Forex Medium-Term Outlook

February 28, 2022

MIZUHO

Overview of Outlook

USD/JPY remained strong again in February. Although the crisis in Ukraine did give rise to some risk-off JPY buying, it was not sufficient to force a correction of the weak-JPY trend. Rate trends in the first two months of the year seem clearly driven by a simple logic – currencies approaching a rate hike are being bought, while those still far from one are being sold. It seems safe, therefore, to assume that monetary policy remains the main driver of rate trends. The policy interest rate trends of major countries and regions, however, do not reflect as dramatic a disparity as the markets seem to be picturing. If the market is indeed focused on monetary policy differences, the effects will be clearer going forward. If JPY and CHF remain the only two currencies to retain conspicuously low interest rates in the highly liquid market of key currencies, this will strengthen their roles as funding currencies and directly result in a greater downward pressure on their rates. Of course, any heightening of geopolitical risks tends to put a damper on highly speculative trades, so the end of the crisis in Ukraine is a prerequisite for JPY's role as funding currency to strengthen and cause the currency to depreciate. However, the current structure of all currencies except JPY moving toward rate hikes is very reminiscent of the "weak JPY bubble" period in 2006-07 – something that cannot be overlooked when forecasting the outlook for JPY. There remain very few reasons to buy JPY both from a short-term, growth-rate disparity perspective and a longer term, structural-change perspective.

Meanwhile, EUR weakened in February. The ECB, previously committed to no rate hikes within the year, is increasingly hawkish in its policy stance, so much so that the markets have gone from being almost certain that there will be no rate hikes, to now wondering not "whether" but "when" a rate hike will take place this year. If things proceed as per schedule, the expanded asset purchase programme (APP) will end with September, so the main forecast scenario is for a rate hike to be implemented in October at the earliest or December at the latest. However, given that the biggest ongoing risk, the crisis in Ukraine, directly affects the euro area (as the recipient of natural gas supplied by pipelines passing through Ukraine), investors will find it difficult to aggressively buy the currency. EUR may well recover its strength if the crisis in Ukraine ends, given the strong demand for EUR backed by the euro area's large trade surplus and considering that a better overall picture of the ECB's policy normalization process will emerge following the March Governing Council Meeting. However, if the crisis is drawn out, and natural gas prices remain persistently high, regional inflation will continue to rise, driven by energy prices. In the latter scenario, the ECB would be inclined to take a graver view of worsening real incomes and real economic performance than of soaring inflation. Consequently, the crisis in Ukraine could derail the ECB's policy normalization process and weaken EUR. Both upside and downside risks, therefore, depend on how the situation in Ukraine plays out, but short-term factors favor EUR selling.

Summary Table of Forecasts

	2022年 Jan (actual)	Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2023年 Jan-Mar
USD/JPY	113.47 ～ 116.35 (115.52)	113 ～ 117 (116)	114 ～ 120 (117)	115 ～ 121 (118)	116 ～ 122 (119)	116 ～ 123 (120)
EUR/USD	1.1106 ～ 1.1495 (1.1177)	1.09 ～ 1.16 (1.10)	1.10 ～ 1.15 (1.12)	1.11 ～ 1.16 (1.13)	1.12 ～ 1.17 (1.15)	1.12 ～ 1.18 (1.16)
EUR/JPY	127.92 ～ 133.15 (129.15)	126 ～ 132 (128)	128 ～ 135 (131)	129 ～ 136 (133)	131 ～ 138 (137)	133 ～ 140 (139)

(Notes) 1. Actual results: until 26 FEB 2021, (): as of 10AM 28 FEB 2022 . 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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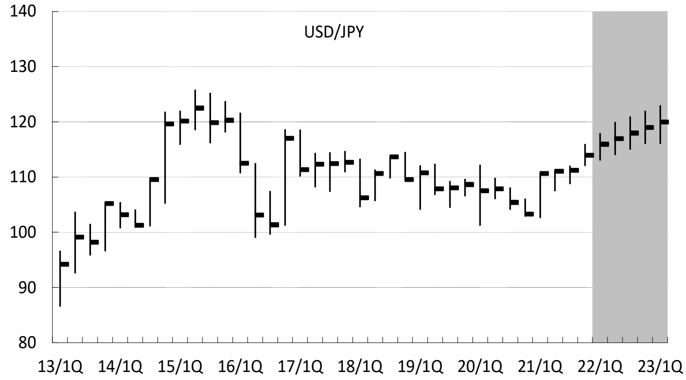
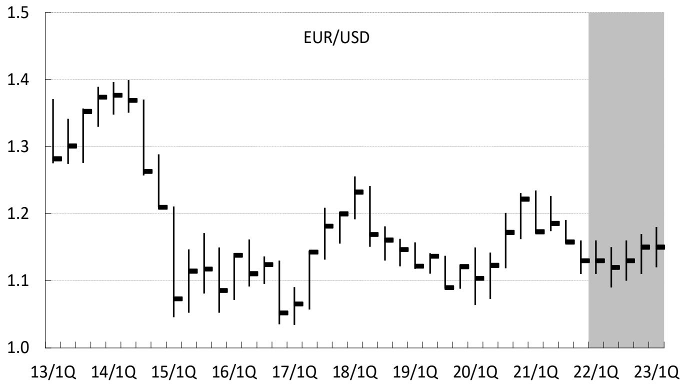
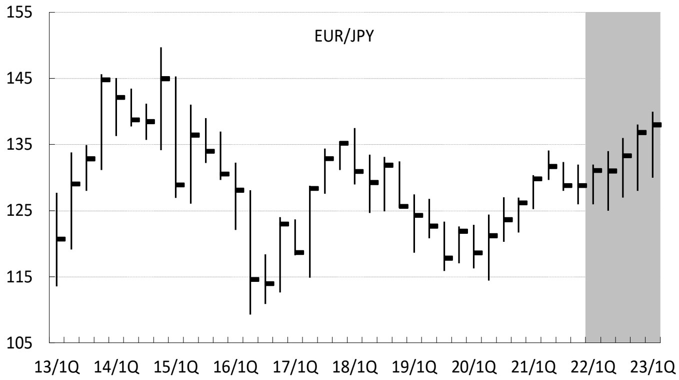
Exchange Rate Trends & Forecasts





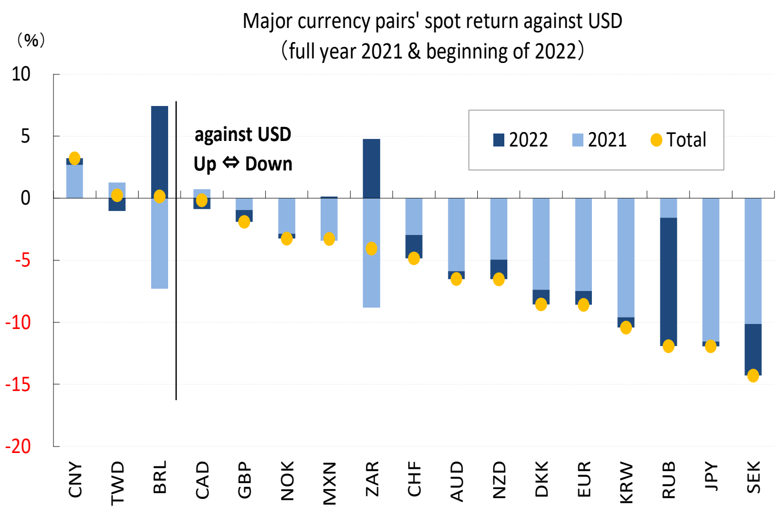


USD/JPY Outlook – Changing Demand Structure of JPY

Overview of the Forex Markets – Monetary Policies More Important than Geopolitical Risks

An Overview of Key Currency Relative Strengths

The crisis in Ukraine is currently the biggest focus of interest for the financial markets, and compared to it, even the Fed's policy normalization process seems to have taken a back seat as a factor influencing trades. However, the relative strengths of key currencies can still only be explained on the basis of monetary policy. As the figure shows, there have been no signs of any reversal of the 2021 trend of USD strength in the first two months of 2022. Most currencies have fallen against USD in the past year, and this trend continues. Two currencies that have clearly begun strengthening against USD are BRL and ZAR. These are currencies that have responded to soaring inflation by raising interest rates multiple times. MXN, which is also on the rise if only slightly, is also a currency on the way to rate hikes. What these three currencies have in common are high policy interest rate levels – as of the time of this report's writing (February 28, 2022), the policy rates of Brazil, South Africa, and Mexico were 10.75%, 4.00%, and 6.00%, respectively.



(Source) Bloomberg (Note) up to 25 FEB 2022

The one discomfiting datapoint is that while CNY is the currency that has appreciated the most against USD, China has been cutting rates. There are probably many reasons for this, including China's expanding trade surplus and an increase in inbound investments. However, given the arbitrariness of China's currency authorities, perhaps CNY cannot be compared with other currencies quite so simply. I will refrain from delving into this issue in the current report.

Moving on to G7 currencies, CAD and GBP are competing with USD and have seen almost no change. While the Fed is very close to a rate hike, the Bank of England has already implemented two, and the Canadian authorities intend to implement one in the near future. The backgrounds to rate hikes notwithstanding, there is a strong sense that currencies that have rate-hike prospects are the only ones capable of competing with USD. Of course, Taiwan, with its strong high-tech industry led by semiconductors, saw high economic growth for the first time in 11 years in 2021 thanks to robust orders from China and the U.S. Perhaps TWD is being bought because investors are betting on this high economic growth rate.

Characteristics of Currencies Weakening Against USD

Meanwhile, SEK and RUB are two currencies that have been depreciating more rapidly since the beginning of 2022. The reason for RUB being sold off despite being a high-interest-rate currency backed by rate hikes is self-evident, but why is SEK being sold off? Presumably, this reflects monetary policy trends. In contrast to the previously mentioned central banks, which are pushing ahead with policy normalization, the Swedish central bank (Riksbank) has declared that it will maintain its bond holdings this year and continue with its current zero interest rate policy until 1H of 2024. JPY, which matches SEK's margin of depreciation, is also a currency for which firm adherence to an accommodative monetary policy path has been outwardly indicated. The BOJ's fixed-yield unlimited JPY-buying operation underscores this stance. It seems clear, then, that all the currencies that have been sold since last year have distant rate hike prospects.

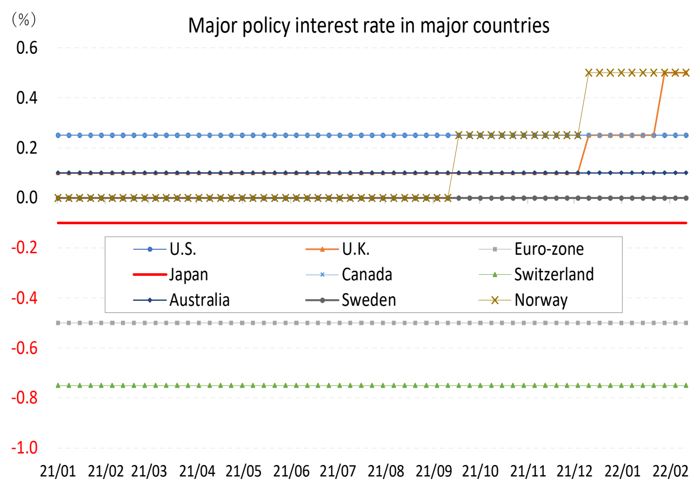
This logic applies to currencies other than SEK and JPY also. For instance, AUD is also lackluster despite being backed by higher resource prices. Perhaps this is because the Reserve Bank of Australia, while planning to end its quantitative easing (QE) in the first half of the year, is somewhat passive about rate hikes due to subdued inflation and wage growth trends and is expected to embark on rate hikes only in 2023 or later. The Reserve Bank of New Zealand next door has already begun rate hikes, but NZD remains weak because of its tendency to be linked with AUD.
Apart from the above, CHF has depreciated significantly since the beginning of the year, also clearly due to Swiss monetary policy. The Swiss National Bank (SNB) is maintaining its deep negative interest rate of -0.75% and continuing forex interventions to contain CHF appreciation. Given the SNB's declaration of an overvalued CHF and its intention to maintain an expansionary monetary policy, it is easy to see why CHF is depreciating.

Currencies that are Weakening but Could See Trend Reversal

Meanwhile, there are some currencies that are currently weakening but could see a trend reversal. NOK, for instance, is a rate-hike currency that has remained lackluster. Given the skyrocketing crude oil prices, one would think that NOK – the currency of an oil producing country – would be better valued. EUR, again, could see a trend reversal. The currency is difficult to buy at the present time and has depreciated significantly as it is directly impacted by the crisis in Ukraine, the biggest risk factor in the financial markets right now. However, the big picture regarding the ECB's termination of QE and start of rate hikes should emerge following the March Governing Council Meeting, and EUR, backed by the world's largest current account and trade surpluses, is the most highly in-demand currency. These factors give it bright prospects going forward. In short, there is hope of better performance for some of the currently weakening currencies.

Market Trends Determined by Policy Interest Rates

Of course, it is difficult to explain the fluctuations of every currency pair in the market based on a single data point. However, going by the relative strengths of the aforementioned currencies, it seems fairly clear that <u>the simple logic of (1) buy currencies with imminent rate hike prospects, (2) sell currencies with distant rate hike prospects is at work</u>. Countries such as Brazil, South Africa, and Mexico are implementing rate hikes, but their fundamentals are not necessarily strong, so it does seem that a high interest rate level and ongoing rate hikes are a major determining factor for investors buying these currencies in the forex markets. Of course, despite the implementation of rate hikes, NOK is lackluster, and RUB is being avoided due to its conspicuous geopolitical risks. On the other hand, CNY and TWD are being bought despite the lack of rate hike initiatives. Incidentally, as the figure shows, the actual disparities among key currency official interest rates are not as large as market participants seem to think (some countries, such as Brazil and South Africa, have been excluded due to their excessively high rates). <u>It would appear, therefore, that the main highlight of this trend of currency rates being determined by policy interest rates is yet to come</u>.



(Source) macrobond

Will Yen Carry Trade Catch On?

Let us take a look at the prospects for JPY carry trade, which is beginning to draw some attention. If the highly liquid JPY and CHF remain the only two currencies to maintain conspicuously low interest rates, their roles as funding currencies will inevitably strengthen, which will directly result in greater downward pressure on these currencies. Of course, any heightening of geopolitical risks puts a damper on highly speculative trades, so an end to the crisis in Ukraine is a prerequisite for JPY's role as funding currency to strengthen and cause the currency to depreciate. However, the current structure of all currencies except JPY moving toward rate hikes is very reminiscent of the 2006-07 "weak JPY bubble" and cannot be overlooked when forecasting the outlook for JPY. One is reminded of the phrases "JPY carry trade" and "Swiss franc carry trade," which were heard frequently in those days.
Of course, compared to those days, Japan's domestic production facilities are on the decline. The depreciation of JPY, therefore, can no longer boost export volume or cause a sufficient overheating of the domestic economy to cause a bubble. Rather, with resource prices remaining persistently high, it seems JPY depreciation will only give rise to concerns of an income drain away from the country.

JPY Now and Going Forward – Rate Outlook as a Mature Creditor

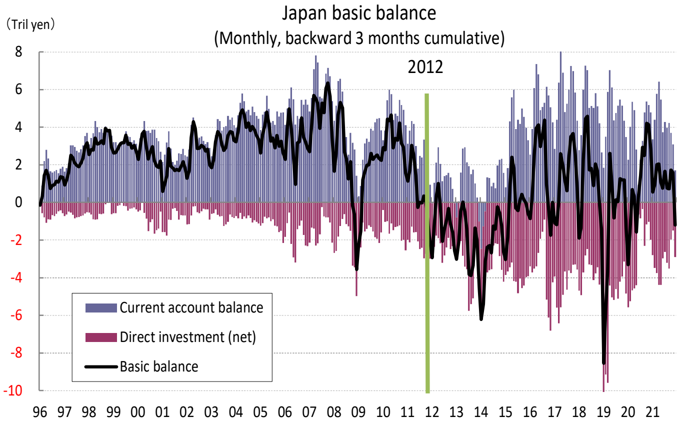
Governor Kuroda Reiterates Continued Monetary Accommodation

At the February 16 meeting of the First Subcommittee of the House of Representatives Budget Committee, BOJ Governor Haruhiko Kuroda reiterated that this was not the time to consider any adjustments to the balance sheet or policy interest rates. An opposition member of the Diet (Committee Member Takeshi Shina, Constitutional Democratic Party of Japan) critically commented that continued monetary accommodation appeared to have become a goal in itself. For once, criticism from a member of the opposition was not irrelevant; it actually hit the mark. It is increasingly difficult to see any benefits from continuing with monetary accommodation. On the other hand, it very easy to focus on the disadvantages of this policy against a weak currency pushing up the price of already expensive imports. Of course, monetary accommodation is only one of the factors causing a weak JPY, but it is still quite difficult to understand Kuroda's decision to continue with monetary accommodation amid pessimism over JPY's purchasing power parity being at a 50-year low in terms of its real effective exchange rate (REER). Again, as resource prices remain persistently high against rising geopolitical tensions, the worst-case scenario for the Japanese economy would be an uncontrollable and hysterical downward spiral of JPY. For a resource-importing country, the combination of high resource prices and a weak domestic currency can only cause an income drain away from the country.

There is no guarantee that JPY will strengthen even if the BOJ revises its accommodative monetary policy, but such a move could at least help contain JPY depreciation. As I have argued in past issues of this report, the worst scenario would be for the BOJ to be forced by the markets to take corrective policy measures to check JPY depreciation. It would be wiser for the Bank to consider gradually correcting monetary policy before it becomes an issue. Kuroda responded to Shina's criticism saying the Bank was not presently in a place where it could consider an exit from its accommodative monetary policy. Of course, it may be possible that the BOJ is quietly considering an exit behind the scenes without saying so openly. However, the structure of JPY rates itself is quite different from what it used to be, so I feel it is important to take into account when conducting monetary policy that reversing the trend from JPY depreciation to JPY appreciation may not be possible in the natural course of things. The following sections will look at this structural change in greater detail.

Change in JPY Rate Structure as Seen from Basic Balance

When considering how the structure of JPY rates has changed, one should give particular attention to Japan's international balance of payment changes (chronic trade deficits) and the expansion of the country's foreign direct investment. The biggest reason JPY is considered a safe-haven currency is thought to be because Japan is the world's largest creditor (with the largest net external assets) thanks to its very large holdings of foreign-currency denominated assets. In this context, a country's basic balance is seen as an indicator that can affect its outstanding net assets and liabilities. If the basic balance shows a consistent net inflow of funds, the country's net external assets will tend to increase; if it shows a consistent net outflow of funds, its net external liabilities will tend to increase (I am using the ambiguous phrase "tend to" here because the figures fluctuate depending on asset prices also).



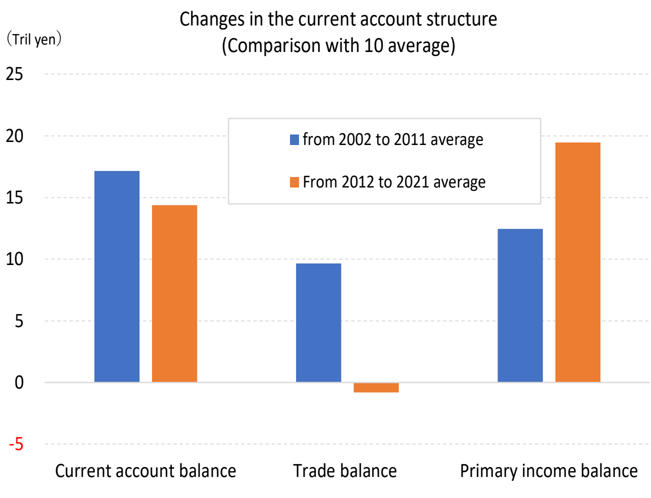
(Source) Ministry of Finance
(Notes) Basic balance＝current account balance excl reinvestment income + direct investment (net)

Back in the days when international capital movement was not as vigorous as it is now, and it was easier to distinguish between long-term and short-term capital, the basic balance was seen as an indicator that greatly impacted the credibility of a country's domestic currency. However, given the current brisk international movement of capital, even if a country's basic balance is robust, its external payments could become difficult if its currency is persistently sold off in the forex markets. Therefore, the significance of the basic balance has diminished with the times.

Having said that, irrespective of its significance as an indicator of a country's ability to make external payments, it is worth paying attention to the basic balance of a country if it has undergone a transformation hinting at structural changes that cannot be overlooked. The figure to the right looks at Japan's basic balance starting the late 1990s, taking the basic balance to be the sum of the current account balance and net direct investment. One can see at a glance that there had been a consistent inflow of funds in Japan's case until around 2012-13, when the inflows began to be interrupted by outflows. Of course, a net inflow has continued despite this, as has Japan's status as the world's largest creditor, but a large part of this is not due to volume (straightforward earning of foreign currency) but to price (as a result of JPY depreciation). Indeed, since 2013, there have been no instances of JPY panic buying in the forex markets as in the past. As the figure shows, the net outflow of direct investments has significantly changed the structure of Japan's basic balance.

Rate Outlook as a Mature Creditor

Incidentally, if one only looks at the basic balance, the current account surplus level has hardly changed. This is because the disappearance of trade surpluses has been offset by an increase in primary income surpluses (see figure), indicating Japan's evolution from a "young creditor" to a "mature creditor" as per the balance of payment stages hypothesis. As per this hypothesis, the stage following "mature creditor" is "asset liquidator," which implies a primary income deficit in addition to a trade deficit, with the country increasingly becoming dependent on capital inflows from abroad. Of course, the time-frame for such a development is fairly long, at 10 years. However, there is also the practical reality that, as soon as Japan progressed from the young creditor to the mature creditor stage, it lost its ability to generate trade surpluses, which drive outright JPY-buying, and most of its primary income surplus remained in foreign currency without ever being reconverted into JPY.

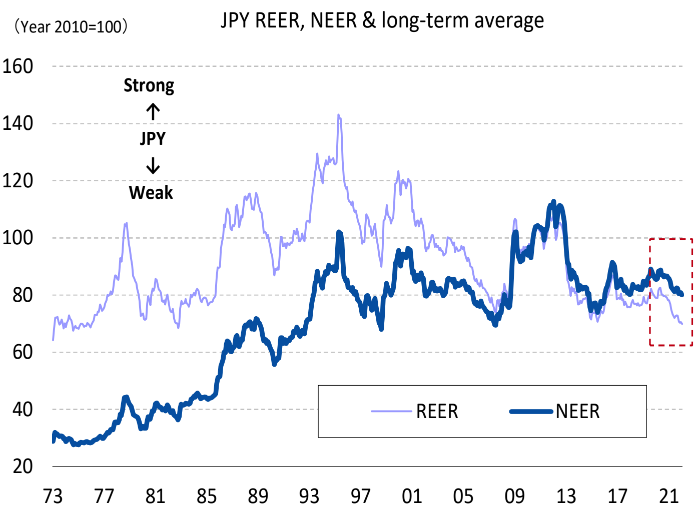


(Source) Ministry of Finance

Taking such changes into account, it may be prudent for policymakers to come to the realization and feel some urgency regarding the fact that it may no longer be possible to reverse the weak-JPY trend in the natural course of things. Some say that the recent increase in resource prices is a structural change reflecting the global move toward carbon-free societies. If so, rather than intermittently talk about continuing monetary accommodation because of the lack of inflation, the authorities must take into account the value of JPY as the currency of a resource-importing country and think about how best to adjust fiscal and monetary policy.

JPY Sinks Below Kuroda Line, Posts 50-Year Low

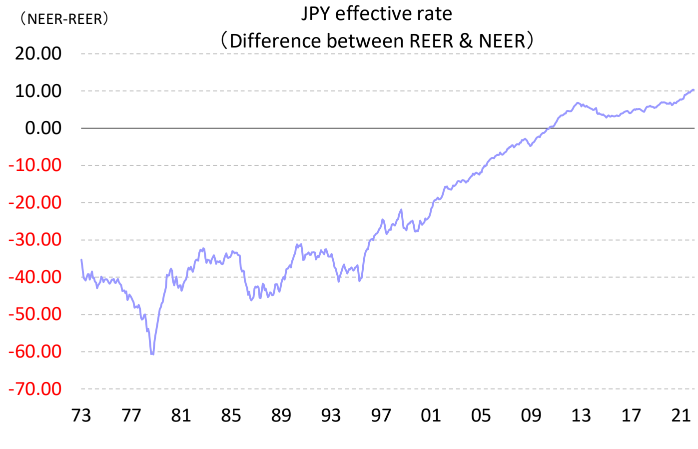
Consistent with the aforementioned rate outlook, JPY's REER (narrow) for January as published by the Bank for International Settlements on February 17 was 69.81, renewing its lowest in nearly 40 years, since October 1982. However, JPY's average REER in 1973-74 was 69.8-69.9, which caused many in the media to mark the event with the headline "lowest in 50 years." Incidentally, while the comparable time series is quite short, JPY's REER as computed based on a broader basket of currencies conspicuously renewed the all-time record low, at 67.55. With regard to the narrow index, the 70.64 low posted in June 2015 had at that time drawn a great deal of attention and been dubbed the "Kuroda line." This is because the rate had coincided with USD/JPY hitting 125.86 on June 10, 2015, and Kuroda had told the House of Representatives Committee on Financial Affairs that same day that JPY was unlikely to fall further on a real effective basis because it was already "very weak." Right now, the REER is weaker by 1% than the famed Kuroda line – the very thing the Governor himself had said was unlikely is in the process of unfolding.



(Source) BIS

Largest Ever Disparity Between Nominal and Real Rates

Note, however, that compared with June 2015, when USD/JPY hit its highest at 125.86, as of January 2022, it is 116.35. Therefore, in terms of its nominal rate, JPY is close to 10 yen stronger now than it was in June 2015. As already seen, JPY weakness in nominal effective terms (NEER) remains reasonable. Specifically, compared with the long-term average (20-year average), JPY's REER as of January 2022 is undervalued by -19.3%, while its NEER is undervalued only by -6.9%. Given that the disparity between JPY's REER and NEER reflects the difference between inflation in Japan and abroad, this provides a clear glimpse into Japan's marked disinflation compared with other economies. While Japan's low inflation levels are an old story, the current disparity between its REER and NEER is the largest it has ever been (see figure).



(Source) BIS (Note) Simply NEER minus REER

It is quite clear what led to this situation. As economic cycles in countries around the world increasingly move in tandem, Japan alone repeatedly posted negative growth over the past year. I have spoken about the reason for this many times in this report – it is, undeniably, Japan's unique emotional response to the pandemic. While the U.S. and European economies grew at rates over twice their potential growth rates in 2021, Japan did not see any such thing because of its strict entry restrictions for overseas travelers and chronic domestic movement restrictions, which dampened consumption and investment appetites. Inevitably then, there will arise a domestic vs. overseas disparity in inflation, which is a barometer of economic growth.

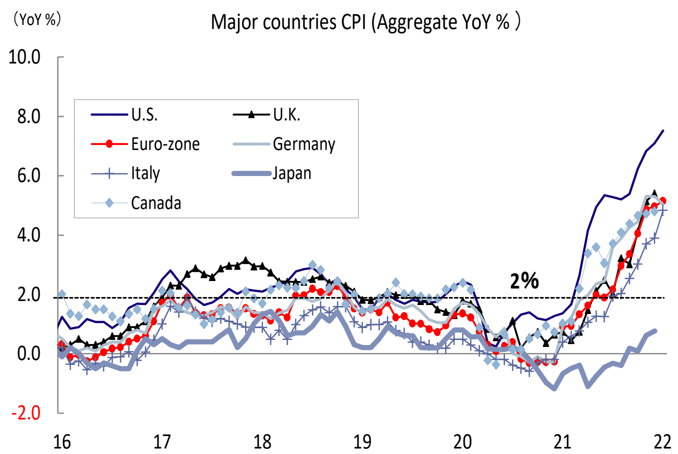
Of course, in countries around the world, wages are also rising alongside inflation, although to different extents in different countries. In other words, regardless of the nominal JPY rate level as seen from USD/JPY levels, Japan's purchasing power in the global markets could increasingly take a hit as JPY's real effective rate stagnates. In fact, media reports in recent years have sometimes pointed out how Japan is losing out to China when it comes to competitive bids to buy meat and seafood products. People tend to focus too much on the USD/JPY, but it must not be forgotten that a decline in REER also has a major impact on the daily lives of people. In fact, in this age of a relatively flat USD/JPY, it would be more prudent for the authorities to focus on REER.

Visitors Could Come Seeking Japanese Services in a Post-Pandemic World

Further, a weak REER for JPY means that prices in Japan will seem relatively cheap to foreign visitors going forward. In other words, with the significant decline in JPY's REER, Japan could become an attractive destination for visitors from countries where the purchasing power has gone up since before the pandemic. This could be seen as an impetus for turning Japan into a global tourist destination, but it could equally be seen as the start of a "cheap Japan" era. Either way, it cannot be denied that low prices are an important factor of competitiveness, so Japan may have no choice but to utilize them to revive its economy. From this perspective, the government's entry restrictions, which have been criticized as unscientific, were nothing but an ill-advised policy lacking in long-term vision. The survival of Japan, a country with a declining population and without natural resources, depends on being able to import people and goods from abroad. In the longer term, it is quite possible that a "cheap Japan" would serve as an attraction, bringing people, goods, and money into the country, thereby contributing to the revival of its economy and prices. However, imposing movement restrictions on the domestic population and entry restrictions on foreign visitors is not a good way to whip up demand.

Lives over Economic Growth

I repeat myself, but it is an unquestionable fact that the excessively strict anti-pandemic measures adopted based on the view that lives are more important than the economy have directly resulted in low economic growth rates, low inflation, and a fall in REER. In February, the government subcommittee on COVID-19 response (hereafter simply "Subcommittee") hinted at the possibility of an exit strategy being considered, to which my response was that it seemed unlikely under the current administration in the run up to a national election. In this context, Prime Minister Kishida was asked whether he would consider lowering the classification of the novel coronavirus under the Infectious Disease Law from the current Type 2 to a Type 5 (similar to the influenza virus). Predictably, he replied, "It would not be practical to change the categorization at this time." With the sixth wave still fresh in our memories, it already seems highly probable that a great fuss will be made once again over concerns of a seventh wave.

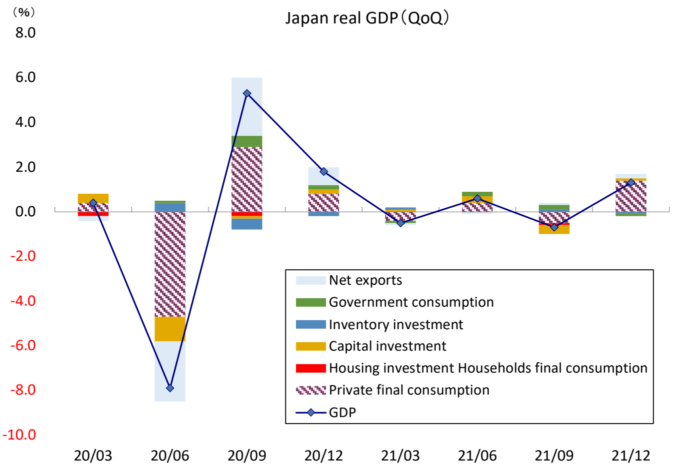


(Source) macrobond

While it is now an established fact that this approach results in a high public approval rate for the administration, it is also true that it is further widening the gap between Japan and other countries' growth and inflation rates. As a result of prioritizing economic normalization, the U.S. and Europe have seen further increases in inflation that was higher than Japan to begin with (see figure). For some time going forward, it seems certain that downward pressure on both the nominal JPY rate, thanks to interest rate differentials, and the real JPY rate, thanks to price differentials, will continue to increase with each passing moment. Unfortunately, Japan is likely to increasingly lose out to other countries in bids to buy resources and a variety of other goods in the global markets. While putting lives ahead of economic growth superficially sounds like a good response during a pandemic, one cannot help thinking that it is going to cost the Japanese economy heavily in the medium to long term. Perhaps, demographically speaking, devotion to the avoidance of near-term risks is Japan's unavoidable fate as an increasingly aging society. While acknowledging the big challenge of changing public opinion, one can only hope that the authorities will heed the financial markets' alarm bells and shift their focus to economic normalization.

The Japanese Economy Now and Going Forward – Weak JPY Trend Resulting from Widening Domestic-Foreign Gaps

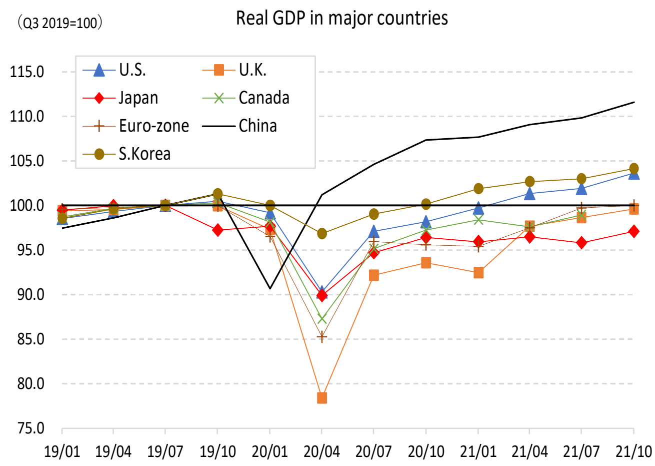
The Impact of Movement Restrictions



(Source) Japan Cabinet Office

On February 15, the Cabinet Office released Japan's October-December quarter GDP (first preliminary report). The impact of price fluctuations aside, the seasonally adjusted real GDP had grown by +1.3% qoq and +5.4% yoy, posting positive growth for the first time in two quarters. The October-December quarter coincided with a period when COVID infections were under control and most movement restrictions had been lifted. Looking at the breakdown by demand category, Private Consumption accounted for +1.4pp of the +1.3% qoq growth. More specifically, Services had made up for the large part of this, at +1.1pp. It is not difficult to see that the service sector, led by accommodation facilities and eating/drinking establishments, had revived during October-December thanks to the lifting of movement restrictions, which affect these industry sectors the most. In other words, the October-December GDP results show the level of consumption/investment appetite that exists in the absence of movement restrictions. Meanwhile, many are predicting the exact opposite results and a return to negative growth for the January-March quarter, when movement restrictions were reimposed. It is clear that easy-to-implement movement restrictions, while not significantly curtailing the spread of infections, definitely sacrifice economic growth, i.e., the economic risks outweigh the returns. There are, however, clear returns for the political establishment in terms of maintaining strong public support. I, therefore, foresee that, even after the next wave of infections subsides, Japan will continue to repeat its past pattern, and my forex outlook will be based on this understanding.

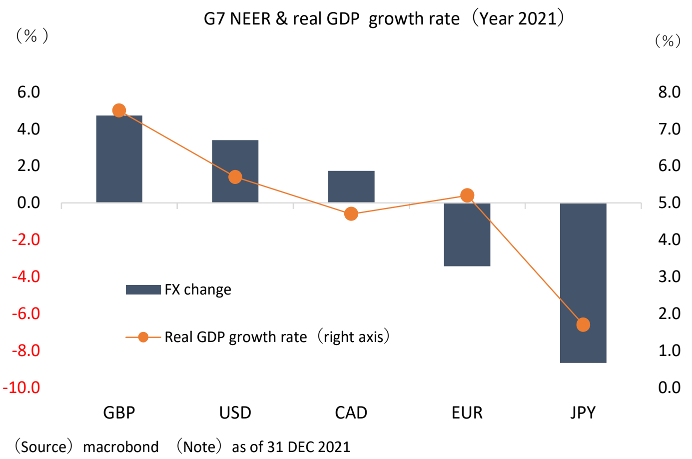
Comparison of Key Country GDPs



(Source) macrobond

The October-December GDP results for all key countries have now been released. Comparing the October-December 2021 real GDP figures against pre-pandemic (October-December 2019) real GDP figures, the U.S. has posted around +3% higher growth and the eruo area has recovered, but only barely so (+0.03%). Individual results are diverse, with the UK and Germany seeing lower growth by -0.4% and -0.5%, respectively, while France has improved by +0.9%, but most of these countries have more or less recovered their pre-pandemic growth levels. Japan, too, appears to have almost recovered, posting -0.2% compared with the October-December 2019 level. However, it must be noted that the October-December 2019 GDP result is not a true representation of pre-pandemic GDP growth rates in the case of Japan. Japan posted a close-to-11-year-low GDP growth for October-December 2019 (-2.8% qoq) because of a consumption tax hike and the impact of the deadly Typhoon Hagibis (October 2019), which caused great casualty. It would, therefore, be inappropriate to call a recovery to this level a "normalization." The figure on the previous page, therefore, looks at the GDP recovery trends of key countries using July-September 2019 as the comparison period, and Japan's October-December 2021 GDP is around -3% lower than in July-September 2019. As is obvious from the figure, Japan's weak performance stands out from the rest quite clearly. I believe this is one of the reasons for the "Japan avoidance" phenomenon visible now and again in the forex and stock markets.

Japan and the Rest of the World Fear Very Different Things



The forex markets are not usually a straightforward world where the relative strengths of currencies are determined using the simple yardstick of economic growth rate, but this simple logic has applied by-and-large during the pandemic (figure). At the present time, all the G7 nations except Japan are walking the path of "economic normalization over movement restrictions → recovery of GDP growth rate → rise in prices partly due to supply constraints → increase in wages → monetary policy normalization," which has strengthened the real effective rates of all their currencies. As already described, therefore, the scenario in Japan (which is still posting -3% lower growth than before the pandemic) is very different from that in its G7 counterparts, which have more or less recovered their pre-pandemic growth levels.

With a such a drastic disparity in terms of real economic performance, it is inevitable that problem awareness would also be different. For instance, the biggest fear in most parts of the world right now is the possibility of runaway inflation, which can be seen in the authorities' moves to scramble to raise interest rates. Therefore, when predicting the relative strengths of non-JPY currencies, it becomes important to carefully compare the difference between each country's growth rate and accompanying monetary policy stance. The fact that, unlike in the case of the Fed, there is still plenty of scope for investors to factor in the ECB's normalization process makes it difficult to predict the relative strengths of EUR and USD going forward. A similar challenge exists when comparing USD and GBP, given that the Bank of England is ahead of the Fed in terms of policy normalization. The relative strengths of currencies that share both high inflation fears and a desire to normalize economic and financial activity are difficult to forecast.

Japan's greatest fear, meanwhile, continues to be an increase in new case numbers, not runaway inflation. Even after the current wave of infections subsides, if signs of a seventh wave become apparent, Japan will probably repeat its actions of the past two years. As evident from the strong GDP performance of October-December 2021, infections were mostly under control during that time, but thorough preparatory measures, such as increasing the number of hospital beds available, failed to be taken. Since such measures were not taken in October-December last year, it seems unlikely they will be taken going forward. In this context, the media reported in February that the COVID response Subcommittee was considering exit strategies, but again, it may be unwise to get our hopes up. So long as the government and ruling party, which effectively govern the Subcommittee, base their decisions on the speculation that strict COVID measures will gain them public support, no major changes to the current situation seem likely. Unless something fundamental changes, it would be difficult to hope for any developments different from the previous years, and a fundamental change may not be easy to come by, as it has to do with the nature of Japanese society and its zero-risk orientation.

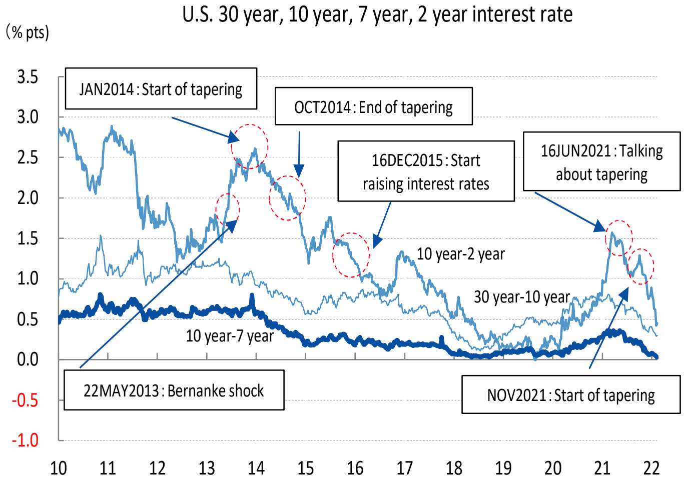
Could the Pain of JPY Weakening Change the Authorities' Attitudes?

As already discussed, perhaps the one thing that could change this situation is the pain resulting from a further depreciation of JPY. It seems extremely likely that the significant disparity between the GDPs of Japan vs. the rest of the world is related to Japan's unique approach to the pandemic. The same can be said of JPY's REER falling to an all-time low. If (1) a weak GDP leads to (2) JPY depreciation, which then results in (3) inflation, and further in (4) the deterioration of business sentiment, the perception that strict COVID measures result in stronger public support may begin to fade, and the authorities may begin to realize that economic normalization is more important than COVID measures. This may already be the only way for the Japanese economy to emerge from its slump.

U.S. Monetary Policy Now and Going Forward – Fears of an Overkill and Impact on JPY

Could the Normalization Process End Before it has Begun?

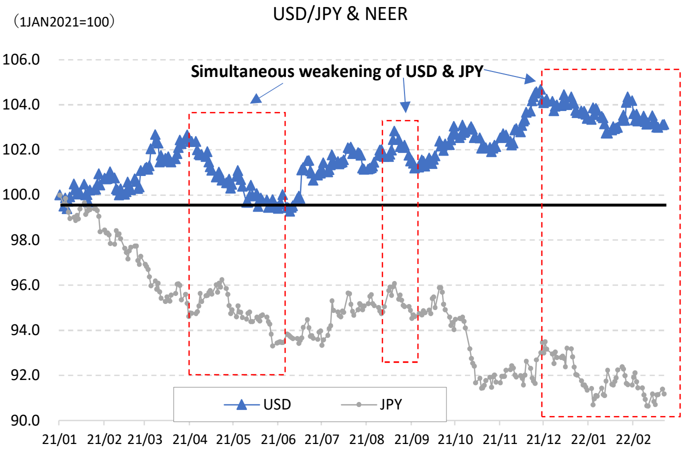
The U.S. January consumer price index (CPI), released by the U.S. Department of Labor on February 10, showed +7.5% yoy growth, accelerating from the December 2021 +7.0% yoy, and posting the highest growth in 39 years and 11 months, i.e., since February 1982 (7.6%). Just under 30% have factored in the likelihood of a +50bp increase in Federal Funds (FF) rates at the March FOMC meeting, and U.S. 10-year interest rates have intermittently been hitting the 2.0% level. Fears of an overkill on the Fed's part continue to rise against the Fed's consistently hawkish messaging, and as of the time of this report's writing, the 10-year to 7-year yield-curve is already flat. The 30-year to 10-year spreads, and 10-year to 2-year spreads are also steadily in the process of disappearing. Given this situation even before the Fed has conducted its first rate hike, one gets the impression that the normalization process could end even before it has begun. At this rate, it seems unlikely that the Fed can smoothly implement four or five successive rate hikes, so my prediction in this report continues to favor only three rate hikes in 2022 (in March, June, and September, respectively). However, if the first hike is by 50bps in March, one could interpret the three rate hikes in 2022 as amounting to four 25bp hikes (however, the prospects for three rate hikes are also rapidly dwindling against the crisis unfolding in Ukraine). The yield for 30-year maturities (which are expected to maintain strong demand from pension funds) remains stable at 2.0~2.2%, and if one assumes that 10-year interest rates will not exceed this, we could be approaching the end of the USD-buying phase based on expectations of an increase in U.S. interest rates.



(Source) Bloomberg

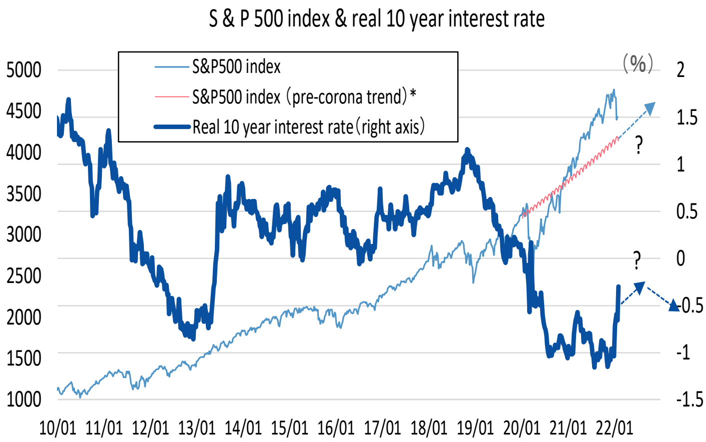
U.S. Stocks Rather than U.S. Interest Rates Behind JPY Selling?

However, the peaking of U.S. interest rates does not signify the end of the weak-JPY outlook. Over the past year, there have been many phases when USD was depreciating, but JPY was depreciating alongside it (see figure), and I see this as evidence that the current phase of JPY weakness reflects a "sell Japan" trend. Of course, a derailment of the Fed's policy normalization process or a drop in U.S. interest rates could certainly slow down the pace of USD/JPY increase, but they are unlikely to establish a strong-JPY trend. Further, if the policy normalization process gets derailed, it could directly result in strong U.S. share prices via lower interest rates, and if that gives rise to a risk-on mood, it could result in a JPY sell-off.



(Source) macrobond

It is often noted that U.S. share price movements are regulated by real interest rate movements. If, for instance, we assume a situation where U.S. 10-year interest rates and U.S. inflation expectations (10-year BEI) both trend at or below 2.0-2.2%, real U.S. 10-year interest rates, which have been rising so far, are likely to peak at around 0% (see figure). This would result in the return of a favorable phase for buying shares and other risky assets. And, as is well understood, JPY selling tends to predominate during such phases. As I have always considered that "COVID measures based on tenuous grounds → deterioration of Japan's growth rate → Japan avoidance" are fundamentally responsible for the JPY and Japanese share price weakness, I do not consider that the derailment of the Fed's policy normalization process could result in a switch to a strong-JPY scenario. However, it is quite possible that the main factor behind JPY selling could change from U.S. interest rates to U.S. stocks.



(Source) macrobond、
(Note) *Average rate of change over the previous month for 3 years up to the end of 2019 (approx. + 1.0%)

Risks to My Main Scenario – Could "Fixed-Rate Operations" Promote Hysterical JPY Depreciation?

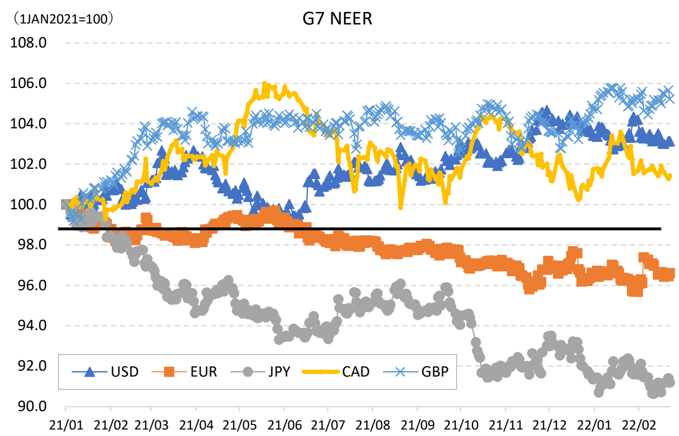
Fixed-Rate Operations' Problematic Effect on Exchange Rate Levels Rather than Interest Rate Levels

During February, Japanese government bond yields were pushed upward by pressures from a worldwide interest rate uptrend. The yield on 10-year Japanese government bonds rose to the 0.20% level, approaching 0.25%, which is considered to be the allowable upper limit within the BOJ's yield curve control (YCC) system. In response, on February 14, the BOJ indicated its intention to curb the rise in interest rates by undertaking the purchase of an indefinite amount of government bonds with the goal of limiting yields to 0.25%. (Such purchases are known as fixed-rate operations). However, it appears that the interest rate uptrend problem was resolved before the BOJ actually initiated the fixed-rate operations. It is presumed that the February JPY interest rate uptrend reflected the fact that Japan's banking sector and other Japanese institutional investors were at that time conscious of approaching the end of their fiscal years, which generally end on March 31. It is likely that the risk tolerance levels of a considerable number of investors have been impacted by rapid rises in interest rates outside Japan. It appears that investors who would normally be "buyers" simply have been finding it difficult to undertake new purchases owing to seasonal factors (associated with the timing of fiscal accounting periods). Therefore, I do not anticipate that the presence or absence of fixed-rate operations will have a persistent effect on JPY interest rates levels – I have relatively more concern about the possible impact of intermittent fixed-rate operations on forex rate levels rather than on interest rate levels.

This article anticipates a moderate trend of JPY depreciation but does not anticipate a hysterical JPY depreciation trend involving intense volatility that the government and the BOJ would have difficulty responding to. However, there appear to be grounds for concern about sharp surges in "fixed-rate operations" designed to countervail global trends and the potential of such surges to promote hysterical JPY depreciation trends.

Selling Currency and Stocks instead of Bonds

Clearly, expectations that any future rises in interest rate levels will be restrained through infinite intervention operations is not healthy for the bond market. As monetary policy-based price controls do not extend to forex and stock markets, suspicions and concerns about the bond market situation may promote JPY selling and Japanese stock sales in those markets. In fact, while JPY interest rates have settled down in financial markets since last year, the performance of JPY and Japanese stocks has clearly been inferior internationally compared to other countries' currencies and stocks, and this seems to suggest that "what cannot be expressed in bond markets is manifesting itself in forex and stock markets". This appears to relate to the "Japan avoidance" theme that this article has been discussing for some time.



（Source） macrobond

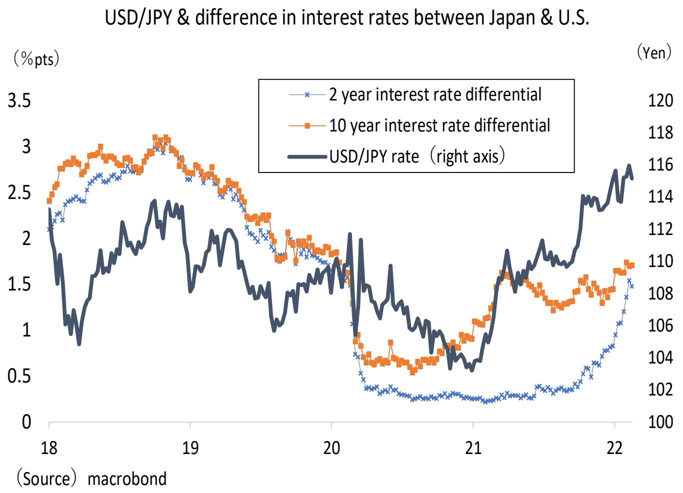
As mentioned above, there are only weak grounds for lengthily protracting Japan's immigration and behavioral restrictions, are these restrictions are clearly undermining the Japanese economy's vitality. The February 7 morning edition of the Nihon Keizai Shimbun featured an article entitled "Corona National Isolation Policy Promoting Japan Avoidance" that straightforwardly reported about foreign-affiliated companies' moves to distance themselves from Japan-related businesses, and it can be said that a similar trend has already been underway in financial markets for some time. JPY's nominal effective exchange rate has fallen by more than 6% in the past year and Japan's stock index is the only stock index of G7 countries to fall below the previous year's level (see graph), and it is natural to suspect that this is attributable to Japan's unique restrictions. For example, although stock prices have fallen globally, other G7 countries' stock prices have increased by more than 10% yoy (as of February 23), which is of a magnitude comparable to the yoy decline in Japan – the trends in Japan and overseas are quite different. It is very hard to attribute the slump in Japanese stock prices to such global themes as rising resource prices and the spread of new covid-19 variants. It seems that there is a general aversion to Japan's special situation and that this mood is being expressed with respect to transactions in JPY and Japanese stocks, which can be freely bought and sold.

Avoiding Acute Damage, but Accumulating Chronic Damage

Ordinarily, rising interest rates (falling bond prices) should be the loudest (and most painful to the real economy) alarm regarding such dangerous political and economic situations, but this alarm will not work so long as the bond market is being controlled with fixed-rate operations. This is continuing to make it difficult for politicians to feel a sense of crisis about the real economy, which helps explain why the government feels free to prolong immigration and behavioral restrictions indefinitely. It would be difficult to sustain the current isolationist policies if domestic consumption and investment proclivities were depressed by sharp interest rate rises. Although monetary policies' effects may suppress the acute impact rising interest rates would have, however, it should also be remembered that consumer and investment motivation will continue to stagnate and chronic economic damage will accumulate so long as the current strict anti-pandemic measures are protracted. This will still further widen the gap between the pace of economic recovery in Japan and elsewhere. This gap is evident from fact that Japan is an outlier in being the only developed country that has not yet recovered its pre-pandemic GDP level (see upper graph on page 9).

If politicians do not feel a sense of crisis regarding the fact that Japan's current lackluster economic and financial situation is largely attributable to strict anti-pandemic measures, the chronic economic damage will only continue to accumulate. Public opinion indicators such as declines in politicians' approval ratings are often early alarms that induce policy revisions, but Japanese still generally support the current government's anti-pandemic policies even though they may realize or suspect that the measures are sapping the economy's vitality. It is not clear whether this stems from Japan's demographic structure (in that there is a high share of conservative elderly people) or Japan's safety-oriented culture, but there is widespread support for strict anti-pandemic measures regardless of the cost.

JPY Exchange Rates Serving as an Alarm



Amid these circumstances, it appears that it may have to be JPY exchange rates that assume the requisite role of sounding the alarm. Persistent declines in stock prices might ordinarily be politically unacceptable, but they may not sound a very loud alarm to the ears of the Kishida administration, which advocates a "shift away from shareholder capitalism". This is particularly true when one considers that less than 10% of Japanese households' financial assets are held in the form of stocks. However, forex rate fluctuations have clear impacts on people's lives. The depreciation of JPY on both nominal and real bases will gradually come to serve as a loud alarm. The intermittent use of fixed-rate operations going forward can confidently be expected to halt the rise in 10-year interest rates at the 0.25% level, but this monetary policy is also likely to promote additional JPY selling. While this article's main forecast scenario already anticipates JPY depreciation, the effect of monetary policies promoting additional JPY depreciation represents an unexpected risk factor.

There are two main factors that seem likely to motivate JPY selling going forward. One is JPY selling promoted by widening interest rate differentials, and the other is JPY selling promoted by growing speculation stemming from the "Japan avoidance" theme. It is inevitable that people will be aware of the first factor. In addition to US-Japan 10-year interest rate differentials, US-Japan 2-year interest rate differentials are also expanding rapidly, and similar developments can be seen regarding Germany-Japan interest rate differentials. Japan's decision to artificially hold down interest rates while other countries are suggesting prospective interest rate hikes will clearly incentivize JPY selling vis a vis multiple currencies.

JPY selling in response to such widening interest rate differentials may be a short-term phenomenon, but there are grounds for concern about the promotion of JPY selling based on a longer-term and structural perspective and suspicions about Japan's desire to seek to prolong its monetary policy easing measures over the longer term. It bears reiterating that the bond market is ordinarily expected to reflect a country's economic and financial situations by means of interest rate fluctuations. As seen during the European debt crisis, countries inspiring widespread doubts about their debt repayment capabilities will be alerted to the situation by rising interest rate levels. In Japan, however, monetary policies have been used to turn this alarm off, so the financial markets' perception of current or prospective problems are no longer communicated. While it would be impractical to discuss the sustainability of Japanese government debt levels in this article, it is worth pointing out that the financial markets have extremely strong aversions to situations determined by uncertain and unknown factors. As the world becomes increasingly focused on the theme of inflation, forcibly restraining long-term interest rates is quite stressful for financial markets, which are likely to decide that the easiest way to dissipate that stress is by selling Japanese stocks and JPY. As already discussed, something similar to that has happened over the past year. In light of these situations, there are solid grounds for concern that the protracted implementation of fixed-rate operations will trigger considerable JPY selling.

Possibility that Fixed-rate operations Could Accelerate the End of Monetary Easing Measures

However, there is a strong possibility that monetary easing policies may be terminated before fixed-rate operations become truly chronic. This is because if JPY depreciates, the rise in domestic prices owing to surging import prices will have a clearly palpable impact on the lives of ordinary Japanese. While wages and prices in Japan have not risen, those overseas are soaring so, on a real basis, JPY would be depreciating more than it would be on nominal basis. When the effect of rising resources prices is added to the real basis JPY depreciation, ordinary Japanese people's perception of the impact on their lives will become even more clear. If the Kishida administration's approval ratings remain high and public opinion is still in favor of strict anti-pandemic restrictions even at that point, then the JPY inflation may be deemed politically tolerable, but that may not be the case. When such phrases as "undesirable price increases" and "undesirable JPY depreciation" become commonly used to explain why people perceive their quality of life is deteriorating, it is likely to lower political approval ratings to a degree that will not be possible to ignore. The adjustment of monetary policies may thus become inevitable.

However, there is a concern that such a demonstration of “how forex trends dictated a monetary policy adjustment” may strengthen financial markets’ speculation about whether they might not be positioned to continue inducing monetary policy adjustments. Just as in the past, when the Shirakawa-led BOJ responded to JPY appreciation by playing its cards (monetary easing measures) one by one but simply lost those cards, it seems possible that if the BOJ responds to JPY depreciation, the markets will continue to attack by selling JPY and thereby progressively diminish the BOJ’s hand of policy option cards. Rationally considered, it appears that the BOJ’s first response move might be to allow for a certain amount of general rise in JPY interest rates by shortening its YCC fixed-rate operations target period (from 10 years to 5 years), but even if that were to be sufficient to weather a short-term emergency, it seems likely that the markets might then simply proceed to pressure for the abandonment of negative interest rates. Ultimately, it might become necessary to raise interest rates into the positive zone.

Once efforts are begun to adjust monetary policies to meet forex market expectations, it seems likely that there would be no end to the requisite adjustments. While it is still much too early to forecast what will happen, one should keep in mind the possibility that, if upward pressure on interest rates were to be countered by excessive use of fixed-rate operations going forward, there is a possibility that JPY depreciation might make it difficult for the BOJ to maintain its current policy trajectory.

Supplementary section: Q&A on SWIFT Sanction Measures – Monetary Policies in the Face of Stagflation

Overview of Issues Related to SWIFT Sanctions

The decision to block the access of “selected Russian banks” from the SWIFT (Society for Worldwide Interbank Financial Telecommunication) financial messaging system was taken as the final element of the Western allies program of sanctions against Russia in response to Russia’s invasion of Ukraine. The SWIFT blockage (which was described as a “financial nuclear weapon” by French Finance Minister Bruno Le Maire) will have great and far-reaching impact, and it has been opposed by such major European countries as Germany, Italy and Austria. For example, German Foreign Minister Annalena Baerbock stated that – “Decoupling all payment transactions would perhaps be the biggest stick, but not necessarily the sharpest sword.” However, after reports that the Russian army had invaded Ukraine’s capital city Kyiv and that ceasefire negotiations had been terminated, on February 26, the major European countries opposed to SWIFT blockage adopted harder-line stances, thereby enabling the Western allies to reach agreement on undertaking the blockage. In addition, although that is a quite separate issue, it has also been reported that the leaders of Poland and Lithuania visited Berlin and persuaded German Chancellor Olaf Scholz to export arms to Ukraine. International affairs are often very surprising, and the more one learns about the history of international affairs, the more surprising it is.

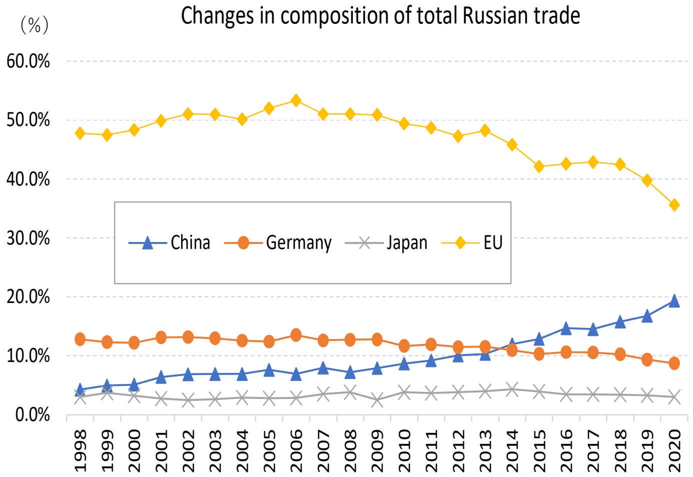
While the war itself is distressing in many ways, the financial markets are not primarily focusing on the war itself but on the economic and financial effects of changes accompanying the war, particularly the exchange of sanction measures between the two sides. In that sense, it is no exaggeration to say that the financial markets were more shocked by the SWIFT blockage than the news of the fighting in and about Kyiv. I have received many related inquiries, and the Q&A sections below are focused on those issues that inspired the most inquiries.

Q1: What is the biggest impact of SWIFT blockage? (Russian side)

A1: The impact of SWIFT blockage with respect to Russia and elsewhere needs to be examined separately. It appears that the primary concerns in Russia will relate to currency crises, while places outside Russia will face rising resource prices.

First, let’s look at Russia’s prospective currency crises. The term “currency crisis” has a very wide range of meanings, it is a general term referring to all the negative economic phenomena that occur when the value of a country’s currency is suddenly damaged. The biggest effect of the SWIFT blockage is that the blocked country will not be able to obtain foreign currency. No matter how much crude oil, natural gas, and grains Russia sells to other countries, the use of the SWIFT system to obtain the foreign currency-denominated payments for those products will be cut off going forward. There are still some kinds of trade transactions with Russia that are not prohibited, but if Russia cannot receive payments for those transactions, the transactions will sooner or later stall. In addition, the sanctions are designed to stymie capital movements to Russia, such as those related to securities investments and direct investments from other countries. Thus, Russia-related trade and capital transactions will be completely suspended, and the Russian ruble (RUB) will be overwhelmingly oversold in forex markets. Since the prospect of this development is clearly evident, almost any economic entity that currently owns RUB will be seeking to

Changes in composition of total Russian trade



(Source) macrobond (Note) EU includes Germany sell them. It is easy to get an general image of Russia's international trade from examination of a few numbers. In 2020, Russia's total international trade amounted to about USD560 billion, accounting for about 40% of its nominal GDP (USD1.45 trillion). Over the past 20 years or so, the share of Russia's trade with the EU has gradually diminished while the share with China has increased (see graph), but despite this shift, the total amount of trade between the EU and the United States and Japan continues to account for 40% or more of Russia's total international trade. If transactions in such G3 currencies as USD, EUR, and JPY are stopped, trade transactions using these as settlement currencies will almost stop. If Russia's nominal GDP is diminished by 16% (≈ 40% x 40%), the impact will be enormous.

In short, the SWIFT blockage is a financial version of a military siege. If SWIFT cannot be used, money will not flow between countries, so not only capital transactions with foreign countries but also trade transactions will be delayed or cancelled. Even if ways are found to bypass SWIFT, it will not be possible to trade at a satisfactory prices or in satisfactory quantities using the collapsed RUB. As a result, goods coming in to Russia from overseas will be more expensive and tend to be smaller in quantity. Russia's domestic supply-demand situation will be tight, as supply shortages will lead to a chronic excess of demand. The consequential "high prices amid economic recession" situation (stagflation) will intensify, and perhaps the Russian people will become dissatisfied with the Putin administration that has launched the war. At present, the only way to lift the SWIFT blockage is to change the Putin administration, so the word "revolution" may sooner or later come to be used.

It is worth noting that it was decided in 2012 to block Iran's use of SWIFT to curb that country's nuclear technology development programs and that Iran was subsequently unable to obtain abundant foreign currency income from its oil exports. It is said that this was the main factor leading to the "Iran Nuclear Agreement" in 2015. A similarly large sanctions effect is expected with respect to Russia, but as described below, the cost to the Western allies will also be large.

Q2: What is the biggest impact of SWIFT blockage? (Non-Russian side: Western camp)
A2: The situation facing the non-Russian side will not be as dire, but the SWIFT blockage has been compared to a nuclear weapon because it will also incur damage on the people who use it. While there will be a wide-range of negative effects on the non-Russian side, there are two main points: (1) rising resource prices, and (2) opportunities to promote the growth of alternative inter-bank payment networks.

The first thing that comes to mind is the issue of rising resource prices. As mentioned above, if Russia can sell resources overseas but is unable to obtain payment for those resources, the Russian side will naturally stop selling resources overseas. Resource importing countries will no longer have a prospect of procuring resources from Russia. Already tight resource supply-demand situations will become more tight, and resource prices will rise. Almost all of the world's USD-denominated transactions are settled via SWIFT. This means that not only crude oil and natural gas transactions, but also transactions in such food products as wheat will be affected, because those are also USD-denominated transactions. (It is worth noting that Russia is the world's top wheat exporter and Ukraine is the world's fifth largest wheat exporter). There are grounds for serious concerns about the prospect for persistently high prices of a wide range of resources, including food. Of course, there will be a lag of several months before these developments directly impact the household sector's cost of living, but it is certain that they will gradually but surely undermine the real income environment. These side effects of the SWIFT blockage sanctions seem likely to be the biggest reason it took some time for the Western camp countries to agree on imposing them. One is naturally inclined to suspect that the SWIFT sanctions were imposed after making some provisions to mitigate these resource-related side effects, but I haven't yet been able to find any reports about such provisions.

Europe will be the region most affected by high resource prices, which is why there was strong opposition there to the SWIFT blockage proposal, but the problems facing Europe are not limited to resources. Many European companies have established and expanded the operations of affiliated companies in Russia, and this is surely a reason for European countries to be particularly concerned about the self-injurious aspect of the SWIFT blockage sanction measure. Of course, there are many companies based in Japan and elsewhere that have been expanding their operations in Russia, led by automobile makers, and Japan must also be prepared for the destructive splash-back effect of the SWIFT blockage, but it appears that the range of affected companies based in Europe is quite wide. Moreover, not only companies but also international students and legitimate citizens' groups in Russia will not be able to receive funds. North Korea was blocked from SWIFT in 2017, and Iran was blocked from SWIFT in 2012 and 2018, but the impact on the private sector will be incomparably larger when targeting such a large country as Russia, so it will be difficult to create an accurate forecast of collateral damages based on past experience.

Q3: What is the biggest impact of SWIFT blockage? (Non-Russian side: other than the Western camp)
A3: The second main point about the impact of the SWIFT blockage is the abovementioned opportunities to promote the growth of alternative inter-bank payment networks. Countries other than Russia seeking to compete with the United States (China, the Middle East, etc.) have long been aiming to develop alternatives to SWIFT. Russia began developing its own SPFS interbank network as an alternative to SWIFT following economic sanctions related to the 2014 invasion of Crimea, but SPFS is basically a system for domestic transactions. On the other hand, it has also been pointed out that the SWIFT blockage may present an opportunity to further develop and expand the Cross-Border Interbank Payment System (CIPS) that China is striving to build. The SWIFT blockage this time also targets the Russian central bank to prevent it from using its abundant foreign currency reserves for currency defense

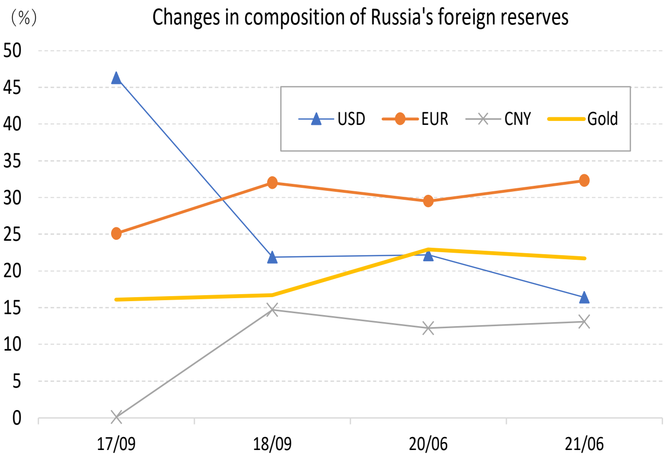
measures (buying RUB and selling foreign currencies). In other words, Russia's holdings of U.S. treasuries, U.K gilts and EUR-regional bonds will be frozen. From the perspective of Western governments, this is tantamount to defaulting on all the funds borrowed from Russia, and it will be a devastating blow to Russia in the midst of its currency crisis.

Of course (see graph below) Russia has already had a clear policy of reducing USD and increasing the RMB within its foreign exchange reserves, so it appears that it could sell RMB and buy RUB via CIPS as a currency defense measure (with the intention of repurchasing the RMB after things settle down). Given President Putin history of confrontations with the West that raised the possibility of SWIFT-related sanctions in the past, it seems unlikely that he did not anticipate the possibility of SWIFT sanctions this time.

With respect to the situation in which U.S. Treasuries held in one's own country can be frozen and cannot be redeemed, is worth noting that China is the country with the largest holdings of U.S. Treasuries (USD1.6 trillion as of December 2021). Given that, it appears quite likely that China's already strong desire to create its own international interbank payment network will be further strengthened by recent developments. There are also concerns about the possibility of using crypto assets to get around the SWIFT blockage. If crypto assets were actually to be used in that way, it can be expected that such crypto asset transactions would eventually become subject to strict regulations.

Q4: Can Russia's foreign exchange reserves be utilized at all?

A4: It is presumed that Russia will be able to utilize a portion of its reserves. So long as the SWIFT blockage disrupts Russia's foreign currency procurement, RUB exchange rates (the value of RUB in terms of foreign currencies) will naturally fall. In anticipation of this, RUB is plummeting to record low levels. As already mentioned, sanctions against the Russian central bank will restrict Russia's use of its huge foreign exchange reserves, so the Russian central bank is not positioned to defend RUB by selling USD and EUR in exchange for RUB. Russia's central bank is one of the few central banks that releases data on the individual currency components of its foreign exchange reserves and, according to that data at the end of June 2021, USD accounted for 16.4% of the reserves, EUR for 32.3%, and GBP for 6.5% (see graph). While that data does not include a JPY item, the Russian central bank's report mentions that JPY accounts for 5.7% percentage points of the 10% "Others" item. Since these are subject to the SWIFT blockage measures, 60% of Russia's foreign currency reserves will be frozen as "unusable foreign currency".



(Source) Central Bank of Russia

On the other hand, there appears to remain a considerable quantity of foreign exchange reserves that Russia may be able to utilize. This portion includes RMB, which accounts for 13.1% of the reserves, and gold, which accounts for 21.7%. As of the end of June 2021, Russia's foreign exchange reserves amounted to USD585.3 billion, of which it seems that Russia may be able to utilize about USD203.1 billion (the 34.7% of total reserves that are in the form of RMB and gold). This is not a small amount, but compared to the scale of the challenges Russia will soon be facing, a little over USD200 billion may only be comparable to a drop in the ocean.

However, Russia has clearly shown efforts to increase the share of RMB and decrease that of USD within its foreign exchange reserves over the past five years or so, and its seems likely that those efforts were designed to prepare for precisely the kind of situation it now faces. This is why some observers believe that Russia must also have been making some other kinds of measures to prepare for the current situation.

Q5: What is the impact of SWIFT blockage on Europe?

A5: There is a possibility that existing and incipient divisions among continental European countries will become exacerbated. Regarding fossil fuel imports, European countries' dependence on Russia ranges between 30% and 40% for both natural gas and oil. (International Energy Agency (IEA) figures indicate that Russian exports account for 32% of natural gas usage in the EU and the UK, while Russian exports account for 32% of oil usage in European OECD countries. The former figure is for 2021 as a whole while the latter is for November 2021.) But individual European countries' levels of dependency vary greatly. Some countries' dependency levels are in the 50%-to-100% range (such as Germany, Finland, the Baltic States, and Eastern European countries), while others are in the 10%-to-20% range (such as France and the Netherlands). Although Europe managed to reach agreement on SWIFT blockage because of the general mood of the international community, countries in the eastern portion of Europe (closer to Russia) will suffer disproportionately from the decision.

Germany and other countries in the eastern portion of Europe are particularly concerned about the prospective extreme tightness of their energy situations, while the concern levels of France, the Netherlands, and other countries in the western portion of Europe are lower. (Although Germany could alleviate its own situation if it were to abandon its plans to shut down its nuclear power plants.) Consequently, one can anticipate a divisive crack running from north to south between countries in continental Europe's eastern and western portions. From 2015, former German Chancellor Merkel's policy of accepting unlimited numbers of refugees caused a similar divisive crack running from north to south between Germany and Eastern Europe countries. This time, the crack will shift slightly to the west, dividing France and other countries in the western portion of Europe from Germany. Such multiple north-to-south cracks have made it more difficult to anticipate and interpret European political and economic developments. Moreover, there is also a divisive crack running from west to east separating Germany from Southern European countries (a north-south conflict based on long-existing economic disparities), and a divisive crack running from southwest to northeast and separating Germany and France from the Netherlands and Scandinavian countries (based on differing views about the EU management system). While this has always been the case, it bears keeping in mind at this time that understanding political and economic developments in Europe requires a quite wide range of knowledge about the region's political, economic, and financial situations.

Q6：Are anti-Russia sanctions other than the SWIFT blockage relatively insignificant?
A6: The other anti-Russia sanctions are also significant. The SWIFT blockage can be expected to cause acute damage in the short-term, while it is anticipated that the export restrictions on high-tech products included in the current sanctions package will cause chronic damage over the long-term. The export of products using U.S. technology to Russia is currently restricted, and the restrictions apply to exports originating from the United States as well as exports from other countries. Russia imports semiconductor products and other items required for the manufacture of robots and utilization of AI technologies from the United States and Asian countries. It has been difficult for Russia to develop domestic suppliers of such items, and it appears that Russia's lack of such domestic suppliers will weaken it over the long run politically, economically, and militarily. This weakening effect may not be dramatically evident immediately, but it will certainly hurt the Russian economy. Unlike the SWIFT blockage, the export restrictions will generate a relatively minor amount of backsplash damage, which is why Japan, the United States, and Europe reached agreement on them at a relatively early date.

Q7: How might Russia-related developments affect the monetary policy normalization process of developed countries' central banks?
A7: It has to be acknowledged that the Russia-related developments will make things very difficult for the central banks. As already mentioned, the SWIFT blockage will inevitably make the global resource supply-demand situation tight. This will cause increases in the prices of energy-related products as well as in the prices of wheat and other food products. These trends are likely to cause the entire world economy to suffer from stagflation.

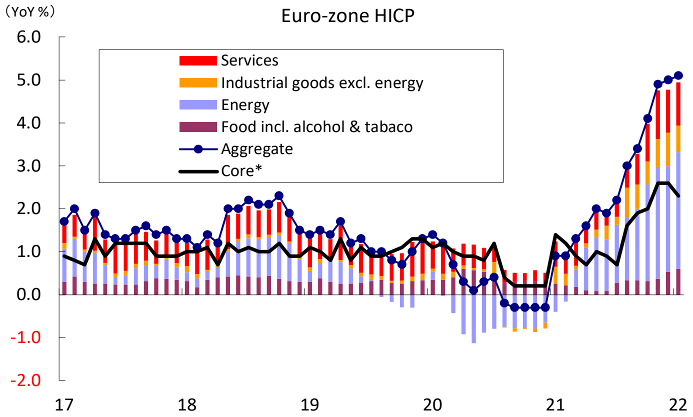
When stagflation becomes the dominant economic theme, central banks have only limited means of alleviating the situation. They may choose to tighten monetary policies to restrain demand along with the rise of prices, or they may choose to continue monetary easing to support the economy as a temporary response until supply constraints are resolved. The former option requires accepting the inevitability of an economic recession, but increases the likelihood of deterring or restraining price rises. The latter option reduces the likelihood of a recession but is more likely to require the acceptance of stagflation (at least for certain period of time). Currently, it appears that the Fed is inclined toward the former option while the ECB is inclined toward the latter option. Given the Fed's desire to maintain monetary policy continuity, it appears unlikely that the Fed will change its attitude about initiating interest rate hikes from March. On the other hand, ECB President Christine Lagarde has admitted that monetary policy is powerless against the current inflation surge, saying – "We need to be open about what we can and cannot do as a central bank. For example, our monetary policy cannot fill pipelines with gas, clear backlogs at ports or train more lorry drivers." In light of that, it appears unlikely that the ECB will rush to tighten its monetary policies.

However, it seems that inflationary pressures in the United States as expressed in yoy changes in prices are very likely to begin diminishing from early spring. U.S. housing price trends have been causing particular concern, but it appears that they have already peaked out. Shipment delays also appear to have eased (to the extent discernable from such corporate sentiment surveys as the ISM Manufacturing Index) but, although plans for a March interest rate hike may be implemented, it is highly likely that the general attitude toward second and subsequent rate hikes will be different. If there are at that time serious concerns about the global economy's downturn owing to the Ukrainian crisis, it seems quite likely that the Fed will shift to a stance closer to that of the ECB. While I had previously anticipated that the Fed would only raise interest rates about three times, I now think it more likely that rate will be raised only once or twice due to the ramifications of the Ukrainian crisis.

EUR Outlook – Outlook For Quantitative Easing Termination and Interest Rate Hikes

EUR Area Monetary Policies Now and Going Forward – Outlook For Interest Rate Hikes

What Has Changed in Six Weeks?



(Source) Datastream
(Note) Core excl. energy, food, alcohol & tabacco

The first ECB Governing Council meeting this year showed the ECB sharply adjusting its dovish stance and moving toward a more-hawkish stance. There were two points regarding this meeting that merit particular attention. One point was that President Lagarde could not deny the possibility of an interest rate hike during 2022, and the other point was that she suggested policy adjustments would be decided on at the March Governing Council meeting. Regarding the former point, at the previous Governing Council meeting in December, President Lagarde dismissed the possibility of an interest rate hike during 2022 as "very unlikely". At the most recent press conference, a reporter frankly asked – "You have been saying that a rate hike this year is highly unlikely. What are you saying now? Are you sticking to "highly unlikely," or have you moved on?" – and President Lagarde responded by saying – "I never make pledges without conditionalities and it is even more important at the moment to be very attentive to that." This suggested a significant change in President Lagarde's posture toward the possibility of interest rate hikes.

The ECB's position through the previous Governing Council meeting was that inflation was being driven by energy prices and that the inflation outlook would settle down in the latter half of the year. In this regard, the latest Governing Council meeting's statement continues to assert that – "inflation is likely to remain elevated for longer than previously expected, but to decline in the course of this year" – so it seems that the ECB has not changed its expectation that inflation will settle down in the medium to long term. However, the statement also notes that – "Compared with our expectations in December, risks to the inflation outlook are tilted to the upside, particularly in the near term." Although the statement is focused on the short-term outlook, it does go on to admit that – "If price pressures feed through into higher than anticipated wage rises or the economy returns more quickly to full capacity, inflation could turn out to be higher."

It is difficult to understand how the perception of the short-term situation changed so significantly during the roughly one month (six weeks) period since the previous meeting. Of course, the current economic outlook is different from the Eurosystem staff projections revised last December, so President Lagarde's statement that – "We are going to [...] respond to the situation – but the situation has indeed changed" – can be considered reasonable. However, since the December staff projections are the latest official economic outlook available to market participants, it is inevitable that there would be demands for explanations of the shift toward hawkishness. In this regard, the euro area's Consumer Price Index (HICP) for January was +5.1% mom, the second straight month of record high HICP levels, and it may be that the ECB perceived this as suggesting an increased level of upside risk. The euro area HICP was temporarily pushed upward in the latter half of 2021 (July-December) by the reaction to a value-added tax rate reduction in Germany. The effect of the tax rate reduction disappeared in January 2022, and so the ECB was naturally anticipating HICP deceleration at that point. It is quite possible that the ECB began taking inflation more seriously when it noted that HICP was accelerating rather than decelerating, due to a rise in energy prices driven by crude oil prices. As the ECB has emphasized for some time, however, only half of broad-based HICP increases are attributable to the energy factor, and core basis HICP has actually begun to decline (see graph). That explains why the ECB chose to maintain its "temporary" basic stance. In fact, the latest Governing Council meeting's shift toward hawkishness has caused considerable fluctuations in financial markets, and those fluctuations occurred largely because the shift toward hawkishness was unexpected. This suggests that the ECB's did not give sufficient attention to its "dialog with the markets".

In any case, the ECB is now acknowledging that short-term inflationary pressures are becoming long-term inflationary pressures, and it seems that the ECB recognizes that if the pressures are left unchecked, there will be overshooting of the inflation target level. This is reflected in President Lagarde's statement at the press conference that – "we do assess risk to the upside for the near term, particularly for the near term. We're not excluding, but we say particularly for the near term. We will know better what impact it will have on the medium-term inflation." Another quite convincing explanation of the ECB's policy stance adjustment is that it was largely a response to increasingly prominent news reports that emerged between the December and February Governing Council meetings about the growing geopolitical risk of an invasion of Ukraine and of an associated surge in crude oil and natural gas prices.

Revision of Pandemic Response Easing Measures

While it is important to note that the possibility of an interest rate hike within the year has been recognized, it is even more noteworthy that there were hints about policy adjustments that may be undertaken at the March Governing Council meeting. It is quite significant that, following her statement that – "I never make pledges without conditionalities and it is even more important at the moment to be very attentive to that." – President Lagarde went on to say – "As I said, we will assess very carefully, we will be data dependent, we will do that work in March." The March Governing Council meeting's work will include approving a temporary increase in the asset purchase programme (APP) from April to compensate for the end of the pandemic emergency purchase programme (PEPP) in March and confirming or amending plans for the gradual decrease of the monthly APP purchases level. (Monthly APP purchases are currently EUR20 billion, and plans call for the level to be increased to EUR40 billion from April and then decreased to EUR30 billion from July and to EUR20 billion from October.) As the Governing Council is concerned about the rising pace of inflation, it will no longer be possible for it to proactively undertake quantitative easing, even if such quantitative easing is designed to mitigate the impact of the catastrophic pandemic.

The Key Word "Sequence"

The urgent issue is how to adjust the monetary easing measures undertaken in response to the pandemic catastrophe, and the key word in this connection is "sequence", which was uttered six times during the latest press conference. The ECB's current forward guidance text reads, "We expect net purchases to end shortly before we start raising the key ECB interest rates." So long as this forward guidance is effective, it can be said that hiking interest rates will become possible only after quantitative easing is discontinued. President Lagarde stated that she will act in accordance with this "quantitative easing discontinuation → interest rate hikes" sequence, and will make decisions gradually so as to not "rock the boat." In other remarks, she reaffirmed that the ECB will make decisions based on data and in line with the sequence stipulated by the forward guidance. Accordingly, it is rational to anticipate that the ECB's "next moves" will entail first terminating the APP and then moving to hike interest rates – the method and timing of APP termination is linked to the start of the interest rate hikes. That is why the decisions to be made at the March Governing Council meeting are so important.

It is natural that financial market players have been mulling over the – "We expect net purchases to end shortly before we start raising the key ECB interest rates" – forward guidance text and are particularly intent on gaining a better understanding of the period of time suggested by the "shortly before" portion of that sentence. In this regard, a reporter at the press conference asking about the specific meaning of "shortly before", and President Lagarde responded – "Shortly before is probably a little shorter than just before". President Lagarde then went on to emphasize that the ECB will be very faithful to the temporal sequence of its forward guidance. This clearly suggests that the ECB is highly aware that devising a means of terminating the APP is its biggest task at this point, and it appears that related decisions are slated to be made at the March Governing Council meeting.

The Main Forecast Scenario... Depends on What Will Happen in March

What will happen in March? It seems most likely that the Governing Council will decide to suspend the APP after using the APP to make monthly pandemic response purchases of EUR40 billion in the April-June quarter and EUR30 billion in the July-September quarter. In this case, the earliest date on which interest rate hikes could be approved would be that of the October 27 Governing Council meeting. If the ECB chooses to begin the interest rate hikes following the revision of its staff projections, the interest rate hikes could be approved on December 15 – the last Governing Council meeting this year. President Lagarde has stated that monetary tightening is less effective against inflationary pressures caused by supply constraints. She strongly emphasized this point in her testimony to the European Parliament on February 14, saying, "We need to be open about what we can and cannot do as a central bank. For example, our monetary policy cannot fill pipelines with gas, clear backlogs at ports or train more lorry drivers." Her point is completely true. As mentioned above, the euro area HICP has is already showing a clear uptrend even on a core basis, and the uptrend is also evident in the five-year in five years inflation swap break-even inflation (BEI) rate that the ECB has traditionally emphasized (see graph). Rather than greatly modifying the value and timing of the pandemic catastrophe countermeasure monetary easing program that it has already announced, it seems likely that the ECB will adopt a moderately hawkish attitude by implementing that program as planned during the second and third quarters and then terminating it from October.

(Souce) Bloomberg

Looking at the Account of the December 16 Governing Council meeting (when the post-PEPP pandemic catastrophe countermeasure monetary easing program was approved), one finds such statements as – "It was argued that on this basis the change in the inflation outlook called for lower purchase volumes or an earlier phasing-out of purchases under the APP" – and – "the Governing Council should keep the APP open-ended but avoid any perception of a commitment to continuing net purchases under the APP beyond 2022." These statements make it clear that the adjustment of the post-PEPP pandemic catastrophe countermeasure monetary easing program was already being considered within the governing council at that time, so the implementation of such an adjustment should not be surprising in light of the fact that the HICP continues to attain record high levels on a comprehensive basis.

Impact of Three Forecast Scenarios on EUR/USD

Regarding the prospective management of the APP and the timing of subsequent interest rate hikes, the main forecast scenario (1) is "APP termination at the end of the July-September quarter/December rate hike" as described above. The upside scenario (2) would be for "APP termination at the end of the April-June quarter/September rate hike", and the downside scenario (3) would be for "APP continuation until some time following the October-December quarter/unclear timing of prospective rate hike". Regarding EUR/USD during the April-June period, I roughly anticipate that 1.16 is the upper limit in scenario (1), 1.20 is the upper limit for in scenario (2), and 1.14 is the upper limit for in scenario (3). Among news reports about ECB-related information leaks, those suggesting early interest rate hikes have begun to become prominent, and the interest rate futures market is also unrealistically factoring in 10bps interest rate hikes at a rate of four times a year. However, given that the euro area itself is subject to considerable geopolitical risks and that the aftermath of the Ukrainian crisis will elevate energy costs and worsen the real income environment, I do not get the impression that it will be easy for the ECB to repeatedly hike interest rates.

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