

The likely economic/financial impact of Japan's earthquake

EDITION 7 – 15 MARCH 2011



Key points

- The Japanese earthquake has caused terrible human suffering. In terms of the economic impact, in the short term it will likely depress Japan's economy as a result of damage to factories, power supply, transport infrastructure and confidence. However, by the second half of the year the rebuilding effort is likely to result in a boost to growth.
- While it has added to short-term uncertainty in global investment markets, we don't expect the earthquake to derail the global economic recovery or growth in Australia. In fact, increased commodity demand associated with rebuilding will ultimately provide a boost for Australia. We continue to see the recent pullback in share markets as a correction, and not the start of a new bear market.

Introduction

It seems the string of disasters in our part of the world this year is not letting up - the Australian floods, the New Zealand earthquake, and now a massive earthquake and tsunami in northeast Japan. At this stage the full extent of the damage in Japan is unknown, but it is clear it has resulted in a terrible human tragedy. Right now the focus is on the rescue effort and our thoughts are with the Japanese people and all those affected. This note looks at the likely impact on economic activity, investment markets and Australia.

Economic impact

All natural disasters follow a similar pattern in terms of their economic impact and the Japanese earthquake is unlikely to be any different. The initial impact is negative as production is disrupted as a result of damage to factories, the power supply, transport infrastructure, confidence, and to homes which means workers are focused simply on survival. This then gives way to recovery as rebuilding kicks in and production returns to normal.

- This was seen in terms of the Kobe earthquake in Japan in January 1995, which claimed 6,434 lives. Japanese industrial production fell 2.6% that month only to be followed by gains of 2.2% and 1% respectively in the subsequent months. In fact it's worth noting that while Japan's gross domestic product (GDP) fell 0.7% in the December quarter of 1994, it actually rose 0.8% in the March quarter of 1995 when the quake hit and rose another 0.8% and 1% in the June and September quarters respectively.
- It was also seen in the Boxing Day tsunami in Asia of 2004, with initial negative economic consequences in the areas affected followed by a strong rebound. In fact it was barely a blip in the Asian growth story at the time.
- The initial negative effects from recent floods are now being felt in Australia, but there is good reason to expect a rebound in growth from the June quarter.

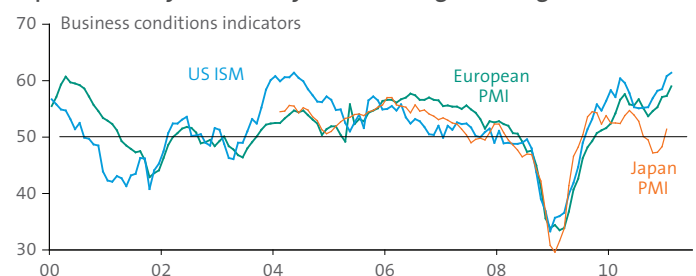
The areas most affected by the earthquake account for around 8% of Japan's GDP. It is a centre for auto production with Toyota, Nissan and Honda plants being shut down. Electronics plants have also been affected and damage to fishing and agricultural production is likely to be immense. That said, given that the area directly affected by the earthquake is a smaller part of the Japanese economy than the area affected by the Kobe earthquake in January 1995, it's possible that the economic effect may be smaller this time. According to Bank of America Merrill Lynch the three worst hit prefectures in the Kobe earthquake accounted for around 12% of Japan's GDP.

However, it is still very early days in assessing the damage and there are some reasons to be a bit more concerned this time around. Firstly, it's the tsunami that has caused most damage this time, wiping away whole towns and parts of cities, as opposed to just earthquake damage to buildings, roads, etc. This also means the rescue operation may be more involved as will be the clean-up before rebuilding can commence. Some areas may now even be unliveable given the shift in land and sea levels. Secondly, as a result of problems at nuclear power stations, the interruption to power supply may be greater and longer than was the case in 1995. Further, the loss of life this time is likely to be much greater. This will have a potentially bigger impact on confidence than was the case in 1995. Finally, this time there is a risk of a serious nuclear catastrophe, which would result in a far more disastrous impact if it occurred.

The most likely outcome would seem to be a setback in activity over the next few months – perhaps 4% or so knocked off industrial production – before rebuilding kicks in boosting growth again during the second half of the year. After the Kobe quake the rebuilding effort was very quick and efficient and the same is likely this time. The Bank of Japan has already responded by pumping liquidity into the Japanese banking system and has announced a doubling in its quantitative easing program (which amounts to using printed money to buy private securities). Fiscal stimulus is also likely to be announced soon.

There are three bigger issues for Japan though. Firstly, Japan's recovery since the global financial crisis has been the most fragile of the G3, i.e. the US, Europe and Japan. This was highlighted by the fall in Japanese GDP in the December quarter and much weaker levels for consumer and business confidence. Please refer to the following chart. The earthquake will likely only add to Japan's fragility.

Japan's recovery was already the most fragile amongst the G3



Source: Bloomberg, AMP Capital Investors

More fundamental is the impact on longer-term confidence. The Kobe earthquake arguably damaged Japan's national confidence in the 1990s adding to the malaise of the last two decades. The latest quake may only add to this sense of longer-term malaise.

Finally, while price deflation means Japan has plenty of potential for further monetary easing, further fiscal stimulus will add to already very high public debt levels. Japan's budget deficit is already 8% of GDP and public debt is around 200% of GDP. This is way above levels at the time of the Kobe quake and is even far worse than Greece. Short term, it's easy to finance as the private sector in Japan is a net lender. Longer term, it is more problematic as a rapidly aging population will mean households will likely become net sellers of Japanese public bonds.

What about the global economic recovery?

The Japanese earthquake is unlikely to derail the global recovery. Apart from the likelihood that the negative impact on Japan will be mainly short term, Japan's importance globally has slipped in recent times. At only 6% of world GDP, Japan only accounted for 0.16 percentage points of the 4.5% or so increase in world GDP last year.

Australian impact

Japan is Australia's second largest trading partner, but its share of Australian exports has slipped from 25% at the time of the Kobe earthquake to 15% today. Short-term economic disruption in Japan could cause a decline in orders for coal, iron ore and other commodities in the next few months. However, this is likely to be no more than a blip as the broader impact is likely to be positive as rebuilding will add to strong global demand for raw materials. Problems with nuclear power stations as a result of the quake, and any resultant rethink of the relative attractiveness of nuclear power globally, will likely be negative for uranium demand but positive for gas and coal demand. There may also be increased demand for food stuffs as the area affected is important in Japanese agricultural production.

It is noteworthy that even though the value of Australian exports to Japan fell in the March quarter of 1995 when the Kobe quake hit, they rose solidly in total - up 13.8% in the March quarter and up 22.2% in 1995 as a whole.

Finally, imports of cars, electronic goods and other manufactured goods from Japan may see a short-term disruption but this is unlikely to last long, with other global producers also likely to step into the breach given still significant global manufacturing spare capacity.

At this stage we see no reason to alter our Australian economic forecasts which see year average growth this year of 2.8% and 3.8% in 2012 and the cash rate rising to 5.25% by year-end.

Financial market implications

For Japan, the earthquake is negative for shares on the back of worries about the short-term economic impact, positive for bonds on 'safe haven' demand and probably positive for the Yen as Japan repatriates funds, particularly by Japanese insurance companies. This is pretty much how it played out immediately after the Kobe quake. So far it appears to be playing out this way as well, particularly for the share market which has fallen sharply.

However, after the initial reaction, which based on the Kobe experience may last several months, expect the Japanese share market to rebound as rebuilding kicks in and production returns to normal. There is a bit more uncertainty around the Yen - past experience suggests it will strengthen initially but this could be short-circuited if the Bank of Japan intervenes (as it should) to help exporters.

Short of a nuclear catastrophe, we don't see the Japanese earthquake derailing the global economic recovery and nor do we see it derailing the cyclical recovery in global share markets.

However, it has come at time when the worry list for investors has suddenly expanded again - to include unrest in the Middle East and oil prices, renewed concerns about European debt and Asian tightening - and so only adds to short-term uncertainty. In this sense it's too early to say whether the correction in shares that began last month is over or not.

The same applies for Australian shares. The initial reaction in the Australian share market has been negative, but any negative economic impact on Australia is likely to be minor and short-lived and Australia is likely to be a key beneficiary of increased raw material demand as Japan rebuilds. With the Australian share market now trading on a forward price to earnings multiple below 12 times, Australian shares are well placed to rebound once the correction in global shares has run its course.

In terms of sector-specific impacts, the earthquake is likely to be negative for insurers and uranium producers, but positive for gas and thermal coal producers. It should ultimately be positive for commodity producers more broadly as rebuilding demand kicks in.

So far the Japanese quake has taken pressure off oil prices, on the assumption that refinery closures in Japan may reduce oil demand. This may be true short term, but ultimately it will mean Japan may import more refined fuel. So overall the impact on the oil price is ambiguous, with events in the Middle East likely more important.

Concluding comment

The events in Japan are heartbreaking. However, like all natural disasters the negative short-term economic impact should hopefully be less than feared and will give way later this year to rebuilding which will help boost growth.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital Investors

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact one of the following:

Financial Advisers

Your Business Development
Manager or call 1300 139 267

Personal Investors

Your Financial Adviser or call
us on 1800 188 013

Wholesale Investors

AMP Capital's Client Services
Team on 1800 658 404

Important note: While every care has been taken in the preparation of this document, AMP Capital Investors Limited (ABN 59 001 777 591) (AFSL 232497) makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.