УДК 331.464.1:811.111.(520)

HOW WILL DISASTER AFFECT JAPAN'S ECONOMY?

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In order to asses the medium-term risks and opportunities created by Japan's triple disaster—earthquake, tsunami and nuclear radiation—we must assess the likely effect on established trends in Japan's economy: will the disaster accelerate, delay, or possibly reverse the major structural forces that have been shaping Japan? In my personal view, there are three economic trends and on policy trend that demand our attention:

1.Deflation; 2.Deindustrialisation and hollowing-out; 3.Risk of shift from net-saver/creditor nation to net-debtor nation; 4.Big government versus reform agenda—all eyes on the Trans-Pacific Partnership. In summary, I expect the fundamental trends to improve relatively quickly for commerce and corporate Japan—the end of deflation has probably been brought forward. Moreover, the risk of Japan becoming a net drain on global savings is very small indeed. At the same time, I am more cautious on policy and social trends and worry that the disaster will accelerate the trend towards big government, tougher regulation and higher taxes, at least in the immediate future.

First, deflation: clearly, there has been a very aggressive monetary policy response. The Bank of Japan has not only added unprecedented short-term liquidity, but more importantly has stepped up purchases of private credit and risk assets. Moreover, the Ministry of Finance got explicit agreement from the G7 to prevent imported inflation from a stronger yen. All said, monetary policy has opened up at least three inflationary transmissions channels—credit, assets, and exchange rate. In coming weeks, base money supply growth is set to accelerate by as much as 15-20%. Possible bonus: it appears likely that the BOJ will agree to monetise part of the fiscal emergency package posed to be forthcoming soon, in my opinion.

Note also a sharp contrast to the aftermath of the 1995 Kobe disaster: yes, 1995 did mark the start of Japan's deflation. However, at that time several powerful deflation forces converged on Japan that were much more important than the Kobe earthquake disaster. 1995 was the start of hard-core labour market restructuring. Life-time contracts were broken, non-wage benefits, like corporate housing, were cut dramatically, and corporate Japan began to hire part-time rather than full time workers. Clearspeak: on top of a cyclical downshift in employment income, Japan's workers were forced to accept a previously unimaginable structural downshift in lifetime income expectations. This was a highly deflationary cocktail. In contrast, the current disaster is more or less "business as usual", i.e. some cyclical adjustment, yes, but no new employment reality and added downshift to lifetime income expectations.

One final point on deflation: today, Japan's general price level is more or less in-line with global levels. The Big Mac or Starbucks coffee index, for example, is close to parity, and expert calculations of purchasing power parity come to similar conclusions. In contrast, the mid-1990s saw a Japan with a domestic price level at a 20-30% premium to the rest of the world (note dollar-yen levels were almost the same now and then). Remember that in the mid to late 1990s Japan went through radical programmes of import liberalisation—literally a case of a previously closed economy with a higher-than-global price level beginning to open up, allowing deflationary price arbitrage into the economy. These dynamics were reinforced by the relentless rise of global competition as Asian producers in general, and Koreans in particular, began to gain market share from the Japanese competition in global markets as well. Most importantly, the structural decline of Japan's consumer electronics industry started

around the time of the Kobe earthquake, yet it clearly would be absurd to attribute any form of causality. Ditto for the demise of Japan's textile industry, which started in the mid-1990s as well, to name just the two most dramatic examples.Global competition remains fierce this time around. However, it de facto started around the time of the Kobe disaster. In contrast to the mid-1990s, global trends are much more inflationary for Japan than the truly deflationary plunge the economy fell into in the mid-1990s. Add to these inflationary tailwinds the aggressively inflationary policy espouses by the BOJ and you pretty quickly reach the conclusion that the disaster has brought forward the exit from deflation in Japan, in my view.

Second, deindustrialisation and hollowing out: over the past three years, outward direct investment has been accelerating. Corporate Japan, across all sectors—industry to services—has "followed the money" more and more aggressively; remember, domestic margins in most industries are wafer-thin, while margins in offshore factories, logistics hubs or call-centres are very high. Some surveys suggest overseas operations may have been as much as five-times higher, on average, over the past couple of years. Moreover, long-term growth prospects outside Japan are significantly higher than at home.

Here, the disaster is likely to accelerate the existing trend: investment for growth goes overseas, while local investment focuses on replacement and, so some suggest, capital deepening, but not much more, in my view. Proximity to customers and markets, as well as diversification of production centres and supply centres is set to remain top priority. Indeed, there is a risk that global producers who depend on Japan Inc's superb quality of components and products may now insist and demand greater global production diversification from Japanese suppliers. Japan country risk has gone up in the eyes of boardroom directors everywhere now.If this is right, the net result of this accelerated hollowing out should actually be positive for corporate Japan—trend margins should be rising. Clearly, this sets the bar a notch higher particular for Japanese policymakers: to counter a likely acceleration in deindustrialisation and hollowing out, they should demand significant changes in rules and regulatory policies, as well as, in the final analysis, a more open debate about importing labour.

Third, could Japan become a net drain on global savings? Worries about Japan beginning to run a current account deficit and thus relying on global savings to fund its budget deficit—rather than funding other countries' savings shortfalls—have been around for many years. Clearly, the need to fund an additional supplementary budget for disaster reconstruction is fueling these worries some more. However, the empirical facts suggest this risk is very low. The shift to offshore production for higher profits has been accelerating, and with it has the income generated on overseas assets. Clearspeak: Japan shows all the signs of successfully becoming a dentist economy, i.e. living off her overseas assets. Moreover, if the BOJ does, as I expect, begin to monetise Treasury debt more aggressively, the domestic savings-investment gap should comfortably remain positive. Here is a trend that is likely to continue—global finance will worry about it, but the productivity and income of global Japan Inc. keeps on churning out hefty surpluses for the time being.

So on the economic trend side, I would suggest that this disaster is likely to accelerate the trend towards a more global, more productive and more profitable Japan Inc. The flip side of this development is likely to be reflected in more conservative, yet "big government" oriented policies from politicians who see themselves fighting a battle between globalisation and domestic frustrations.

Fourth, policy paralysis and big government: clearly the disaster requires a unified and coordinated policy response. First signs are good—the monetary authorities are out aggressively, and politicians across all parties have pledged to push through a quick and decisive rebuilding programme. For now, the deeply entrenched trend of policy paralysis appears to have been broken. However, the content of the response inevitably pushes Japan

back down the road of "big government" and more public sector intervention in private sector affairs.

Specifically, Prime Minister Kan had launched an impressive programme seeking agricultural liberalisation so that Japan could possibly become part of the Trans-Pacific Partnership by the autumn of this year. Now, the disaster having struck heavily in many farming areas, it will take a truly heroic effort to proceed with this naturally very difficult program.

Moreover, the push for higher taxes on consumers—something advocated by the ruling Democrats—is poised to become stronger. Already several policy makers suggest part of the reconstruction should be funded by abandoning the extra child-support implemented by the Democrats last year. Clearly, Japan need both—more children and a rapid rebuilding of the destroyed infrastructure. Both work to lift the potential growth rate. In my personal view, Japan has the necessary savings surplus and financial wherewithal to afford both. Taking from Watanabe to pay for Suzuki is neither necessary, nor prudent in the current situation. In contrast, an all-out pro-growth strategy would be welcome, including a long overdue fundamental review of Japan's rules and regulatory framework, in my view.

Will policy be creative, or standard? For example, a simple response to projected power-supply shortage in Tokyo could be to enforce daylight savings time. Possibly as much as 5% of Tokyo's power demand could be saved with one simple rule change. Pro-forma, past opposition to this had come from farmers who argued their cows and pigs could not adjust to the change, though in reality the utilities companies naturally prefer to see 30m people switch on lights earlier rather than later in the evenings. Either way, extraordinary times call for creative solutions. Could Japan's government surprise us?

It would be wrong to be too pessimistic on this front. Within little more than a year after the Kobe earthquake, Japanese politicians led two fundamental policy revolutions: the financial big bang was launched together with a radical programme of administrative reform. Both were supported by the main stakeholders: the financial industry—domestic and global—wanted a better system (free, fair, global was the slogan of the big bang), and the biggest proponent of administrative reform was the most powerful administrator itself—the Ministry of Finance. This is because the MOF was very much in favour of more streamlined government, cutting administrative and regulatory red tape, as well as excessive administrative personnel costs. In the end, the number of central government bureaucracies and agencies was cut by almost 25%. Make no mistake, these were radical changes, and there is no question that the bureaucratic incompetence exposed by the Kobe disaster helped focus the minds of the reformers. Chances are that, eventually, something similar will happen this time around as well. Patience.

Changing agricultural policy faces obvious big opposition from agricultural cooperatives, agricultural financial institutions, farmers, etc. However, there are also powerful advocates: corporate Japan is pushing forward, as they know Japan's failure to enter TPP would be a further step towards relegation to second rate nation on the global power stage. Moreover, corporate Japan sees sizable profit opportunities from supplying high-grade top quality food produce to the increasingly wealthy Asia gourmets. By one expert calculatioin, Japan could actually run a trade surplus in agricultural products if the right combination of agricultural reform and rural land reform is implemented. Also, the MOF should be much in favour as agricultural subsidies and farm support cost much for the national coffers.

In many ways, the unfolding debate and direction of agricultural policy and TPP may prove the real litmus test for how the country's leaders respond to the challenges forced upon them by this disaster. Rebuilding should prove easy. Rebuilding and reforming is the real Japanese challenge. In the meantime, corporate Japan is unlikely to take its chances and accelerate its push offshore.