



An earthquake, tsunami and nuclear crisis

Japan's largest recorded earthquake and subsequent tsunami has caused huge devastation and loss of life. Unfortunately events are still unfolding. Our hearts go out to everyone impacted.

Sadly, Japan is no stranger to natural disasters that have been brought about by earthquakes. This short note looks back at the last earthquake that took place in Kobe in 1995 to help provide an insight into some of the potential ramifications.

What happened after the Kobe earthquake?

The 1995 Kobe earthquake measured 7.3 on the Richter scale and almost 7,000 people lost their lives. It also knocked out essential infrastructure, including communication, highways, railways and water.

At the time, analysts thought it would take at least 10 years for Kobe to get back on its feet. Remarkably, two years later all of the debris had been cleaned up and infrastructure had been restored with greater insulation against future shocks.

Manufacturing and exports returned to similar pre-quake levels over a similar time frame.

Japan's most recent earthquake was more than 170 times larger than the Kobe earthquake and the subsequent tsunami has wreaked devastating destruction.

In contrast to Kobe, the Sendai region is less crucial economically. However, there are many differences this time round, which warrant caution when extrapolating from the past.

What's different this time?

The nuclear scare

The most obvious differences are the explosions at the nuclear facilities at Fukushima and the uncertainty surrounding radiation exposure.

Almost 30 per cent of Japan's power generation is nuclear. In the worst case scenario, Tokyo Electric Power Co estimates that power supply could be reduced by around 50 per cent if its operations are suspended at all nuclear plants.

Although Japan has halved its consumption of oil since the early 1970s, it is currently the third largest consumer of oil after the US and China.

Japan has very few natural resources and recent events in the Middle East and North Africa have highlighted this potential vulnerability.

For Japan, an oil supply disruption on top of a reduction in nuclear energy could impede reconstruction efforts.

For the world, it again brings the question of alternative, clean energy into greater focus.

Japan is already saddled with debt

Japan's government debt levels are already twice the size of its economy. This is far higher than the Eurozone countries, even high debt countries such as Greece, Portugal, Ireland and Spain.

A key difference is that the majority of Japan's government debt is funded domestically, so there is less dependence on global capital markets.

Even so, there will still be much concern over the coming weeks as to how Japan will pay for reconstruction without triggering further rating downgrades.

At the beginning of March, the Japanese government pushed a 92.3 trillion yen (\$1 trillion) budget through parliament. Officials have indicated that a significant portion of this budget will be redirected to relief and construction work.

Following the Kobe earthquake, the government spent approximately ten trillion yen on reconstruction, around 2.5 per cent of Japan's GDP. At that time, Japan's government debt was around 80 per cent of GDP, less than half of what it is now.

While economic activity initially declined, policy responses helped stimulate the economy, which was largely back on track a year later.



Before the earthquake hit, credit rating agencies Standard & Poors and Moody's had both already cut their ratings by two notches, with Standard & Poors warning that the Japanese government had no 'coherent strategy' to address its widening deficit.

This issue is likely to weigh on the markets for some time.

Official cash rates already near zero

Back in early 1995, Japan's official cash rate was 2.25 per cent. A year later it was down to 0.5 per cent.

This time Japan entered its crisis with cash rates already at zero and persistent deflation (falling prices).

The Bank of Japan has already injected more than 20 trillion yen into the financial system to stabilise credit markets. Financial markets are functioning 'normally' but the cost of insuring Japanese government debt has increased by about 30 basis points.

Japan has also doubled its asset purchase program, but the scale of this measure is only around 10 per cent in comparison to that of the US quantitative easing (printing money) programs.

What does this mean for the markets?

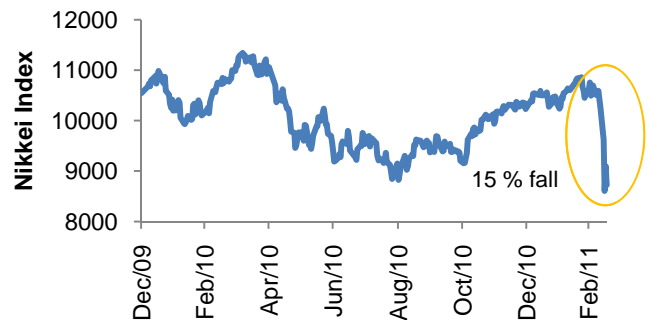
Since the earthquake struck last Friday, the Japanese sharemarket has dropped 15 per cent, as shown by figure 1.

This fall over the first five days is almost double that of the Kobe earthquake, when markets fell by 8 per cent.

This suggests that the Japanese market is priced for greater uncertainty this time round.

The yen has also come under pressure, rising to its highest level since World War II. G7 nations are considering intervening in currency markets to help take some of the heat out of the yen.

Figure 1: Japanese sharemarket fallen by 15 per cent



Source: Bloomberg, data up to 17 March 2011

The experience of Kobe indicates that the economy can recover relatively quickly from an earthquake. However there are a number of differences this time.

Japans most recent earth quake and tsunami follows a global recession and includes the risk of a nuclear disaster. In addition to this, Japan already had record levels of government debt and no leeway to further reduce the official cash rate.

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