

# Japan: Surplus No More?

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Japan recorded a trade deficit in 2011. While historically rare, this is set to become a more regular part of the landscape. And although Japan will continue to run current account surpluses for a while yet, this further diminishes perceptions that Japanese government bonds can continue to be domestically funded.

Last week's trade figures for December confirmed what everyone had expected—that Japan ran a deficit in goods trade in calendar year 2011, the first time this has happened since 1980. Despite being well anticipated, the news generated a substantial number of comments and questions.

In part, this is because it represents a potential sea-change in people's thinking. We're used to seeing Japan as an export-driven, trade-surplus economy. In fact, in seasonally adjusted terms, Japan has run a trade surplus (on goods only, customs-cleared basis) every month from November 1980 until July 2008. At its highs—from 1985 to 1987—the trade surplus was running at above 4% of GDP (**Display 1**). But in broad terms, the surplus has trended lower since then, dipping briefly into deficit territory in 2009 in the wake of the Lehman Brothers debacle and again in the last nine months following the Great East Japan Earthquake.

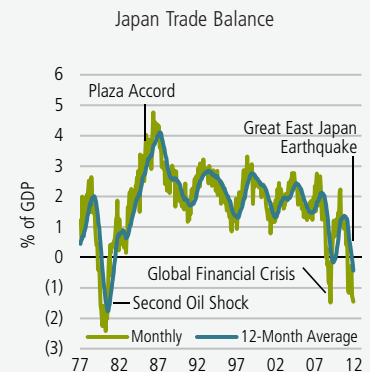
It's also of interest because of the fiscal

question. One of the key reasons behind a sanguine attitude to Japan's public sector debt problem is that the country runs a current account surplus—and national saving exceeds national investment (see *Japan Perspectives*, January 14, for a discussion). Headlines of a trade deficit raises questions about whether this picture also needs to be reassessed.

### Cyclical or Structural?

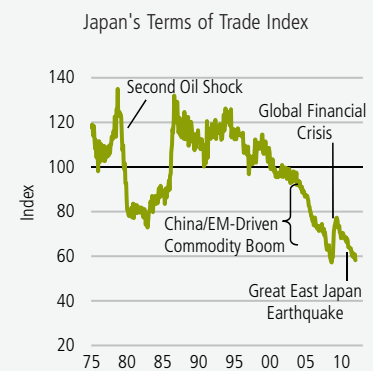
The last few forays into deficit territory—following the first and second oil shocks of the 1970s and again in 2008–2009—were followed relatively quickly by a return to surplus. Both price and volume developments drove these outcomes. It's clear from **Display 2**, which shows Japan's terms of trade index (i.e., the ratio of export to import prices), that changes in relative prices did a lot of the work through the 1980s, and played a big role in a deteriorating trend in the trade balance since the early 2000s. In fact, over the period from 2000 to 2007, trade volumes alone would have improved the trade balance by around 0.5 percentage

Display 1  
Japan Records a Trade Deficit



As of December 2011  
Source: Thomson Datastream

Display 2  
Terms of Trade on Declining Trend



As of December 2011  
Source: Thomson Datastream

point of GDP per annum, but this was more than offset by price changes.

However, in the last 12 months, price and volume developments have worked in the same direction. Rising energy prices boosted import prices and contributed to a deterioration in the terms of trade; and export volumes were reduced by the March disaster and subsequent supply-chain disruption, as well as the disruption from the Thai floods later in the year.

Does this presage a structural deterioration? In part, this depends on whether the comparatively good export volume performance of 2000–2007 can continue. There are at least a couple of potential headwinds:

—First, the value of the yen. Although not outrageously high by historical standards, the real effective exchange rate (**Display 3**) is nonetheless considerably above its 2000–2007 average. And versus key competitors like Taiwan and Korea (or Germany, for that matter), the yen is close to all-time highs.

—Second, one impact of the earthquake/tsunami has been an accelerated relocation of production offshore. Alongside the strong yen, continuing concerns over electricity supply is helping to drive this—there is still a chance that all Japan’s nuclear capacity will be shutdown come April/May. And one of the key lessons from 2011 has been the need to geographically diversify the supply chain.

The bottom line is that while we can expect some export improvement over coming months as disruptions related to

the Thai flood are resolved, it’s likely that deficits will be an ongoing part of the landscape in the absence of a significant decline in commodity prices. Not every month will necessarily see a deficit, but the notion of Japan as a trade-surplus country will need to be reassessed.

### External Funding Issue?

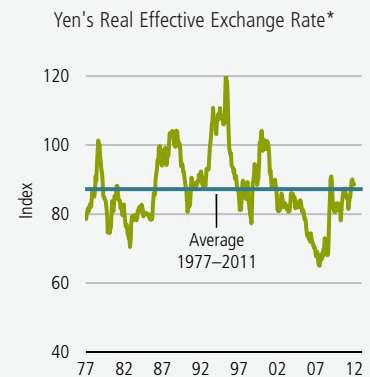
While the trade balance has slipped into deficit, the current account remains firmly in the black (**Display 4**). Japan’s ongoing surpluses have allowed it to accumulate substantial net foreign assets. The income generated from those assets—interest and dividend payments—form the net income flows in the current account of the balance of payments. As is clear in Display 4, these flows now dominate—a significant change from a couple of decades ago when the trade surplus was the key story.

A feature of these income flows is the growing importance of equity-related flows, itself a function of the move of Japanese production offshore.

By their very nature, these flows tend to be quite “sticky.” Over the last 25 years, these flows have gradually risen from 0.5% of GDP to around 2.5%–3% of GDP.

This will continue to help underpin a current account surplus, in a trend sense at least. But this doesn’t mean that a surplus is baked in the cake every month. Indeed, given the volatility in these figures, it would not be surprising to see the occasional monthly deficit—reinforcing the argument that we made in our aforementioned *Japan Perspectives* piece that the underpinnings of the Japanese government bond market are starting to fray. ■

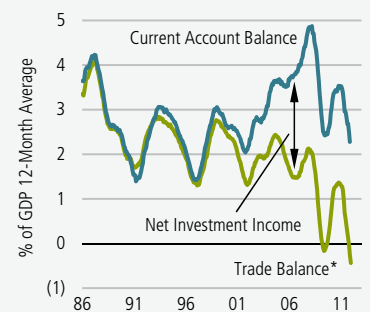
Display 3  
REER at Long-Term Average, but Above 2000–2007 Troughs



As of December 2011  
\*JPMorgan Broad Real Effective Exchange Rate  
Source: Thomson Datastream

Display 4  
Current Account Still in Surplus

Trade Balance vs. Current Account Balance



As of December 2011  
\*Goods only, customs cleared basis  
Source: Thomson Datastream

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