Interview with Daisuke Karakama, Chief Market Economist, Mizuho Bank (Nov. 11, 2024)

# Is Japan's Current Account Surplus Sustainable?

By *Japan SPOTLIGHT*

## World Economic Situation

**Haraoka: First of all, how would you evaluate the current state of the global economy?**

**Karakama:** The issue we need to focus on is the reorganization of production bases. The narrative that always appears in the IMF's World Economic Outlook these days is that so-called friend-shoring and reshoring are progressing day by day, and as a result the speed of globalization is slowing down, which is a characteristic of the world economy today, and inefficiencies are increasing. The world is changing in a way that makes business more costly and time-consuming, which in itself will depress growth rates in the long run. These events were first noted by the IMF in the term "slow globalization" in April 2023.

*Daisuke Karakama*

**Haraoka: Inflation has eased somewhat recently, but in any case prices have remained high due to continued inefficient production activities caused by reshoring and friend-shoring. Under such circumstances, is there a strong concern worldwide that continued high interest rates to control inflation will lead to tighter fiscal conditions? It seems to be a very big cause for concern in many countries. What do you think?**

**Karakama:** Among developed countries, it seems that Japan is the one where this issue would lead to the greatest concern. The United States has always had a strong dollar and has avoided a decline in the value of its currency due to financial instability. In the European Union, the Stability and Growth Pact (SGP) is starting to be re-activated this year, and I think it is moving in the direction of tightening monetary policy, but thanks to this, at present, inflation has not become so serious as the value of the euro has not declined, and economic growth has remained stable, so concerns about fiscal tightness have not become a cause for economic anxiety there. By contrast, in Japan there has been much discussion over the past year or two about the need to either curb inflation by raising interest rates or accept a weaker yen. Underlying this argument seems to be a concern about the sustainability of government debt.

My impression is that, with the exception of Japan, few people bring up the issue of public debt first as a cause for concern about the global economy.

**Haraoka: What about the economies of developing countries, especially in the Global South? Are high global interest rates hindering their economic growth?**

**Karakama:** Yes, that is true. I think that is also ultimately part of the IMF's point that growth rates will not increase in an inefficient world.

## State of the Japanese Economy

**Haraoka: Regarding the Japanese economy, I believe that high prices, and the fact that wages have not risen much in comparison, have caused a slump in personal consumption, but what is your outlook?**

**Karakama:** The outlook is not bright. Looking at factors seemingly causing real wages to decline, the biggest factor is the worsening terms of trade. This worsening stems from the depreciation of the yen and the appreciation of resource prices. For the time being, I think that the depreciation of the yen and inflation via import prices will become the norm.

Also, looking at oil and resource prices, they are around $70 per barrel, although they have recently calmed down. This is 20-30% higher than before the pandemic and the Ukraine war, before 2019. One-third of Japan's imports are fuel now, so if the depreciation of the yen is not corrected and the price of crude oil remains high, the unit price of one-third of imports will continue to rise. The trade deficit will keep widening and the terms of trade will continue to worsen. Objectively, real wages are unlikely to rise under these conditions.

Certainly, nominal wages are rising. But there is a debate as to how long this will continue. To begin with, the ratio of job openings to job applicants has recently been declining. There are doubts as to whether the job openings are absorbing the unemployed. One theory is that many of them gave up looking for jobs after the pandemic and have statistically exited the labor force, making it appear that the number of unemployed is simply decreasing. In any case, the idea that wages will permanently increase because of the labor shortage is not definite. On the other hand, there is no end in sight for the weak yen and high resource prices. Because of these factors, I do not have a very bright outlook for real wages.

**Haraoka: Do you think the yen's depreciation will continue for quite some time?**

**Karakama:** Yes. We operate on a floating exchange rate, so the yen sometimes appreciates and sometimes depreciates. Its depreciation phase that began in March 2022 started at 110 yen and ended at 162 yen. My position is that it is impossible to explain all of this solely by the Japan-US interest rate differential. My hypothesis is that the current account balance, viewed on a cash flow basis, is becoming more vulnerable, and that is why the yen is weakening more easily.

**Haraoka: It has been said for some time that Japan's economic growth potential is close to 0.5 or even 0, and some people believe that the yen will continue to weaken because there is no prospect for it to return to its previous level.**

**Karakama:** I think you are right. Ultimately, you are saying that the depreciation of the yen is a reflection of national power. Cars are not selling as well as they used to, home appliances are not selling as well as they used to, and if you look at the balance of services, which did not get much attention in the past, the deficit in the digital sector is increasing, and I think that the declining competitiveness in goods and services is leading to loosened supply and demand for the yen, which in turn is weakening it. While there is some debate as to what constitutes "national power," this evidence at least suggests that it is going in the wrong direction.

**Haraoka: For example, is population decline one factor?**

**Karakama:** Population decline is the beginning of the decline of national power. Because of the population decline, public finances via social security spending will not improve; because of the population decline, it is not possible to set up production bases in Japan, and because it is not possible to set up production bases, export volumes will not increase even if the yen depreciates, and thus population will definitely be the bottleneck of sustainable growth.

## Japan's Current Account Balance

**Haraoka: Japan's current account surplus is still large. It is earned from the income balance surplus, but I am not sure if we can really say that all of this is a surplus. In other words, it has been said that the earnings of companies that have expanded overseas are reinvested locally and therefore may not actually be returned to Japan.**

**Karakama:** This is one of the biggest problems facing Japan today. Japan is a large current account surplus country, and in 2023 it was one of the three largest surplus countries in the world. However, what has actually happened is a historic depreciation of the yen. Do we really have a large current account surplus? I think we should at least be skeptical as to how much of the current account surplus that is said to be in place is leading to purchases of the yen.

Basically, Japan's current account surplus consists of a primary income surplus, but my estimate is that a large portion of this surplus has not led to yen purchases. In short, it has not returned to Japan. Why has it not returned? For example, about 20% of the receipts from the primary income account are retained by overseas subsidiaries of Japanese companies, so-called reinvested earnings. This, by statistical definition, is not returned to Japan.

From the perspective of Japanese companies, they have increased their retained earnings as a result of their individual optimal actions, so even if they are asked to return their earnings, they have no way to spend them. They may argue that they made the decision to leave Japan because there is no future for Japan in the first place, so why should they return to Japan what they have earned overseas?

Even if they were to return to Japan, there is a labor shortage, and there is no prospect of restarting nuclear power plants. Because of this "unstable supply of people and electricity," there is no way for Japanese companies to spend their earnings even if they return to the domestic market. Given these circumstances, there is basically no way for Japanese firms to return what they have retained overseas to home.

Interest on US Treasury bonds and dividends from US stocks account for about 40% of the income received in the primary income account as income from securities investments. Normally, such income flows would not be converted back into yen but reinvested in foreign currency if the effect of compound interest is pursued. These are rational actions for Japanese companies and investors. However, I think that the result of these rational actions has not been rational for the nation, and this is how it is a problem of the fallacy of synthesis.

**Haraoka: In addition to a large budget deficit, the need to increase defense and social security spending is growing, and in this context the budget deficit will increase further as the population declines and tax revenues decrease. But the only thing we can say is that Japan has a current account surplus, and as long as this surplus continues, the risk of fiscal collapse is small because foreigners holding government bonds in the case of the current deficit may cause their prices to plummet and interest rates to rise, according to our experts' explanations. If current account surpluses do not persist for a long period of time, does this increase the risk of a fiscal meltdown?**

**Karakama:** I think it depends on the definition of financial collapse. If we replace the possibility of fiscal collapse with the question of whether there will be a spike in interest rates, I think there will be. As I mentioned earlier, if there is a current account surplus but money is not actually coming back to Japan, it is quite conceivable that yields will rise as Japan struggles to digest its government bonds. I do not think this is unrelated to the fact that yields on government bonds have been rising over the past year or two, albeit via the weakening of the yen. Whether the current account surplus is 20 trillion yen or 30 trillion yen, I don't think that alone should be cause for relief.

## Restoring a Sense of Security about Finances

**Haraoka: I think we need to do various things to prepare for the possibility of future financial collapse, but what kind of policies are necessary?**

**Karakama:** There are many things that can be done, but first of all a gradual increase in interest rates is necessary. For example, the policy rate of 0.25% is too low in light of the CPI for the past three years. The inflation rate should be at a stable level of 2% now. What the public wants is not an end to deflation but an end to inflation. The yen's depreciation cannot be stopped until real interest rates stop being negative, and if the yen's depreciation cannot be stopped, inflation, which the public is complaining about, cannot be stopped either, so I think it is fair to say that interest rates must be raised first.

Since the young population is smaller than the elderly one, there is no doubt that the social security burden will increase. Without social security reform, the budget deficit will only grow. In turn, it will only make it harder to raise interest rates. I believe that the most important discussions are about raising interest rates and social security reform.

**Haraoka: In an effort to reduce the budget deficit, it may be necessary to take political initiatives to implement large-scale administrative reforms and reduce spending while at the same time raising the consumption tax in order to create a sense of assuredness among the public.**

**Karakama:** Naturally, it is important to reduce the budget deficit on a flow basis. However, whether the means to do so is a consumption tax rise or not will not be known until we see the economic situation at that time. I cannot make a clear statement at this point, but it is not appropriate not to raise interest rates. There are various policy mixes in fiscal, monetary, and currency policies, but what is clearly wrong is the current policy rate of 0.25%. I think we should wait and see how it finishes when we raise it to 0.75% or 1% before considering the next policy.

In fact, both the outstanding government debt and the budget deficit have clearly decreased over the last three years. Since government finances are clearly improving while benefiting from the effects of inflation taxation, I believe the current situation is such that the government debt and the budget deficit are decreasing on their own without intermittently raising taxes. In the end, there are only three options for fiscal consolidation: cutting spending, increasing revenue, or inflation taxation, and in the case of Japan we are now at the third as a result of its unwillingness to do the first two. This kind of unclear, no-brainer approach seems suited to Japan, and I believe it will continue to be so.

## Strengthening the Japanese Economy

**Haraoka: From what you say, I think that strengthening the Japanese economy, in other words, creating new growth industries, will help to solve various problems. Whether this is realistic or not, I think there is a way forward in the service industry. For example, tourism and entertainment could possibly grow. Meanwhile, the medical industry and medical services are becoming increasingly important against the backdrop of an aging population. It may be optimistic to say that by promoting these industries each one has the potential to become an industry that could surpass steel and automobiles. What are your thoughts on this?**

**Karakama:** In the end, if the weak yen is a given condition, the next strategy is to think of a card to take advantage of it, and inward direct investment often comes up as one such move. I think the most symbolic example of this is the Taiwan Semiconductor Manufacturing Company (TSMC). The Japanese government has also set a target of 100 trillion yen in inward direct investment by 2030, and I believe that for the time being this will or must be the main axis of the policies to enhance Japan's economic growth.

As you said, the best thing would be for new industries to emerge from within Japan, but it is more realistic to achieve growth with the help of foreign capital. Of course, I don't think we are giving up on new industries emerging, but at any rate there is a shortage of labor. If we were to make a quick-acting policy in a situation where there is a lack of manpower, I think it would be good if the TSMC case became a best practice and was horizontally expanded in Japan, although there are of course pros and cons to this, having seen Kikuyo-cho in Kumamoto Prefecture enjoying unprecedented prosperity thanks to a TSMC factory being established there.

However, since there is a shortage of people and electricity, it will probably be necessary to mitigate these two supply shortages in order to promote inward FDI or the return of Japanese companies to Japan. A discussion on immigration policy will be necessary to ensure a stable supply of people, and a discussion on nuclear power policy will be necessary to ensure a stable supply of electricity. These are very serious issues. The public atmosphere is such that it is not allowed to talk about immigration policy, and such discussions would end up in philosophical conflicts. But without pursuing additional labor supplies, we will not be able to resolve the issue of labor shortages. Regarding nuclear power generation, we must consider the fact that Germany, which has completely abolished nuclear power generation, is now in a very dire situation. I think that if there is an alternative, it does not have to be nuclear power, but the argument that the use of nuclear power is unavoidable has already been made in Germany.

## Geopolitical Risks & the Economy

**Haraoka: One last question. The global economy is unstable, as you mentioned. As this stems from supply chain fragmentation due to geopolitical crises, I think the only way to restore global economic stability is to eliminate the sources of geopolitical crises. Is that the purpose of the policy of international cooperation for macroeconomic stability in the global economy?**

**Karakama:** The best thing would be to stop the wars. Currently, the direction is toward no international cooperation in terms of economic policy, and all countries are thinking about how to attract investment, whether this is in the US IRA bill or the CHIPS bill, or the EU's policies. I think Japan is rather naïve in some sense, constantly advocating the importance of free trade. I think we can rather consider the fact that the US and Europe are more cunning on this issue. With the US in the age of President Donald Trump once again, Japan should consider policies that will benefit its own country rather than cooperation. However, I do not think that this will help the macro stability of the global economy. Free trade is still necessary for macroeconomic stability.

**Haraoka: How can we establish an international agreement that balances free trade and economic security? It seems difficult, but if this can be done, would it also lead to macroeconomic stability?**

**Karakama:** For this reason, Taiwan, for example, has scattered its production bases in various places. However, in attracting Taiwanese companies, it has become a competition to see who can pay how much. It might be a good idea to draw a line that says, "No more than this amount of investment per location as a percentage of GDP."

**Haraoka: Perhaps such fine tuning is necessary, and it is important to create evidence-based policies and international rules by mobilizing econometricians. For example, there is a view that it is acceptable to depend on certain countries up to this point, but from now on dependence is undesirable from a security perspective, so fine-tuning such as reshoring or friend-shoring should be allowed.**

**Karakama:** Of course, that could be the case. After all, it is meaningless to say friend-shoring if there is only one friend, so I would like to know how much friend-shoring is the most effective way to achieve the most effective diversification. Sometimes the IMF does econometric analysis. It does a quantitative analysis that shows how much damage was done when there was no reshoring or friend-shoring.

**Haraoka: Thank you very much for your valuable views.** JS

Written and translated by Naoyuki Haraoka, editor-in-chief of *Japan SPOTLIGHT*, with the cooperation of Tape Rewrite Co.