Is Japan's Trade Deficit Becoming Chronic?

JUNG Ho-Sung Research Fellow Samsung Economic Research Institute

I. Japan's Mounting Trade Deficit

Japan's exports and imports are rebounding in a sign of recovery from the 2008 global financial crisis and 2011 Tohoku earthquake. At the same time however, Japan's trade deficit rose to a record 8.2 trillion yen last year as growth in exports failed to keep pace with growing imports. This was almost twice the amount recorded in 2011 when the earthquake derailed the Japanese economy. Even with a cheaper yen thanks to Abenomics, Japan's trade deficit in the first half of this year, at 4.8 trillion yen, has outpaced last year's numbers.

According to the Japanese government, the widening deficit came due to expanding demand for conventional fuel under its post-Fukushima "zero nuclear" policy, as well as the "J-curve effect," indicating a trade balance that initially worsens after depreciation of the currency, before improving later. The government claims that the trade deficit is a temporary phenomenon and that the country will see a surplus in the second half.

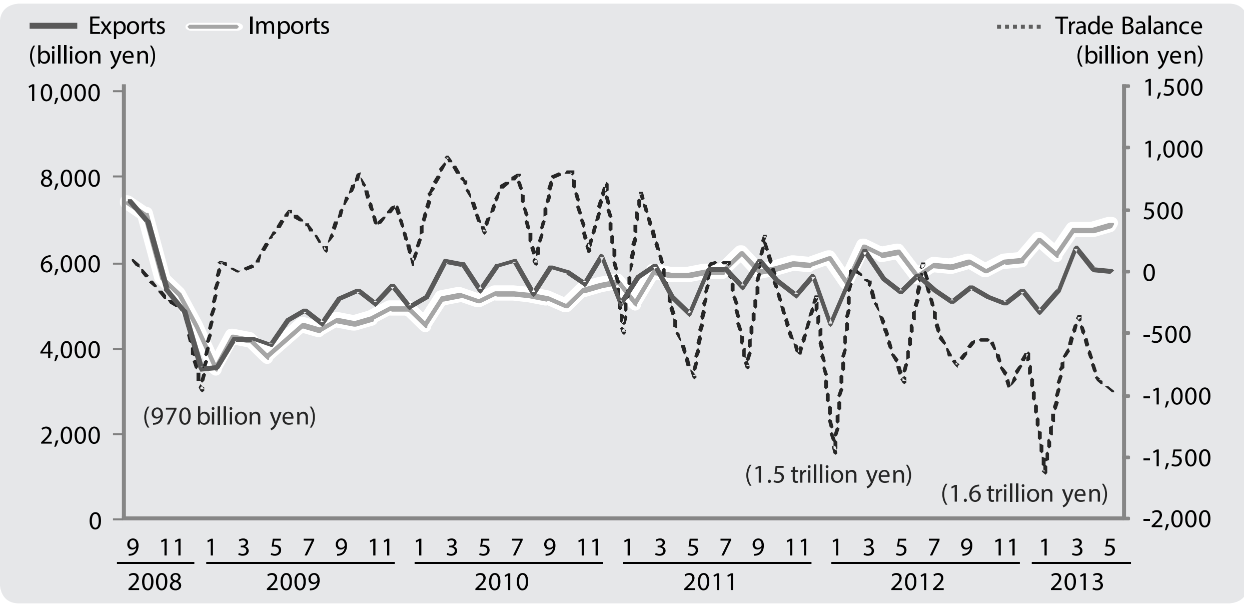
Such optimism however, may be misplaced. Japan's trade deficit may actually be structural rather than temporary, requiring a significant amount of time for improvements to make themselves felt. Trade deficits may have become a chronic fixture of Japan's economy. This paper examines the underlying causes of Japan's trade deficit, including structural factors, and assesses whether the deficit is here for the long-term.

II. Causes of the Growing Deficit

1. Slowing exports

Japan's exports rebounded from the global financial crisis in 2010 to reach 67.8 trillion yen. Thereafter, however, exports tumbled in 2011 and in 2012, posting declines of 65.2 trillion yen and 63.9 trillion yen respectively. The

Japan's Monthly Trade since the Global Financial Crisis



Source: Japan Ministry of Finance.

debt crisis in Europe and slowing demand in Asia have both taken their toll. Exports to China and the "Newly Industrializing Economies" each dropped by 2 trillion yen in 2012 compared to 2010,[1] while outbound shipments to the EU dropped 1.3 trillion yen.[2] The total decline in exports to Asia and the EU reached 4.6 trillion yen.

By product, exports of electrical devices and general machinery sharply decreased; the former slowed from 12.5 trillion yen in 2010 to 11.3 trillion yen in 2012, and the latter from 13.8 trillion yen to 12.6 trillion yen. By subcategory, electronics components, including semiconductors, and computer-related products, have been particularly weak due to slack global demand and the falling price competitiveness of Japanese products.

2. Rising imports

In the wake of the Fukushima nuclear power plant accident, Japan has tapped into its thermal energy potential as it struggled to find alternatives to nuclear power. As a result, imports of fuel, including crude oil and liquefied natural gas (LNG) have expanded. Fuel imports reached 24.6 trillion yen in 2012, up from 18.1 trillion yen in 2010. This 6.5 trillion yen increase accounted for 68% of Japan's total import growth of 9.6 trillion yen in the two-year-period. Especially, LNG accounted for most of the fuel import growth.

At the same time, changing consumer preferences and lifestyle and a rapidly aging population have increased imports of smartphones, mid-priced clothing and age-related disease prevention drugs. Food and beverage imports (mainly grain) surged after the nuclear accident at Fukushima, while imports of cars produced overseas by Japanese makers also increased sharply. Growth in inbound shipments of these five items stood at 2.8 trillion yen (from 2010 to 2012), surpassing growth in LNG imports.

3. Foreign exchange rate and price changes

The impact of a foreign exchange rate on exports has been limited. The yen surpassed 100 per dollar from the 70-yen level immediately following the dissolution of the House of Representatives in the Japanese Diet in

1 Exports to China fell by almost 20% in 2012 compared to 2010 due to worsening relations with China.

2 The amount of exports to the EU was similar to that of exports to China before the global financial crisis, but now is half of exports to China. Exports to the EU shrank from 12.6 trillion yen in 2007 to 6.4 trillion yen in 2012.

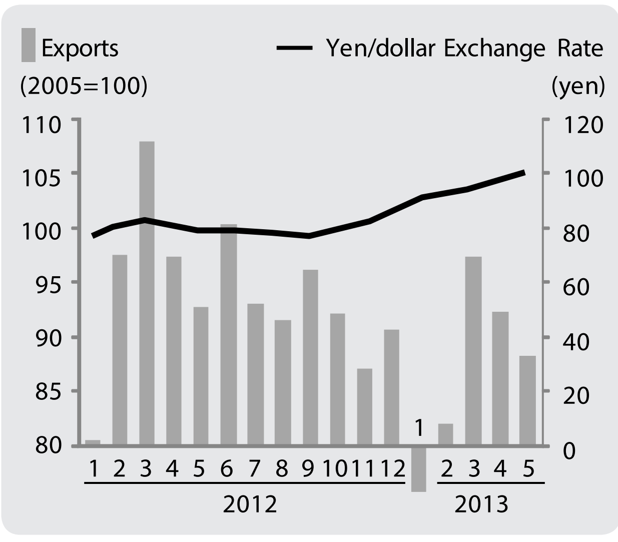
Japan's Exports by Region from 2010 to 2012

(Unit: trillion yen, %)

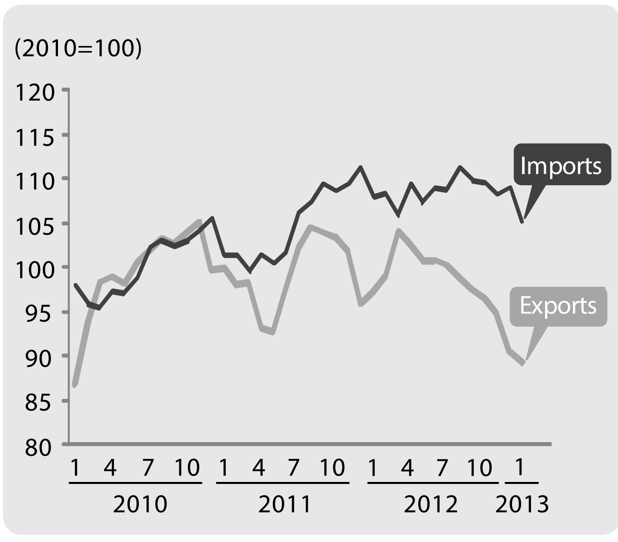
	China	US	NIES	Asia	EU
Amount	13.4 → 11.4	10.4 → 11.4	15.9 → 13.9	38.2 → 34.9	7.7 → 6.4
Share	(19.8) → (17.8)	(15.3) → (17.7)	(24.8) → (21.7)	(56.3) → (54.6)	(11.4) → (10.0)

Source: Japan Ministry of Finance.

Foreign Exchange Rate and Export Volume



Real Exports and Imports



Source: Bank of Japan. Japan Ministry of Finance.

November 2012. However, export volume has changed little,[3] implying that a weaker yen did not help improve price competitiveness of Japanese products.

The effect of export/import price changes on trade has also been limited. While imports in real terms have steadily increased since the beginning of 2011, real exports turned downwards in June 2012.

4. Structural factors

A combination of structural factors -- including expanding overseas production by Japanese companies and falling global competitiveness for Japanese products -- has delayed recovery of Japan's exports.

The yen has tumbled since late last year driven by aggressive economic stimulus from Prime Minister Shinzo Abe, but exports have not increased significantly and export volume growth remains in negative territory. This is attributable to Japanese companies' increased overseas production and Japanese products' declining global competitiveness. While a weak currency value typically bolsters exports, the weakening yen's impact has inevitably been limited due to these two factors.[4]

3 The J-curve effect can be divided into price effect based on the settlement currency, and volume effect from falling currency value. Up to now, a slight price effect has appeared but a volume effect has not been seen.

4 According to a Development Bank of Japan survey (June 2013), approximately 40% of facilities investment by Japanese companies was made overseas, and 73.3% of manufacturing companies said they will increase overseas production in the future.

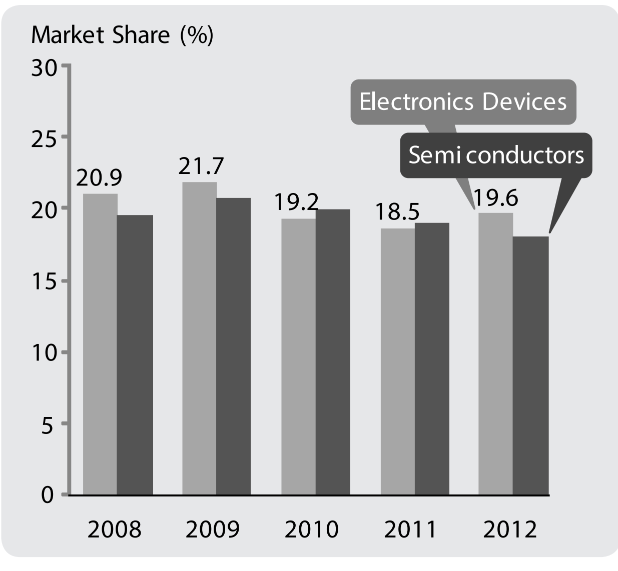
In particular, exports of electronics devices and general machinery, Japan's major exports (along with automobiles), have remained sluggish. Information and communication technology products, another major item, are witnessing a decline in market share and exports despite the expanding global market for these products. Japan's share in exports of these products has declined by half after the global financial crisis, while the share of rivals in East Asia including Korea, China and Taiwan, has topped 70%.

The import side is also undergoing structural changes. Fuel imports, as already noted, have been the main driving force for the recent increase in Japan's imports, driven by an increased need for fuel to generate electricity after the Fukushima disaster. In actuality however, fossil fuel imports have been growing by more than 20% annually since 2000. Instead, the most remarkable import growth has occurred in smartphones, pharmaceuticals, clothing and automobiles in line with changes in Japanese consumers' lifestyles and preferences. Inbound shipments of five major items in 2012 grew by 2.8 trillion yen compared with 2010, surpassing growth in LNG over the same period. While the Japanese government claims that fuel imports have led recent growth in imports, changing lifestyles and preferences are the real cause behind the changes in import structure.

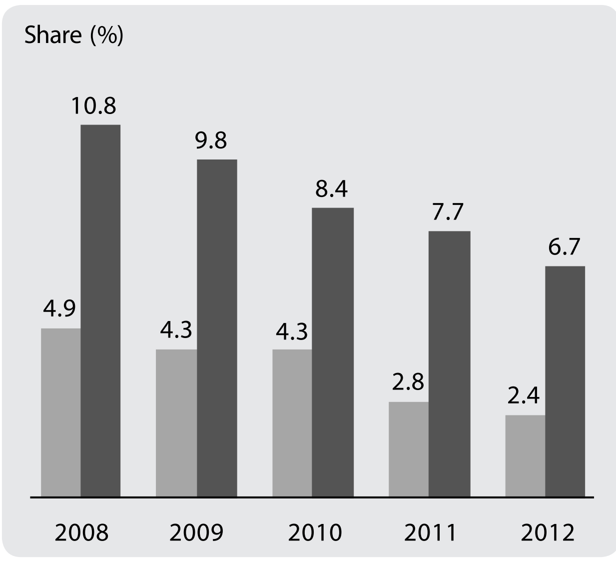
III. Prospects and Implications

Japan's exports will likely pick up pace during the sec-

Japanese ICT Products' Global Market Share

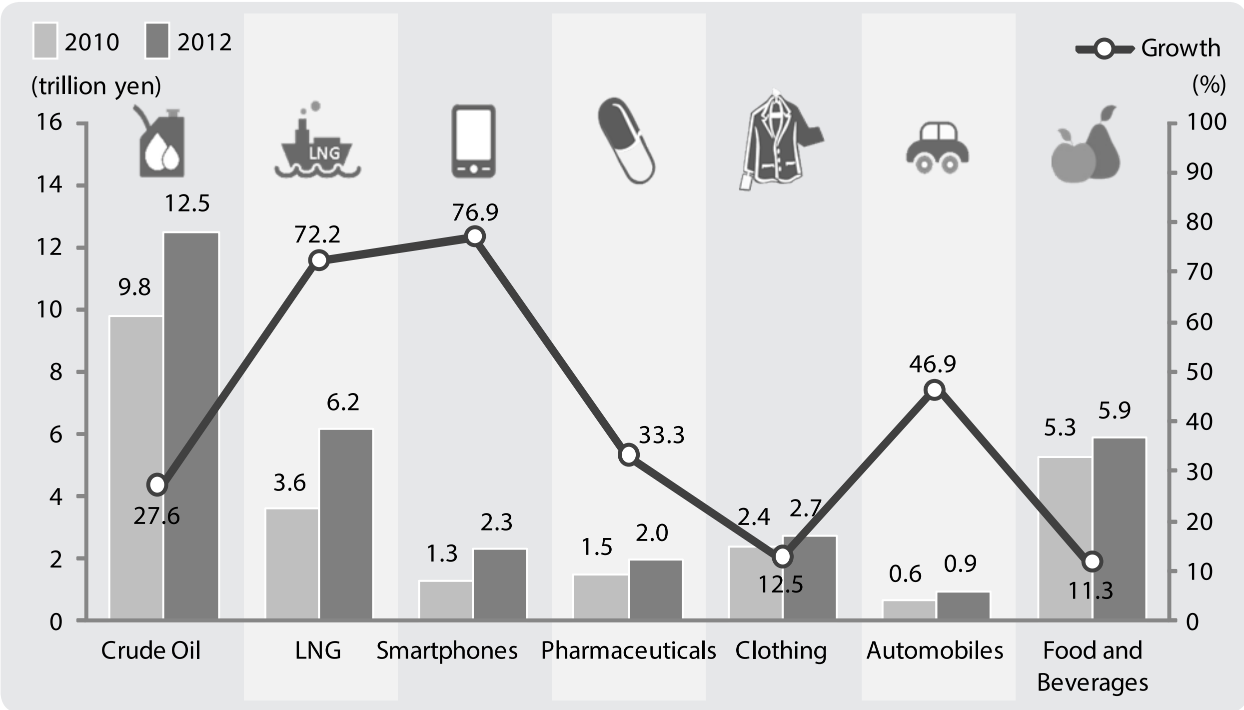


Japanese ICT Products' Share in World Exports



Note: "Electronics devices" include terminals (mobile phones, PCs and liquid crystal displays), semiconductors, integrated circuits and liquid crystal devices.
Source: Japan Ministry of Finance.

Imports of Japan's Top Five Import Products



ond half of this year based on the J-curve effect. Nonetheless, it will still take a considerable amount of time for the trade balance to improve fundamentally. The Japanese government expects the trade balance to improve in the second half as the weakening yen makes itself felt, but the trend toward a weaker yen has eased after the upper house election in July. Under these circumstances, export recovery could be tepid while imports continue to increase, increasing the possibility of an entrenched trade deficit. A further worsening of the trade deficit could lead to an earlier-than-expected switch to a current account deficit. Japan has maintained a current account surplus since 2010 driven by gains in the income account surplus -- which has been over 1 trillion yen a month. However, the current account surplus has been narrowing since 2011, and the assumption of a permanent surplus has already been disproven.

Korea, on the other hand, is likely to post a record current account surplus in the first half of this year. Yet its trade structure is similar to Japan's, its exports are overly dependent on shipbuilding and information and communications devices, and it faces increasing encroachment as its neighbor China sharpens its competitive edge. While Korea enjoys high global market share in some products, the country urgently needs to build a stronger presence in more diverse products to continue its current surplus trajectory. SERI