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Interview with Prof. Motoshige Itoh, Department of Economics, University of Tokyo

# Assessing the Short-term & Long-term Consequences of the March 11 Disaster for the Japanese Economy

Interviewer: Naoyuki HARAOKA

A distinguished Japanese economist, Dr. Motoshige Itoh, Professor of Department of Economics, University of Tokyo, has been actively providing advice on the restoration of the Japanese economy since the March 11 disaster. This issue of Japan SPOTLIGHT features Prof. Itoh's views on Japan's economy and public policy in the post-disaster period.

On the short-run perspective of the impact of the earthquake and tsunami on the Japanese economy, the foreign press highly values the competence of Japanese people and, according to them, the negative growth brought about to Japan will be temporary and in a few months from the bottom of business in the middle of this year, the Japanese economy will follow a V-shaped recovery, thanks to a drastic increase in effective demand stimulated by the need for restoration of the devastated regions by the disaster.

Japanese firms have been returning their borrowed money so far and they have had only a limited chance for investing new money for new business opportunities. However, the need for the restoration of the regional economies will create a new demand and thus increase new business opportunities, though this is the result of a horrible tragedy. What is your opinion on this matter?

**Itoh:** There are optimistic views and pessimistic views on the future prospects. Though uncertainty is truly high due to some negative factors such as the difficulty in restoring the electricity supply and rapid implementation of government policies for restoration of the economy or Japan's neighboring countries' reluctance to import goods from Japan due to fear of nuclear contamination, I agree with the majority saying that the Japanese macroeconomy will not fall into a serious recession in the short run.

There are some reasons for this positive assessment. One of them is that the stimulating effect of a possible increase in effective



*Motoshige Itoh*

demand created by restoration should be large enough to sustain economic growth. This was exactly what happened after the big earthquake in the Kansai area about 15 years ago.

Secondly, the damaged production sites seem to be recovering much sooner than we expected. This is thanks to the potential strength of a Japanese firm brought about by the unity of all the employees pursuing restoration. The recovery does seem to be truly accelerated by such mental strength of the Japanese people.

Whereas the earthquake in the Kansai area hit urban areas in the big cities, this one hit local areas. Therefore, though the human damage is enormous in this disaster due to the tsunami, and we have the serious problem at the nuclear power station, the impact on GNP is smaller than the last one's.

**On the question of the exchange rate, there is concern about the possibility of Japanese firms getting back yen money on their deposits in foreign banks, since the yen once drastically appreciated and then after the government intervention in the foreign exchange market, it has depreciated. What do you think about the trend in the value of the yen? Will it depreciate further?**

**Itoh:** It is very difficult to predict the exchange rate in the future. However, I personally believe that in the long run the yen is heading for depreciation. Some factors are working in favor of that direction. The possible decline of exports from Japan and tourists visiting Japan will push down the value of the yen. In terms of monetary policy as well, under the circumstances where the overheated BRICs economies are leading the world economy into an inflationary state,

the EU and the US are now on the verge of raising their interest rates. Assuming that Japan's interest rate remains very low in the state of recession, the interest rate differential between Japan and the US or the EU would work in yen depreciation. In addition, the possible rise of the price of natural resources worldwide could depreciate the yen further.

However, we observe quite often that before the currency starts depreciating, it tends to appreciate to some extent. This is what we economists call 'the theory of the rational bubble.' We certainly have a risk of further appreciation of the yen in the foreign exchange market before the trend of yen depreciation begins, just like what happened right after the disaster.

### **You mention a decline of exports. What do you think about the possibility of Japan's trade balance or current balance falling into deficit?**

**Itoh:** We could have a deficit or at least a reduction of trade surplus in trade balance due to a rise in the price of natural resources or a possible increase of domestic demand caused by restoration of the damaged areas. However, since we have a tremendous amount of surplus in the income balance, mainly consisting of the earnings of the business firms' overseas investment, the current balance including this income balance will not fall into deficit in the near future.

### **It is pointed out that Japan's economy could be hollowing out as a result of the rise of energy costs or the shortage of energy because of nuclear power no longer being a principal energy source in Japan. Industries may have to look for their production sites overseas, where cheap energy is available. In this light, is the long-term perspective of the Japanese economy more uncertain than the short-run one?**

**Itoh:** Assuming that it would not be easy to increase the nuclear power supply, the price of electricity will most likely rise; thus, the energy cost will be a serious impediment to the Japanese economy.

However, there may be one possible breakthrough to resolve it. The electricity supply in Japan has been very unique in the world. Regional monopoly in all the sectors; and generation, transmission and distribution of the electricity and the supply at a fixed price to meet any demand are the two distinctions of the industry in Japan in comparison to the standard electricity supply in the world.

This certainly has validity in high-growth periods when the demand for electricity permanently increases at the fastest speed in proportion to economic growth. But this is no longer valid in our lower-growth period. Like any other product, if demand exceeds supply, the price will increase, and that will curb the demand as well as provide an incentive for investment to increase the supply capacity. This function of the market mechanism should work in the electricity supply as well.

Such a market mechanism should be achieved by regulatory reform that allows new entries in all the domains of the electricity



*Ishinomaki City, where about 80% of offices were damaged by the tsunami*

industry such as generation, transmission and distribution.

Renewable energy sources such as solar power will increase because of the declining dependency on nuclear power, though they do not have sufficient capacity to replace nuclear power completely. However, the expansionary use of such natural energy sources will encourage not only reduction of CO<sub>2</sub> emissions, but also overall innovation of producers, and change human life or create more local-society-demand-oriented energy supply. A possible shortage of the electricity supply can thus be instrumental in creating an innovative society, not only bringing about negative economic consequences.

If the government raises the price of solar power, solar panels will increase and the price of electricity will increase as well and thus electricity consumption will be curbed, but the supply of solar power will be consolidated. The market thus achieves an ideal situation for the country.

In regard to the concern about the possibility of a hollowing-out of Japanese industries, there could be a negative impact upon domestic employment, in particular on SMEs due to an increase in Japanese companies relocating their production sites from Japan to overseas. However, I think this could also have a positive consequence. Japanese companies have so far been very domestic-market-oriented and far behind US or European companies in terms of global competition. Catching up with other countries in globalization could have a positive impact on the national economy as well.

On the assumption that such globalized relocation of production sites is consistent with the world standard, we should find a way to vitalize local economies or restructure industries in the domestic market in order to secure jobs in the country.

### **If so, should we be more seriously engaged in promoting a service-industry-oriented economy?**

**Itoh:** It is certain that we should consolidate a development base for banking, retail, medicare and the other service sectors. But we should also be paying attention to a portion of knowledge-based services in the manufacturing industry such as R&D, marketing, etc. The knowledge-based economy is certainly to be pursued in Japan as well, though Japan was far behind the other mature countries in this field.



*A fish processing plant in Ishinomaki, after the earthquake*

**For other Asian countries, Japanese industries are very important for their economic growth, since their economies are highly dependent on the supply networks of Japanese firms' products. How can we restore our supply chain with these countries?**

**Itoh:** The materials or devices of Japanese firms are indispensable not only for Asian firms but also for other global companies. It is rather difficult to replace them with Korean or Taiwanese ones. Restoration of the supply chain is now making remarkable progress and we need to make further efforts to restore it as rapidly as possible.

**Another structural issue is budget deficit. The existing snowballing fiscal deficit of Japan will be exacerbated due to the additional expenditure for restoration from the disaster. How can we finance the restoration, such as by issuing special national bonds or implementing a tax hike? How can we restructure our budget in the long run in order to meet the increasing need for social welfare expenditures for the coming aging society?**

**Itoh:** I think a tax increase is inevitable to carry out the restoration of the country from the disaster as well as the need to be prepared for the aging society. Financing these crucial national needs by issuing national bonds could lead to a rise in the interest rate of national bonds in the near future, which would severely damage the Japanese economy.

Therefore, we should have a clear outlook on financial sources for measures to deal with the social needs of the aging society, integrating a plan for a tax increase, either a consumption tax or an income tax hike, which would finance short-hand measures for recovery from the disaster, and then in the long run a social welfare program to deal with aging.

One important point on the possible impact of a tax hike on the economy noted by economists is that spending money collected by a

tax increase for a certain purpose, such as the restoration of the economy or whatever, would lead to an increase in effective demand. Thus a tax increase, as far as it is spent, would not automatically cause a negative effect on business.

Reform of the social welfare program would cost much more than the post-disaster restoration, since it would take a much longer time. The government is expected to achieve a balance between the needs for finance in the short run and the long run. And if the short-run need for finance, namely restoration after the disaster, is financed by a tax increase and the government can manage to make this tax hike consistent with the long-run need for finance, that would enable the bond market to have a stable outlook for the future.

**What do you think about the combination of a corporate tax cut and a consumption tax increase as a possible tax reform?**

**Itoh:** I do not think it is necessary to cut corporate tax immediately, since the need for restoration of the economy from the disaster would create new demand and thus business will be activated, which is supposed to be a goal of corporate tax cuts. A consumption tax hike would have a much more enormous effect on the budget, since a 1% increase would produce more than \$25 billion. In the light of the urgent need for reconsolidating the budget, we need to focus on a consumption tax increase, and then when it becomes necessary to activate business after the effect of new demand created by restoration activities is over, we should think about a corporate tax cut.

**We need economic growth in order to restore fiscal health as well. As you mentioned, regulatory reform is necessary to consolidate a sound basis for growth. It is at the same time also important to pursue trade liberalization for revitalizing the economy. What do you think about the need for trade liberalization to restore our economy, such as the efforts to promote the participation of Japan in the negotiation of the Trans Pacific Partnership (TPP) and other regional or bilateral FTAs?**

**Itoh:** TPP is certainly an important way to achieve further opening of the country and trade liberalization. However, there are many other ways to achieve liberalization in Japan as well. For example, liberalization of airline networks, international treaties for investment, liberalization in finance, etc. are measures that can be taken in responding to the needs of globalization.

In the area of education, we also have the so-called Campus Asia project, which attempts to provide students with a double degree in four years, run by a group of the main universities of Japan, Korea and China. This is a sort of liberalization of education. While we are conducting these liberalization efforts in a specific area, we should pursue a wider-scoped liberalization such as TPP.

**Even if we achieve further liberalization, harmful rumors about Japanese products coming from the nuclear power station crisis, which may continue for a while, could prevent Japan from benefitting from it. We may neither be able to export much any more nor host enough internal investment or people from anywhere. How can we cope with this?**

**Itoh:** It is uncertain how long the harmful rumors will continue. It may depend on what evolves from the nuclear power plant crisis hereafter, but we now see signs of improvement to some extent and there seem to be fewer and fewer harmful rumors.

On the question of negative rumors concerning agricultural products, we need to provide as precise information as possible for consumers. Disclosure of the information on the traceability of agricultural products, namely, how and where they are produced and how they are sold, etc., is crucial to reduce such rumors. We should do our best to acquire a reputation whereby information on Japanese agricultural products is the most clearly disclosed to everybody in the world, and thus consumers overseas as well as domestic ones can check their quality.

**The WTO should function very well in order to check inappropriate trade measures imposed against Japanese products concerning their safety. Should we use the WTO function to eliminate such protectionist measures without any scientific reasoning on their safety?**

**Itoh:** Certainly. We should use WTO rules to avoid the adoption of protectionist measures on the basis of harmful rumors. At the same time, efforts on the exporters' side are necessary to improve consumers' understanding of and confidence in the quality of their products.

Perhaps, a difficult situation for us will continue for a while. However, food prices will rise drastically and this brings us a concern about inflation, in particular in China.

BRICs will be getting rich and particularly Asian countries will be increasingly wealthy.

In Asia, the area for agriculture is extremely small in relation to the population. Therefore, there is an enormous potential demand for food or agricultural products. Against this long-run background, there may be a growing demand for Japanese agricultural products in Asia. We should carefully consider such a business opportunity for Japanese agriculture.

**The nuclear power station crisis in Fukushima could affect negotiations for a post-Kyoto Protocol and the future of the global environment, since nuclear power was considered a key to resolve the issue of global warming and CO<sub>2</sub> reduction worldwide as a clean and cheap energy. At the**

**same time, we should achieve economic growth to keep employment. Can you suggest a solution to achieve a balance among energy, environment and growth (jobs)?**

**Itoh:** How much we should continue to depend on nuclear energy after the crisis should be a matter for the nation to decide. Certainly, the rise in the cost of energy from oil as a result of this crisis could impact the economy gravely, just like the two big petroleum price hikes in the 1970s seriously affected the world economy then. In this regard and from the perspective of the constraints imposed by the global environment as well, which is our contemporary issue, we may have to consider the possibility of a slowdown in economic growth worldwide.

Looking back at history, what we call the IT bubble collapsed in 2000, business recovered in 2002, and the world GDP per capita grew between 2002 and 2007, before the Lehman crisis happened in 2008, at the highest speed in human history. Such growth is wonderful and can be seen as a blessing, but we should not take it for granted.

Rather, we should realize that it would be very difficult to achieve such high economic growth for the coming two or three decades. Assuming that economic growth worldwide will slow down hereafter, we have to think about the desirable features of income and wealth distribution policies.

It is to be noted that a slowdown in economic growth will not necessarily lead to an increase in unemployment. If, as economics textbooks say, even though growth declines, the labor market functions in accordance with the supply and demand principle, then wages fall and the labor demand increases, and thus employment will be kept.

What is more important than unemployment is how much we can maintain our quality of life and level of income in the coming years. The experts' job is to show the nation what constraints and opportunities might exist in this world in the future as clearly as possible.

**There are many difficult problems facing the world now and in the future. However, existing global governance schemes such as G8 are not working well, whereas BRICs are emerging as new powers. How do you think we should improve our global governance schemes?**

**Itoh:** We should take note that BRICs themselves face challenges of their own. Therefore, even before we start worrying about the growing presence of BRICs in the world preventing a smooth functioning of global governance, we have to think about BRICs' domestic governance to enable them to realize their own stable society and economy.

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