

ECONOMIC OUTLOOK

by Richard Katz

Japan fallout from US credit woes No 'decoupling'

There has been a lot of talk lately that Japan is "decoupling" from the US economy. If this were true, Japan's recovery could forge ahead even if the US economy stumbled. However, we see few signs of "decoupling." On the contrary, the turbulence in Japan's financial markets unleashed by the US credit crisis underscores the links in dramatic fashion.

Moreover, Japan's current economic recovery is more dependent on US growth than any recovery in decades. That's because the recovery is extraordinarily dependent on exports. While Japan is shifting its exports from the US to Asia, Japan's ability to export to Asia hinges on Asia's own ability to export to the US.

Sub-prime fallout hits Japan

For most of this year—indeed, ever since autumn 1998—the closing price of the S&P 500 in New York has been followed 13 or 14 hours later by the closing price on the Nikkei 225 index in Tokyo (see top figure). The gyrations of the New York market over the last two months have been echoed in Tokyo. The tightness of the linkage can be measured by the correlation index, which goes to a maximum of 100%. During the May-August financial storms, the correlation of daily closings was extremely high at 88%. In fact, for the nine years since autumn 1998, the correlation has been 90%.

This tight linkage is new. During most of the 1990s, there was almost no correlation at all. But today, Japan's stock market has become very internationalized. Foreign investors now own nearly 30% of all Japanese shares and, on most days, account for up to 60% of the trades. In August, Japanese stock prices were driven down when US-based hedge funds sold stocks in order to raise cash. When the US Federal Reserve acted to calm the US situation, both the US and Japanese markets bounced back.

Because of the tight connection between Japan's exports, GDP growth and the profits of export-oriented manufacturers,

stock prices in Japan also echo the ups and downs of the ¥/\$ rate (see bottom figure). Since 2005, almost every time the yen weakened, stock prices rose; when the yen strengthened, stocks fell.

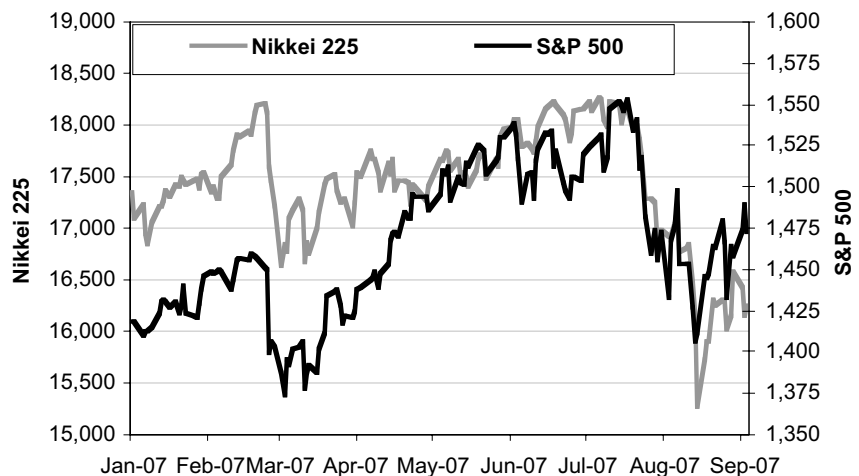
Once again, this tight connection is new. In the past, not only was the connection usually much looser, but sometimes it was in the opposite direction: i.e. stock prices rose when the yen rose, not when it fell.

The yen—whose recent weakness has been so critical to Japan's export drive—has likewise danced to a tune partly composed by the US Federal Reserve. Ever since 2002, the ¥/\$ rate has bounced up and down depending on the size of the gap between US and Japanese short-term interest rates. The currency market is now bouncing around so much partly because investors are uncertain as to what the Fed and Bank of Japan (BOJ) will do—and when.

The BOJ had been expected to hike the overnight rate to 0.75% in August, but was unable to do so because of the US financial storms. Many forecasters are now saying the BOJ will have to wait until at least October and Morgan Stanley is saying it will have to wait until next year.

If it were only Japan's financial markets that were so closely tied to US develop-

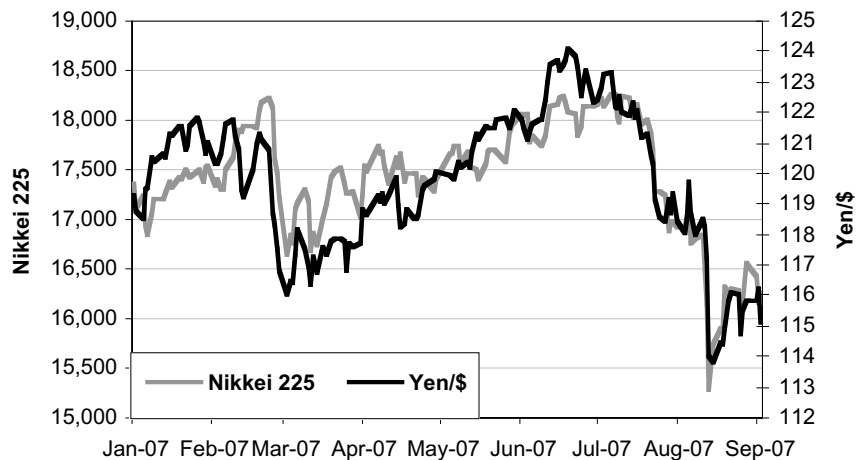
Tokyo Stock Ups and Downs Echo US Stock Market



Source: Nikkei and Yahoo Finance

Note: The closing price for the Standard & Poor's 500 Index and the closing for the Nikkei 225 Tokyo on the next date (13-14 hours after the New York closing)

Japanese Stocks Mirror Yen/\$ Rate



Source: Nikkei and US Federal Reserve

ments, Japan would be less vulnerable to the risks of a US downturn. But the financial links are so tight because the underlying real economy is so inordinately dependent on the US.

Export tail wags growth dog

Ever since the recovery began in early 2002, growth in the trade surplus has provided a stunning third of all GDP growth. The other main driver has been business investment, which has supplied an unprecedented 40% of growth since 2002. It turns out that this investment is heavily dependent on export growth. Manufacturers are building capacity for the export market, and non-manufacturers are building capacity to service those manufacturers. Since 2001, the correlation between exports in one quarter and business investment two quarters later has been a very high 80%. If Japan's exports plunged for any length of time, so would business investment.

Given all this, is it any surprise that, since 2001, there has been a 77% correlation between Japanese exports and its GDP growth a quarter later?

Asian Trade Dominoes

Proponents of the "decoupling" view would reply that, these days, Asia is Japan's export market, not the US. Since 2002, price-adjusted exports to Asia have soared 52%, while exports to the US are flat.

But this view overlooks the triangular trade. Much of Japan's exports to Asia and China consist of parts, supplies and equipment used for Asia's own exports to the US. Japan is able to export so much to Asia only because Asia exports so much to the US.

Consider China, which now takes 15% of Japan's exports. If Japan's exports were aimed mostly at China's domestic market, then growth in Japan's exports to China would depend on the ups and downs of Chinese GDP growth. In reality, since 1998, China's own exports to the US have been more important than Chinese GDP growth in determining how much Japan can export to China (see top figure).

The same situation applies even more so to emerging Asia ex-China, which buys an even larger 35% of Japan's exports. Japan's exports to Asia hinge on Asian's own exports to both the US and China. Meanwhile, over the last decade, Asia has been incorporated into China's own production networks. A large part of Asian exports to

China serve as inputs for China's own exports. Hence, since 1998, there has been a 65% correlation between Japan's exports to Asia and China's own exports to the US.

If a US downturn caused the US to sharply cut imports from Asia, Japan's own export drive would stop in its tracks.

Double Helix: US and Japanese GDP

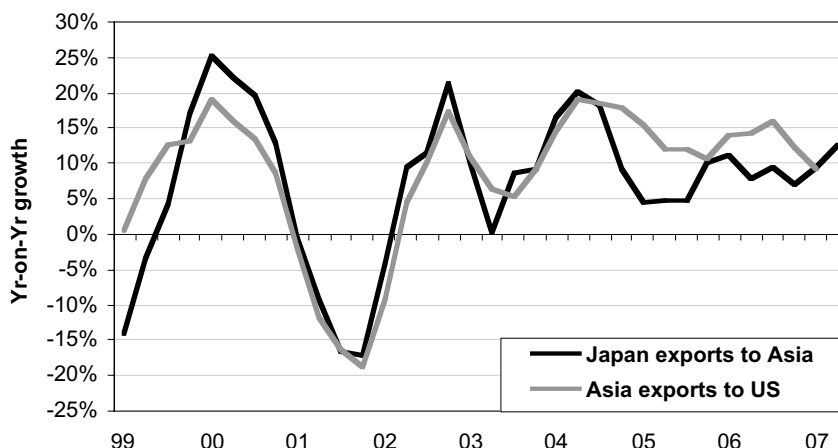
Far from becoming "decoupled," Japan's economy has become even more dependent on US growth during this decade. America's high-tech downturn in 2000 sent Japan and its Asian markets into a tailspin, and then the US recovery served as the locomotive for Japanese and Asian growth. In 2000-2007, the correlation between GDP growth in the two countries was 70% (see bottom figure). No other comparable period going back to at least 1980 even comes close to that tight linkage.

True, in the last few quarters, Japanese

growth kept going despite a growth slowdown in the US. But most of the US growth slowdown has occurred in sectors relating to housing construction, which are not very import-intensive. It is also true America's nominal imports from Japan during the first half of 2007 were down 0.5% from the same period of 2006—mainly due to the impact of high oil prices on auto sales. However, so far this year, US imports from the rest of East Asia are up 10% from 2006, mostly due to a 16% rise in imports from China.

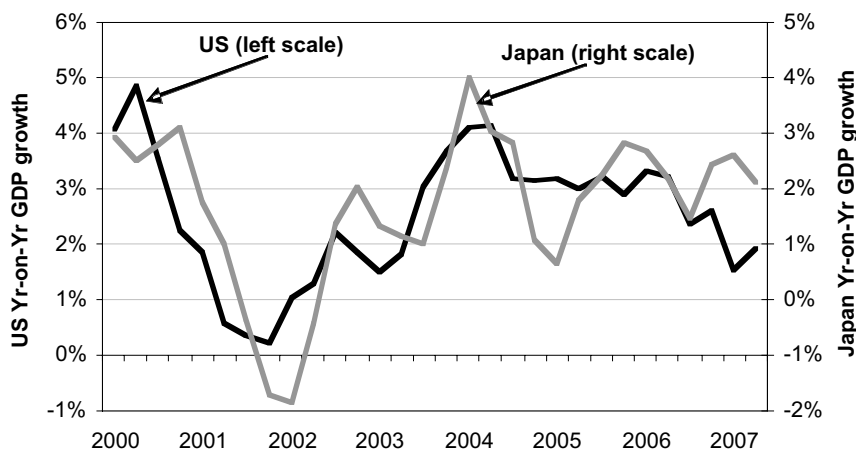
In early August, 60 leading economists told the *Wall Street Journal* that they expect GDP growth to slow to 2.4% in the second half of 2007 before rebounding to 2.8% in 2008. If they're right—and we think they are—Japan should not suffer a big impact. However, these economists also warned that there is a 28% chance of recession. If that does happen, Japan would definitely be buffeted by the storm.

Japan's Exports To Asia Hinge On Asia's Exports to US



Source: HSBC Asia
Note: Asia ex-China; in nominal yen and dollars

Japanese GDP Goes Up and Down With US GDP



Source: Cabinet Office, US Department of Commerce