Sound of Money

Will the Tremors of Japan hit the World Economy?

by *Sundar Sankaran*[1]

Will the 8.9 magnitude earthquake, and the 30 foot tsunami it triggered in the world's third largest economy leave the world economy unchanged? We need to understand the Japanese economic realities, to appreciate the likely impact.

Japanese Economy

75% of the Japanese GDP comes from services (banking, insurance, telecom, retailing, transportation), 23% from industry (automobiles, electronics) and a negligible 2% from agriculture (hardly surprising, given the mountainous nature of large parts of the land).

Being not so well-endowed in natural resources, it has to import a large part of its requirements of food, fuel and raw materials. Industry imports the raw materials and exports finished goods. Overall, the Japanese have a positive trade balance i.e. exports are more than imports. The exports in the last few years have not been so robust. China has replaced Japan as a large exporter.

Over the years, the country has accumulated large surpluses, which are invested in US Treasury Bills. Japan held USD886bn of US T-Bills as on January 2011 - the second largest holder in the world, after China.

The Japanese population at about 125million is shrinking. Worse, the population is aging. The number of people above 65 (who generally do not contribute much to the GDP) is set to touch a quarter of its total population. The 0 – 15 years (who will join the workforce in future) category is less than 15%.

An aging population has a low tolerance for inflation. It also spends less and saves more. In the last two years, Japanese economy has been contracting in terms of real GDP, while inflation is negative. This means that a person is better off buying the same goods tomorrow, instead of today. This is a good recipe for postponement of purchases and higher savings; hardly a scenario where companies would like to invest inside Japan.

In the normal course, immigration of labour force into Japan would be a way to boost the productive workforce and domestic consumption. But Japan does have its language barriers for people to integrate in the country. It is also not viewed as an attractive destination for people to migrate, unlike the US and Europe.

Since the 1990s, the Japanese fiscal situation has been deteriorating. Budget deficit and debt are mounting. Government debt is nearly twice the GDP. The Japanese Government Bonds (JGBs) are largely held by the aging risk-averse local population and Japanese institutions. Interest payments on the debt are adding to the Government's deficit problem; welfare expenses related to an aging population are compounding the problem.

The Japanese Yen, at about 82 to the dollar is almost at its strongest. Since mid-2007, when it was at 123, it has been following a direction of strength. Strong currency means the exports of the country are less competitive.

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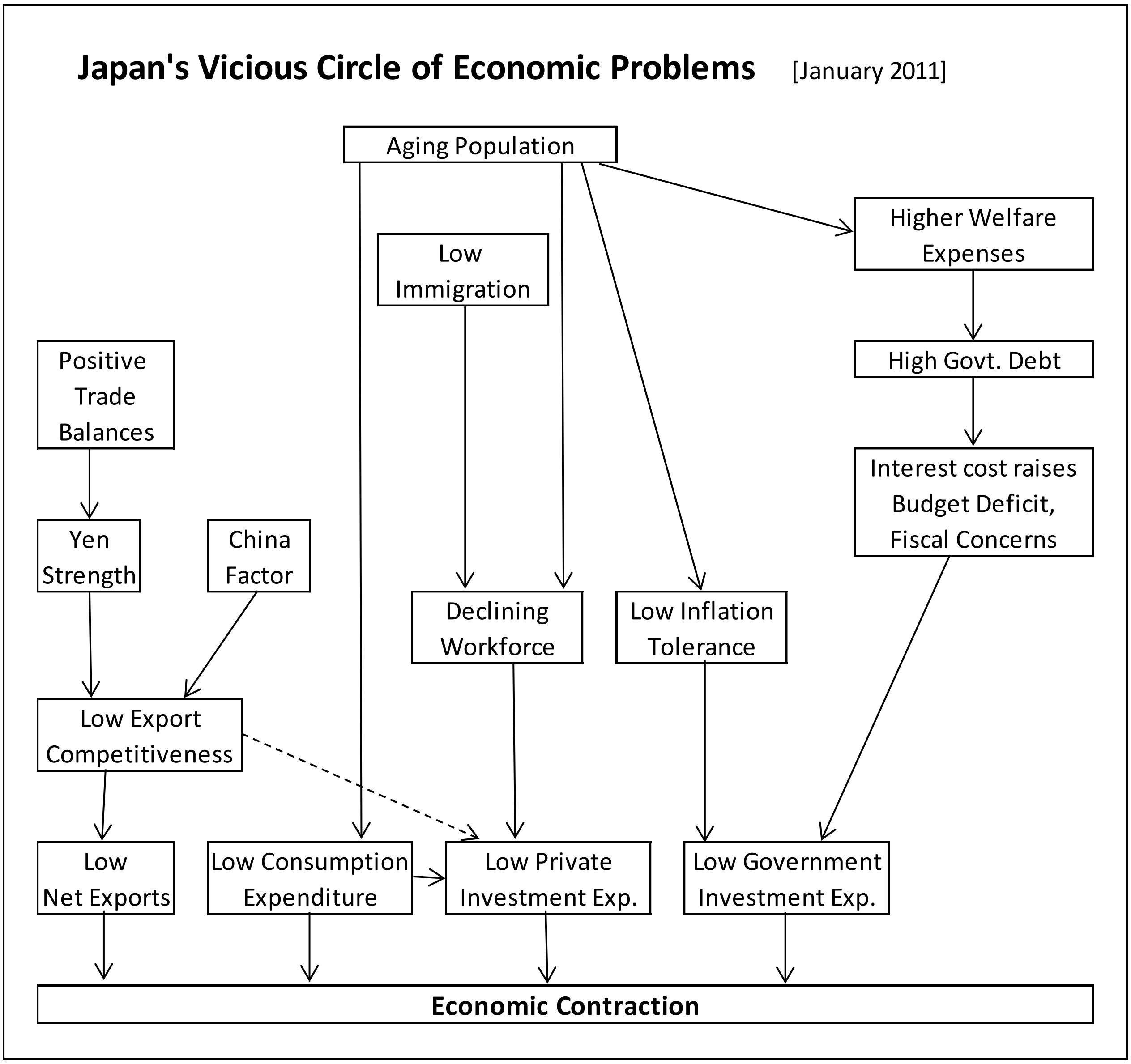
Consumption Expenditure + Investment Expenditure + Net Exports is equal to GDP. Each of the elements that go into Japan's GDP has been weak –

- Consumption expenditure is low on account of aging population;
- The already high and growing budget deficit is a dampener for the Government to engage in large investment expenditure;
- Currency strength is hitting the net exports;
- Lack of export competitiveness coupled with weak consumption expenditure makes it less interesting for companies too to invest inside Japan.

This is the story of Japan's economic contraction [See accompanying table – Japan's Vicious Circle of Economic Problems].

For long, global economists were of the view that Japan needs to kick start its economy with active governance and programs. But unstable governments have only allowed a steady deterioration of the situation.



The Tremors from the Quake

On March 11, 2011, the quake and tsunami happened. Damages are estimated to be USD200-300bn. No more than 15% of this is likely to be covered by insurance.

Let us first look at the supply side of the equation, within Japan.

- Production capacity of the economy is obviously disrupted. The impact would have been much greater if the role of industry in the economy had been higher. The gaps in production capacity for consumption would need to be met by imports. In some cases therefore, import of raw material might have to be replaced by import of finished goods.
- Banking and construction can quickly recover and meet the likely increase in demand for these services.

What is the impact on markets outside?

- It is expected that moneys for Japan's redevelopment will have to flow back to Japan, from abroad. The demand for Yen would increase. In anticipation, Yen has been strengthening. EU is helping Japan prevent the Yen from appreciating.
- "Yen carry trade" positions are being unwound. People who borrowed Yen to invest in other currencies – especially Australian Dollar and Brazilian Real are now getting out of these positions. This has added to the demand for Yen and its strength.
- In automobiles and electronics, Japan is a significant part of the global supply chain. The affected production capacity will disrupt the global production of some of these items. Prices of computers and mobiles, for instance, might get firm. Some brands might face supply shortages.
- Japanese steel mills contribute significantly to the global supply. Impact on Japanese production capacity will push up steel prices.
- Demand for construction material for the re-development will increase. Zinc, copper and aluminium might see an increase.
- The disruption in nuclear power in Japan, and likely lethargy across the world towards this form of energy could increase the demand for alternate sources like oil and gas, pushing up those prices.

The Japanese government will now be forced to increase spending – something that global economists have been suggesting for long. There seems to be a consensus on this between the Government and the opposition too. Thus, as regards the policy environment, the quake is a blessing in disguise!

Financing the Spend

The impact on the economy depends on how the spending will be funded.

- Insurance moneys will fund part of the damages. Since most large policies are likely to have been re-insured abroad, part of the claims-money would flow in from abroad. This has been the reason for the recent Yen strength.
- Unwinding of "Yen carry trade" by Japanese residents will increase their Yen-holding. JGBs can be issued to tap into these funds. This would increase the already high Government debt, but is likely

to cause the least disruption to the economy. Unfortunately, this avenue will not be adequate, given the magnitude of damage.

- The Government can print notes. This high inflation approach, which also lightens the load of repayment of Government debt, is adopted by developing countries. But, as mentioned earlier, the aging population is wary of inflation. The Bank of Japan itself operates on a mission of "ensuring price stability and financial system stability". Thus, one can expect less recourse to this form of money.

- Japan's large holding of US T-Bills is an obvious option. The investments have been made to take care of such calamities. The implications of Japan selling US T-Bills can be immense. A large sale will pull down security prices and push up the USD yields. This will make a mockery of the US Government's policy of keeping interest rates low to kick start its local economy. Further, the approach can cause serious depreciation of the value of the dollar (and appreciation of the yen), and create ripple effects the world over.

  The US can prevent such a scenario by giving grants to the Japanese. It would be interesting to watch the Obama administration sell this approach to the US public, who are deeply worried about their own economic ills.

  The alternate would be to nudge US Corporations to step in. Indeed, some of them might find it a good business opportunity to engage in the re-building of Japan.

- If something can be an opportunity for US Corporations, then why not for the Chinese? After all, they are the second-largest economy in the world; they have the financial and non-financial resources; and most important, they are Japan's neighbor. China is in a unique position to get involved in the re-development without disturbing the Dollar-Yen currency markets. Will Japan get over its suspicious approach towards China, to welcome the dragon?

The story of Japan's second re-building will unfold over the next two years. Whatever happens, the earthquake will change the global order for the good.