JAPAN’S POST-DISASTER GROWTH STRATEGY

The Great East Japan Earthquake on 11 March 2011 was the biggest earthquake recorded in Japanese seismic history, and the fourth largest recorded in the world. The scope of the triple disaster consisting of an earthquake, a tsunami, and a nuclear accident, far exceeded that of the Hanshin Earthquake of 1995. The repercussions of this disaster spread far beyond the geographical areas directly affected. For example, electric power supply capacity in the Kanto area, which accounts for about 40% of Japanese gross domestic product (GDP), fell at one stage by about 40% from the normal peak—a severe constraint on economic activity, and the supply of nuclear-generated electric power has largely been cut off since then. Production supply chains were significantly disrupted, not only in Japan, but all over Asia, although they recovered surprisingly rapidly. **Short-term challenges** Japan appears able to overcome its short-term difficulties.

Total financing needs are expected to be close to ¥19 trillion (4% of GDP) over the next few years, which will further push up Japan's massive government debt. However, Japan's current account is still in surplus, so its fiscal deficit continues to be financed by domestic private savings, an important stabilizing factor. It remains to be seen how much the government will be able to finance the fiscal deficit out of consumption tax increases, and what impacts such increased taxation would have on aggregate demand.[1] It is hoped that the government will be sufficiently mindful of potential deflationary drags in a situation where the economy is already weak. Monetary policy and exchange rate policy can contribute to reducing the deflationary impact. Also, despite the shutdown of all nuclear plants in the country, representing about 24% of Japan's total electricity generating capacity, the economy managed to pass through the period of peak summer demand without experiencing power outages though at substantially increased cost of fuel imports. **Longer-term challenges: Need for a new growth strategy** The disaster highlighted Japan's many other structural challenges besides reconstruction needs, including persistently low growth, population aging and low fertility, burgeoning government debt, declining international competitiveness, and uncertain energy supplies.

Moreover, the experience of the global financial crisis and the ongoing euro area sovereign debt and banking sector crisis suggest that Japan needs to create its own growth momentum without relying excessively on markets in the United States and Europe.

Our recent paper (Kawai and Morgan 2012) discusses the scope of these challenges and sets out a long-term strategy for overcoming them and putting the Japanese economy on a stable growth path. To recover from the disaster on a sustainable basis, the key challenge for Japan is to use reconstruction as an opportunity for pursuing more far-reaching structural reforms. Our strategy recommendations encompass both supply-side measures to promote productivity growth and raise labor force participation in the domestic economy, and external demand-side reforms to enable Japan to benefit more from emerging Asia's rapidly growing markets and rising middle class. Domestic supply-side reforms: key areas that need to be focused on are supply-side policies, including support for research and development (R&D) in high-technology and green growth industries; deregulation to promote growth in service sectors and agriculture; corporate tax reduction; and increased energy security. In addition, fiscal and social security reforms are needed to put the public debt to GDP ratio on a sustainable basis.

Increasing the labor force, especially through higher labor market participation by the female and old-aged workforce, is a key challenge given the shrinking population of productive age. Effective measures would include further expansion of child-care facilities, elimination of the tax reduction for dependent spouses, and an increase in the retirement age to above 65 years. Further liberalization of the immigration policy would also be needed.

Raising labor productivity is the most important challenge for the Japanese economy, ranging from the manufacturing to services and agricultural industries, given the shrinking labor force. Facing greater competition from the rest of Asia, the Japanese manufacturing industry needs to keep moving up the value-added chain and increasing the innovation content of its production. To this end, it needs to encourage R&D in high-tech and knowledge-intensive sectors, and provide further support for R&D at universities. To raise productivity in protected services sectors, easing regulations and barriers to entry in areas such as social services (health, medical, and old-age care) would be needed. The agricultural sector remains a major bastion of protection and an obstacle to achieving broad free trade agreements (FTAs). In view of the loss of confidence about the safety of nuclear power generation, Japan’s long-term electric power capacity investment plans need to be completely rethought.

Intensive efforts must be made to boost the contribution from renewable energy sources such as wind, solar, geothermal and biomass power, as well as promoting even greater energy efficiency. There is also a need to reform the electric power sector in Japan, which has been plagued by regional monopoly and segmented markets. Separation of power transmission and distribution operations would stimulate new firms' entry into power generation, thereby stimulating electricity supply, while the introduction of market mechanisms would facilitate supply and demand adjustment at the time of heavy demand. External demand-side reforms: Japan's internationalization in the area of foreign direct investment (FDI) is limited. Its ratio of inward FDI (stock) to GDP is miniscule, as it ranks last among major countries by a large margin. This means that Japan is passing up valuable investment opportunities that foreign firms could take advantage of to stimulate productivity, employment, and growth. Japan needs to take more aggressive measures to encourage inward FDI by improving the climate for FDI inflows—i.e., lowering barriers to investment and ownership, eliminating behind-the-border regulations, simplifying administrative procedures and market access, and relaxing labor regulations. Japan's strength in manufacturing and its location in Asia, the fastest-growing region in the world with a rapidly rising middle class, make it imperative to maximize the growth benefits by taking advantage of business opportunities in this rapidly growing market.

It needs to promote greater economic links with the rest of Asia, including moves toward a Regional Comprehensive Economic Partnership (RCEP)—an Asia-wide FTA among the ASEAN+6 countries—and support for the TPP, which could eventually develop into a trans-Pacific FTAAP. These trade agreements would allow the Japanese economy to become more open to the rest of the world, thereby increasing its trade volume and inward FDI. Finally, it is essential that Japan resolve the territorial disputes peacefully with the People's Republic of China and the Republic of Korea.

Escalation of the disputes to military confrontation would do severe damage to the bright future of Asia—the so-called "Asian Century." Japan needs to work with its neighbors, starting with the launch of a trilateral PRC-Korea-Japan FTA, as its growth strategy cannot be pursued successfully without peace and stability in the region.

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