

Japan's trade balance Seeing red

After half a century of trade surpluses, Japan is now in deficit

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IMBALANCES are not for ever. In the 1980s and 1990s, Japan's huge trade surplus was a popular target for American and European protectionists. No longer. Provisional estimates suggest that Japan's merchandise trade moved into the red in 2011—its first annual deficit (excluding freight costs) since 1963. Japan remains the world's biggest net foreign creditor. Income from its assets more than offset the trade gap, keeping its current account in surplus, equivalent to about 2% of GDP (down from 5% in 2007, see chart). That surplus, however, could also disappear within a few years. Is that good news or bad?



Last year's trade deficit partly reflected some temporary factors, notably the earthquake tsunami which disrupted production and exports. Imports were inflated by higher oil and larger imports of energy following the shutdown of nuclear-power plants.

But if, as seems likely, many plants stay closed, future energy imports will remain high. A stronger yen and weak overseas demand will also keep squeezing exports. Until 2008 had been buoyed by an abnormally weak yen, as foreign investors borrowed in yen in higher-yielding currencies. But that carry trade has now been unwound as interest rates elsewhere have plunged.

The stronger yen and high corporate taxes are also encouraging manufacturers to shift production abroad. J.P. Morgan forecasts that by 2014, 76% of Japanese car firms' production will be based overseas, up from 49% in 2003. As well as curbing exports, this could also reduce imports if some car models are only made abroad.

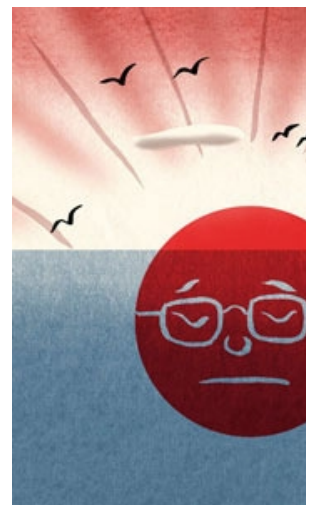
If Japan's trade deficit widens, the fate of its current-account surplus will depend on investment income (interest payments, profits and dividends). This rose sharply until 2008 but has since fallen as a result of low interest rates and the global downturn. If firms repatriate more of their overseas profits instead of repatriating them, this might further erode investment income over the next few years. Even if net income stays constant, Masaaki Kanno of J.P. Morgan forecasts that Japan's overall current account will be in deficit by 2015.

Some economists disagree: global growth and Japanese exports could be stronger than Kanno assumes. But there are powerful structural reasons to expect Japan's current account to move towards deficit. A nation's current-account balance reflects the gap between saving (by households, firms and the government) and investment. Historically, the Japanese were keen savers, with national saving greater than investment. But a rapidly ageing population saves less because people draw down their assets when they retire. The retired folk there are relative to workers, the lower the saving rate.

Japan's household-saving rate has fallen from 14% of disposable income in the early 1990s to only 2% in the past couple of years. The government's budget deficit (10% of GDP) also counts as negative saving. The current account has remained in surplus because shrinking household saving has been offset by a surge in corporate saving. Since 1990 Japanese firms have swung from being big borrowers to big savers as they sought to pay off their debts. Wage moderation and low interest rates lifted their profits, and they invested

As the population continues to age, households' saving rate is likely to turn negative. Firms are also unlikely to keep piling up cash as much as they are now. Profits are being squeezed and they may invest more abroad. If private saving shrinks while the government borrows heavily, Japan will inevitably move into current-account deficit and become a net importer of capital.

A shrinking surplus would be good news for Japan and for the rest of the world if it were caused by a strong rebound in domestic consumption and investment. Instead, it mainly reflects weaker exports and higher energy imports, which will bring little benefit to other rich economies. It will also weaken Japan's growth. Over the ten years to 2010, net exports accounted for half of Japan's real GDP growth. To fill the gap, Japan would need structural reform to boost domestic spending.



Even more worrying are the implications for financing Japan's government debt. Its debt-to-GDP ratio—more than 130% in 2011, according to IMF estimates—is second only to Greece. Yet Japanese bond yields are among the world's lowest largely because of its current-account surplus and willing domestic investors (unlike other fiscal sinners such as Italy and Greece). Around 95% of Japan's sovereign debt is owned by domestic investors. If Japan's current account moves into deficit the government will need to rely more on foreign investors, who are likely to demand higher yields.

Catalyst or catastrophe

A sudden rise in bond yields could seriously worsen the government's debt dynamics. A one-percentage-point increase in yields would cause the interest bill to double, requiring a bigger reduction in the rest of the budget deficit simply to stabilise the debt-to-GDP ratio. Higher yields would also imply big losses for Japanese banks and pension funds. If forced to cut their lending, this would depress growth and lead to a withdrawal of liquidity from global capital markets.

If, on the other hand, the government takes action to put fiscal policy on a sustainable long-term path by raising taxes and trimming spending, bond yields might rise only moderately.

Unlike euro-area economies, Japan's debt mountain reflects low taxation as much as unsustainable spending. The government has ample room to increase taxes, particularly consumption, but lacks the political will to do so. Indeed, while borrowing costs are high, politicians have had little incentive to take unpopular action. A serious threat of high yields because of a looming current-account deficit might prod the government to raise rates and push through structural reforms. If it does not act, a current-account deficit and unsustainably high public debt are the ingredients of a potentially lethal cocktail.

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