Section 2   Evaluation of current account balance fluctuations

【Key points】
1. The Japanese economy and IS balance trends
   From a macroeconomic perspective, the current account balance weighs the Japanese economy against the world. It expresses the difference between savings and investment, reflecting changes in savings and investment behavior and population composition, fiscal balance fluctuations and other medium- to long-term factors. In the past, Japan’s IS balance has demonstrated excess savings on the part of the household sector, and excess investment by the corporate sector. The household sector savings ratio, while remaining at a high level, has maintained a gradual downturn since Japan’s high-growth period, while the corporate sector has begun to record excess savings in recent years as plant and equipment investment has fallen away. As a result, the private sector has seen excess savings continue to expand since the 1990s. In the government sector, the fiscal deficit grew in the early 1990s due to reduced tax income and rising social welfare payments but has recently started to shrink, and excess investment in the government sector has stopped expanding and is instead falling away. The national IS balance, which represents the amalgamation of these results, reveals no clear trends at this point in time.

2. Perspective on current account fluctuation
   The recent fluctuation in Japan’s current account balance is due primarily to an export slump, a short-term factor caused by the worldwide economic slowdown.

   However, fluctuations in Japan’s current account balance are heavily determined over the long term by the IS balance, and particularly by investment trends. Greater domestic investment reduces the current account surplus, but boosts economic growth and sustains economic vigor, producing more stable capital inflows. Conversely, stagnant domestic investment expands the current account surplus, but if economic dynamism is lost as a result, international competitiveness too can be affected. When considering the state of the Japanese economy, therefore, rather than excessive emphasis on current-account fluctuations, particularly over the short-term, priority should be placed on stimulating investment and the economy and maintaining the credibility of the Japanese economy.

3. Evaluation of current account level and economic revitalization
   While the dwindling current account surplus seems to be causing concern in some quarters, no clear relation is evident in Japan or elsewhere in the world between the current account level on the one hand and unemployment rates and international competitiveness on the other. To lock
in future economic development, it will be vital to stimulate investment, the wellspring of economic growth, and work to improve the domestic economic environment to attract inward investment, boosting Japan’s international credibility and standing.

1. The Japanese economy and IS balance trends
(1) Japan’s current account balance and IS balance

As noted in the previous section, trends in the current account and trade balances have recently been heavily affected by short-term cyclical factors reflecting economic trends in Japan and the world. The economic slowdown occurring in the United States and indeed worldwide caused exports to slump while imports increased, resulting in a substantial pullback in the trade and current account surpluses in 2001.

From a macroeconomic perspective, the current account balance expresses the gap between savings and investment. The current account balance reflects changes in the savings and investment behavior of companies and individuals, shifts in the budget balance, changes in population composition, and other medium- to long-term structural factors.

(2) Trends in IS balance by sector
(a) High savings rate in household sector

In the past, factors behind Japan’s high household savings rate (an average of 15 percent in the 1960s, 20 percent in the 1970s) included: (1) more disposable income as a result of high economic growth; (2) the motivation to save prompted by the low postwar level of household assets; (3) the bonus system; (4) the high percentage of young people in population composition; (5) people saving for their old age due to low public pensions; (6) undeveloped consumer credit systems; (7) tax breaks such as the preferred savings system; (8) government and Bank of Japan encouragement of saving; and (9) the nature of the Japanese people.

Accompanying the gradual loss of relevance of many of these factors, the household savings rate slowly began to slip as of the mid-1970s, although still remaining relatively high. In the 1980s, the average rate was 15 percent; in the 1990s, 13 percent. However, the savings rate has leveled off since the mid-1990s (Fig. 2.2.1) due to negative asset effects such as falling land and stock prices prompted by the collapse of the bubble economy, while consumption fell in response to uncertainty over employment, post-retirement years and other future prospects.
(b) Investment trends in corporate sector

Plant and equipment investment by the corporate sector dropped following the two oil shocks of the 1970s, but staged a gradual recovery to regain vigor as of the late 1980s (Fig. 2.2.1). The corporate sector’s investment surplus subsequently shot up to reach negative 8.9 percent of GDP in FY1990. In the 1990s, however, the collapse of the bubble caused plant and equipment investment to decline, leading the corporate sector to run a savings surplus as of the mid-1990s. In FY1998, the corporate sector’s savings surplus had climbed as far as 6.6 percent of GDP (Fig. 2.2.2).
(c) IS balance in the government sector

The IS balance in the government sector began to record a savings surplus in the late 1980s due to rising tax revenue and progress with fiscal restructuring. However, in the 1990s, expansion of the fiscal deficit replaced this with an investment surplus. On the revenue side, the slump in tax income was one of the main factors behind this trend. The economic slowdown following the collapse of the bubble economy reduced income, while a succession of tax cuts—six trillion yen in 1994, including income tax; a four trillion yen special tax reduction in 1998; and a permanent tax cut of more than six trillion yen in 1999 for income and corporate tax—slashed back direct tax revenues.

In terms of expenditure, the government implemented a succession of measures to boost the economy following the bubble’s collapse, while the graying of society increased social security spending. The once-substantial savings surplus registered by social security funds began to diminish rapidly as of the 1990s (Fig. 2.2.3). One factor behind this trend has been the growth in social security benefits paid to the elderly as Japanese society ages (Fig. 2.2.4). As a result, the fiscal deficit began to expand in the 1990s.

Figure 2.2.3 Details of public finance balance

Source: National Accounts (Cabinet Office)
This growing fiscal deficit could become a burden on the current or future economy and impede economic growth over the medium- to long-term. As society ages, further expansionary pressure will come to bear on social security spending, but it will be important to pursue structural reforms\(^1\) in the relevant areas to promote a sounder fiscal situation. Very recently, the fiscal deficit has begun to diminish, dropping to negative 7.5 percent of GDP in FY1999, then to negative 6.6 percent in FY2000, with the investment surplus in the government sector shifting from expansion to contraction.

\((d)\) Recent trends in the IS balance

Trends to date in Japan’s IS balance reveal an almost consistent savings surplus in the household sector and an almost consistent investment surplus in the corporate sector. However, as of the late 1990s, while there has been no substantial change in the savings surplus trend demonstrated by the household sector, the corporate sector’s investment surplus has changed to a savings surplus, with the result that the savings surplus in the private sector has continued to grow since the 1990s. By contrast, the investment surplus in the government sector moved on to a growth trajectory as of 1992, but has more recently begun to shrink. In combination, the two elements offset each other, so that no clear trend has emerged in terms of the overall IS balance\(^2\)

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\(^1\) *Structural Reform and Medium-Term Economic and Fiscal Perspectives* (Council on Economic and Fiscal Policy, January 2002)

\(^2\) These only indicate an ex post facto equal constant relationship, and not a simple causal relationship such as increased fiscal spending reducing the current account surplus.
2. Perspective on current account balance fluctuation

(1) Long-term and short-term fluctuations in the current account balance

Fluctuations in the current account balance need to be considered in two parts: the long-term structural element and the short-term cyclical element.

The long-term structural element of the current account balance refers to the current account balance level where a national economy achieves full employment and the economy is in equilibrium. The short-term cyclical element refers to the fluctuation which occur when full employment breaks down because of economic fluctuation.

Fluctuations in the Japanese current account balance can be explained long-term in terms of the IS balance as noted above, but the recent decline of the current account surplus has been heavily influenced by a short-term factor, namely the export slump resulting from the slowdown of the world economy.
With the cooperation of Professor Kyoji Fukao of the Institute of Economic Research, Hitotsubashi University, and Assistant Professor Makoto Chigira from the Department of Economics, Toyo University, we estimated the extent of the structural component of the current account balance which can be explained by the IS balance in order to conduct a positive analysis of the long-term structural and short-term cyclical components of the current account balance.

(2) Short-term fluctuation in the current account balance

(a) Equilibrium current account balance

An economy is thought to reach a state of full employment through the long-term operation of price mechanisms. The real exchange rate, a factor regulating the relative domestic and offshore prices of goods, serves as the instrument of adjustment bringing the current account balance into accord with the IS balance at the point of full employment. Therefore the current account balance is fixed by savings and investment trends in the long-term. This is known as the IS balance theory, based on which the current account balance is referred to below as the equilibrium current account balance, while the exchange rate which realizes this is called the equilibrium exchange rate.

For example, where an offshore production shift caused exports and imports to fluctuate despite the continued presence of a large savings surplus, resulting in a shrinking current account surplus, the country would experience a short-term oversupply of goods. However, over the medium- to long-term, the deterioration of the domestic economy would cause real interest rates to fall and the currency of that country to devalue, expanding the current account surplus. In other words, offshore transfers of production and other factors causing import and export fluctuations are absorbed through currency rate adjustment over the long term. However, where these factors impact on long-term savings and investment trends, the current account balance will also be affected over the long term.

The actual current account balance fluctuates primarily due to fluctuations in the equilibrium current account balance, as well as domestic and external economic fluctuations and

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3 Estimate based on Fukao (1987) method (see Appended Note 2.2.1), adding the direct impact of the rising offshore productivity ratio of Japanese companies and Asian economic trends on Japan’s imports and exports.

4 See Appended Note 2.2.1 (3. Details of equilibrium value calculation process) in regard to calculation of the equilibrium current account balance, equilibrium exchange rate and full employment GDP.
the distance between the equilibrium exchange rate and the actual exchange rate. The following analysis was undertaken accordingly.

(b) Recent short-term fluctuation

Figure 2.2.6 estimates the equilibrium current account balance and compared this to trends in the real current account balance. In recent years, the distance between the actual value of the current account balance and the equilibrium value has expanded, with the actual value falling well below the equilibrium value. This suggests that recent fluctuations in the current account balance have been caused mainly by short-term cyclical factors. The 2001 decline in the current account surplus too appears to have been primarily affected by short-term factors, namely the slump in imports following the slowdown of the domestic economy at the same time as world economic deceleration caused exports to plummet.

(3) Long-term fluctuation in the current account balance

(a) Factors expanding the current account surplus

Figure 2.2.7 shows the main external variables explaining fluctuation in the equilibrium current account balance in the 1990s, as well as the extent of the impact of these. The

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5 Exchange rate changes and GDP fluctuations were treated as external factors.
6 The state where the economy has reached full employment. The exchange rate is treated as an internal factor and GDP is the value of full employment.
7 The reaction of the nominal current account balance was examined for the first quarter of 1995 when each of the main external variables was shifted.
equilibrium current account balance tended to expand in the late 1990s, based on which it was calculated that fiscal restructuring efforts since 1996 had shrunk fiscal spending on full employment, reducing the investment surplus in the government sector and pushing up the equilibrium current account balance to around one percent of GDP as of 1996.

(b) Factors shrinking the current account surplus

Factors surmised to have pushed down the equilibrium current account balance in the 1990s are the fall in world interest rates, the fall in import prices, and the increased sales of Japanese affiliates established abroad, reducing the equilibrium current account balance by minus 0.3 percent, minus 0.5 percent and minus 0.6 percent respectively of GDP.

(Rise in offshore production ratio and increase in re-imports)

Greater foreign direct investment has been followed by offshore operations by Japanese companies, consequently boosting the sales of local foreign affiliates. The offshore shift of the manufacturing industry has been indicated as the cause of Japan’s slowing exports and import growth. Amid economic globalization, Japanese companies have moved offshore in search of

8 This calculation does not consider whether the fall in internal investment in Japan is due to long-term factors such as excess capital and changes in population composition, or whether it is due to temporary factors such as growing uncertainty.
optimal business conditions. Manufacturers have increasingly tended to shift their production bases into China and other Asian countries offering low labor costs, with the offshore production ratio for manufacturers rising almost consistently since the 1990s (Fig. 2.2.8).

Because the offshore production shift reduces exports of finished goods but boosts exports of interim goods to offshore production bases, exports do not decrease over the short-term. However, it is a long-term factor in diminishing exports due to the fall in the average unit price for exports, the offshore shift of production facilities for interim goods, and growing offshore local procurement ratios.

Moreover, as a result of the offshore production shift of the manufacturing industry, re-imports by Japanese companies have surged, particularly from Asia. Re-imports currently comprise as much as 15 percent of total imports (Fig. 2.2.9).
In terms of current account balance fluctuation, this increase in foreign investment such as the offshore shift of production reduces exports and brings about a structural increase in imports due to the expansion of re-imports, and as such serves as a long-term structural factor in reducing both the trade and current account surpluses.

(c) Investment-related fluctuation in the current account balance

As observed above, Japan’s investment activity plays a considerable role in current account surplus fluctuation. Because the current account balance is determined by the difference between total domestic savings and total domestic investment, where other factors are equal, the stimulation of domestic investment reduces the current account surplus. However, this reduction of the current account surplus is also evidence of the growth and revitalization of the domestic economy. Even where a smaller current account surplus and a greater deficit does result, if Japan can maintain the credibility of the domestic economy, this will open the way for retaining a stable capital inflow.

Conversely, a slump in domestic investment will expand the current account surplus. However, more sluggish investment will also detract from the dynamism of the domestic economy and cause a further reduction in investment not only in but also from outside Japan, threatening Japan’s international competitiveness. Further, if domestic companies favor foreign over domestic investment and expand the former, this will ultimately impact on fluctuation in the current account balance through the change in imports and exports.

When considering the state of the Japanese economy, therefore, rather than excessively emphasizing fluctuation in the current account surplus, and particularly short-term fluctuation, the priority should be placed on stimulating investment and the economy and maintaining the credibility of the Japanese economy.

3. Evaluation of current account level and economic revitalization

(1) Concern over shrinking current account surplus

Some have linked the recent shrinking of the trade and current account surpluses noted above to a drop in international competitiveness, and are concerned at this trend.

For example, the view has been expressed that the diminishing current account surplus will reduce employment by domestic industries and increase unemployment, and that because the current account surplus is the measure of a country’s competitiveness, we must prevent the surplus from declining and becoming a current account deficit. However, is this an accurate
perception?

Current account balance fluctuation needs to be considered in terms of long-term structural elements and short-term cyclical elements. The current account balance primarily reflects the relative relation between a country’s gross savings and gross investment, and responds not only to short-term cyclical fluctuation such as changes in economic conditions, but also to long-term structural fluctuation such as changes in the savings ratio, investment ratio, fiscal account balance and population composition.

(a) The current account balance and the unemployment rate

Firstly, there is no clear relation between the current account balance and the unemployment rate. Figure 2.2.10 indicates changes in the current account balances and unemployment rates of OECD countries in the early and late 1990s. No clear relation is indicated between changes in the current account balance and changes in the unemployment rate. A falling current account surplus which is not accompanied by growing exports and production can reduce domestic demand and cause unemployment over the short-term. However, this impact is generally temporary. Over the medium- to long-term, the labor force shifts from sectors with low productivity which are slumping as a result of increased imports to sectors with high productivity which are in a growth phase, with the national industrial structure undergoing adjustment.

Figure 2.2.10  Changes in national current account balances and unemployment rates

Note: Change from early 1990s (1990-95) average and late 1990s (1996-2000) average.
Sources: IFS (IMF), Employment Outlook (OECD)
(b) The current account balance and international competitiveness

Secondly, the current account balance does not reflect a country’s so-called “competitiveness”\(^9\). Figure 2.2.11 looks at the relation between changes in the “world competitiveness rankings”\(^{10}\) of the main powers as evaluated by the International Institute for Management Development (IMD), a Swiss research institute, and changes in the level of current account balances. No clear relation appears between the rise in what is generally called “competitiveness” and current account surplus expansion or deficit reduction. The level of the current account balance would not seem to be determined by the factor of “competitiveness”.

![Figure 2.2.11 Changes in national current account balances and international competitiveness](image)

Note: Change from 1990 to 2001.
Sources: IFS (IMF), *The World Competitiveness Yearbook* (IMD)

(2) Stimulation of investment and credibility of the domestic economy

As a falling current account surplus therefore neither reduces long-term employment nor reflects a drop in international competitiveness, the level of the current account balance does not in itself merit much concern. It would be inappropriate to position manipulation of the level of the current account balance as a principal arbitrary policy objective.

Regardless of the level or direction of change in the current account balance, if a country can maintain the international credibility and estimation of its economy, this will lock in stable investment and capital inflows, opening the way for economic stimulation and sustained growth.

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\(^9\) A number of experts (see Krugman, 1997) have expressed skepticism regarding the concept of national competitiveness.

\(^{10}\) Due to changes in evaluation criteria, there is no strict continuity before and after 1997.
international competitiveness. For example, even where developing countries operate ongoing current account deficits, this is not problematic as long as stable capital inflows are locking in steady economic development. Conversely, a country needs to avoid the combination of accumulating external debt and economic recession raising country risk and limiting offshore financing, as has been the case of Argentina because of the economic confusion which has reigned there since fall 2001.

The truly critical issue in terms of future economic development is to stimulate investment as the source of economic growth, working to improve the domestic economic environment to attract foreign investors, and boosting and maintaining the international credibility and estimation of the Japanese economy\textsuperscript{11}.

\textsuperscript{11} See Section 3 concerning internal investment and stimulation of the domestic economy.