The Kobe Earthquake and Japan's Economy

By Sakamoto Sakae

A plus over the mid- to long-term

Although the January 17 earthquake that struck west of Osaka in Hyogo Prefecture will have a negative impact on the Japanese economy over the short term, it appears that results might tend favorably over the mid- to long-term. Earthquake damage will temporarily disrupt economic activity, particularly in Hyogo Prefecture, but this will be eclipsed by demand related to rebuilding and calculations are that spare change will eventually be left over. In mid-February the Yamaichi Research Institute of Securities and Economics, Inc. revised its December 1994 forecast of a 2.4% real growth rate for fiscal 1995 (April 1995 to March 1996) upward to 3.1%. The additional 0.7% derives from the impact of the Kobe earthquake.

This writer flew to Kobe in mid-February to survey damage conditions. Many old office buildings had been rendered unusable, but according to a taxi driver a flood of applicants for vacancies in relatively new buildings that had survived the quake had led to zero vacancies in newly constructed high-rises whose vacancy rates had been 60-70%. Because there had also been a rush to purchase unsold ready-built luxury residences, Kobe found itself in the midst of a real estate boom.

Demand for power shovels and other types of construction equipment was also flourishing and construction machines that had been on the verge of being scrapped had been repaired for reuse. Word has it that, thanks to this earthquake, the construction industry is guaranteed work in the Hanshin region for the next one and a half years.

The city gave the impression that comparatively new buildings had survived while older structures had either been completely or partially destroyed. Hit by the earthquake in the same way, some houses in the same neighborhoods had come through while others had not. The townscape after the quake offered the results of "a building stress test." Prefabricated homes had withstood the earthquake and the prefab industry unfurled a modest newspaper ad campaign, while delivering fliers directly to homes, overtly declaring that prefabricated structures could stand up to earthquakes.

Conventional wisdom regarding housing in Japan had previously ranked prefab construction methods below traditional building techniques, but the major earthquake has begun to alter this mind-set.

¥10 trillion of reconstruction demand

The Yamaichi Research Institute offers the following calculation regarding the negative repercussions on the macroeconomy: "The damaged region's entire industrial output accounts for a bit more than 2% of the nation's total and, as such, estimating that around

The earthquake that struck southwest Hyogo Prefecture reduced the entire city to a mound of rubble in a blink of an eye, including sections of the Hanshin Expressway.

one-third of the damaged region's production has been halted, it would push Japan's total January to March production down by around 0.7%. As a result, real fiscal 1994 (April 1994 to March 1995) gross domestic product would be pulled down by a bit less than 0.3%."

Economic activities in the affected areas have been brought to a standstill by damage to factory and shop facilities, products, and merchandise and the accompanying halt to manufacturing and retailing. Production in other areas that receive parts supplies from the afflicted region has also been affected and at the same time distribution functions have deteriorated due to Kobe Port's operational paralysis and expressway damage.

On the other hand, reconstruction demand related to housing, manufacturing facilities, roads, and the port has been steadily increasing. The research institute provisionally estimates ¥700 billion in individual consumption (new purchases of furniture and other items), ¥3 trillion in housing investments over two years (rebuilding or repairs to damaged homes), ¥4 trillion in facilities investments (rail lines, communications facilities, stores, buildings, and machinery), and ¥2.5 trillion in public sector investments (port, roads, and waterworks), for a total of a bit more than ¥10 trillion in reconstruction demand.

Seen year-by-year, this would mean ¥400 billion (a 0.1% boost to GDP) in fiscal 1994, ¥4 trillion in fiscal 1995 (a 0.8% increase), ¥5 trillion in 1996 (a 1.1% increase), and ¥1 trillion in 1997 (a 0.2% increase). In fiscal 1994 the 0.3% negative effect of the earthquake will be offset by the 0.1% positive effects of reconstruction demand, for a minus 0.2% impact on GDP. With these calculations in mind Yamaichi Research Institute reduced its fiscal 1994 real growth estimate to 1.2% compared to its December 1994 forecast of 1.4%.

Drop in exports shrinks margin of surplus

How will trade be affected? According to the Yamaichi Research Institute's provisional estimate, "Exports have been revised downward and imports upward, so the current account surplus will decline by $3.8 billion from the previous forecast to $129.7 billion in fiscal 1994 and by $8.1 billion to $111.9 billion in fiscal 1995."

Before the earthquake, Kobe Port handled around 30% of nationwide container imports and exports. By category there was a high ratio of food products, clothing, and sundries. Naturally, this trade has been diverted to Osaka, Nagoya, Yokohama, and Tokyo, steadily easing the overall impact on trade, but negative repercussions on exports will be unavoidable.

How will merchandise costs be affected? According to DKB Research Institute Corp., anxiety regarding the strain on supply and demand due to damaged production and distribution facilities will basically be alleviated by a shift to alternate production and distribution channels. Further, regarding increased distribution costs due to diverted transportation, the institute says, "Items for which price increases are expected include cotton, steel, cement, and lumber. Shortages of plywood, asphalt, rolled steel, and other construction materials may arise as reconstruction demand picks up. However, supply and demand will not be strained over the medium- and long-term because domestic reserve supplies are large."

Regarding the impact on merchandise costs, the Yamaichi Research Institute says, "The improving domestic economy and rising international commodity market conditions have halted downward price trends.

In the midst of this there is also some concern regarding rapid increases in product costs stemming from increased distribution costs due to expanded reconstruction demand and damage to the port, roads, and other distribution routes. However, considering that Japan's economy still has a huge supply and demand gap, the price-boosting effects of the earthquake are expected to be limited at most."

Interest rates stable and low

How will financial markets be affected? The leading short-term interest rate indicator, the overnight call rate, was 2.28125% on the 18th, the day after the earthquake (it was 2.2500% on the 17th), but fell to 2.21875% by mid-February because the Bank of Japan, concerned that interest rates would shoot up, flooded the short-term financial market with funds. DKB Research Institute predicts, "As the Bank of Japan is expected to continue to take a moderating stance until reconstruction gets on track, short-term interest rates will remain low and stable."

Considering that since mid-February the yen has again strengthened while the dollar has weakened, that the Tokyo stock market has been slack, and that the economic recovery is not perceived to have any strength, the BOJ will probably take the market stance predicted by DKB Research Institute for the time being.

In the expectation that more government bonds would be issued to procure reconstruction funds the bond market also temporarily took a tumble (long-term rates rose), but subsequently recovered (long-term rates fell). The market yield on the 10-year government bond jumped to 4.710% on the 17th from 4.630% the previous day. But it fell to around 4.650% by mid-February.

DKB Research Institute predicts, "Supported by stable low rates on the short-term market, long-term rates will not likely rise sharply, despite upward pressure arising from concern over easing supply and demand of bonds. Further, even if an increase in public bond issues amounts to several trillion yen it is considered possible that institutional investors will absorb them due to a lack of other investment vehicles. Upward pressure on long-term interest rates will not be very strong and there is no need to worry much about negative effects on the economy." JJTI

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