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## BROKEN WINDOWS: A PERSPECTIVE ON THE JAPANESE ECONOMY

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Natural disasters abound all around the globe; from hurricanes along the coast; to tornadoes on the mainland, to fearsome earthquakes that can strike virtually anywhere. Incredible destructive forces like these cause great amounts of property damage. Most people, especially those in the affected areas, realize, nothing beneficial could come from natural disasters of this sort. This, of course, is a reasonable assumption.

But it is one to which economists are sometimes blind. For example, in the Wall Street Journal on September 17, 1999, "Hurricane Floyd may leave robust economy in its wake." Marilyn Schaja, chief economist at Donaldson, Lufkin and Jenrette Securities Corp in New York, tells a journalist that, "one of the most powerful storms to surge out of the Atlantic this century may actually give the economy a boost." The article, which focuses on the rebuilding effort, claims all this new activity is giving the economy a shot in the arm, and is actually expected to boost GDP by 0.2 per cent. However, it is not at all true that a natural disaster can help spur economic growth.

The same article contains a similar analysis of hurricane Andrew stating: "In 1992, after Hurricane Andrew tried to sink Miami, damage estimates – and they are always estimates – topped \$ 26 billion. Ian Shepherdson at High Frequency Economics Inc., a New York research firm, notes the damage was equal to about 0.4 per cent of gross domestic product. But rather than slowing national growth, GDP for the quarter actually accelerated by 0.5 per cent to the equivalent of about \$ 30 billion."<sup>1</sup>

A similar report from Reuters dated September 23, 1999, concerning the affect of the great Taiwanese earthquake averred. "A giant earthquake forced Taiwan to trim its 1999 economic growth target to 5.5 per cent, but officials said on Thursday a post quake reconstruction boom should drive growth beyond six per cent in 2000." The author report that, "...the earthquake, which measured 7.6 on the open-ended Richter Scale, would have a positive effect in 2000, with reconstruction stimulating domestic demand, said Chang Yao-tsung, the (economic) ministry's chief statistician."

It appears that after a natural disaster we can count upon a person calling himself an economist to reassure his audience that there is always an upside. He proclaims that all the rebuilding that takes place will provide a productivity boost for the economy. The architects, carpenters, plumbers, roofers, building suppliers, etc., all enjoy business they would otherwise not have had. The money they make will be spent on other goods. Theoretically, all this new activity spurs the economy and boosts GDP. Apparently, instead of weeping about Floyd we should be celebrating in the streets.

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<sup>1</sup> One could conceivably interpret this as the claim that in spite of the hurricane there was economic growth. The context, however, seems to suggest that the good economic record was because of the storm.

<sup>2</sup> Citation is from the *Arlington House Publishers, New York, 1979 edition.*

Henry Hazlitt<sup>2</sup> in "Economics in One Lesson" (1946) P.23, eviscerates the fallacy that one can break a window and thereby benefit the economy. A boy throws a rock through the baker's window, and the on looking crowd debates the meaning of it. An "economist" of the Keynesian<sup>3</sup> stripe mistakenly concludes that it is a good thing the glass was broken. After all, now some glazier will benefit from the shopkeeper's business and have more money to spend on the product of other merchants. These in turn will have more to spend with still others. This is the Keynesian multiplier effect in economics, which is similar to the ripple effect of a pebble cast into a pool of water; it will go on providing money and employment in ever widening circles. The fallacy is uncovered when it is realized that property destruction will always make people worse off than they were before. The cash paid out for rebuilding is always a poor use of resources. Wealth is lost when something of value is destroyed; it takes capital and resources to replace it. As in the broken window fallacy, the economic activity seen at the time of reconstruction is the accumulation of capital and resources that otherwise would have been used for better economic alternatives.

True, when a building is destroyed, and a new one comes into being to replace it, that latter activity creates jobs. But had not the building been destroyed, and a new one erected, as before, then there would be not one but two edifices. Yes, when Hiroshima and Nagasaki were destroyed during World War-II, it took Herculean effort, many jobs and many raw materials to replace them. But had these efforts been made in the absence of the destruction of these two cities, there could have been four cities, not two. If bombing really brings about economic value, why did not the west destroy Chicago, London and Paris instead.

When it comes to calculating the cost of something, the alternative uses of the resources used in its creation simply must be considered. The gross domestic product is a poor instrument to use when trying to measure the losses and or gains from economic destruction. For example, you can't add and subtract, what you can't see, and most of the costs of hurricanes consist of goods not produced and services not provided. Also, the GDP only calculates money spent and resources produced. It does not take into account, the fact that, there were better economic alternatives. Yes, it is true there were X amount of homes built, and there were X amount of cars built, etc., but it should not be considered an addition to economic growth when identical amounts were previously destroyed. If this crazy principle were applied we could all destroy our homes and rebuild and the gains would be astronomical! So, of course, hurricanes cause the GDP to rise, but that should not be the same thing as causing productivity to rise.

Seemingly, an economic benefit can develop from a natural disaster when individual firms and households make new and often better decisions while rebuilding. A report, written by Douglas Ostrom, dated 16 June 1995, from the Japan Economic Institute, disasters, especially earthquakes and the Japanese economy, attempts to demonstrates this fallacy.

The great Hanshin earthquake that struck in January this year – arguably the second-worst tremor to hit Japan this century – serves to highlight the perceived vulnerability of the Japanese archipelago to a variety of natural disasters. The economic effects of the quake to date illustrate the ways in which a market economy like Japan's responds to a catastrophe. Individual firms

<sup>2</sup> See Keynes, John Maynard, *General Theory of Money, Interest and Money*, New York: Harcourt, Brace, 1936; for a refutation, see Hazlitt, Henry, *The Failure of the "New Economics,"* New York: Van Nostrand, 1959; Garrison, Roger.

and households make decisions that tend to accelerate the changes that would have occurred eventually in any case.

This phenomenon is very much in evidence in Kobe and other areas affected by the Hanshin quake. Economy-wide changes, however, are likely to be much more modest. The short-run disruption to output already largely has run its course. Additional effects have to compete for influence with other changes sweeping the Japanese economy, such as the appreciation of the yen itself partly a result of the quake. Over the very long term the quake is likely to reduce the size of Japan's economy slightly compared to the levels it otherwise would reach.

Policy measures directly targeted at Hanshin earthquake victims are unlikely to affect the pace of the current economy recovery significantly or to impact the overall economy's performance. However, government initiatives intended to prevent a repetition in Tokyo of the Kobe experience could have a significant impact.

The economic initiatives, presumably, consist of stricter building codes or the establishment of flood plans. However, if the fall of the Soviet system of economics has taught us anything, it is that central planning does not work<sup>4</sup>, whether on the national, state or local level. Buildings tend to be hurricane proof not because of bureaucratic intervention into the market, but due to economic development, and wealth creation, which are retarded by such interference in the first place.

It cannot be denied that at some of the manufacturing business normal production schedules and processes had to be modified or stopped altogether to assist in the relief effort. For example, Kirin Breweries filled liter-sized beer bottles with drinking water and shipped thousands of cases into the Kobe area. On the other hand, had there been no crises, the efforts could have gone toward an increase in economic well being, instead of at attempt to ameliorate the worst excesses of economic loss.

Here is another example attesting to the fact that natural disasters have negative economic repercussions.<sup>5</sup>

Beyond disaster-related damage to plant, equipment and inventory is the condition of related firms. Some businesses locate in a given area because their suppliers, customers or rival companies are there. In each instance a firm may add towards income by having easy access to each type of operation. For example, companies in a particular industry may benefit from the flow of ideas and personnel among firms; this is more likely to occur if the firms are physically close to each other. If an earthquake jolts one company into moving out of a region, then the benefits to remaining firms may decline, spurring a mass exodus.

Finally, a disaster changes other characteristics of a region probably to the detriment of firms already operating there. For example, in the wake of the largely unexpected 1980 eruption of Mount St. Helens in Washington state, Japanese electronics firms were reported to reassess

<sup>4</sup> Mises, Ludwig, *Socialism*, Indianapolis, Liberty Fund, 1981 (1969); Mises, Ludwig von, *The Anti-capitalist Mentality*, South Holland, IL: Libertarian Press, 1972; Mises, Ludwig von *Human Action*, Chicago: Regnery, 1963; Boettke, Peter J., *Why Perestroika Failed: The Politics and Economics of Socialist Transformation*, London: Routledge, 1993; Boettke, Peter J., *The Political Economy of Soviet socialism: The Formative Years, 1918-1928*, Boston: Kluwer, 1990; Boettke, Peter J., ed., *The Collapse of Development Planning*, New York: New York University Press, 1994.

<sup>5</sup> Page. 9 paragraph 1-2, *Japan Economic Institute Report*.

southwestern Washington and northern Oregon as locations for semiconductor plants in light of higher-than expected levels of airborne particles that could make manufacturing operations more difficult. (Ultimately, they stayed and even expanded, perhaps because the firms' domestic plants face similar problems. Both Silicon Forest, as the area around Portland, Oregon is known, and Kyushu's Silicon Island lie in volcano country). Similarly, parts of the Japanese silk industry, located in Yokohama at the time of the Great Kanto Earthquake, chose not to rebuilt in what was thought to be the earthquake-prone Kanto region; instead, the industry set roots in presumably safer areas to the west – notably Kobe.

The point is, businesses in a region that suffers a disaster are likely either to shrink or move, both of which must be counted in the economic debit column. A natural disaster inevitably causes economic activity to decline in an area, as demonstrated in the following.<sup>6</sup>

Some of these factors already are showing signs of being at work in Kobe. For instance, Sumitomo Rubber Industries Limited, announced plans to close its Kobe plant, hit with significant damage by the quake. Production of tires for motorcycles and bicycles was moved to its Nagoya plant, while golf ball production was shifted to Fukushima prefecture.

Kobe Steel Limited, whose facilities were damaged extensively by the quake and whose products have become less competitive as a consequence of the yen's appreciation in the first part of the year, announced at the end of May a Three-Year plan designed to address its multiple problems. Among other measures the large steel maker will eliminate 3,000 positions or about 20.7 per cent of its work force by the end of March 1998. The company also has said that, portion of its steel bar and pipe production that was shifted after the quake to a joint venture in Lorain, Ohio, will stay at the USS/Kobe Steel Company plant, even after corporate facilities in Kobe are restored.

Meanwhile, large retailers in Kobe have announced plans to downsize. Sogo Company Limited, which operates department stores throughout Japan and even overseas, has said that, it will scale back by 71 per cent the size of its huge downtown Kobe outlet before it reopens in the summer of 1996. In late May the store was a minor tourist attraction, with train passengers disembarking in downtown Kobe getting a good view of a huge hole in the building's side, one large enough to swallow up a typical American department store.

In addition, although many small firms were reopening every day in Kobe and the surrounding areas throughout the spring and each summer, thousands of others that were forced to close as a consequence of the quake may never reopen. Many such businesses including coffee shops and vegetable stands, were operated either by a single individual or by a family. Most were only marginally profitable. Investments in repairs presumably would not earn a competitive return. Even if the owners would like to reopen – certainty considering the advanced age of many such proprietors – they might be unable to obtain financing.

Another of the consequences of the Kobe earthquake was the tremendous loss of human life. However, in addition to the 5,497 people killed, more than 300,000 survivors in the heavily impacted cities of Kobe, Ashiya and Nishinomiya, who were displaced from their homes, also faced the hardships of finding shelter; securing food and water; locating friends and family members; and acquiring winter clothing.

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<sup>6</sup> Page 10, *Japan Economic Institute Report*.

Those requiring emergency shelter reached a peak of 235,443. Many camped in public parks or assembled makeshift shelters from materials salvaged from the wreckage of their homes. Others competed for housing with construction workers, technicians, and engineers that were converging on the area to begin reconstruction. Severe crowding and limited facilities increased sanitation problems and increased risk of communicable disease.

It is not at all unusual that what is harmful or disastrous to an individual is equally harmful and disastrous to the collection of individuals who make up a nation. States the Japan Economic Report.<sup>7</sup>

The strong visual evidence of destruction in central Kobe forms a backdrop to feverish repair activity in Block after Block. In late May many repairs being made were still of a temporary nature, such as placing plywood panels over damaged sections of buildings. Real rebuilding clearly is months away. Hyogo Governor Toshitami Kaihara, for weeks a fixture on Japanese television and someone who has become one of the nation's best-known politicians, has said that complete reconstruction is three years away. Even so, the frantic activity has created concerns that particles of asbestos and other building materials have created a health risk for shoppers and office workers in the area. The Environment Agency says that, while Kobe's level of airborne asbestos this spring was eight times higher than the national average, it still was below the warning levels stipulated by law and posed no immediate health threat. Some area doctors are not so sure, particularly regarding individuals with daily exposure. In any event, facemasks have become a familiar sight among those walking outside in downtown Kobe.

The description of Kobe and other affected areas show that a disaster is comprised of countless instances of suffering and damage, large and small. Similarly, the economic impact of a disaster consists of the sum of the effect on thousands of businesses, workers and consumers. Disasters waste resources and disrupt the normal working of a market economy and the interactions among its people. Therefore, no gain should be reported.

What of the objection that some disasters actually bring about economic gains which can be exhibited? The best example of this is the invention of radar during wartime. As well, numerous medical emergency breakthroughs were attained under wartime conditions when doctors were forced to treat patients under conditions not hitherto encountered. True, war is not a "natural" disaster; rather it is a man-made one. However, the broken window fallacy applies equally to the one as to the other.

There is no gainsaying the fact that radar has tremendous and positive impacts on the economy. The same can be said for medical improvement gained under emergency wartime conditions. Must we then renounce, or qualify our claim that disasters, whether natural or not, are an unmitigated loss?

Not quite, for if we were to do so, we would have to take the position that had the war not occurred, with its millions of people killed, and had peacetime reigned instead, we would not have invented radar, nor benefited from these new medical technologies. In other words, any such conclusion requires that we answer the contrary to fact conditional in the negative. But what evidence for any such claim could be put forth? It is hard to see how this could be done.

On the other hand, had not millions of man-hours not been spent on wartime pursuits, and

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<sup>7</sup> Japan Economic Institute Report, Page 7.

had tens of millions of people who were killed not perished in the war. It seems reasonable to suppose that not only these few paltry breakthroughs might have occurred, but many more as well. The flower of an entire generation of young people, from all around the world, on both sides of the conflict, had years of their lives wasted, when they were not killed outright. It is hard to believe that had the efforts of all these people been turned toward economic development, instead of blood letting, that more and better would not have eventuated.

No, it is not a down right logical contradiction to suppose that greater economic progress might have come about through accident, attendant upon a war or natural disaster. To posit that it actually occurred is not quite in the same category as speaking of square circle. But the burden of proof very much remains with those who maintain this position. And if these proponents were serious about their stance, they would be observed destroying their own property, risking their lives and their property in voluntary physical altercations with those of like mind. Yet we see nothing of the sort occurring in the real world. We are thus justified in rejecting this contention on the ground that even its proponents do not take it seriously.

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