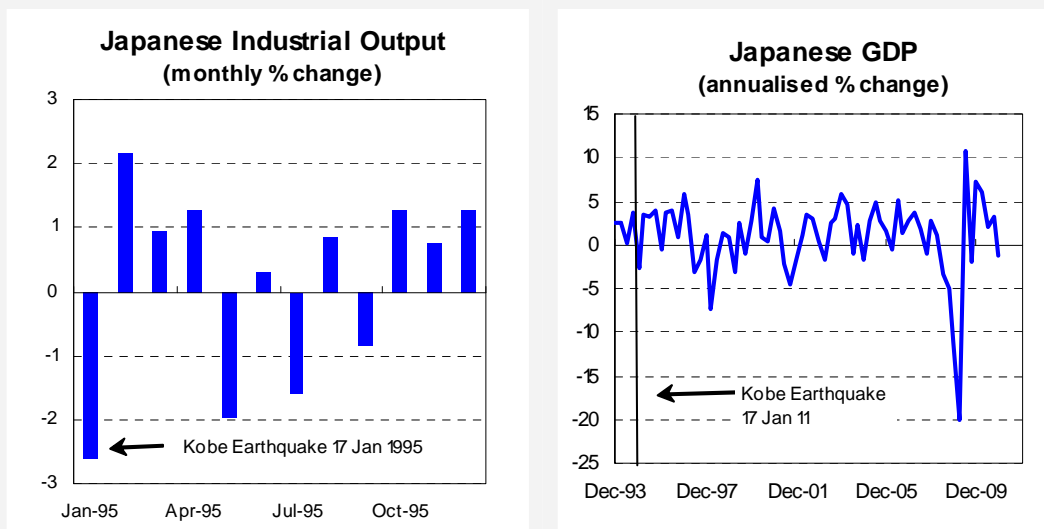


# JAPAN ECONOMIC UPDATE

Tuesday, 15 March 2011

*The human tragedy from the earthquake and tsunami that struck Japan on March 11 is significant and tragic. Below we take a look at the economic impact. We stress that this preliminary economic analysis pales in significance to the lives lost and affected.*

- Economic activity will be under significant downward pressure in the short run. Japan is likely to enter a recession this year.
- We expect the JPY to appreciate, largely from an increase in net inflows to Japan. We also expect AUD/JPY to be under downward selling pressure from this disaster.
- Global growth forecasts are likely to be shaved lower. The risk appetites of investors are being hurt. It has been reflected in sharp falls in share market bourses.



Japan's worst earthquake, which was followed by a devastating tsunami, struck on Friday afternoon of March 11. The Tohoku region in the north-east of Japan was the worst affected. There are six prefectures within this region; the Miyagi prefecture is worst affected. Overall, Tohoku region accounts for approximately 6½ of Japan's gross domestic product (GDP).

## Economic Implications – Japan, World & Australia:

Comparisons are being made the earthquake that occurred in Kobe of Japan. Kobe occurred on 17 January 1995. This earthquake caused ¥10 trillion in damage, equivalent to about 2.5% of Japan's GDP. The Japanese economy was hurt in the near term from the Kobe earthquake, but it recovered relatively quickly, helped by the government adopting an extra budget worth around ¥3 trillion. The industrial production and GDP charts above show how the economy recovered relatively quickly.

However, there are some notable differences between this latest disaster and Kobe. The negative impact on economic activity may therefore be greater and recovery may take longer. These differences make forecasting more difficult and subject to greater error.

There are three notable differences. Firstly, the damage is likely to be much more widespread this time due to the combination of an earthquake and tsunami. Rescue operations are therefore also likely to be more involved and take longer.

Secondly, there are problems with the nuclear reactors in Japan. It means there may be longer disruptions to power supply. Some manufacturers in Japan, according to some sources, are planning for power outages for a full year. There are also risks of a serious nuclear catastrophe with risks of further radiation leakages.

Thirdly, the human death toll is likely to be larger.

The initial economic impact is negative as production is disrupted as a result of damage to factories, the power supply, transport infrastructure, confidence, and to housing. This then gives way to recovery as rebuilding kicks in and production returns to normal. For example, after the Kobe earthquake, industrial output fell 2.6% in January 1995, but bounced back in February and continued to rise in March and April.

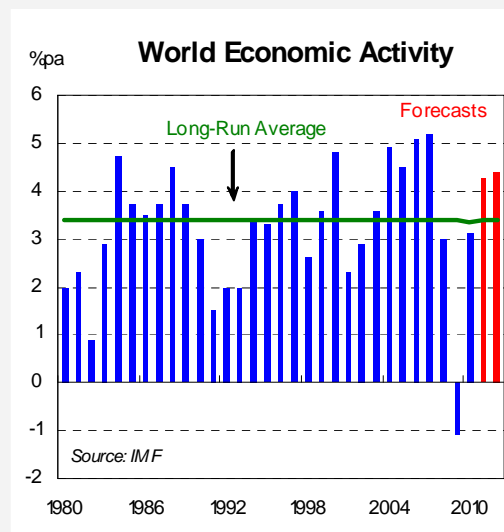
It is expected that Japan will record a technical recession this year (a recession is defined as two consecutive quarters or more of contraction in GDP). Reconstruction will boost economic activity in the medium term but the net effect for 2011 is unclear at this stage. Much depend on how long it takes to get the nuclear threat under control.

The Japanese government is likely to lift spending to support economic activity and help in recovery efforts. The high level of government debt to GDP and official interest rates close to zero, however, will compound government efforts. Japan's fiscal problems were highlighted only two weeks ago when Moody's threatened to downgrade Japan's credit rating.

The Bank of Japan (BoJ) is trying to give its helping hand; on March 14 announced it is expanding its asset purchase program to 10 trillion yen, from 5 trillion yen previously. The purchases are to be made by June 2012.

Initial estimates from AIR Worldwide released on March 12 place the economic loss at approximately US\$100 billion. Preliminary estimates of insured losses are US\$15-\$35 billion, according to both Moody's and Fitch ratings agencies. These losses are estimates and so may rise further as the assessment of the damage improves in coming days and weeks. Insurance claims should result in net inflows to Japan, from a few key channels.

Japan is the world's third largest economy. It accounts for a little under 6% of world GDP. However, the trend has for some time been one in which Japan's share of the world economy is declining. In the early 1990s, Japan's share of world GDP was considerably higher in the double digits.



The International Monetary Fund (IMF) estimates that Japanese economic growth accounted for about 1% of the world's growth rate over the past five years. It means the near-term falls in output in Japan will hurt global growth but the negative impact may be

relatively modest. It also means that this disaster is likely to be a smaller negative risk to world economic growth than what it used to be.

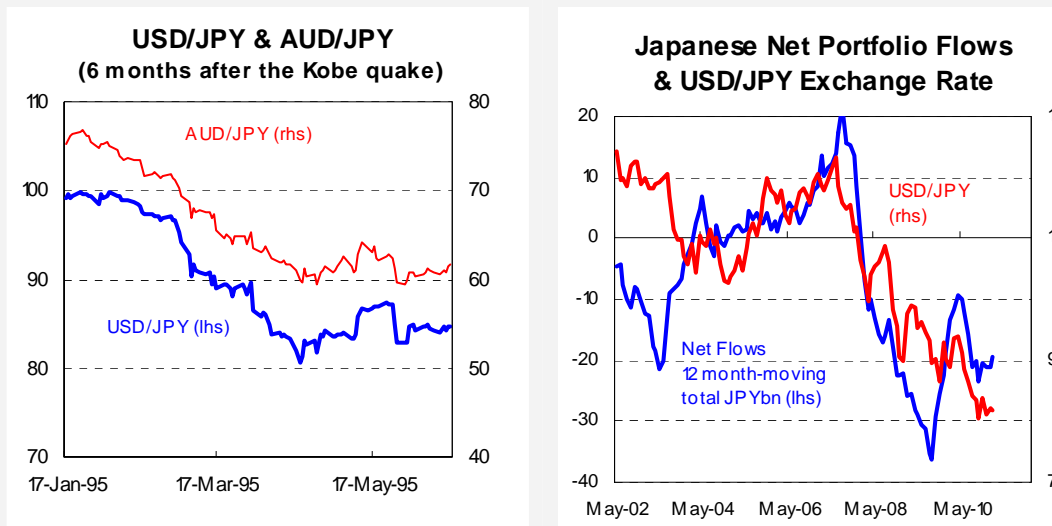
The IMF predicts that the world economy will grow by 4.25% this calendar year. This growth rates is well above the long-run average for world economic growth of around 3.4%. So it is unlikely that the disaster in Japan will hurt world economic growth by enough to push world economic activity under the long-run average. Nevertheless, it may shave global growth prospects for the first half of this year. It also is likely to contribute to some heightened risk aversion in the near term. Heightened increases in risk aversion are reflected in sharp falls in world share market bourses. Japan's Nikkei share market index today entered bear market territory. A bear market is defined as a fall of more than 15%. The Nikkei has fallen by 14.5% since March 11 and by 17.2% from its peak last week (on March 9).

Japan is Australia's second largest trading partner. China is Australia's largest. Approximately 18.5% of Australian exports are destined for Japan. In terms of total two-way trade (i.e. includes both exports and imports), the share sits close to 12%.

So the prospect of a sharp fall in Japanese economic output is likely to shave some of Australia's growth prospects. However, we still believe that the core fundamentals remain unchanged in Australia. Further, Australia's prospects are more closely tied to that of China (Japan's largest trading partner). Japan is China's largest source of imports (the share is a little over 20%). It suggests that China may need to look to alternative markets for some of its imports.

#### Currency Implications:

Japan is the world's largest creditor nation and has the world's second largest current account surplus.



We expect the Japanese yen to gradually appreciate in coming months, as net fund inflows to Japan rise. The rise in net foreign inflows will come from a few channels.

Firstly, foreign insurers and domestic insurers may need to sell their foreign holdings of assets. Secondly, rebuilding and recovery efforts should eventually boost Japanese GDP and channel Japanese savings inwards. Thirdly, overseas help for the rebuilding efforts may lift net inflows to Japan. Finally, measures of risk aversion reveal that risk aversion is rising among investors. Typically, risk aversion among the Japanese investors helps the JPY appreciate.

Kobe experience reveals that the depreciation is not immediate (refer to the chart on the left) but is more gradual in nature. The relationship between capital flows and USD/JPY is tight.

When the Kobe disaster occurred, there were net sales of foreign securities between January and April 1995. Outstanding investments in foreign securities by Japan in 1995 were significantly smaller than now (¥85bn compared with around ¥266bn yen). It suggests that there is more potential for larger repatriation flows to Japan and a greater potential for the JPY to appreciate.

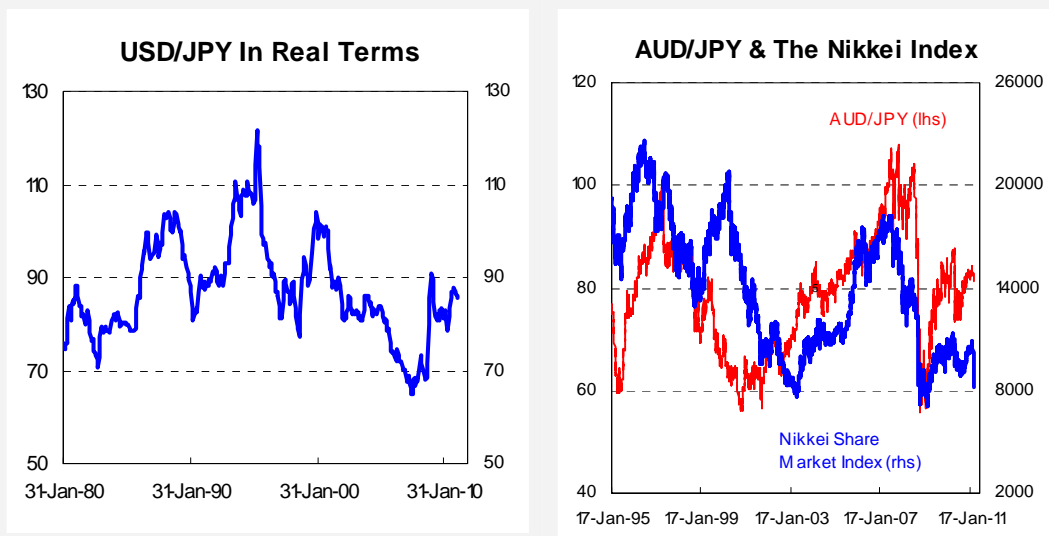
In nominal terms, USD/JPY is near record lows but in real terms USD/JPY is well above record lows (see chart below). It suggests that USD/JPY can still move lower in nominal terms.

If the JPY appreciates sharply, we would not rule out the BoJ stepping into the market to intervene.

In terms of the AUD/JPY exchange rate, we would expect this currency pair to be under downward pressure over coming months as USD/JPY depreciates. AUD/USD may also come under modest downward pressure.

The AUD is closely positively correlated to risk appetites and movements in Asian equities. The Japanese share market has officially entered a bear market today with the Nikkei bourse falling by more than 15% over the last four trading sessions. The Nikkei has posted its biggest daily decline since October 2008. Other Asian share markets have also recorded sharp falls.

Both risk appetites and equities are falling, suggesting the AUD is under selling pressure in the near term. If the Japanese situation deteriorates further, the AUD could be eyeing a break under the USD0.9800 handle in the very short term.



**Debt Market Implications:**

The repatriation of capital to Japan will also have an impact on debt markets. The Japanese government is likely to increase spending to fund the recovery efforts. The expansion of the government’s fiscal deficit may not necessarily cause investors to shift funds offshore. So we expect that there may be some upward pressure on Japanese long-term bond yields.

Japan’s holdings of Australian debt are estimated at just over \$50 billion. Selling of some of this debt for repatriation purposes could place some downward pressure on Aussie debt prices. Japan’s holdings tend to be largely in the highly-rate securities.

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