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First Trust

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Monday Morning Outlook

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Japan, "Supply Shocks" and Money

While the news coverage of problems at Japan's nuclear power plants was sensationalized and misleading, the death toll from the Japanese earthquake and tsunami is horrendous. Moreover, the economic damage to the affected areas is substantial and will require a large re-direction of resources. Japan's economy will not gain from this shift in resources because the cost of repair only replaces what was lost.

That said, after the initial economic blow is fully absorbed, Japan's economy may accelerate for a time because people change their labor-leisure trade-off. Leisure will be much less appealing to working-age victims of the disaster who do not like their new (lower) standard of living. As a result, some of them may work harder and longer hours in the short-term in order to recover their lifestyle.

Either way, we are not worried about Japan healing from the disaster. The country is wealthy and did not get that way because of large endowments of natural resources, like oil. Although Japan has had problems with "crony capitalism" in its banking system, property rights are generally well-respected and contracts enforced.

The most dangerous and damaging part of the recovery will come from government response to the crisis. Over-regulation of nuclear facilities has the potential of creating long-term damage to global growth.

But, it is monetary policy that can have the most short-term damage. In economics, the disaster is what's known as a "negative supply shock," which is when the ability of the economy to churn out goods and services becomes suddenly and unexpectedly impaired. A hit to Saudi Arabia's oil fields is another example.

This type of supply shock is "stagflationary." Production goes down, while prices go up. But, this hit is self-correcting – increasing prices for goods produced in the damaged sector of the economy automatically incentivizes others to increase production. It also incentivizes users to look for substitutes. The free market automatically shifts resources to help solve the problem. Globalization makes this recovery process even more dynamic and the economy more resilient.

But rather than counting on this process of self-correction, central banks always print more money in a crisis. A looser monetary policy because of a negative supply shock may boost production faster in the near term, but it also makes the extra inflation related to the disaster even worse. In time, that just means more suffering down the road.

Our best guess is that the US will feel almost no *net* economic effect from Japan's disaster. But even if we do feel a small temporary negative effect, the disaster should in no way encourage the Federal Reserve to remain as loose as it is already, much less push the Fed toward a third round of quantitative easing.

Negative supply shocks may reduce real GDP growth. But, because inflation increases, they do not alter the growth rate of "nominal" GDP, which is what the Fed should ultimately be tracking with its overnight interest rate.

Printing money during times of crisis is always tempting and the closest analogy is like giving morphine to sick people. While morphine will help mask the pain, it does nothing to solve the underlying problem. In fact, it can sometimes make it worse.

As we have said, a supply shock raises prices for the goods or services affected. Increasing the money supply allows consumers to pay the higher prices, but also afford other items, too. In other words, central banks are attempting to keep the economy unaffected by the disaster. This can't work. There is real damage to the Japanese economy and the supply chain is affected. Allowing it to heal on its own is the fastest and best way to recover. Artificially covering up the pain extends the recovery time and creates inflation.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-21 / 9:00 am	Existing Home Sales - Feb	5.13 Mil	**5.210 Mil**	4.88 Mil	5.360 Mil
3-23 / 9:00 am	New Home Sales – Feb	0.290 Mil	**0.286 Mil**		0.284 Mil
3-24 / 7:30 am	Durable Goods – Feb	+1.1%	**+4.0%**		+3.2%
7:30 am	Durable Goods (Ex-Trans) - Feb	+2.0%	**+2.8%**		-3.0%
7:30 am	Initial Claims - Mar 19	380K	**378K**		385K
3-25 / 7:30 am	Q4 GDP Third Report	+3.0%	**+3.2%**		+2.8%
7:30 am	Q4 GDP Chain Price Index	+0.4%	**+0.4%**		+0.4%
8:55 am	U. Mich. Consumer Sentiment	68.0	**65.0**		68.2