Sumitomo Mitsui DS Asset Management

Iron sharpens iron: Japanese competitiveness in an evolving global landscape

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SMDAM

We are one of the largest investment management companies in Japan, offering discretionary investment management, investment trusts and advisory services to a range of institutional investors, pension funds, government agencies and retail investors worldwide.

Highlights:

- In the goods sector, Japan's Trade Specialisation Index (TSI) indicates comparative advantages in autos, steel, machinery and related areas, suggesting that the international competitiveness of Japanese manufacturing remains solid.
- Innovation is accelerating in automotive electrification and humanoid robotics, and global competition is intensifying as Chinese companies strengthen their capabilities. Even so, Japanese companies still have scope to regain momentum through business-model adjustments.
- In the services sector, the TSI shows a standout comparative advantage in travel, with inbound demand supporting Japan's earning power. The digital category, by contrast, shows a significant comparative disadvantage. Going forward, the key will be to raise value added and improve monetisation in areas of strength such as content, while making effective use of overseas technology.
- Japanese companies' overseas expansion is translating into earnings, with Japan's outward Foreign Direct Investment (FDI) rate of return remaining high relative to major economies. With the domestic business environment also improving, opportunities for Japanese firms to capitalise on their potential appear to be expanding.

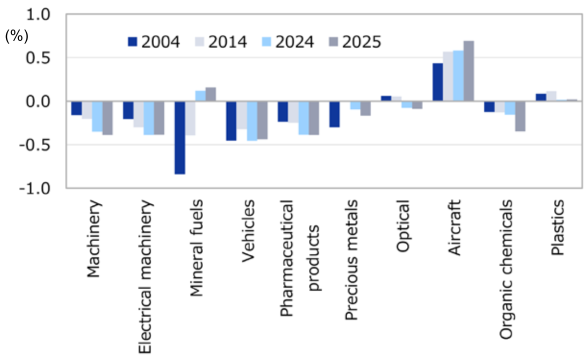
With the new year underway, I revisit the international competitiveness of Japanese companies from macro and sector-level perspectives, as part of assessing the outlook for Japan's economy and equities in 2026.

To gauge Japan's international competitiveness, I track the Trade Specialisation Index (TSI) on a regular basis. TSI is calculated using export and import values for each sector or product category as (exports − imports) divided by (exports + imports). Readings closer to +1 indicate a comparative advantage, while readings closer to -1 indicate a comparative disadvantage. By comparing TSI over time across major regions and key traded products, we can capture one aspect of how the global competitive landscape is evolving.

Japan retains comparative advantages in autos and steel

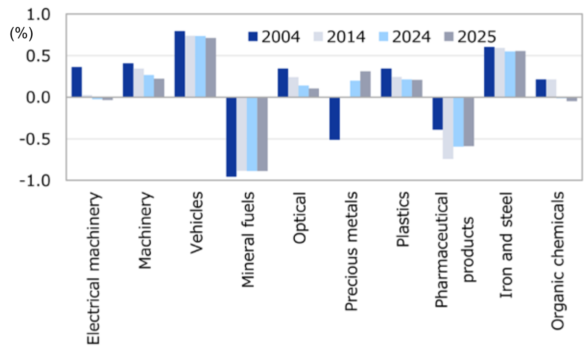
Using internationally comparable Organisation for Economic Co-operation and Development (OECD) data based on the (HS2) classification system, Japan's TSI by major goods sectors for Jan–Oct 2025 ranks as follows (Figures 1–4): autos at +0.71, steel at +0.56, precious metals at +0.31, machinery at +0.22, plastics and plastic products at +0.21, and optical and precision instruments at +0.11. These figures confirm Japan's comparative advantages in areas such as autos and steel.

Figure 1: U.S. Trade Specialisation Index (Top 10 Items)



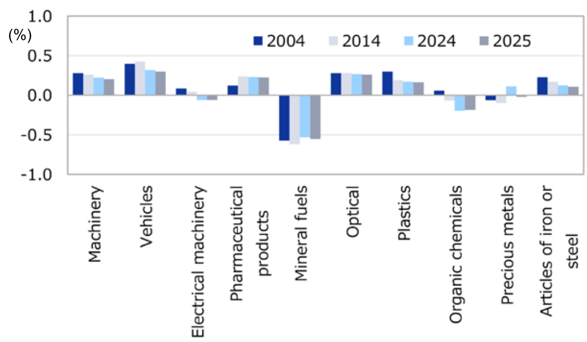
Note: 2025 figures are for January–September.
Source: SMDAM, OECD and Trade map.

Figure 2: Japan Trade Specialisation Index (Top 10 Items)



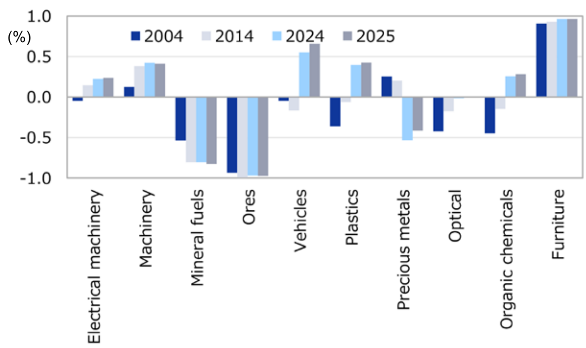
Note: 2025 figures are for January–October.
Source: SMDAM, OECD and Trade map.

Figure 3: Germany Trade Specialisation Index (Top 10)



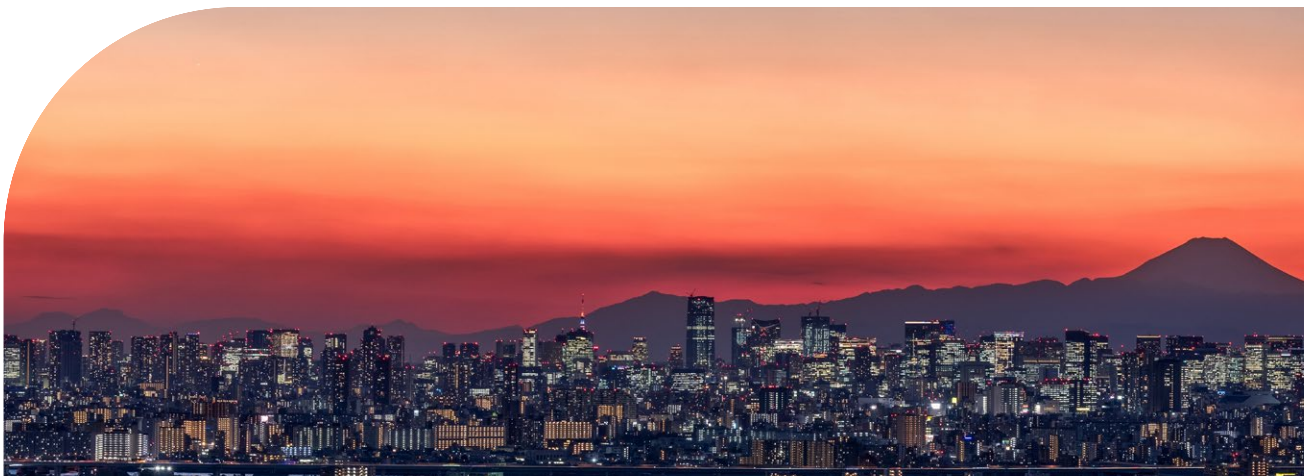
Note: 2025 figures are for January–October.
Source: SMDAM, OECD and Trade map.

Figure 4: China Trade Specialisation Index (Top 10 Items)



Note: 2025 figures are for January–October.
Source: SMDAM, OECD and Trade map.

That said, excluding precious metals, Japan's TSI has been trending down across these sectors, suggesting that Japan's manufacturing comparative advantages have gradually weakened. This likely reflects an increasingly tough global competitive environment for manufacturing. For example, comparing China's TSI between 2004 and 2025, autos rose from -0.05 to +0.66 and machinery from +0.13 to +0.41, indicating that China has strengthened its comparative position in higher value-added sectors as well (Figure 4). Even so, Japan's TSIs for autos, steel and machinery remain meaningfully positive, and Japanese manufacturing can still be said to retain strong comparative advantages.



A comeback in robotics is worth monitoring

In autos, there had been concern that Japanese companies might fall behind the global shift toward Electric Vehicles (EVs) and lose comparative advantage. Recently, however, EV demand has shown mixed momentum across regions, and hybrids—an area of strength for Japanese automakers—have been regaining traction.

Even in EVs, the rapid rise of Chinese players has been widely discussed, particularly in China, where Japanese companies have faced headwinds. That said, some Japanese companies are seeking a turnaround by adjusting their business models, for example by increasing local sourcing to respond more quickly to local needs.

Beyond autos, attention is also turning to humanoid robots within the broader robotics space. US and Chinese companies are often seen as leading in this area, particularly in AI integration. Still, robotics is a field where Japanese companies have long had strong technical capabilities, and it is reasonable to expect that they may regain momentum.

In services, travel is a strength while digital remains a weakness

Next, I look at Japan's Trade Specialisation Index (TSI) across key services categories. For services, I constructed TSI by classifying services trade into six categories—transport and related, Intellectual Property (IP) and related, travel, digital, finance, and other—based on the definitions in the note below.

Note: Definitions used for the services-trade classification

- **Transport and related:** freight transport + manufacturing services on physical inputs owned by others + maintenance and repair services
- **IP and related:** charges for the use of intellectual property + Research & Development (R&D) services + technical, trade-related and other business services
- **Travel:** passenger transport + travel
- **Digital:** charges for the use of copyrights and related rights + telecommunications services + computer services + information services + professional and management consulting services
- **Finance:** insurance and pension services + financial services
- **Other:** construction + personal, cultural and recreational services + government goods and services, n.i.e.

Japan's TSI for key services between Jan–Oct 2025 is as follows (Figures 5–8): travel at +0.47, IP and related at +0.06, other at +0.05, transport and related at -0.21, finance at -0.30, and digital at -0.42. With inbound tourism continuing to recover, travel shows a large positive reading. Meanwhile, as widely noted, digital shows a large negative reading, indicating a substantial comparative disadvantage.

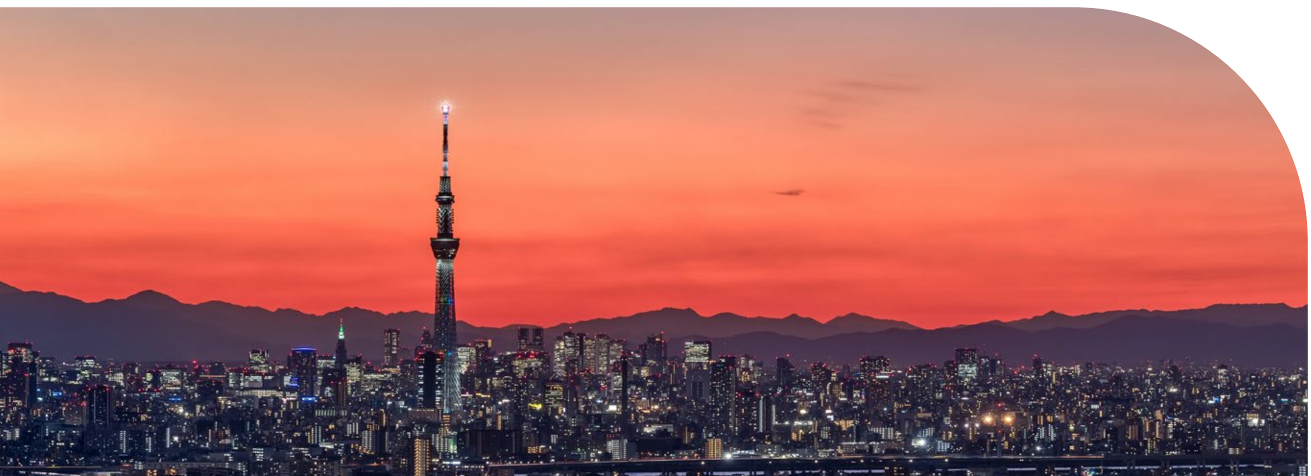
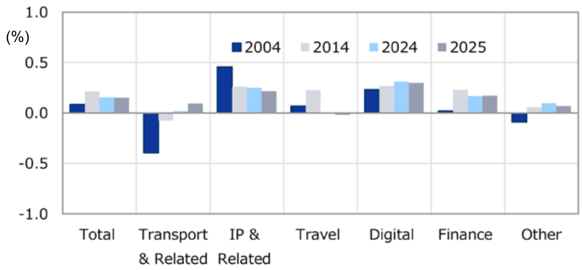
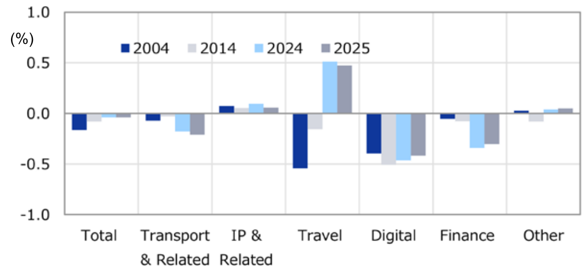


Figure 5: U.S. Services Trade Specialisation Index



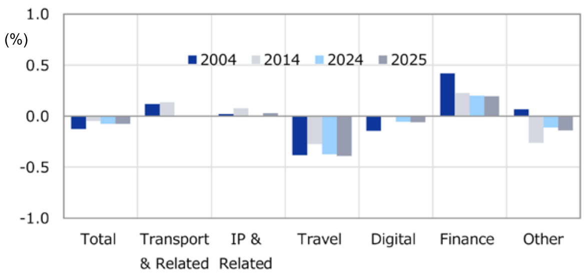
Note: 2025 figures are for January–September.
Source: SMDAM, BEA and Trade map.

Figure 6: Japan Services Trade Specialisation Index



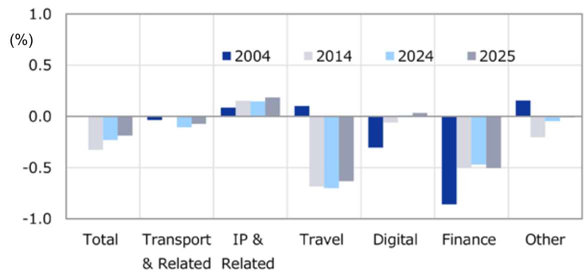
Note: 2025 figures are for January–October.
Source: SMDAM, BOJ and Trade map.

Figure 7: Germany Services Trade Specialisation Index



Note: 2025 figures are for January–October.
Source: SMDAM, Deutsche Bundesbank and Trade map.

Figure 8: China Services Trade Specialisation Index



Note: 2025 figures are for January–October.
Source: SMDAM, SAFE and Trade map.

Japan's TSI is also negative for transport and related, and for finance. For transport and related, part of the negative reading may reflect statistical, technical factors: Japanese shipping companies' use of overseas subsidiaries can result in payments to those subsidiaries being recorded as services imports, while the subsidiaries' earnings are recorded under primary income rather than the services balance. For finance, payments to overseas reinsurers appear to be a contributing factor.

Digital's comparative disadvantage and how to think about it

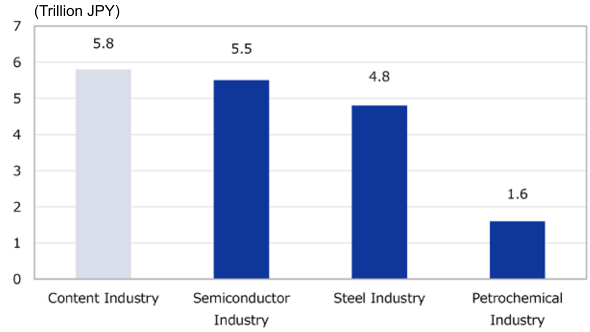
Japan's digital comparative disadvantage, often discussed as Japan's "digital deficit", appears to be driven largely by items such as payments for web advertising, cloud-service fees, software downloads, and various licensing fees associated with music and video streaming, reflecting reliance on US platform providers (Figure 5).

However, attempting to eliminate the digital deficit by reducing reliance on US platforms and reducing their use could in fact weaken Japan's competitiveness and reduce overall economic benefits. Rather than treating the digital deficit as a problem in itself, Japan should focus on using platforms effectively, improving productivity, fostering innovation, and nurturing new competitive fields.

Potential in the content industry

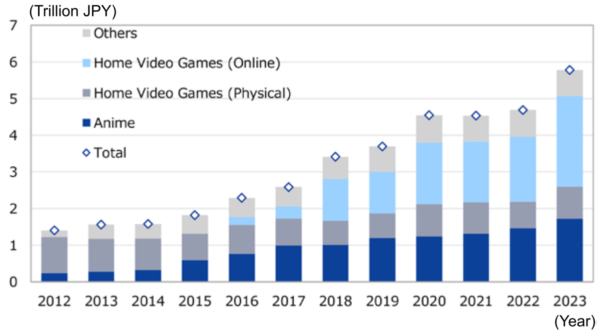
As many have already pointed out, there is still room to raise Japan's earning power by further strengthening the competitiveness of Japan's content industry often viewed as one of Japan's comparative advantages (Figures 9 and 10). With continued growth in emerging economies that have large populations, and with economies tending to shift toward services as they mature, the potential of the content market looks significant. AI can also make multilingual rollout and localisation faster and easier, creating ample opportunities to unlock the content industry's potential.

Figure 9: Export Scale of Selected Sectors in Japan



Note: Data covers 2023.
Source: SMDAM and Cabinet Secretariat.

Figure 10: Trends in the Overseas Market Scale of Japanese

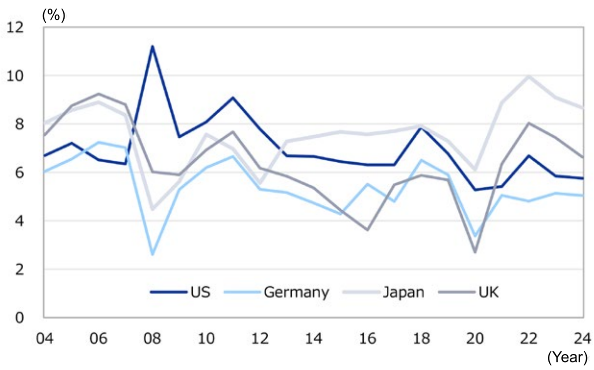


Note: Data covers the period from 2012 to 2023.
Source: SMDAM and Cabinet Secretariat.

Japanese companies remain strong in overseas expansion

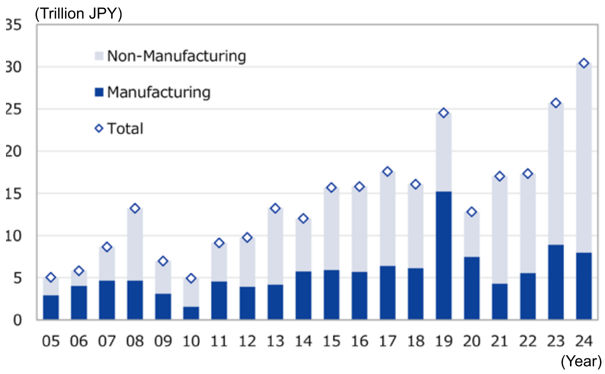
Another area I have been focusing on is the strength of Japanese companies' overseas expansion. Based on calculations referencing the FY2025 Economic and Fiscal Report, Japan's outward Foreign Direct Investment (FDI) rate of return averaged 8.09% over the decade spanning 2015–2024, higher than the US at 6.38%, the UK at 5.62%, and Germany at 5.04% (Figures 11 and 12).

Figure 11: Return on FDI in Major Countries



Note: Data covers the period from 2004 to 2024.
Source: SMDAM and BOJ.

Figure 12: Japan's Outward FDI



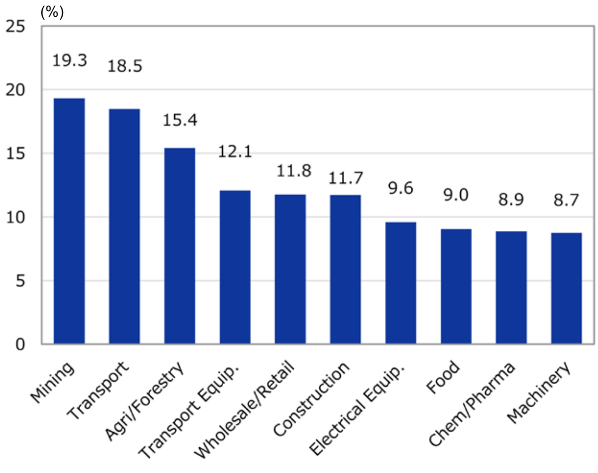
Note: Data covers the period from 2005 to 2024.
Source: SMDAM and BOJ.

There are important caveats. Because capital losses are not reflected, some argue that returns would not look as high if losses from unsuccessful investments were fully taken into account. In the case of the US, tax-driven structures used by major IT companies—such as routing profits through conduit countries like Ireland—may shift profits away from direct investment income and into services exports, making US direct investment income appear lower. For these reasons, the cross-country comparison should be interpreted with caution. Even so, it would be hard to conclude that Japan's outward FDI returns are exceptionally low. The Cabinet Office offers a positive interpretation, noting that Japan's high outward FDI returns reflect overseas profits being reinvested locally and deployed effectively.

My view is broadly aligned with that of the Cabinet Office. Against the backdrop of a stronger yen and a difficult domestic business climate during the deflationary period, Japanese companies—especially manufacturers—sought opportunities overseas, sharpened their competitiveness there, and as a result raised the returns on outward direct investment.

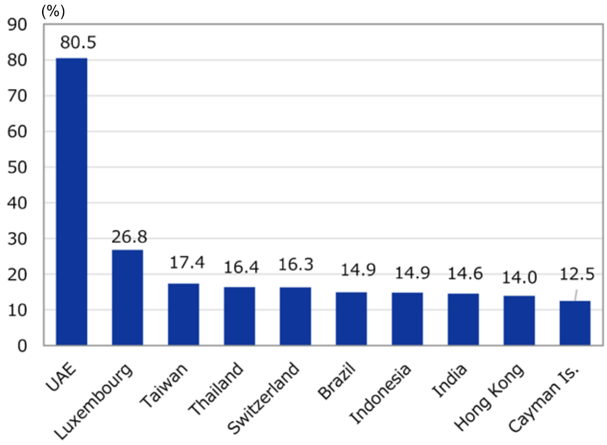
Looking at Japan's outward FDI rate of return in 2024 by sector, mining stands at 19.3%, transport equipment at 12.1%, wholesale and retail at 11.8%, and electrical machinery and equipment at 9.6%, all above the overall average (Figure 13). Returns are high both in resource-related areas and in assembly-type manufacturing. For manufacturing, returns by region are 16.4% for Thailand, 14.9% for Indonesia, and 14.6% for India—again above average—suggesting that Japan has effectively captured Asia's strong growth, which underpins its high outward FDI returns (Figure 14).

Figure 13:
Japan Outward FDI Return: Top Industries (2024)



Note: Data covers 2024.
Source: SMDAM, and BOJ.

Figure 14:
Japan Manufacturing Outward FDI Return: Top Regions (2024)



Note: Data covers 2024.
Source: SMDAM, and BOJ.

Expectations for overseas expansion in services

More recently, even non-manufacturers have been stepping up expansion into Asia by leveraging competitiveness honed during Japan's deflationary period. This has not been limited to price competitiveness: for example, Uniqlo has strengthened its "price plus alpha" proposition by enhancing functionality.

I recently traveled to China and visited stores operated by Japanese companies such as Uniqlo, MUJI and Sushiro. The trip was short and the visits were limited to a handful of stores in major cities, but I came away with the impression that local customers do value the "plus alpha" appeal offered by Japanese companies.

Japan has largely emerged from deflation, and the domestic business environment has improved. While global competition and geopolitics remain challenging, opportunities for Japanese companies to realise their potential appear to be expanding, and there seems to be ample room for upside.

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