Global Uncertainties and Currencies

The earthquake in Japan, the third largest economy in the world, has come at an awkward time for the global economy. It adds further to the uncertainties and volatilities, on the back of the still extremely tense situation in the Middle East. The conflict in Libya remains unresolved at the time of writing, but Arab support for the NATO actions seems to be waning as it will surely hit the civilian population, howsoever carefully the missile and bombing attacks are targeted. Incidentally, one has read analysts arguing that a disruption of oil supplies from Libya may not matter too much since it accounts for just about 2% of the global consumption. It is, however, worth recalling that there is little proportionality to changes in demand: supply gaps, and price changes, the latter generally being far more volatile than the former. To add to the uncertainties, terrorist attacks in Jerusalem seem to have restarted after a long gap. And, could the preoccupation of the West with the Arab countries tempt Israel to take the opportunity to destroy Iran’s suspected nuclear capabilities? So, do not rule out the possibility of oil going up to say $ 150 (or even more) a barrel (latest Brent crude price $115.30).

Nor is the overall economic picture any more stable in the West. The U.S. seems politically too divided to put in place any definite plan to curb its twin deficits – fiscal and external. In Europe, the Portuguese government fell last week and the election uncertainties would surely add to the country’s already serious sovereign debt problem. At the time of writing, there is no news of whether the European Union Weekend Summit has succeeded in hammering out an agreed solution to Europe’s problems. Chances of course are that, in typical Euro style, some compromise may well have been hammered out in the early hours of Sunday.

The world’s second largest economy, namely China, recently came out with its latest 5-year plan. The twin objectives seem to be to bring the inflation down and simultaneously boost wages in order to increase consumption as long demanded by the G-7. The plan aims at a lower growth to achieve this but, unlike our experience at home, the Chinese economy always seems to achieve growth well above planned target, just as projects often get completed before their scheduled time.

The Japanese triple tragedy – earthquake, tsunami, and the very dangerous situation in the nuclear power plants – has also brought into sharp focus how the effectiveness of complex supply chains, which are at the heart of globalization of output, is crippled if there is a crisis or major problems in a large manufacturing or high technology economy. While Japan has outsourced of lot of manufacturing, critical components continue to be made within the country. A disruption of supplies would affect manufacturing output in other countries as well.

The post-earthquake yen: dollar movement reminded many people of what happened in the wake of the Kobe earthquake in 1995: the yen had surged from around JPY 100 to less than JPY 80 In the following four months. (One incidental consequence was the tsunami which hit Barings Bank: Mr. Leeson’s naked bets on the Nikkie Index suffered so much loss as to make the 300 year old bank worthless.) Just before the recent earthquake, the yen was trading at around JPY 83. Immediately after the scale of the earthquake got known, the currency started strengthening sharply and at one stage had hit an all time high of JPY 76.25 against the dollar. The expectation that drove the market was that the loss claims would force Japanese insurance companies to liquidate their foreign investments and repatriate the money to their home country. Given that the Japanese market had fallen sharply, liquidating foreign investments was probably better than selling domestic assets. Inasmuch as markets work on expectations, this logic led to traders/speculators buying yen. The yen’s rise surely hit stop losses of any short yen players, leading to there being forced to purchase the Japanese currency, in a text book example of feedback loops. It is interesting that the yen surged less than a week after Japan reported an all-too-rare deficit on trade account for January, and a halving of the current account surplus. The G-7 intervened heavily, selling yen on a massive enough scale ($ 25 bn?) to take it close to its pre-earthquake level. Since then it has risen a bit in dollar terms, to JPY 81.30 at the time of writing. And, the euro has risen to $ 1.4158, despite the problems in Portugal: the third domino in the Euro zone could well fall, with Portugal joining Greece and Ireland, sooner rather than later.

So far the Japanese tragedy and the loss of output for at least a few months it may lead to, have not impacted commodity prices. Also, chances are that the economic impact of the natural disaster may prove short-lived. As the World Bank says, “If history is any guide, real GDP growth will be negatively affected through mid-2011. Growth should pick up in subsequent quarters as reconstruction efforts…accelerate.”

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