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Japan's Trade Surpluses

In recent years, Japan has experienced large and persistent trade surpluses. Its current account balance rose from a small surplus of \$5 billion in 1981 to \$86 billion in 1986 and levelled off at \$87 billion in 1987. Relative to GNP, the surplus increased over this period from less than one-half of one percent to more than four percent.

Such a large trade surplus has generated tensions between Japan and its trading partners, particularly the United States. Trade with Japan accounts for almost 40 percent of the total U.S. trade deficit. This trade imbalance with Japan has put increasing pressure on the U.S. Administration to seek ways to expand U.S. exports to Japan and to protect U.S. domestic industries from Japanese and other competition. The U.S. Congress has considered broad, punitive trade bills designed to slow imports from abroad, and has threatened retaliatory sanctions unless access to Japan's beef, agricultural, and construction markets is expanded.

However, contrary to popular opinion, the level of protectionism in Japan actually has *decreased* in the last several years even as Japan's surpluses have risen. Thus, although further reductions in Japan's barriers to U.S. exports may be desirable, the explanation for the emergence of Japan's surpluses lies elsewhere. This *Letter* suggests that Japan's trade surpluses are a reflection of macroeconomic imbalances in saving and investment between Japan and its trading partners. Therefore, the reduction of Japan's trade surpluses hinges on adjustment of domestic and foreign saving and investment behavior rather than on reductions in bilateral trade barriers.

Current account balance

One measure of a country's international trade position is its current account balance. The current account balance measures the difference between a country's exports of goods and services and its imports of goods and services. National income account relationships imply that a country's current account reflects domestic private saving and investment behavior, as well as

domestic government saving. When domestic private saving exceeds domestic private investment and government tax receipts exceed expenditures, thereby generating net saving for the economy as a whole, savings will flow abroad into overseas assets. Such an accumulation of foreign assets implies an excess of exports over imports, that is, a current account surplus. Thus, the large trade surpluses in Japan may be associated with high private saving relative to investment and/or high government tax receipts relative to expenditures.

Moreover, since Japan's current account surplus is the rest of the world's deficit, macroeconomic developments and saving-investment behavior in the rest of the world also may be among the determinants of Japan's current account surplus. Specifically, an excess of both foreign private investment over foreign private saving and of foreign government expenditures over tax receipts also are associated with a current account surplus in Japan. Thus, for example, a rise in foreign government budget deficits can contribute to a rise in Japan's external surplus. (The *Letter* of March 27, 1987, discusses the accounting relationship between a country's trade balance and domestic spending in greater detail.)

Recent trends

To weigh the contributions of domestic and foreign saving-investment behavior to Japan's external surpluses, it is useful to look at recent trends. Chart 1 plots four-quarter moving averages of Japan's current account, private saving-investment, and government saving balances as a share of GNP over the period 1966 to 1986.

Over the past twenty years, Japan's current account balance has shifted widely from deficits to surpluses. Surpluses averaging roughly two percent of GNP were recorded in 1971-72 and in 1978. Deficits averaging one percent of GNP emerged at the time of the oil price crises of 1974 and 1979-80. The most recent surpluses, however, are significantly larger than those previously attained. In 1985, the surplus reached 3.7 percent of GNP and in 1986, 4.3 percent.

Chart 1
Japanese Net Saving
and Current Account Balances

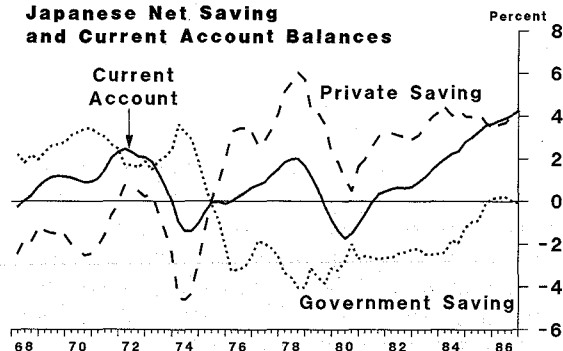


Chart 1 also shows that in recent years Japan's net private saving-investment balance has increased as a percent of GNP. From 1966 to 1974, this balance averaged 1.4 percent; from 1975 to 1980, 3.2 percent, and from 1980 to 1986, 3.7 percent. Between 1980 and 1986, it rose by almost three percentage points.

Contrary to the common view, however, this rise in Japan's net private saving is the result of a sharp decline in investment rather than a rise in saving. Private saving averaged 17.5 percent of GNP from 1966 to 1974, 16.6 percent from 1975 to 1980, and 14.1 percent from 1981 to 1986. Clearly, the trend has been a small decline in Japan's private saving rate.

At the same time, since 1975, the rate of private investment in Japan has fallen sharply. Net investment averaged 18.9 percent of GNP from 1966 to 1974, 13.4 percent from 1975 to 1980, and 10.3 percent from 1981 to 1986. This decline in investment reflects the deceleration in Japan's long-run growth rate and the resulting reduction in domestic prospects for net investment.

In addition to Japan's growing saving-investment surplus, the behavior of government saving (that is, government receipts minus expenditures) also has played a role in generating such large surpluses in Japan's current account in recent years. Over the period from 1975 to 1979, the growth in net private saving largely was matched by a rise in government budget deficits that reached 4.1 percent of gross national output in 1978, well above the average of 2.2 percent over the period from 1966 to 1974. Since 1979, however, the budget deficit has declined steadily, primarily as a result of reduced spending. A small surplus

was attained in 1985. This improvement in the budget balance reduced the public sector's demand for domestic saving.

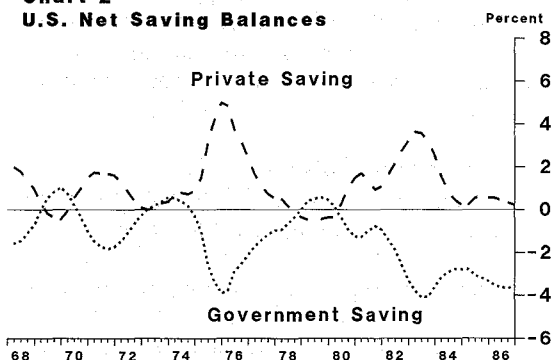
Even though Japan's private saving rate has declined over the last twenty years, the demand for domestic savings used for investment has declined by more. Thus the dramatic rise in Japan's external surpluses in the 1980s can be attributed to sharp drops in private investment and the government budget deficit, and not to an increase in private saving.

The global context

In a global context, Japan's net exports are net imports by the rest of the world. These net imports reflect an excess of investment over private and government saving in the rest of the world. Since trade with the United States accounts for nearly 60 percent of Japan's trade surplus, analysis of saving and investment behavior in the U.S. provides a rough approximation of the role of foreign factors in Japan's current account.

Chart 2 plots four-quarter moving averages of the private saving-investment and government saving balances of the United States, Japan's largest trading partner from 1966 to 1986. In contrast to recent trends in Japan, fiscal saving in the U.S. shifted from small surpluses (0.5 percent of GNP in 1979) to large deficits, averaging 3.4 percent of GNP from 1982 to 1986. Along with these increasing deficits, the U.S. private saving-investment balance has fallen in recent years. This decline in net saving in the U.S. undoubtedly is another important factor contributing to the development of Japan's current account surpluses.

Chart 2
U.S. Net Saving Balances



Keeping in mind that saving and investment behavior domestically and abroad are jointly determined, empirical analysis can estimate the relative contributions to Japan's current account surpluses of declining U.S. net saving and rising net saving in Japan. This analysis indicates that the decline in the U.S. saving-investment balance played as important a role in the emergence of Japan's external surpluses as did Japan's saving-investment behavior. In other words, in the absence of any effects of U.S. fiscal policies, Japan's current account surplus in 1986 would have been roughly one-half its actual level. Of the cumulative four percentage point increase in the ratio of its surplus to potential GNP between 1981 and 1986, net saving behavior in Japan explains 2.5 percentage points and net saving behavior in the U.S. accounts for 2.3 percentage points. (Business cycle factors worked to *reduce* the surplus by roughly one percentage point.) Thus, U.S. policies, as well as developments in Japan, have played a role in Japan's emergence as a major surplus country in international trade transactions.

Implications

These findings suggest that both Japan and the United States may need to adjust their fiscal policies to reduce Japan's large external surplus. Although the depreciation of the dollar since 1985

and the corresponding appreciation of the yen have made Japanese exports less attractive and imports from the U.S. more attractive, the United States still needs to reduce its fiscal deficits, and Japan simultaneously ought to increase its fiscal spending relative to its tax receipts.

In fact, there are signs that such adjustments already are occurring. Following the recommendations of the 1986 Maekawa Report, Japan has moved to stimulate domestic demand and reduce net saving. Government expenditures have increased; stronger incentives for housing investment have been provided; and taxes on previously exempt savings accounts have been introduced. The desire to stimulate a lagging economy was the motive, but such measures also should contribute to a decline in Japan's current account surpluses.

At the same time, since 1986, the United States has moved in the direction of reducing its fiscal deficits. The federal budget deficit has been reduced significantly, from \$221 billion in 1986 (5.2 percent of GNP) to \$150 billion in 1987 (3.5 percent of GNP). While it is unclear how quickly the deficit will be reduced in the future, the trend is in the proper direction.

Reuven Glick
Senior Economist

Research Department
Federal Reserve
Bank of
San Francisco

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington