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Economic Policies Following the Great East Japan Earthquake

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Japan, Tsunami, Macroeconomics Budget, Fiscal reform, Reconstruction.

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The Great East Japan Earthquake of 11 March 2011 was the strongest earthquake to hit Japan in recorded history, causing unprecedented destruction. In addition to the extensive damage caused by the earthquake and tsunami, there was also a severe accident at the Fukushima Daiichi Nuclear Power Plant. It is now certain that recovery will take much time. In this paper, the author considers the direction that future economic policies in Japan should take following the multiple disasters.

1. Effects of the Earthquake

The earthquake caused tremendous damage to the Japanese economy. Mining and industrial indices for March 2011 fell 15 percent compared to February, recording the largest drop in Japanese history. Consumption fell by a hefty 8 percent, and Japan's trade balance surplus fell a remarkable 79 percent versus the previous month. In addition to the confusion caused by insufficient electric power and planned power outages, and a breakdown in supply capabilities caused by disruptions in supply chains due to the earthquake, uncertainty increased as the situation at the Fukushima Daiichi Nuclear Power Plant worsened. But the indices for April rose 1 percent, indicating the production activities have been already bottomed out. The mid-term outlook is for an increase in demand related to disaster rebuilding efforts in the second half of the year and a modest improvement in the uncertainty surrounding the nuclear power plant. As a result, the first stage of the contraction in demand will end, and production activities in Japan will then make a brisk upturn.

Since the breakdown in supply capabilities and the decrease in demand occurred at the same time, the deflationary gap (the gap between supply capabilities and demand, i.e. the volume of insufficient demand) is not expected to change much after the earthquake.

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According to research into the economic effects of past disasters, the possibility is high that if only earthquakes and tsunami are involved, there will be no long-lasting negative effects from the current disaster. The future effects of the nuclear plant accident, however, are immeasurable. One certainty is that electric power costs in Japan will increase, which will encourage Japanese companies to locate operations overseas. There is concern, therefore, about a hollowing out of Japanese industry in the long term. In such a scenario, Japan's long-term economic growth will decline. Among positive factors, the foremost is promotion of the development of technology related to natural energy resources and energy conservation. Japan's competitiveness in the field of energy-conservation technology, therefore, might be strengthened. If that happens, it will have a positive effect on the rate of economic growth.

2. Suppressing Instability in the Foreign Exchange Market

In the foreign exchange market, the yen continued to appreciate after the earthquake. At one point, it reached 76.25 yen, setting an all-time high rate versus the U. S. dollar. Afterward, due to coordinated intervention in exchange markets by G7 finance ministers and bank governors, the exchange rate returned temporarily to the 81 yen per dollar level. Later, however, the yen again began gradually appreciating. In early June, the rate was fluctuating in the range between 80 to 81 yen.

The powerful earthquake and nuclear plant accident should be reasons for the yen to depreciate. Due to disruption of supply chains and breaking down of the supply capabilities of Japanese companies, the trade surplus dropped substantially. The reasons for explaining the yen's strength even in those circumstances might include favorable factor income and the fact that Japan is the world's number one holder of foreign assets. In addition, although the United States and the countries of Europe continue their expansionary monetary policies and increase their money supply, the emerging economies are tending, albeit slowly, to shift their foreign currency holdings to the yen, another factor contributing to the yen's appreciation. Since the yen continues to appreciate even after the agitated market mentality settled down, it is necessary to watch foreign exchange trends closely in the future. Following the earthquake that struck Kobe in January 1995, the yen appreciated for over six months, in the process setting what was then the all-time high rate at the time of 79.75 yen to the dollar in April 1995. If the yen today continues to appreciate for several months as it did in 1995, Japanese exporters affected adversely by the earthquake disaster will find their efforts to recover thwarted.

The earthquake and nuclear plant accident, meanwhile, are major factors for the yen to depreciate. In addition, compared to the period after the Kobe earthquake, the situation today concerning Japan's public debt has worsened. With those two factors in mind, some uneasiness can be expected in the future concerning government bonds. It is completely possible that some investors will dump their bond holdings. In such a case, confidence in the yen would be shaken and it should depreciate substantially.

Considering that the yen's current appreciation is an obstacle to the recovery of Japanese companies and, conversely, that the risk is growing stronger toward an excessively depreciated yen, it can probably be said that calls will become increasingly vocal for the Japanese government to demonstrate its strong interest in stabilizing the foreign exchange market through action. At some point, a need might emerge for the government and the Bank of Japan to adopt a strong posture toward large-scale market intervention.

Above all, preventing instability in the foreign exchange market should be the standard for determining the timing and scale of intervention. Even if intervention (selling yen and buying foreign currency) has only a minor effect on rectifying the appreciated yen, it would have the major effect of stabilizing future public finances as a type of byproduct. The reasons for such a development are generally as follows. Japan was already burdened with huge public debt, and has now suffered serious damage from the earthquake and the nuclear power plant accident. One result is an increased risk of eroding confidence in government bonds. If that risk becomes a reality, market confidence in the yen will also decrease and the yen will depreciate. At the stage prior to deteriorated confidence in the yen, if the Japanese government intervenes in the market to accumulate foreign currency-denominated assets by selling yen and buying foreign currencies, then as the yen depreciates the foreign currency-denominated assets will earn a capital gain and the government's (yen-denominated) finances will automatically improve. In this way, by moving in advance to accumulate foreign currency-denominated assets, then when the yen begins to depreciate (price of government bonds decreases), the new situation should ease any drop in the market confidence in government bonds and the yen. In short, government market intervention by selling yen and buying foreign currencies will bring about the same results as the fiscal authorities hedging the risk of a rapidly depreciated yen. If the Japanese government carries out such measures, it will serve to prevent a sharp drop in the price of government bonds (in other words, prevent a rapidly depreciated yen), and will have the effect of bringing stability to the government bond market.

3. Supporting Businesses: Resolving the Problem of Double Liabilities is Crucial

Immediately following the earthquake, supply chains and chains of credit interdependency broke down and a series of bankruptcies occurred, causing concern about economic damage spreading widely outside the areas directly affected by the earthquake and tsunami. Although it is difficult for the government to introduce measures for restoring material supply chains, the Bank of Japan and the banking industry quickly introduced measures for resolving problems in the financial sector. Examples were extensions of the due date for promissory notes and the allowance of probationary periods for bad checks.

Together with measures related to financial credit, another area requiring solutions is the problem of so-called double debt borne by companies and individuals affected by the earthquake and tsunami. When assets provided as collateral were either destroyed in the earthquake or washed away by the tsunami, loans taken out before the disaster became irrecoverable and banks had to write them off. If the former loans remained and companies needed new loans to use for business recovery, the companies would be overburdened if they had to pay back both loans, and they would not be able to resume their businesses. Although it cannot be said that all debt should be completely reduced from the standpoint of fairness to the lenders and among various borrowers, a certain level of justification is possible to resolve this problem if emphasis is placed on the need for quickly rebuilding a global supply chain for greater efficiency in the overall economy.

The lenders, meanwhile—the banks—are responsible for explaining losses to their stakeholders and government authorities. They face many hurdles before they can decide to exempt borrowers from their debt, including appraising the value of assets used as collateral and requesting repayment from unconditional guarantors. Much time will thus be required for individual banks to decide on whether to reduce or forgive loans. In this context, and in order to move forward quickly with exempting affected individuals and businesses from repaying their loans, it would be best to establish for a limited period a public institution ("Organization for Disposal of Liabilities for Recovery"; hereinafter, "liabilities disposal organization") exclusively responsible for handling liability exemptions. This organization could buy all the irrecoverable liabilities from local banks related to individuals or businesses affected by the disaster and exempt the borrowers from their obligation to repay the loans (or convert the liabilities to equities). Assets used as collateral (real estate, etc.) can be held for a long period and eventually sold on the market, or perhaps donated to local governments for use in local redevelopment projects. If such a public organization demonstrated ways of handling liabilities and provided actual examples of success, it would allow local banks to explain the situation more readily to their stakeholders and would contribute to having those banks dispose of bad debt more quickly.

When exempting such double-debt liabilities, however, there is a danger of generating sizeable moral hazards. Since a considerable amount of outstanding loans were already considered as bad debt, there is a possibility that within the corporate liabilities this new public institution would buy up from banks would not only be loans made irrecoverable by the disaster but also a large amount of loans that were irrecoverable prior to the disaster. It is necessary, therefore, for the local banks and the liabilities disposal organization to design a contract, and for the overseeing government institution to supervise the situation closely in order to prevent moral hazards emerging for the financial institutions. (For example, when the liabilities disposal organization buys up the liabilities of a corporation from a bank, one idea would be to set certain conditions, such as the bank having a responsibility to provide new financing to be used for the corporation's reconstruction.)

In addition, the double-debt liabilities issue is inseparable from the losses recorded on the balance sheets of the banks. When the liabilities disposal organization buys up from banks the old liabilities of an individual or organization affected by the disaster, it is essential that public funds be used to provide capital to the banks. In order for those activities—capital being provided to the banks, and bad debt being bought up from the banks—to be conducted rationally from the viewpoint of the national economy, the activities of providing capital and purchasing credits should be carried out after first being negotiated as a set.

4. Funding the Recovery: A Stable Government Bond Market, Long-Term Fiscal Rehabilitation, and Social Security Reforms

On March 12, the government designated the Great East Japan Earthquake as a major disaster, thus paving the way for the release of large-scale fiscal support for disaster recovery programs. Considering that the earthquake damage covered an extremely wide area, and that funds will also be needed for recovery from the Fukushima nuclear power plant accident and for rebuilding the power supply system, a total layout of many trillions of yen in public funds will be required for disaster recovery. Naturally, the government must issue bonds (or new "Earthquake Restoration Bonds") to finance such a massive recovery program. Accompanying such a large issuing of bonds is a risk that the bonds may suffer a substantial drop in price. Since Japan already had an enormous public debt even before the earthquake, the situation was one in which it would not have been strange for confidence in the nation's finances to have dropped. If a situation develops in which confidence in the market is lost and the price of government bonds falls sharply, disaster recovery will be delayed because of a lack of funds, and the suffering of those affected by the earthquake and tsunami will be increased several times over.

In order to avoid such a development, the difficult measure of maintaining the market's confidence in government bonds while issuing new bonds to provide funds for disaster recovery is necessary. If viewed from the standpoint of standardized taxes, it would be best to issue bonds to finance the disaster recovery program -- a one-time increase in fiscal spending -- rather than raising taxes. Once such a program goes into effect, it would then be best to redeem the recovery bonds through permanent, small tax increases. Rather than financing short-term expenditures through repeated tax increases and decreases, a tax system that is stable over the long term causes only small damage to the economy. For this reason in particular it is preferable to issue government bonds to fund disaster relief and then later raise taxes slightly over many years to redeem the bonds.

The combination of issuing recovery bonds and raising taxes slightly over many years is the most appropriate approach for procuring the funds needed for disaster recovery. The problem, however, is the discussion underway since before the earthquake about public finance reform. If the earthquake is presented as a reason for halting discussions about the public debt, then confidence in government bonds will be shaken. What must be done, therefore, is nothing other than a firm political decision to institute reforms for recovering fiscal sustainability. Moreover, economic structural reforms should be introduced without concern for vested interests, productivity should be increased, and economic growth should be recovered. Doing so will stabilize public finance. It is the very recovery of fiscal sustainability that will allow the issuing of government bonds for the smooth financing of the huge funds needed for disaster recovery and the realization of early recovery.

Concerning the discussions from before the earthquake about "integrated reforms related to taxes and social security," the government should present its ideas as scheduled at the end of June. Afterward, the government and the opposition party should quickly reach an agreement and pull together a bill, and reforms should then be carried out post-haste. Wide-ranging reform of the social security system is needed, including reduced payments to wealthy, elderly persons. As well, increases will be necessary for the consumption tax, income taxes, and other taxes. In order to change the amount of social security payments and the percentage of medical costs borne by a patient in the national health system, to a system that depends on the size of their assets, introduction of an ID number system for taxpayers will be unavoidable.

It is necessary to have the pain accompanying such wide-ranging reforms shared by all citizens. The same can be said concerning reform of the civil service system for reducing government expenditures. A clear schedule should be presented for reducing fiscal expenditures and increasing fiscal income. One issue of utmost urgency is to link such action to raising the level of market confidence in government bonds. From a long-term perspective, moreover, when reforms are introduced to reduce the public debt, proposals such as allowances for children and gratis use of expressways should be reevaluated from the same perspective. It is necessary to propose a system of national policy that is consistent over the long term.

In order to make the system of government spending healthier and to support disaster recovery efforts, not only should fiscal spending be shrunk but it is also essential to achieve high economic growth and to increase taxes. Regulatory reforms should be introduced in agriculture, medical care, welfare and other areas, without regard for vested interests. As well, it is important for Japan to open its economy further, such as by joining the Trans-Pacific Partnership, and to increase productivity.

It is most important to institute policies that for many years have been postponed. By doing so, a strong system of fiscal spending will be built that will allow smooth financing to support disaster recovery efforts. That is our responsibility toward those affected by the earthquake and tsunami.