Deepening gloom descends on Japan's financial markets

Financial problems are mounting in Tokyo as the stock market falls sharply, the yen weakens and longer-term fiscal worries overhang the bond market.

While many investors have been concerned about the US Dow Jones Index it has been the Japanese stock market that has cracked. Since the start of December the Nikkei index has fallen over 16% from 20,674.7 to 17,303.7. It could fall further.

Pessimism about economic prospects triggered the market's fall. We have been here before in 1995, when the Nikkei looked like it would collapse. Then the stock market was rescued by a triple boost of a weaker yen, a huge fiscal expansion and a cut in official interest rates to an all time low of 0.5%. But the government does not have room for policy manoeuvre now and is, in fact, raising taxes this April. A U-turn on fiscal policy is unlikely and could even backfire, adding to worries about the budget deficit. Interest rates will clearly have to remain low for some time.

Even though the Nikkei's fall may have generated too much gloom about the economy's prospects this year, this will not be of much immediate relief to the stock market. A rebound in the Nikkei requires evidence of a sustained economic recovery.

But any recovery in the private sector, whether in consumption or investment, will not occur soon enough to help the market. Furthermore, any bounce may be dismissed as not being a genuine recovery, merely being spending that has been brought forward to avoid the tax increase.

The solution is for the authorities to encourage a weaker yen. However, comments during the last week suggest the government is reluctant to let the yen fall. There are a number of reasons for this, including deep suspicion about the dollar's prospects. The last thing the Japanese authorities want is for the yen to weaken now, only to then appreciate. They prefer currency stability.

The lower the Japanese stock market falls the greater the financial risks become. Japanese banks and financial institutions have always held large amounts of stocks, many of which were bought some time ago when the market was lower. Thus they hold unrealised gains on their equity holdings, which have been of great help in the past. For the banks they have been able to use these gains to reduce their bad loans, while insurance companies have used their equity market profits to meet obligations to existing clients. The trouble is that this now means that the level of the Nikkei at which unrealised profits disappear is much higher than in the past. This is a worry.

The last time financial institutions had to report their unrealised stock market gains was at the end of September. Then the Nikkei stood at 21,556 and the gains were ¥23.5 trillion. Now a falling stock market is reducing such gains. There are different levels at which these hidden profits disappear for the banks and insurance companies. For some of the most vulnerable the stock market is already below the level at which their hidden profits disappear, casting doubt on the financial viability of some financial institutions. The stock market's fall could feed on itself, as the lower it goes the greater the doubt about the ability of some banks to service their bad loans.

Traditionally, one of the most stabilising features of the stock market was the fact that many shares were held for long term reasons, and were not sold, particularly by banks, insurance companies and parent firms.

But this could be about to change, because of financial deregulation and greater economic competitiveness. Also, in recent years up to last summer foreign investors had become large buyers of Japanese stocks. Such investors are more likely to sell, highlighting the stock market's vulnerability.

What are the global implications? When the Japanese economy went through severe difficulties in recent years the consequences were felt at home, with little global impact. However, as Japan is the world's largest saver the global implications of a falling stock market could always be greater. The international impact will result from Japan's role as a provider of global liquidity.

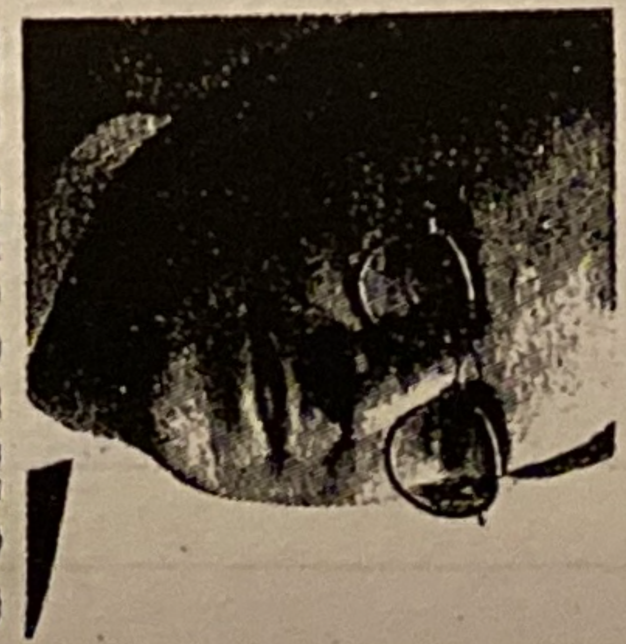
In 1995 the weakness of the Nikkei did not have a negative global impact. The reduction in Japanese rates and the weakening of the yen meant Japan became an attractive source of borrowing for some international investors, who borrowed in yen to invest in higher yielding assets elsewhere. As the Nikkei's decline means continued low interest rates for some time, this should be well received internationally.

The worst news is if the Bank of Japan intervenes to prevent the yen weakening.

To finance such intervention would involve the Bank of Japan selling some of its vast holding of US bonds. Such a move could damage US bond market sentiment, even pushing US yields higher.

The usual concern when there are problems in Japan is a repatriation of capital back home. This is always possible ahead of the end of the fiscal year. Despite this the factors that have contributed to the Nikkei's fall highlight the need for Japanese investors to move funds abroad, and this should become more apparent during the year. If so this will weaken the yen. And that would be the best news for the Japanese stock market. If a Nikkei collapse and its damaging financial implications are to be avoided a weaker yen is necessary.

Dr Gerard Lyons is Chief Economist of Dai-Ichi Kangyo Bank (DKB) International



ECONOMICS WEEK

The Japanese stock market's collapse means severe financial problems and a weaker yen, says **Gerard Lyons**