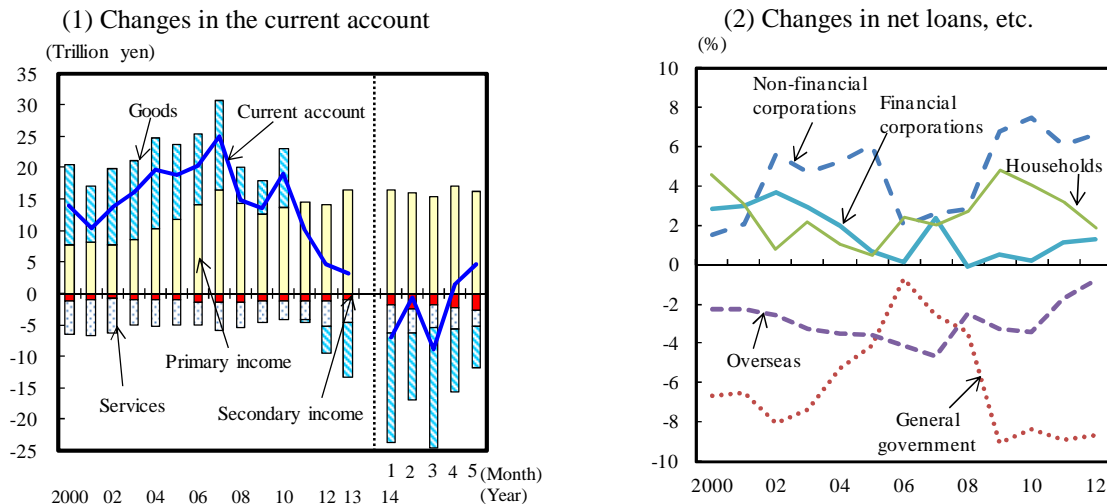


Chapter 3 Structural Changes in the Japanese Economy and Challenges for Industries

Section 1 Questions Posed by the Current Account Surplus

- The current account surplus has rapidly shrunk since 2011. From the autumn of 2013 onwards, the current account stayed roughly in balance, and from January through April 2014, the current account recorded a deficit of around 4 trillion yen on an annualized basis.
- Amid progress toward an overcoming from deflation, excess savings in the household and corporate sectors shrank. The current account deficit arose against the backdrop of this change in the savings-investment balance. From the perspective of the supply-demand balance, the deficit indicates the problem of constraints on the supply of capital and labour that has been hidden during the deflation.

Figure 3-1-1 Changes in the current account balance and the savings-investment balance

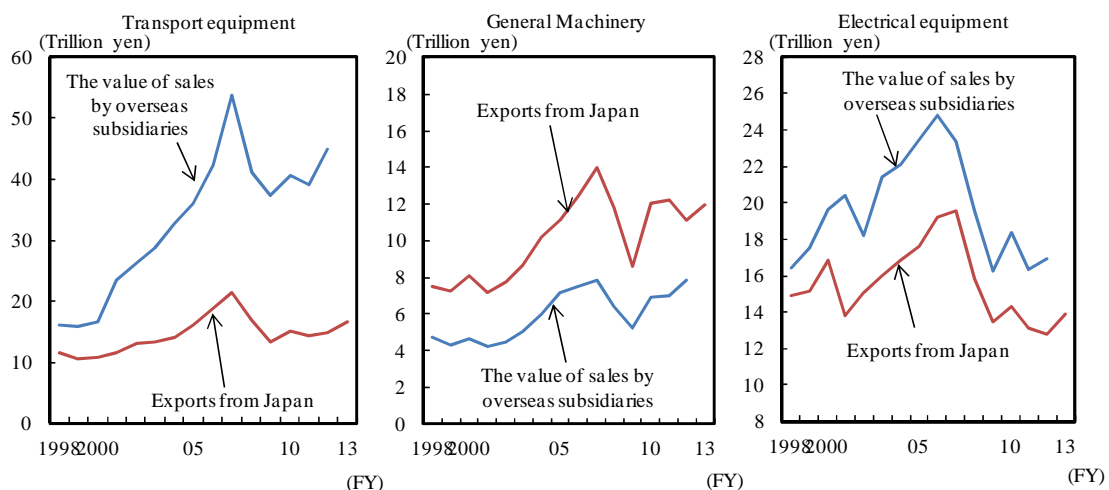


- (Notes) 1. (Left) Compiled based on the Balance of Payments Statistics, the Ministry of Finance and the Bank of Japan. Calculated by annualizing the seasonally adjusted monthly figures.
2. (Right) Compiled based on the System of National Accounts, the Cabinet Office.

- When the yen strengthened after the Lehman Shock, Japanese manufacturing industries expanded overseas production and their non-price competitiveness declined due to intensified competition with emerging countries. As a result, a significant change has occurred in manufacturing industries' comparative advantage and their earning power (capability to create value added).
- If manufacturing industries are to enhance their earning power in the future by exporting goods amid the emergence of supply constraints in some sectors, it is important for them to take advantage of their comparative advantage in terms of capital goods, etc.

Figure 3-1-2 Trend of overseas production and exports

(1) Changes in the values of overseas sales and exports from Japan



- (Note) Compiled based on the Trade Statistics, the Ministry of Finance; and the Survey of Overseas Business Activities, the Ministry of Economy, Trade and Industry.

- The export volume has remained stagnant since hitting the most recent peak at the beginning of 2011. In the October–December period of 2013, because of a rise in manufacturing industries’ ratio of overseas production (from 18.1% in FY2010 to 20.3% in FY2012) and a change in their comparative advantage, the export volume was around 10% lower than it would have been if the export structure that had been in place until 2010 had remained.
- Due to the yen’s strengthening and the decline in non-price competitiveness after the Lehman Shock, the import volume of communications and office equipment increased.

Figure 3-1 in the Column
The impact of changes in the export structure on export volume

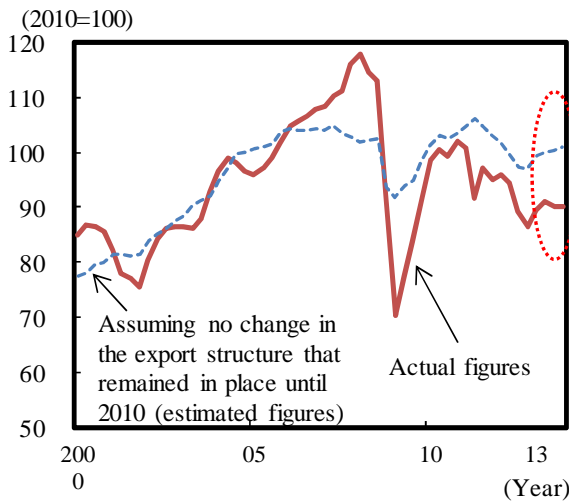
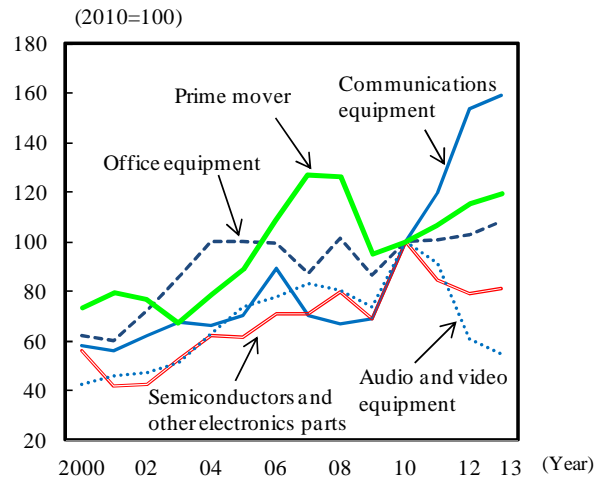


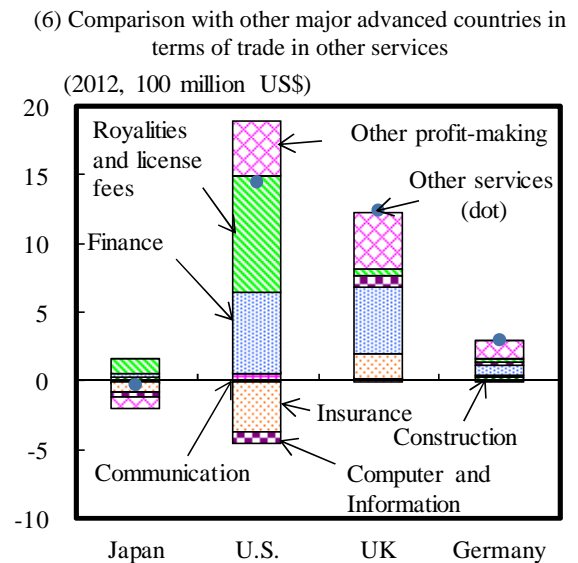
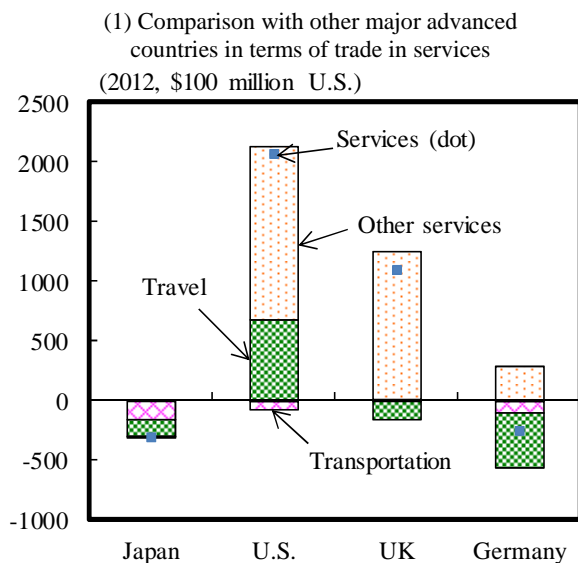
Figure 3-1-3 Trend of import volume
(2) Changes in the import volume index by item



- (Notes) 1. (Left) Compiled based on the Trade Statistics, the Ministry of Finance; and the Bank of Japan and OECD. Stat. The estimated figures represent export volumes estimated from the relationship with real GDP of major export destination countries, real effective exchange rates and the high value added index between 1990 and 2010. (As for the estimation formula, etc., see Additional Note 3-1).
2. (Right) Compiled based on the Trade Statistics, the Ministry of Finance.

- Although major countries have acquired an advantage in knowledge-intensive services, the Japanese service industries have captured foreign demand only on a limited scale. In particular, Japan lags far behind other major countries in terms of “other services.”
- Japan’s core revenue from “other services” is fees for the use of intellectual property rights. However, such revenue comes mainly from foreign subsidiaries of Japanese companies, so there is room to enhance the “earning power” through service trade.

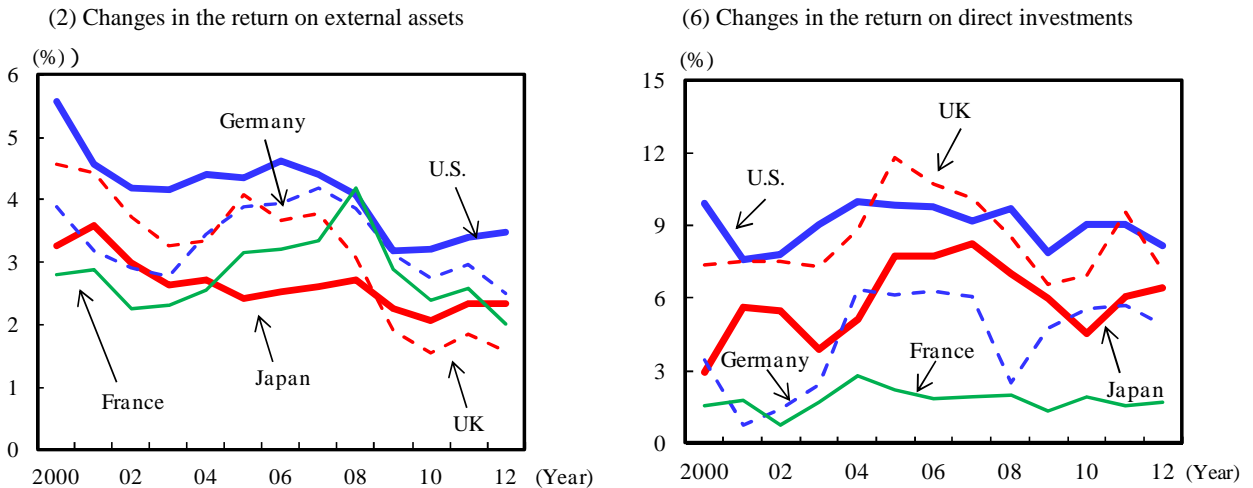
Figure 3-1-5 Changes in the balance on trade in services



(Note) Compiled based on OECD.Stat. “Other business, etc.” include other business, Personal cultural and recreational and government services,n.i.e.

- There is room to improve earning power through external assets by continuing to raise the ratio of foreign direct investment to external assets and also by changing the security investment mix, which is comprised mainly of bonds.
- In 2000, investments in advanced countries accounted for more than 60% of Japan's outstanding foreign direct investment, but in 2012, the ratio of direct investment in emerging countries rose to around 50%. As a result, the return on direct investment has been on a trend of improvement.

Figure 3-1-6 Changes in outstanding external assets and return



(Note) Compiled based on "International Financial Statistics," the IMF.

- A rise in mineral fuel prices has accounted for most of the rise in import prices since 2000. The risk of income flowing out of Japan due to the rising energy prices has grown because the value of imports has been far higher than the value of exports since the Great East Japan Earthquake, against the backdrop of an increase in imports of mineral fuels.
- Japan has a low level of external debts compared with other major countries, and in particular, the level of direct investment in Japan is low. The current account deficit will not immediately pose a problem, but in light of the severe fiscal position, it is important to make efforts to secure a stable inflow of funds in the future.

Figure 3-1-7 Trend of import prices and trade gains/losses

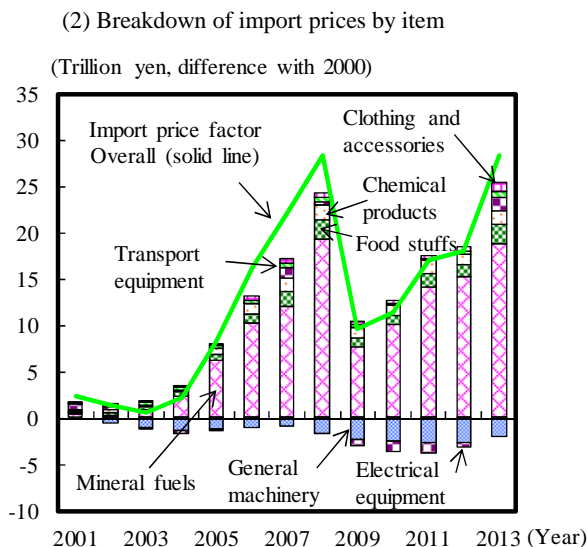
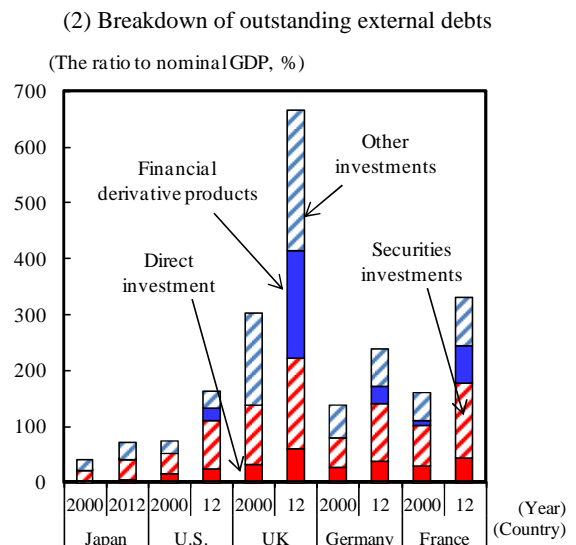


Figure 3-1-8 Changes in the inflow of funds



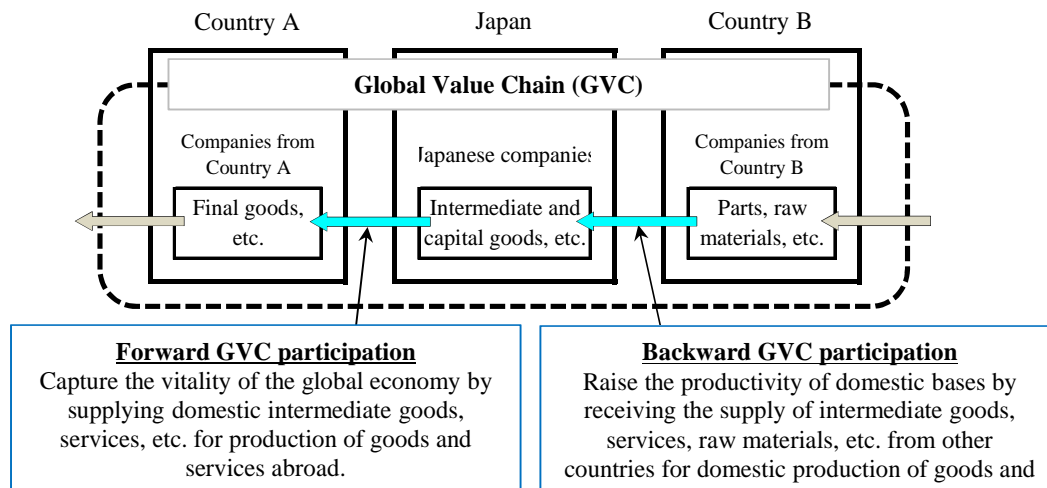
(Notes) 1. (Left) Compiled based on the Trade Statistics, the Ministry of Finance.

2. (Right) Compiled based on "International Financial Statistics" and "World Economic Outlook Database, April 2014," the IMF.

Section 2 Global Market and Challenges for Japanese Industries

- To enhance the “earning power” (capability to create value added) in response to changes in their comparative advantage, companies are reforming domestic and foreign production processes, creating a global value chain (GVC) by supplying and procuring goods and services across national borders.
- It is important for companies to enhance the “earning power” (capability to create value added) and make it easier to capture global economic growth by optimizing domestic and foreign production processes through increased participation in a GVC.

Figure 3-2-1 Participation in the global market through GVC (concept image)



(Note) Compiled based on OECD (2013), etc.

- Participation in a GVC through the supply and procurement of intermediate goods and services, including parts and raw materials, has tended to increase. While forward participation is relatively higher, backward participation is also increasing.
- It is important to increase participation in a GVC through the supply and procurement of not only intermediate goods and services but also capital goods, such as production equipment and business-use machinery. In response to changes in the comparative advantage, Japan is strengthening exports of capital goods while increasing imports mainly of producer goods (intermediate goods and raw materials).

Figure 3-2-2 (1) GVC participation through supply and procurement of intermediate goods and services

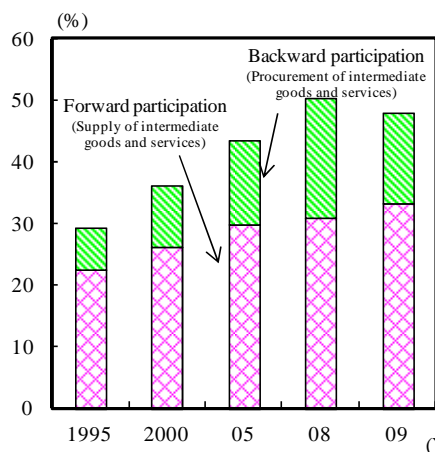
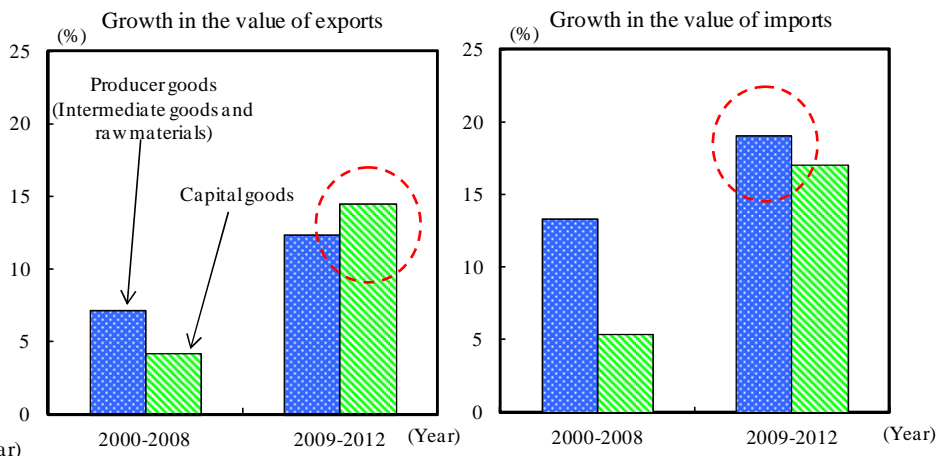


Figure 3-2-3 Growth in the values of exports and imports by the type of goods



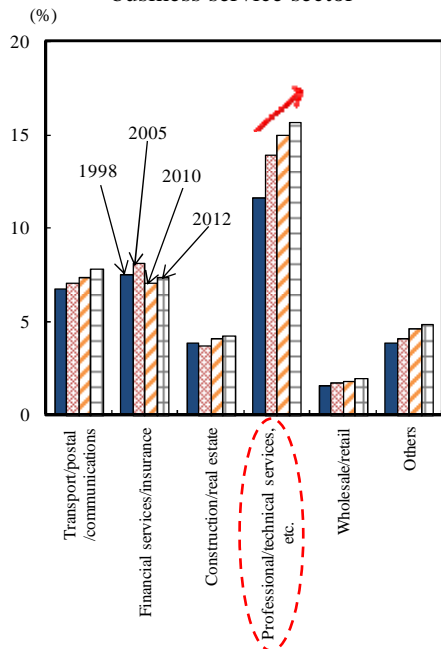
(Notes) 1. (Left) “Global Value Chain Index,” OECD; (Middle and right) Compiled based on “RIETI-TID 2012,” the Research Institute of Economy, Trade and Industry.

2. (Right) “Forward participation” in the figure on the left refers to the ratio of the value of a country’s exported goods and services that are used as intermediate input for production of other countries’ goods and services for export to the country’s overall export value. “Backward participation” refers to the ratio of the value of a country’s import of goods and services from other countries that are used as intermediate input for domestic production of goods and services for export to the country’s overall export value.

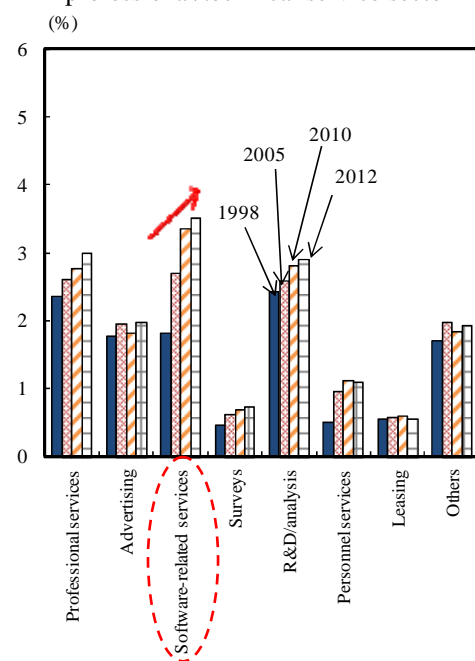
- Companies are enhancing productivity and creating value added for their products and services by outsourcing production activities to the business service sector and specializing in core business activities.
- Until now, Japanese companies have outsourced mainly ICT-related services.

Figure 3-2-8 Ratio of intermediate input from the business service sector to the value added

(1) Ratio of intermediate input from the business service sector



(2) Ratio of intermediate input from the professional/technical service sector



(Note) Compiled based on Euromonitor International 2014.

- Japan lags in terms of the use of professional services in such fields as consulting, accounting and legal affairs compared with the U.S. and Germany. In the future, it will be important to encourage companies to reform their organization and restructure business operations by increasing the use of professional services.
- Manufacturing companies are not only outsourcing business operations but also promoting an internal shift to services.

Figure 3-2-9 (2) Ratio of intermediate input from the professional/technical service sector to the value added (international comparison)

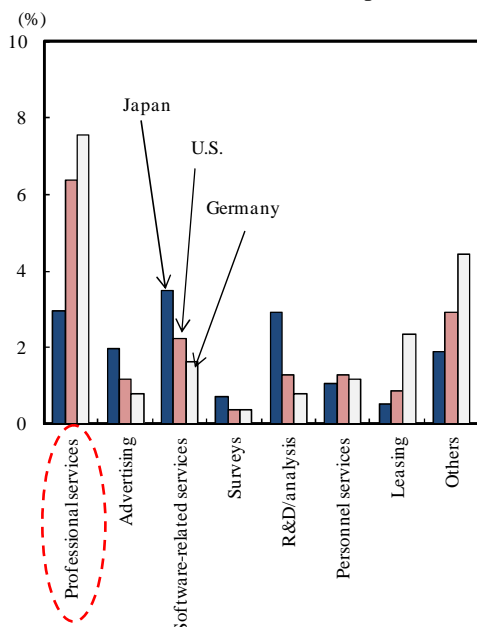
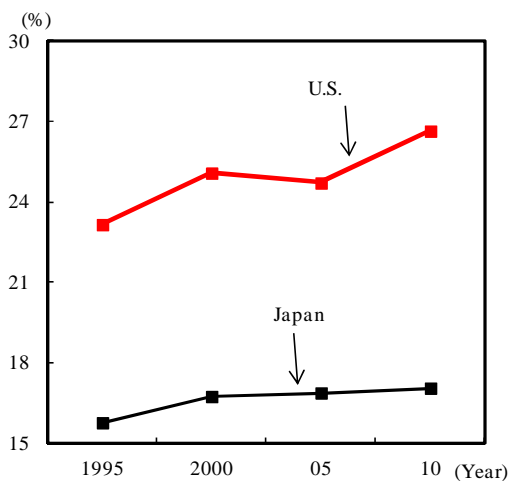


Figure 3-2-10 Ratio of workers engaging in service-related jobs to workers in manufacturing industries

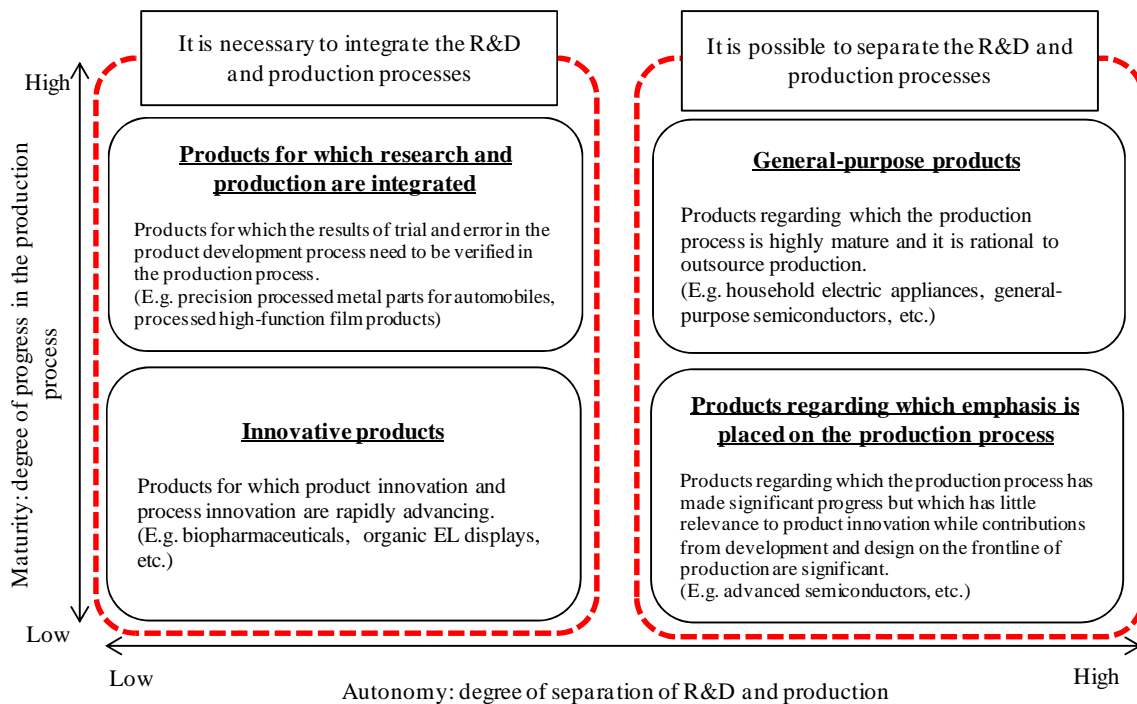


(Note) (Left) Compiled based on Euromonitor International 2014.

(Right) Compiled based on Population Census, the Ministry of Internal Affairs and Communication; and "Employed persons by industry, sex, race, and occupation," Bureau of Labor Statistics.

- Regarding innovative products and products for which research and production processes are integrated, it is effective to deepen flexible collaboration between manufacturing and service industries, and to conduct R&D and production processes within Japan in an integrated manner.

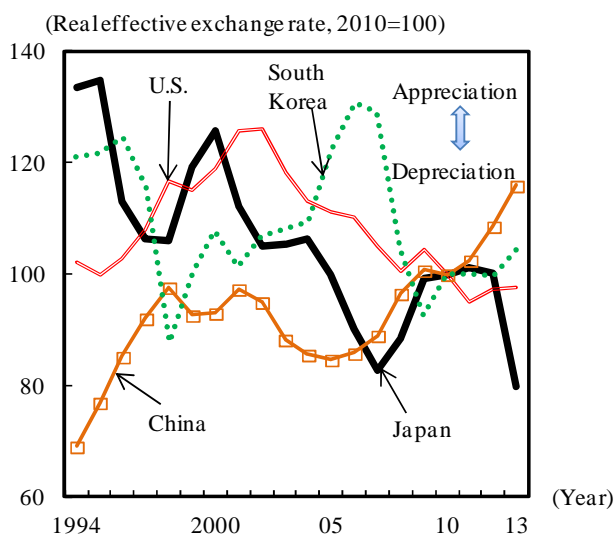
Figure 3-2-11 Matrix of maturity and autonomy of the production process



(Note) Compiled based on Pisano and Shih (2012), Nakamura (2013), Matsumura (2013), etc.

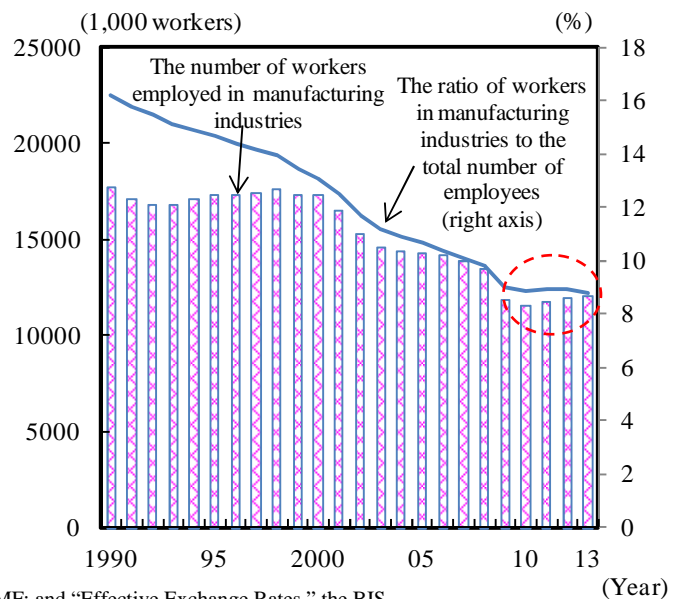
- In the U.S., there are moves to bring back production bases to the domestic market, against the backdrop of improvement in price competitiveness and reevaluation of domestic manufacturing bases.
- Since 2012, the yen's real effective exchange rate has weakened due to its depreciation, leading to an improvement in Japan's price competitiveness. It is possible that more and more production bases will be brought back to Japan in order to keep the R&D and production processes closer to each other.

Figure 3-2-12 (2)
Changes in real effective exchange rates



(Notes) (Left) Compiled based on "International Financial Statistics," the IMF; and "Effective Exchange Rates," the BIS.
(Right) Compiled based on the Employment Situation, the U.S. Department of Labor.

Figure 3-2-13 Changes in the number of workers employed in U.S. manufacturing industries

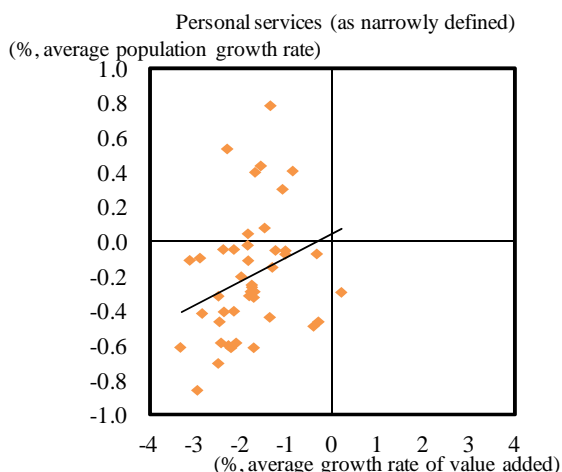


Section 3 Population Decline, Aging of Society and Challenges for Japanese Industries

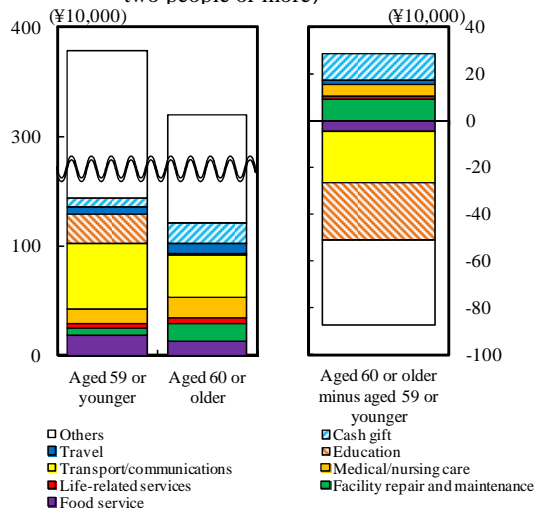
- Personal services have a particularly high level of simultaneous production and consumption among services, so a fall in demand density due to the population decline may push down production.
- Demand for medical and nursing care is increasing due to the aging of society. While demand for retail and food services is declining, travel-related demand is increasing due to the aging of society. It is important for the personal service industry to adapt to changes in demand due to the population decline and aging of society.

Figure 3-3-1 Impact of the population decline and aging of society on the personal service industry

(2) Growth rates of population and value added in prefectures (FY2001–FY2010)



(3) Annual expenditures by age group (households of two people or more)



(Notes) 1. (Left) Compiled based on the system of prefectural accounts, the Cabinet Office.
2. (Right) Family Income and Expenditure Survey, the Ministry of Internal Affairs and Communications.

- The rise in labour productivity in the personal service industry is generally low because the contribution of the capital equipment ratio is lower than the all-industry average with regard to all types of personal services.
- However, the Baumol effect, which refers to a decline in the ratio of a rise in the macro labor productivity due to a rise in the share of sectors where the growth rate of labor productivity is relatively low, has not appeared.

Figure 3-3-2 Growth rate of labor productivity in the personal service industry

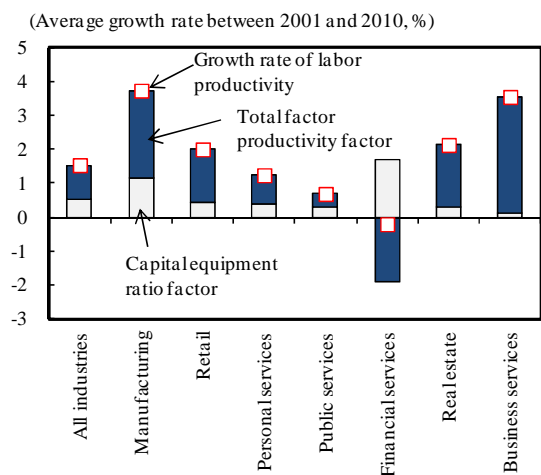
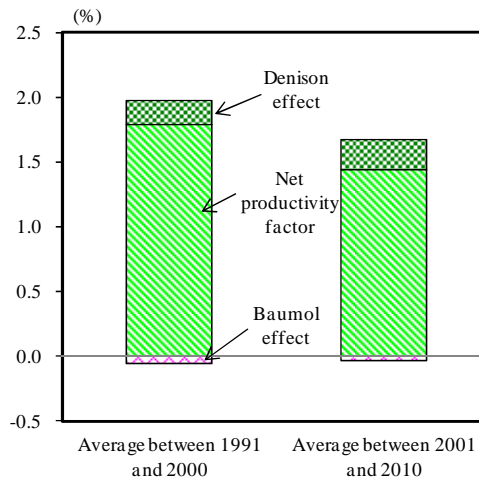


Figure 3-3-3 Breakdown of labor productivity and the Baumol effect

(1) Breakdown of contributions to labor productivity growth

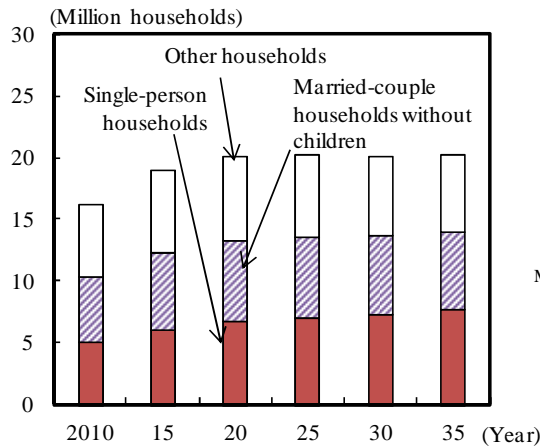


(Notes) 1. (Left) Compiled based on JIP Database (2013), the Research Institute of Economy, Trade and Industry.
2. (Right) Compiled based on EU KLEMS; and JIP Database (2013), the Research Institute of Economy, Trade and Industry. “Net productivity effect” refers to the growth rate of labor productivity in individual industries. “Denison effect” refers to a rise in macro labor productivity caused by a movement of labor from industries with relatively low labor productivity to industries with relatively high labor productivity.

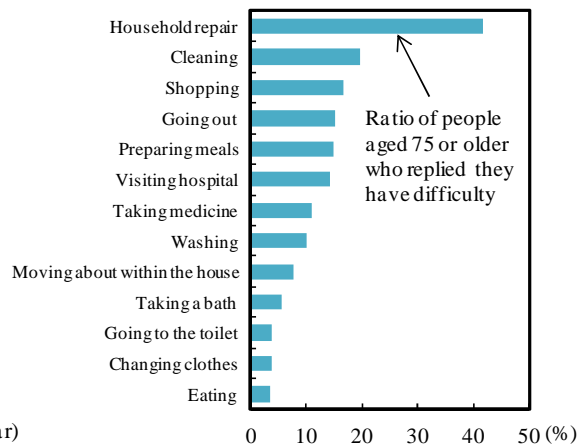
- The number of elderly people, particularly those who comprise single-person households, will increase rapidly in the future.
- Single-person households comprised of elderly people have strong needs for living support services, such as household repairs, cleaning and shopping. It is important to further encourage various types of entities to enter industries peripheral to medical and nursing care.

Figure 3-3-5 Environment surrounding elderly people and support for them

(3) Changes in the number of households of persons aged 65 or older



(4) Living activities which pose difficulty for elderly people

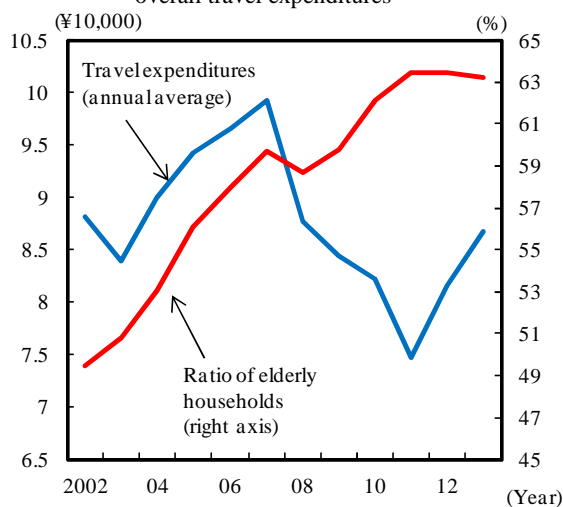


- (Notes) 1. (Left) Compiled based on Household Projections for Japan, the National Institute of Population and Social Security Research.
 2. (Right) Compiled based on reference materials presented at a meeting of the nursing care subcommittee of the Social Security Council (47th).

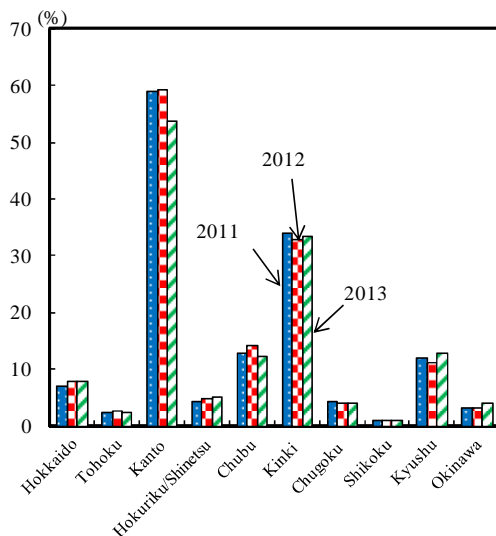
- Elderly people account for an increasing share of travel expenditures due to the aging of society. Elderly people are willing to spend money on travel as well as medical and nursing care.
- Destinations of foreign visitors to Japan are concentrated in the Kanto and Kinki regions, so there is room to increase visitors to other regions by establishing the “Japan Brand” through traditional and local cultures.

Figure 3-3-6 Growing tourism demand due to the aging of society and an increase in the number of foreign visitors to Japan

(1) The ratio of expenditures by elderly people to overall travel expenditures



(2) Rate of visits by foreign tourists by region



- (Notes) 1. (Left) Compiled based on the Survey of Household Economy, the Ministry of Internal Affairs and Communications.
 2. (Right) Compiled based on the Consumption Trend Survey for Foreigners Visiting Japan, the Japan Tourism Agency.

- In Japan, public insurance plays a large role in medical care compared with that in other OECD countries, and the role of private medical insurance is fairly limited.
- The ratio of people replying that public nursing care benefits are adequate has remained flat. The ratio of people considering financial preparations for their own future needs for nursing care has been rising since 2004.

Figure 3-3-7 Medical care expenses and the people's attitude

(1) International comparison of the burden of medical expenses

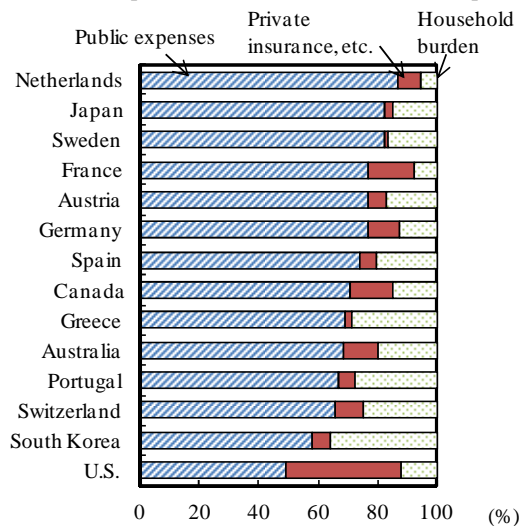
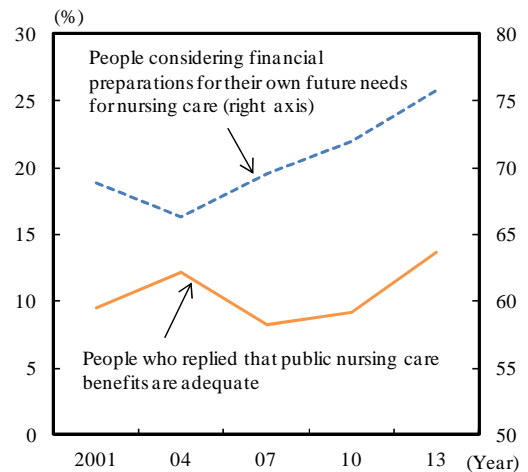


Figure 3-3-8 Nursing care expenses and the people's attitude

(2) The people's attitude to nursing care insurance



(Notes) 1. (Left) Compiled based on OECD.Stat.

2. (Right) Compiled based on the survey on living support coverage, the Japan Institute of Life Insurance.

- The personal service industry plays an important role in the autonomy of local economies. Raising the agglomeration effect of the retail industry also contributes to the autonomy of local economies.
- In line with a rise in health expectancy, the ratio of elderly people who want to work is increasing in many prefectures. The level of medical care expenses for people aged 75 or older tends to be low in prefectures where the employment rate is high, so there are hopes that promoting the employment of healthy elderly people will contribute to the autonomy of local economies and fiscal consolidation.

Figure 3-3-9 Autonomy of local economies and role of the personal service industry

(3) Autonomy and agglomeration effects of local economies

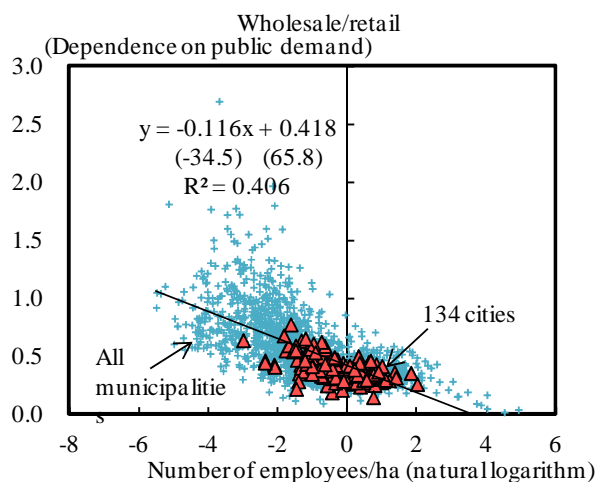
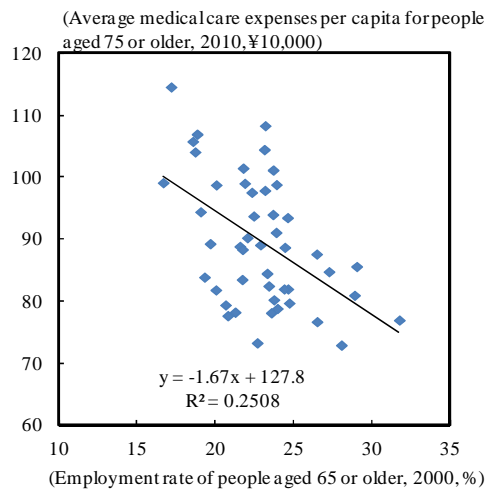


Figure 3-3-10 Promotion of health and longevity and the impact on local economies and fiscal position

(3) Employment rate of elderly people and medical care expenses



(Notes) 1. (Left) Compiled based on the system of prefectural accounts and the economic and fiscal model database for prefectures, the Cabinet Office; Population Census, the Ministry of Internal Affairs and Communications; e-Stat, etc.

2. (Right) Compiled based on the Employment Status Survey, the Ministry of Internal Affairs and Communications; and the report on the status of medical care services for people aged 75 or older, the Ministry of Health, Labour and Welfare.

Conclusion

○ Prospects and risks of the Japanese economy

- >> There are expectations that the Japanese economy will recover at a moderate pace as the impact of the demand pullback after the consumption tax hike subsides and the effects of policy measures are realized.
- >> Attention must be paid to the slowdown of the Chinese economy, the tapering of the U.S. quantitative monetary easing, geopolitical risks, etc. It is also necessary to keep a close watch as to whether or not the demand pullback after the consumption tax will be prolonged.

○ Steady implementation of economy-supporting policy measures

- >> Economic policy measures will support the economic recovery.
- >> A virtuous circle of economic revitalization and fiscal consolidation will be realized.
- >> As for monetary policy, it is necessary to continue to take strong measures toward an overcoming deflation.
 - If awareness about an exit grows, more careful communication strategy will be required. It is important to implement prudence policy and work on fiscal consolidation in advance.

○ Challenges on the road to an exit from deflation and sustainable higher wages

- >> It is important to raise real wages through productivity improvement. Attention should focus on hourly wages, rather than on per-capita wages.
 - Improve the quality of labour through personnel training
 - Enhance employment mobility and the flexibility of working arrangements

○ Overcome supply constraints

- >> Improve productivity
- >> Fully utilize domestic and foreign resources
 - Women and elderly people will exercise their capabilities.
 - Create the world's most business-friendly environment and promote investments by domestic and foreign companies

○ Flexibly adapt to changes in comparative advantage and create added value

- >> Take advantage of strengths
 - Strengthen export competitiveness in light of changes in comparative advantage and earn income through pricing without preoccupation with volume.
 - Participate in a global value chain and devote efforts to areas of strength.
- >> Earn income from a broad range of sources
 - There is room for an expansion in trade in services. It is important to expand investment returns and improve trade gains.
- >> Create demand through challenges
 - Adapt to changes in needs due to the aging of society and promote innovation in service sectors.
 - Export business models developed in Japan as a “pioneer challenge-solving country.”