Structural changes in Japan's current account balance

17 November 2023

- The main drivers of the yen depreciation that took place in 2022 includes factors such as the interest rate differential between Japan and the United States as well as the rapid expansion of Japan’s trade deficit. Although the trade deficit has decreased in 2023, the exchange rate remains at a depreciated level. In this article, we examined the structural changes in Japan’s current account balance using data from 1996 onwards.
- In recent years, the presence of “reinvestment earnings”, which are not likely to be converted to yen, has increased in the primary income balance, and the structure of the current account surplus has changed to one where it is less likely to lead to an appreciation in the yen.

The yen weakened in 2022, mainly due to the interest rate differential between the US and Japan as well as the rapid increase in Japan's trade deficit. The interest rate differential widened between the United States, which is rapidly tightening monetary policy, and Japan, which is maintaining monetary easing in an effort to end deflation. In addition, the value of imports has increased considerably due to higher prices of imported resources, including mineral fuels such as crude oil, resulting in the largest trade deficit ever recorded in 2022. The relationship between balance of payments statistics and exchange rates is generally regarded as a main factor for the appreciation of the currency when the current account balance is in surplus. The year 2022, which saw the largest trade deficit in history, was a time when the yen depreciation was very likely.

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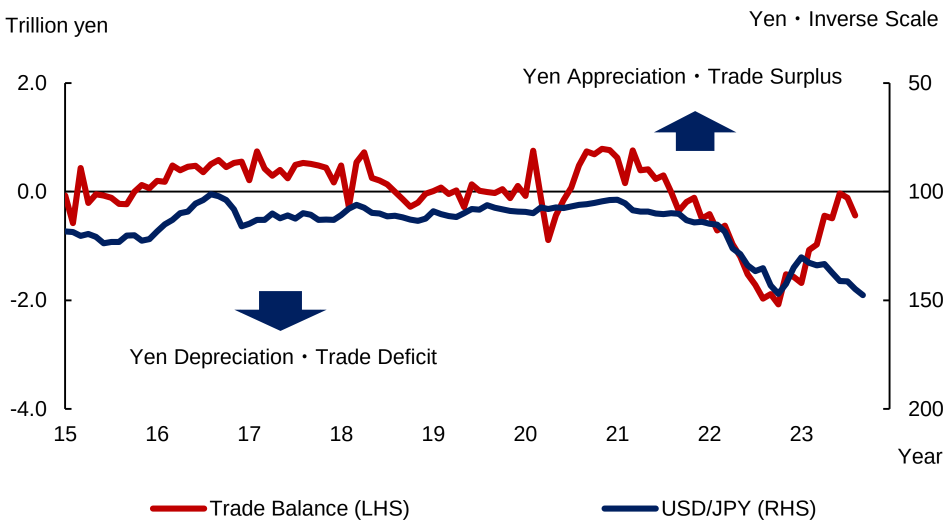
“Largest ever trade deficit in 2022”

While the interest rate gap between Japan and the US remains large, with the halt of US interest rate hikes and the normalisation of Japanese monetary policy on the horizon, the interest rate gap is expected to narrow going forward. In addition, resource prices are expected to remain subdued in 2023 compared with 2022, and the trade deficit is narrowing. Nevertheless, the yen rate against the dollar has been hovering around JPY 150 to the dollar as of late (Figure 1).

Figure 1: Trade Balance and USD/JPY



Source: NEEDS-Financial Quest

Note: 1. Monthly data from January 2015 to September 2023

2. Trade Balance is calculated by August 2023

3. Trade Balance is seasonally adjusted

In 2022, the current account balance maintained a surplus as much as JPY 10 trillion due to an increase in the surplus in the primary income balance, in spite of an increase in the deficit in the trade and services balance.

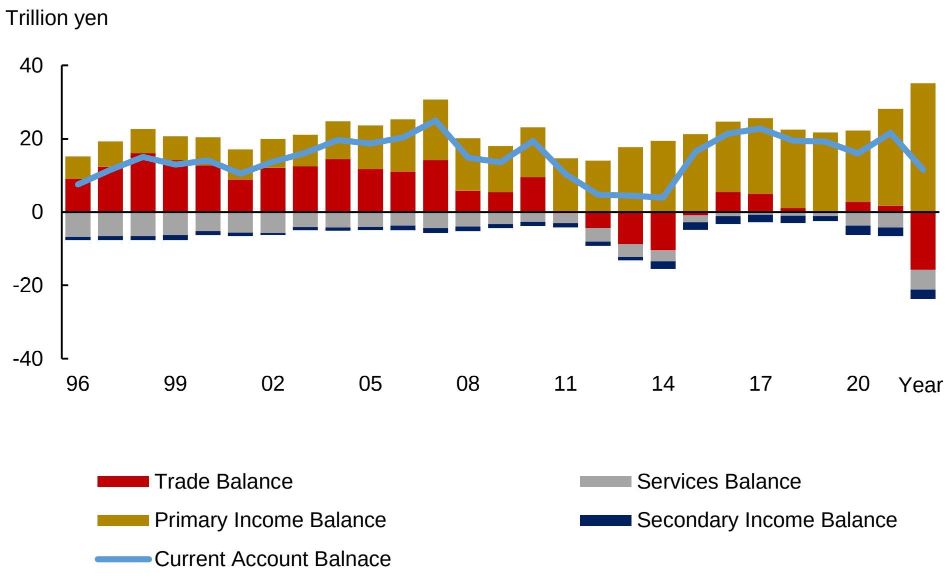
The primary income balance shows the balance of payments, such as interest and dividends from external financial claims and debts, while the secondary income balance consists of grant aid from the public and private sectors, donations as well as gifts received and paid.

Looking at the current account balance since 1996, we can see that it has consistently remained in surplus, but the content has changed (Figure 2). Until the early 2000s, the current account surplus was supported by a trade surplus. Following the Global Financial Crisis and the Great East Japan Earthquake, the current account surplus was supported by the primary income surplus, as the trade surplus shrank or turned into a deficit. This represents, in overview, a shift from a structure of manufacturing domestically and earning money from exports to one of earning money from manufacturing and sales activities at overseas locations.

In the following, the trends in the services balance and the primary income balance are reviewed together with their breakdown.

"Current account balance maintains surplus"

Figure 2: Breakdown of Current Account Balance



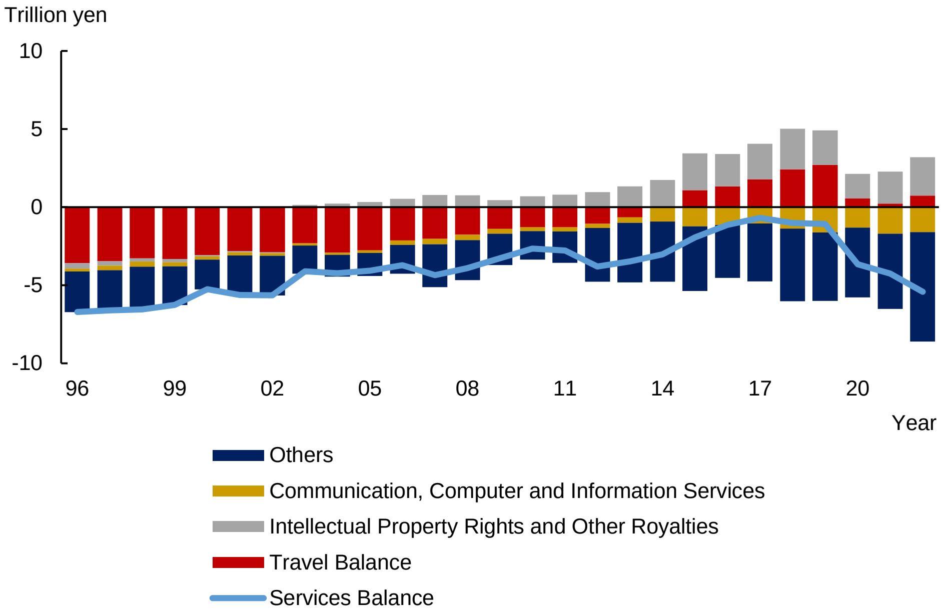
Source: NEEDS-Financial Quest
Note: Annual data from 1996 to 2022

The ‘travel balance’, which accounted for more than half of the deficit in the services balance in 1996, has turned into a surplus since 2015 due to increased inbound demand. In addition, the surplus in 'Intellectual property rights and other royalties' has been increasing since the 2010s. This is due to an increase in the receipt of patents and other intellectual property rights and other royalties as a result of more active manufacturing and sales activities at overseas locations.

On the other hand, in recent years, the deficit in ‘communication, computer and information services’ and ‘others’ has been expanding (Figure 3). The ‘others’ category consists of ‘insurance and pension services’, ‘research and development services’, and ‘professional and management consulting services.’

“Trends in the services balance”

Figure 3: Breakdown of Services Balance



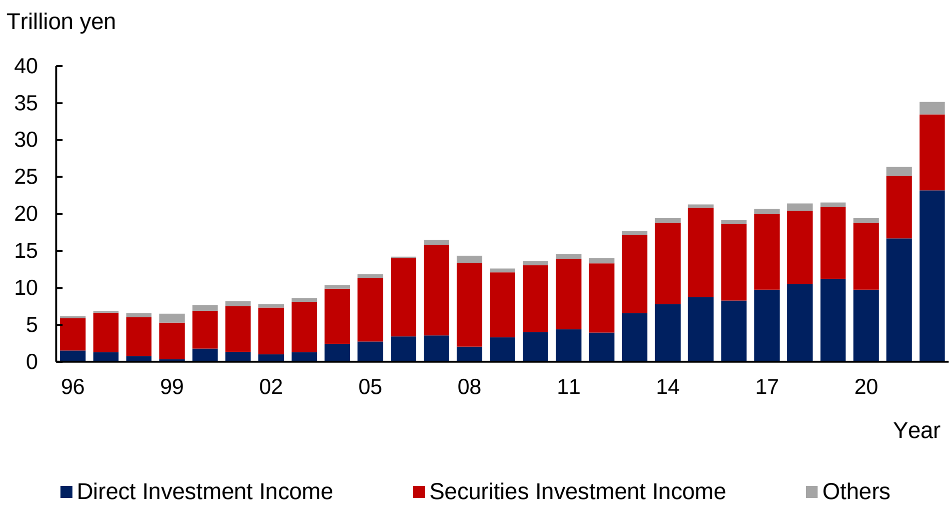
Source: NEEDS-Financial Quest
Note: Annual data from 1996 to 2022

In 2023, the waterfront measures to cope with the Covid-19 pandemic have eased and the number of inbound foreign visitors is increasing, which is a positive factor for the services balance. On the other hand, the use of digital services provided by foreign operators, such as online communication tools, has increased amid the pandemic, which is a deficit factor. This trend is not expected to change significantly to date, and the surplus and deficit factors are expected to remain mixed.

The primary income balance mainly comprises 'direct investment income' and 'securities investment income' (where income is receipts minus payments). In 2022, direct investment income accounted for 66% of the primary income balance of JPY 35 trillion (JPY 23 trillion) as shown in Figure 4. Japan's net foreign assets balance is the largest among the advanced economies, which shows that the manufacturing and sales activities of Japanese companies at their overseas bases are providing a stable current account surplus.

"Trends in the primary income balance"

Figure 4: Breakdown of Primary Income Balance (Receipts Minus Payments)



Source: NEEDS-Financial Quest

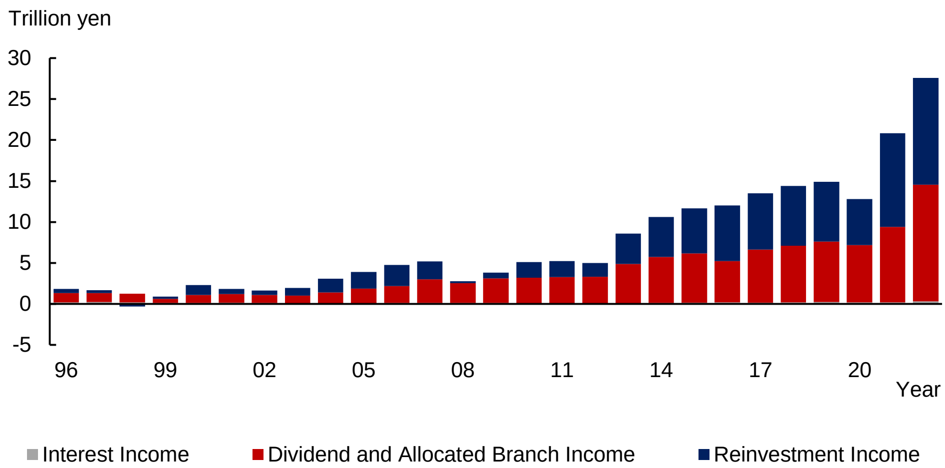
Note: 1. Annual data from 1996 to 2022

2. Each Income is receipts minus payments

'Direct investment income' comprises mainly 'dividend and allocated branch income' and 'reinvestment income' (where income is received). 'Dividend and allocated branch income' includes dividends received and paid between the parent company and its subsidiaries. 'Reinvested income' include retained profits of the local companies in which the company has invested, in proportion to its share of the profits (Figure 5).

"What the structural changes in the primary income balance suggest"

Figure 5: Breakdown of Direct Investment (Receipts)



Source: NEEDS-Financial Quest
Note: 1. Annual data from 1996 to 2022
2. Each Income is received

Generally, a current account surplus is regarded as an increase in demand for the local currency, but whether it leads to actual buying or selling of the yen or foreign currency depends on how much of it returns to the domestic market. In this regard, it is likely that much of the 'reinvestment income' that have increased in presence in recent years will remain in foreign currencies due to their nature.

Although there are various factors that contribute to exchange rate fluctuations, and it is not possible to speak solely of currency demand through the current account balance, the relationship between Japan's current account balance and the exchange rate appears to be changing.

The depreciation of the yen is linked in some respects to higher costs associated with imports of raw materials and other goods, as well as to a decline in purchasing power due to higher prices. Although the focus tends to be on the disadvantages, there are also positive aspects, such as boosting the performance of exporting companies, inbound demand, which Japan has set as its growth strategy, and on-shoring to create more resilient supply chain.

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