

# MyConsultant

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## Aftershocks from Japan



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The world has been appalled by the horrifying events in Japan. The human toll is unimaginable. The economic impact will gradually be revealed. Most obviously there has been a massive destruction of wealth. The economic focus now is on the economic growth implications both for Japan and the global economy.

This event has occurred while the world is still working through the fallout from the developed world's excessive build-up of debt and the resultant global financial crisis (GFC). Importantly, global growth rebounded strongly post the GFC and the world is now in much better shape to withstand further shocks. US growth in particular continues to exceed expectations and is following more an 'old normal' than the envisaged muted 'new normal' recovery path. Manufacturing and export demand (helped by a weaker dollar after two rounds of Quantitative Easing) have been particularly impressive, employment has risen and the unemployment rate has dropped (though partly due to a decline in the labour force) but housing construction remains depressed. Nevertheless recent US business cycle indicators are impressive and both capital and consumer spending are strong. Super high profits support capacity expansion and should support continued employment growth.

All this should make us more sanguine about the global impact of the Japanese crisis. Indeed the near term global recovery looks set to continue. However, while on the surface it may seem like the global economy is returning to normality, sky high debt levels have barely begun to decline in the US, are still rising in Europe and are certain to rise in Japan. This means that the global economy remains far more vulnerable to shocks and crises than is normal. It also means that there must be doubt about the medium term resilience of growth in the absence of regular liquidity injections and extremely stimulative fiscal policy.

Adding to concern is the fact that the Japanese disaster has occurred coincidentally with a significant rise in oil and food prices, with the latter contributing to Middle East unrest which has served to push oil prices higher still. An oil price rise acts like a tax and is a counter to stimulative policy settings. This rise is of a magnitude to have a significant effect on growth if sustained (a rule of thumb is that every prolonged \$10 rise reduces global growth by 0.5%). All this occurs at a time when the developed world has exhausted its traditional policy levers, and quantitative easing has become the policy of choice.

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The oil price impact on the global economy will take time to come through and will depend on how high prices go and how prolonged the rise is. The Japanese crisis presents a more immediate negative for growth. However, it is unlikely to de-rail the global economy—after all, Japan's growth has been in the doldrums for 20 years, and it is a very long time since it was a driver of global growth. Japan has been a passenger not a driver of the growth recovery.

The most optimistic view is that this crisis in Japan could ultimately end their slump. While in the short term electricity shortages (which could go on for some time), factory closures to check for damage and supply disruptions will constrain growth, in the medium term there will be a boost to growth from catch-ups on lost production and reconstruction efforts. After the Kobe earthquake in 1995 there was such a boost to growth but it did not end the malaise. While the well known stoicism of the Japanese is admirable (and vital in current circumstances), their extraordinary tolerance for inadequate political leadership and deficient structural reform has prolonged the slump. Lack of leadership and strategic direction, in combination with a declining population, do not auger well for the future. However, there was recently a glimmer of hope in a draft government plan to allow private sector investment in state owned infrastructure. It would be very positive for Japan if the bureaucratic barriers to efficient allocation of resources were progressively broken down. Perhaps it is finally the right time for this to occur and this together with the reconstruction boost to growth has the potential to end the slump.

Risk-on/Risk-off market behaviour has fluctuated with the unfolding of the Fukushima nuclear situation, the evolution of Gulf instability (particularly fears flow-on to Saudi Arabia, Kuwait and Bahrain), and concerns about developed world debt. At the time of writing markets had shrugged off warnings about US sovereign debt and the 'risk-on' trade was well and truly underway again.

Looking at the broader macro backdrop, in the medium term the course of policy action remains a critical variable. It is uncomfortable that we have a global economy that is in a less than sound state combined with a sequence of adverse shocks. The most positive medium term scenario is that the developed world would commence a prolonged period of deleveraging; if debt levels do not decline we risk a further financial crisis. While private sector leverage has declined, this is not (yet) a sign that we are on the path to normalisation; it has been made possible via an increase in public sector debt. However, household savings rates have increased which is a positive for economic stability but it does potentially reduce growth.

These latest shocks do not significantly change the principal investment themes we are focusing on, and at present our assessment is that no significant changes are required to our medium term scenarios. They do, however, affect scenario probabilities. The events in Japan push out the time frame within which policy settings will be normalised ... and that, together with commodity price rises, increase the risk of an ultimate inflationary end game.



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