

Im Fokus

Has the Japanese Economy become More Open?

Ist die japanische Wirtschaft offener geworden?

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Abstract

Statistical analysis indicates that Japan trades less than most other OECD countries even after controlling for economic and natural factors. Border barriers to trade, domestic regulations, peculiar national standards, and business practices cannot explain Japan's low trade dependency. The paper argues that imports to Japan need to be supported by FDI in sales, marketing and service activities in order to fulfil the high quality and service requirements that Japanese customers have. However, the predominance of internal labour markets presents an important structural barrier to inward FDI. In combination, high quality requirements and structural barriers to FDI could therefore at least partly explain why Japan trades so little. If the argument is correct, attempts by the Japanese government to increase trade and FDI through further deregulation and liberalisation will do little to improve the situation.

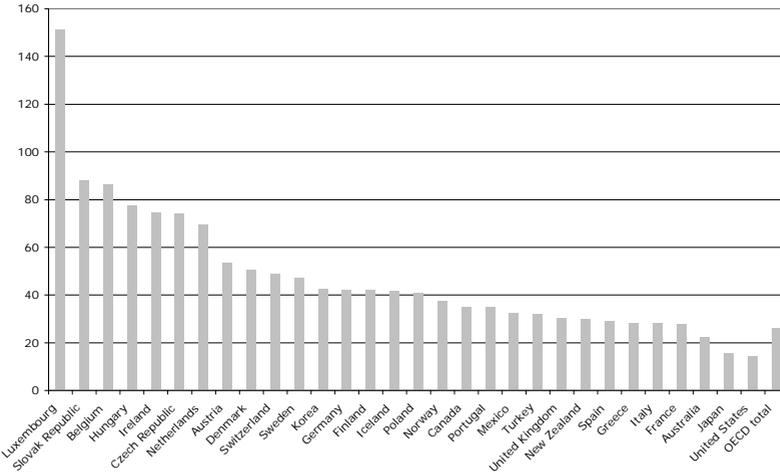
Keywords: Japan, trade, FDI, international integration, trade barriers

1 Conflicting Impressions

Schoolchildren in Japan learn that their country is heavily dependent on international trade. The lack of cultivatable land, primary energy and other natural resources makes it necessary for Japan to import food, energy and raw materials. These imports have to be paid for by exporting manufactured goods. The situation is well reflected in Japan's international trade position; no other OECD country has a lower share of imported manufacturing goods or a higher share of manufacturing export goods than Japan (OECD 2007a: 64-65).

The necessity to trade does not translate into a high propensity to trade, however. Due to its size and stage of economic development, Japan is one of the largest importer and exporter countries in the world in absolute terms. Relative to GDP, though, Japan traded less than all the other OECD countries except the United States in 2006 (see figure 1).

Figure 1: Japan's Trade Ratio in 2006 from an International Perspective



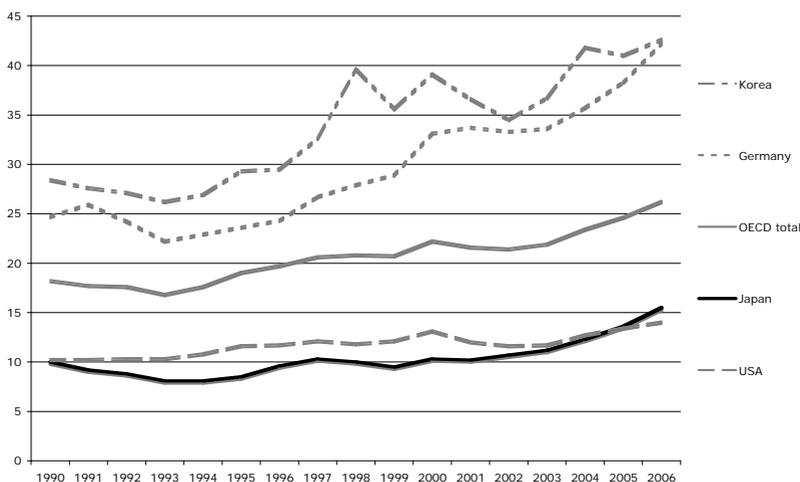
Notes: The trade ratio measures the sum of imports and exports of goods and services divided by twice the respective country's GDP.

Source: OECD 2008.

Between the mid-1980s and the early 1990s, Japan's low degree of international integration was interpreted as the outcome of protectionism and over-regulated markets. All the more surprising it is, then, that even after comprehensive liberalisation and deregulation programmes undertaken by the Japanese government over the last 15 years, the numbers have hardly changed. This is not to deny the rise in Japan's trade ratio over this period, but other OECD economies have also increased their trade dependence, which means that the gap has not narrowed, as figure 2 shows.

How are these observations to be interpreted? Is Japan's degree of international integration too low? If so, what are the causes and what are the implications? These questions are addressed in the following section.

Figure 2: Trends in Japan's Trade Ratio from 1990 to 2006



Notes: Trade ratio measured as in figure 1.

Source: OECD 2008.

2 Does Japan Trade too Little?

The answer to the simple question posed above requires a benchmark to evaluate observed levels of international trade. An ideal benchmark would be the level of trade at which national economic welfare is maximised. Unfortunately, we do not have a theory to tell us unambiguously how to calculate the optimal degree of international trade. Lacking a theory to deduce “optimal” ratios for exports and imports relative to GDP as we do, we are obliged to apply inductive methods. The benchmark is then defined as some kind of statistical average, and our problem is transformed into the question of how we can arrive at such an average.

Figures 1 and 2 reveal a great deal of variety in trade ratios across OECD countries. Obviously, trade ratios depend on factors that differ from country to country. Therefore, simple cross-country comparisons or simple averages provide little information on the question of whether trade levels are too low. More information can be gained by considering what factors are most likely to affect trade ratios and by controlling for these factors in international comparisons.

Using OECD data, Jones and Yoon (2006) conducted a simple regression analysis to estimate the quantitative impact of per capita GDP, size of population and distance to trading partners on import ratios. As import ratios may differ from year to year due to exchange rate movements, they looked at ten-year averages from 1995 to 2004. They then compared the actual import ratio with the estimate of the regression analysis and checked whether deviations were significant. They found that Japan's import ratio was below the estimated ratio, but still within the five per cent confidence interval. The deviation was therefore hardly significant at all. Also, the import ratios of Australia, New Zealand, Finland and Greece deviated more from their estimates than Japan's. The authors' interpretation that the "level of imports in Japan is surprisingly low" is not really supported by these results.

Although per capita GDP, size of population and distance are relevant factors to control for in a comparison of trade ratios, the simple regression analysis suffers from several drawbacks. First, it only looks at imports, which constitute just one aspect of the trade balance. Imports and exports may deviate; in fact, imports were persistently lower than exports in Japan over the period from 1995 to 2004, whereas the situation was the reverse for other countries. The import ratio therefore underestimates Japan's propensity to trade. Second, the linearity assumption made in the regression function is arbitrary; it is not justified on theoretical grounds. Third, trade and GDP per capita are likely to be interdependent, which means that the causation may work in both directions. A simple regression is unable to account for reverse causation. Fourth, not all goods and services are equally tradable. In fact, the trade ratios vary largely across industries (Harrigan/Vanjani 2003: 512). Countries that produce more tradable goods and services will tend to have higher trade ratios. To compare trade ratios of countries in a meaningful way, one has to control for differences in the composition of output. Fifth, trade is not only influenced by the absolute distance between two countries, but also by the relative proximity of other trading partners. New Zealand and Australia will trade more intensively with each other than European countries separated by the same distance because Australia and New Zealand have no other partners nearby, whereas European countries do (Harrigan 2001: 35).

In their 2003 paper, Harrigan and Vanjani (2003) directly addressed the question of whether Japan's trade is still different. Their statistical analysis covering the years from 1981 to 1998 avoids the shortcomings mentioned above.

They estimated industry sector-specific trade relations derived from a general equilibrium model and explicitly controlled for deviations between imports and exports. They also accounted for relative distance. Their analysis reveals that Japan had, in fact, imported and exported less than most OECD countries. Controlling for all the country characteristics captured by the model, Japan's trade volume was on average 40 to 70 per cent lower than the trade volume of the US between 1981 and 1998.

How can this difference be explained? Although the data underlying the statistical analysis is no longer up to date, as figure 2 above shows, Japan's relative trade position has not changed much over the last ten years. The question has not lost its relevance.

3 In Search of Barriers to Trade with Japan

If we control for various economic and natural factors, we discover that Japan trades less than most other countries, and we are tempted to assume that there are specific barriers that prevent the country from integrating into the world economy any further. Looking for such barriers is a fruitful activity in two ways. If we can detect them, they will provide us with a better understanding of why Japan trades too little and will give us some idea of whether such barriers could and should be lowered to promote the international integration of Japan's economy. If we cannot find any specific barriers, on the other hand, we might be tempted to question the above conclusion that Japan trades too little – if there are no specific barriers to trade, then there is nothing to worry about.

The barriers could be classical trade restrictions such as tariffs or quotas, or they could be domestic regulations that put an extra burden on trade with Japan. Last, but not least, barriers could also result from structural characteristics of the Japanese economy like business practices or market structures that are neither natural nor purposefully planned, but the outcome of “spontaneous order”, to use a term introduced by F. A. Hayek (see for example Petsoulas 2001; Hunt/McNamara 2007). Whether directly trade-related, regulatory or structural, to qualify as a cause for Japan's low trade ratio the following two conditions must be met:

- the barrier must discriminate cross-border trade against domestic trade;
- it must be more restrictive in Japan than in other OECD countries.

3.1 Tariff and Non-tariff Barriers

At first sight, Japan's level and scope of tariff and non-tariff barriers (NTBs) do not seem to be any higher or wider than that of any other OECD countries. The data given in table 1 shows that Japan imposes very high tariffs on more than half of its agricultural imports. However, more than 80 percent of non-agricultural products are duty-free and the rest is taxed a moderate 2.6 percent on average. The frequency of core NTBs is more or less in line with the EU and the US:

Table 1 Incidence of Tariffs and NTBs in Japan, the EU and the US

		Japan	EU	US
Simple average of import duties applied	all goods	5.2%	5.2%	3.5
	agriculture goods	22.3%	15.0%	5.5
	non-agricultural goods	2.6%	3.8%	3.2
Duty-free imports	agriculture goods	44.5%	39.7%	38.9
	non-agricultural goods	80.8%	62.3%	54.5
Simple frequency of core NTBs		0.32	0.29	0.27

Notes: Core NTBs include price controls, quantity restrictions, monopolistic measures and technical regulations.

Source: Tariff statistics are taken from the most recent WTO country trade profiles available at <http://stat.wto.org/CountryProfile/WSDBCountryPFReporter.aspx?Language=E>. NTB frequencies are from Kee et al. (2006), table 1.

The simple averages and frequencies do not provide a sound basis for evaluating trade effects, however. The same tariff rate may impose more or less harm, depending on the price elasticity of import demand. If price elasticity of demand is high, a small tariff will result in a strong reduction in imports. If it is low, the same tariff will hardly have any effect on the volume of imports.

An extensive theoretical and empirical research base on the measurement of trade effects resulting from tariff and non-tariff barriers now exists. Kee et al. (2006) calculated aggregate trade restriction indices for 91 developing and developed countries using the most recent and comprehensive data on tariffs and NTBs. The latter were translated into tariff equivalents and added to the actual tariff rate to arrive at an overall product-specific protection level. The aggregate level of protection was calculated as the weighted sum of product-specific protection levels. The aggregation method depends on what one wants

to know. Following the methodology used by Anderson and Neary, the authors calculated three aggregate indices:

- a trade restrictiveness index (TRI) measuring the effect of protection on national income. The weights used reflect the welfare loss associated with product-specific protection levels;
- an overall trade restrictiveness index (OTRI) measuring the impact on import levels. Here the weights take account of the respective price elasticity of import demand;
- a “market access overall trade restrictiveness index” (MA-OTRI) measuring the effects of protection levels by trading partners on a country’s bundle of exports.

Table 2 The Trade Restrictiveness of Japan from an International Perspective

Overall level of restrictions on imports (OTRI)								
	Tariffs only All sectors		Tariffs & NTBs All sectors		Tariffs & NTBs Agriculture		Tariffs & NTBs Manufacturing	
	Value	Rank	Value	Rank	Value	Rank	Value	Rank
Japan	0.058	22	0.143	41	0.580	84	0.073	22
EU	0.030	6	0.126	32	0.453	66	0.075	24
US	0.027	5	0.082	14	0.205	18	0.068	20
Overall level of restrictions imposed by trading partners (MA-OTRI)								
	Tariffs only All sectors		Tariffs & NTBs All sectors		Tariffs & NTBs Agriculture		Tariffs & NTBs Manufacturing	
	Value	Rank	Value	Rank	Value	Rank	Value	Rank
Japan	0.050	13	0.081	8	-	-	0.081	24
EU	0.084	37	0.151	38	0.343	29	0.122	62
US	0.051	14	0.111	18	0.480	66	0.070	14

Notes: The values stated give the overall trade restrictiveness index equivalent to an aggregate (uniform) tariff rate. The lower the rank, the lower the restrictiveness. The ranks range from 1 to 91.

Source: Kee et al. (2006), table 3.

For the present study, only OTRI and MA-OTRI are of interest. Table 2 gives the values of the indices for the EU, the US and Japan. It also shows how these economies rank in terms of trade restrictiveness among the 91 countries analysed.

The calculations suggest that Japan is more protectionist than the EU and the US overall, but it is less exposed to restrictions imposed by its trading partners. Japan's high level of import restrictions is mainly due to agriculture, where high product-specific restrictions are combined with a high dependence on agricultural imports due to limited domestic production.

The information presented in table 2 suffers from the poor quality of primary data on NTBs. This is a severe problem because NTBs account for 70 per cent of overall restrictiveness on average. It seems very likely that the quality of NTB data varies across countries, thus affecting inter-country comparisons.

A more fundamental problem relates to the methodology applied by Kee et al. (2006). The tariff equivalent of an NTB was calculated in two steps. The authors first estimated the quantitative effect of an NTB, which was then transformed into a price effect using product- and country-specific price elasticity estimates of import demand. The quantitative effect measures the difference between the quantity imported in the absence of a product-specific NTB and the actual import level observed. The first variable cannot be observed. It is estimated using a general equilibrium model. The quantity effect attributed to an NTB represents the deviation of actual imports from the theoretical general equilibrium estimate. The methodology is similar to the one applied by Harrigan and Vanjani (2003), who tried to find out whether Japan trades too little. Kee et al. (2006) attributed all the deviations between how much would or should have been imported theoretically without NTBs and how much was actually imported to the existence of NTBs. This means that the trade restrictiveness measures stated in table 2 rely on information similar to the information that gave rise to the question about Japan's low trade ratio. As such, they can only reconfirm the observation, but not explain it. The only way to solve the problem is to use data on tariff and non-tariff barriers explicitly in models like the one applied by Harrigan and Vanjani to estimate the impact of these factors on the extent of trade. This still needs to be done.

Kee et al. (2006) only looked at one date or period of time; they did not analyse any changes over time. As a member of GATT and later the WTO, Japan has been actively involved in and committed to trade liberalisation measures ever since the mid-1960s, moving from a protectionist to a liberal policy stance (Oyama 1994: 46). Over the period from 1970 to 2000, however, its trade ratio showed no clear upward trend, but fluctuated between 8 percent and 14 percent (OECD 2008). This casts doubt on whether border regulations are key

to understanding Japan's low involvement in international trade.

3.2 Domestic Barriers?

Are domestic regulations, business practices or market structures responsible for Japan's low trade ratio? Domestic regulations do not impede trade *per se* as they apply to domestic and foreign firms alike. However, empirical research suggests that product market regulations that restrict competition by increasing barriers to entry have a negative impact on trade in goods and services. Similar effects are found for labour market regulations (Nicoletti et al. 2003). These results refer to all OECD countries. To explain Japan's low trade ratio, Japan's domestic regulations would need to be more restrictive. However, this does not seem to be the case. Compared to other OECD countries, Japan's level of domestic product market regulation is neither relatively liberal nor relatively restrictive (Conway et al. 2005). The level of labour market regulation is in line with countries in continental Europe. The general pattern of regulatory intervention resembles that of continental European nations (Nicoletti et al. 1999). As in the case of tariff and non-tariff barriers, product market regulations have been continuously reduced in Japan since the mid-1980s, but this has not been accompanied by a marked rise in Japan's trade ratio. Taken together, these observations suggest that domestic regulation seems to have contributed little to Japan's low involvement in international trade.

Nicoletti et al. (2003) only analyse differences in the level of restrictiveness; they do not consider differences in the content of regulations. Differences in regulatory norms may impede trade because products and services will need to be adjusted to fulfil differing requirements. The respective costs of adjustments will reduce the benefits of trade and consequently the observed volume of trade. This applies both to imports and exports as the difference has to be overcome in both directions. Do Japanese regulations deviate more from international norms? The question cannot be answered for all fields of regulation. However, comparative information is available for industrial standards, which represent an important area. According to a recent WTO trade policy report on Japan, 93 percent of the country's industrial standards (JIS) are in line with their international counterparts (WTO 2007: ix). This suggests negative trade effects resulting from deviations in standards are likely to be negligible.

Japan's business practices such as long-term exclusive business relations between buyers and suppliers and multi-layered distribution channels were the

focus of trade disputes between the US and Japan between the end of the 1980s and the beginning of the 1990s. The argument at that time was that such business practices represented structural impediments to trade (see, for example, the contributions in Yamamura 1990). However, like national regulations, such structural barriers do not discriminate against international trade *per se*, they equally hurt domestic newcomers or outsiders. Their effect on international trade is therefore arguable and the developments during the 1990s seem to question their impact on Japan's trade ratio.

Vertical business ties became more open and exposed to international competition as a result of Southeast Asia's economic development in the early 1990s. As a result, the share of transport equipment and machinery in total imports almost tripled (see table 3 below). Also, restructuring in Japan's distribution systems has made structures less complex, more efficient and more open. So far, however, none of these structural adjustments have had any noticeable effect on Japan's overall engagement in international trade.

The rise of Japan's trade ratio to a post-world war record high of 15.5 percent in 2006 (depicted in figure 2 above) may indicate the beginning of a trend where the effects of domestic deregulation and changes in business structure finally start to show up. At present, though, this is mere speculation.

3.3 Flexible Adjustment

When talking about barriers to trade, one normally thinks that such barriers prevent economic agents from taking advantage of the benefits of trade in general. Thus the effect of barriers should show up not only in the level of trade, but also in the speed of structural adjustment to new trading opportunities. However, on examining the changes in Japan's import and export trading structure, we find that there have been impressive structural adjustments not only in the regional structure of trade, but also in the product composition of trade (tables 3 and 4). This suggests that trade with Japan has been responsive to changes in the international environment by rearranging Japan's role in the international division of labour both regionally and with respect to the range of products and services traded. This casts further doubts on the existence of trade barriers. Or at least, the barriers to explain Japan's low trade ratio must be compatible with the flexible adjustment in Japan's trade structure, i.e. they should restrict the volume of trade without impeding structural adjustment.

Table 3 The Commodity Structure of Japan's Trade from 1985 to 2005

		1985	1995	2005
Imports	Foods	12.2	15.2	9.8
	Raw materials	14.5	9.8	6.2
	Mineral fuels	43.8	15.9	25.6
	Chemicals	6.2	7.3	7.6
	Transport equipment and machinery	8.3	23.3	26.6
	Others	15.0	28.6	24.4
Exports	Chemicals	0.3	6.8	8.9
	Transport equipment and machinery	71.8	70.0	65.6
	Textile products	3.5	1.7	1.2
	Iron and steel products	7.7	4.0	4.6
	Others	16.7	17.5	19.6

Source: Statistical Research and Training Institute (2007).

Table 4 The Regional Structure of Japan's Trade from 1980 to 2005

		1980	1990	2000	2005
Imports	USA/Canada	20.7	26.0	21.4	14.2
	EU*)	5.9	15.0	12.4	11.1
	Asia	22.4	26.6	36.9	39.9
	(China and Hong Kong)	0	(6.0)	(12.1)	(19.7)
	Middle East	30.8	12.5	18.1	21.8
	Others	20.2	19.9	11.2	12.9
Exports	USA/Canada	26.1	33.8	31.5	24.2
	EU*)	13.8	18.6	16.4	13.9
	Asia	25.7	29.6	39.3	46.6
	(China and Hong Kong)	0	(6.7)	(15.0)	(21.5)
	Middle East	9.1	2.7	4.4	5.3
	Others	25.3	15.3	8.4	10.0

Notes: * "EU" refers to the EU12 until 1990 and the EU15 from 2000 onwards.

Source: Statistical Research and Training Institute (2007).

4 Can FDI Offer an Explanation?

The international integration of economies is not only visible in cross-border trade, it also manifests itself in international capital transactions. One important group of transactions that has attracted a lot of attention from researchers and policy-makers alike is foreign direct investment (FDI). FDI involves the international transfer of equity capital combined with the right to control business operations abroad. Inward FDI flows into the country from abroad. Outward FDI takes the opposite direction from home to abroad.

To see whether and how FDI could provide an answer to Japan's low trade ratio, it is necessary to understand the relationship between FDI and trade. Such an understanding can be gained by looking at the case of a company trying to exploit a competitive advantage in a foreign market. Such a company may

- a) export its product to an importer abroad,
- b) export as above, but set up an affiliate to distribute its product abroad,
- c) license the underlying business idea or technology to a company abroad,
- d) set up an affiliate in the foreign market to produce and sell the product abroad.

Alternatives a) to d) reveal that the relationship between FDI and trade is an ambivalent one. In the case of alternative b) above, trade and FDI occur at the same time. FDI in the foreign country's market replaces an independent importer by a foreign affiliate, but it does not substitute exports. In fact, it does not directly concern the question of whether to export or not. Instead, if the FDI decision turns out to be correct and the affiliate can operate the business at a lower cost than an independent importer, FDI will stimulate exports. In many cases, the decisions to export products and to set up a foreign sales affiliate are made simultaneously, suggesting that FDI and export decisions are directly related. But such an interpretation would not grasp the two-stage character of the underlying decision problem. Is it profitable to export? If so, should exports be done by using an independent importer or through a foreign sales affiliate?

In the case of alternative d), products are no longer exported, but produced abroad to serve the foreign market locally. In this case, we observe FDI instead of exports, but it would not be fully correct to say that FDI replaces exports. As with alternative b), FDI is the outcome of a two-stage decision problem. First of all, one has to answer the question of whether production abroad is cheaper than at home. Then one has to decide whether production abroad is better undertaken

by an independent company or by a foreign affiliate. The substitution between exports and production abroad occurs at the first stage of the decision problem when the choice of the production location is made. The FDI decision only determines the organisational form. Of course, the cost advantage implied by a foreign affiliate will feed back into the decision on whether to locate production abroad or not, but this is only because when comparing the benefits of exports and foreign production, not only production costs, but also costs associated with different organisational forms have to be considered.

Table 5 rearranges alternatives a) to d) to account for the fact that FDI and trade choices are the outcome of decisions made at separate stages in a two-stage decision problem. It is therefore incorrect to speak of a direct substitute or complementary relationship between FDI and trade. The acquisition of ownership rights in foreign businesses through FDI can lower transaction costs. Such a lowering of transaction costs may support exports or foreign production, but its effect on the location and trading decision may be neutral or negligible as well.

Table 5 Possible combinations of ownership and trade decisions

Ownership decision	No foreign direct investment	Foreign direct investment
Produce abroad	Export to independent sales agent (a)	Export to foreign sales affiliate (b)
Produce locally	License production to independent company (c)	Produce with foreign production affiliate (d)

Source: the Author.

Empirically, FDI and trade are often correlated positively (Nicoletti et al. 2003: 22-23, Head/Ries 2004: 412-414). Therefore, cases of trade-enhancing FDI seem to outweigh cases where FDI supports foreign production as a substitute for trade. For Japan, too, FDI and trade seem to be positively rather than negatively linked. As shown in figure 3, Japan's combined inward and outward stock of FDI to GDP ratio is the lowest among OECD countries. This corresponds to its low trade ratio. The evidence reinforces the impression of a comparatively low degree of international integration. But can the low level of FDI explain the low trade ratio?

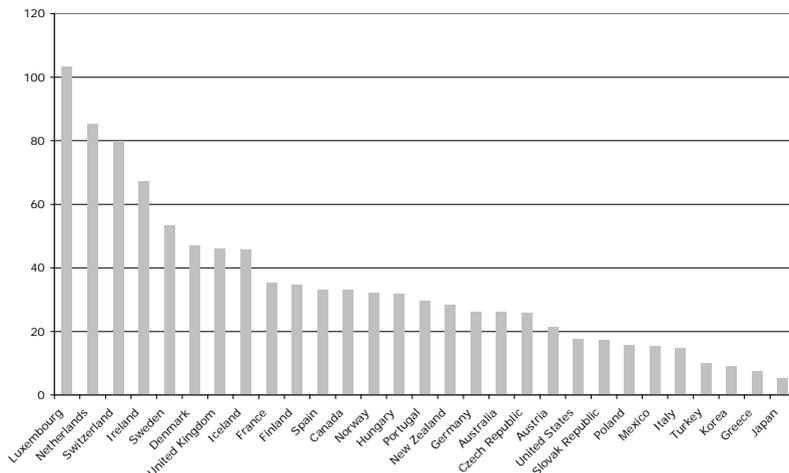
Our understanding of why companies use FDI to exploit international business opportunities is far from complete (Krugman/Obstfeld 2003: 172-173). The following arguments are therefore neither supported by a clear theoretical consensus, nor are they based on broad empirical evidence. They rely on information I gained over many years of contact with European firms – mainly German companies – doing business in Japan and in many seminars jointly organised with the Japan External Trade Organisation in Germany.

Japanese customers, whether private or corporate, have very high expectations with regard to the quality of a product and/or service delivered to them. To be able to fulfil the high quality requirements of Japanese customers, it is necessary to make adjustments to products and to pay close attention to customer feedback. Both factors favour alternative b) above over alternative a) for at least three reasons:

- the investment involved in setting up a foreign sales affiliate signals a long-term commitment to the Japanese customer;
- an independent agent will be reluctant to undertake product-specific investments in customer acquisition, customer retention and after-sales service as such investment is exposed to risks that he cannot fully control;
- a foreign sales affiliate allows for more effective feedback of customer requirements to the firm's headquarters in Germany.

The last point needs some clarification. If it is unaccustomed to the quality requirements of Japanese customers, then headquarters will not pay due attention and will probably underestimate the negative impact on business if these requirements are not fully met. An independent Japanese sales agent will have difficulty convincing the German headquarters that quality or service improvements specific to the Japanese market are really necessary. Such demands by an independent agent might be interpreted as exaggerated or even as a kind of “collusion” between the Japanese agent and the Japanese customer. With ownership control, on the other hand, it is possible to dispatch a company-trained manager to Japan who, by witnessing the high level of customer requirements, can feed back a picture of the Japanese situation that will result in more understanding at headquarters because the dispatched manager has a better personal network in the firm, is able to argue his case more effectively and/or is trusted and felt to be more loyal than the independent agent.

Figure 3: Japan's FDI ratio for 2005 from an international perspective



Notes: The FDI ratio measures the sum of outward and inward FDI stock divided by twice the respective country's GDP.

Source: OECD 2008.

The above argument leads one to conclude that exporting to Japan is more likely to need support by FDI in local sales, marketing and service activities. If this holds true, restrictions on FDI will hurt exports to Japan more than they do in other countries.

Regulatory barriers to FDI seem to be lower in Japan than in most other countries. A recent OECD study of 29 OECD members and ten non-member countries assessing the FDI regulatory restrictiveness in nine sectors ranks Japan as the tenth least restrictive country (OECD 2007b: 140). But FDI is not only subject to regulatory barriers. In Japan's case, especially, there is a severe structural barrier to FDI caused by the ever-present predominance of internal labour markets for qualified personnel (Waldenberger 2004). With the exception of financial services, where restructuring following the banking crisis has led to more inter-firm mobility since the end of the 1990s, it is very hard to induce an employee moving from a Japanese company to work for a foreign affiliate. The market for qualified labour that foreign companies can tap is segmented from the market accessed by larger Japanese companies – and is thin. Since FDI not only

requires capital, but also qualified personnel, the lack of the latter will effectively restrict the level of inward FDI.

The importance of high customer requirements and the difficulty of securing personnel are well documented in the annual JETRO survey on “Attitudes of Foreign-Affiliated Companies toward Direct Investment in Japan” (table 6). It is interesting that even well-established foreign affiliates frequently stated recruitment as a major impediment in 2007. This was not the case in previous surveys, which allows for at least two interpretations:

- the strong absolute increase in FDI since the mid-1990s and the recovery of the Japanese economy since 2003 have intensified competition in the labour market segment accessible by foreign affiliates;
- other barriers have lost in relative importance as a result of deregulation and restructuring or due to depreciation of the Yen, which affects business costs.

Table 6 Impediments to Business in Japan

	2007 (864)	2006 (936)	2005 (614)	1995 (616)
Difficulty in securing personnel	66.2	66.6	53.3	40.4
High business costs	60.2	65.5	65.5	70.3
High standards for products demanded by users	59.6	66.5	57.8	51.8
Closed character and particularity of Japanese market	50.6	48.0	49.7	56.7

Notes: The number of respondents in the respective year is given in brackets. The numbers in the table are the percentage of respondents who noted the item as a major impediment. Multiple responses were possible.

Source: JETRO 2008: 13.

The combination of high customer requirements necessitating FDI in sales, marketing and service activities to support exports to Japan combined with difficulties in securing qualified personnel may provide a clue to Japan’s low level of trade. For sure, it only looks at inward FDI and exports to Japan. There is little reason to expect that FDI from Japan faces any more restrictions abroad than FDI from other countries. In fact, although Japan’s FDI to GDP ratio is very low, the wide gap between outward and inward FDI is actually even more striking. Whereas Japan’s stock of outward FDI to GDP was 8.5 percent in 2005

(the OECD total was 25.7 percent), the ratio of inward FDI amounted to only 2.2 percent (OECD total: 21.0 percent) (OECD 2008). This gap supports the argument that FDI entering Japan is more restricted than FDI leaving Japan.

The argument that barriers to inward FDI are an important cause for Japan's low trade ratio does not necessarily preclude a flexible adjustment in Japan's trade structure, as noted above. If the adjustment can be achieved by restructuring intra-firm trade, little or no additional inward FDI is required. In fact, the adjustment in Japan's trade structure depicted in tables 3 and 4 above was accompanied by a pronounced increase in the share of intra-firm trade by Japanese companies (OECD 2002: 163-164).

5 Summary and Conclusion

The findings are summarised in the following statements:

- 1) Statistical analysis based on general equilibrium models of trade indicates that Japan trades less than most other OECD countries even after controlling for economic and natural factors.
- 2) The argument that trade with Japan is substituted by FDI has to be refuted. Japan's inward and outward FDI position relative to GDP is the lowest among the OECD countries.
- 3) Border barriers to trade, domestic regulations, peculiar national standards or business practices cannot explain Japan's low trade dependency. Although measurement problems do not allow for a final conclusion, the observation that reductions in border, regulatory and structural barriers have so far had no noticeable impact on Japan's trade ratio suggests that they have low explanatory power.
- 4) Over the last few decades, Japan's commodity and regional structure of trade has quickly adjusted to changes in the international trading environment. The barriers to trade indicated by Japan's low trade ratio do not seem to impede the speed of adjustment in the structure of exports and imports.
- 5) The high quality and service requirements that Japanese customers have seem to call for FDI in sales, marketing and service activities to support imports to Japan. However, the predominance of internal labour markets presents an important structural barrier to inward FDI. In combination, high quality requirements and structural barriers to FDI might at least partly explain why Japan trades so little.

The Japanese government has recognised the importance of FDI for a long time

and has undertaken various measures to foster inward FDI. If the above analysis is correct, then an improved environment for FDI in Japan will also enhance Japan's ability to trade. However, if structural barriers like internal labour markets for qualified personnel present the root of the problem, deregulation and liberalisation alone will do little to improve the situation.

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