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Near-term Outlook For A Troubled World

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Although 2011 is only three months old, the world has changed dramatically. Along with the evolving European debt crisis, seemingly -isolated Tunisian protests grew to varying levels of upheaval throughout the Arab world, and an historic earthquake and subsequent tsunami have left Japan's outlook under a cloud of uncertainty. Each of these situations is significant in its scope and magnitude, but by focusing on just the key elements, the main risks can be appreciated.

Japan

- Economic impact likely to be localized and deep but relatively short-lived from a national perspective
- Reconstruction will provide prolonged but modest economic stimulus, but contribute to price pressures as well; global impact will target specific supply chains versus broader industry
- Fukushima reactor disaster will have limited impact within Japan, loss of electrical capacity is the greater threat to long-term outlook

Over the past month the images from the earthquake, tsunami, and nuclear accident in Japan have evoked images from some of the worst disasters in a generation, along with vigorous discussion of similarly apocalyptic scenarios and forecasts. And from a humanitarian perspective, the loss of life and property will be indelibly etched in the country's mindset. But strictly from an economic perspective, as more information is released and the situation moves toward recovery phase, the facts suggest that the nation will experience only a moderate recession overall, and that the rebuilding will provide only modest economic stimulus in H2 2011.

The prefectures that sustained the most damage—Miyagi, Fukushima and Iwate – represent one of the country's bases for heavy industry, and the Fukushima nuclear plant accounts for 6% of the country's electricity generation. The destruction caused by the earthquake itself was not as severe as one might think, as these areas have a long history of seismic activity and were considered prepared for even a 9.0 temblor. Rather, the bulk of the damage was caused by the subsequent tsunami, which at its deepest incursion pushed inland by five kilometers. In this regard, the destruction was primarily residential, with the industrial heartland mostly intact. So despite the horrible loss of life – with casualties in excess of 20,000 people – and the displacement of hundreds of thousands more, most of the economy's production capacity (in value terms) remains intact and able to resume production.

The main challenge for the Tokyo government will be addressing the displaced population, as restoring the affected areas may be neither possible nor feasible. Reconstruction of the coastal areas will require more than just property repair, as entire roads and bridges need to be reestablished to ease supply bottlenecks for future construction. To complicate matters further, massive seismological shifts caused broad stretches of land to sink, capturing the seawater and rendering some farmlands unusable, while other coastal areas have suffered such severe infrastructure damage that they may be considered a total loss. This logistical nightmare will require an extended period of repair, and relocation will be the more cost-effective option in a

number of cases. However, the main recovery phase will gain traction by the end of this year, offering a modest boost to overall growth, though probably less than most people are forecasting.

As the local economy gets reestablished, a certain amount of production will not be recovered. Of particular note are the factories producing parts for cars and computers assembled in other countries. The disruption of this one area of the supply chain has caused assembly plants not just in Japan but in other developed countries to go on work slowdowns due to thin inventories. When facilities in Fukushima and Miyagi resume production, it will likely be at only normal capacity at best because downstream demand has abated as well. And even for those operations that escaped significant damage, many will still face problems from a shortage of electricity and perhaps a reduced staff count. And there is also the risk that with such restrictions on capacity, operations could opt against rebuilding and instead leave for lower-cost markets such as Malaysia and Taiwan. This suggests that at least on a local level, the economy will not exhibit the traditional V-shaped recovery but something more of an L-shaped turn.

Extending the effects of this disaster beyond Japan's shores, the global economy is unlikely to feel the impact in the broadest sense. While supply chains for specific products will be temporarily disrupted, Japan's economic slowdown will have a limited impact on its major trade partners. Over the past ten years, global economic growth has shifted strongly toward low-cost emerging markets such as China, which overtook Japan last year as the world's second-largest economy. Japan has been mired in economic stagnation for the better part of two decades, yet global output has increasingly expanded despite Japan's performance. The limited impact of this disaster on the global economy will be a sad affirmation of the country's reduced influence in the world.

With regard to the Fukushima Daiichi nuclear facility, while the situation will remain a significant concern for months to come, it appears at this point that the most dangerous moments have passed. Initial worries of a full meltdown and frequent comparisons to Chernobyl have died down to talk about how much of the facility – if any – can be brought back online and the time required to fully cool facilities deemed too damaged for further use and destined for entombment. The greater concern in an economic sense is how to make up for the lost capacity on Japan's power grid. Since national grids and power distribution have only limited fungibility, the loss is being accommodated through rolling blackouts and conservation measures. But with the Fukushima Daiichi plant accounting for 6% of the nation's electricity, making up the difference will be problematic, and a lingering detractor to the broad economy.

As Japan is entirely reliant on imports for its coal and oil needs, market prices for those commodities have risen under the assumptions of higher purchases to make up for the losses in Fukushima. Indeed, more production will be demanded from the country's oil- and coal-burning power plants, but it is not clear if there is enough extra power-generating capacity to compensate, and whether that surplus is geographically positioned to efficiently fill in losses in the northeastern prefectures. Plans are already being initiated to restart once-retired power plants on a temporary basis, but this is also a stop-gap measure at best. Barring a dramatic salvage of any reactors in the Fukushima Daiichi facility, Japan will have to struggle with capacity strains on its

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national power grid until new power plants are built. And yes, they will most likely be nuclear facilities. Japan's energy security depends on having a stable source of inputs for its power facilities, and prefers sourcing nuclear feedstock from the likes of Australia rather than buying oil from the Middle East. Internationally, Fukushima will become a rallying point for opponents of nuclear power and the industry may suffer a brief setback. However, most nations are willing to accept the trade-off of oil dependence for the risks of nuclear energy, and will press their development programs in turn.

As the damage totals rise, analysts are using comparisons with the 1995 Kobe earthquake to sketch out the impact of the most recent disaster on the economy. There are some parallels worth noting – an estimated 6,400 people were killed in the Kobe earthquake, and the damage was estimated at just over \$102 billion, or 2.5% of GDP at the time. However, to draw conclusions from this example overlooks some critical differences. Aside from the nuclear situation in Fukushima, the most gripping difference is that Kobe, a major urban center with a population of 1.5 million at the time, retained the necessary infrastructure to rebuild the city. The worst-damaged areas of the city lost one-fifth of their buildings (either destroyed by the quake or later condemned), and the main transportation infrastructure was largely recovered within a month. In Fukushima prefecture, the worst-hit areas experienced total destruction – mostly from tsunami waves sweeping entire areas clear of standing structures. Along with salt water permeating untold acres of farmland, the coastal villages have lost the capacity to be economically productive. Strictly in financial terms, there is a strong argument to be made for relocating surviving coastal residents to inland cities and writing off the destroyed areas as a total loss.

Middle East/North Africa (MENA)

- Transition suggests near-term instability throughout Arab nations, regardless of relative freedoms
- Spread of democracy a double-edged sword, with anti-Western interests poised to gain influence
- Uprising could be MENA's "European Revolution," marking the beginning of a prolonged period of transition throughout the region as the people gain voice

Most of the world was blindsided by the events in Tunisia, which over the course of one month grew from an isolated incident to a national uprising that unseated a president and inspired a region to rise against regimes once thought too deeply entrenched to be forced from power. The subsequent fall of Egyptian President Hosni Mubarak, a leader of the most populous nation in the region and an integral part of Arab world politics, showed that no government was safe. Now, protests and unrest are evident from Morocco to Bahrain, with Libya degenerating into civil war and Yemen on the brink of collapse. The Arab people have gained a voice, and calls for change will redefine the region.

As public discontent spread from Tunisia's Jasmine Revolution and into Egypt, outsiders hastily tried to connect the dots and see what other countries were vulnerable. Common elements seemed to be endemic institutional corruption and chronic unemployment, but protests also emerged from

sociopolitical differences, disapproval of government officials and issue-based differences. Even in relatively liberal, reform-minded countries such as Bahrain and Oman, people came out in unprecedented numbers to rally against government policies. And in the case of Bahrain, the government's harsh response to this activism turned a contained movement for reform into a violent demand for change, while aggravating the sensitive Shia-Sunni divide. Most governments in the MENA region are entirely unfamiliar with handling public discontent, and poor crisis management has been a key contributor to the spread of unrest and further emphasizes why the people want a change of leadership. In some cases the push is specifically for democratic reform, but in most cases the people want a government that responds to their demands, whether expressed through the ballot box or otherwise. And given the successful uprisings in Tunisia and Egypt, people throughout the region know that change is possible and can be brought about with enough effort. This suggests that 2011 will be marked by activism throughout the MENA region, with a significant possibility of economic disruption from social unrest and perhaps even civil war.

Internationally, concerns about MENA stability – primarily the Middle East – center around oil production. While the region is synonymous with massive oil industries, it is not coincidental that the countries with limited oil production also witnessed some of the worst disruption over the past three months (Tunisia, Egypt, Yemen and Bahrain). The region's major oil and natural gas producers (Saudi Arabia, Kuwait, Oman, Qatar) have been awash in funds and quick to spread the wealth as a palliative. The Saudis quickly put together a \$39 billion stimulus package, Kuwait sent each of its citizens KD1,000 (about US\$3,600) just in case, and other wealthy economies found ways to make sure the people did not have a strong economic incentive to protest. The one major exception to this so far has been Libya, which has rarely let its oil money flow down to the people and bears more resemblance to the corrupt, repressive institutions previously found in Tunisia and Egypt. In this regard, civil war seemed an inevitable byproduct of the Jasmine Revolution, and will serve as both a rallying point for protestors throughout MENA and a warning to governments still not convinced that the people cannot be ignored.

While few would argue that the spread of democracy throughout the MENA region is a positive development, it also gives voice to some of the more unsavory elements in the Arab world. In Egypt, the radical Islamist Muslim Brotherhood (MB) is possibly the most organized political entity aside from former President Mubarak's party, and would likely garner a significant percentage of the vote in a truly open national election. Considering the MB's hostility toward Israel, more fundamentalist ideologies and anti-Western sentiment, the conversion to a democratic process could turn one of the Arab world's mediators into a threat to stability on Israel's southern border. In Yemen, al-Qaeda has a significant though informal presence, and is kept at bay by the current government. However, as the country and leadership fall further into chaos, such a power vacuum could give the terrorist organization an established foothold on the Arabian Peninsula and a rallying point for other like-minded groups. Indeed, an abrupt shift to democracy could create a number of headaches for those interested in a stable MENA region.

As this situation unfolds, one cannot help but to draw comparisons to 1848, when a series of revolutions swept through Europe with varying degrees of success. The events of that year alone

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did not transform Europe immediately, and some changes were only temporary. However, those uprisings initiated a different approach to the political relations between the people and their governments, and over the next generation Europe was transformed. In the MENA region this same pattern seems to be unfolding, although with the odd wrinkle that the governments that have fallen so far have been constitutional democracies. This is possibly due to the fact that Tunisia and Egypt, while both democratic in theory, offered little in terms of free expression and were little more than autocracies with a thin veneer of public voice. For now, the important takeaway from this situation is that even after the last protests end, the old monarchies and new regimes will realize that the loyalty of their constituencies cannot be taken for granted, and may at times have to be earned. In all likelihood this implies further waves of change in the MENA region, including further activism, the possibility of more regime changes, and a prolonged period where a troubled region will have another significant risk factor to consider.

Euro-zone Debt Crisis

- Domestic political concerns will continue to shape, even stymie, ‘zone-wide decisions
- Increasing risk that Greece at least will undergo some form of sovereign debt restructuring before 2013
- Portugal will sign an EU/IMF funding agreement, likely sometime in May

After the apparent decisiveness with which the Euro-zone members put in place the rescue plan for Greece a year ago, then crafted a funding program for Ireland in November, the lack of progress in recent weeks has unnerved the markets anew. Two much-vaunted summits in March were supposed to come up with definitive plans for increased fiscal coordination between the 17 ‘zone members along with a final deal on a new, permanent funding facility. Although some progress was made, domestic political developments in a few members have delayed the key decisions to mid-late June.

A general election is due in Finland on April 17, and the current center-right coalition is being challenged by the opposition center-left and also by the populist True Finns party. Polls show a surge in support for the latter party, which is strongly euro-skeptic and opposed to “bailing out” other ‘zone members. Although True Finns is unlikely to lead the next government, a strong showing could leave the party in a position to play kingmaker in the next coalition, and could mean that Finland will take a tougher line in subsequent EU negotiations over funding.

Meanwhile, German Chancellor Angela Merkel has seen her domestic political standing further undermined after poor showings by her Christian Democrat (CDU) party in regional elections last month. In particular, the CDU lost control of the state of Baden-Wuerttemberg to a coalition of the Green Party and the Social Democrats. The loss occurred in one of the country’s most prosperous states, the heart of the Mittelstand – the medium-sized, export-oriented industrial companies that have underpinned Germany’s economic success in recent years – and a state that has been dominated by the CDU for 58 years. Merkel has not been brought down by the result – there is no viable alternative leader waiting in the wings of the CDU, and the partner FDP was so weakened in Baden-Wuerttemberg and elsewhere that it will be in no hurry to bring down the national

coalition. However, it adds to the perception of a weakened national government in disarray. Merkel had already lost her majority in the Bundesrat (upper house), where the 16 states are represented, and gains for the opposition will make it that much harder to pass any controversial legislation. Facing more regional elections in the coming months, the Chancellor is not willing to be particularly generous in the ongoing EU funding negotiations.

The two key issues still to be decided in June will be a proposal to get wealthy EU members to boost guarantees for the existing “temporary” European Financial Stability Facility (EFSF), and the precise parameters of the “permanent” European Stability Mechanism (ESM) that will replace the EFSF from 2013. At the first summit in mid-March, the Euro-zone 17 agreed to increase the effective lending capacity of the EFSF to the full €440 billion initially planned, up from the current effective capacity of about €250 billion (current capacity is limited by the need to maintain a AAA credit rating, so issues can only be guaranteed by AAA-rated sovereigns). However, a deal on expanding the national guarantees given by AAA-rated countries was stymied by Finland’s electoral calendar. With that country’s parliament now dissolved, any decision on increasing the EFSF’s lending capacity can only be taken by the next legislature.

Meanwhile, a few more details have been hammered out about the ESM. The facility will have a lending capacity up to €500 billion, ensured by a still-to-be-decided mix of paid-in capital, callable capital, and guarantees, and will be allowed to buy sovereign debt on the primary market (Germany had strongly resisted the notion of debt purchases from the secondary market). Merkel has insisted that the timetable for paying into the ESM be extended over a period of five years, rather than making bigger payments in a shorter time period – likely a way to give her government more fiscal room to potentially cut taxes before the federal elections scheduled for 2013. This could mean that the new facility’s effective lending capacity will be more limited than headlines suggest, which would undermine investors’ faith in the ESM’s role as funder of last resort. In addition, the new facility will have fairly stringent conditions attached and will place ESM (and IMF) obligations ahead of any private sector debt holders. It will also require an assessment of the sovereign’s “solvency” before any funds can be distributed. This makes it increasingly likely that one or more “peripherals” will have to undergo some form of debt restructuring event in order to get ESM funding from 2013.

The most likely restructuring candidate is Greece, followed by Portugal. Ireland would only have to draw on the ESM if it has not been able to stabilize its banking sector and economy by 2012. However, given the negative impact of any form of restructuring on banks in other EU countries, the EU (and narrower Euro-zone) will likely continue to do all they can to sweep debt sustainability questions under the proverbial carpet. This is bad news for taxpayers in Greece (and Portugal and Ireland) who will be asked to bear the burden rather than private sector and bank investors from the likes of Germany.

The first country to draw on the current EFSF – Ireland – released its bank stress test results at the end of March. (Greece’s funding deal was put in place before the EFSF was created.) On the positive side, the tests were based on realistic assumptions about growth. If the banking sector recapitalization and restructuring continues as planned, and if the economy sees some level of

growth this year, then the sovereign will be able to meet its funding obligations. However, there is still considerable uncertainty about the outlook for growth and for the banks. Market reaction to the stress test has been generally positive but government bond yields remain highly elevated – i.e., investors are not convinced that the economy and/or banks can recover. Medium-term, the outlook for Ireland is more positive than that for Portugal (or Greece) – the economy is more competitive and more broadly based, the export base is more diversified, and the population is younger. Ireland's "only" problem is the debt burden from the banking sector.

Finally, Portugal has now thrown in the towel and admitted that it cannot meet its funding needs without assistance from the EU and IMF. The details of an agreement have yet to be hammered out, but the various sides apparently are working toward a facility valued at around €80 billion, which implies about half of this will come from the EFSF and the remainder from the IMF. The deal will doubtless include stringent fiscal austerity demands and may also call for a number of state-owned enterprises to be privatized. After years of very subdued growth, it is likely that Portugal will be pushed back into recession by a new round of spending cuts and reforms. The government collapsed late last month and a snap election has been called for June 5. The make-up of a new administration remains highly uncertain but the next government will start life with its policy hands tied by the terms of a funding program that is bound to be politically unpopular. And, given the parameters of the ESM mentioned above, there is a risk that Portugal may see some form of debt restructuring event in 2013.

The one good piece of news in the Euro-zone debt crisis is that investors are increasingly buying the "three and out" story, i.e., that only three Euro-zone sovereigns will need external funding support (Greece, Ireland, and Portugal). Spain is not seeing the kinds of market contagion fears that erupted a few months ago. Its fiscal picture is certainly better than Greece's; its banking sector appears in better shape than Ireland's; and its medium-term economic outlook is more promising than Portugal's. The plan to recapitalize and restructure the small regional savings banks is well underway. Negative developments could yet trigger negative headlines but it appears that most of the "bad" news from the *cajas* is now known and that the sovereign has the willingness and the ability to see the plan through.

Meanwhile, although the Euro-zone 17 have agreed in principle that there should be closer fiscal monitoring and coordination, the devil will be in the details and some of the deals being suggested would require additional parliamentary approval in some countries. It is also worth bearing in mind that the Maastricht criteria developed before the founding of the Euro-zone were supposed to ensure that the current situation could never arise. Clearly, this did not work – not least because France and Germany ensured a weakening of the oversight and consequences part of the Growth and Stability Pact back in the mid-2000s. EU-level promises will always take a back seat to domestic political considerations.