

# Economic Insights

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## Will Japan's Crisis Cause Force Long-Term Reform?

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For all the pain and angst suffered by the Japanese as a result of the earthquake and tsunami in March, the disaster and its ripple effects do offer them at least one source of smugness. The world, obsessed with the new, had for years glibly dismissed Japan as a part of the past, preferring instead to enthuse over China and other emerging economies. But now, like the old man of the workplace, ignored until he stops doing his job, this horrible disaster has made one thing very clear: Japan still plays a critical role in the global supply chain and the global economy generally. Still, if smugness can offer some satisfactions, it cannot generate electricity or staff factories. And Japan now needs to do both. The questions, then, to consider are: "How soon, if ever, will Japan recover its former productive role? And how will the shock of the recent disaster change the Japanese economy's long-term direction?"

### Unknowns and Likelihoods

Too much uncertainty remains to make any credible forecast on timing. Even now, months after the first quake struck, questions remain about when or if the damaged nuclear reactors can resume generating electricity, although some already have. Neither is the extent of damage to the reactors yet clear, nor is the severity of radioactive contamination. Since these reactors have several layers of containment shield, even the cracked one hides the full extent of damage. Without some notion on these fronts, no one can gauge how fast rebuilding can begin.

Even after rebuilding begins, it will take years to ascertain exactly how bad things were. At Three Mile Island, for instance, it was five years after the 1979 disaster that the Nuclear Regulatory Commission could open the containment vessel completely to discover that, during the trouble, half the nuclear fuel had melted—and had done so quite quickly. Of course, the delay in opening the containment vessel at Three Mile Island was welcome; those same containment vessels that hide the information also protect. They were the reason why Three Mile Island avoided contamination and death, unlike at Chernobyl, in 1986, where there was no containment vessel. So a delay in opening the vessels at Fukushima might be beneficial for all concerned.

Still, despite all the huge remaining mystery, it is possible to draw some broad conclusions about economic and financial prospects for Japan and the rest of the world. First, it is certainly clear that the immediate shuttering of much commercial and industrial activity in Japan will manifest itself in slower economic activity there in the second quarter and possibly will show evidence of a slowdown in the third quarter as well. Second, it is also clear that the repercussions of this economic interruption will almost certainly crimp economies elsewhere that use Japan as a supply source—though for them, the economic shortfall will not likely turn growth to decline. Third, it seems likely—contrary to commonly held beliefs these days—that one way or another the supply-chain problems will quickly dissipate. Fourth, it is clear that after such immediate effects, Japan will rebuild and faster than the consensus of opinion presently expects. And finally, this crisis has the potential to alter the fundamental direction of the Japanese economy. Each phase, of course, has its investment implications, and could open up a number of investment opportunities, in retailing, for instance, not typically associated with Japan.

### Immediate Depressants

Japan's economy has already felt the practical weight of this tragedy. The Tohoku region (which took the brunt of the earthquake and tsunami) produces just under 9% of Japan's overall national output. Beyond that, Japan has lost some 25% of its electric-generating capacity, extending the adverse economic effects far beyond the region immediately affected. Many factories cannot run as actively as they would like. Transportation links have broken down or have suffered disruptions, slowing the shipment of goods and the movement of people to and from work. The shock of events has, understandably, set back consumer and business confidence, causing cutbacks in spending, hiring, and business expansion plans generally. As these effects play out in spring and summer, all major economic gauges will likely pause

or decline. Accordingly, the consensus forecast for real Japanese growth has gone from a meager 1.5% rate of expansion in 2011 to a modest 0.4% dip. Some prominent Japanese forecasters worry about a 1.5% drop in real economic activity.

Japan's impact on the rest of the world seems to have arrived more in detail than generally. In aggregate, Japan simply no longer carries the weight it once did to rock the global economy. The nation at present contributes less than 9% of world gross domestic product (GDP), far below the almost 18% it constituted at the time of the Kobe earthquake in 1994. Japan's slow growth rate in past years makes it even less significant to the global growth picture. The International Monetary Fund (IMF) estimates that Japan during the past five years has contributed a mere 1.0% to overall real global growth. The removal of such an influence would hardly be noticed. But if aggregate effects mean less, the particulars of certain supply chains will give Japan's immediate troubles an outsized global impact.

True to Japan's reputation, this effect will lie mostly in electronics and autos. The nation produces 60% of the world's silicon wafers, 90% of the BT [bismaleimide-triazine] resin so essential in making printed circuit boards, 60% of the air flow sensors so important in modern autos, one-fifth of the world's semiconductors, almost 17% of its consumer electronics, more than 6.0% of its larger-size LCD panels and a much larger percentage of LCD components, most especially the glass, color filters, and polarizing film. Of course, the disaster affects only a part of this production, but still, it is significant enough to interrupt global production rates in these areas.

An even bigger burden will fall on autos, where Japan has dominated for decades. There are already reports of how parts shortages have forced slowdowns or shutdowns in Toyota and Honda plants in Japan, the United States, and elsewhere around the world. Even General Motors and Chrysler, which at first glance would seem likely to benefit from the misfortunes of their Japanese competitors, report a need to slow production for fear of outrunning the Japan-based inputs they have on hand or even American-based inputs that in turn depend on Japanese production. Industry sources predict that, for at least a while, auto production may fall by a third, but for the year as a whole, consensus seems to have settled on an overall shortfall of about 7%—a not insignificant figure, especially when most of the ill effects are concentrated in just the next quarter or two.

### **Prospects for Refilling the Supply Pipeline**

Still, as acute as some particular supply-chain problems seem at the moment, a broader consideration of the situation suggests that the effects may not last as long as some fear. Already, energy-short factories in Japan, at least those outside the area of immediate danger, have restarted operations with temporary power sources, such as portable diesel generators. Nissan, for instance, reports that its operations have returned to full function just weeks after they first lost power. Obviously, jerry-rigged operations are not a lasting answer, but they can fill enough of the gap to keep factories running and supplies flowing. Even the most pessimistic auto executives speak of a troubled horizon only into summer, and some see improvement as early as this month. The hiatus, of course, will undoubtedly last long enough to do damage, but nothing from which the Japanese and global economies cannot quickly recover.

There also is a good chance that alternative sources will relieve much of the strain on supply chains. Japanese firms own plants all over the country and overseas that are unaffected by these events. Some surely can retool to manufacture products that their hamstrung sister plants had produced. It is instructive in this regard that after the Kobe earthquake, alternatives arose much faster than most expected. Kobe had been one of Japan's busiest ports before the quake destroyed it. People at the time spoke in terms of years before Japan could once again handle as much shipping as previously. Yet, other port cities took up much of the shipping slack in the space of weeks and months so that commerce into and out of Japan hardly showed a pause. And if Japan alone cannot step up to the need, many firms elsewhere in Asia are more than eager to supplant Japan in the global supply chain.

Though some of the Japan-based electronics may be harder to replace quickly, other areas may find relief very soon. In autos, for instance, Korea's Hyundai, which relies not at all on Japanese parts, America's Ford, and several European producers are already speaking eagerly about filling the gap left for a time by Toyota, Honda, and those non-Japanese producers more dependent on Japanese parts. Outside of autos and electronics, the global economy will have even less trouble replacing Japanese supplies. In steel, for instance, even though Japan is the world's largest producer, the global industry easily has enough spare capacity to fill the gap left by Japan. Much the same can be said of other affected industries as well.

The supply interruption and substitutions may, however, have a strangely perverse impact on energy and commodity demands. Though the interruption in Japanese commerce and industry has immediately reduced world energy and commodity demands, the effect may reverse very soon. Japan is so efficient, in energy especially, that any substitute production, particularly if based in the emerging economies, will almost certainly use more energy and other

commodities than if production could have remained in Japan. Further, a shift in sourcing out of Japan will move production to places more reliant on fossil fuels to generate electricity than highly nuclear Japan. If, as history shows, the substitute supply links stick, the heightened oil and commodity demands may well linger with obvious upward pressures on prices. Shipping also will likely become less efficient, as it adjusts to substitute supply sources. Indeed, existing ships and other carriers may for a while seem inadequate, with commensurate increases in shipping costs. Unlike fuel demand, however, if the substitute sources hold their business, shipping would eventually adjust and shed the immediate inefficiencies and pricing impacts.

### **Fundamental Rebuilding**

However this immediate disruption works out, there can be little doubt that Japan will rebuild and likely much faster than many now anticipate. After the Kobe quake, for instance, which so many at the time claimed would set back Japan's economy for years, even decades, the local economy and the port rebuilt sooner than any projected, reaching 98% capacity only 15 months after the first tremors of that quake.

Though the still-unresolved nuclear questions will delay rebuilding this time, certainly compared with Kobe, the economic issues hinge less on full recovery than on its start. As soon as Japan can stabilize the nuclear situation, it will almost surely move forward with a massive effort, first to clean up and then to construct new generating facilities, either on the affected site or nearby or both. As this push develops, Japan's economy will substitute a stimulus for today's immediate shortfalls, so much so, in fact, that Japan during this time will offer the world economy more of an engine of growth, than in a long time. Consensus figures point to an economic growth pace of 3.5–4.0% in Japan during this phase of events, very strong by Japanese standards. Though uncertainty clouds when the effort can begin, some of this effect seems likely by the fourth quarter at the latest.

This rebuilding will, of course, add still more to global energy demands. Already, the increasing use of temporary power generation in Japan has undoubtedly lifted Japanese demands for diesel fuel, though comprehensive figures are not yet available. Such needs will only increase over time as more of Japan's industrial and commercial life comes back on line. Similarly, efforts to replace lost generating capacity, especially as Japan debates the nuclear issues, will increase the country's use of fossil fuels above levels from before the disaster. On this score, Japan could dramatically increase its imports of liquefied natural gas (LNG). LNG shipping has already diverted to Japan, and Russia has responded to the situation by increasing pipeline shipments of gas to Europe specifically so that it can make additional LNG deliveries to Japan.

Once the rebuilding effort gains momentum, construction activity in Japan will soar, with all the associated ripple or multiplier effects. Aside from increasing Japan's demands for fuel, commodities, and materials, such as structural steel, concrete, and the like, the effort will also raise demands for construction equipment. Japanese rebuilding efforts may well rely exclusively on Japanese equipment, especially if run by the government. But there is only so much capacity, leaving room for American and European producers to make inroads in third markets left by the Japanese producers as they become fully absorbed in their country's increasing domestic demands. Similar opportunities will emerge in mining and in oil and gas extraction equipment, especially if Japan and other countries turn from nuclear.

Of course, this tragedy has made more countries than just Japan question the nuclear option. Germany, for instance, has put on hold its earlier decision to extend the life of seven of its existing reactors. Switzerland has halted its nuclear program altogether. China is rethinking how it handles its 50 plants, plus the 27 more it has under construction. The United States, which uses nuclear to generate about 20% of its electricity, has taken a more ambiguous stance. Much remains uncertain, for obvious reasons. But even with all the talk of the sudden end of nuclear energy's "renaissance," it nonetheless seems likely that Japan ultimately will rebuild around nuclear.

Japan really has little choice. It already uses nuclear to generate half its electricity, has no oil or coal or natural gas resources of its own, and, without significant pipelines, must ship in all fossil fuels. Japanese authorities can answer the obvious safety concerns with upgrades, as occur in all such rebuilding and as Kobe proved in other areas 16 years ago. Replacements are always more efficient, more effective, and safer. In replacing the ancient Fukushima reactors, Japan could draw on plants that embody several generations of more advanced technology. These new plants are built, the engineers say, to survive both human error and power failures by relying on gravity and natural heat-transfer systems to cool in the absence of either power or human interaction. Though nothing is foolproof, especially contemplating the worst earthquake in 100 years, the much greater safety of this new generation of reactors may well sway Japanese decision makers who otherwise want to avoid fossil fuels anyway.

### **Finance and Politics**

Of course, the question of finance haunts any Japanese rebuilding effort. It looks as though life insurance companies

will pick up \$20–30 billion of the estimated \$200-plus billion rebuilding cost, so that means most of the cost will fall on Japan's government, which, as the world already knows, is deeply in debt. Indeed Japan's gross public debt, by some measures, exceeds 200% of the economy's GDP, far higher than any other developed nation, including even the shaky nations on Europe's periphery, such as Greece. Against such a burden, some have questioned whether Tokyo has the wherewithal to finance a rebuilding effort that effectively would amount to some 2–3% of its GDP. Some of the rating agencies have already threatened downgrading in the face of the additional debt.

But as precarious as the financial situation may seem, there are at least four reasons why such doubts about rebuilding are misplaced. First, it is essential for the country's prosperity, leaving government with little choice but to rebuild—if it wants to stay in power, that is. Second, this spending, if what occurred during the Kobe incident is any guide, will likely spread out over the next two to three years, making for more incremental, though not insignificant, additional annual credit demands. Third, Japan's gross debt burden ignores the government's substantial liquid wealth in financial investments abroad and substantial foreign exchange reserves, mostly held in U.S. Treasury bills and notes. After taking such assets into account, the net debt burden falls to almost half the gross figure, still large, but not as outsized as it might otherwise seem. Fourth, about \$50 billion of this fiscal year's budget, set before the disaster, consisted of make-work construction projects. By shifting these monies toward more economically productive rebuilding, Tokyo will cover much of the rebuilding's annual cost without much additional financial strain than was already planned, and to much better economic effect.

Neither should the government have trouble selling the additional debt. Some 95% of Japan's debt is held by its citizens, who will be even less likely to balk now in the face of an emergency. Besides, it is clear that the only way Japan can meet its public debt obligations, large or small, is with a vibrant economy, and that requires rebuilding. Rather than fret over such spending and even the debt incurred to do it, existing bond holders would seem likely to welcome it as the best way to ensure that the country can meet its future interest and principal payments. If the international credit rating agencies, wedded, as ever, to their rigid and mechanical algorithms, cannot see this, then their judgments are even more suspect than they already seem (especially in the wake of the financial crisis of 2007–08) and perhaps betray a fundamental misunderstanding of the nature of public finance and debt generally.

But if the financing is likely easier than it appears, this setback still raises more fundamental, economic issues. For two decades now, while Japan's economy has suffered deflation and near stagnation, the authorities in Tokyo have failed to implement needed fundamental economic reforms. Their failure is that much more profound because it is clear to many how Japan must change. Its aging population, for example, demands that it shift from an export-driven to a consumer-driven economy. When one-fifth to one-quarter of a nation's population exceeds 65 years of age, it is impossible to remain the workshop of the world or even one of the world's workshops. With a limited work force, Japan also must innovate more and depend less than previously on big industrial conglomerates. All inside government, industry, and academia are aware of Japan's need to move in these directions. But despite the clarity on what needs to happen, politics has for years prevented much reform along these lines.

Now this great crisis—the worst since World War II, according to many in Japan—may well provide an opportunity for these long-sought, fundamental changes. Given the disappointing performance of Japanese politics for so long, the odds, even after such a shock, remain long. But there is a chance that the relatively newly elected Democratic Party of Japan may see such moves as a way to make its mark and secure future power. If Japan's leadership can use the crisis as a way to overcome the resistance that has stymied reform for over 20 years, then a range of new business and investment opportunities could open in services, retailing, and small capitalization firms more than in the massive exporters with which that economy has long been associated. If a reformed Japan uses its superior training to leverage the labor and natural resources of the rest of Asia, then opportunities could also open in design, consulting, and, of course, finance as well, an area otherwise dormant for a long time now. But still, all hinges on the leadership's willingness to make the change.

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