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Japan After an 'Export Bubble'

Recent economic indicators of the performance of the Japanese economy have been weak and prognosis negative.[1] In December Japanese industrial output contracted by 10%. In January this trend intensified. Moreover Toyota has announced 7,000 job losses and Honda a four month closure of their UK plant. Other labour market indicators and consumption related data suggest that the negative shock in the manufacturing sector is spreading gradually to the household sector.[2]

Paul Kurgan, has suggested that the Japanese economy is in 'free fall' as is world trade.[3] This view can be linked to those who accuse Japan of relying on exports for growth and contributing to international imbalances that lie at the heart of the current financial crisis.[4] Nevertheless one must be cautious about confusing short term macroeconomic performance with the economy's fundamental long term health. Questions must also be asked about how critical export growth is to the Japanese economy.

I. Trade Balance

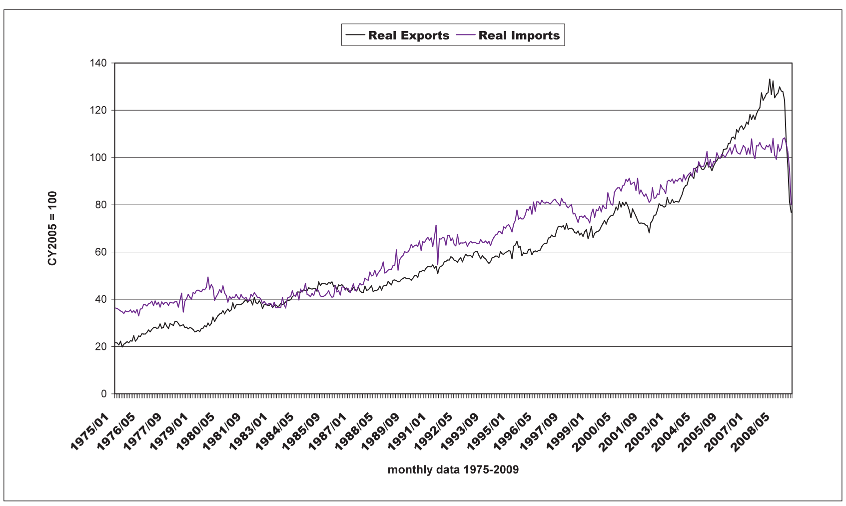
Weak projections for Japanese growth are linked to arguments that the economy is reliant on exports and therefore foreign economic conditions. Certainly nominal exports have fallen by almost 3% in 2008. Nominal Imports have also started to decreased due to weak domestic demand. It should be noted that the high nominal value of total imports in recent years is accounted for by a rise in import prices rather than an increase in volume (Table 1).

Table 1: Nominal Exports and Imports

Name of time-series	Total Exports (million ¥)	Year-on-year % growth rate	Total Imports (million ¥)	Year-on-year % growth rate
1996	435,660		347,172	
1997	495,190	13.66	374,211	7.79
1998	488,663	-1.32	331,138	-11.51
1999	457,948	-6.29	320,163	-3.31
2000	495,256	8.15	371,538	16.05
2001	465,835	-5.94	381,821	2.77
2002	494,797	6.22	379,294	-0.66
2003	519,341	4.96	399,576	5.35
2004	582,951	12.25	443,929	11.10
2005	626,318	7.44	522,971	17.81
2006	716,308	14.37	621,665	18.87
2007	797,254	11.30	674,030	8.42
2008	773,522	-2.98	733,183	8.78
Jan-09	32,822	-	41,266	-
Feb-09	29,934	-	38,584	-

Source: Bank of Japan

Figure 1: Real Exports and Imports



Source: Bank of Japan

By contrast, the total value of real exports and imports has shown sharp falls (Figure 1).

Real exports have been on an upward trajectory since at least 1975 (Figure 1). Particularly striking, however, is the steep upward trend from 2002 to 2008 and subsequent dramatic fall. According to JP Morgan Global Data Watch, the decline in real export growth accelerated to -68.6% in January 2009 and -73.1% in February, compared to –48.1% in December 2008 (seasonally adjusted annual rate)[5]. These falls have impacted most heavily on Japanese manufacturing, particularly small firms that are highly exposed to foreign orders (Table 2).

Real imports also have been declining since October 2008 as the pace of the domestic contraction has accelerated, particularly for the last two months (Jan-Feb). These falls in imports reflect an environment of weakened domestic demand and pessimism.

As a result of high oil and other commodity prices in 2007 and first half of 2008, outflows of income from Japan have increased (Figure 2: Table 3). The Ministry of Economy, Trade and Industry (METI) estimated that Japan's trading loss was approximately 21 trillion yen in 2007 (6% higher than in 2006).[6] The indications are that this has lead the Government to recognise the need for major structural change in the Japanese economy. METI has recommended that Japanese firms invest to improve resource productivity and strengthen mechanisms for innovation to heighten added values of products and services.[7] However, there are longstanding debates (both within the Japanese and English language literature) over the extent and effectiveness of Japanese Government efforts at directing investment activity.[8]

Japan has had a real trade surplus only sporadically: 1980-1987; 1992-1993; 1997-2000; 2002-2008; and again in February 2009. The real trade surplus increased by more than 200% for the period 2005-2008 (Figure 3). Much of this is explained on the export side. An export boom was maintained by the increase in worldwide consumption arguably facilitated by a so-called 'credit bubble'. The

Table 2: Ministry of Finance Business Outlook Survey Index

Large firms	**3Q 2008**	**4Q 2008**
all industries	-10.2	-35.7
manufacturers	-10.0	-44.5
non-manufacturers	-10.2	-30.5
Small firms		
all industries	-34.3	-40.7
manufacturers	-34.7	-51.3
non-manufacturers	-34.3	-38.5

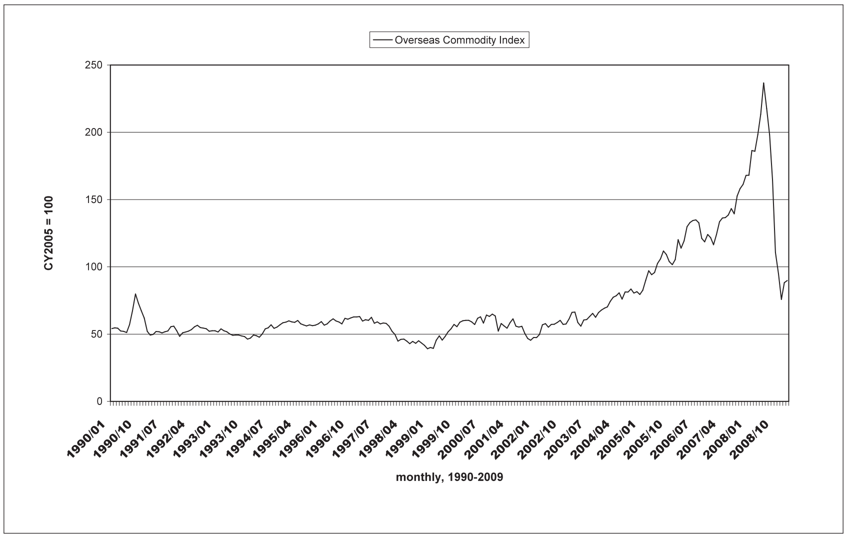
Source: JP Morgan, Global Data Watch, March 2009

Table 3: Bank of Japan Overseas Commodity Index

Month	**Index**	**Month**	**Index**
January 2008	168.1	August 2008	198.1
February 2008	186.5	September 2008	164.6
March 2008	185.9	October 2008	110.7
April 2008	198.2	November 2008	94.8
May 2008	213.4	December 2008	75.8
June 2008	236.7	January 2009	88.2
July 2008	217.6	February 2009	89.8

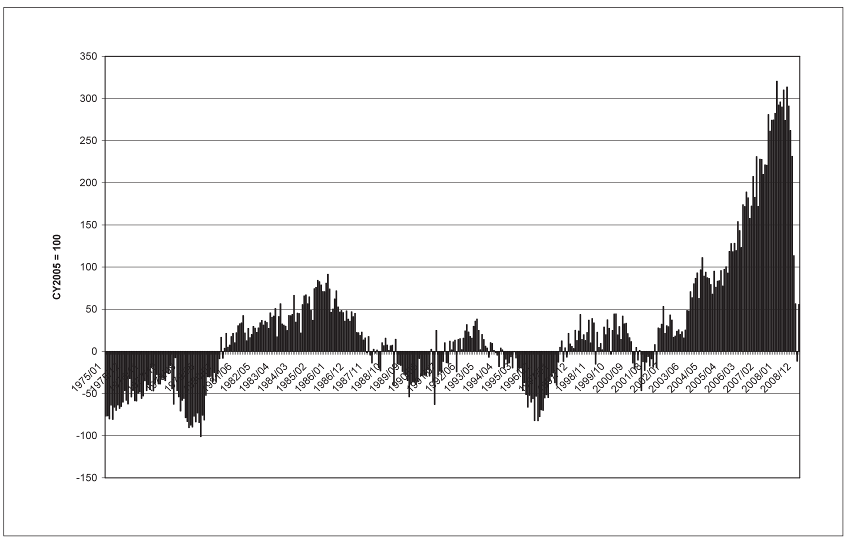
Source: Bank of Japan

Figure 2: Overseas Commodity Price Index



Source: Bank of Japan

Figure 3: Real Trade Boom from 2002 to Jan 2008 (trade balance, seasonally adjusted)



Source: Bank of Japan

bursting of this and consequently of the Japanese 'export bubble' has naturally had an effect on inventory, production and employment levels.

II. Current Account

In January 2009 the Japanese current account went into deficit for the first time since 1996, but recovered sharply in February (Figure 4). Which as been the usual case in the relatively few previous instances of monthly deficits. Which reinforces the view of Japan's current account surplus being structural. Reflecting a low propensity to import, a highly competitive export sector, diversified production base substituting for imports and an economy unreliant on foreign capital. This emerging structure is deeply rooted historically and traceable back to at least as far as the inter-war period.[9]

However, while the surplus had been supported by the exports of production and services for decades, from 2005 portfolio and direct foreign investment income took a leading role (Figure 5). The former accompanied the accelerated spread of complex financial instruments (equity and debt securities) in the international capital markets. However, questions must be raised about whether this marks a long-term structural shift or merely amounts to a short term temporary phenomenon.

Indications are that the latter would seem to be the case. Portfolio investment is now on a downward trend in line with the international credit crunch and the collapse of major financial institutions. For example, there were large losses for hedge funds in Asia throughout 2008. The top ten Asian funds saw assets fell on average by 50% compared to 21.5% for European based funds, and 25.3% for all funds.[10] The total estimated assets managed by hedge funds decreased by 23.2% in 4Q of 2008 to US$1,932 trillion. However, it should be stressed that the total assets administered by the top 10 Asian hedge funds accounted for only 1.38% of global managed assets in 4Q of 2008 (see Table 4). That is, Asia has not been a major field of activity or base for hedge funds.

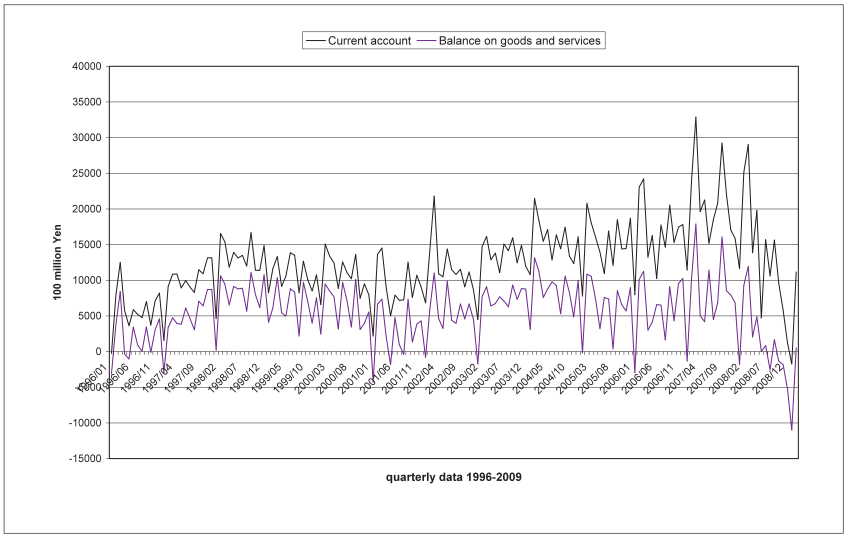
Furthermore, according to the Policy Board of the Bank of Japan, the unwinding of positions by hedge funds due to redemptions requested by their clients is likely to be one of the causes of the fall in Japanese stock prices and the appreciation of the exchange rate.[11] The repatriation of capital into Japan following the unwinding of the carry trade is also likely to explain the temporary fall in the current account surplus.

III. Trade Partners

In terms of trading partners, Japan has a regular surplus with Asia, the EU, the US and Central & South America (Figure 6). It maintains a deficit with China (although relatively close to balance) and with countries from which it imports commodities - Australia, the Middle East and Africa (Figure 7). The deficit against the Middle East increased by 177% from mid-2005 to reach almost ¥45,391 million in the 3Q of 2008.

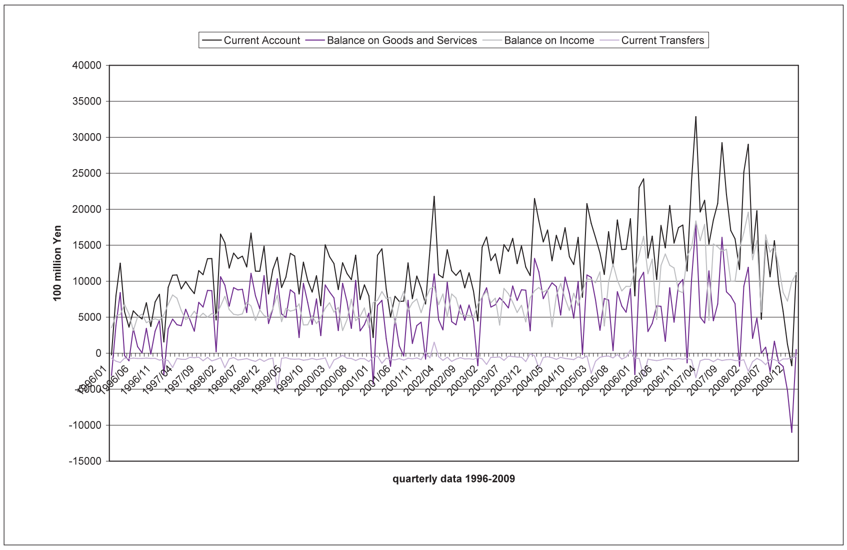
While the current account surplus with the EU has been on an upward trend since 2002,

Figure 4: Quarterly Current and Trade Account Balances 1996-2009



Source: Bank of Japan

Figure 5: Quarterly Income Flows 1996-2009



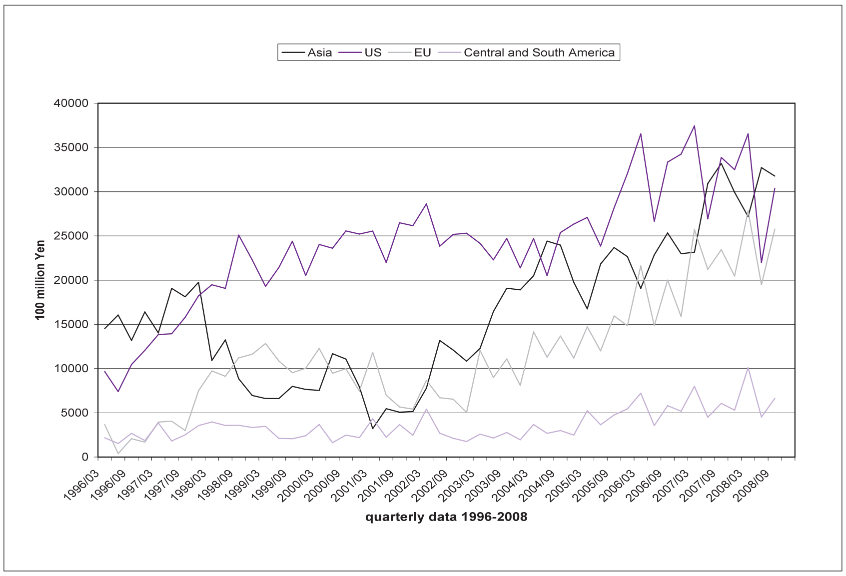
Source: Bank of Japan

Table 4: Top 10 Hedge Fund Administrators with funds in Asia

Hedge Funds	Asian assets under administration (US$ billion) 4Q 2008	Asian assets as a % of total assets under administration
Citco Fund Services	11.25	3
RBC Dexia Investor Services	2.75	10
OpHedge Investment Services, LLC	2.15	6
Trident trust	2.12	10
NAV CONSULTING, Inc	2.00	8
Harmonic Fund Services	1.90	12
SS&C Fund Services	1.50	2
Kingsway Taitz Fund Adm	1.40	100
Citi	0.86	1
Meridian Fund Services	0.80	7
Total	26.72	

Source: www.hedgefund.net

Figure 6: Bilateral current account surpluses with Asia, the EU, the US and Central & South America



Source: Bank of Japan

when the export bubble began to emerge, it has been overtaken by the surplus with the rest of Asia.

Particularly sensitive politically, has been Japan's current account surplus with the US which oscillated for almost a decade around ¥25,000 million until the 4Q of 2005. The large and persistent Japanese and Chinese current account surpluses are seen as a major cause of the current financial crisis[12]. After 2005 the Japanese structural surplus was then greatly augmented, supported by an inflationary rise of dividends, equity and debt income in the context of the credit bubble.

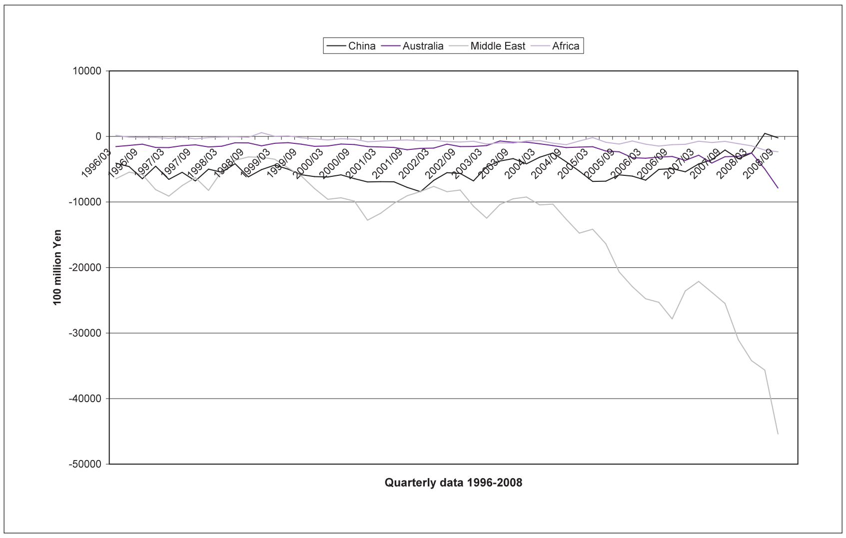
IV. Asian Trade

Japan's current account surplus with

Asia has risen dramatically since 2002. Much of this can be explained by an increase in the trade surplus (Figure 8). Trade of services such as transportation, construction and communication are much less important and only turned into surplus in 2006 and 2007. Portfolio investment income likewise has a relatively minor role (Figure 9). The most important component of the income flows in the Asia Pacific region is direct investment income which has risen steadily during the 2000s (see Figure 10). This is arguably part of a permanent long term trend and linked to a continued expansion of Japanese foreign direct investments in Asia over the last two decades.

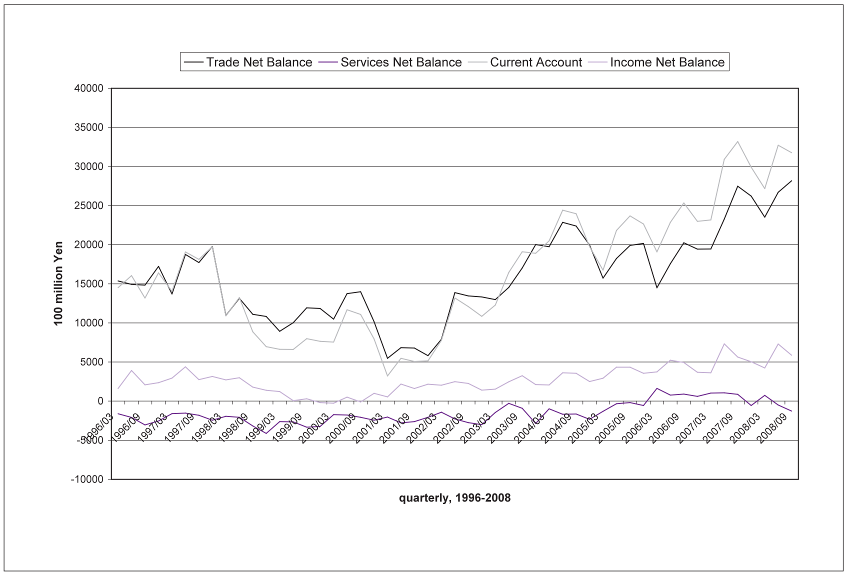
Although causation is not necessarily implied, capital outflows from Japan to emerging markets have risen in accordance with the Japanese Government's current economic growth and regional strategies. METI recommends the development of a system that will foster the flow back of income to Japan from emerging countries in Asia. The new growth mechanism reinforces competitiveness via commitment of channelled-back funds to future innovations and distributing them to household income.[13] It is hoped that a change in the investment strategies of Japanese affiliated firms abroad will redirect income from foreign markets back into to the country and provide the foundations of productivity growth. However, economic integration in East Asia continues to deepen via trade and research partnerships with ASEAN.[14] Arguably this is a recognition by the Japanese Government that in a mature, post-catch up high speed growth economy new

Figure 7: Bilateral current account deficits with China, Australia, Africa and Middle East



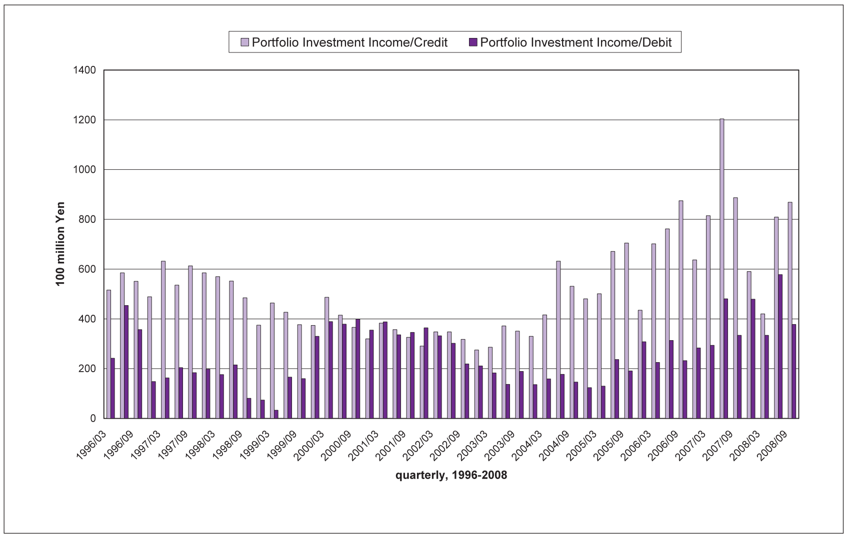
Source: Bank of Japan

Figure 8: A trade and current account surplus with Asia



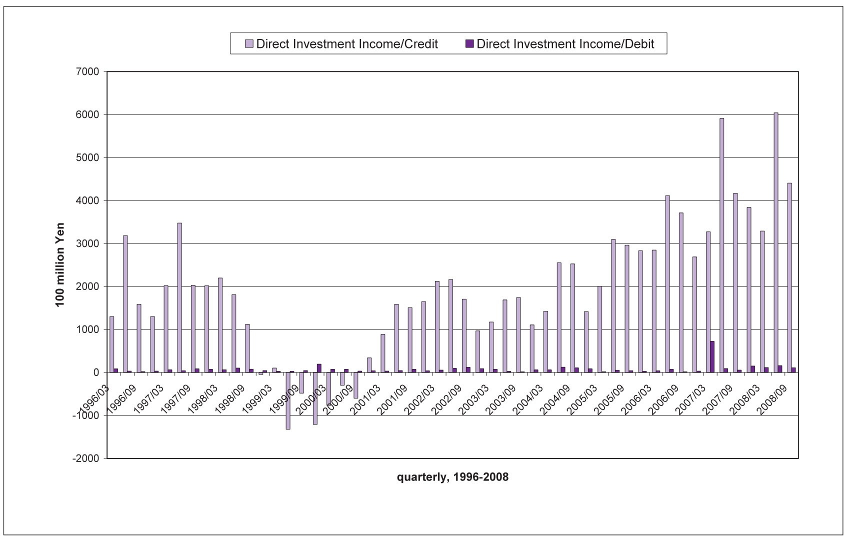
Source: Bank of Japan

Figure 9: Income from Portfolio Investments in the Asian region



Source: Bank of Japan

Figure 10: Income from Japanese Direct Investments in the Asian region



Source: Bank of Japan

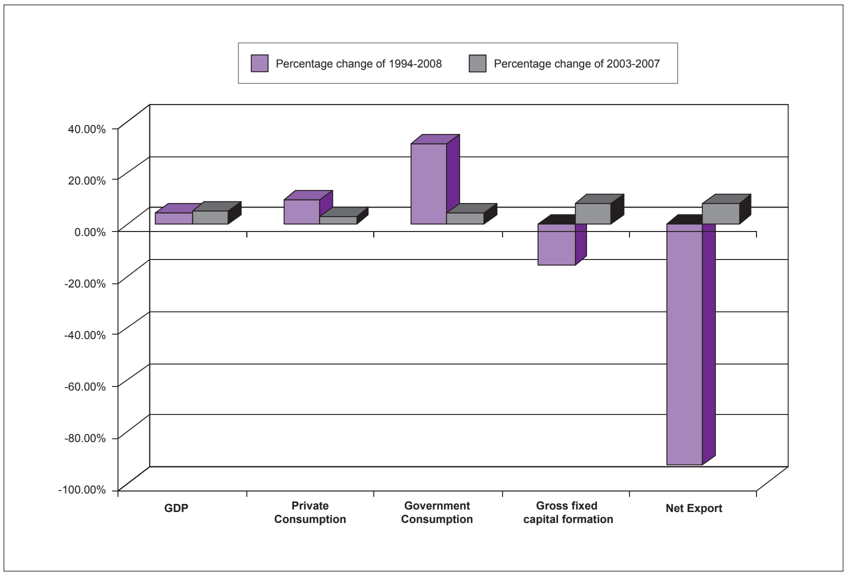
ways need to be found to find high yielding investments. On the one hand is a desire to tap into low capital/labour ratios in East Asia where returns are higher and on the other to use the income from this export of capital to identify future domestic industries and deal with problems associated with an aging population.

V. Conclusions

Just how important is this fall in exports for the Japanese economy? If, as is often presumed, Japan is an export-led economy, the results are likely to be very large. Figure 11 disaggregates Japanese GDP growth into its major components.

Certainly movements in net exports would appear to have a disproportionate effect on GDP growth, implying that the cyclical movements in the Japanese economy has been tied to exports and to a lesser extent fiscal stimulus. However, it is clear that policies such as macro-economic stimulus or exchange rate depreciation, while possibly at best a short term panacea for cyclical downturns (at worst a major cause of domestic and even international asset price inflation) are not likely to lead to sustained and substantial increases in Japanese economic growth. Such changes, if deemed desirable, require permanent substantial increases in Japanese domestic consumption and investment rates. This is a hard task: the Japanese economy is a mature one where high yielding investments are not easily found. Nevertheless, the Japanese Government's policy of encouraging direct investment in East Asia while using income from this source to find new innovative post-high speed growth industries would seem appropriate. Calls from the US government and US based economists on Japan to use conventional macro-economic solutions to deal with the international recession insofar as it relates to the problems of inbuilt imbalances are and a mature economy would appear on the basis of this discussion to be misguided.

Figure 11: During the export bubble all GDP components went up particularly Investment and Net Export (nominal percentage changes)



Source: Statistics of National Accounts, Japan

Endnotes

1 Krugman, P. (2009), *The eschatology of lost decades* (http://krugman.blogs.nytimes.com/2009/02/18/the-eschatology-of-lost-decades)

2 The unemployment rate has risen to 4.4%, Financial Times ‘Japan unemployment hits three-year high’, 31st, March 2009

3 Krugman op.cit.

4 Seijiro Takeshita Senior Strategist, International Mizuho Bank, interviewed by the *Financial Times*, 9th March 2009.

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7 METI op. cit.

8 Bruce D., (forthcoming), *Globalisation and the Japanese Economy*, Routledge

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10 Hedge Fund* Research, Administrator Survey, www.hedgefund.net

11 Mizuno A., ‘Recent Economic and Financial Conditions and Policy Measures: The Importance of Safety Nets for the Financial System and Employment’, Bank of Japan, Member of the Policy Board, February 2009

12 Bernanke, B. (2005), *The Global Saving Glut and the US Current Account Deficit,* (http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm)

13 METI op. cit.

14 Association of Southeast Asian Nations www.aseansec.org

The Global Policy Institute was created in August 2006 as a Research Institute of London Metropolitan University. It brings together academics from the social sciences and business disciplines to analyse the dynamics of globalisation and formulate policy solutions. The Institute's research and consultancy will be of direct practical use to decision-makers, policy formation, business users and civil society groups, and it will offer partnerships within and beyond the academic community.

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