



Economic Flash!

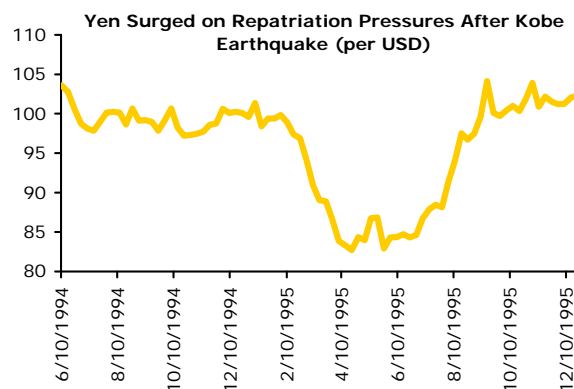
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Economic and Financial Impact of Japanese Natural Disaster

- On March 11th 2011 Japan was hit by the strongest earthquake since modern record-keeping began. While the information needed to make a full damage assessment is not yet available, the reports so far point to a tragic loss of life and sizeable economic toll. The last major earthquake to cause devastation in Japan was the 1995 Kobe quake. An examination of the sequel to that event may hold potential clues as to the impact of the more recent disaster.

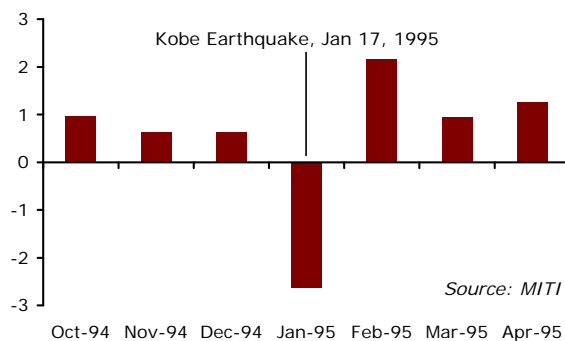
- One of the more visible near-term financial effects of the Kobe quake was a 20% rise in the yen against the USD over the subsequent quarter (Chart 1). Early estimates put insured losses from the latest quake at around \$30 billion, suggesting heavy repatriation of funds to Japan by insurance companies to pay claims. Some other firms and individuals may also sell foreign assets to fund reconstruction in Japan, putting upward pressure on the yen. While the resulting demand for the yen could help lift the currency further, the yen's rise is unlikely to match the run-up seen after the Kobe quake for a number of reasons, including heavy liquidity provision on the part of the BOJ. Given the quake's direct adverse effect on exporters, any significant rise in the yen would carry an increased risk of intervention from the central bank.



- Following through on its post-quake pledge to ensure financial stability, the Bank of Japan has so far provided up to ¥15 tn in addition liquidity (same day settlement) to affected financial firms in the region most affected by the quake, with a pledge of more to come if needed in the days ahead. The Bank has also doubled the size of its previous ¥5 tn asset purchase program. That includes ¥3.5 tn in additional ETF, REIT and other private sector assets plus an additional ¥1.5 tn of JGBs and Treasury discount bills. This should put downward pressure on funding costs and broadly ease elevated demand for the yen, countering the tendency for the currency to rise.
- Japan's GDP grew at a 4%-pt rate in 2010, leading some to hope that the economy was beginning to emerge from another "lost decade", before the disaster struck. Heavy as the blow from Friday's earthquake appears to be, the area most impacted accounts for about only 7% of GDP, about two-thirds of the output of the area affected by the Kobe quake, which hit one of Japan's largest ports and industrial areas. That incident, which cost about \$120 billion in today's dollars, did not however involve either a tsunami or the severe nuclear power problems that are likely to add to the cost of this disaster.

- The economy rebounded quite rapidly from the Kobe quake. Industrial production fell 2.6% in January 1995, but then rose 2.2% in February and 1% in March (Chart 2). GDP growth in 1995 and 1996 averaged 1.9% and 2.6%, also above the long-term trend. While it could take somewhat longer to recover from the latest quake, the same general pattern should hold, with the near-term drag being offset by a lift to growth in the second half of 2011 and 2012, as repair and reconstruction efforts begin in earnest. Some preliminary estimates put repair and reconstruction expenditures at around 1% of GDP.

Japanese Industrial Production and Kobe Earthquake
(m/m % chg)



- Given the prospect for large covered losses, insurers' shares took the brunt of selling right after the quake, contributing to the stock market's near double-digit decline. Looking at the implications for other sectors, a focus on obtaining food and other necessities of life is likely to hurt demand for luxury goods. Tourism, which accounts for just over 2% of the country's GDP, is also likely to suffer. Much of the country's auto production is located south of the capital, away from the quake site and assemblers and some parts producers have also shifted production offshore in recent years, to be near customers. While that could cushion the blow to some extent, the auto sector and other manufacturers are likely to be affected for some time by ongoing disruptions to country's transportation and electrical power systems.
- Coming just a month after a Moody's rating downgrade, the quake is likely to intensify pressure on the Kan government to bolster spending, straining the county's already precarious finances. While much of the total is held domestically, Japan's 200% debt-to-GDP ratio is the highest in the G7 by a wide margin. Even before the quake struck, the primary (non-interest) deficit was expected to readily surpass 2% of GDP this year, also extremely high.
- Led by insurers, the Tokyo stock market has plunged by about 8% since the disaster hit. Given continued strong earnings growth in the US and Europe and support to valuations from low yields, the disaster's impact on equity markets outside Japan should continue to be limited.

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