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FOREIGN SUBSIDIARIES, A KEY DRIVER OF THE JAPANESE INDUSTRY

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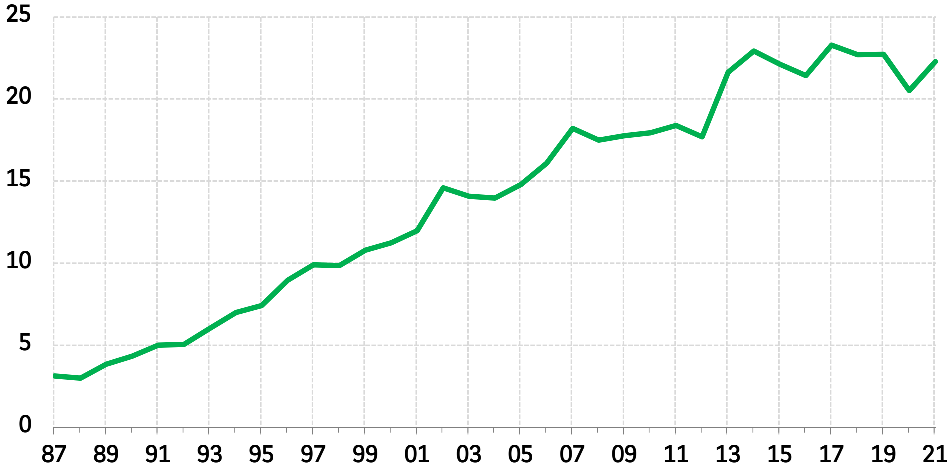
In 2021, sales by foreign subsidiaries of Japanese industrial companies accounted for nearly a quarter of total sales. China is the main anchor country, particularly for the automotive industry.

Despite this, Japan has retained a larger industrial base than most other OECD countries. The sector accounted for more than 20% of total national value added in 2021. The share of goods exports in GDP has also increased, reaching 16.4% in Q1 2022.

This production structure for Japanese companies, based on the complementarity between domestic facilities and foreign subsidiaries, has helped support profits, which climbed to a record as a share of GDP in Q1 2022.

Industrial production in Japan is continuing to shift towards capital goods and away from final consumption goods, largely in response to the increasing competition from other Asian countries in the latter segment.

JAPAN'S MANUFACTURING OVERSEAS SUBSIDIARY SALES RATIO (AS % OF TOTAL SALES)*



* Total sales by Japanese foreign subsidiaries and Japanese companies based in the domestic market (METI methodology)

Note: overseas production ratio based on all domestic companies = Sales of overseas affiliates (manufacturing industries) / (Sales of overseas affiliates (manufacturing industries) + Sales of domestic companies (manufacturing industries)) × 100.0

CHART 1 SOURCE: METI, BNP PARIBAS

At a time when the debate around the concept of de-globalization is gaining traction, it is interesting to focus on Japan, where many industrial companies have chosen to set up subsidiaries abroad. The subject is even more relevant today, given the significant depreciation in the yen and the growing geopolitical tensions in Asia. One would expect that this would influence the organisation of Japanese production in the medium and long term.

In recent decades, Japanese manufacturing companies have expanded their share of international activity. Initial estimates from the Ministry of the Economy, Trade and Industry (METI), indicate that sales by foreign subsidiaries in 2021 reached JPY 132 trillion (USD 1 trillion). This was nearly a quarter (22.3%) of total sales by Japanese companies, if we add these foreign sales to those made by Japanese companies located in Japan (Chart 1)[1]. Progress has been impressive over the past thirty years, as this figure was only 10% in the early 2000s and just 5% in 1990. However, it has stabilised since 2014.

1 This calculation follows the methodology employed by METI. See Summary of the 2020 (50th) Basic Survey on Overseas Business Activities (page 6).

Several factors have encouraged Japanese companies to strengthen their presence abroad. The gradual strengthening of the yen between 1980 and 2012 (the date of the introduction of 'Abenomics' and the beginning of a new phase of depreciation in the currency)[2], was the first key factor, but is not the only explanation. According to a METI survey conducted in July 2018[3], companies wanted to get closer to local markets where *"demand is strong or expected to be so in future"* (68.6% of companies agreed with this statement) in order to compensate for structurally low growth in demand in Japan[4]. The same survey indicated that the cost and quality of foreign labour had a less important role (16.0% agreeing). The extension of global production chains and Japan's integration into them have also driven the expansion of businesses beyond the country's borders.

However, the scale of this phenomenon varies from one sector to the next. The automotive industry and companies in information and communication electronic equipment have expanded their production facilities abroad to a much greater extent than those in the food, metals, oil or coal sectors, where businesses remain more heavily focused on Japan (Chart 2). Most production of Japanese foreign subsidiaries are sold into their host region: this accounted for three quarters of the sales in 2021; the remaining quarter are sales outside the area of operation, and mainly directed back to Japan.

CHINA, THE MAIN FOREIGN BASE

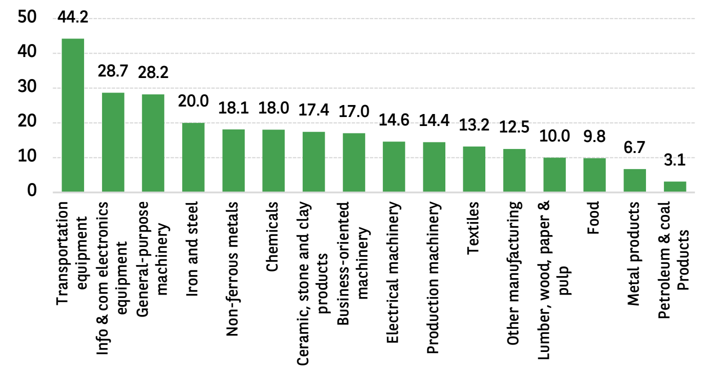
Japanese companies have mainly strengthened their presence in Asia (Chart 3), and particularly in China. At the end of the 1990s, sales by Japanese subsidiaries in China accounted for just 5% to 6% of total sales of Japanese subsidiaries around the world[5]. This figure has increased fivefold over twenty years, with a peak of 24.6% reached in 2021.

The move into China came alongside growth in bilateral trade between the two countries. Over 20 years, trade (exports and imports combined) has doubled, whilst exchanges between Japan and the US have contracted by 20 percentage points (Chart 4). 2001 represented a turning point, as this is the year when China joined the World Trade Organisation.

In China, the automotive industry is by far the sector where Japanese companies have the greatest presence: in 2021, this industry represented more than half of sales by Japanese subsidiaries in the country (Chart 5). As the METI survey suggests, the presence of Japanese companies in China is an efficient way to get closer to the Chinese market, which is growing faster than its Japanese counterpart, and thus bolster their market shares in the country. This presence reduces the exposure to the risk of a raising of trade barriers targeting Chinese imports.

The other major bases for Japanese companies are North America and ASEAN countries. These accounted for 26.6% and 22.5% respectively of total sales by subsidiaries in 2021, whilst Europe accounted for a smaller share (11.8%).

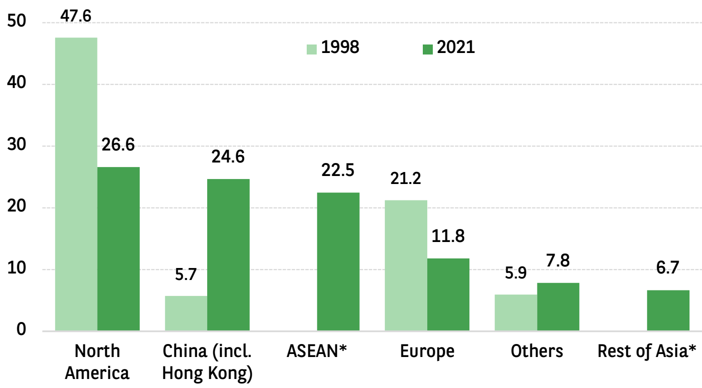
JAPAN OVERSEAS SUBSIDIARY SALES (AS % OF TOTAL SALES, 2019)*



*Total sales by Japanese foreign subsidiaries and companies based in Japan (METI methodology)

CHART 2 SOURCE: METI, JAPAN'S MINISTRY OF FINANCE

JAPAN OVERSEAS SUBSIDIARY SALES, BY REGION (AS % OF TOTAL SALES)



* Data not available for 1998

CHART 3 SOURCE: METI, BNP PARIBAS

JAPAN TRADING PARTNERS (% OF TOTAL EXPORTS & IMPORTS)

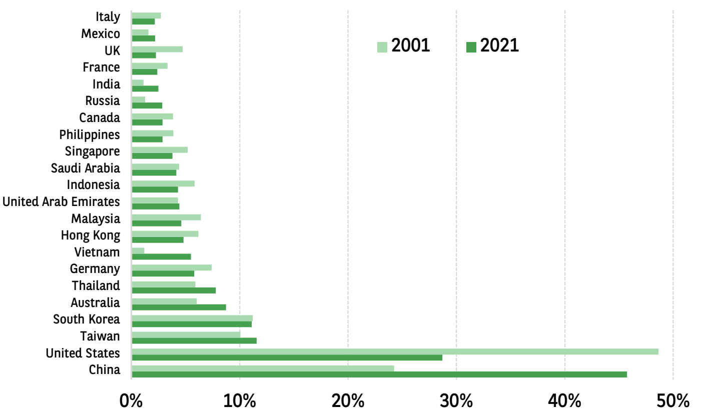


CHART 4 SOURCE: INTERNATIONAL TRADE CENTRE, BNP PARIBAS

2 Between 1980 and 2012, the yen strengthened against the dollar, rising from JPY226/$ to JPY79.8/$.
3 See *Summary of the 48th Basic Survey on Overseas Business Activities*, METI.
4 This trend is confirmed by the substantial share of sales made by subsidiaries in the country or region where they are based.
5 These figures include Hong Kong.

INDUSTRY CONTINUES ITS TRANSFORMATION

Despite this underlying trend in the expansion of Japanese companies abroad, the process of de-industrialisation in Japan has been more limited than in most Western economies. In 2019, manufacturing industry still accounted for more than 20% of the country's total value added (20.9%), whilst the comparable figures for France, Spain, the UK and the US[6] are all below the 12% mark (Chart 6). Meanwhile, the share of goods exports in real GDP has continued to grow for more than twenty years now, reaching 16.4% in the first quarter of 2022 (Chart 7). Therefore, Japan remains a major exporting power. The yen's depreciation – which continued in June – is thus likely to provide substantial support to industrial activity in Japan again.

Nevertheless, the expansion of foreign subsidiaries has contributed to holding back industrial production in Japan, which is close to 20% below its October 2007 peak. Activity in the transport sector, the biggest in terms of industrial production (a weight of 18%), has fallen by nearly one-third relative to its level at the end of 2007 (Table 1). Nor is this the only sector to have seen a substantial contraction. The fall in output has continued relentlessly in information and communication electronics equipment (-61% between 2008 and 2021) and in 'other manufacturing sectors' (-25%), two categories consisting primarily of final consumption goods (computers, TVs, telephones, apparel, supplies, musical instruments, toys, etc.). Of the 15 major sectors making up the industrial production index, only two now have production levels greater than 15 years ago: production machinery and electronic components. Both of these cover mainly intermediate goods used in the production of other final consumption goods. The latter includes, for example, integrated circuits, LCD screens and other micro-electronic components. Industrial activity in Japan has therefore pursued its transformation, focusing increasingly on products upstream in production chains, rather than on final goods.

This is a response to changes in international competition: there is much greater competition from emerging Asian economies in final goods than in advanced industrial products, that are greater value-added goods, and Japan's specialism. This specialisation has allowed the country to retain significant non-price competitiveness (which is manifested, most notably, in the preservation of high profit margins for companies; Chart 8) and strong exports. This has avoided an excessive deterioration of the country's trade balance, even though its surplus is not as large as it was in the early 2000s[7].

Profit levels at Japan's industrial companies show the sector's resilience. According to the latest Ministry of Finance report (published on 1 June 2022[8]), manufacturing profits hit JPY9.39 trillion in the first quarter of 2022 (Chart 8), slightly below the record of JPY9.44 trillion set in Q2 2018, but the highest as a share of GDP, at 6.9%. Profit margins have also remained strong. However, profits for Q2 2022 will suffer from the closure of factories in China, due to lockdown measures; these had a severe effect on production chains for Japanese automakers, which, as we showed above, are highly active in the country[9].

6 Source: France, Spain, United Kingdom: Eurostat; United States: BEA
7 The trade balance worsened significantly between 2008 and 2014 (the deficit has since been reduced), but this was mainly due to two exogenous factors: the collapse in global demand after 2008 and the sharp rise in the yen, which is viewed as a safe-haven currency in times of crisis.
8 https://www.mof.go.jp/english/pri/reference/ssc/r4.1-3e.pdf
9 See Shanghai Lockdowns Slam Japanese Automakers' Production in China, Bloomberg, 30 May 2022.

JAPAN SALES OF OVERSEAS SUBSIDIARIES BASED IN CHINA, SHARE BY SECTOR

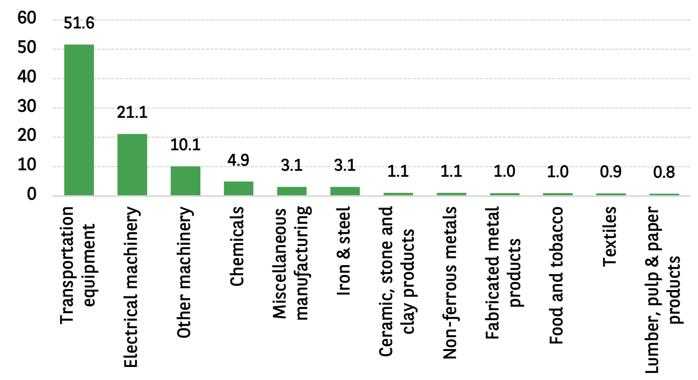


CHART 5 SOURCE: METI, BNP PARIBAS

SHARE OF MANUFACTURING IN NATIONAL VALUE ADDED

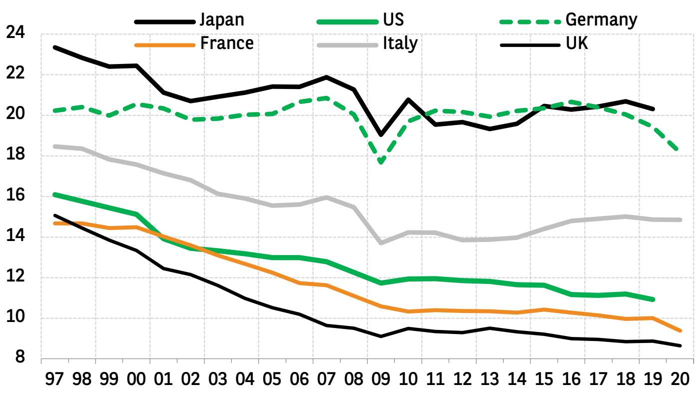


CHART 6 SOURCE: WORLD BANK, BNP PARIBAS

GOODS EXPORTS (AS % OF REAL GDP)

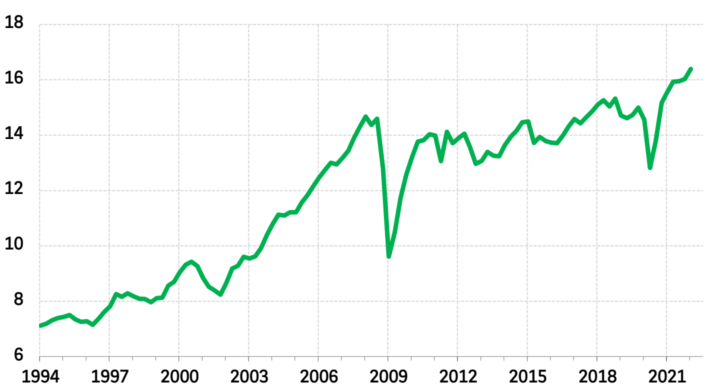


CHART 7 SOURCE: CABINET OFFICE, BNP PARIBAS

Shortages of electronic components will be a further brake on activity over the short and medium term. That said, the production structure for Japanese companies, based on the complementarity between domestic facilities and foreign subsidiaries, has been effective so far, as shown by the strong profit numbers.

TOWARDS A TURNING POINT?

The prospects of a slowing in trade globalisation (without going as far as using the concept of de-globalisation) raise questions on the process of Japanese companies creating foreign subsidiaries, which has already somewhat stalled since 2014 (Chart 1). Several factors suggest that this slowdown will continue: (i) logistics problems during the Covid-19 pandemic and the Japanese authorities' desire to shorten production chains; (ii) the increase in geopolitical tension in Asia and the desire for greater autonomy, particularly in strategically important sectors; and (iii) rising labour costs in China which reduce the country's price competitiveness. Countries' labour costs are also becoming a less significant factor, given the increasingly automated nature of production. Companies rely increasingly more on highly-qualified employees than low-wage workers, which is likely to help a development of activity in Japan.

Even before the global pandemic, the Japanese government had introduced fiscal incentives, admittedly still on a modest scale, to encourage Japanese companies to invest in their home country. In April 2020, the authorities launched a JPY 248.6 billion (USD 1.9 billion) scheme of this kind. In November 2021, the Government also released funding of JPY 774 billion (USD 6 billion) to help develop new semiconductor production facilities within the country, of which more than half (JPY 400 billion) will be dedicated to the construction of a new foundry in the Kumamoto Prefecture.

However, shifting the balance by developing activity in Japan rather than abroad will not be easy, nor is it the government's sole priority. It is also pursuing greater diversification of production chains in Asia, in order to reduce dependence on China. It will be particularly difficult to relocate highly capital-intensive or knowledge-intensive production chains, given the vast sums invested in them and/or the knowledge ecosystems that have been created around them. Moreover, relocation of industrial activity to Japan would imply higher production costs, which would affect company margins. Although more onshoring is expected, this phenomenon could be slow to materialise.

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PROFIT MARGINS & CURRENT PROFITS OF JAPAN'S MANUFACTURING SECTOR

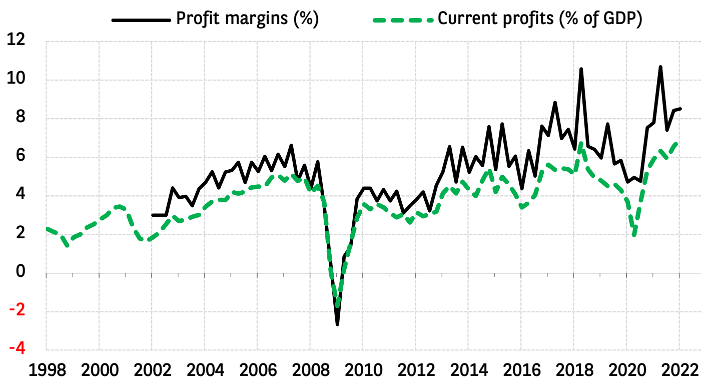

CHART 8

SOURCE: JAPAN'S MINISTRY OF FINANCE, BNP PARIBAS

INDUSTRIAL PRODUCTION BETWEEN AUGUST 2007 (PEAK) AND APRIL 2022

Sectors	Gap (%) between April 2022 & October 2007 (peak)	Weight in industrial production
Manufacturing	**-19.0**	**99.83**
Electronic parts & devices	8.7	5.81
Production machinery	2.3	7.08
Chemicals	-5.9	10.93
Electrical machinery	-6.2	5.97
Plastic products	-12.1	4.42
Business-oriented machinery	-12.6	1.52
Food and tobacco	-14.0	13.14
Pulp & paper	-17.2	2.27
General-purpose machinery	-17.4	5.77
Ceramic, clay, stone products	-23.8	3.22
Fabricated metal products	-26.4	4.38
Other manufacturing	-27.4	7.52
Iron & steel	-28.8	6.25
Petroleum & coal products	-30.3	1.18
Transport equipments	-32.4	17.97
Info & com electronics equipment	-70.1	2.42
Mining	-35.3	0.17

TABLE 1

SOURCE: METI, BNP PARIBAS

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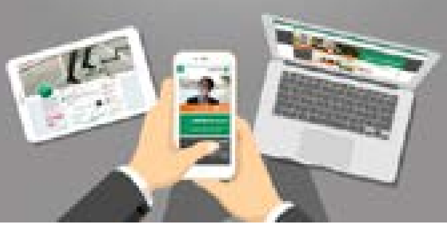

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