Special report

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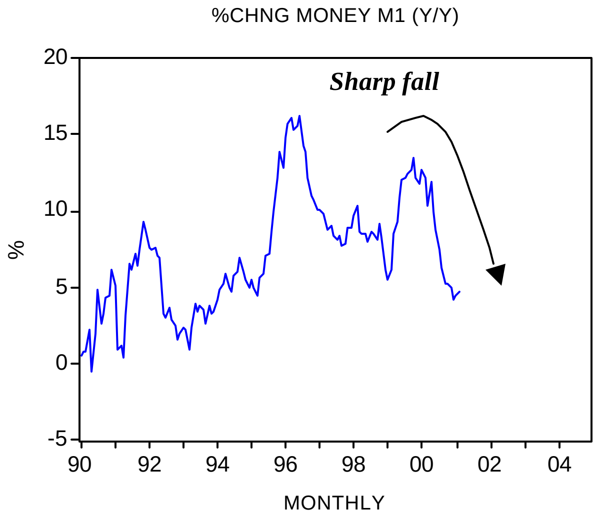
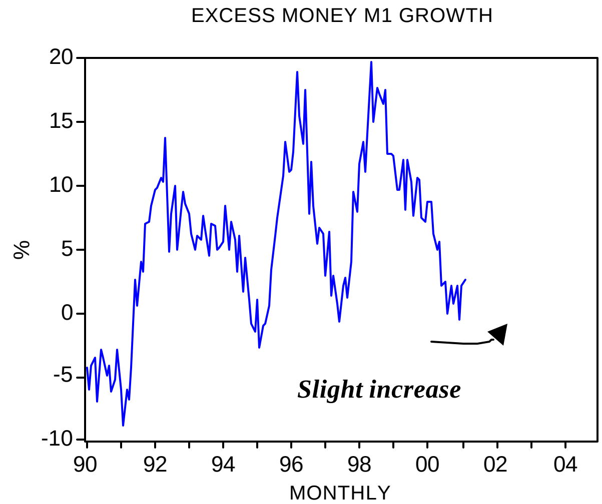
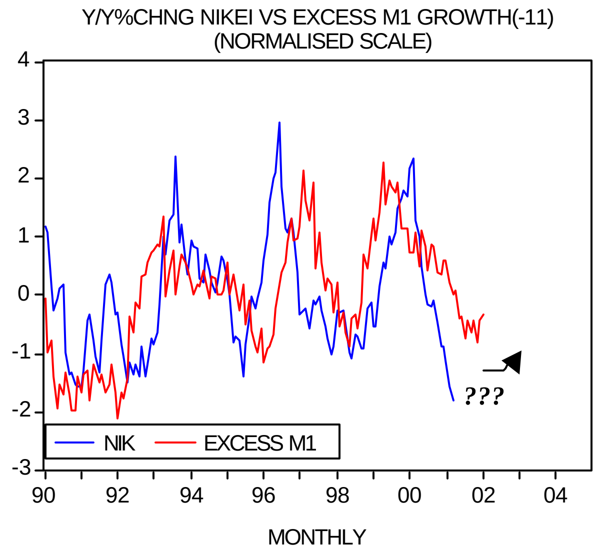
Will improvement in Japanese liquidity help the stock market?

Year-on-year the rate of growth in money M1 stood at 4.7% in February against 4.4% in the previous month (see chart). We have estimated that monetary growth adjusted for nominal economic activity increased to 2.7% in February from the 2.2% in January (see chart).



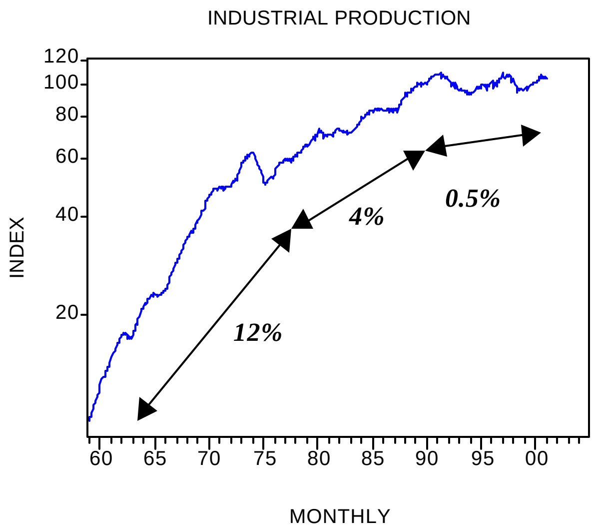


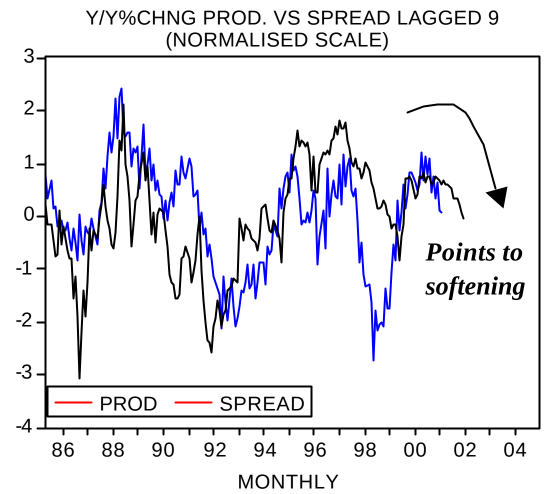
After closing at 13,843 at the end of January, the Nikkei share price index has plunged to below 12,000, its lowest level since 1984. Notwithstanding this fall, the improved liquidity points to likely support for the Nikkei in the months to come (see chart).



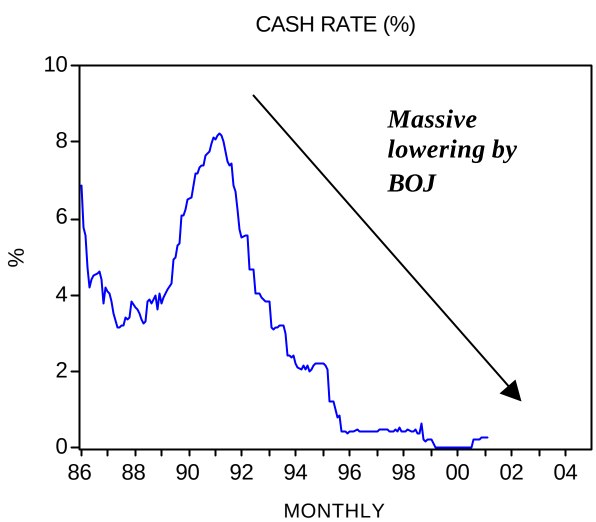
But don't hold your breath that improved liquidity will be sufficient to revive the stock market. If the real pool of funding is stagnating or worse, falling, then the rebound in monetary growth is not going to be effective. The underlying trend of industrial output raises the possibility that the real pool of funding is vulnerable. Between 1990 and the present the underlying trend of industrial output has been growing by an annualised

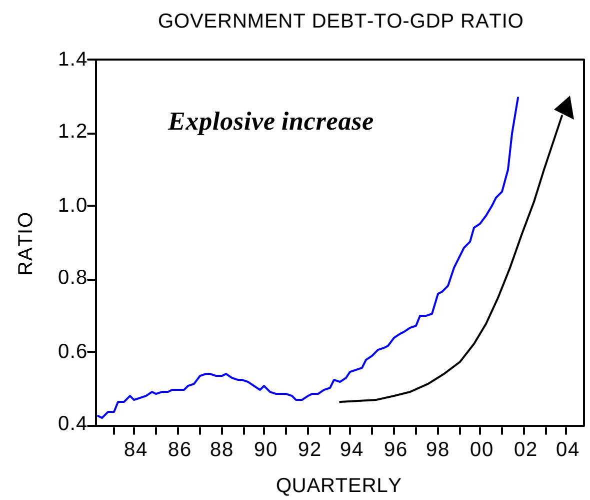
0.5%. In contrast, between 1974 and 1989 the underlying trend had been growing at an annualised rate of 4%, whilst between 1959 and 1973 the rate of growth stood at 12% (see chart). Furthermore, the spread between the 10-year government bond yield and the overnight lending rate fell to 0.98% from 1.1% in February and 1.28% in January. The narrowing of this spread points to a further weakening in the yearly rate of growth of industrial output (see chart).



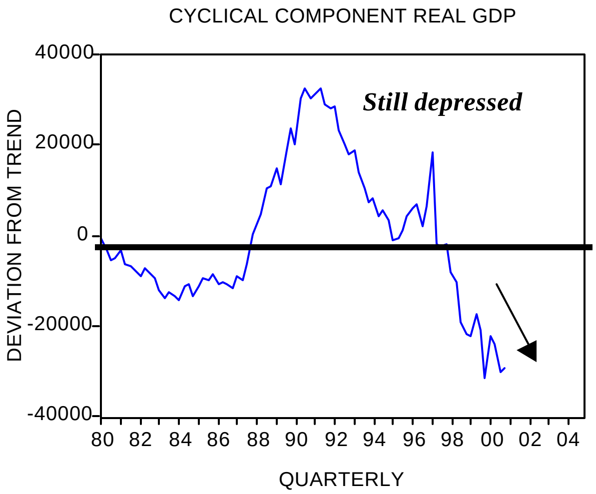


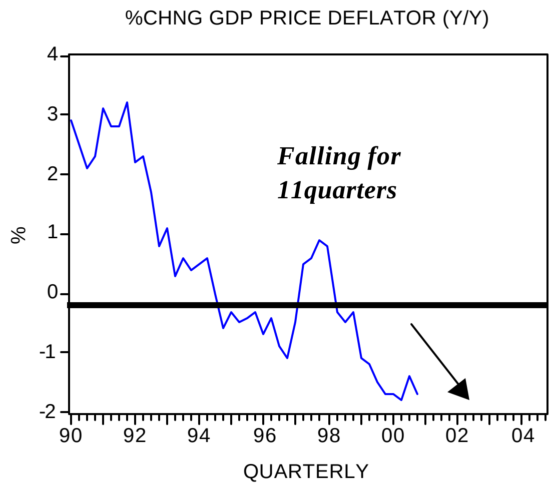
Observe that despite extremely loose monetary and fiscal policies Japan has been in a severe recession for the past 10 years. From a level of 8.22% in March 1991 the BOJ lowered the overnight lending rate (cash rate) to the present figure of 0.15% (see chart). I suggest that this massive loosening of the interest rate stance must have severely weakened the real pool of funding. Another major contributor to the weakening of the pool of funding is the ever growing government spending. It is estimated that government debt as a percentage of GDP will rise to 130% this year. According to some experts this ratio could already be around 200% (see chart).





Although real GDP grew by 0.8% in Q4 (seasonally adjusted) after a fall of 0.6% in Q3, the cyclical component of GDP remains depressed (see chart). Subdued economic activity is also evidenced by a relentless fall in the GDP price deflator. Year-on-year, the price deflator fell by 1.7% in Q4 after a fall of 1.4% in Q3. The price deflator has been declining on a yearly basis for the past 11 quarters (see chart).





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