

March 31, 2022

Overview of Outlook

USD/JPY increased rapidly in March. Although the pace of the increase was sudden, the current level of JPY weakness is not surprising, given that this report has been predicting a weak-JPY scenario since the end of 2020. As I have repeatedly argued here, there are very few reasons to buy JPY in terms of fundamentals such as Japanese economic growth rate, JPY interest rates, or real demand for the currency. Japan has been in the process of committing economic suicide as the government repeatedly imposes movement restrictions on tenuous grounds, and so long as the public supports such government action, the situation can be expected to continue. Interest rates are being kept low as part of monetary policy, and the BOJ is on a conspicuously different policy path compared with other developed nation central banks, which are moving closer to rate hikes. However, the most significant factor behind JPY weakness is the fundamental change in JPY supply and demand. JPY has been seen as a safe haven currency so far mainly because of Japan's status as the world's largest net external creditor, thanks to its large current account surpluses. However, cracks are beginning to appear in this stronghold of JPY demand as high resource prices expand Japan's trade deficit and eat into its current account surpluses. Driven by high resource prices owing to the pandemic and wars, Japan may be transitioning from a "mature creditor" to an "asset liquidator" faster than one would expect. Looking at the nominal effective exchange rates of different currencies, it is clear that the current phase of JPY weakness is not due to USD strength, but rather a trend unique to JPY. This is the reason phrases such as (loss of) "confidence in JPY" and "Japan selling" are beginning to be heard more frequently. Of course, it is beginning to look more likely that the Fed's policy normalization process will get derailed, and if that happens, the mechanics of the floating exchange rate system could cause JPY to strengthen. However, one cannot brush away the impression that the conditions this time are different from past phases of JPY weakness. Under such circumstances, the likelihood of USD/JPY surging past 125 cannot be ruled out.

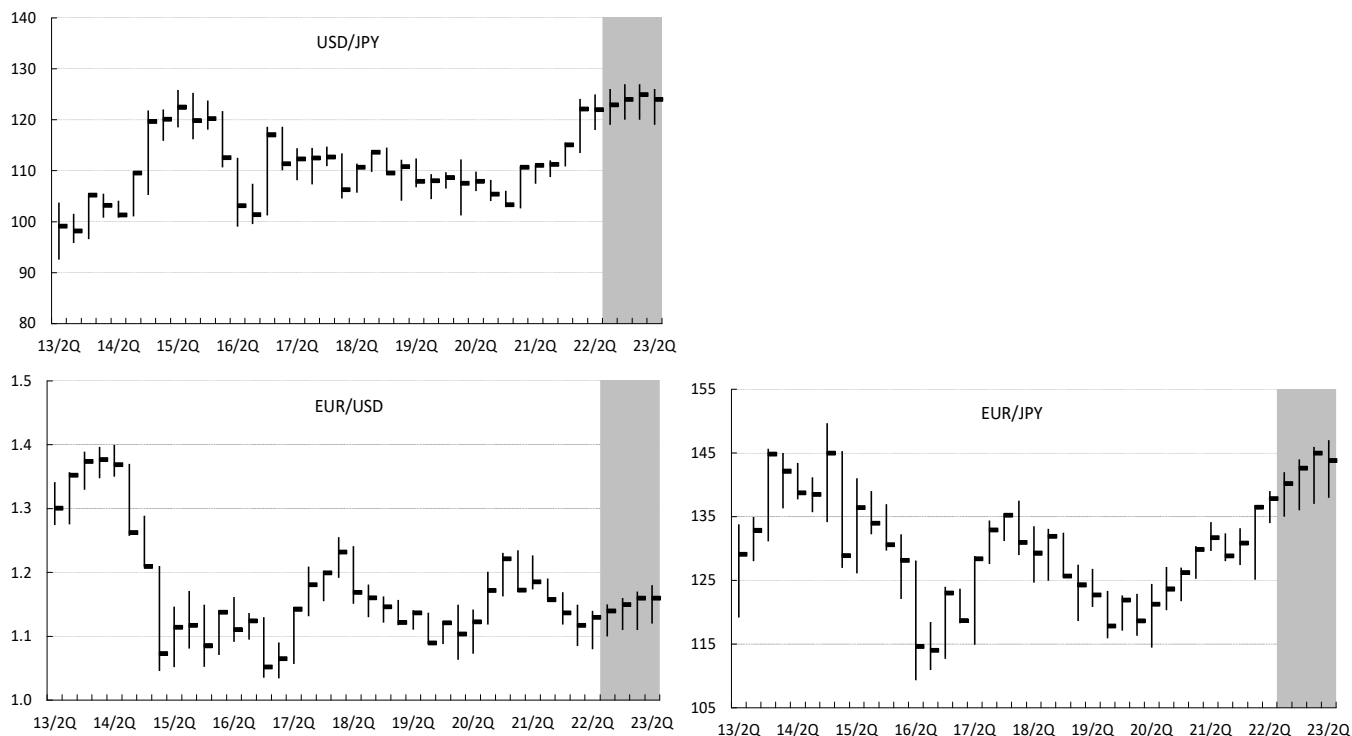
EUR weakened conspicuously during some phases in March but its underlying strength was obvious. While not as definitely as the Fed, the ECB is also leaning toward a hawkish policy path, and the end of the asset purchase programme, which is one of the conditions of a rate hike, seems to be in sight. One of the biggest differences between euro area and the U.S. has been the former's low wage increase rate, but there is an increasing sense of caution over a rise in wages going forward, which will bolster the ECB's hawkish stance. Of course, given that the ongoing geopolitical tensions directly impact the euro area, investors will find it difficult to aggressively buy the currency, but there is a high likelihood of EUR recovering its strength if the crisis in Ukraine ends, given the strong demand for EUR backed by large current account and trade surpluses. However, as the ECB's risk scenario indicates, growth could be weaker than expected if the crisis is drawn out, natural gas prices remain persistently high, and regional inflation continues to rise, undermining real incomes. While there are both upside and downside risks to EUR/USD, EUR/JPY is forecast to remain essentially strong. Unlike Japan, which is beginning to see a decline even in its current account surplus, the euro area continues to boast the world's largest current account and trade surpluses, and this is a determining factor when it comes to assessing the relative strengths of the two currencies.

Summary Table of Forecasts

	2022				2023	
	Jan -Mar (actual)	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	113.47 ~ 125.10 (122.30)	118 ~ 125 (122)	119 ~ 126 (123)	120 ~ 127 (124)	120 ~ 127 (125)	119 ~ 126 (124)
EUR/USD	1.0806 ~ 1.1495 (1.1175)	1.08 ~ 1.14 (1.13)	1.10 ~ 1.15 (1.14)	1.11 ~ 1.16 (1.15)	1.11 ~ 1.17 (1.16)	1.12 ~ 1.18 (1.16)
EUR/JPY	124.41 ~ 137.50 (136.65)	134 ~ 139 (138)	135 ~ 142 (140)	136 ~ 144 (143)	137 ~ 146 (145)	138 ~ 147 (144)

(Notes) 1. Actual results released around 10 am TKY time on 31 March 2022. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts



USD/JPY Outlook – Overview of JPY Weakness: The Background, Merits, and Demerits

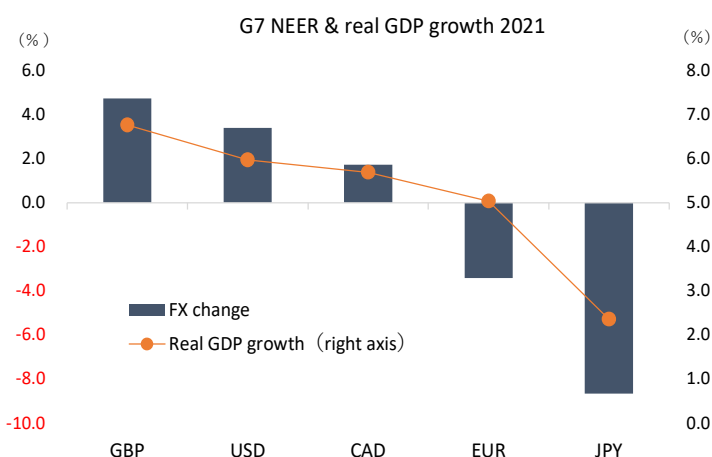
Basic Understanding of JPY Rates – Three Perspectives

Background to USD/JPY Increase

USD/JPY rose steeply in March, successively hitting new year-to-date highs. While the pace at which it rose exceeded the assumptions even of this report, which has consistently been predicting JPY weakness since November 2020, the movement itself was not all that surprising. Taking into account Japan’s political and economic circumstances, there are few reasons to invest in JPY-denominated assets. Several more concrete factors can be cited, namely (1) the Japanese economic growth rate, (2) JPY interest rates, and (3) JPY supply and demand, and in this section, I would like to review the basic arguments related to each of these.

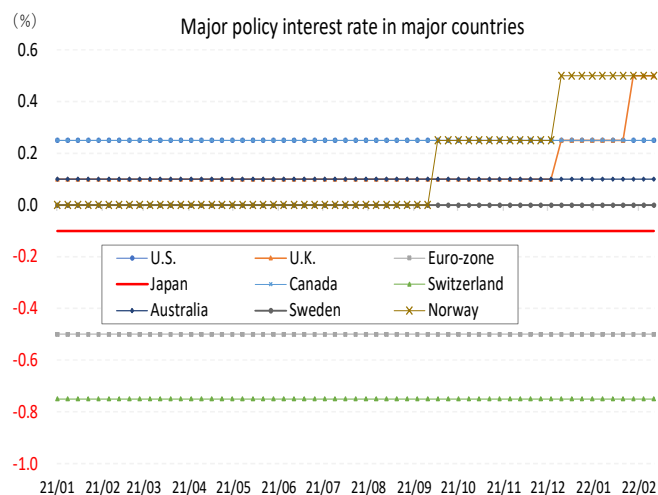
Beginning with (1) – the world of floating exchange rates is typically not so simple as to directly reflect the relative strengths of two economies in the strength of their currencies. However, over at least the past year, and with respect to the G7 group of countries, such a correlation seems to exist.

This is essentially due to the difference between the U.S. and European economies – which lifted movement restrictions completely in anticipation of the post-COVID phase starting spring 2021 and grew at the pace of two or three times their potential growth rate to recover ground lost during 2020 – and the Japanese economy, which has treaded warily, constantly watching for some new movement restriction based on the authorities’ obsession with keeping new case numbers low. This pattern has already been repeated during the January-March quarter of 2022, and the impact will probably be confirmed by numerical data released in April and May. Intoxicated by the idea of putting lives ahead of the economy, Japan is likely to sacrifice growth further going forward.



(Source) macrobond & IMF (Note) as of 31 DEC 2021

In this sense, (1) also relates to (2). In the U.S. and Europe, recovery in demand has naturally resulted in an increase in prices and interest rates, resulting in talk of monetary policy normalization, which is currently on way to being implemented. In Japan, by contrast, the Tokyo metropolitan region and surrounding areas were under a state of quasi emergency to prevent the spread of infections until late March, with restaurants and other establishments forced to operate under reduced business hours. Daily new case numbers are still a subject of intense social interest, being reported regularly alongside other news headlines. As this social conditioning seems unlikely to change anytime soon, there is little reason to expect major changes to pandemic-related measures implemented by the government or ruling party in the coming months. I do not intend to discuss the effectiveness or otherwise of these measures in keeping the pandemic under check,



but what is clear is that the difference between Japan and other countries in handling the pandemic has resulted in the widening gap between their growth rates, monetary policies, and further in the relative strengths of their currencies. Japan's average growth rate is quite low, but that should have nothing to do with seeing a reactionary increase in growth rates in 2021 following the weak performance in 2020. The fact that we did not seems to indicate that some other factor unique to Japan was at play.

Of course, with regard to (2), things could change if the BOJ were to feel a sense of urgency in view of the recent rising pace of JPY depreciation and begin to show some interest in policy normalization. However, BOJ Governor Haruhiko Kuroda has repeatedly disagreed with arguments pointing out the adverse effects of JPY weakness since last year. Earlier this year, he expressed the view that large-scale monetary accommodation was good for the economy, and that persistently working toward policy targets was the most important thing to do. His opinion seems unaffected by increasing resource prices following the Russian invasion of Ukraine, and he reiterated at his press conference following the March Monetary Policy Meeting that JPY weakness benefited the economy, prompting JPY selling. Subsequently, on March 28, his words were translated into action with the notification of Fixed-Rate Purchase Operations for Consecutive Days, which further spurred JPY selling. At any rate, unless the BOJ begins to consider policy normalization, the gap between domestic and foreign monetary policies will expand dramatically. As of the time of writing this report, of the developed nation central banks, the Bank of England has already implemented three rate hikes, while the Fed has already implemented one, so one can say that interest rate differentials have only just begun to expand (see figure on previous page). During 2005-07, JPY carry trade grew robustly as Japan was the only country with zero interest rates, and that situation may be repeated again in the near future.

End of "Mature Creditor" Phase?

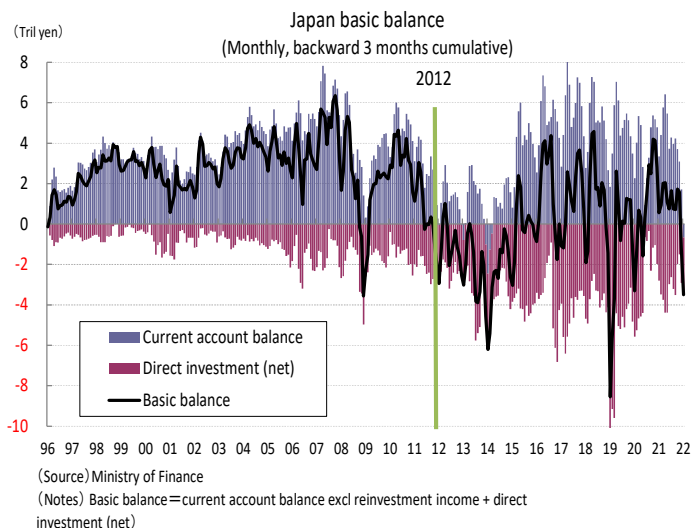
The most deep-rooted factor causing JPY weakness, however, is (3). JPY has been seen as a safe haven currency so far mainly because of Japan's status as the world's largest net external creditor, thanks to its large current account surpluses. The reason JPY and Japanese government bonds have remained stable despite Japan having the world's largest government debt and its rapidly aging society and low birth rates is without a question because of the robust demand for the currency, which has acted as an impregnable stronghold. In more recent years, the trade surplus has disappeared, but the expansion of primary income surplus more than makes up for the loss in trade surplus, allowing Japan to maintain a high current account surplus. This earning through the income balance rather than the trade balance is characteristic of a mature creditor. The fact is that Japan has graduated from a young creditor to a mature creditor, evolving by one step, in the past 10+ years (2008~2020), having survived the collapse of Lehman Brothers, the European sovereign debt crisis, and Abenomics, having become no longer able to make trade surpluses starting around 2012.

Theory of the development stage of the balance of payments

	Theory of the development stage of the balance of payments				Current	Future ?
	① Immature debtor country	② Mature debtor country	③ Debt-paying country	④ Immature creditor country	⑤ Mature creditor country	⑥ Asset liquidator country
Current account balance	deficit	deficit	surplus	large surplus	surplus	deficit
Balance of goods and services	deficit	surplus	large surplus	surplus	deficit	deficit
Primary income balance	deficit	deficit	deficit	surplus	large surplus	surplus
Net foreign assets	deficit	deficit	deficit	surplus	large surplus	surplus
Financial balance	surplus	surplus	deficit	large deficit	deficit	surplus

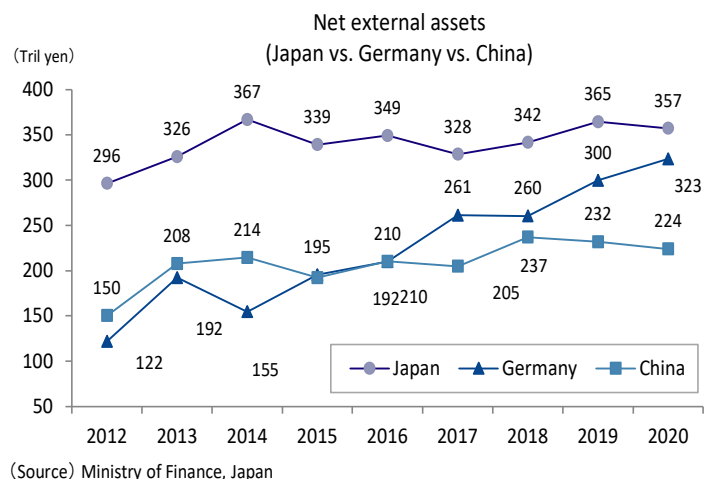
(Source) Author creation

However, evolution process is continuing. We are now beginning to see changes in the two main advantages Japan has – its current account surplus and net external assets. In January this year, Japan posted a current account deficit for only the second time ever, but if resource prices continue to rise, deficits are sure to continue. The expansion of trade deficits is natural when a country's income comes from its income balance – this is a characteristic of an asset liquidator. However, even if Japan manages to scrape up a current account surplus going forward, it would be due to a primary income surplus, which does not create demand for JPY; and Japan's large trade deficits are unlikely to shrink anytime soon. When it comes to forex markets, the main thing to pay attention to are trade surpluses, which result in outright JPY buying or selling. Primary income surpluses are made up largely of interests and dividends on marketable securities, which are reinvested without being converted back to JPY in most cases. Therefore, from the perspective of supporting JPY rates, Japan's current account surplus, which mainly bank on its primary income surplus, was never more than a paper tiger. Meanwhile, with regard to the financial account balance, which contrasts with the current account balance, foreign direct investments have increased at a roaring pace over the past 10 years. As a result, the fundamental balance (current account surplus + direct investment, see figure) has intermittently shown foreign currency flowing out from Japan, making it easy for a weak-JPY trend to take hold. Such changes in the JPY supply-demand structure are not recent, they have been taking place over the past 10 years.



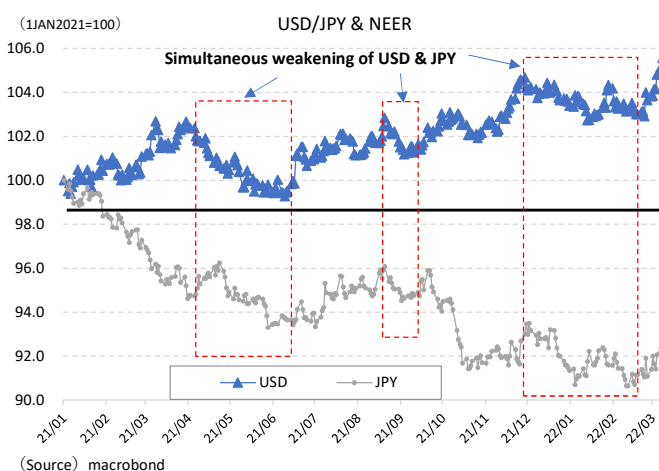
Can Japan Remain the World's Largest Net External Creditor?

The forex market functions on impulse, so the current account balance turning red can easily become the focus of attention. So, when USD/JPY hit another peak in March, soon after it was announced that Japan had posted a current account deficit for the second time in its history, that was probably not a coincidence. More important, however, is the fact that Japan's net external asset structure will change if the current account deficits continue. As the figure on the previous page shows, the pace of increase (surplus) in net external assets becomes gentler when a country becomes an asset liquidator. The balance of net assets may increase as a result of the price effect if JPY depreciates, but if the pace of this increase drops, Germany, with its enormous annual current account and trade surpluses, may supplant Japan as the world's largest net external creditor (see figure). Not that there is any real difference between being No. 1 and No. 2, but will the forex markets respond calmly to Japan losing its No. 1 position for the first time in 30 years? I am concerned that market participants will be harsh in their evaluation of a waning JPY.



USD Weakness Does not Guarantee JPY Strength

Of course, from the perspective of the near-term forex outlook, USD may weaken if the Fed decides to abort its policy normalization process in view of its impact on the real economy. If that happens, U.S. interest rates will fall, and this could trigger USD selling/JPY buying. Further, the U.S. current account deficit has once again ballooned up to the size it was during the peak of the financial bubble in 2006. Some consider this a factor conducive to USD depreciation. However, as I have repeatedly argued in this report, one should not assume that USD weakness will directly result in JPY strength. As the figure to the right shows, there have been several times in the past year when USD was depreciating but JPY was depreciating alongside it. Therefore, setting aside USD-related circumstances, factors (1) to (3) above



all suggest that investors might avoid JPY as a currency that is obviously on the decline. Putting this in a bigger context, one may even say that the recent JPY weakness reflects “Japan avoidance.”

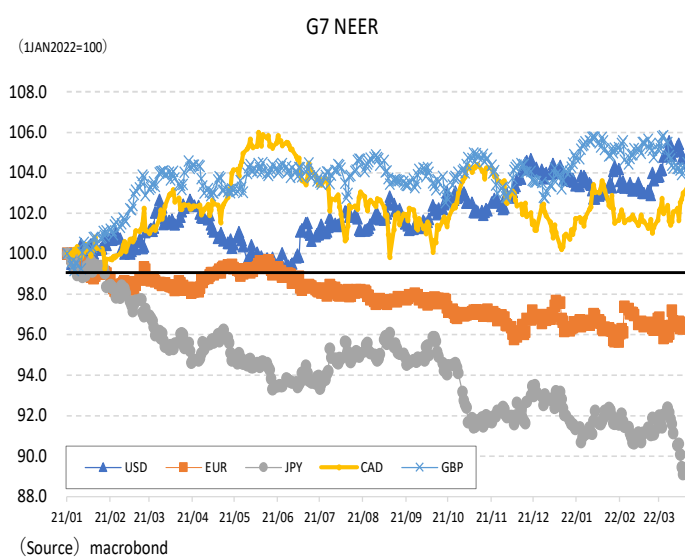
As mentioned, JPY is unattractive no matter which of the above factors you look at – (1) economic growth rate, (2) interest rates, or (3) supply and demand. During risk-off phases such as the present, investors may not differentiate much between countries in terms of (1) or (2), but they tend to prefer currencies that are strong in terms of (3). This has been the reason JPY was traditionally bought as a safe-haven currency. However, there are ominous signs of JPY’s advantage being threatened in this area too. At the very least, it can be said that there are no signs of JPY buying triggered by the ongoing crisis in Ukraine at the present time. Perhaps I am being harsh, but if JPY cannot be viewed positively in terms of factor (3), that leaves nothing attractive about it for investors – it simply becomes a currency with low growth rates and low interest rates.

Going further, both the Fed and the ECB are prioritizing inflation control and intend to increase (2) interest rates even at the expense of (1) economic growth. Can Japan afford to follow in their footsteps? Perhaps not. There is no reason to believe that a country that cannot even lift movement restrictions to recover economic growth is capable of embarking on interest rate hikes. The political decision to put lives ahead of economic growth is a reflection of the people’s will, and it is not my place to argue with this state of affairs. It is a fact, however, that this policy has caused JPY depreciation as a result of low growth and interest rates. The reason the U.S. and Europe can discuss monetary policy normalization now is because they achieved high growth in 2021. Their high growth rates last year have given them the policy space to be able to weather a potential economic slowdown now. The underlying strength of their economies is in a different league from that of Japan, which spent the larger part of the year under movement restrictions. Taking Japan’s political, economic, and financial circumstances into consideration as a whole, therefore, it would be unsurprising if USD/JPY were to surge past the 125.86 peak posted under Abenomics in April-June this year and perhaps hit 130 before the year ends.

Merits and Demerits of a Weak JPY – Rate Trends will Ensure Survival of Fittest

The View that JPY Weakness Indicates Decline in National Power

USD/JPY has intermittently been hitting new highs. On March 28, following the BOJ’s announcement of its fixed-rate operations, JPY selling further accelerated due to speculation that the BOJ approves of JPY weakness. Based on my understanding that the loss of Japanese trade surpluses starting 2012-13 has propped up USD/JPY, I think we have now entered a phase of established (and/or expanding) trade deficits pushing up USD/JPY. This indicates the possibility that Japan is in the process of transitioning from a mature creditor to an asset liquidator. It is not a stretch to assume that the increase in a wide range of resource prices due to the pandemic and war has probably further sped up Japan’s evolution as per the development stage theory of balance of payments. Japan being a resource importing country, the deterioration of its terms of trade as a result of resource price increase signifies a drain of income from Japan to resource-producing countries, and JPY weakness is a market phenomenon that further exacerbates this situation.



As already mentioned, the BOJ continues to justify the recent JPY depreciation. Of course, even if the BOJ were to embark on monetary policy normalization, that would not guarantee any change in forex market trends overall. Rather, it seems likely the trends would not change – one is reminded of how the BOJ under former governor Masaaki Shirakawa was unable to change the predominantly strong-JPY trend at that time. Under the floating exchange rate system, currency rates move essentially in tandem with USD and U.S. monetary policies, and going by the Fed’s basic policy stance at the moment, it seems somewhat inevitable that USD will appreciate, while JPY depreciates. However, one cannot help but be concerned about the BOJ approving/ignoring JPY depreciation. On March 25, BOJ Governor Kuroda said that the recent weakness of JPY did not indicate a loss of confidence in JPY. While he may not be wrong, the very fact that (the loss of) confidence in JPY has come up for public discussion is unprecedented. It is the result of concerns that JPY may be depreciating due to “Japan selling” as investors lose confidence in Japan, rather than simply as a by-product of USD appreciating due to strong U.S. economic performance or interest rates. While there is scope for arguing about the merits and demerits of a simple “JPY depreciation,” what we have seen over the past year is “solitary JPY depreciation” (see figure on previous page), which may be synonymous with Japan losing its influence as a country. Under such circumstances, one has to question how right the BOJ is, as the guardian of the domestic currency, to continue maintaining that JPY weakness is a positive thing. Was it really necessary at the present time to introduce a measure like the fixed-rate operation to keep long-term interest rates artificially down? I think it is important to stop and think about this.

Merits and Demerits of JPY Weakness as per the BOJ

Notwithstanding the cause of JPY weakness, if its merits have a fair chance of outweighing its demerits, JPY weakness would benefit the nation. For this reason, it is important to take fresh stock of both the pros and cons of JPY weakness, given the BOJ's continuing support for it. In this context, the January 2022 Outlook for Economic Activity and Prices (below simply "Report") concluded in its empirical analysis section that "the JPY depreciation is likely to continue to have a positive impact on Japan's economy." Some positive impacts from JPY depreciation are (1) an increase in goods and services exports as a result of higher price competitiveness, (2) an improvement in corporate revenues as a result of an increase in export value in JPY terms, and (3) an increase in JPY-denominated income balance. Meanwhile, a negative impact is (4) the decline in domestic corporate revenues and consumer purchasing power as a result of the rise in import costs. The BOJ's basic understanding here seems to be that $(1) + (2) + (3) > (4)$ (see chart).

Image of the merits and demerits of the yen's depreciation

		Merits & demerits	Notes	Magnitude of influence	Economic entity
Merits	①	Expanding exports of goods and services	Low expectations due to rising overseas production ratio and pandemic	Small - Medium	Global giants and exporters
	②	Improving corporate earnings through increased yen-denominated exports	Corporate profits improve but do not spread to wages	Medium	
	③	Increase in yen-denominated income balance	As demonstrated in the past 10 years. The only advantage of the weak yen?	Large	
Demerits	④	Declining domestic corporate profits and consumer purchasing power due to rising import costs	Import penetration is increasing year by year. Due to high resource prices, it is easy to attract attention.	Large	Domestic demand-dependent small and medium-sized companies and the household sector

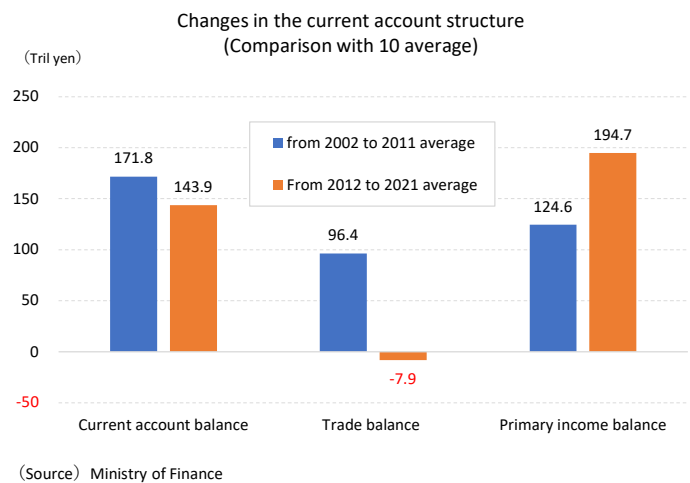
(Source) Compiled by Karakama from the Bank of Japan's "Outlook Report (January 2022)".

Impact (1) above is debatable. The BOJ itself assesses that "the positive impact of the JPY depreciation on the volume of goods exports has been smaller in recent years" as a result of more Japanese firms shifting their production sites overseas, as well as the shift to higher value-added goods. JPY depreciation does serve to increase the export volumes of many items, but the BOJ's assessment indicates that interest in these items is on the decline. The increase in service exports is mainly the result of an increase in the travel surplus due to JPY weakness, but there is not much discussion of this in the Report, perhaps because it has evaporated under the pandemic (it is merely mentioned that service exports are "expected to start operating again when these restrictions are eased as the impact of COVID-19 wanes.")

The above problems regarding impact (1) have been pointed out right from the time Kuroda took office. I remember this clearly because of the harsh criticism aimed at those pointing out the problems. At that time, however, it could be argued that even if impact (1) had weakened, there was still impact (2). In other words, it was thought that an improvement in corporate revenues as a result of JPY weakness could have a ripple effect on fixed investments and wages (when zero interest rates were lifted in 2006, this theory was popularly called the "dam theory"). However, as is now widely known, JPY depreciation did not in the event result in a commensurate increase in wages.

With regard to the third positive impact of JPY weakness, the Report concludes that "the positive impact that the JPY depreciation has on Japan's economy through improvement in the income balance within the balance of payments has been larger in recent years. Globalization of firms has led to steady increases in the amount of profits that Japanese firms earn from their overseas businesses and the amount of profits repatriated to Japan through dividends and other means." It goes on to say, "The increase in profits, including income transfers from overseas, also seems to have pushed up domestic business fixed investment," which is somewhat persuasive. As the figure on the next page shows, Japan has seen its trade surpluses disappear over the past 10 years, but the increase in primary income surplus has more than made up for this. To repeat a point I have made several times already, this signifies Japan's evolution from a mature creditor to an asset liquidator. The forex markets have been pointing out the decline in the trend of buying JPY as a safe haven currency over the past ten years, but because the current account surplus was able to be maintained through an increase in the income surplus, talk of issues related to (the loss of) confidence in JPY were able to be avoided.

In contrast to the above merits of JPY weakness, the Report says regarding impact (4), which is a demerit, that “the pass-through (import penetration) of the JPY depreciation to the CPI seems to have been larger in recent years.” Other than this, very little space has been devoted to discussing this point, and the Report abruptly concludes with the words, “Thus, even when taking into account economic structural changes in recent years, the JPY depreciation is likely to continue to have a positive impact on Japan’s economy on the whole” right after.



Market Sentiment may Dictate Weak JPY Assessment, Some Say

To summarize the BOJ’s analysis, no service exports can be considering the total lack of inbound tourism; the effect of JPY weakness on goods exports has been waning recently; and the past ten years have shown that an increase in corporate revenues do not trickle down to personal consumption. So, the only positive impact of JPY weakness is an increase in the income surplus. As for whether this is sufficient to offset the decline in purchasing power as a result of an increase in consumer prices, the Report’s conclusion that “the JPY depreciation is likely to continue to have a positive impact on Japan’s economy on the whole” suggests a basic understanding that $(1) + (2) + (3) > (4)$ on the BOJ’s part.

The Report does, however, mention “three points (that) need to be borne in mind.” These are 1) that “regardless of whether the JPY depreciates or appreciates, if the exchange rates change rapidly at a pace that economic entities cannot keep up with, this may have an adverse impact on the economy,” 2) that “the direction and magnitude of the impact of exchange rate movements seem to vary depending on the industry and firm size, (resulting in an) increased impact on the CPI through the rise in the import penetration ratio, and 3) that “exchange rate movements have a different impact on sentiment, depending on how the economy, including stock prices and general prices, is affected by exchange rates.” The second and third points mentioned here seem to be complementing impact (4) above.

Point 3), in particular, is interesting in light of the present situation. Looking at the (household activity-related) comments in the Cabinet Office’s Economy Watchers Survey, one learns that (A) from the end of 2012 through 2013, JPY depreciation tended to be mentioned along with the increase in share prices in comments that hinted at economic improvement. Subsequently, however, (B) in surveys from fall 2014 through 2015, JPY depreciation tended to be mentioned along with the increase in share prices in comments that hinted at economic deterioration. Whether (A) or (B) applies at the present time is as clear as day, with such rapid JPY depreciation (and high resource prices) that the governor of the BOJ has to overtly reject the idea of a “loss of confidence” in JPY. Even if the BOJ’s conclusion for the moment is that $(1) + (2) + (3) > (4)$, going by the points mentioned in the addendum, could one perhaps say that the reality is closer to $(1) + (2) + (3) > (4) + 2) + 3)$? I reserve judgment on this point for the moment as it is unclear simply based on the January Outlook Report.

Weak JPY will Ensure Survival of Fittest

Of course, the BOJ’s conclusion that $(1) + (2) + (3) > (4)$ is based on an empirical analysis it conducted, and given that this analysis is presented as part of the Outlook Report, which represents the basic understanding of the Policy Board Members, it does have a certain level of authority and reliability. There is, however, at least one inherent problem that cannot be quantified by simply listing and weighing the pros and cons and against each other. It is that there is an unbreachable wall between economic entities that benefit from the pros and economic entities that suffer as a result of the cons. In other words, JPY weakness is widening economic disparities.

As a result of quantitatively weighing the pros and cons of JPY weakness, the BOJ concluded that the impact on GDP (and/or GNI) would be positive. However, the only entities that can benefit from this are large global corporations, which are directly affected by exports, overseas investments, and profit repatriations. The demerits are greater for domestic-demand-driven small and medium-sized enterprises and households. This point is closely related to the Outlook Report’s second addendum that “the direction and magnitude of the impact of exchange rate movements seem to vary depending on the industry and firm size.” The conclusion that JPY weakness will have a positive impact on the Japanese economy is based on simply adding up the positive and negative impacts. It fails to address the issue of bridging the gap between “economic entities that benefit from the merits” and “economic entities that suffer from the demerits.” In other words, JPY weakness merely helps widen economic disparities and cause a polarization, making it a market phenomenon that ensures the survival of the fittest.

As mentioned, corporate revenues grew strongly during the weak-JPY phase under Abenomics starting 2013, but there was no commensurate increase in wages for or consumption by the household sector. Even assuming that JPY weakness boosted revenues for the corporate sector, given the broken link between corporate revenues and domestic demand in the present situation, there may be no respite for the household sector as it is weighed down by the loss of purchasing power due to JPY depreciation. Nor is it just the household sector; tough times are expected to continue similarly for SMEs, which depend on domestic demand for revenues. This point can be separately analyzed and explained in detail using such indicators as the GDP deflator and terms of trade. Please refer to a past issue of Market Topic for the details.

Intuitively speaking, one gets the feeling that “economic entities that are disadvantaged by JPY weakness” have louder voices in the current social milieu, so it may increasingly become politically difficult to ignore their needs.

Monetary Policy May be Difficult to Revise, Practically Speaking

Having examined the causes and impacts of JPY weakness, one has to wonder whether the BOJ should revise its monetary easing path. I would certainly say “yes” to the question of whether the path should be revised, but when it comes to whether the BOJ can, practically speaking, revise its path, my answer would have to be “no.” The fact is that it may be better for the central bank not to make any awkward moves at a time when public attention is focused on themes such as (loss of) confidence in JPY and an undesirable JPY weakness. USD/JPY increase began to accelerate after Japan posted its second ever current account deficit as per the January Balance of Payments report. This datapoint created the sense of an impending change in Japan’s stage of development to “asset liquidator,” and is what probably snowballed into a discussion about the (loss of) confidence in JPY. If the BOJ were to move to revise its accommodative monetary policy at this time, the markets will interpret it to mean that the Bank does not like the present level of JPY weakness, and no amount of explaining on the part of Kuroda will convince them otherwise.

That could prove to be a trap. Often, the forex market trends go in the direction that the policymakers do not want them to go. If it becomes widely known that the BOJ would not like JPY to weaken further, investors would probably sell of JPY in order to pressure the authorities into tightening monetary policy. This is because they can then make higher profits by buying JPY back after the policy has been revised (i.e., tightened). If their ruse succeeds, they are likely to try it again ahead of the subsequent Monetary Policy Meeting – similar to how the BOJ’s attempts to check JPY appreciation were tested by the markets in the wake of Lehman Brothers collapsing and during the European sovereign debt crisis. The BOJ may be taking this into account, and it may be for this reason that Kuroda keeps insisting that JPY weakness is a plus for the Japanese economy. To begin with, it would be hardly appropriate for the BOJ to admit that JPY weakness could have a negative impact, and it would be highly unlikely for the Bank to admit a loss of confidence in JPY.

Perhaps the only thing the BOJ can do to help the situation improve is continue on its present monetary path and play the waiting game. Given that the current account deficit is the result of high resource prices, if the resource price increase proves temporary, the current account will return to a surplus as it did in 2014, which might lead to JPY being reevaluated positively as a safe-haven currency. In the U.S., the yield curve flattening process is nearly complete, and the end of USD buying due to an increase in U.S. interest rates also seems to be in sight. According to Kuroda, the reason for JPY weakness is JPY being sold off in exchange for USD for the purpose of investing in more profitable USD-denominated assets, given the strength of the U.S. economy and an increase in U.S. long-term interest rates, but this trend may also end in the medium term. Perhaps the BOJ’s real intent is to persevere on its current policy path rather than making the wrong move and inviting speculative JPY selling. If so, that would be understandable.

Government’s Job to Secure Path to Utilize Merits of Weak JPY

Kuroda gave another explanation for JPY weakness, namely that the prices of crude oil and other resources imported by domestic companies had gone up, causing these companies to sell JPY and procure USD at higher levels. In other words, the trade deficit is expanding. This is not something that is likely to end soon. If there is a ceasefire in Ukraine, the rise in resource prices could slow down, but one must assume that the future of the world economy involves going on without Russia. Based on this assumption, it seems quite likely that supply constraints will be more severe than they have been so far, and that the world will become a more expensive place. Even if a current account deficit (or its expansion) does not become an established feature of Japan, it seems likely that current account surpluses will continue slowing even after the world has moved past COVID-19 and the Ukrainian crisis. This seems to suggest that USD/JPY will no longer undergo deep corrections going forward, even if there are phases during which JPY appreciates against USD.

If so, what the Japanese economy needs going forward is to find a pathway to enable the merits of JPY weakness to trickle down from the entities that benefit from it to those that are disadvantaged by it. For instance, what is the reason wages are not increasing? Perhaps they would increase if we were to reform lifetime employment, seniority-based wages, and other uniquely Japanese employment practices, which are frequently the subject of discussions. Of course, this would be a major task, and one that must be handled by the government rather than the central bank.

In other words, perhaps Kuroda currently has no choice but to pretend to approve of JPY weakness while waiting for society to change. However, given that the administration of Prime Minister Fumio Kishida is beginning to feel a sense

of panic at the real-world problem of JPY weakness, it is quite possible that some political interest could be directed at the BOJ's monetary policy operation. For instance, the present may be a golden opportunity for the Bank to abolish negative interest rates, which are thought to be ineffective for the most part, while also heightening systemic risks. Of course, considering the BOJ's recent announcement of fixed-rate operations, it seems unlikely that it would consider abolishing negative interest rates so long as Kuroda is at the helm, although this may depend on how interested the political administration is in making it happen. The BOJ removed itself from the limelight after publishing its September 2016 Comprehensive Assessment report, but as the guardian of the domestic currency, it may return to the limelight over the medium term.

U.S. Monetary Policies Now and Going Forward – Decisive Pace of Rate Hikes; Impact to Emerge in 2024 or Beyond

Decisive Pace of Rate Hikes

The federal funds (FF) target rate was raised by 25 bps from 0~0.25% to 0.25~0.50% at the FOMC meeting held on March 15-16. This was the first rate hike in around three years since December 2018. There is agreement within the FOMC regarding the need for rate hikes. One member (St. Louis Fed President James Bullard) voted against the action this time, but it was merely to propose a 50-bp increase in rates instead. The dot plot, which shows the future FF rate projections of FOMC members, pointed toward 7 rate hikes in 2022, 3 rate hikes in 2023, and none in 2024 (considering each rate hike to be for 25 bps). The neutral interest rate, which tends to be the end point of interest rates, has fallen from 2.50% to 2.25%, but as there were two fewer voters this time than there were last time, it may be safe to consider the level to be flat for now.

Policy interest rate outlook as of each year end (median estimate)

FOMC Date	2021	2022	2023	2024	Longer run
Mar-21	0.125%	0.125%	0.125%	n.a.	2.500%
Jun-21	0.125%	0.125%	0.625%	n.a.	2.500%
Sep-21	0.125%	0.250%	1.000%	1.750%	2.500%
Dec-21	0.125%	0.875%	1.625%	2.125%	2.500%
Mar-22	0.125%	1.875%	2.625%	2.625%	2.250%

(Source) FRB

Regardless of whether the neutral interest rate is 2.25% or 2.5%, the projections indicate surpassing this level in 2023, so it seems likely that the current phase of rate hikes may only last 1 year and 9 months, if that. From the perspective of a central bank, monetary "austerity" begins only after the official interest rate surpasses the neutral interest rate level. The recent soaring inflation necessitates reaching that level (the neutral interest rate level) at the earliest, which is what is being reflected in the projection of 7 rate hikes this year. Depending on resource price trends, if there is a 50-bp rate hike included among the rate hikes this year, the neutral interest rate level could be reached sometime in 1H of 2023, and the rate hike phase could come to an end soon after. It would seem, therefore, that the current phase of rate hikes will take place at a decisive pace.

To look at this another way, the fact that the Fed feels it has to rush to raise the rates now indicates that it is currently "behind the curve," and reporters at Fed Chair Jerome Powell's press conference did indeed ask about this. Powell acknowledged it, but also emphasized that he believed the Fed could bring down inflation, as there was significant room for rate hikes as well as for reducing the Fed's assets. A practical problem is the difficulty of forecasting how long resource prices will remain high in light of the crisis in Ukraine, and it would be harsh to hold the Fed accountable for this.

Impact of Decisive Rate Hike Phase to Emerge in 2024 and Beyond

At the start of his press conference, Powell emphasized the strength of the U.S. economy, and stated that the situation was favorable, especially going by the falling unemployment rates and rising wages in the labor markets. Acknowledging that the impact of the crisis in Ukraine was a source of uncertainty in the near term, he pointed out that it could put a damper on the real economy through a decline in exports, for instance. The Summary of Economic Projections (SEP) by FOMC members did, indeed, indicate conspicuous revisions for the forecasting period as a whole, especially real GDP for 2022, which was lowered by -1.2 pp from 4.0% to 2.8% (no change for 2023-24). This is consistent with the

FRB economic outlook (multiple forecast, %) as of MAR 2022

	2022	2023	2024	Long-term
Real GDP Growth rate as of DEC	2.8 (4.0)	2.2 (2.2)	2.0 (2.0)	1.8 (1.8)
Unemployment rate as of DEC	3.5 (3.5)	3.5 (3.5)	2.6 (3.5)	4.0 (4.0)
PCE inflation rate as of DEC	4.3 (2.6)	2.7 (2.3)	2.3 (2.1)	2.0 (2.0)
Core PCE inflation rate as of DEC	4.1 (2.7)	2.7 (2.3)	2.3 (2.1)	

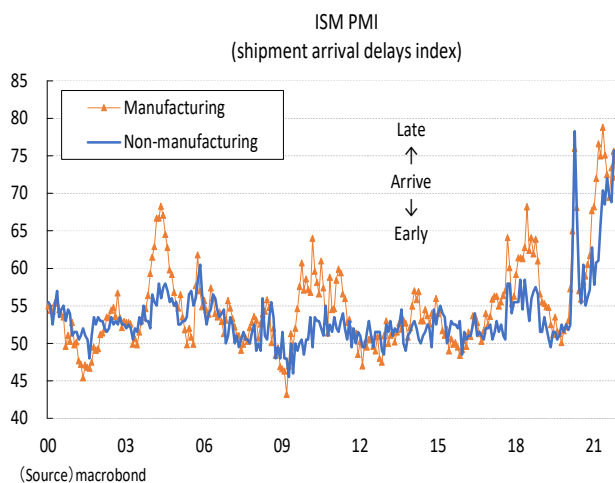
(Source) FRB

personal consumption expenditure (PCE) deflator forecasts, which were increased significantly even on a core basis from +2.7% to +4.1% for 2022, and from +2.3% to +2.6% for 2023. The Fed's understanding seems to be that the problem of supply constraints and high resource prices, which already existed, have only become more protracted because of the crisis in Ukraine, inviting rapid inflation growth and bringing consumption and investment activities to a standstill. Note that the impact of the recently started phase of rate hikes will only become apparent after a delay, so they are not sufficiently reflected in the recent SEP.

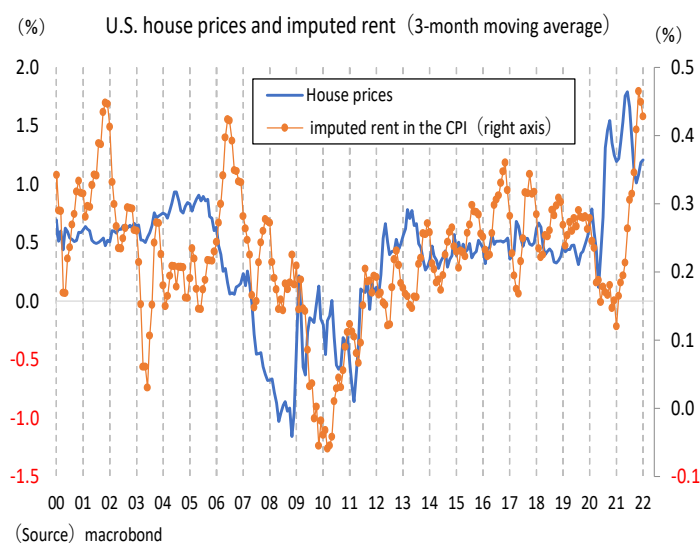
The aforementioned points in the dot plot and the SEP give us a good idea of what the FOMC may be thinking. As indicated by the dot plot, the current phase of rate hikes will end by the end of 2023, as FF rates remain level for the end of 2024. As already mentioned, the FF rates will have reached the neutral interest rate level by this point, so subsequent rate hikes would amount to monetary tightening. As Powell himself acknowledges, the effect of austerity measures emerge with a slight delay, so they could weigh down on growth rates and prices significantly starting 2024 and beyond. The SEP projections are very much in conformity with this. In other words, the impact of rate hikes decisively implemented starting 2022 will only be felt in 2024 and beyond.

Can Dot Plot Retain Current Stance in June?

Having said that, the U.S. yield curve is steadily becoming flatter, and there are deep-seated concerns of an overkill in the financial markets. The 10-2 Treasury yield spread, which draws the greatest attention, has already turned negative. Looking back a few years, this spread was still around 120 bps when the previous phase of rate hikes began in December 2015. This spread has now completely vanished. Both the Fed and market participants are increasingly factoring in 7 rate hikes in 2022, but it may be difficult to continue with them if they further deepen the negative spread. Of course, rate hikes can be justified as an austerity measure to prevent the protraction of inflationary concerns amid the crisis in Ukraine, but earlier supply constraint concerns have been gradually easing. For instance, shipment arrival delays in the ISM indices, while still high, peaked in mid-2021 for the manufacturing sector and in the fall of 2021 for the nonmanufacturing sector (see figure to the right, top).



Other indicators of concern, such as housing prices and the associated imputed rent (in the CPI) have also peaked (see figure to the right, bottom). Powell's predictions came in a climate of it being too late to go back on a March rate hike, but the market's mood may change significantly after the first two rate hikes. In that sense, even if the Fed can safely implement another rate hike at its May 3-4 meeting, one wonders if the dot plot and SEP projections can remain unchanged at the June 16-17 meeting. I still think there is a possibility of only three rate hikes going through this year, given the damage to the real economy. This is an undeniable possibility considering that nobody could have dreamed of projecting 7 rate hikes in a year just three months ago. Of course, such a development would serve as a tailwind for USD/JPY, but the current JPY weakness seems unrelated to U.S. actions and appears to be based more on a "Japan selling," so irrespective of the number of rate hikes, the upside risks to JPY are likely to remain limited.

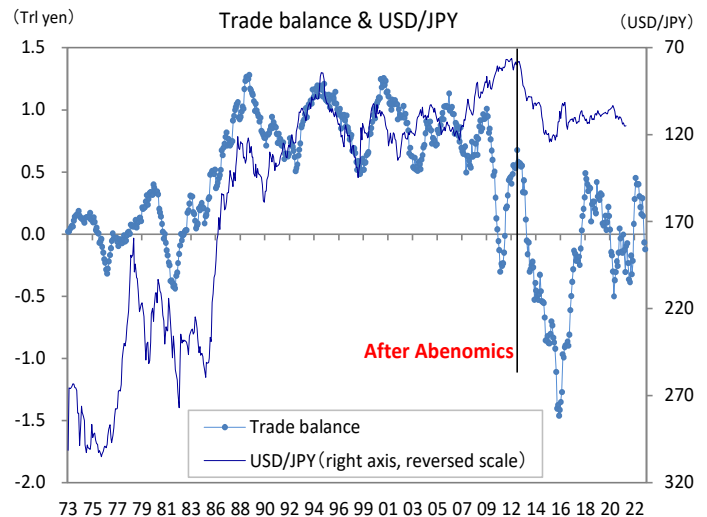


(Note) Imputed rent: Owners' equivalent rent of residences

Risks to My Main Scenario – Reminiscent of the Volcker era and the Plaza Accord

Repeated Pattern of Three Steps toward JPY Depreciation and Two toward JPY Appreciation

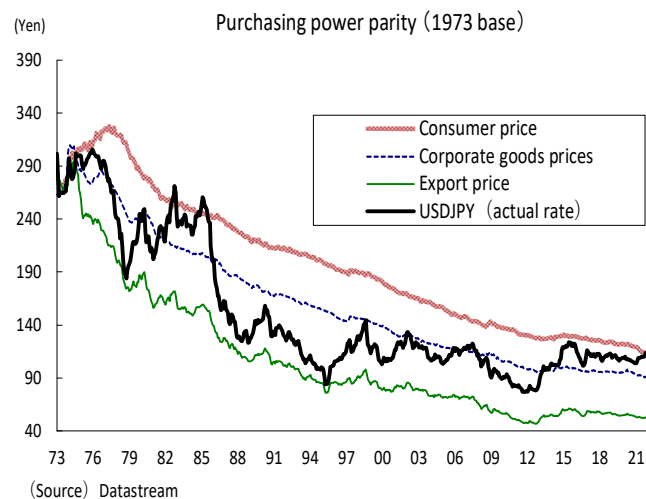
At the time this article was written, USD/JPY had become stable in the JPY120-125 range, and it seems likely in the near future that some observers will be anticipating a rise to the USD/JPY130 level. At this point, most forex market participants have begun tending to expect a JPY depreciation trend going forward, and some have begun opining that the current situation suggests that USD/JPY is close to its ceiling level. It can certainly be said that USD/JPY can easily reach its ceiling levels at times when market consensus about USD/JPY take shape. Although this seems to be a somewhat vague qualitative concept, there definitely is a pattern in which market level movements become steep during consensus-building processes, while less-sharp adjustments become easier following those processes. However, this does not mean that one can anticipate another sharp JPY appreciation trend. So long as exchange rates fluctuate, it is natural that there will be ups and downs. After a period of considerable JPY depreciation, it is natural to expect the onset of a



JPY appreciation trend – net external debtor countries' currencies also have periods of persistent appreciation. The key issue relates to the adjustment range. As discussed above, if Japan is in the process of moving away from being a mature creditor country and toward becoming a country that is progressively drawing down its external assets, there is a possibility that the JPY-appreciation adjustment may be shallow. Trade balance trends are the driving force behind a change seen from around 2012, when Japan entered a period of protracted trade deficits, and one can see from the graph that JPY has generally depreciated against USD since that time. The real demand structure on which forex trends are based has changed, and this may cause movements toward JPY appreciation to become more moderate going forward. Roughly speaking, I anticipate that USD/JPY movements for the time being will gradually move toward JPY depreciation in a repeated pattern of three steps toward JPY depreciation and two steps toward JPY appreciation.

Structural Changes Also Apparent in PPP Trends

The fundamental changes in the situation surrounding USD/JPY can be clearly discerned from purchasing power parity (PPP) level movements. As the graph on the right shows, the relationship between prevailing market exchange rates and PPP rates has changed since around 2012. In particular, the JPY depreciation/USD appreciation trend that began in 2012 has caused USD/JPY to surpass the corporate goods price-based PPP, which had been functioning as USD/JPY's ceiling for many years but has now become its floor. Such a long period of USD/JPY exceeding the corporate goods price-based PPP has no precedent. Moreover, USD/JPY is currently on the brink of surmounting the consumer goods price-based PPP. The only time USD/JPY has clearly surmounted the consumer goods price-based PPP was during the strong-USD period of the late 1970s and early 1980s, which led to the Plaza Accord. It is worth noting that Japan's aggregate trade balance for the five years (1980-84) immediately before the Plaza Accord was a surplus of about JPY14 trillion, while the country's aggregate trade balance for the last five years (2017-2021) was a deficit of about JPY1 trillion, so it should be understood that JPY's supply-demand environment is now considerably worse than it was prior to the Plaza Accord. "Excessive JPY depreciation" compared to PPP is considered "excessive" because it promotes increased exports and the recording of trade surpluses, eventually causing JPY to appreciate. Given that Japan's capabilities for realizing the "JPY depreciation → increased exports" reaction have already greatly diminished, however, it is difficult to justify excessive currency depreciation with respect to PPP in the case of Japan.



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Reminiscent of the Volcker Era and Plaza Accord

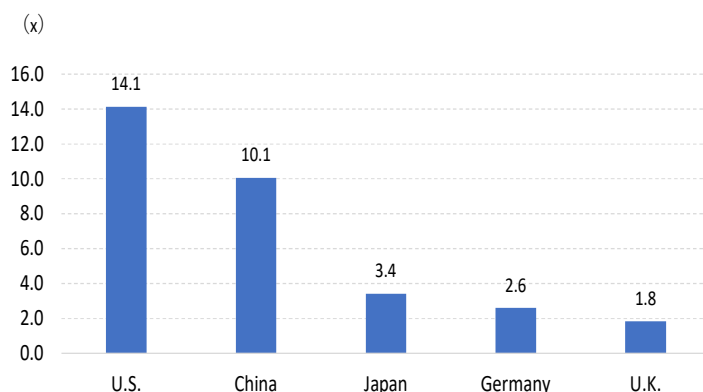
The previous sub-sections of this article tell the story as it relates to Japan, but when considering the situation from the U.S. perspective, one will be reminded of the late 1970s to early 1980s era, which is roughly the period when former Fed Chairman Paul Volcker orchestrated strenuous efforts to overcome stagflation. While one should avoid an overly simplistic comparison of that era with the current period, such a comparison does suggest the possibility of a risk scenario in which the current USD appreciation trend eventually attains a level requiring international monetary policy coordination. Despite concerns about the burden the United States' real economy is already bearing due to the pandemic as well as the war in Ukraine and the associated height of resource prices, there has not yet been any hint that Fed Chairman Jerome Powell might change the Fed's current policy course, so one should be prepared for the possibility that the interrelated rises in U.S. interest rates and USD will continue regardless of the Ukrainian crisis. Moreover, even if the Fed's normalization process were to be postponed, there remains a possibility that JPY will tend to depreciate in a risk-on-mood amid stable U.S. interest rates and declining U.S. stock prices. Even though it is possible to conceive various other scenarios and there remains a possibility that JPY might suddenly begin strengthening in the future, it should be recognized that it is quite difficult to perceive what factors might cause that to happen.

Supplementary section: Potential for Russia Credit Defaults – Current Situation as Reflected in BIS Statistics

Could Russian Defaults Drastically Impact the Global Financial System?

The inquiries I received in late March related mostly to JPY depreciation, but many of the inquiries received early and mid-way through the month were about the Ukrainian crisis's potential impact on the financial system, and numerous people wanted to know about the likelihood of Russia defaulting on its debts and whether that might lead to a chain of bankruptcies. In brief, my view is that any Russian debt defaults that might occur following the Ukrainian crisis are unlikely to generate global systemic risks. Russia is a major military power but not a major economic power. Comparing Russia's nominal GDP (about USD1.5 trillion) to that of other countries, one finds that the United States' GDP is 14 times larger, China's is 10 times larger, Japan's is 3.4 times larger, Germany's is 2.6 times larger, and the United Kingdom's is 1.8 times larger. In light of Russia's vast land territory, abundant resources, and strong military capabilities, many people may assume the country is also one of the world's major economic powers, but the scale of Russia's economy is actually close to that of Brazil, Canada, South Korea, and Spain. While not a small country, Russia is not a major economic power when considered from a global perspective. Given that economic scale, it appears likely that the scale of Russia's cross-border credit (inevitably directly linked to systemic risk) is similarly limited.

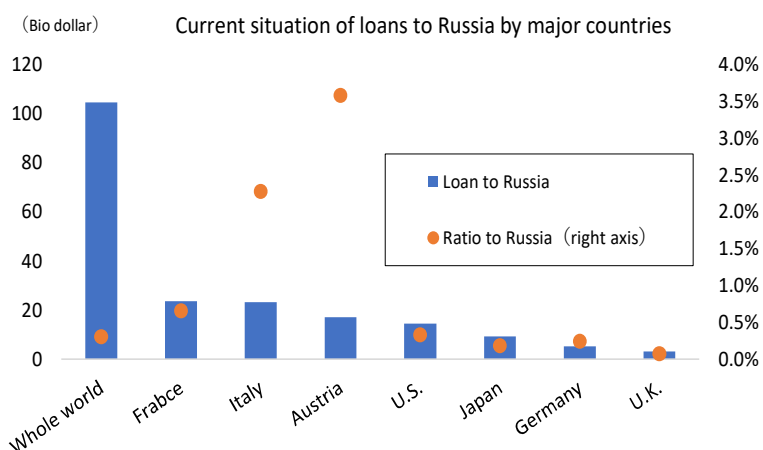
Economic size of major countries
(Nominal GDP of each country/Nominal GDP of Russia)



(Source) IMF

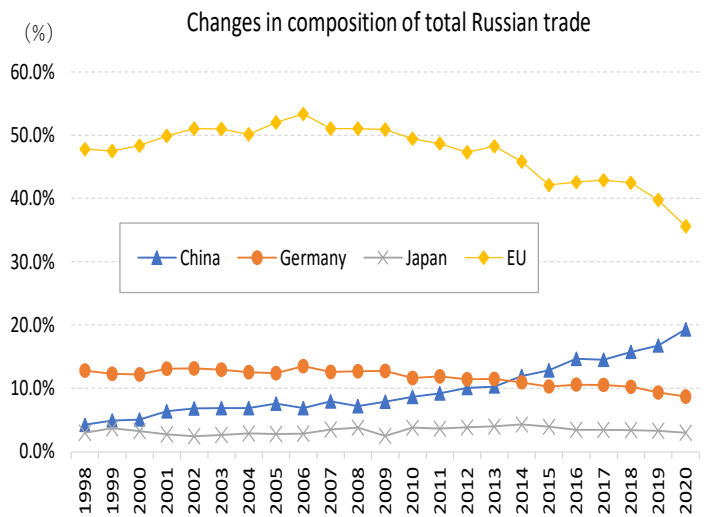
Significant Distancing from Russia following the Crimea Invasion

Let's look at the actual statistics. According to Bank for International Settlements (BIS) data, globally, external balances of credit to Russia amounted to USD104.7 billion at the end of September 2021. That is only 0.3% of the world's total external credit balances. Looking at individual countries, while France has one of the largest balances of credit toward Russia, that was about USD24 billion – only 0.5% of France's total foreign credit balance. Even for Austria, the country for whom credit to Russia accounts for the largest share of its foreign credit balance, the level is only 3.6%. Even if it were inevitable that Russia would default on all its external debts, such a default could not actually devastate the international financial system.



(Source) BIS

It is worth noting that, since Russia's 2014 invasion of Crimea, Western camp countries have distanced themselves from Russia not only in terms of trade but also in terms of finance. The main trend in Russia's international trade relationships is quite apparent. Since 2014, the share of Russia's trade with the EU has clearly decreased (although the EU has remained Russia's largest trading partner) and the share with China has been increasing (see graph). This may be a factor related to Russia's progressive de-dollarization of its foreign exchange reserves since 2017. Looking back, one finds that there were calls for blocking Russia's access to the SWIFT network even as early as 2014. As a result, it appears that both the western camp and Russia have progressively distanced themselves from each other in anticipation of an upcoming conflict. It seems that the prior incidence of the 2014 Crimea invasion provided some time for measures to be taken to mitigate the economic and financial shocks that will be occurring going forward.



(Source) macrobond (Note) EU includes Germany

Criticisms of “Watering Down” of SWIFT Blockage Sanctions Inappropriate.

Regarding finance, the European Commission attracted considerable attention on March 2 when it announced additional sanctions that would block seven major Russian banks' access to SWIFT. There were some criticisms that the sanctions had been “watered down” because they do not cover Sberbank, Russia's largest bank, and Gazprombank, which plays an important role in energy procurement, but objectively considering what is now happening, it seems that the criticism is not appropriate.

It is clear that the decision to exclude such top Russian banks from the sanctions is based on the western camp's desire to enable Europe to continue obtaining natural gas from Russia. About 40% of all the natural gas used by EU countries comes from Russia, and the (foreign currency) payments for this gas will continue to flow to Russia. Mineral fuel (energy) products account for half of Russia's exports to the world, and if such exports were prohibited, Russia would lose a major means of earning foreign currency. (SWIFT is simply a means of streamlining remittances and not a means of earning foreign currency. Resource exports are the means of earning foreign currency.) At the same time, mineral fuel exports are the Russian government's main revenue source (accounting for slightly less than 40% of government revenue), so if sanctions were applied to all Russian banks including the largest ones, Russia's national treasury would almost certainly be exhausted quite quickly. When the SWIFT blockage was initially announced, there was speculation that Russia was not well positioned to play its strongest (worst for the Western camp) card of stopping the supply of natural gas to Europe because it would cut off this important income source. In light of that, it is highly likely that Russia was relieved by the European Commission's decision to exclude the top Russian banks from the sanctions.

But that does not mean that the SWIFT blockage is completely ineffective. As is well known, even before the SWIFT blockage was implemented, its announcement caused a sharp plunge in the value of the Russian ruble (RUB), and RUB does not appear likely to completely regain its pre-announcement level. Russia's central bank would like to support RUB by selling foreign currencies and buying RUB, but nearly half of the foreign currency reserves that it might use for such an intervention are frozen. Countries that export goods to Russia will not welcome the receipt of RUB payments but are likely to demand payments in such currencies as USD, EUR, and JPY. However, payments in such currencies are blocked. In other words, although trade transactions with Russian companies are not prohibited at this time, the SWIFT blockage-induced collapse of RUB is causing many companies to avoid trade transactions with Russia. In light of these and other current effects of the SWIFT blockage, the criticisms of the “watering down” of sanctions are inappropriate.

Ramifications of a “World without Russia”

Given the BIS data cited above, it seems unlikely that the international financial system will be strongly impacted even if Russia's financial system collapses. However, the separation of Russia's financial system from the international financial system will continue undermining the value of RUB, and that currency weakening can be expected to damage Russia's real economy. Of course, in the upcoming “world without Russia” scenario, the world's natural resource supplies will be tighter than previously, so companies will have to proactively diversify their resource procurement sources and upward pressure on resource prices is likely to be persistent. This kind of situation can probably be expected to continue so long as the Putin administration survives. Given this, when forecasting economic and financial trends, it will be important to maintain awareness that we are now in a period of transition from an “era of disinflation” to an “era of inflation”.

EUR Outlook – Wartime Initiation of Monetary Policy Normalization

EUR Area Monetary Policies Now and Going Forward – Wage Increases the Most Fearsome Prospect?

ECB Embarks on Monetary Policy Normalization during a War

The March 10 ECB Governing Council meeting announced a plan to end asset purchases under the asset purchase programme (APP) in the July-September quarter. While the ECB has become a leader among the major central banks regarding responses to Russia's invasion of Ukraine, it has now adopted a posture more focused on countering inflation than on forestalling a recession. Since the ECB's proposed normalization process is quite modest, however, it is probably true that there is no need to modify the original plan, which at this point centers on the termination of the APP. At the February Governing Council meeting, ECB President Lagarde 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 included approving a temporary increase in the APP from April to compensate for the end of the pandemic emergency purchase programme (PEPP) in March and confirming or amending provisional plans for the gradual decrease of the monthly APP purchases level. (Monthly APP purchases are currently EUR20 billion, and the provisional plans called 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.) At the March GC meeting, the ECB announced that it would gradually shrink (taper) monthly net purchases under the APP from EUR40 billion in April to EUR30 billion in May and EUR20 billion in June. Regarding the July-September period onward, (1) if the ECB judges that the medium-term inflation outlook will not weaken even after the end of net asset purchases, those purchases under the APP will be terminated during the July-September period, but (2) if the medium-term inflation outlook changes (inconsistent with the 2% target), the ECB will reconsider the scale and period of such net asset purchases. In brief, the ECB is avoiding making a firm promise about what will happen in the third quarter, saying “if the situation is stable, the APP will end in the third quarter, but it is possible that that termination might not happen.”

In this regard, President Lagarde emphasized that – “it is a conditional provision [...] and we are not in any way accelerating.” – and that the decision – “was in line with our December meeting [at which it was decided to terminate the PEPP], with our February meeting and press conference, and what we are doing is confirming our step-by-step approach, our maximum optionalities in the face of maximum uncertainty[.]” There remains a possibility that APP might continue from the third quarter depending on the nature of incoming data, so one can understand the reasoning behind President Lagarde's assertion that the ECB's posture should not be considered completely hawkish.

Given that the financial markets consider APP termination to be the starting gun for a race to interest rate hikes, however, it is only natural that (after hearing the ECB president mention a possible APP termination timing) they would begin making forecasts based on the premise of a rate hike within the year. As discussed below, undertaking monetary policy normalization at a time of war and while facing an accelerating stagflation trend requires extremely difficult situational judgments and, based on currently available information, it does perhaps seem inevitable that countering excessive inflation should be given top priority.

Emphasizing Current Inflation Trends Rather than Future Recession Risks

The ECB's growing concerns about inflation are reflected in the latest (March) Eurosystem staff projections. This time, in addition to the main projection scenario, the projections include an “adverse scenario” and a “severe scenario”. Particularly noteworthy among these projections are those for the euro area's Consumer Price Index (HICP). Even in the

ECB staff outlook (YoY %)

	Outlook MAR 2022				Adverse scenario				Severe scenario			
	2021	2022	2023	2024	2021	2022	2023	2024	2021	2022	2023	2024
Real GDP	5.4	3.7	2.8	1.6	5.4	2.5	2.7	2.1	5.4	2.3	2.3	1.9
HICP	2.6	5.1	2.1	1.9	2.6	5.9	2.0	1.6	2.6	7.1	2.7	1.9

(Source) ECB (Note) 2021: Actual figures

main scenario, the projected HICP figures for 2022/2023/2024 are “+ 5.1% → + 2.1% → + 1.9%”. Compared to the previous (December) projections, the new main scenario elevates HICP by 1.9 percentage points in 2022, 0.3 percentage point in 2023, and 0.1 percentage point in 2024. This alone is a sufficient basis for beginning a monetary policy normalization process, and the case for normalization is even stronger in the adverse and severe scenarios, which seek to take account of protracted economic sanctions against Russia and associated supply constraints that are expected to exert upward pressure on inflation rates. On the other hand, even in the severe scenario it is projected that the real GDP growth rate will only descend slightly below 2% in 2024. Given that the euro area's potential growth rate is around 2%, it is reasonable to speculate that the ECB considers it worthwhile to first emphasize measures to counter the rise of inflation rates. While it might be ideal to strive to both restrain inflation and prevent a recession, there is an evident rationale for emphasizing the threat of current inflation trends more than future recession risks.

Timing of Prospective Interest Rate Hikes

At the March Governing Council meeting, the announcement of the APP termination policy was accompanied by a new articulation of the policy regarding prospective interest rate hikes. Within the description of the ECB normalization process, the sentence – “The Governing Council expects net purchases to end shortly before it starts raising the key ECB interest rates” – was removed and replaced by – “Any adjustments to the key ECB interest rates will take place some time after the end of our net purchases under the APP and will be gradual.” The basic concept that “rate hikes will come after the end of the APP” has not changed but, regarding the time period between the end of APP and the rate hike, it is noteworthy that the “shortly before” expression has been changed to “some time after”.

While several reporters at the press conference sought to clarify the significance of this change, it seems that the ECB’s intention was to further increase the level of ambiguity regarding the timing of prospective interest rate hikes. President Lagarde responded to one of the reporters’ questions by saying – “Clearly, “some time after” is all-encompassing. It can be the week after, but it can be months later[.]” One intuitively senses that the time period suggested by “some time after” is longer than that suggested by “shortly before”. On the other hand, the ECB’s forward guidance on interest rate levels has long been described as – “the Governing Council expects the key ECB interest rates to remain at their present or lower levels” – but the “or lower” portion of this has been removed beginning from the March Governing Council meeting. It appears that the latest adjustments of forward guidance phraseology are cunningly designed to increase the level of ambiguity regarding the timing of prospective interest rate hikes but also to clarify that the prospective interest rate adjustment will be upward. Despite this cautious approach, euro area interest rate levels jumped upward after the meeting, and it is probably reasonable to tentatively conclude that the ECB intends to continue using vague phrases to forestall such jumps as it crawls very gradually and inconspicuously toward prospective interest rate hikes.

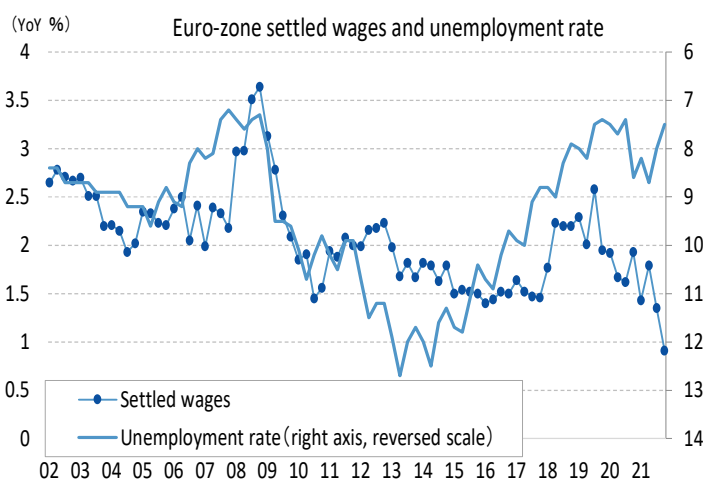
Growing Concerns about Prospective Wage Increases

As mentioned above, wartime initiation of monetary policy normalization is a battle against stagflation, which is basically high levels of inflation during a recession. At such a time, a central bank is forced to decide whether to give greater emphasis to countering the recession or countering inflation. At this time, the euro area’s exposure to geopolitical risks makes it even more difficult to strike an optimal balance of emphases on those two goals.

As already noted, the ECB currently seems to be intending to emphasize measures to counter inflation. This reflects the ECB’s awareness of the high risk that the euro area’s high level of dependency on Russia for resources may make it particularly vulnerable to unexpected price increases going forward, and that concern is also reflected in the preparation of two alternative forecast scenarios – the “adverse scenario” and “severe scenario”. But what really matters is trends in wages. The March Governing Council meeting’s statement and press conference both evidence a level of concern about wage increases that is clearly higher than in the previous month. At the press conference, for example, President Lagarde said, “What we are not seeing so far and we are very, very much scrutinising the numbers, is wage pressure”. Until the February Governing Council meeting, the lack of upward pressure on wages tended to be brought up as a reason for not hurrying to normalize.

The euro area’s wage growth rates have recently been at historically low levels despite the region’s quite low unemployment rates (see graph). In this regard, President Lagarde said the ECB is – “trying to get as much intelligence and as much understanding of how and where wage pressures are going to come from.” The recent restraint of wage increases may stem from greater emphasis being placed on job preservation than on wage increases during the pandemic, but just as in the United States, the euro area faces labor shortages that are expected to sooner or later make wage increases unavoidable. Given that the unemployment rate has declined significantly (indicating a “quantitative” improvement in the employment situation), it is unnatural that wages have not been rising (indicating a “qualitative” improvement in the employment situation), and it seems rational to expect that this disparity will be resolved by means of wage increases. Such eventual wage increases will exert upward pressure on HICP and the underlying inflation rate, particularly in the case of service prices. So far, it is largely because wage increases have been restrained that the ECB has considered itself to be in a position to be more cautious than the Fed about undertaking a policy normalization process.

If and when this assumption that wage increases will continue to be restrained proves to be mistaken, wage increases may exert upward pressure on euro area interest rates and eventually on EUR, albeit there are desirable aspects of EUR appreciation, such as its ability to moderate rises in import prices. Given EUR’s rock-solid supply-demand environment and the euro area’s world-leading current-account and trade surpluses, if the Ukraine crisis dissipates, it



(Source) Macrobond

(Note) It will be different from the actual labor cost growth due to settled wages

can be expected that EUR will recover from its recent declines within this year. I am anticipating that EUR will rise to roughly EUR1.15/USD1 and EUR1/140JPY.

Considerable Improvement in Euro Area Employment Situation

It is worth analyzing the euro area's wage situation in somewhat greater depth. Despite the increasingly grave geopolitical risks the euro area is facing, the region's internal economic situation has been becoming more robust. Announced on March 3, the euro area's January unemployment rate was 6.8%, down from 7.0% in December, and the lowest level recorded since this statistic has been calculated. In addition, the number of unemployed decreased 214,000 mom, to 11.23 million, the ninth consecutive month of decrease in this statistic. Both the unemployment rate and the number of unemployed have already improved compared to their pre-pandemic levels, and it appears that this trend of improvement is gaining momentum. As the graph shows, the pandemic did have a strong impact on the employment environment, but the magnitude of the impact was not as great as the impact of the European debt crisis. The euro area employment market's worst period was in the first half of 2013, when the unemployment rate was 12.2% and the number of unemployed was over 19.5 million. Those levels are almost twice the current figures.



Disengagement of Employment and Wages

One might ordinarily expect such strong and sustained improvement in the employment market to be reflected in similarly strong wage increases, but wage increases have continued to be restrained. It is easy to compare the ECB's monetary policies with those of the Fed, and many reporters make such comparisons at post-Governing Council meeting press conferences, but while the ECB and the Fed are both facing strong aggregate domestic demand and rising housing costs, the ECB's situation greatly differs from that the Fed in that euro area wage increases have been conspicuously subdued. The Account of the February Governing Council meeting includes the sentence – “Nor did expectations of labor costs point to any evidence so far of significant second-round effects from the current high level of inflation.” In other words, there is an incongruity in that the euro area economy as a whole is facing a serious labor shortage, but this shortage is not causing a rise in labor costs. As the above graph shows, the rise in the unemployment rate peaked out at the end of 2020 and has declined significantly since mid-2021, yet the rate of growth in collectively bargained wages has continued to slow throughout the euro area. Inflation is generally more likely to get out of control when it is accompanied by a sustained rise in wages. When wages rise and boost the household sector's purchasing power, general uptrends in prices become less likely to stall. Until February, the ECB did not appear to be very worried about these developments but, as mentioned above, the ECB's level of concern rapidly increased in March.

Wages Likely to Rise Going Forward

It seems that the discrepancy between trends in employment and wages stems from a special situation created by the pandemic. The graph above shows that unemployment rates and wages have historically had a stable inverse relationship as described theoretically by Phillips curves. It is believed that reason this relationship has not persisted recently is that workers have adopted less aggressive attitudes in their collective bargaining for wage hikes because of the pandemic. As uncertainties about the future increase to levels unprecedented in recent history, it is natural that workers will tend to increase their emphasis on stable employment rather than wage hikes, and the existence of this tendency is attested to by the results of the ECB's Corporate Telephone Survey (begun during the pandemic). The Fed's Beige Book and the BOJ's Tankan also include reports that job preservation (rather than wage growth) has been emphasized more than in normal times.

Given that, the deviation from the usual stable inverse relationship between trends in employment and wages is likely to be transient and can be expected to diminish as the effects of the pandemic fade away – so, as the societal situation heads toward post-pandemic normalization, it is necessary to prepare for a scenario in which wages catch up with the employment situation in a non-linear manner. A situation in which wages do not rise despite labor shortages cannot be expected to persist. This is also recognized by the ECB Governing Council, and the Account of the February Governing Council meeting notes that – “Data on past wage growth, however, were a lagging indicator and did not provide timely signals about future inflation.” Soon after that comment, the Account goes on to say – “More prominence should therefore be given to forward-looking indicators, such as those based on surveys. Reference was made to the results of the ECB's Corporate Telephone Survey, which pointed to expectations of significantly higher wage growth compared with last year, as well as significant labour shortages and a strong pass-through of input prices to final consumer prices[.]” There are definitely signs of impending wage hikes, and it appears likely that the

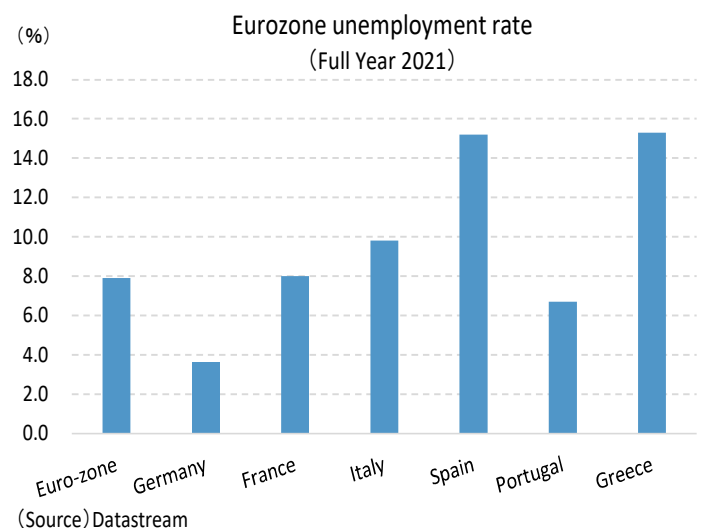
level of the ECB's concern about them further increased at the time of the March Governing Council meeting, but an examination of all the recent data suggests a risk that the euro area's Phillips curve may suddenly become considerably steeper than the ECB is anticipating. This is consistent with the latest staff projections, which (assuming an inflation rate of about 2%) are predicting that the annual rate of increase in wages will reach about 3% during the forecast period. As noted above, the current annual rate of increase in wages is below 2%, so it seems that the prospect of non-linear growth in that rate is fully acknowledged by the projections.

The ECB has been emphasizing that half of the annual rate of increase in HICP (currently approaching 6%) is attributable to energy prices. On the other hand, this also means that the other half is attributable to things other than energy prices. For example, 1.0 percentage point (20%) of the January HICP rise (+5.8% yoy) is attributed to service prices, which mostly reflect wage levels. It thus should be noted that (although the rise in euro area wages has proceeded slower than in the United States) wage trends are already making a considerable contribution to euro area price increases. In the past, service prices were usually relatively stable even when prices measured on a comprehensive basis fluctuated, but this time there has been an unprecedented surge in service prices. It appears that the secondary pass-through of wage input prices to service prices has already begun in a mild form.

The ECB's current main forecast scenario does not anticipate the headline inflation rate being reflected in wages, but if the Ukraine crisis elevates various production costs and the pandemic situation progressively fades away, then it can be expected that wages will rise by a considerable margin. If this happens, then the uptrend in service prices will gain additional momentum and the speed and magnitude of the uptrend may accelerate discontinuously. In light of this basic understanding, there may be cause for considering the current situation to be the calm before the storm.

How Well Can Germany Cope with "Outlier Status"?

The fate of the ECB rests on its ability to move ahead with a difficult normalization process in the future, and one of the key difficulties associated with that process is the question of how to overcome regional disparities within the euro area. Looking at unemployment rates of individual euro area countries for all of 2021, one finds that France's unemployment rate is twice as high as that of Germany. Moreover, the unemployment rates of Spain and Greece are twice as high as that of France (see graph). Such intraregional economic disparities have existed since well before the pandemic, but during the prospective process of general improvement in regional economic conditions, the individual euro area countries will inevitably be achieving disparate rates of improvement. In this regard, when the ECB considers beginning its policy normalization process, it must always give due attention to which euro area countries will benefit from such normalization. When the



pro-normalization sentiment began surging in the 2016-2017 period, Germany was believed to be approaching a full employment situation, but progress toward normalization was not made despite awareness of the possibility that bubbles in prices of such assets as stocks and housing might be created and eventually pop. In the current phase, the issue of how to take into account discrepant conditions in different euro area countries has not been emphasized, but it seems likely that the discrepant conditions will become increasingly conspicuous over time. The ECB has no choice but to make decisions based on consideration of average euro area statistics, but it seems inevitable that it will struggle to implement policies that are appropriate for countries with economic conditions that are significantly above or below the "average" level.

Two consecutive Deutsche Bundesbank governors have been forced to resign mid-term because of Germany's "outlier status" with respect to progress toward monetary policy normalization, and one wonders how harmoniously the ECB Governing Council can work with Deutsche Bundesbank Governor Joachim Nagel (who assumed his position in January) in that regard. It is probably still too soon to speculate much about this but, given that Governor Nagel is said to be a strong candidate to become the ECB's next president so long as he avoids problematic statements and behavior, it may be worth giving particular attention to his policy stances going forward.

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