2011, and a slowdown ensued in 2013. As a consequence, the world economy as a whole grew at a moderate pace in 2013.

・A remarkable occurrence in 2013 was the financial market turmoil triggered by anticipation of the tapering of the quantitative easing program in the United States. After the global economic crisis, some emerging economies achieved high growth, supported by inflows of surplus funds arising from large-scale economic stimulus measures taken by major countries, while others increased their current account deficits substantially. In May 2013, capital outflow accelerated amid increased anticipation of the tapering of the quantitative easing program. From late May through the end of June, the financial markets in emerging economies were severely impacted. Subsequently, investors became selective in investing in emerging markets in accordance with the status of current account balances, growth rates, foreign currency reserves, and inflation rates, etc.

In January 2014, the tapering of FRB's quantitative easing program started. Depending on future conditions, some emerging economies, including those with current account deficits, may be impacted in the short term. However, the possibility of major turmoil arising is presumed to be small because emerging economies have increased their resilience against risks compared with past crises.

・Future risk factors include a tightening of financial conditions that may be caused by sudden changes in the financial environment during the process of the tapering of the quantitative easing in the U.S., as well as geopolitical risks.

■ International trade and investment trends in Japan

・In 2013, while Japan's exports increased for the first time in three years due to the yen's weakening since late 2012, imports grew for the fourth consecutive year because of an increase in the value of imports of fossil fuels for thermal power generation and robust domestic demand. As a result, Japan registered a record trade deficit in 2013.

・An import price rise was the greatest factor for the expansion of the trade deficit in 2013, followed by an export volume decline and an import volume increase. Since the third quarter of 2013, export volume has been growing moderately.

・A comparison of the trade balances in 2005, 2010 and 2013 by major item shows that while the deficit regarding mineral fuels expanded, the surplus for electric machinery and general machinery declined. As for Japan's export competitiveness regarding its major export items expressed as the trade specialization coefficient, the country still maintains a high level of export competitiveness regarding motor vehicles, and iron and steel products. However, regarding electrical machinery, general machinery and precision instruments, Japan’s relative superiority in terms of export competitiveness has been declining, presumably because of the effects of the growth of the ROK and China, among other factors.

・At the moment, a strong linkage is not observed between the foreign exchange trend and corporate practices regarding production bases and export prices. Companies may be keeping a close watch on overseas demand trends and the stability of foreign exchange rate levels. On the other hand, as for factors that affect export volume, many companies pointed out the effects of overseas demand trends as key elements regardless of foreign exchange rate levels. However, a relatively large proportion of companies pointed out a decline in price competitiveness due to the strong yen as a factor behind the drop in export volume in the yen-strengthening phase and cited a decline in local prices due to a weak yen despite the absence of a reduction of yen-based export prices as a factor behind the increase in export volume in the yen-weakening phase.

・In 2013, Japan’s current account surplus fell to its lowest level since 1985. The service account deficit shrank and the primary income surplus expanded. However, these positive factors were more than offset by an increase in the trade deficit.

・For Japan to maintain a current account surplus in the future, it is important for the country to further reduce the already-shrinking service account deficit by inviting more tourists and increasing earnings from intellectual property usage fees, further increase the income surplus by improving the rate of return on foreign direct investments and narrow the trade deficit by strengthening export competitiveness and ensuring stable, low-cost resource procurement.

Part II　Economic fundamentals and growth strategy and structural reform initiatives in each country

■ Growth strategy and structural reform initiatives in major countries

・In Europe, although signs of economic recovery are starting to appear at long last, the unemployment rate has remained high, being a structural problem. In this situation, labor market reform has emerged as a critical challenge. Efforts to increase labor market flexibility (e.g., relaxing wage adjustment procedures) in southern European countries are attracting attention, but over the whole of Europe, there are moves to place emphasis on resolving inequalities (between regular and non-regular workers) and implement active labor market policies (e.g., support for unemployed people to find jobs) as well. This indicates the importance of a policy mix in the reform.

・In the United States, there have been moves to reshore manufacturing bases ― namely bring manufacturing back to the United States ― mainly for products to be consumed in the domestic market, against the backdrop of the narrowing of the difference in unit labor costs due to wage rises abroad and an improvement of the business environment due to an increase in shale gas and oil production. On the other hand, macroeconomic indicators regarding the manufacturing industry show that some sectors are enjoying positive effects from the increase in shale gas and oil production, but a structural change that deserves to be called a manufacturing renaissance is not currently observable. Regarding the employment situation, there has not been a significant improvement, so creating high-quality jobs continues to be a challenge. While the reshoring movement is attracting attention, U.S. companies have been actively operating abroad. There have also been moves to enhance the deployment of business resources, such as capital investment and R&D expenditures, to foreign affiliates. In addition, U.S. multinational companies are striving to improve their business process efficiency and maintain and strengthen their competitiveness by using foreign affiliates in making strategic business operations that suit the characteristics of countries and regions where they operate.

・Having maintained an average annual economic growth rate of around 10% for more than 30 years, China is expanding its presence in the world economy in terms of GDP, international trade and foreign currency reserves. However, as the various conditions that have until now supported its high growth, such as demographic trends and the wage level, are changing, China's growth rate has recently slowed down to between 7% and 8% and distortions of such growth, for example income inequality, are becoming apparent. If China is to continue economic growth in the future, China will need to implement structural reforms in a broad range of closely interlinked sectors (shifting away from the investment-led growth model, resolving the problem of excess production capacity and problems related to state-owned enterprises, promoting sophistication of industries, carrying out deregulation and financial reforms, establishing social security systems and resolving the problem of local government debts).

・ASEAN4 (Thailand, Malaysia, Indonesia and the Philippines) have been implementing various structural reforms intended to achieve sustainable economic growth. Thailand has promoted the development of high-value added industries and raised the minimum wage. Malaysia is strengthening its service industries in order to attain the goal of transforming itself into an advanced country by 2020. Indonesia is implementing structural reforms regarding industries and exports. The Philippines has positioned the rapidly growing business process outsourcing (BPO) industry as a priority sector.

■ Changes in economic fundamentals and growth strategy in emerging economies

・Some emerging economies suffered serious economic damage from past currency and financial crises. The vulnerability of economic fundamentals of emerging economies was a cause of past crises. However, in recent years, emerging countries have enhanced their risk resilience to external shocks by improving their economic fundamentals. The analysis of the risk resilience and growth fundamentals of emerging countries based on cross-country data shows that there is a positive correlation between these two factors. However, the correlation has weakened somewhat in recent years, indicating that the differences between countries in overall risk resilience and growth fundamentals are narrowing.

・After the Asian currency crisis in 1997-1998, the economy of the Republic of Korea(ROK) recovered from the economic slump caused by the crisis in a relatively short period by carrying out structural reforms in addition to implementing economic stimulus through macroeconomic policy measures. Through bold structural reforms, the ROK aimed to improve economic fundamentals and strengthen the growth base while enduring economic pain. Particularly noteworthy was the ROK's implementation of an aggressive strategy of opening up to the outside world. The ROK implemented a series of measures, including abolishing barriers to market entry, easing the restriction on foreign ownership of the ROK's companies and concluding FTAs. As a result, Western-style corporate governance was introduced, the capital market was liberalized and the establishment of new companies, including venture companies, was promoted in the ROK's economy, leading to the creation of a dynamic cycle of economic regeneration.

・The lists of the top 10 export items of Mexico and Brazil show the contrasting trends for the two countries since the 1990s. While Mexico has made a major shift in export items and now exports mainly industrial products, Brazil has continued to export mainly agricultural products and other primary goods and this trend has recently strengthened further. Behind this difference is the fact that the two countries have pursued different growth strategies. Mexico promoted structural reforms, including liberalization and privatization, and achieved growth as a manufacturing and export base by actively implementing a policy of opening up to the outside world while taking advantage of its proximity to the United States. Meanwhile, Brazil grew the domestic market by fostering domestic industries and expanding the middle class while accepting foreign direct investments. In recent years, Brazil has achieved development through export of resources, mainly to China.

・An automotive industry comparison between Mexico, Thailand and India shows that the industry is export-oriented in Mexico, is balanced between export and domestic sales in Thailand, and is domestic market-focused in India. All of the three countries have shifted away from a policy of protecting domestic industries and have promoted deregulation and conclusion of FTAs amid the international trend of trade and investment liberalization. They have also accepted foreign investments and established strategic platforms of production, exports and sales while taking advantage of their respective characteristics including their geographic locations and the size of the domestic markets, although there are differences between them in the timing, substance and degree of opening up to the outside world.

■ Deepening of trade and investment in East Asia and Japan's contribution to the shift to a new growth model

・Looking at the trade structure in East Asia, intermediate goods, such as parts and components and processed goods, comprise a large proportion of intra-regional trade, whereas the share of final goods, including consumer goods and capital goods, is high in terms of trade with Europe and the United States. This suggests that the international division of production is advanced in the region and final goods assembled within the region are exported to Europe and the United States. We can also see some changes in this trade structure after the collapse of Lehman Brothers, such as a moderate decrease in North America's share and an increase in East Asia's share of exports of final goods from East Asia. Among exporters in Asia, Japan's share has been decreasing over the long term and China is increasing its presence instead.

・The trade structure in East Asia described above has a close relationship with the overseas expansion of Japanese companies. Japanese manufacturing companies have established local subsidiaries overseas centered on Asia through direct investments, and material procurement between the local subsidiaries has become the background to the trade of intermediate goods. In addition to exports of materials including key parts and components, dividends and royalties income derived from overseas local subsidiaries are becoming increasingly important in the way Japanese companies generate income. Looking by country in which local subsidiaries are located, Asian countries hold important positions for Japan as both a destination for exports of materials and a source of dividends and royalties income. In Asia, Japanese local subsidiaries are expanding local sales and procurement and promoting more active research and development activities, which all deepen the relationship between Japanese companies and the region.

・In the shift to a new growth model, which countries are now seeking in order to achieve long-term development, an improvement of the business environment that would allow companies to operate to their full potential will play an important role. This would include the development of high-level human resources for the development of local supporting industries, the enhancement of local companies' capacity, promotion of structural and non-structural infrastructure, and reductions of trading costs through the abolition of non-tariff barriers. We consider that the deepening of the business expansion of Japanese companies in Asia described above can make a contribution to the improvement of the business environment through the provision of technologies, business models and know-how, while also accommodating consumers' needs, which are becoming more sophisticated.

Part III Development of a business environment which expands the business opportunities of Japanese companies

■ Worldwide expansion of economic partnership networks

・Promoting the expansion of free trade and economic partnerships is the key pillar of Japan's international trade policy; in particular, it would be fair to say that tapping into the Asia-Pacific region's growth and major markets by promoting such wide-area EPAs as TPP, the RCEP, the China-Japan-ROK FTA, and the Japan-EU EPA, thereby drawing an economic partnership network across the entire globe, is essential to Japan's growth. In addition, the creation of rules by bodies such as the WTO and APEC – as well as by countries acting voluntarily in individual fields – and compliance with those rules are vital.

・Furthermore, with a view to promoting strategic business development by Japanese companies in emerging economies, it is necessary to work on concluding investment treaties and tax treaties, in order to put in place a stable business environment in those countries.

・Although the information provided by the government and relevant organizations about EPAs/FTAs is being utilized to some extent, there remains some scope for improving awareness; providing specific examples of the use of EPAs/FTAs by other companies could be the catalyst that triggers their use by companies that are not currently using them. In addition, companies that are proactively using EPAs/FTAs are utilizing a range of information, as well as striving to use various methods tailored to their own company to ensure that the know-how acquired concerning the use of EPAs/FTAs does not merely end up as the know-how of certain individuals, but becomes explicit knowledge within the company. In future, it is hoped that increased awareness of the available information concerning EPAs/FTAs (websites, etc.) and the provision of more diverse information will reduce the costs involved in using EPAs/FTAs, thereby helping to promote their use.

■ The emerging economies strategy

・Capturing demand in emerging economies is necessary in order to enable Japanese companies to tap into growing worldwide demand and channel that wealth back into Japan, as well as to promote exports of goods and procurement of components and materials from Japan.

・As part of such efforts, the government has classified emerging economies into three groups (China and ASEAN; Southwest Asia, the Middle East, Russia, and Latin America; and Africa), according to their degree of economic development, the extent of expansion into those regions by Japanese companies, and the competitive environment with companies from other countries, and has been promoting initiatives in each region since 2013.

■ Promoting inward direct investment

・Japan lags behind other countries in terms of inward direct investment, but amid intensifying competition between countries worldwide to attract foreign companies, activating inward direct investment will help to promote open innovation through new stimuli. It is also vital from the perspective of regional economic revitalization.

・With Invest Japan serving as a control tower, the government will implement regulatory and institutional reforms that take into account the views of foreign enterprises, and will work in partnership with JETRO, diplomatic missions overseas, and forward-thinking local governments to conduct activities aimed at attracting foreign investment to Japan.

Explanatory Notes

1. Abbreviated expressions

The main abbreviations used are as follows.

ADB : Asian Development Bank
APEC : Asia-Pacific Economic Cooperation
ASEAN : Association of South-East Asian Nations
BEA : Bureau of Economic Analysis
BIS : Bank for International Settlements
DBJ : Development Bank of Japan
ECB : European Central Bank
ECLAC : UN Economic Commission for Latin America and the Caribbean
EFTA : European Free Trade Area
EPA : Economic Partnership Agreement
ERIA : Economic Research Institute for ASEAN and East Asia
ESA : Economics and Statistics Administration
FAO : Food and Agriculture Organization of the United Nations
FRB : Board of Governors of the Federal Reserve System
FTA : Free Trade Agreement
GATS : General Agreement on Trade in Services
GATT : General Agreement on Tariffs and Trade
GCC : Gulf Cooperation Council
GDP : Gross Domestic Product
GNI : Gross National Income
IEA : International Energy Agency
IEC : International Electrotechnical Commision
ILO : International Labour Organization
IMF : International Monetary Fund
ISO : International Organization for Standardization
JBIC : Japan Bank for International Cooperation
JETRO: Japan External Trade Organization
JICA : Japan International Cooperation Agency
JOGMEC : Japan Oil, Gas and Metals National Corporation
JST : Japan Science and Technology Agency
M&A : Merger and Acquisition
NAFTA : North American Free Trade Agreement
NEDO : New Energy and Industrial Technology Development Organization
NEXI : Nippon Export and Investment Insurance

NIEs : Newly Industrializing Economies
OECD : Organization for Economic Co-operation and Development
PPP : purchasing power parity
RIETI : Research Institute of Economy, Trade and Industry
TFP : Total Factor Productivity
UNCTAD : United Nations Conference on Trade and Development
USDA : United States Department of Agriculture
USTR : office of the United States Trade Representative
WIPO : World Intellectual Property Organization
WTO : World Trade Organization
UN : United Nations
World Bank: an abbreviation for the International Bank for Reconstruction and Development and the International Development Association.

* EPAs/FTAs
A "Free trade agreement (FTA)" is an agreement which proposes to abolish tariffs and other restrictive trade laws between the contracting countries. An "Economic partnership agreement (EPA)" is a wide-ranging series of agreements seeking to integrate market systems and economic activities into the elements of an FTA. Unless otherwise specified, this White Paper uses the FTA/EPA as a collective term inclusive of the tariff agreements under both the EPAs and FTAs (agreements to abolish tariffs and other restrictive trade laws within the region, and to establish the region as a uniform tariff region which applies the same tariffs and other restrictive trade laws toward countries outside the region).

2. Materials

The abbreviations of the main foreign statistics used are as follows.
(1) World Bank statistics
WDI: World Development Indicators
(2) IMF statistics
DOT: Direction of Trade Statistics
IFS: International Financial Statistics
BOP: Balance of Payments Statistics
WEO: World Economic Outlook
(3) Other statistics
PS&D: Production, Supply and Distribution Database (United States Department of Agriculture)

3. Figures/ mathematical expressions, etc.

(1) A year, written within the text or within a statistical table, is a calendar year (January-December) unless stated otherwise. Likewise, a financial year (FY) is the 12-month period from April 1 to March 31 of the following year, unless stated otherwise.

(2) Figures are rounded, as a general rule. Therefore, there are cases where figures are not consistent with the corresponding total.
(3) When used alone, with no values following it, the symbol "-" indicates that a value is unclear, cannot be reported, or does not exist for the relevant item, unless stated otherwise. A "0" indicates a value of less than one.
(4) This White Paper is based on the statistics, etc. available at the time of the writing. Later revisions, etc. are not reflected in this document.

4. Classification of countries and regions

(1) In some cases, the term "country" includes regions.
(2) The definitions of NIEs and ASEAN are as follows:
 (a) NIEs are four countries/regions: South Korea, Taiwan, Hong Kong and Singapore.
 (b) The first three of these countries/ region (South Korea, Taiwan and Hong Kong) are referred to as "NIEs3" in this White Paper.
 (c) ASEAN is 10 countries: Thailand, the Philippines, Indonesia, Malaysia, Singapore, Vietnam, Brunei, Laos, Myanmar and Cambodia.
 (d) The first four of these countries (Thailand, the Philippines, Indonesia, and Malaysia) are specially referred to as the "ASEAN 4", and the first six countries/ region (Thailand, the Philippines, Indonesia, Malaysia, Singapore and Vietnam) are specially referred to as the "ASEAN 6" in this White Paper.
(3) "BRICs" refers to 4 countries (Brazil, Russia, India, and China) is referred to as.
(4) The European Union (EU) was founded when the Treaty on European Union came into effect in November 1993. The 12 countries of the EU at the time of foundation are referred to as "the EU12"; the 15 countries from January 1995, as "the EU15"; the 25 countries from May 2004, as "the EU25"; and the 27 countries from January 2007, as "the EU27."
(5) In some cases, the term "Germany" indicates West Germany before the unification of the country. Because of this, there are cases where the figures for each year are not consistent.
(6) "OPEC" has 11 members: Iraq, Iran, Kuwait, Saudi Arabia, Venezuela, Qatar, Indonesia, Libya, the United Arab Emirates (UAE), Algeria and Nigeria. In many cases, however, the statistics from Iraq are lacking. Therefore, OPEC is deemed to include only 10 countries, excluding Iraq, in the analyses of statistics, as a general rule.
(7) "GCC" refers to 6 countries/regions: Saudi Arabia, Kuwait, Bahrain, Qatar, UAE and Oman.

(8) "MERCOSUR" refers to Argentina, Brazil, Uruguay and Venezuela.
 However, Bolivia and Paraguay are also member countries. (See Notes 1 and 2)
 (Note 1) Bolivia signed the accession protocol in December 2012 and is now waiting for ratification of each parliament. Bolivia does not have a voting right.
 (Note 2) Paraguay suspended its right to participate in MERCOSUR meetings. Although the suspension was terminated when President Cartes became president on August 15, 2013,

Paraguay has not still rejoined the meeting as of October 2014.

(9) The maps referred to in this material do not exhaustively cover territories in Japan.

This paper was compiled with information obtainable as of the end of April 2014 except for where otherwise noted.