Putting Tohoku Into Perspective

BY TADASHI NAKAMAE

The negative global effects are being exaggerated.

As Japan rebuilds the Tohoku region, devastated by an earthquake and tsunami in March, it will have to invest a considerable amount in infrastructure. Thus, amid the dark clouds, there is an economic silver lining: the twin disaster could serve as a catalyst for investment-led growth.

This would make a significant contribution to the global economy. However, several misconceptions about the impact of the twin disasters on Japan need to be addressed. For example, there is a general perception that the investment required for reconstruction will need to be so large that it will stimulate the whole economy. Similarly, there is a widely held belief that Japanese imports will surge, benefiting the global economy.

Another misperception is that massive costs of rebuilding will create financing problems for a government that is already burdened with a huge budget deficit. As the need for additional funding grows, the government and the private sector will be forced to sell foreign assets, such as U.S. Treasury bonds, in order to repatriate enough funds to finance the large-scale

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The city of Ofunato, Japan, was severely damaged by a 9.0-magnitude earthquake and subsequent tsunami on March 11, 2011.

investment needed to rebuild the Tohoku region. This will have a negative impact on the global financial market.

However, it is unlikely that Japan, the largest creditor nation in the world, which has a sizeable current account surplus (¥17 trillion; $210 billion in 2010), will see its surplus disappear. The increase in imports due to reconstruction will not be large enough to tip the current account balance to deficit. On the contrary, the magnitude of investment required to rebuild the disaster area is actually quite manageable relative to the size of the overall Japanese economy. According to an estimate by the Cabinet Office, ¥16 trillion–¥25 trillion (3–5 percent of Japan's GDP) in assets were destroyed, of which ¥9 trillion–¥16 trillion were non-residential private-sector assets. The remaining ¥7 trillion–¥9 trillion in losses were to social infrastructure including houses, ports, roads, and bridges.

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Assuming the total damage is roughly ¥25 trillion and it will take three years to rebuild the affected areas, annual investment will be roughly ¥8 trillion, which is 8 percent of the ¥100 trillion Japan spends every year on total investment (including housing, non-residential private sector investment, and government investment). Even though capacity utilization in the construction industry was low prior to March 11, it is physically impossible to shift all excess capacity to the Tohoku region. Therefore, ¥8 trillion per year in recovery investment is probably the maximum available from a supply-capacity point of view. This ¥8 trillion will create ¥3 trillion in imports (this assumes Japan's historic import-dependency ratio of investment of 35 percent), equivalent to only 5 percent of ¥61 trillion of total imports in 2010. Thus, there will be no need to sell foreign assets.

There are also concerns that a current account deficit will arise as imports of construction materials go up and exports of components used in cars and electronic products go down because damaged manufacturing facilities are unable to keep up production. Worse,

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there are fears that the production of assembled goods will also decline as supply shortages impact assembly plants outside of the disaster area. But these are short-term problems. It will be only be roughly three to six months before production capacity recovers and exports return to normal. The restoration of supply chains is occurring extremely rapidly, and some are already almost back to normal.

The negative impact of the additional deficit financing required to fund reconstruction has been overstated. Over the next three years, ¥3 trillion per year will be needed by the government to rebuild the ¥7–¥9 trillion of social infrastructure destroyed on March 11. These annual amounts are relatively small and will add less than 10 percent to the ¥44 trillion of new debt the government had already committed for fiscal 2011. Also, funding private-sector reconstruction will not be difficult because the private sector has plenty of savings.

The amount required to fund reconstruction is not large enough to cause debt-financing problems. Nor will it wipe out the current account surplus. Even before March 11, the real economic challenge was structural reform. Reducing the government deficit mattered, not because it was difficult to finance, but because it was stifling economic growth—a large government deficit absorbs private savings and crowds out private investment.

An important post-disaster gauge is the level of energy prices. These are likely to remain elevated. Even before the disaster, the prices of energy resources such as oil had increased substantially because of rising demand in emerging economies. The disaster in Fukushima has made building new nuclear power plants difficult in both developed and emerging-market economies. Dependency on traditional energy sources is going to increase, which will increase energy costs and have a negative effect on the global economy. However, this will also encourage the energy innovation, as happened with the oil crisis in the 1970s. Japan responded to that crisis by developing new energy-saving technologies. Japan has an incentive to do this again.

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Though the disaster is unlikely to cause any sudden or dramatic shift in the Japanese economy, investment-led economic growth should gradually accelerate. Japan needs to transform its economy from export-oriented to domestic-demand oriented. This means shifting from manufacturing to services such as health care, nursing, and education. To develop these service industries, Japan needs to make fresh investments in, say, robots, to compensate for its shrinking working-age population, improve productivity, and raise wages. Capital-intensive, high-productivity, and high value-added service industries are needed, rather than labor-intensive low-wage industries. To achieve this, deregulation is essential for both Japanese and foreign companies—competition for better services needs to be stimulated.

In the 1950s and 1960s as Japan's economy was industrialized, it achieved double-digit economic growth. This was underpinned by high capital investment in factories, housing, and infrastructure, akin to what is going on in China today. As those investments matured, the economic growth rate slowed to 4 percent in the 1970s and 1980s and to zero since the 1990s. In the last twenty years, total investments have seen negative growth.

Japan needs to revive investment. And now Japan also needs to increase infrastructure investment to rebuild the devastated Tohoku region. The disaster could serve as a catalyst for investment-led economic growth. This would be Japan's most important contribution to the global economy. ◆