

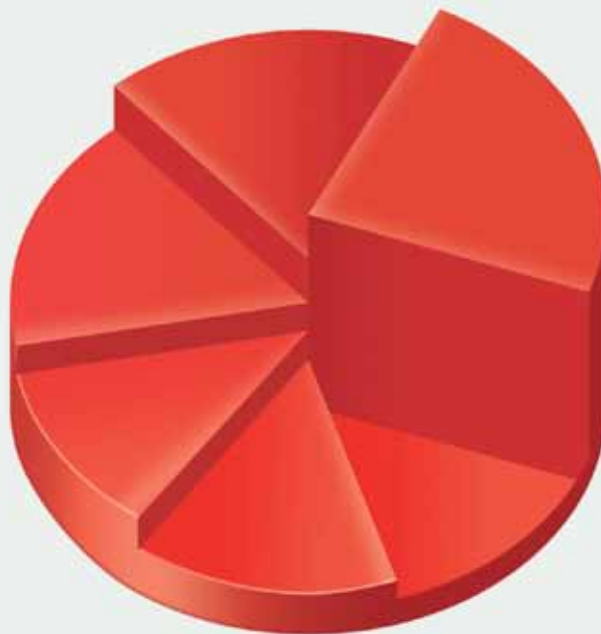
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After the earthquake: A more open Japan?

Restructuring and less fractious politics could speed the building of a more balanced and open economy.

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In 1995, when an earthquake ravaged the city of Kobe, an important industrial hub in Japan, the country's government and economy surprised and impressed the world. Within 15 months, economic activity in the area returned to about 98 percent of pre-quake levels, and the cleanup was largely completed within two years. Now Japan's massive earthquake and tsunami, plus its emergency involving damaged nuclear reactors, have generated headlines around the world and persuaded some that natural disasters have compounded the country's long-term economic woes, rendering it a spent force on the international stage.

Yet there is little reason to fear that recovery from the recent Tohoku earthquake and tsunami and their aftermath need prove much more difficult or take much longer than the recovery from the disaster in Kobe. As before, the reconstruction effort will stimulate both immediate industrial activity and long-term investment in housing and in commercial and industrial infrastructure. Excess manufacturing capacity will help Japan cope with temporary capacity losses. Moreover, the country's industrial core lies outside the region most badly damaged by the disasters, so long-term damage will probably be limited. Even credible worst-case scenarios for the Fukushima Daiichi meltdown indicate that it would have little impact on long-term economic recovery. Net government debt hovers above 100 percent of GDP, but other countries have managed with even heavier burdens. The Bank of Japan will ensure that adequate funding is available to financial institutions to finance recovery efforts, both public and private.

On the political front, Prime Minister Naoto Kan's government actually has gained from this natural disaster. Kan faced an opposition push for early elections and potential challenges from within his Democratic Party of Japan (DPJ) before the earthquake and tsunami, and he continues to do so now. But the need for relief and recovery efforts is leaving the Japanese public with little appetite for contentious national elections and restraining both opposition party intransigence and rebellion in the DPJ. This improves Kan's chances for survival and the resumption of his drive for a more open Japanese economy.

Kan's consumer-oriented growth strategy and social-welfare program will remain faithful to the DPJ's broader agenda, but Japan's demographics, as well as challenges from emerging economies, will push his plans toward greater economic openness. This trend will eventually provoke battles with the opposition and within the DPJ—fights that will determine the speed and ease with which Japan sheds its export-oriented past and moves toward a more balanced and open political economy. Over the longer term, generating economic growth in Japan will require a substantial restructuring of its economy, including deregulatory efforts to promote competition. It is unclear how much progress Kan will make in the next couple of years, given political inertia and the immediate needs of the disaster response. But the trajectory of Japanese politics remains on track for an embrace of greater openness over the next decade.

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Kan’s government will focus on two tactics. First, it will prod the Bank of Japan to commit itself to expansionary monetary policies. There had been some success on this front even before the earthquake as the bank gradually expanded the range of its asset purchases to reduce longer-term interest rates.

Second, the government will move to promote trade. Kan wants to embrace the Trans-Pacific Partnership (TPP), the multilateral free-trade agreement (whose expansion is backed by Washington) that’s designed to integrate the Asia–Pacific region’s largest economies. That won’t be an easy political sell in Japan, where some farmers demand, and historically have received, extensive protection from import competition. Efforts to placate farmers will continue, but if the DPJ remains in power for the next several years, we can expect the TPP to remain an important part of the government’s longer-term plans. Whether Japan can make this leap while Kan remains in charge is uncertain. Rivals within the DPJ and opponents across the political aisle will continue trying to drive him from office. But the demographics and economic competition that are driving Japan to alter its export-oriented economic strategy will eventually prevail, even if that takes a decade or more.

Japan’s attractiveness as an investment destination will remain in flux for some time. The triple disaster is likely to quicken the pace of efforts to shift production overseas. But that trend has been well established for nearly two decades. By contrast, as Japan’s economy becomes less export oriented, the sorts of opportunities the country offers the outside world will change. A more open Japan will intensify local competition and improve opportunities for more efficient corporations, both Japanese and foreign. Improving aggregate Japanese productivity should eventually pay off for domestic and foreign investors in equities, as well.

Despite the natural disasters and a declining population, Japan’s economy need not continue to slump. As efficient as the country’s export industries have been, there is still much room for improving productivity—low-hanging fruit that a more open Japan will eventually enjoy. ○

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