Issues surrounding Japan's balance of payments and the impact on the yen foreign exchange rate

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Abstract

In recent years, in Japan, changes in the structure of the balance of payments have attracted attention along with the continued decline of the Japanese yen exchange rate. In this paper, we critically introduce the Report on the balance of payments published by the Advisory Council under the Ministry of Finance in July 2024, and discuss the actual state of the structural changes occurring in Japan's balance of payments and their significance for the Japanese economy as a whole and for fluctuations in the yen exchange rate in recent years.

Introduction

On July 2, 2024, amid an 'historical' weakening of the Japanese yen foreign exchange rate, the Ministry of Finance of Japan published a report on Japan's external balance (hereafter, the Report). The Report was titled 'Issues of Japan's economy and the prescriptions for them, from the perspective of international balance of payments.'

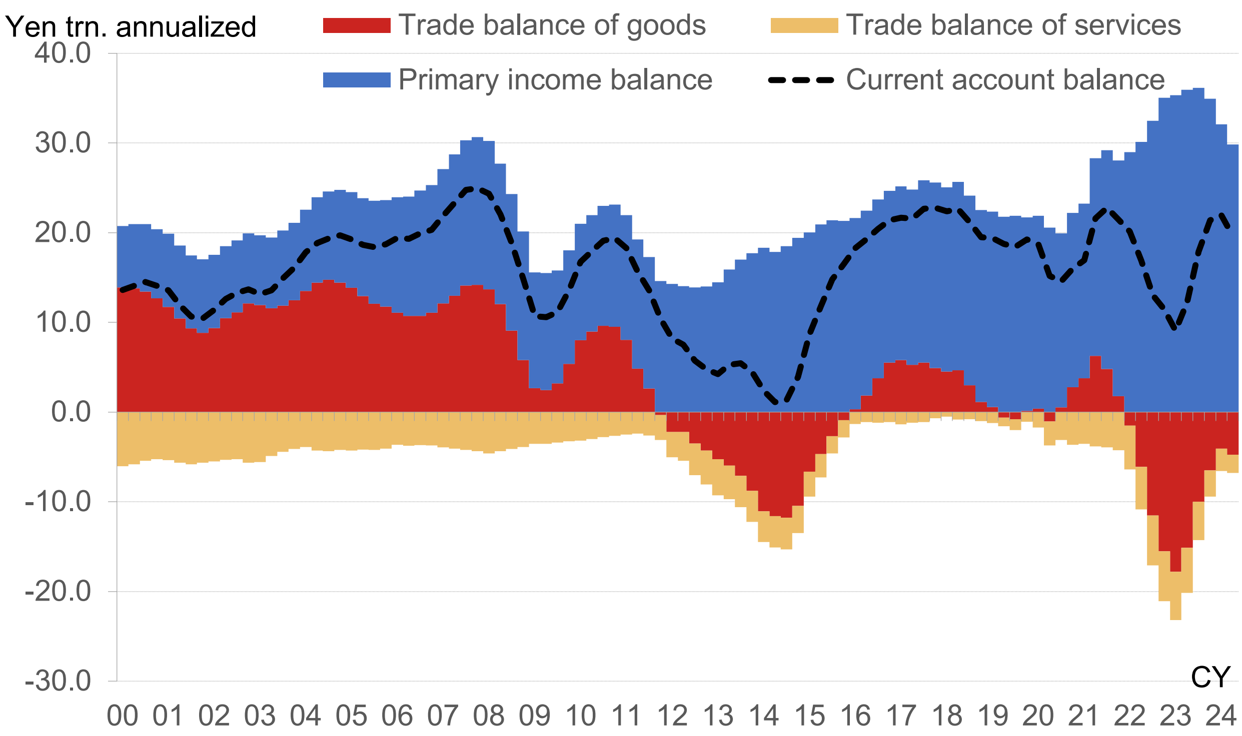
As the Report was published by an advisory council initiated and chaired by Masato Kanda, a former Vice Minister of Finance for International Affairs, it is natural to suppose the Report as well as the council were driven by a strong sense of urgency against the rapid weakening of the yen foreign exchange rate. In Japan, the Vice Minister of Finance for International Affairs is the final decision maker on currency intervention.

Alongside the Report, the weakness of the yen in foreign exchange markets as well as the deterioration of Japan's balance of payments have been an increasing concern in Japan (Figure 1). As the reopening of the global economy from the COVID-19 pandemic along with increasing geopolitical tension symbolized in the Russo-Ukrainian Conflict have materially elevated living costs for Japanese citizens, people tend to interpret yen weakness and the deterioration of Japan's balance of payments as signs of an irrevocable worsening of economic conditions for Japan.

In fact, we can find various structural changes in Japan's balance of payments which might reflect a possible decline in the growth potential and international competitiveness that Japan's economy has maintained so far. It is meaningful to revisit various aspects embedded in Japan's balance of payments if we try to sort out what to do to maintain, or even enhance, Japan's growth potential. Also, it makes sense to clarify if and how such factors led to the recent weakness of the yen exchange rate.

The approach in this article is as follows. Firstly, we summarize the key findings of the Report. Secondly, we sort out what specific aspects of Japan's balance of payments correspond to issues the Report identifies. Thirdly, we discuss the relation between those issues and the recent yen weakness. Finally, we evaluate whether the Report's proposed recommendations are adequate in addressing those issues as well as the excessive weakness of the yen.

Figure 1: Japan's current account balance decomposed



Source: Nomura, based on Ministry of Finance data

1. Issues identified in the Report

Facing a historical weakening of the Japanese yen exchange rate, many people tend to blame a shrinking balance of payment surplus as a major cause. The Report, however, does not explicitly attribute the yen weakness to changes in the international balance of payments. Rather, the Report focuses more on the detoration in Japan's economic growth potential and competitiveness reflected in structural changes in the balance of payments.

In the introduction, the Report points out:

> *From the perspective of the balance of payments, Japan's situation appears to be solid, but a closer analysis of the details reveals little reason for optimism. […]. Since the balance of payments is a mirror image of the structure of the Japanese economy, the current state of the balance of payments highlights the structural issues facing the Japanese economy.*

The question here is what concretely the Report sees as the 'structural issues facing the Japanese economy'. In summary, the Report raises two points as the major structural aspects of the Japanese economy that are embedded in the recent changes in the balance of payments structure.

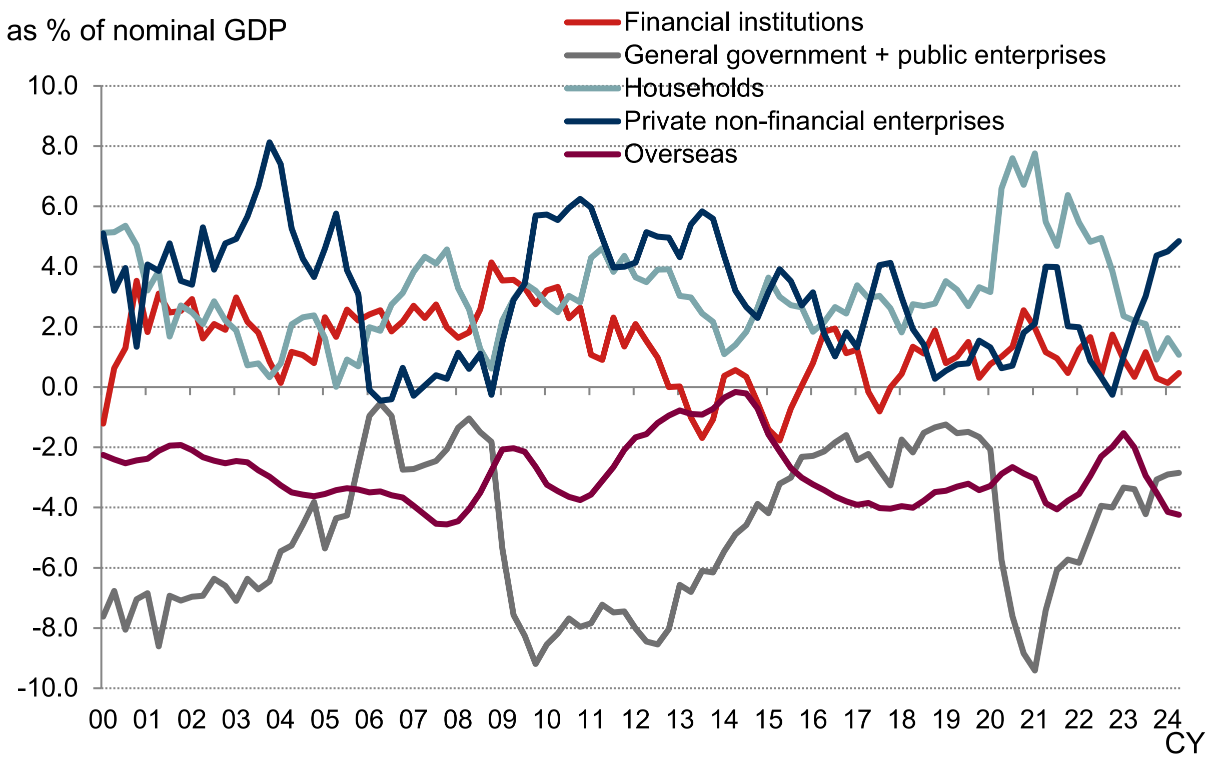
The first issue is what structural changes in the balance of payments mean in the context of Japan's economy experiencing the aging of the population.

An important and very basic precondition is the inevitable sharp decline and rapid aging of Japan's population, which can lead to enlarging current account deficits as the economy is theoretically likely to have a negative net savings by households (***Figure 2***). If Japan loses international competitiveness, failing to maintain sufficient exports of goods and services, the balance of payments inevitably will fall into a large deficit.

As is well known, Japan already had a fundamental deficit in goods trade mainly due to the recent increase in fossil fuel imports. The current account, on the other hand, still maintains a significant surplus mainly thanks to a primary income surplus.

A relatively large primary income surplus is a reflection that Japan so far has been less dependent on inward foreign investment, keeping outflows of interest and dividend payments on domestic financial assets in check, while historically accumulated claims on foreign assets by domestic entities continue to earn significant interest and dividend income. If the current account surplus gradually shrinks in the longer run, Japan has to become more and more dependent on foreign capital inflow, which eventually can also lead to a shrinking primary income surplus.

Figure 2: Net financial surplus/deficit (Savings-investment balance) by sector in Japan



Source: Nomura, based on the Bank of Japan data

Secondly, the simple fact that (the council under) the Ministry of Finance published the Report implies a strong sense of crisis and urgency regarding the sustainability of Japan's fiscal policy and public debt.

From a simple accounting perspective, a shrinking current account surplus means a narrower national saving-investment balance surplus. The narrower the surplus, the more dependent Japan will be on overseas capital to finance its public debt. In addition, the Bank of Japan's pivot in monetary policy, with its March 19, 2024, decision to end large-scale monetary easing is another factor leading to a sense of crisis. In this regard, the Report states:

> *Regarding Japan's public finance, the ratio of government debt to GDP is extremely high compared to other countries, and the rating of national bonds is lower than other developed countries. In addition, interest rates are currently on the rise, and the Bank of Japan is expected to reduce its purchases of government bonds in the future. With the risk of interest payment*

expenses expanding in mind, the challenge is to quickly build a sustainable fiscal structure.

In summary, the Report raised the issues of weakening international competitiveness, on the one hand, and the risk to the sustainability of fiscal and public debt management, on the other, as issues reflected in Japan's balance of payments.

2. Aspects of the balance of payments that relate to issues raised in the Report

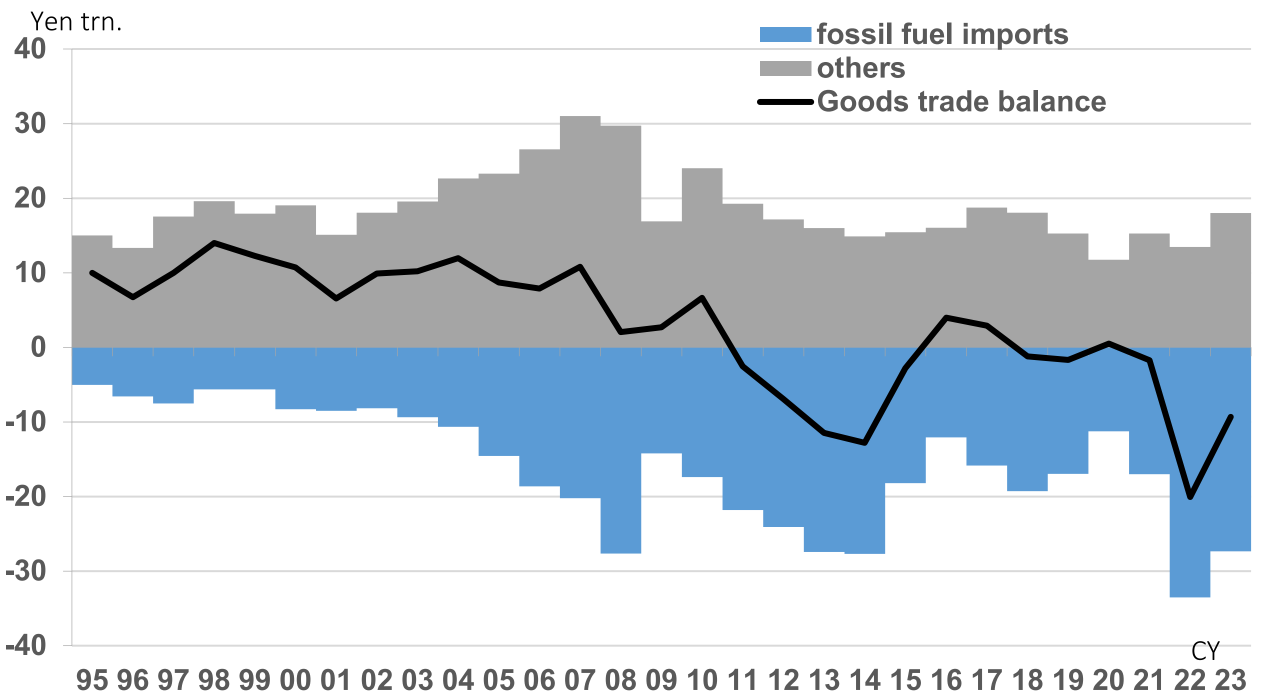
We now investigate the details of Japan's balance of payments that imply and relate to issues raised in the Report.

As for the loss of international competitiveness, we can point out various factors that are leading to larger trade and current account balance deficit.

A simple reason for the recent widening trade deficit has been the increase in fossil fuel imports. Higher international commodity prices after the end of the COVID-19 pandemic obviously contributed to thehigher cost of energy resources imported to Japan.

Japan recorded a trade deficit of ¥20 trillion in 2022 when fossil fuel imports amounted to ¥34 trillion(***Figure*** *3*). Both the trade deficit and fossil fuel imports exceeded the maximum recorded in 2014 after the Great East Japan Earthquake.

Figure 3: Impact of increasing fossil fuel imports on Japan's goods trade balance



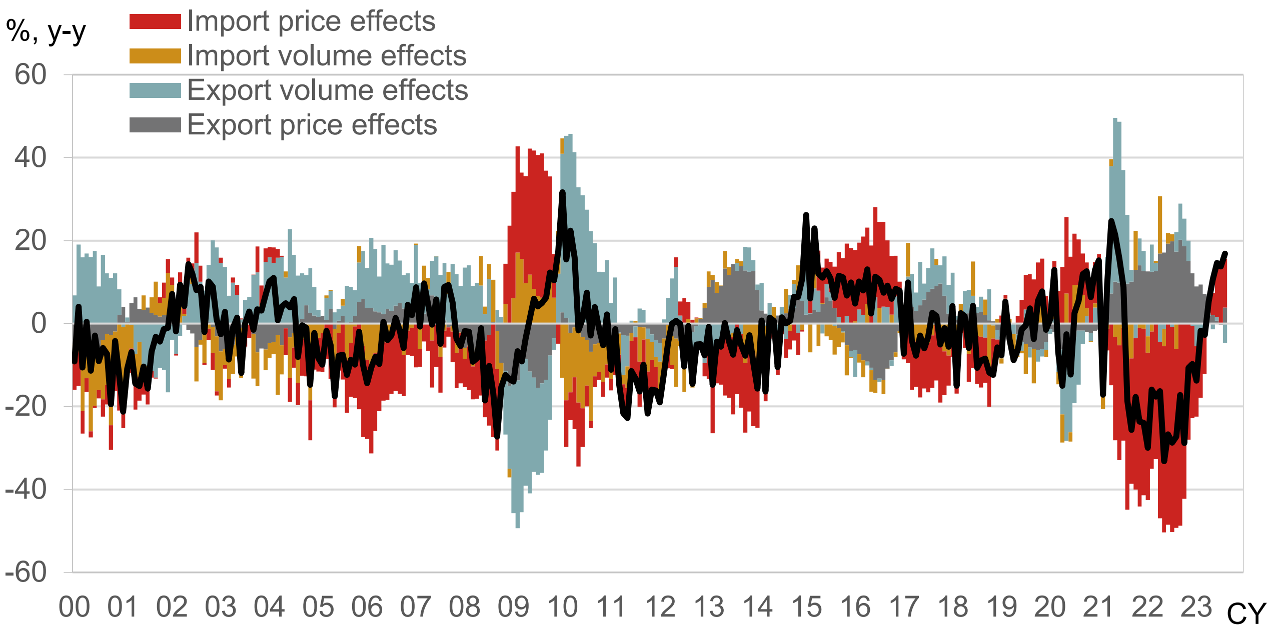
Source: Nomura, based on Ministry of Finance data

More important, however, has been the change in the composition of basic energy sources in Japan and a policy that allowed greater dependence on fossil fuels. A major reason was the complete shutdown of nuclear power plants after the Great East Japan Earthquake that caused the accident at the Fukushima nuclear power plant.

In contrast to imports, there are few changes in nominal exports that would suggest a structural deterioration in the trade balance. If we break down export trends into volume and price, however, we find the elasticity of export volume against the exchange rate has been getting smaller recently. This is mainly due to the diversification of production capacity by Japanese manufacturers, which has raised the value added of export products so that they need to adjust their selling price in overseas markets less as the exchange rate fluctuates.

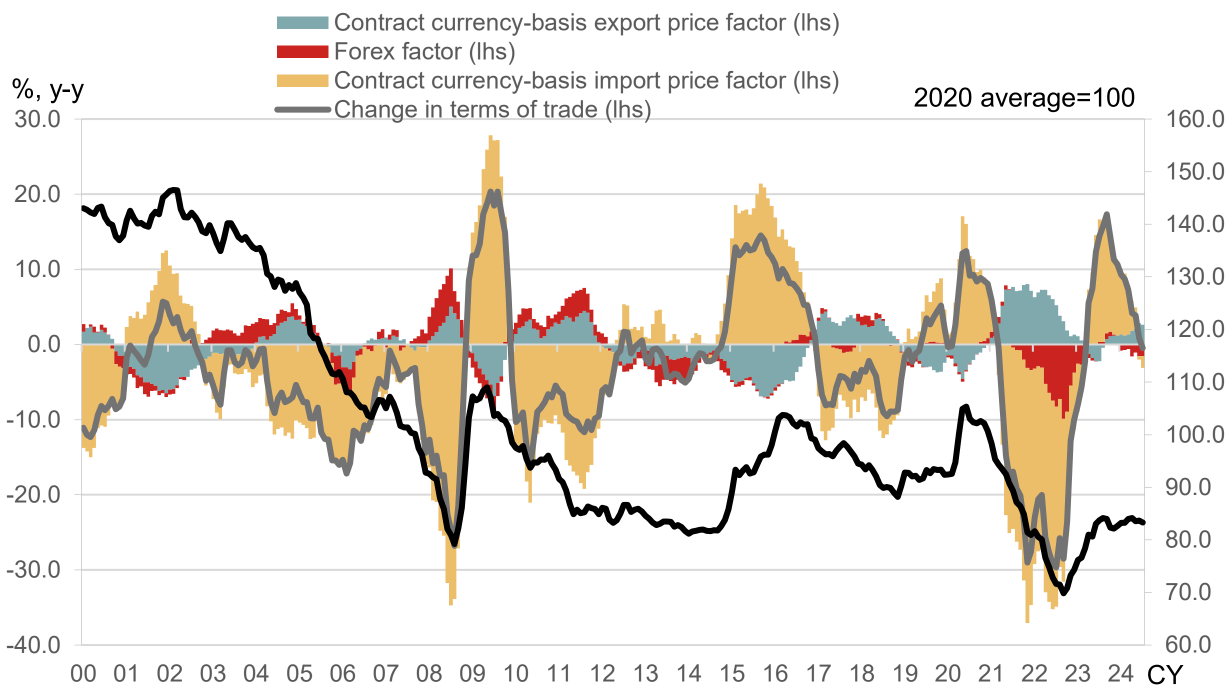
The correlation between Japan's export volume and the yen exchange rate has gotten smaller in recent years. Japanese exporters no longer use the depreciation of the yen to boost their exports. Also, the export prices on a contract currency basis have become less sensitive to the yen exchange value recently, which means Japan's exporters do not really revise the sales price of their products in overseas markets in response to exchange rate fluctuations (***Figure 4, Figure 5***).

Figure 4: Factor decomposition of Japan's goods trade balance



Source: Nomura, based on Ministry of Finance and the Bank of Japan data

Figure 5: Changes in terms of trade and decomposition

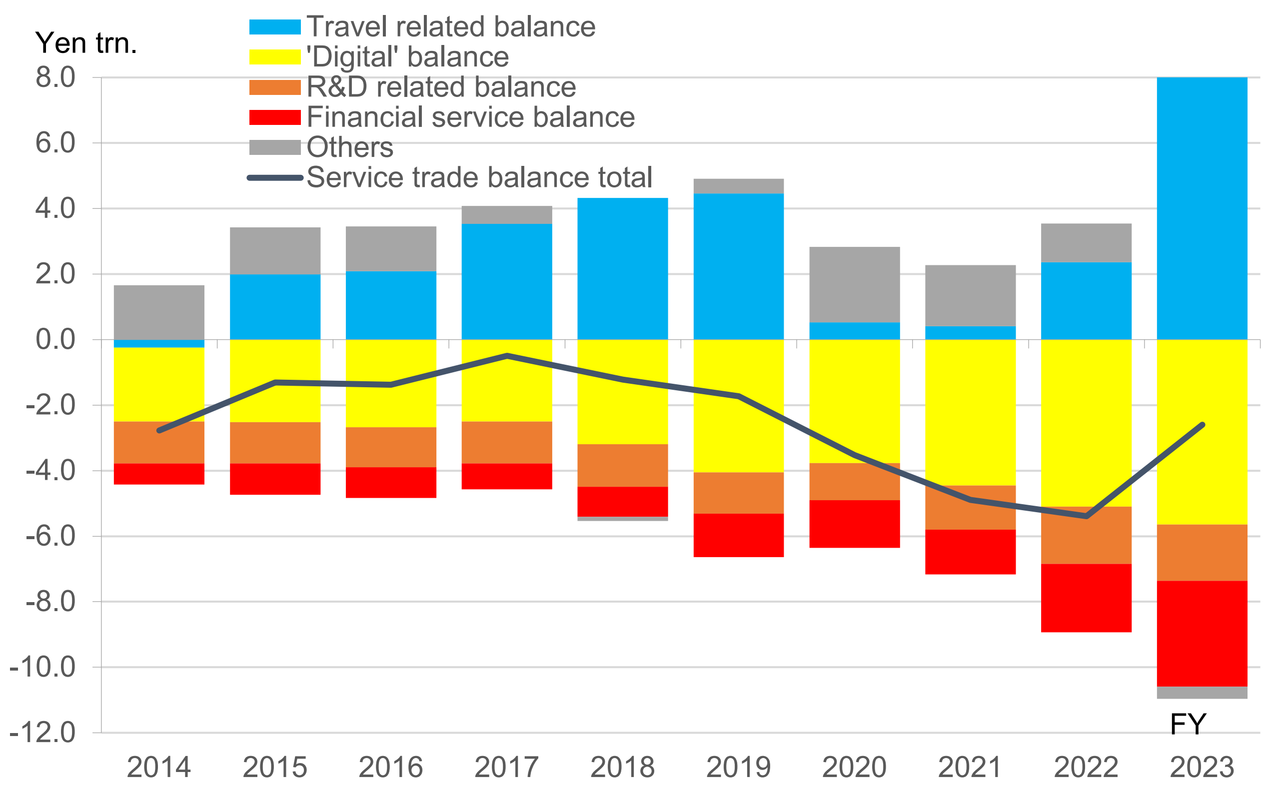


Source: Nomura, based on Ministry of Finance and the Bank of Japan data

The Report also pointed out factors that can aggravate Japan's service trade balance. A typical one is what they call 'digital' deficits, which is defined as the sum of computer service charges, licensing fees for intellectual property, and management and consulting service fees. The digital deficit in FY2023 was ¥5.6 trn, nearly double the ¥2.3 trn deficit in FY2014. Japan has also been subject to increasing deficits from financial service payments and research and development related payments (***Figure 6***).

Other than the digital deficit, a deficit in net financial services payments has also been on a steady increasing trend, contributing to the deterioration in Japan's international payments balance. Among various financial service payments, the largest contributor to the widening deficit is insurance charges, which widely reflects reinsurance payments by Japanese casualty insurance companies. Also, the increasing penetration of foreign owned life insurance companies in Japan's insurance market has elevated the outflow of financial services payments.

Figure 6: Factor decomposition of Japan's service trade balance



Source: Nomura, based on Ministry of Finance data

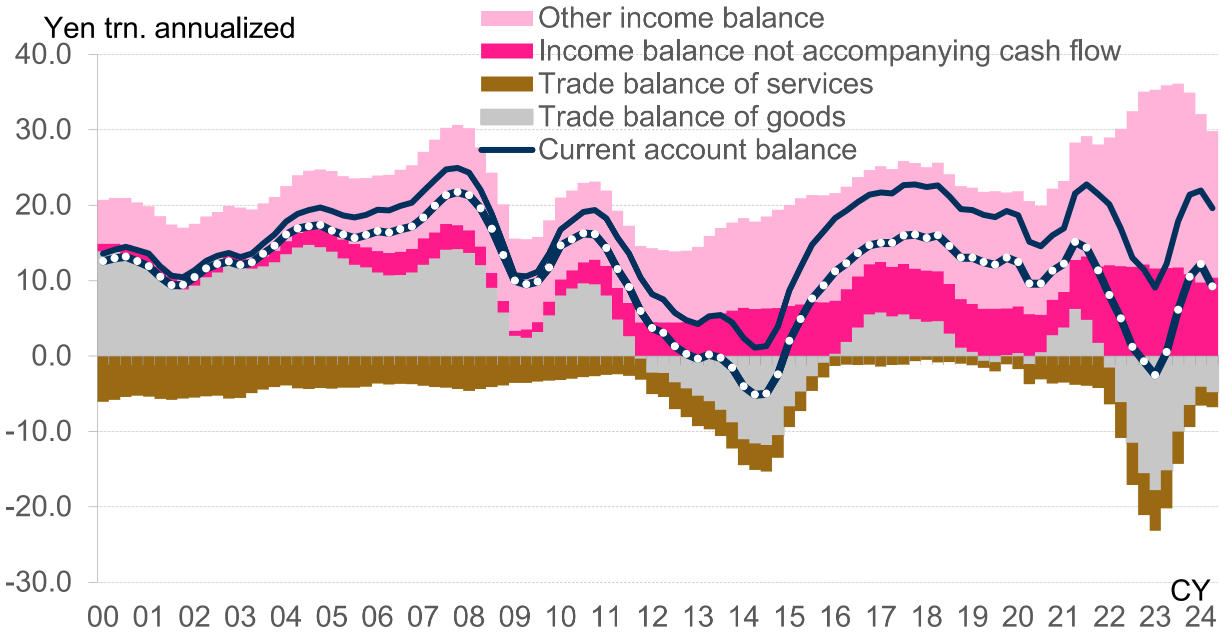
Despite these factors contributing to the deterioration of the external balance, Japan's current account balance recorded an historic surplus in 2023. This is almost solely due to the large and widening primary income surplus.

The Report pointed to the condition where large receipts of primary income do not really contribute to stimulating domestic economic activities and thus to demand for Japanese yen, because not all the primary income receipts are repatriated to Japanese territory. Excluding primary income receipts that may not be repatriated (so-called cashflow basis balance of payments) reduces Japan's primary income surplus by about two thirds (***Figure 7***). A typical example of primary income receipts not repatriated is the 'net reinvested income' portion of the income from foreign direct investment by Japanese enterprises (***Figure 8***).

In this regard, The Report argues as follows.

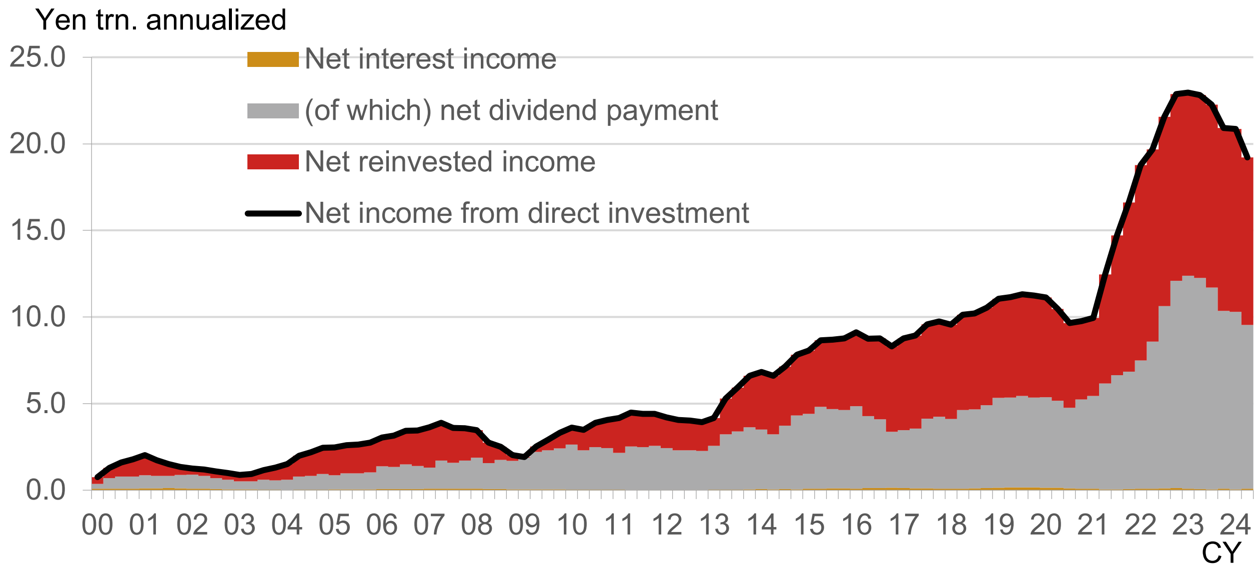
> *About half of direct investment earnings are repatriated as dividends, with the remainder being reinvested as earnings to expand business at overseas bases. In this way, Japanese companies are expanding their businesses "outside of borders" using overseas earnings as a source of capital, while capital investment "inside borders" has long been stagnant, reflecting Japan's lack of attractiveness as an investment destination. While the balance of outward direct investment is expected to expand rapidly by about 8.5 times from 2000 to 2022, the balance of private corporate capital stock has grown by about 18%, or just 0.8% on average per year.*

Figure 7: Cashflow basis primary income balance in Japan's current account



Source: Nomura, based on Ministry of Finance data

Figure 8: Decompostion of Japan's net income from foreign direct investment



Source: Nomura, based on Ministry of Finance data

The Report also discusses issues regarding the financial balance. The Report focuses on: 1) subdued inward direct investment; 2) how to make inward portfolio investment in domestic equities more sustainable; 3) how to redirect households' outward portfolio investment more toward inward equity investment; and 4) the possible impact of the financial balance on the sustainability of Japan's public debt.

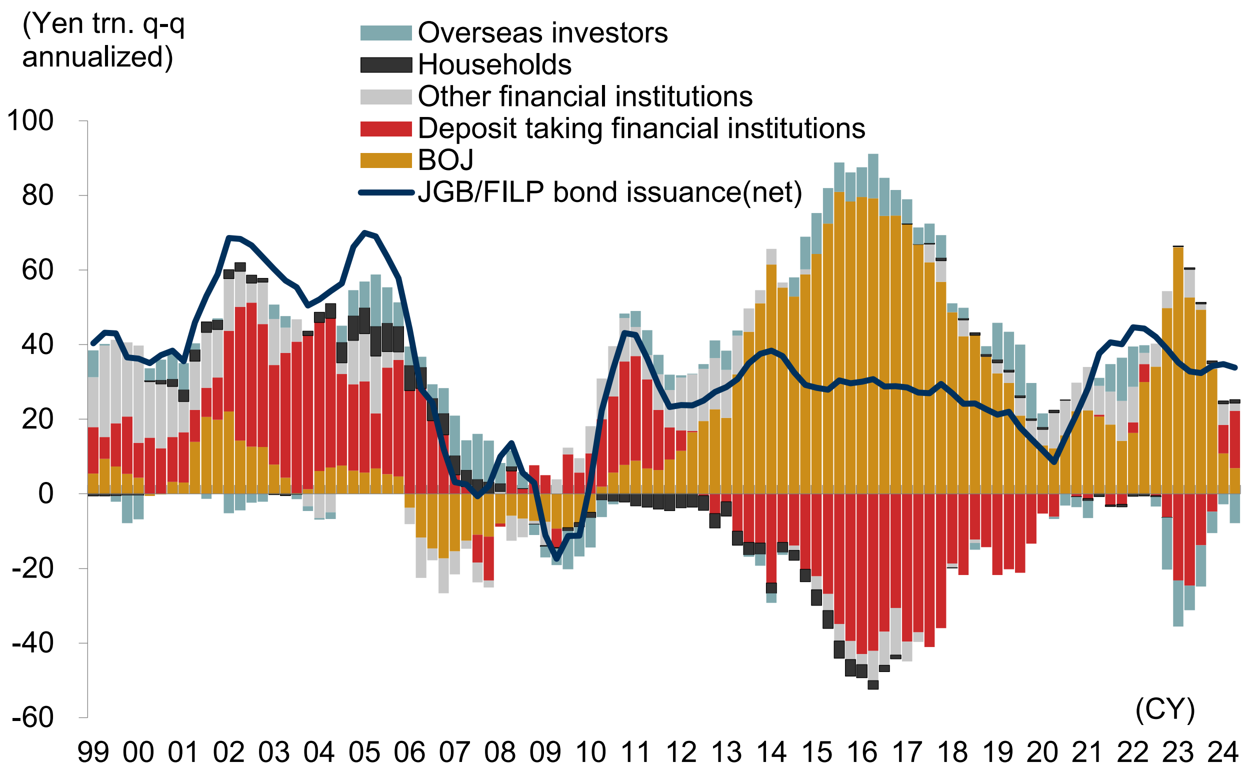
As for point 4 above, the Report strongly urges higher financing cost of public debt based on the following changes in the financial balance.

Firstly, as overseas investors' share of Japanese government bond holdings as well as transactions is on an increasing trend, the JGB market should become more volatile. This is because overseas investors tend to be more proactive in JGB transactions compared to their domestic counterparts.

Secondly, increasing outward portfolio investment by domestic households can weaken so-called hometown bias and can make domestic interest rates more subject to overseas rates.

Overseas investors' appetite for JGBs tended to strengthen as the BOJ's ultra-easy montery policy created negative hedging costs to investing in yen-denominated vehicles (***Figure 9***). As a result, the ratio of JGB holdings by foreign investors has reached as high as 10% of overall outstanding JGBs.

Figure 9: Net changes in Japan's government debt securities and its decomposition by holder



Source: Nomura, based on the Bank of Japan data

3. Is the recent yen weakness the result of changes in Japan's international balance of payments?

We next deal with the question of whether the structural issues discussed above materially affect the recent weakness in the yen and, if so, how. The common answer in Japan, including from market participants, is yes.

Market participants generally believe that two main changes in the balance of payments are causing the recent yen depreciation.

One is the structural deterioration in the goods and services trade balance caused by the large increase in energy and commodity imports as well as the steady widening of the digital deficit.

The second is the widening discrepancy between the nominal current account balance, which still maintains a huge surplus, and the so-called cashflow basis current account balance. Here, they argue that part of the current account surplus, such as the earnings and dividends on foreign direct investment by Japanese enterprises, is not repatriated and is thus not producing demand for Japanese yen.

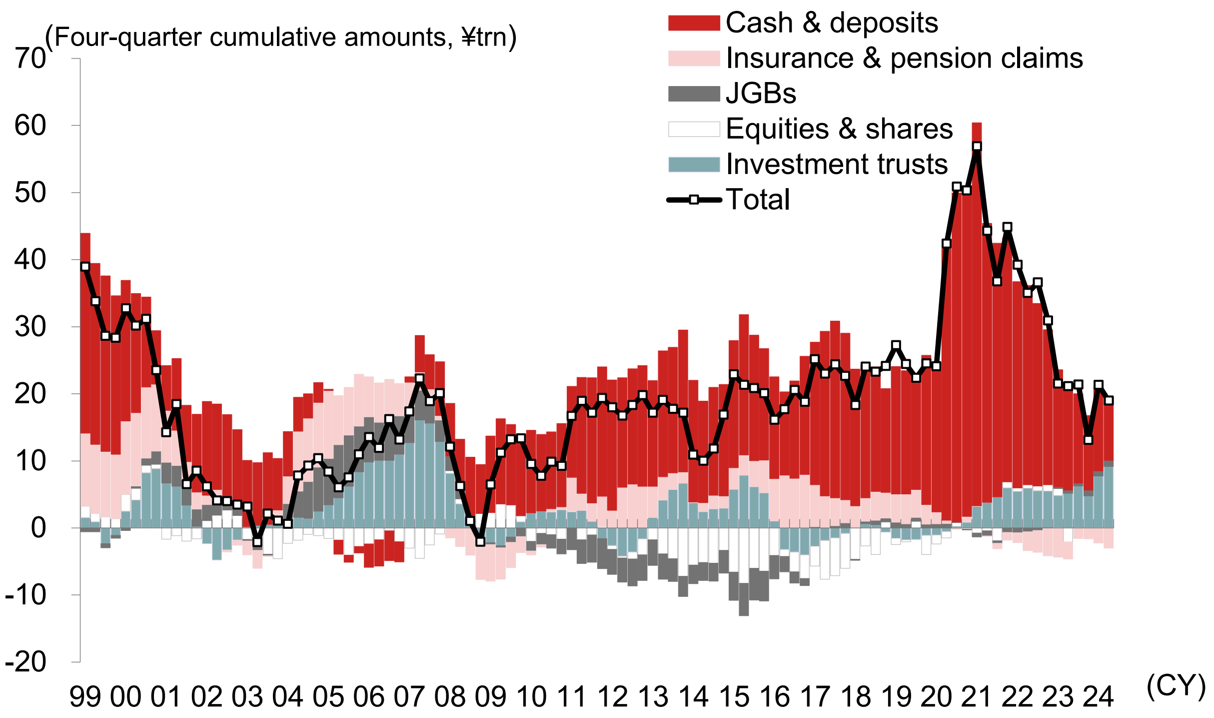
The significance of these two factors tempts us to say that they are materially the reasons behind the recent historical weakening of the Japanese yen. However, the factor that has had much greater power in explaining the weakening of the yen since around 2020 is simple interest rate parity.

Only in the several months since the start of 2024 has interest rate parity lost its explanatory power. It is difficult to explain such short-term fluctuations of the yen exchange rate in terms of structural changes in the balance of payments over the recent time horizon.

Among balance of payment factors, the increase in outward portfolio investment by Japanese households may be better suited to explain the depreciation of the yen in recent months.

From the beginning of 2024 the Japanese government introduced the so-called New NISA program as a tax incentive measure to promote financial investment by individuals. Against the backdrop of still low interest rates, this measure boosted to some degree foreign currency-denominated financial assets held by Japanese individuals. We found net acquisition of investment trust assets by households increased gradually but steadily in recent years (***Figure 10***).

Figure 10: Net change in financial assets of households and its decomposition

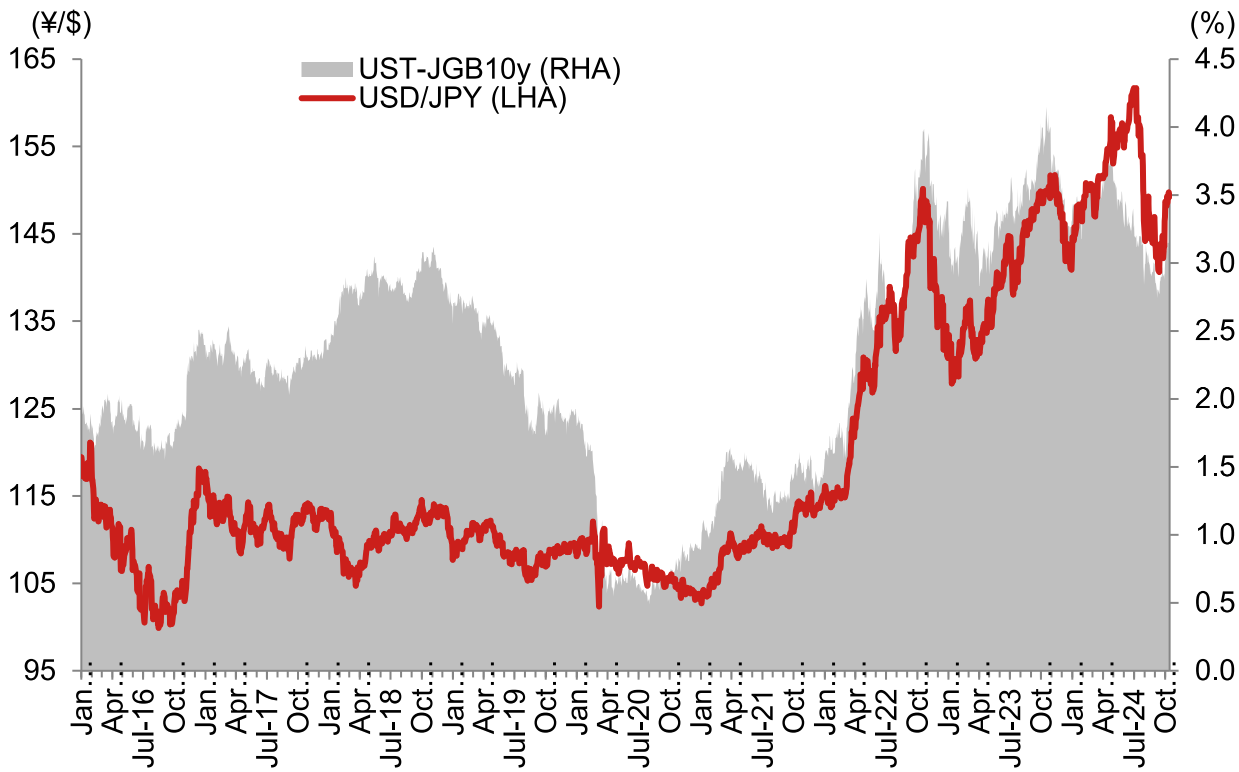


Source: Nomura, based on the Bank of Japan data

The reality of the sudden and sharp drop in the dollar-yen exchange rate over the first weekend in August, 2024, may be that the accumulation of yen-short speculative positions in a relatively brief period caused the weakening of the yen. Such a build-up of short positions drove the dollar-yen rate higher despite the already narrowing differential between yen and dollar interest rates (***Figure 11***), the sudden unwinding of which led to the sudden fall in the dollar-yen rate at the beginning of August.

When it comes to the underlying level of the Japanese yen exchange rate, or in other words, the underlying strength of the yen, structural changes in Japan's balance of payments certainly still matter. Among the various observations in the Report, what particularly matters will be how hometown bias among Japanese households fades as the surplus-earning power of Japanese enterprises fundamentally weakens, on the one hand, and how well Japan can attract and maintain steady financial inflows as inward direct and portfolio investment to balance the shrinking current account surplus, on the other.

Figure 11: USD/JPY exchange rate and US-Japan rate differential



Source: Nomura, based on Bloomberg data

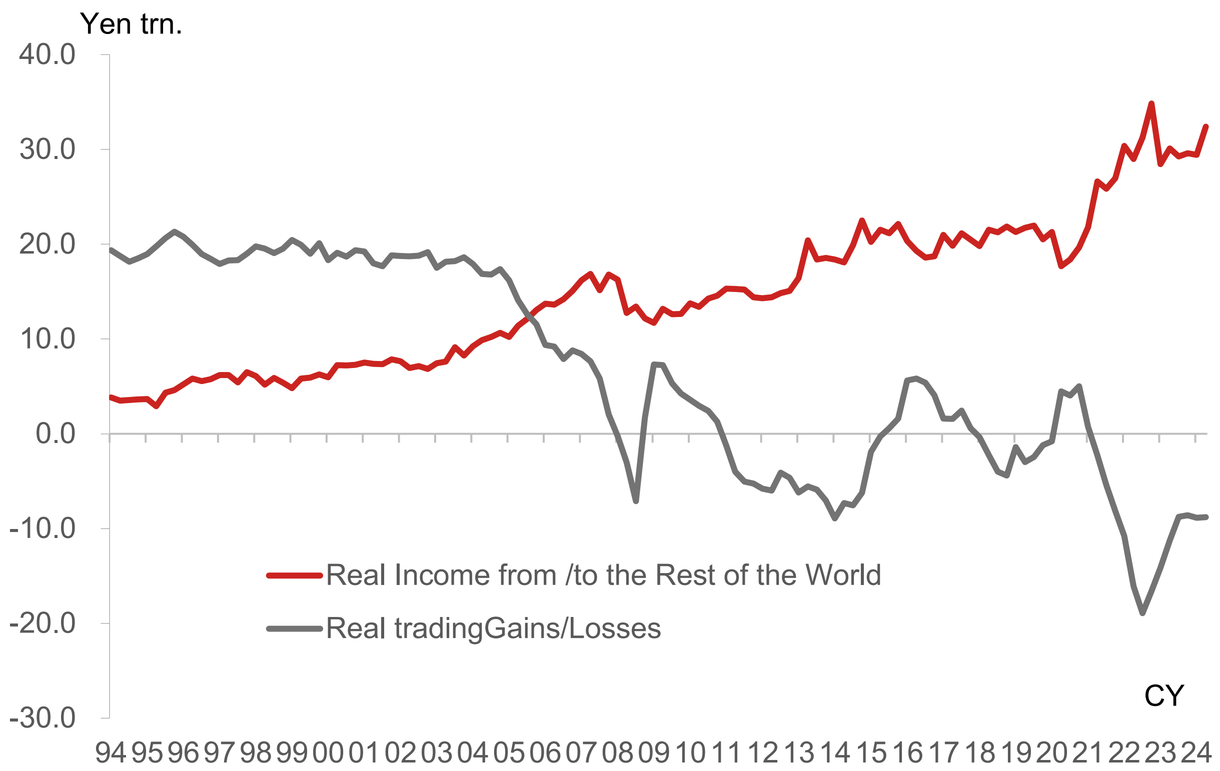
Another important point in the relationship between the yen exchange rate and Japan's balance of payments will be the self-stabilizing power of the exchange rate for the balance of payments, i.e., how much weakness in the yen will contribute to correcting the balance of payments.

As pointed out earlier, movements in the yen exchange rate have less power to boost Japan's exports. In recent years, Japan's export volume has not significantly increased as Japanese exporters adjusted their selling prices in overseas markets less sensitively against the weakening of the yen exchange rate. In this regard, we can no longer expect any weakening of the exchange rate will significantly lead to a larger trade surplus, or to a larger current account surplus.

To some extent, however, we find that the exchange rate does have an autocorrecting influence on Japan's balance of payments.

One way to gauge this should be to compare the net increase in primary income receipts that tends to increase along with yen weakness with the net trading gain/loss in national income statistics that tends to deteriorate with yen depreciation. For the first half of 2024, net income receipts from/to overseas ran around ¥30 trn per annum while net trading gains/losses ran around ¥10trn (both in real terms) (***Figure 12***). This implies that the depreciation of of yen still has some self-correcting power in Japan's balance of payments.

Figure 12: Net primary income receipts and net trading gains in Japan's national accounts



Source: Nomura, based on Cabinet Office data

4. Prescriptions of the Report – will balance of payments and exchange rate really matter for Japan's economy?

Against the backdrop of the ongoing structural changes in Japan's balance of payments, the Report proposes four prescriptions for Japan's economy. Below is a summary of these prescriptions with some supplementary explanation of how they relate to the balance of payment issues.

The Report first points out the need to improve productivity by promoting creative descruction among Japanese enterprises and industries and by accelerating labor mobility. These measures are primarily proposed as a response to the declining competitiveness of Japan's export industries and the widening digital deficit that reflects the competitive disadvantage of ICT and software-related industries in Japan. This prescription also intends to improve the competitiveness and productivity of domestic companies, thereby helping to curb the outflow of personal financial assets overseas.

Secondly, the Report recommends increasing investment in human capital and further developing and utilizing new technologies in Japan. These measures are also aimed at recovering the competitiveness of export industries with the spillover effect of reducing dependency on fossil fuel energy by developing new power generating resources.

Thirdly, the Report calls for the promotion of domestic investment and inward direct investment by highly competitive foreign companies. Increasing inward investment can also help to achieve the first prescription of improving productivity. Japan will also need increasing inward direct investment to counter-balance the shrinking current account surplus.

Finally, the Report highlights the need for fiscal consolidation. The aim is to brace for the risk of rising interest rates due to the diversification of government bond funding structures, with the inevitable increasing dependence on overseas investors as well as decreasing dependence on domestic savings in the future.

The aim of the series of prescriptions proposed in the Report is, above all, to strengthen the growth potential and competitiveness of the Japanese economy. However, it is also true that one of the means to achieve this is to strengthen the resilience of the international balance of payments structure. To that extent, if these prescriptions are implemented correctly, they are expected to help eliminate the structural vulnerability of the Japanese yen.

On the other hand, as can be seen from the relationship between the U.S. current account, which has been in deficit for many years, the growth potential of the U.S. economy, and the exchange value of the U.S. dollar, there is no linear relationship between the balance of payments structure, represented by maintaining a current account surplus, the growth potential of an economy and the value of a country's currency.

As for the relationship between Japan’s external balance, economic competitiveness, and public finance, we can find an ironical interdependence. Technically, if weakening economic competitiveness leads to a shrinking current account surplus, maintaining stable public finance will become more vulnerable, as the economy’s public debt funding depends more on overseas capital.

Nevertheless, an economy’s current account, as the sum of the saving-investment balance of every economic sector, can record an increasing surplus even in the case the economy’s overall demand growth weakens and households and enterprises tend to save more. It seems this is what has actually happened so far in Japan’s economy as it experienced a prolonged deflationary phase.

In this respect, the Report will inevitably be criticized for focusing too much on the balance of payments structure as a factor in resolving the serious task of strengthening the growth potential of the Japanese economy. There is no one-to-one correspondence between the economy maintaining its previous growth potential and competitiveness and maintaining its previous external balance structure. Even if the structure of the current account balance were to change completely, it is possible that the growth potential and competitiveness may actually improve.

Neither is it fair to say that the recent weakness of the yen exchange rate is a sign of the structural weakening of Japan’s economic potential. As pointed above, the sudden unwinding of speculative investors’ yen-short position alone significantly and irrevocably affected the dollar-yen level. We do not really have to suppose the weakness in the yen is something structural. It could have been a temporary phenomenon.

As the U.S. Federal Reserve’s FOMC started cutting the policy rate in September 2024, we expect the dollar-yen rate to go lower for a while. Nomura expects the rate to reach as low as ¥135 per dollar by the end 2025.

Conclusion

As the COVID-19 pandemic came to an end and economic activity resumed globally, accelerating inflation and a sharp fall in the yen exchange rate, along with a structural deterioration in Japan's balance of payments, have been feared as symbolic of the weakening of the Japanese economy. The Report, published by Ministry of Finance in July 2024, shares this point of view.

As the Report points out, we must acknowledge that to a certain extent the changes in Japan's international balance of payments reflect important challenges facing the economy in the medium to long term, such as a structural and irreversible deterioration in competitiveness.

Still, it is not fair to link the recent weakness of the yen foreign exchange rate solely and directly to such changes in the balance of payments. We can attribute the weakening yen exchange rate more to widening interest rate differentials against the yen and to accumulation of short positions in yen by speculative investors rather than to structural deterioration of Japan's international balance of payment position. We also find that some self-correcting contribution of a weaker yen to improving the balance of payments still survives.

The Report's argument that the structural changes in Japan's balance of payments reflect the economy's fundamentally weaker competitiveness due to the ongoing demographic shift, does not necessarily mean that Japan must focus on maintaining a current account surplus.

The existence of a structural current account deficit, as in the case of the U.S. economy, does not always negate the strength of a country's competitiveness. Generally speaking, those economies that have robust underlying domestic demand tend to have larger trade and current account deficits. It is not fair to take the deterioration of Japan's balance of payments as something unilaterally negative for the future of Japan's economy.

There should be multiple styles and models of balance of payments structure that Japan can live with while maintaining, or even enhancing, its growth potential under an aging demography. Of course, we do not have to deny the significance of the Report itself and the various prescriptions in it. We should not stick solely to the balance of payments structure that supported Japan's past success; rather we should adopt a more flexible approach.