

Japan Must Construct the Future, Not Rebuild the Past
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Japan will bounce back. Of that nobody has any doubt. But the way that Japan recovers is the essential question. And here, one should be very concerned.

Japan has choices that it must make. The decisions made in the days, weeks and months ahead will to a large extent determine the kind of country Japan will be for the next three or four decades and beyond. The choices range from infrastructure and economics to society and politics.

And there is an essential role to play by us, right here in this room. We, the international friends of Japan, must throw our weight behind our Japanese friends to see that their vision of a modern Japan is achieved. A Japan that leads global trends and provides the greatest fulfillment to its people. We owe this to our adopted country, which has given the world so much, and today receives the support of the world.

In his remarks just now, Yoshito Hori of GLOBIS Group, the main backer and inspiration for today's event, used words like "awakened", "determined" and "vocal" to describe his attitude towards overcoming the crisis. And I believe it is a fitting description for the Japanese people as a whole, and for the relief workers who have done so much -- and the spirit of the people in the disaster areas themselves.

Yet in realizing these words, Japan has difficult choices it must make. It is vital that Japan constructs the future, not simply rebuilds the past.

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The first decision is of a very concrete sort: rebuilding physical infrastructure.

Some argue that the tsunami's ferocity shows that existing protections were inadequate. The mayor of Rikuzentakata -- a small city which I visited a few days after the disaster and which was utterly washed away -- has suggested literally moving a mountain to raise the city's ground level higher. Here in Tokyo, Prime Minister Kan speaks of elevating entire communities.

I deeply respect the sentiments that go into this vision. But I wonder whether there are more practical ways forward.

For instance, instead, perhaps establish better ways to respond to those rare tsunamis

that only occur once in a thousand years. The risk, otherwise, is Japan goes bankrupt for the next 999 years trying to protect against them.

Also, rather than reconstruct the same homes, factories and roads, this is a chance to build "smart cities," which use energy more efficiently and provide easier access to public services. Prime Minister Kan strongly advocates this. We can hope that the LDP and other opposition parties put aside their rivalries and support him.

A sensitive matter confronts Japanese leaders. Many of the communities in the region were in decline prior to the disaster. Young people were moving away while the elderly remained. Before 3/11 a debate simmered over consolidating towns to operate more efficiently. Today, the real choice will be not be how to rebuild but whether to rebuild at all.

The temptation to grant survivors their last wish and restore what was lost is enormous. But it should be resisted. I say it with the frankness of a friend, that Japan must rebuild the region for its children, not its great-grandparents.

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The next decision concerns the economy more broadly. The economy was sickly before the disaster. There is hope that the crisis might spur it to action.

Certainly the reconstruction will mean a jump in output. But the optimists are shortsighted. Replacement spending provides a one-time fillip. But it ultimately deprives other parts of the economy of resources. So it is fair to say that the economy may expand in the medium term, but is hurt in the short and long terms.

Consider some of the forces at work:

The supply-chain disruptions have been shocking. The "good news," if we can call it that, is that it has jolted salarymen out of their two-decade-long funk, to remind them that Japan Inc is a vital linchpin of global businesses.

The drawback is every executive outside Japan is going to want to hedge their suppliers and the geographic source. So we can expect a slight shift away from Tokyo to other cities like Osaka or Kobe. And a shift away from Japan itself to other places, like South Korea or Singapore. Ironically, the very evidence of Japan's importance will accelerate corporate Japan's march out of Japan.

Next, the power shortage. There is a 25% shortfall in the power generation capacity in the Tokyo area. It will take years to rebuild. Automakers will rotate operations. Companies will run shifts at night and on weekends. It will be a hot summer in Tokyo.

But the need to conserve energy places a choice before Japan. The country can pioneer "smart grids" that reduce electrical usage. And it can adopt a "green industrial policy" of

subsidizing the upfront installation costs of solar panels and LED lightbulbs. This conserves energy and helps companies at the same time.

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A bigger problem is the cost of reconstruction. Japan plans to spend what it takes, as it absolutely should. But this will have to be paid for, and it will be financed by government bonds. This exacerbates the public debt, which is already twice the size of the economy.

The government has rightly resisted calls to "monetize" the debt (that is, have the central bank print money to buy it). But this fiscal probity only prevents the situation from worsening; it does nothing to fix it.

The silver lining -- literally -- is that the crisis fuels pressure to reform tax policy. In early 2011 the DPJ planned to lower the corporate tax rate to 35% from 40% (which is the highest among industrialized countries). But it resisted raising the 5% consumption tax (which is the lowest by the same measure).

Now, the need to improve state finances and the public's recognition for belt-tightening changes the debate. The thinking in Nagatacho is: pass the legislation now, while public sentiment favors it. But set it to begin only once an economic recovery is well underway. That way, it doesn't undermine the economy.

One beneficiary will be social services, which is intimately linked tax policy. A widely held idea among fiscally-conservative members of the Diet has been to earmark consumption-tax revenue for pension outlays.

As the role of the state increases with the relief efforts, people may come to expect more from government. But Japan has a small proportion of tax payers. Some individuals escape it by bizarre write-offs (like wood houses or "businesses" operated from the ground floor of their residences) and the lack of taxpayer ID numbers. Two-thirds of companies pay no taxes since they book no profit (which is perhaps a sign of clever accountants, not dim merchants).

Japan finances half of its government spending with bond sales. One-fifth of the spending is simply to pay interest on the debt -- which at almost zero interest rates, says a lot. This is unsustainable.

So provided Japan chooses wisely, a long term impact of the disaster will certainly be more taxes and a stronger social safety net.

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I'll pass now to politics. There are many reforms that the disaster could inspire.

We could see political parties collaborate, and the government provide more disclosure and accountability. We could see stronger regulations on nuclear power and fewer institutional conflicts of interests. We could see the abolition of *amakudari*, whereby retired bureaucrats work for firms they previously supervised. And the elimination of the press club system -- which is an "information cartel" that neuters the media, and prevents it from performing its societal function as a check on power.

Will any of this happen? Probably not.

The problems are too deeply ingrained. And though the Tohoku region was devastated, Tokyo was spared. There is little recognition that these features of Japan may have resulted in inadequate crisis-recovery plans at Fukushima before the disaster, or an inefficient response afterwards.

So I predict that the crisis will not lead to political reforms, only the talk about reforms.

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One of the most interesting areas of "choice and change" for Japan is in the interplay between the public and private sectors. It seems that a massive transformation is taking place. It is clear that the crisis is bringing the public sector to the fore -- and, paradoxically, bringing the private sector to the fore too.

For the public sector, the bureaucracy in Kasumigaseki will see its stature enhanced. But evolution is required. In 2000 the Ministry of Finance separated the FSA, or Financial Services Agency, from it -- because of perceived conflicts of interest, as revealed by the 1990s banking crisis. So too now there is the likelihood that METI, the trade ministry, will have to shed NISA, the Nuclear and Industrial Safety Agency. The conflict of interest of housing an industry regulatory body inside a ministry meant to promote that industry is just too great.

But ridding Japan of conflicts of interest must not stop there. Japan's bureaucrats are highly competent -- but they exist in an environment where their talents are wasted. Setting them in better structures will improve their performance. It will help Japan. And it will bring the DPJ a step closer to realizing its worthy aim of a politician-led government.

Another dimension of the public sector are the Japan Self-Defense Forces. Their work in the disaster areas have earned them the lasting respect of the Japanese people. Just as Germany in the 1990s shifted its military to humanitarian operations, I expect that over time this is what Japan will do as well.

At the same time, the private sector has also been enhanced by the crisis. And by private sector, I do not simply mean "business" but also non-profit organizations and civil society groups. Very quickly on during the crisis, it was clear that convenience stores were as much a lifeline for broken communities as water, power or telecoms. And the importance

and value of non-profit groups is apparent to the Japanese public.

One legacy of the crisis, I would argue, is that the private sector will eventually be seen as a pillar of society equal to the public sector. And this will something very new for Japanese society.

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Ultimately, the biggest decision facing Japan is one of identity. Will the country play a greater global role or turn its attention inward?

Prior to the disaster, Japan was already in retreat. Fewer people spoke English, or studied and worked overseas, among other things. A post-crisis Japan could help the world define robust standards for nuclear safety, crisis response and supply-chain resilience -- just as it offered valuable lessons during the 2008-2009 financial crisis, based on its experience a decade earlier.

But Japan may chose differently, and the process of domestic rebuilding only increase its insularity, making Japan less relevant globally.

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Added to the classic three Ds of Japan -- debt, demographics and deflation -- we regrettably, tragically add a fourth: devastation. As the country rebuilds, will it accept the difficult decisions? Yes, I believe it will -- but realistically, only a little bit.

Humans are biologically programmed to minimize trauma over time, and to quickly forget. Life would be unbearable otherwise. Our brain synapses literally get clogged up, and biologically it looks like "healing." So I think it is right to presume that only marginal changes are likely.

Yet this should be a reason for optimism. Marginal changes are good. And for even this to happen, the old practice of *gaiatsu*, or "outside pressure," can be of great help -- to support the bold and innovative Japanese in positions of influence: who want to build the future, not the past.

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