Japan's Post-disaster Economic Policies

Author Keiichiro Kobayashi

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Firstly, I would like to take this opportunity to offer my sincere condolences for all those who lost their lives in Japan's recent unprecedented tragedy, as well as my heartfelt concern for all those who suffered any kind of loss.

An enormous disaster of a scale unprecedented in the history of Japan occurred. On top of the mega-earthquake and gigantic tsunami, a severe accident took place at the Fukushima No. 1 nuclear power plant, and its consequences will definitely be dragging out over the long term. In order to smoothly carry out restoration of the areas that suffered damage, and to rebuild the lives of all the victims, it is desirable for the Japanese economy to move onto a strong, steady track. From this perspective, and especially from the viewpoint of supporting post-disaster recovery, in this essay I would like to consider the direction that Japan's economic policies should take from now on.

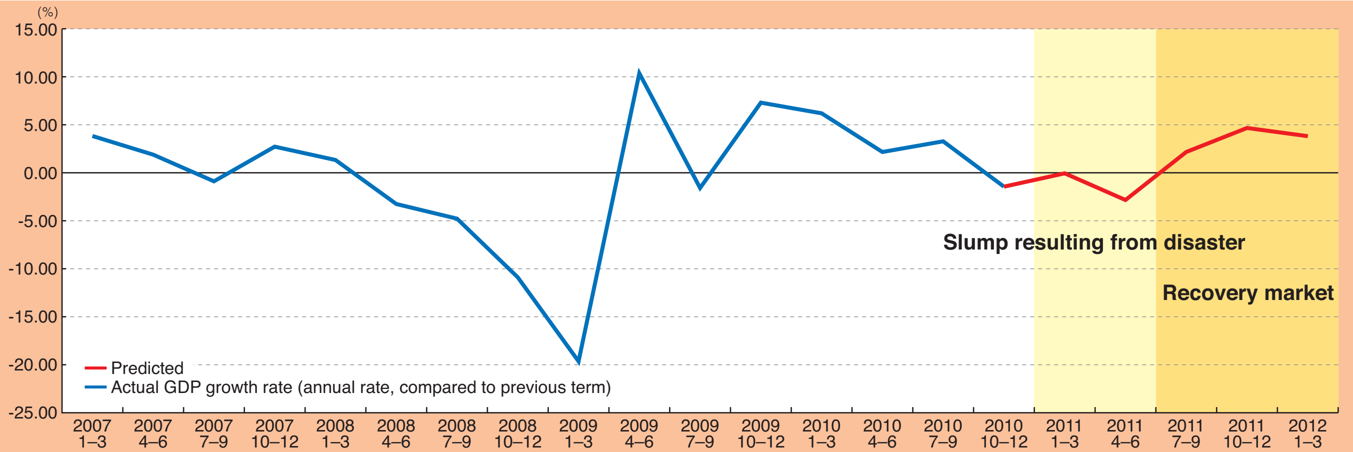
The Effects of the Mega-earthquake

The Great East Japan Earthquake caused a great deal of damage to the Japanese economy. March's Steel Manufacturing Production Indices showed a drop of 15% over the previous month, the biggest recorded decrease in history. Consumption also decreased dramatically by 8%, while the trade surplus showed an enormous 79% fall against the previous month. In addition to the confusion caused by the lack of electricity and the planned power cuts, as well as the breakdown in supply capacity resulting from the disruption of the supply chain because of the disaster, the worsening of the accident at the Fukushima No. 1 nuclear reactor increased the amount of uncertainty, and the aggregate demand shrank considerably. It is expected that in the latter half of the year the increase in the demand for reconstruction will grow considerably, and moreover that improvement in the nuclear reactor accident situation will reduce the amount of uncertainty. As a result, it is expected that the reduction in demand will stabilize, and Japan's production activities will be revitalized *(Chart 1)*.

Since, as a result of the disaster, the breakdown in supply capacity and the drop in demand occurred simultaneously, it is probable that the deflationary gap (the gap resulting when the demand is subtracted from the supply capacity) would not have changed much before and after the calamity. Accordingly, it is expected that the trend of "deflation," which was a characteristic of the Japanese economy before the disaster, will not change much after the disaster.

According to research done by economists on analysis of the effects of disasters in the past, there was a high possibility that, if there had been only the earthquakes and tsunami, there would not have been major long-term negative effects on economic growth. However, the future effects of the accident at the nuclear power plant are still immeasurable. For one thing, it is certain that the cost of Japan's electricity will increase. There is concern that this will encourage the establishment of corporate bases overseas, and lead to the long-term hollowing-out of domestic industry. In that case, it would mean a long-term drop in economic growth in Japan. Also, in

CHART 1
Economic growth



Note: "Predicted" means the average of the predictions of 43 private-sector think-tanks; responses were during the March 29 – April 5 period.
Sources: GDP Preliminary Report by Quarter, Cabinet Office; ESP Forecast Survey, Association for Economic Planning

contrast, as a potential plus, it is possible that technological development related to natural energy and energy-saving could be promoted, leading to improvement in the competitiveness of Japan's energy-saving technology. In this scenario, there would probably be a positive effect on the growth rate. In regard to future energy policies, it will certainly be necessary for the Japanese people to make a serious political choice, based on a clear explanation of both the scenario that proceeds with the development of nuclear power, while steadily improving safety, and the scenario that weans us away from nuclear power.

Photo: Yoshiaki Sasaki

Paper mill in industrial zone in coastal part in Ishinomaki

The Need to Adjust the High Yen

After the disaster, the high yen in the market has continued. At one point a record historic high value of 76.25 yen to the dollar was reached, and subsequently, as a result of coordinated intervention by G7, for a while the exchange rate went back to around 81 yen/dollar. However, even after this intervention, the yen continued to rise in value, and at the start of May had moved to the mid-80 yen/dollar range.

Since the mega-earthquake and nuclear power plant accident caused major damage to the Japanese economy, this should be a factor creating a low yen, rather than a high one. At first sight, it appears unthinkable that a high yen should be continuing. Because the calamity led to a breakdown in the supply chain, so that the supply capacity of Japanese corporations was destroyed, the trade surplus decreased dramatically. It may be that the reasons that a low yen did not occur even in this situation, lie in the fact that the income balance surplus remained firm, as well as in the fact that Japan is the world's largest holder of foreign assets. While Western countries are continuing to increase the money supply, there is a trend, if only slight, for the emerging market countries to shift their foreign currency reserves to yen. This is also a factor behind the higher yen. Moreover, the high yen immediately after the calamity was said to be partly caused by the fact that foreign investors rushed to buy yen, out of the belief that, in order to obtain funds for reconstruction and recovery, Japanese corporations that were affected by the disaster would probably sell their assets that are in foreign currency and buy yen.

But even after such market psychology had calmed down, the trend to a high yen continued, so we need to pay attention to trends in the exchange rate from now on. Directly after the Great Hanshin Awaji Earthquake in January 1995 also, the high yen continued for about six months, and reached the highest-ever value (79.75 yen/$) in April of that year. If, this time, the high yen continues for several months in the same way, for Japan's exporting companies that were damaged by the disaster, it will be a major obstacle on their way to recovery. Meanwhile, when we consider the fact that the disaster and the nuclear power plant accident comprise a large factor behind the low yen, and moreover that Japan's public debts are considerably worse now than they were at the time of the Hanshin earthquake, if a worsening of economic conditions after the disaster is clarified, uncertainty about Japan's public debt is likely to increase dramatically, and it is entirely possible that conditions would arise whereby the public debt would be sold off cheaply. In such a case, since trust in the yen would then start to waver, the exchange rate would fluctuate greatly in the direction of a low yen.

When we consider that an immediate high yen has the possibility of preventing the reconstruction of Japanese corporations, and that, in contrast, there is an increasing risk that the exchange rate could experience extreme fluctuations leaning towards a low yen, it seems clear that the Japanese government is expected to show by action its strong will to achieve stability in the exchange rate. In order to gain the benefits of adjustment of the high yen, there may indeed be the necessity for the Japanese government (GOJ) and the Bank of Japan (BOJ) to conduct a large-scale intervention, showing a determined stance.

Further, even if there were only slight benefits resulting from adjustment of the high yen through exchange-rate intervention (intervention to sell yen and buy foreign currency) by the Japanese government, there would still be the additional benefits of maintaining trust in Japan's public debt post-earthquake, and stabilizing the finance for post-disaster recovery funds. The reasons for this, as explained by the author elsewhere, can be outlined as follows.

Since Japan already had enormous sums of public debts, and on top of that has experienced tremendous damage from the mega-earthquake and nuclear power plant accident, market faith in Japan's debt will soon begin to waver. If that happens, since credibility in the Japanese yen will also worsen in reaction, the exchange rate will move towards a lower yen. At the stage before trust in the Japanese yen is lost, if the Japanese government builds up its foreign-reserve assets, through intervention to sell yen and buy foreign reserves, as well as a lower yen progressing, foreign-reserve-based assets will create exchange rate profits, and thus the government's finances will automatically improve (in yen). By accumulating foreign reserve assets in advance in this way, in regard to a low yen (= a drop in the value of the national debt), it is probable that a drop in the credibility of the national debt and of the yen would be alleviated. In other words, it can be said that intervention to sell yen and buy foreign reserves is equivalent to dramatic risk-hedging against a low yen on the part of the Japanese government authorities. If the Japanese government implements these kinds of policies, it would even prevent the arising of a serious disturbance in the national debt (that is, dramatic progress towards a low yen), and there would also be the added benefit of a stabilization of the national debt market. Because of the above reasons, speedy, large-scale intervention in the exchange rate by the Japanese government, as well as having the benefit of directly improving the economy, would promote the stabilizing of the national debt market on a mid-term span, thus facilitating the smooth provision of financing for Japan's post-disaster recovery.

Policies for Corporate Financing – Urgent Need to Resolve the Double-debt Issue

Post-disaster, there is concern that there will be stoppages of both the physical supply chain and the financial credibility chain, leading to the occurrence of a rush of bankruptcies, which would result in economic damage spreading over a large area, even outside the area where the disaster occurred. Although it is difficult to implement policies for the recovery of the physical supply chain, policies to resolve problems in the financial area were undertaken promptly by, in particular, the BOJ and the banking industry. For example, extension of bill *(tegata)* clearance and the forgiveness of bounced payments for companies affected by the disaster were allowed.

Also, considering that recently there has been an increase in inter-company account settlement that does not use *tegata,* further thoroughgoing policies might be advisable. Through measures such as the BOJ increasing the scope of credit, using inter-company credit such as accounts receivable as collateral,; or else by the BOJ or the GOJ guaranteeing the value of collateral such as accounts receivable, loans by private-sector financial institutions using inter-company credit as collateral would be enhanced; implementing such a policy as a mid-term response for a period of from several months to a year should also be considered. Or, it might also be feasible for the BOJ and the Japan Policy Investment Bank to again implement the buying of commercial papers (CPs) that was put into place just after the Lehman shock, from autumn 2008 to spring 2009. Moreover, the corporate loans and debts of TEPCO, which is faced with the enormous responsibility of having to provide compensation in regard to the nuclear power plant accident, involves a huge risk. In order to alleviate the financial market uncertainty in relation to TEPCO, the BOJ may have no choice but to actively increase the purchase of CPs and corporate debts.

Another issue that must be resolved at the same time as this kind of flexible policy for the financial market, is the problem of the double debt of companies and individuals that experienced damage as a result of the disaster. In the case that collateral assets were destroyed by the earthquake or washed away by the tsunami, pre-disaster loans must be treated as bad loans and debt reduction carried out. That's because, when companies receive new financing and make a new start, if previous loans remain, the burden of repaying them is too heavy, making it impossible to revive operations. However, banks on the loan side have a great many hurdles to overcome on the way to reaching a decision to forgive debts, such as the responsibility to provide explanations to shareholders and regulatory authorities, evaluation of collateral assets, invoicing affiliated guarantors, and so on. For individual banks to undertake debt forgiveness on their own initiative would take a great deal of time. Therefore, in order to speedily proceed with debt forgiveness for affected individuals and companies, it is probably preferable to temporarily establish public organs that specialize in debt forgiveness ("recovery debt streamlining organs"). Such debt-streamlining organs would buy the entire debts of affected parties and implement debt exemption (or turn the debts into shares). Collateral assets such as land could be held for the long term, and gradually sold on the market over time, or else donated to local government bodies for utilization in public uses of recovery plans. If public organs were to demonstrate such models or precedents of debt streamlining in such ways, since it would pave the way for local banks to provide explanations to shareholders, bad-debt-streamlining by banks could also be expected to proceed rapidly.

Stable Finance for Recovery Funds through Stabilization of the International Market – Long-term Financial Reconstruction & Improved Social Security

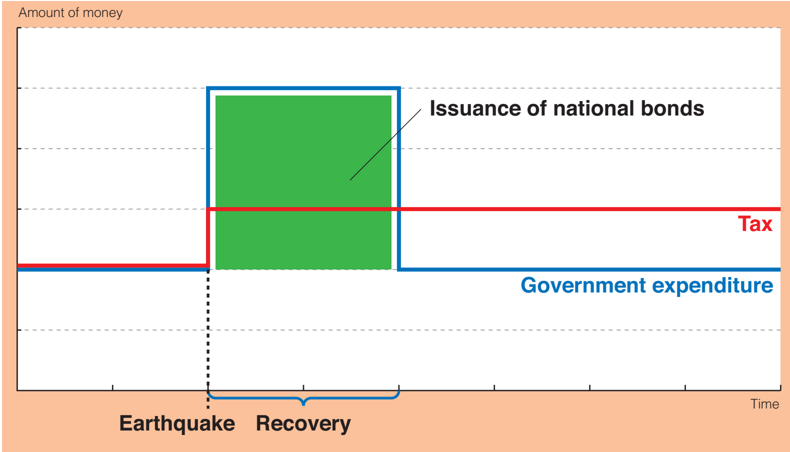
On March 12, the Great East Japan Earthquake was designated a disaster of the highest level, and it was decided that large-scale financial support for the recovery of the disaster-stricken areas would be implemented. Considering the facts that damage from the disaster covers an extremely large geographic area, and that recovery from the effects of the nuclear power plant accident and the re-establishment of the electricity supply system is also essential, a huge sum amounting to many trillions of yen will be required for recovery. Naturally, since the issuance of national bonds (or a new "disaster recovery national bond") would provide financing for rebuilding operations, it is possible that Japan's national bonds would face the risk of a substantial loss in value. Because Japan is burdened with gigantic public debts, even before the occurrence of the disaster, government finance was in such a state that its credibility could have been lost at any time. If market credibility is lost and national bonds suffer a serious decline, the suffering of those already affected by the disaster will be made ten times worse.

In order to avoid this happening, it is necessary to implement the difficult policies of issuing a reconstruction national bond, while at the same time maintaining market trust in Japan's national bonds. From the theory of tax smoothing, it would be preferable for the addition of a temporary financial expenditure such as for post-disaster recovery to be financed not by taxation but rather by the issuance of national bonds. With that in mind, it would be desirable for the bonds to be repaid through permanent small-scale taxation. Rather than repeatedly implementing tax increases and decreases to finance short-term expenditure, maintaining long-term stability in the taxation system results in less damage to the economy, leading to the above conclusion *(Chart 2)*.

For example, 1997 research by UCLA'S Professor Lee E. Ohanian studied the obtaining of military expenditure by the US government for the Korean War. In reality, the US government obtained the military outlay needed by means such as increasing taxes including income taxes, but Professor Ohanian conducted simulation of a case in which the military expenditure had been obtained through national bonds. The results showed that the case of obtaining military expenditure through national bonds would lead to improvement in the economic health of the US more than had occurred in the actual case.

Accordingly, the combination of the issuance of reconstruction national bonds and a permanent, small-scale taxation increase would be an appropriate measure to obtain financing for post-disaster recovery. However, a remaining issue is discussion on fiscal reconstruction, an ongoing concern since before the disaster. If the discussion on fiscal reconstruction disappears, using the disaster as an excuse, the credibility of the national debt will be badly affected. Therefore, our mission is nothing less than to make a strong political decision and implement reform to promote recovery of fiscal sustainability. Furthermore, we must implement structural reform of

CHART 2
Tax standardization diagram



Source: Compiled by author

the economy, without paying heed to vested interests, and increase production to recover economic growth. In these ways we can achieve fiscal stability. If fiscal sustainability recovers, smooth financing would be facilitated through both the enormous disaster recovery fund and the issuance of national bonds, and we will be able to achieve early recovery.

Fiscal reform, which has been needed since before the disaster, is in fact more of a political measure than an economic one. Regarding the "reform to harmonize taxation and social security," the GOJ should announce a government draft in June as scheduled, and subsequently both the ruling party and the opposition should rapidly agree to it and compile a plan, so that reform can be quickly implemented. It is also necessary to conduct large-scale reform of social security, including the reduction of pension payments to elderly people in the higher-income bracket. Also, it may be necessary to increase various taxes such as consumption tax and income tax. In order to alter the burden allocation of pensions and medical costs in relation to assets owned, it will be essential to introduce a taxpayer-numbering system.

The burden of these coming reforms must be borne by all the Japanese people as a whole. This is also true for expenditure-cutting policies such as reform of the public servant system. Clearly indicating the specific schedule for expenditure reduction and revenue increase, and anchoring this to market credibility in relation to the national debt, can be considered a critical issue. Also, I believe it is essential when implementing fiscal reform from the long-term view that various immediate policies, such as providing child allowances and abolishing highway road tolls, are also re-evaluated from the same perspective, so as to provide a policy system that is consistent over the long term.

In order to develop sound finances and support post-disaster recovery, it is essential not only to implement austerity finances, but also to realize high economic growth and increase tax revenue. Meanwhile, in fields such as agriculture, medicine and social welfare, it is important to implement regulation reform that is not hampered by vested interests, and to increase the openness of the Japanese economy by means such as participation in TPP, while improving productiveness.

We must actually resolve the various issues that have been put on the back burner for such a long time. Establishing strong finances that can finance the disaster recovery demand by doing so is our responsibility to the victims of the disaster.

Fiscal Expansion or Fiscal Consolidation? Lessons from the Great Kanto Earthquake

The changes in the economy following the Great Kanto Earthquake that occurred in 1923 were as follows. First, because of the demand for reconstruction immediately after the disaster, economic activities were strong, but based on the belief that the reconstruction demand would continue to rise, imports increased rapidly, and foreign reserves dropped, so bringing the Japanese economy up hard against the international expenditure wall. Further, since the disaster bonds became difficult to sell because of concern about Japan's national debt repayment, the Takaaki Katou Cabinet (June 11, 1924 – Jan. 28, 1926) took the bold step of fiscal adjustment (in other words, a 15% reduction in expenditure through fiscal reform). As a result, enormous deflationary pressure affected the Japanese economy, and Japan sank into a serious recession.

When we consider the possible lessons to be learned from these experiences, in regard to disaster recovery, should we avoid austerity finances? Or, should we expand fiscal action?

In fact, at the time of recovery from the Great Kanto Earthquake, it is true that it was difficult to sell the government bonds for reconstruction, and if austerity finances had not been implemented, it is possible that obtaining recovery funds would have become even more difficult. Therefore, along with smoothly facilitating international finance for disaster recovery, to avoid a worsening of the economy resulting from fiscal austerity, officially implementing the macroeconomic policy of "fiscal austerity + financial deregulation" that prevailed in the US in the 1990s is likely to be effective.

Monetary policies after the Great Kanto Earthquake were restricted by the adoption of the gold standard. (To be accurate, at the time of the earthquake, Japan had already broken away from the gold standard, but aiming for its return, at former parity, was considered a natural course of action.) As a consequence, facing a low yen resulting from the rapid increase in speculative imports, and tied by the policy goal of wanting to avoid a drop in the yen rate, the government was unable to maintain its monetary easing policies.

Since the Japan of today does not have "raising the exchange rate to a fixed standard" as a policy goal, it is possible to steadily improve market credibility in relation to Japan's national debt by implementing fiscal austerity, proceeding with large-scale monetary easing, and stimulating overall demand. This is the strategy of expanding external demand through the advantage of a low yen attained by a monetary easing policy. Macroeconomic management conducted by pursuing economic growth through austerity finances and monetary easing was implemented by the Koizumi administration in the first half of the 2000s, achieving Japan's longest post-war economic expansion. I believe that this type of policy is what we should aim for in order to achieve post-disaster recovery. JS

Keiichiro Kobayashi is a professor at Hitotsubashi University and a fellow at the Research Institute of Economy, Trade and Industry (RIETI).