

Japan Earthquake: Wharton's Franklin Allen on the Economic Costs

Knowledge@Wharton: Before we start talking about the earthquake and tsunami of the last week or so, could you give us a quick rundown of state Japan was in, especially its economy, prior to these events? They've had their ups and downs.

Franklin Allen: It was not in a good state to start with. The economic situation hasn't been good for a long time. They have many problems in that dimension. They have very large debt. People often talk about 200% gross debt. That's a little misleading. What's more important, perhaps, is the net debt. If you offset the assets the government has against the debt, it's more like 100% to 120% of GDP. That is a serious number. It's not quite as serious as 200%, but it's the same order of magnitude as Italy. That is a big burden for them. At the moment, it doesn't matter too much because interest rates are so low. But if interest rates go up in Japan, this is going to be a big problem. The second problem they have is demography. They're getting older. With the large debt, that potentially is a problem as to how they're going to support [an aging population].

The third problem is lack of competitiveness. What we've seen is South Korean companies have increasingly taken over in many areas. Samsung, for example, has grown tremendously and has taken many markets from the Japanese companies that dominated them for many years. Panasonic, Sony and so on have not been competing as effectively as they did 10 to 20 years ago. Even among cars -- Hyundai and Kia -- these companies are taking market share [from Japanese firms] and doing very well. Obviously, Toyota's had problems in the last couple of years. Japan's economy hasn't been doing well from a competitive standpoint.

Fourth, the government has not been doing a good job. They haven't provided leadership. We've had many prime ministers. They don't seem to be able to come to a decision about how to proceed with not only the economy, but also many other directions.

Knowledge@Wharton: I don't know how closely you've been able to study the event's impact, but from what we have read, is there any way of describing the areas most affected by the earthquake and tsunami? How important are they to Japan?

Allen: I've been to Sendai twice. It was a very beautiful city. I'm sure it will be again. It isn't a manufacturing heartland. It's not like this hitting Osaka, Nagoya or the whole central part [of the country] from Tokyo down to Osaka. In that sense, it isn't the big one. It didn't take out the economy in the way that a massive earthquake like this would do [elsewhere]. Having said that, however, obviously the damage is very severe. We've seen the dramatic photos of the tsunami going across the landscape and so on. Clearly, there is a lot of damage. I don't think we have a good sense of how big that damage is yet. You hear people say \$20 billion, you hear people say \$100 billion. My guess is that, in the end, it's going to be substantially higher than that. The other big area is the nuclear power stations. It seems most unfortunate that they didn't realize that a tsunami could take out these diesel generators and hadn't prepared for that.

Hopefully they will get that under control. But if the worst were to happen there, that would

be a great deal more damage and a very serious event in many dimensions, not least, of course, loss of life.

Knowledge@Wharton: Are the government and insurance companies in a position to handle the losses and rebuilding costs?

Allen: This is a big question. One of the positive points about Japan's situation is that their debt is mostly owed to Japanese people. They don't have to worry about what the rest of the world thinks. They also have huge foreign holdings. They can deal with this. One of the things the government may have to do is have something like a one-off wealth tax, whereby they can raise the money they're going to need, which is going to be very substantial.

I also think that the way that they've handled it so far suggests they're going to need to think very hard about what would happen if they had this kind of earthquake hit Tokyo, Osaka and the manufacturing belt. They're going to need to start thinking about stockpiling food and resources around the populated areas, so that if anything of this magnitude happened there, they could deal with it without the problems that they seem to be running into now. That will cost them a lot of money. They're also going to need to think very carefully about the safety issues of not only nuclear reactors, but also other places. They don't seem to have done a very good job of thinking about all the possible contingencies that they could run into.

All of this is going to cost money. They have it. I have no doubt they're going to be able to deal with this problem.

Knowledge@Wharton: Costs involve not just recovering from this event, but also preparing for similar events that could take place later?

Allen: Yes.

Knowledge@Wharton: Compared to other developed countries, how heavy is the tax burden on companies and individuals in Japan?

Allen: They have very high tax rates, but the taxes don't raise that much money. There is scope for more taxation. They've been terrified to do that. The last time they tried to raise the consumption tax was in 1997, and it had a big effect on the economy. One of the big debates they've been having is the extent to which they should do that at the current time. They're going to need to think about doing that. But they don't have a choice here. They have to rebuild. They have to deal with this issue. They have to worry about making sure that if there were a massive earthquake in Tokyo -- which is quite likely to happen, though it may now be several decades away -- they need to be prepared for it. That just takes a huge amount of resources.

Knowledge@Wharton: In the United States, we often bemoan the problems we have in thinking just a couple of years ahead. In Japan, is it similar, or are they better at thinking ahead?

Allen: They used to be much better. I'm not so sure that they are so good at it now. The political problems, some of the paralysis they've had, have prevented them from really

thinking through what they need in a major catastrophe. It seems as though it's taking longer than one would expect. I know that in the United States, we didn't go a great job with Hurricane Katrina, which was much, much less severe than what they've had. But they know that earthquakes are going to hit them. They've had them for hundreds of years. This is not something that's new or unsurprising.

Knowledge@Wharton: What do you see as the main obstacles there to spending more on that kind of preparation? Is the political system able to handle it? Is the public opposed to long-term investment?

Allen: It's the political system. There's just a paralysis that makes it difficult for them to do things in a determined way, in the way that they used to. This is a big problem for them.

Knowledge@Wharton: In United States, we often talk about how important the consumer is to the economy. I've seen some stories suggesting that first of all, Japan is suffering a terrible economic blow, in which one of the ongoing effects could be tightening of consumer spending. Is consumer spending as important to their economy as it is in the United States?

Allen: It's important. It's not quite as important, I believe, as here. But it's important in most economies. And it's important there. One of the problems is Japan has been in this lethargic state since the bubble burst 20 years ago. What they need is some kind of event that will shake them out of it. It may well be that this kind of event, tragic though it is with a terrible loss of life, may in the long run benefit their economy. They have to now go out and do many things to rebuild [their country]. This is potentially going to energize the economy.

Knowledge@Wharton: They seem to be fairly dependent on nuclear power. If there is a backlash to nuclear power as a result of this, what can they use as an alternative?

Allen: The alternative is the usual carbon-based fuels. This is the problem. It's going to be coal, oil and gas as the main alternatives. They can do alternative energy, too, but that's very expensive.

Knowledge@Wharton: They don't have many of those resources in Japan, is that right?

Allen: No, they don't. This is going to affect the global markets in the long run.

Knowledge@Wharton: If you look at other countries in the region or elsewhere in the world, which ones are the most interconnected with Japan, and the most likely to suffer in some way if Japan's economy is badly shaken?

Allen: By and large, they run a surplus. In terms of the direct trade links, this is not going to have much of an effect on that. Most manufacturing and the kinds of things we consume in the U.S. or Europe are made in Osaka, Nagoya and that whole belt. That hasn't been so affected. I don't think that direct trade effects will be that important. There may well be financial effects, though, because they're going to need to run down some of their overseas assets. The \$1 trillion of foreign exchange reserves, much of which is in treasuries, is going to have to be liquidated and repatriated. That could well affect our economy more than the direct trade linkages. Long-term interest rates may go up as a result and this could have a significant effect.

Knowledge@Wharton: If interest rates go up here, would that slow the recovery?

Allen: Particularly long-term interest rates, which are the ones that are likely to be affected. That is obviously going to raise mortgage costs, affect the housing market and cause the kinds of problems we have talked about in the past.

Knowledge@Wharton: At the same time, to put this delicately, there may be some winners. A story mentioned construction firms' stocks were going up in Japan. I assume there will be certain beneficiaries of this, both domestically and abroad. Who would they likely be?

Allen: It's the makers of construction material -- steel, cement, concrete, all the kinds of things for which there's going to be huge demand.

Knowledge@Wharton: The Bank of Japan has bumped some money into the system. Do you think they'll be effective? Will they need to do more?

Allen: These are mainly attempts to boost morale. I don't think they will have much real effect on the economy.

Knowledge@Wharton: Are there other moves they should have taken?

Allen: No, I think they're doing the right kind of things.

Knowledge@Wharton: What about international agencies, like the IMF or the World Bank? Is there a role for these big international organizations here?

Allen: No, I don't think so. Japan is a rich country. They have the capacity to deal with this. They have large overseas holdings and they can pay for all of this in the long run. They may have to have more taxes to balance out the tax load. But basically, they should be able to deal with it.

Knowledge@Wharton: Many investors in America and Europe these days have international mutual funds and that sort of thing. What kind of effect do you see over the next few months or year on the Japanese stocks that are so big in these portfolios?

Allen: Today [March 14] the market was down about 6% in Japan. That's a big effect on those holdings. In the long run, they'll make it up. One has to take a long-term view of this. Clearly, they're going to have problems. But they've absorbed many of these kinds of catastrophes before. The 1923 earthquake, the Second World War, all of these things are a part of their resilience. The Japanese respond very well to these kinds of national challenges.

Knowledge@Wharton: You mentioned interest rates perhaps going up around the world as a result. Will inflation rates rise as well?

Allen: The effects on inflation will be mixed. As I say, the commodities that are going to be in high demand will go up -- steel and the other things used in construction. Oil is an interesting one. A lot depends on how things play out over the next few days in the nuclear

power stations. If they manage to keep the situation under control and the radiation leaks are manageable, everything will be fine and they'll continue with nuclear power. If we see a major accident -- hopefully not -- like Three Mile Island or Chernobyl, with a nuclear explosion, things are going to be dramatically different because many countries will have big reservations about nuclear power as a result.

Knowledge@Wharton: One of the things we often see with nuclear radiation leaks is that the emotional impact is very high, often higher than what is really warranted by the dangers involved. There is some talk now that there could be steam venting going on for weeks or months. Is that likely to affect people's willingness to buy Japanese products, things that are made anywhere in Japan?

Allen: Because of the Second World War with Hiroshima and Nagasaki, and the terrible tolls from radiation that occurred there, this is an extraordinarily difficult issue for the Japanese. I am sure they will be on top of making sure that if there are any controlled releases of radiation and so on, they won't contaminate goods. We certainly shouldn't worry about Japanese goods having radioactivity.

Knowledge@Wharton: Could you put these events in Japan into a worldwide context. We have lots of problems in the world. We have debt problems in the U.S. and Europe. Where does this rank? Is this something that's going to tip the balance badly? Or is it something that's thrown into the big mix of worldwide problems, which will not make much of a difference?

Allen: A lot depends on how things play out. As I say, if the nuclear situation gets worse, it could have a big impact. This is one of a series of earthquakes we've seen in the Pacific in the last few months. We had the one in Christchurch. There were some in China, which were fairly big. We've seen this whole pattern of aftershocks. If they have any more big ones, that's going to be a big problem. If things stop where they are now, this is still a serious problem. It will have some effects. But it's not a catastrophic problem; it's a manageable one....

Knowledge@Wharton: We'll hope that's the case, or it's less than that.