It has been more than six months since the March 2011 Tohoku earthquake, tsunami and the subsequent nuclear crisis, and the country continues to invest heavily in the region’s reconstruction efforts. This paper reviews such efforts and summarises the accomplishments as well as the emerging problems. In doing so, it revisits the five signposts that Yoshito Sakakibara, an economist in our investment research team in Tokyo, highlighted in an April 2011 report, *Restoring Japan: An Early Macro Assessment*.

We think investors looking for signposts on the road to recovery should look at the following five issues:

- The crisis at the Fukushima nuclear plant
- The supply chain problem
- Electricity supply constraints
- Corporate pricing activities
- Implementation of a positive policy response

The report also looks at the impact of the reconstruction efforts on the Japanese equity market.

1. **The crisis at the Fukushima nuclear plant**

Three out of four nuclear reactors in the Fukushima plant are in “cold shutdown”—a condition where the water temperature is below 100 Celsius. The Tokyo Electric Power Co. (TEPCO) stated in its “road map” that it hopes to achieve “cold shutdown” in all four reactors by January 2012. Meanwhile, the crisis—which had resulted in a meltdown at one stage—has since stabilised and is expected to remain stable.

However, the focus of the nuclear crisis has shifted in the last six months from worries over a meltdown to fears of radiation contamination. TEPCO has revealed that the recycling system and purification of vast volumes of contaminated water that pooled at the plant have become more pressing problems. The victims of the crisis are demanding that the contaminated soil be treated immediately. The Kan administration was openly criticised for its slow response and lack of policy. The new Noda
administration proclaimed the reconstruction of Tohoku as its most urgent priority, and has started preparations to pass the third supplementary budget of JPY 10 trillion next month.

Another new problem is the impact on other nuclear generators in the country. Of the 54 nuclear generators, 33 reactors are shut down. After regular inspections (which are required every 13 months by nuclear safety regulations), the local authorities have not allowed the reactors to start operations because of local protests.

Five more reactors are scheduled for inspections by the end of the year. Since Japan relies on nuclear resources for 30% of its electricity supply, the situation could potentially cause serious damage to the industry. However, the public demand to abolish nuclear facilities has spread and become louder. Many believe the Kan administration failed to manage the situation appropriately. The new Noda administration aims to work with local authorities to resume operations of the reactors shortly.

2. The supply chain problem

Given the unprecedented coordination efforts among Japanese manufacturers, the supply chain was restored earlier than expected. This helped boost production in the auto and electronic industries in particular, helping to improve exports and bring them back to pre-earthquake levels earlier than anticipated.

3. Electricity supply constraints

TEPCO supplies electricity to the Kanto region where Tokyo is based. Given lower supplies, the government enforced a 15% electricity reduction in this area in order to manage usage. Despite initial concerns over the impact that the electricity constraints would have on the economy and daily life, things went well. Companies coped by introducing flexi-time and asking workers to come in on weekends (and compensated them by giving them two days off during the week). People managed to live through a very hot summer with limited use of air conditioners and darker streets. On 11 September, the government lifted the restrictions.

One spillover problem is that companies voiced their intentions to relocate more production sites abroad in order to compete globally should the strong JPY and electricity shortages be more permanent. The Prime Minister Noda has voiced concerns over this possibility and has expressed his intention to work on countermeasures to the situation.

4. Corporate pricing activities

Japan still remains in a deflationary environment despite many other countries facing inflationary pressures. After the tsunami, many shops in the eastern regions, including in Tokyo, ran out of goods. This raised hopes that the shortages would give corporations more pricing control. While some succeeded in raising prices, the increases weren’t widespread. In fact, the CPI excluding food was -0.7% in March and reached +0.1% in July. Therefore, it is too early to say if the corporate pricing activities—which are still very mixed—will have a positive effect.

5. Implementation of a positive policy response

The implementation of positive policies was disappointingly slow. The Kan administration, for example, was criticised for its post-crisis management. On August 30, Mr. Yoshihiro Noda became the third prime minister since the Democratic Party of Japan (DPJ) took power two years ago. He vowed to quickly pass the third supplementary budget and other pending policies to help the victims of the tsunami and nuclear contamination.

Does the Japanese equity market reflect these developments?

No. Confidence reflected in the Japanese equity market resulting from strong economic data has completely wilted since August. On 6 September, the TOPIX broke through the low last seen in March, when it hit 741.20. The market was overcome by fears of the sovereign debt crisis in Europe, a possible recession, and distrust of politics in the U.S.

It is wise for global investors to look at Japan’s broader picture. Instead of focusing only on the negative impacts of a strong JPY, the economic slowdown in Europe and possibly in the U.S., and the potential effects on Japanese exporters, they should also pay attention to Japan’s unique reconstruction efforts. We think that the reconstruction efforts in the public and private sectors will drive the economy until they are complete. The Japanese government plans to spend JPY 19 trillion (USD 247 billion) over the next five years, with spending peaking in the 2012 fiscal year. The scale of the project equates to approximately 1% of Japan’s GDP. So far, JPY 6.1 trillion has been secured from the first and second supplementary
The third supplementary budget is expected to raise another JPY 10 trillion or so in November. Its impact is clear. After the negative growth of -2.5% (seasonally adjusted annual rate, or saar) in the April-June quarter due to damage from the earthquake/tsunami, the July-September quarter GDP is expected to reach 7.0% (saar) followed by 3.5% (saar) in the October-December quarter. Real GDP in 2012 is expected to grow 2.5%, much higher than the average of 1.4% for developed nations.

When will TOPIX reflect Japan’s economic recovery?

It remains to be seen whether the Japanese equity market eventually catches up with the real economy, but we believe it has become a defensive market thanks to its unique situation. The downside has been more limited recently compared with other markets where concerns continue to mount over European sovereign debt problems and the potential of a banking crisis, along with concerns over a double-dip recession in the U.S.

1 Global Data Watch by J.P. Morgan as of September 16, 2011
Six months after the Tohoku earthquake

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