

# Financial Insights

with Australian Unity Personal Financial Services

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## One Woe Doth Tread Upon Another's Heel

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As Shakespeare wrote centuries ago, (and paraphrasing just slightly) there's nothing so bad that it can't get worse.

January brought floods and a cyclone to Australia. In February, we witnessed the calamitous Christchurch earthquake. But neither compared with the devastation of the Japanese earthquake and accompanying tsunami in mid-March.

Financial markets took fright at the possible consequences of so much damage to the world's third-largest economy, with the **world share market index** falling by more than 4% in just three days.

The Australian share market, which had already fallen by more than 4% from its early-March level, dropped by a further 2.5% in two days.

And yet, some two weeks later, markets are generally back above where they were on the day of the quake. For the month of March, the US share market fell by just 0.1%, to be up by 5.4% in the first quarter of the calendar year. The Australian market rose for the sixth time in the past seven months, albeit by just 0.2%. For the year to date, the Australian market is up by almost 2%.

And, by the way, April has historically tended to be a good month for share markets. In the past 70 years, the average gain in the month in the US market has been 1.4%, second only to December.

There is no question that the Japanese quake/ tsunami had, and will continue to have, massive economic effects. The Japanese economy has a rough time ahead of it, not least because of the extraordinary blow to confidence. GDP will fall significantly in Q2 2011, but should show stronger growth thereafter than would otherwise have been the case.

The human costs of the tragedy (so far, close to 30,000 dead or missing) and the loss of capital stock (perhaps equivalent to 3% of one year's GDP) are immense, of course, but I made the point two months ago that, **up close, analysts tend to overestimate the economic (and hence the financial-market) effects of disasters.**

This is not to say that they have no lasting effect, only that it's usually less than first feared. In 1872, John Stuart Mill, the English economist and philosopher, marveled at *"the great rapidity with which countries recover from a state of devastation; the disappearance, in a short time, of all traces of the mischiefs done by earthquakes, floods, hurricanes, and the ravages of war."* Not a bad list of non-economic worries that markets have had to contend with so far this year!

Much has been made of the **relatively limited economic effects of the Kobe earthquake**, which struck in January 1995. The quake was smaller (6.8 on the Richter scale compared with 9.0 on this occasion), and there was no accompanying tsunami, but the area affected was more important economically (at the time, Kobe was the sixth-largest container shipping port in the world). Japan's manufacturing output plunged by 3% in January 1995 and there were major, but very short-lived, effects on exports.

But the global economy was scarcely affected.

There is one crucial difference on this occasion, however: the large-scale power outages caused by the damage to the nuclear power plants. These have already caused major disruption to supply chains. The short-term effect on manufacturing production may be three times as large as that which followed the Kobe earthquake.

There has thus been much speculation of severe economic effects **outside** of Japan. This is quite unlikely in my view. It's true that Australia's exports may suffer temporarily. Japan is still our second-largest export market, but it accounts for less than half the share of our exports than it did 30 years ago. Our total exports actually increased in the March quarter of 1995, at the time of the Kobe earthquake. The US economy will scarcely notice anything. The area at biggest risk of fallout is South-East Asia, along with Korea and Taiwan.

Of course, all of this is written on the assumption that the nuclear threat does not escalate. And none of it denies that what Japan has just been through may well turn out to be the largest economic disaster ever when measured by its effect on global GDP.

One of the concerns about the way in which the Japanese situation could affect the world economy is via its effect on **oil prices**. Ordinarily, a decline in output in the world's third-largest economy would have a negative effect on oil (and other commodity) prices. But this time it's different because of the nuclear-plant situation; there will be some substitution towards oil in Japan and elsewhere.

There is already concern about the escalation of oil prices, which have approximately tripled from their low of \$US37 per barrel in late-2008.

Surely, it is argued, this will strangle world growth! Not necessarily. Note first that most of the price rise was **caused by** stronger world growth. It had already hit \$US92 in December last year, before the increase in Mideast

tensions. Since that time, global GDP growth forecasts for 2011 have **risen**, by about 0.4 percentage point according to Consensus Economics.

The world is simply less sensitive to oil-price shocks than it used to be. Less than half as much oil is consumed per real dollar of GDP than was the case in the 1970s. Of course, much of the developing world remains vulnerable.

So if the oil price increase hasn't reduced growth forecasts, where has it shown up? The answer is in increased expectations of **inflation**. Globally, world inflation is expected to be 0.7 percentage point higher this year than seemed likely late last year. This is a very big revision in such a short period of time, and it does raise the likelihood of relatively early monetary tightening around the world.

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