

Risk assessment: Japan, oil, euro

Weekend headlines

- Nuclear crisis in Japan has not escalated further, some apparent progress instead
- Western-led coalition enforces no-fly zone in Libya
- Losses for German coalition parties in regional election ahead of EU summit

Risks to global growth

Three major risks to our positive outlook for the world economy and global markets have emerged so far this year: Japan, oil and the ongoing euro debt crisis.

- **Japan:** Regional disasters distort the quarterly pattern of regional activity, but do not change the global growth trend. That was the lesson from previous disasters such as the Kobe earthquake (1995), Hurricane Katrina (2005) and even Chernobyl (1986). In Japan, the worst-case scenarios (full-scale evacuation of Tokyo; giant nuclear cloud threatening regions far away) have not materialised so far. The less bad nuclear news from Japan over the weekend suggests that we can still classify the events there as a regional natural disaster with very limited impact on the world economy except for some short-term supply chain disruptions and a likely knee-jerk wobble in global confidence indicators.
- **Oil:** The surge in oil prices in January and February reflected largely an unexpectedly strong bounce in the global economy. Such a demand driven spike in energy prices and hence in the overall price level is a consequence of and not a threat to global growth as long as central banks do not overreact, which they do not seem to be doing. A major disruption of oil supply from the key producers around the Persian Gulf would be different, though. It could trigger a bout of stagflation in the oil-importing world. Whether the military action against Gaddafi that started over the weekend has raised or reduced the hypothetical risk of a major civil war in the Gulf region and hence a protracted disruption to global oil flows is hard to judge for an outsider. The risk needs to be watched. But it has not materialised. The events in Libya itself (2% of global oil output pre-crisis) do not jeopardise the global economic outlook.
- **European debt crisis:** So far this year, Europe has contained the crisis even better than expected at the end of 2010. Whereas small Portugal is trundling towards a likely bail-out more slowly than projected, much bigger Spain has moved a little away from the brink. As EU leaders get ready to agree on a more comprehensive anti-crisis package, the key hypothetical risk remains that the German parliament may refuse to ratify the compromises which Merkel looks set to strike at the 24-25 March EU summit. The debate within the parties backing Merkel remains lively. Still, the risk that the German parliament may trigger a potential Lehman-type financial crisis by saying "no" to an enhanced euro rescue shield continues to look small. The parties backing Merkel, notably the small and somewhat Euro-sceptic FDP, lost votes at the regional election in Saxony-Anhalt on Sunday. This highlights the risk that Merkel may also lose the more important election in the CDU heartland of Baden-Württemberg next Sunday. However, nuclear issues (and the fate of a railway station in Stuttgart) seem to dominate the state election campaigns. Regional election setbacks will probably not affect the euro policies of Merkel and the parties backing her in a major way.

On balance, we maintain our medium-term positive outlook for the world economy and global markets. Of course, the events in Japan and higher oil prices will probably be a modest drag on global growth for a few months. Leading indicators are likely to retreat for a while. But we still seem to be in a rock'n'roll recovery, that is in an economic recovery that is rocky but keeps on rolling despite some serious obstacles in the way. A very aggressive monetary policy is working.

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