GIC Update

March 14th, 2011

The Impact of the Japanese Tragedy

Massive earthquake struck North-eastern Japan on March 11, 2011

The March 11 earthquake and the following tsunami struck hardest in the northern region of the main island of Honshu. As a first consequence, production has been temporarily halted at some oil refineries, steelworks, auto, nuclear power and other production facilities. The area (Tohoku) accounts for approximately 8% of Japan's GDP.

Although the situation is devastating from a human perspective with a very serious risk related to an unknown nuclear event, we think that it is still too early to gauge the extent of macroeconomic impact on the Japanese economy as well as the global economy. The economic impact on Japan would likely depend on how long it takes to regain its lost capacity. The fact that the disaster hit about 200 miles northeast of Tokyo, the nation's population center, and well north of Japan's primary manufacturing region may have softened the immediate economic consequences, although the impact should still not be underestimated at this point, especially with the potential meltdown at a nuclear power facility.

The Japanese government has so far been quick in terms of their policy responses to maintain financial stability

The Bank of Japan has been quick to assure the Japanese economy that they stand ready to take the necessary precautions to stabilize the economy. They have poured 15 trillion yen ($183 billion) in short-term liquidity into the economy and increased the size of their asset purchase program to 10 trillion yen (from 5 trillion yen).

Economic and Fiscal Policy Minister of Japan, Kaoru Yosano, stated that the government still has 1.3 trillion yen in discretionary funds from the budget for the year through March 31 that can be allocated for disaster relief and opposition parties have said that they would cooperate on any necessary supplementary budget measures.

Our view on the situation

In the near term, we think that the markets' main focus will likely be on the efforts to contain - and assess - the extent of damage caused. Thus, an elevated volatility in the Japanese financial markets could be expected in the near term. However, it is important to note that Japan is largely operating as an insulated entity on the debt side (debt mainly owned domestically) and Japanese equities are generally only a residual place in global investors' asset allocations. On the currency side, the yen is still a very important currency but due to the low global interest rate environment it has lost some of its importance regarding carry trades. Thus, the impact on global financial markets from this Japanese incident may be limited.

While the recent calamity will likely have negative near term effects on the Japanese economy, it is likely going to be short lived as the Japanese government is already starting to propose rebuilding. Short term disruptions due to power outages, infrastructure problems, damaged manufacturing facilities and the potential radiation from Japan's nuclear reactors may slow down economic activity. However, the long term prospects of the economy remain the same as the economy may likely pick up as government efforts to rebuild the nation take effect.

In addition, markets over the last few weeks have already shown strong resilience given developments in the Middle-East/North Africa, Euroland (Spain downgrade, ECB Trichet's comments on interest rates) and China announcing lower GDP targets. Against this background we will not change the GIC assessment of the global economic perspective at this time and consequently are not recommending any change to the asset allocation. However, we will monitor further developments (not only) in Japan closely and keep you updated in case a reassessment of the situation appears necessary.

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