

May 2, 2022

Overview of Outlook

USD/JPY continued to surge through April, eventually surging past the major milestone of 130. Rather than half-way conciliatory measures, the Bank of Japan (BOJ) has chosen all-out confrontation in dealing with the market, so its every move will inevitably affect USD/JPY levels for some time to come. However, none of the key points to be considered in formulating a JPY outlook have changed since last year. A JPY selling trend is consistent with all the fundamental factors, including growth rate, interest rates, and demand for JPY. While there is a worldwide increase in downside risks for economic growth rate, China and Japan stand out from the rest when it comes to strict regulations to contain the COVID-19 pandemic, and this suicidal approach of the two countries is difficult to witness. During the current forecasting period, concerns of rapid inflation may be the focus of attention in the U.S. and Europe, but the Japanese government seems likely to devote itself to movement restrictions of dubious effectiveness while remaining uneasy about new case numbers against the backdrop of public support rates. While the BOJ feels compelled to persevere with monetary accommodation in view of the weakness of Japan's real economy, other central banks around the world are likely to steadily proceed with rate hikes and shrinking their asset holdings. Further, Japan may also be unable to resume domestic nuclear power generation and casually continue importing expensive resources. Again, despite discussions on lifting the ban on inbound tourism, there seems no hope yet for its actual implementation. There are, therefore, a whole range of reasons for letting go of JPY both from interest rate and demand perspectives. Of course, there is a possibility that the Fed's policy normalization process will go off the rails, causing U.S. interest rates to decline and USD to depreciate, thereby resulting in JPY appreciation against USD. However, given that the current market trend is the result of JPY selling rather than USD buying, one must keep in mind that USD depreciation will not necessarily result in JPY appreciation.

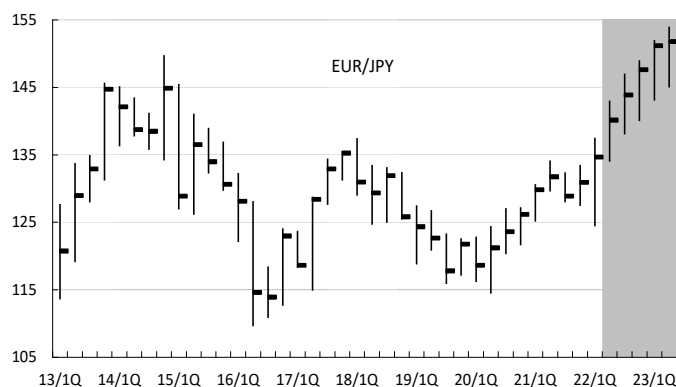
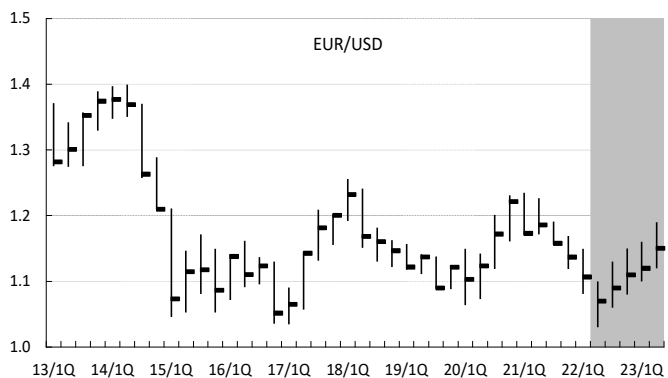
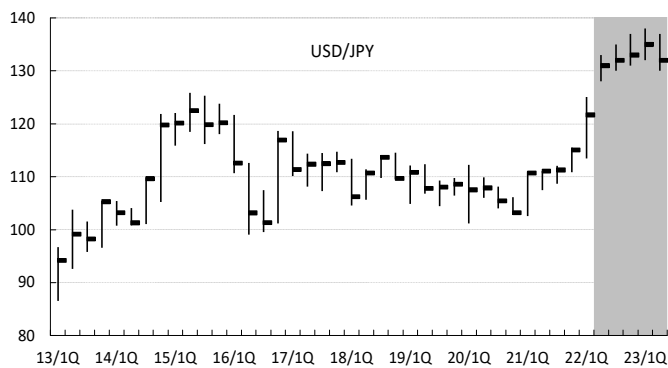
EUR weakened through April. The ECB is leaning more and more toward a more hawkish stance, with some even speculating about an early rate hike. However, there is an undeniable gap between the monetary policies of the Fed and the ECB, not to mention that the latter governs over an area at the epicenter of a geopolitical conflict. These factors and the uncertainties surrounding the future of the region's real economy appear to be putting off investors. Given that there is solid demand for EUR because of the euro area's considerable current account and trade surpluses among other reasons, I believe EUR is very likely to recover once the crisis in Ukraine ends. However, it is unclear when this crisis will end, so things may remain difficult for the region for some time to come. At this rate, one may have to take a serious view of the ECB's risk scenario released in March – protraction of the crisis in Ukraine, persistently high resource prices, regional inflation continuing to soar and undermine the real economy, and weaker-than-expected growth rates. However, despite this forced depreciation against USD, EUR has been performing quite strongly against JPY, so one has to conclude that it is doing better than JPY at any rate. Unlike Japan, the euro area's current account surpluses are driven by trade surpluses, which are the largest in the world. Even if EUR is forced into a difficult battle with USD, it seems likely the currency will establish itself at the 140 level against JPY during the current forecasting period.

Summary Table of Forecasts

	2022				2023	
	Jan-Apr (actual)	May-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	113.47 ~ 131.25 (130.04)	128 ~ 133 (131)	130 ~ 135 (132)	131 ~ 137 (133)	132 ~ 138 (135)	130 ~ 137 (132)
EUR/USD	1.0470 ~ 1.1495 (1.0533)	1.03 ~ 1.10 (1.07)	1.06 ~ 1.13 (1.09)	1.08 ~ 1.15 (1.11)	1.10 ~ 1.16 (1.12)	1.12 ~ 1.19 (1.15)
EUR/JPY	124.41 ~ 140.00 (136.99)	134 ~ 143 (140)	138 ~ 147 (144)	140 ~ 149 (148)	143 ~ 152 (151)	145 ~ 154 (152)

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



USD/JPY Outlook – Can JPY Depreciation Be Checked?

Measures Against JPY Depreciation – Is There Anything Japan Can Do?

How to Stop JPY Depreciation?

There seems no sign of an end to the current JPY depreciation trend. In the approximately two months since early March, USD/JPY has increased by around 15. Given that the average annual rate movement range was 9.74 over the three years immediately before the pandemic began (2017~2019), the recent rate movement is indeed dramatic. In view of this, two of the most frequent recent inquiries I have been receiving from clients are: (1) To what level do you think JPY will depreciate? and (2) How can this depreciation be checked? Without having actually counted the number of inquiries, I think the first one is slightly more frequent, but the second one is almost equally frequent. There is a fundamental difference in the relative difficulty of defending against excessive JPY appreciation vs. excessive JPY depreciation (needless to say, the latter is more difficult). It is not surprising, therefore, to see more people gripped by inexplicable anxiety about whether the current JPY depreciation trend can be stopped. The concerns are understandable, because unlike an appreciating JPY, a depreciating JPY is like a kite that has been cut off from its string, in the sense that it is difficult to find the next “plausible milestone” based on purchasing power parity (PPP) and other indicators.

However, leaving aside the question of effectiveness, Japanese authorities have three types of measures available to them if they decide that they would like to check JPY depreciation. As the current phase of JPY depreciation is frequently explained as being caused by interest rate and demand-related factors, remedial countermeasures will have to be appropriately tailored to these factors. (1) The BOJ starting policy normalization is a possible countermeasure against the interest-rate factor, while (2) resuming nuclear power generation and (3) lifting the ban on inbound tourism are possible countermeasures against the demand-related factor. Of course, none of these measures guarantees a reversal of the JPY depreciation trend. As exchange rates always involve two parties, their direction of movement cannot be determined simply based on the situation in Japan. However, the forex markets at the moment appear to be seeing through the impotence of Prime Minister Fumio Kishida’s administration, as it passively tries to avoid controversial moves ahead of the House of Councilors election, and there are perhaps many who are striving to sell JPY, albeit somewhat reluctantly, at its present undervalued rates. If so, measures (1) ~ (3) may not be completely devoid of value. In fact, if all the measures were undertaken simultaneously, I believe there is a good possibility of being able to reverse the current JPY depreciation trend.

(1) BOJ Starting Policy Normalization

Measure (1) is probably the easiest to understand. It is clear that every move of the BOJ has been closely watched in the forex markets since March this year. For instance, JPY moved quite sharply (hitting 126- to the dollar) on April 13, following a rather low-key event of BOJ Governor Haruhiko Kuroda addressing the annual meeting of trust banks. Given this level of attention on the BOJ's actions, it is not impossible that the BOJ revising its accommodative monetary policy path could change the direction of USD/JPY. However, going by the decisions made at the April 28 Monetary Policy Meeting and by Kuroda's post-meeting press conference, there seems very little likelihood this measure being adopted. In addition to reiterating that the BOJ would persevere with its monetary accommodation, the decision was made to retain the current policy framework and conduct fixed-rate operations on every business day. Far from tightening monetary policy, the Bank seems to be fighting this battle by strengthening monetary accommodation, choosing an all-out confrontation with the forex markets. In my view, this was a masterstroke. The forex markets are fickle and easily bored. Once the daily operations become regularized, there is a good chance of eliminating the noise resulting from JPY sell-offs following each announcement of an operation. If the Bank had begun revising its easy money policy in an effort to stop JPY depreciation, the markets would have seen this as a good way to manipulate the BOJ into tightening monetary policy, thereby strengthening JPY, resulting in a ballooning of expectations regarding the Bank's "next move," and creating a situation of market-manipulated rates. For this reason, the best option for a central bank when it gets sucked into a volatile market situation, is not to play along and to keep communications simple and straightforward – the damage can be minimized this way. Therefore, introducing daily fixed-rate operations was a good move.

However, all of the BOJ's policies seem to be based on the rationale that JPY weakness is an advantage for the Japanese economy as a whole, and if this rationale begins to be questioned, some sort of revision will become necessary. At his April 28 press conference, once again, Kuroda stated that excessive JPY volatility would have a negative impact, appearing to align more closely with Finance Minister Shun'ichi Suzuki's views on the current "undesirable JPY weakness." If it becomes imperative for the BOJ to take some action, what could that action be? Superficial actions such as revising the forward guidance to suggest monetary tightening or shortening the YCC target maturity (from 10 years to 5 years) tend to draw attention, but if the Bank would like to avoid its next moves being influenced by market manipulation, a good way to do that might be to start raising interest rates, aiming to achieve positive rates right away – this way, the markets would see the BOJ's stance as having changed fundamentally. Of course, doing so would raise interest rates on housing and other loans that are important for the household sector. There would also be political resistance to the move – it seems unlikely that the Kishida administration would have the courage to approve something like this ahead of the Upper House elections. If so, one could say that the current situation may continue until the end of July. As of now, it seems rather unlikely that either the government or the BOJ would choose Measure 1 as a way to correct the JPY depreciation trend.

(2) Resuming Nuclear Power Generation

One of the key claims being made in the current phase of JPY depreciation is that a weak JPY is not a problem given that JPY supply and demand is leaning toward a net JPY selling. Given that this is an indisputable fact, there is almost no scope for argument here. It is symbolized by the significant trade deficit posted each month, which is the result of a steep rise in import value, as is widely known. Trade balance flows are represented by outright transactions (outright selling or buying of a currency) in the market, so they contribute to the formation of the trend. The import value is calculated as import volume x price, and Japan is powerless to do anything about resource prices.

However, the volume of resource imports can be changed by revising the structure of the domestic power generation mix. This is one of the reasons nuclear power generation, which has nearly been tabooed, is drawing attention once again. Please note that I do not intend to go into the fundamental propriety of resuming nuclear power generation here. I present it mainly as one of the measures that can be taken to arrest JPY depreciation. However, from an overall perspective, it is fairly trivial to note that JPY depreciation can be arrested as a side effect of resuming nuclear power generation. The bigger question here is – is it right to downsize the Japanese economy any more than it already has been? I will discuss this issue in greater detail later in the report.

At any rate, as mineral fuels account for 25% of Japan's current import value, high resource prices are contributing significantly to the composition of the trade balance. Resource prices are being driven by a variety of deep-rooted factors including decarbonization, the pandemic, and wars. Unless Japan does something to combat its current situation of trade deficits resulting from continued import of expensive resources, demand-driven JPY weakness will remain a key story.

Some moves by the government and ruling party are also evident. In a program broadcast by TV Tokyo on April 26, Prime Minister Kishida stated that the government would like to "operate nuclear power plants to the extent possible" to ensure a stable supply of energy as part of emergency measures in view of soaring resource prices, adding that it was "necessary to find out to what extent nuclear power generation can be resumed under the current framework." Kishida further declared while addressing the general meeting of the Japan Committee for Economic Development (JCED) on the following day (April 27) that he would promote the utilization of nuclear power. As is widely known, it has now become normal, thanks to stricter screening by the Nuclear Regulatory Commission (NRC), for the application screening process to widely exceed the standard processing time (2 years), and some nuclear plants have been waiting 8 years or more since applying to start operations. However, there are now growing calls from the government and ruling party to make the screening process more efficient.

To repeat a point I made earlier, checking JPY depreciation would merely be a side-effect of resuming nuclear power generation, and cannot be its main goal. The main goal should be to stably conduct the real economy. As reported in the media, many are strongly predicting power supply constraints this summer and winter. Will the government's response to tight power supply conditions be similar to its calls for movement restriction to counter the pandemic? In other words, will it seek to overcome the situation by calling for people to conserve power? Calling for movement restrictions or power conservation amount to attempts to downsize the macroeconomy. People rebel against monetary austerity or 10-yen increase in prices but quietly follow calls to restrict their movements or save electricity. It is difficult to understand this psychology – perhaps the large majority of Japanese people simply assume that the government can never be wrong. At any rate, resumption of nuclear power generation would be a positive development that could help check JPY depreciation and avoid macroeconomic downsizing.

Of course, I am fully aware that resuming nuclear power generation is a difficult issue, but my above points must be viewed in a separate light from the emotional arguments surrounding nuclear power generation. Among G7 countries and China, Japan is the only one that has not yet recovered pre-pandemic real GDP levels, but given that Japan has been following its motto of “lives over the economy” to its logical conclusion and almost neglecting post-pandemic economic recovery, it is possible the country will once again choose the option of economic downsizing rather than resume nuclear power generation.

However, it is absolutely unsustainable for a resource-poor country to adopt a passive attitude toward economic growth while also putting up with high prices of imported resources. Also, it will be difficult in the future to exit any fiscal expansion in the form of temporary subsidies and other measures to alleviate hardships and get people on board with the idea of putting up with higher resource prices. As has been the case so far, the result will be the firm establishment of a “cheap Japan” with a further deterioration of its terms of trade. Whether or not to resume nuclear power generation will ultimately be determined by public opinion, but it is important to discern from the past two years the extent to which a country that gives up on economic growth can deteriorate.

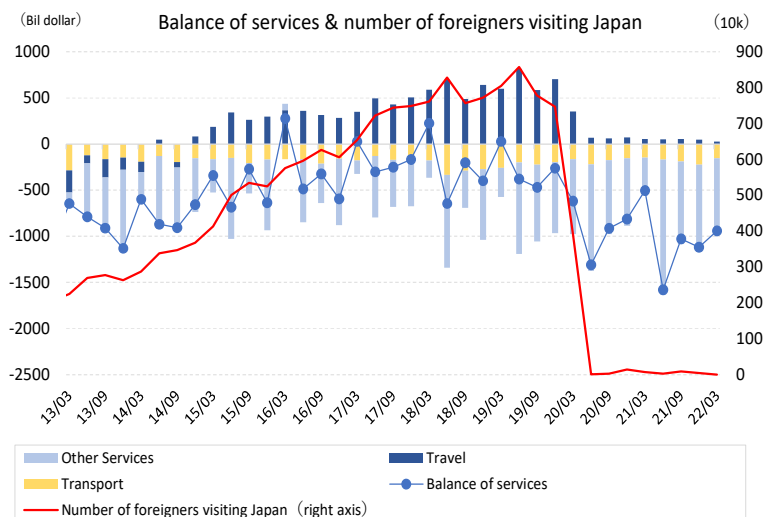
(3) Lifting the Ban on Inbound Tourism

At the meeting of the Council on Economic and Fiscal Policy (CEFP) held on April 27, private-sector advisers proposed an early resumption of inbound tourism, which is currently banned as part of border-control measures against COVID-19. Of the three measures described in this section, the first measure could trigger speculative JPY selling, the second one may be difficult to find sufficient public support for, but there is very little scope for opposing the third measure of lifting the ban on inbound tourism. The recent shrinking of Japan's current account surplus is due to both the expansion of its trade deficit amid an increase in resource prices, and the vanishing of its travel surplus amid no demand for inbound tourism. If the ban on inbound tourism is lifted and the travel surplus returns, it will certainly ease the JPY selling pressure from the demand perspective, even if only slightly. Prime Minister Kishida has also indicated a desire to pursue this path, stating that “Incorporating robust overseas demand will strengthen economic vitality and the prospects for long-term growth.”

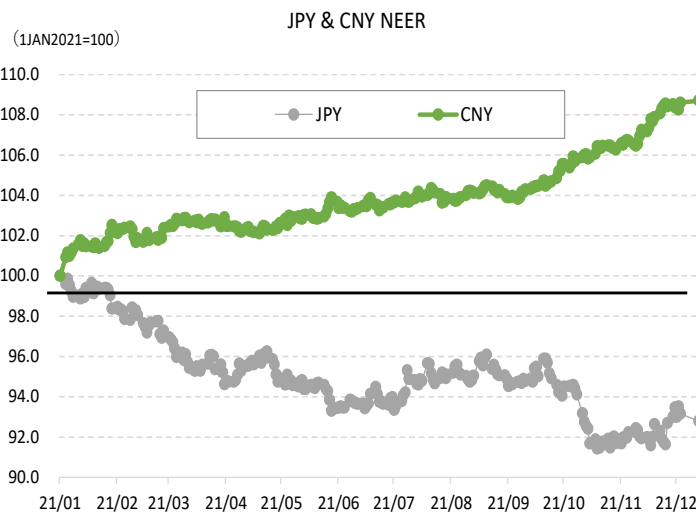
Considering Japan's conservative public opinion, one can predict opposition to lifting the ban on inbound tourism based on fears that letting foreigners enter the country will result in the spread of infections, but such views are almost comical given that China and Japan are the only two countries still constricting real economic growth due to their excessive obsession with new case numbers. If Japanese people can travel abroad during Golden Week, why can the reverse not be true? It is difficult to explain the situation logically. Moreover, as non-Japanese are unlikely to follow non-scientifically-grounded requirements, such as outdoor masking, the government will need to end such domestic pandemic measures that are being continued simply due to inertia.

With the amount of attention currently focused on the subject of “cheap Japan,” it would be natural to consider initiatives to utilize the situation to the country's benefit.

The aforementioned private-sector advisers pointed out that Japan needs to do something to remedy its international image as a closed-off country, and called for border-control measures to be made easier to understand and project a more relaxed image. Although unfortunate, the deteriorating real-income climate in Japan makes it necessary to rely on the purses of foreign tourists. Whether or not one desires it, utilizing the demand for inbound tourism to acquire foreign currency is one of the few options left to Japan. In 2019, right before the pandemic began, the number of foreign tourists to Japan surpassed 30 million, and the country posted a travel surplus of around +JPY 2.7 trillion, both the figures being all-time record highs (see figure).



As is generally known, most of this is attributable to tourism from China. Recently the nominal effective exchange rates (NEER) of JPY and CNY have been moving in opposite directions because of the simultaneous disappearance of Japan's travel surplus and China's travel deficit. The travel surplus is unlikely to be large enough to impact the direction of currency rate movement, but the above relationship between JPY and CNY is quite intriguing (see figure).



(Source) macrobond

Going by Japan's stance thus far, the worst-case scenario I can imagine is: receive inbound tourists → condemn foreign tourists for not wearing masks → raise a fuss over the spread of infections due to foreign tourists → reimpose entry restrictions. If that happens, the country will be back where it started, and without skillful handling, further discussions on lifting the ban on inbound tourism could be shelved on a semi-permanent basis. Following after the U.S. and Europe, several Asian countries are now removing all restrictions. Even in Japan, people are beginning to question the effectiveness of outdoor masking. Now seems like a good time, therefore, to make some big decisions. If the government is unable to do it, the Japanese economy may end up stagnating over the longer term, and "cheap Japan" may end up becoming nothing but just that.

The Japanese Economy and JPY Depreciation – A Country that Cannot Imagine Inflation Troubles

The Business World Also Disapproves of JPY Weakness

As I stated in last month's edition of this report, it is dangerous to simplistically talk about JPY weakness as being a good or bad thing. My basic understanding is that it would be fair to say that it is a positive thing for the Japanese economy overall, but there are conspicuous negatives in various specific areas, inevitably resulting in a bipolarization. The overall effect of JPY weakness on GDP is positive, thanks mainly to the benefits it confers on large global enterprises, but the media tends to portray it as a predominantly bad thing because the positive effects are invisible while the negative effects, such as price rises, are more evident to the people on the street, who are overwhelmingly larger in number. Arguments about the disadvantages to the common man are in a completely different dimension from those about a positive/negative impact on the GDP.

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)".

On April 4, for instance, Keidanren (Japan Business Federation) Chairman Masakazu Tokura pointed out that, while the revenues of companies that had to procure energy resources from overseas were taking a hit as a result of JPY depreciation, export companies were benefitting from the situation. He went on to say that it was inappropriate to make short-term judgements on whether JPY weakness was a good thing or a bad one. This is close to what the BOJ

and economists have also been saying, and one has to admit that this is a general argument that is valid from a macroeconomic perspective. To reiterate my earlier point, the reason central bankers and other economists point out the benefits of a weak JPY is because JPY weakness confers extremely large value-addition benefits on large global enterprises in the manufacturing sector, and when simulating GDP calculations, these benefits are highly likely to contribute positively. The Keidanren is not an organization either of economists or of central bankers, but it includes large global enterprises in its federation, so Tokura's views on the matter are natural.

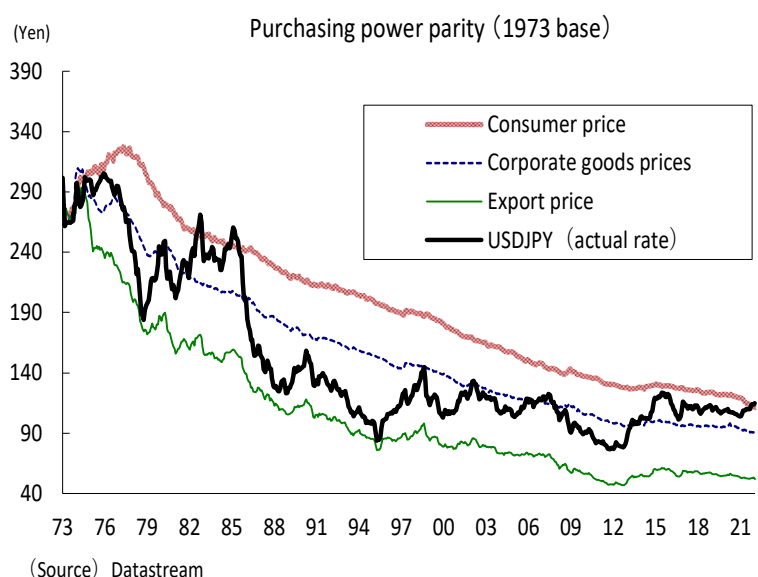
However, in the current social climate, it would be quite difficult to overcome resistance to JPY weakness simply by proffering general arguments about its merits. Increasingly, it will become necessary to also thoroughly discuss the demerits in the various specific areas. In theory, it is valid to say JPY weakness is not, in itself, a good or bad thing. However, during the ultra-strong JPY phase between 2009 and 2012, did they listen to the argument that a strong JPY also has its benefits, such as allowing resources to be procured at cheap prices? I remember quite clearly that anybody who made that argument at that time faced a barrage of criticism. As the number of economic entities experiencing JPY weakness as a disadvantage increase, even theoretically flawed arguments will be treated as just. In this context, there have been a spate of comments disapproving of the current levels of JPY weakness even from the business world, which look increasingly likely to exert some influence on policymakers. The following are some examples:

- JCED Chairman Kengo Sakurada (also CEO of Sompo Japan Nipponkoa Holdings) on March 29: "I really do not think current levels of JPY weakness are appropriate. Some companies may view it differently, but overall, JPY is seen as being too weak."
- Japan Iron and Steel Federation Chairman Eiji Hashimoto (also Representative Director and President of Nippon Steel Corporation) on March 29: "(Unlike the past, when JPY weakness improved Japan's competitiveness) this time the situation is completely different;" "For the first time, JPY weakness is a risk;" "It is an indication that Japan alone is on the losing side among its global counterparts;" "It is a serious problem."
- Japan Chamber of Commerce and Industry Chairman Akio Mimura on April 7: "JPY weakness has almost no benefits for small and medium-sized enterprises, which have no export or other overseas businesses for the most part, but its disadvantages are significant. The same can be said for ordinary consumers;" "It may be okay if JPY weakness results in export companies increasing their fixed investment or employee compensation, but they are currently unable to increase production. The rise in resource prices means that they are not enjoying the benefits of JPY weakness either."

In addition to the above, Nippon Yusen President Hitoshi Nagasawa is reported to have said that "JPY weakness is a disadvantage overall" because freight charges for outbound marine transportation are paid in USD, and that he is "concerned" about the negative impact of JPY weakness on the economy due to higher fuel and resource prices. At the very least, nobody in the business world seems to be calling for a further weakening of JPY, and voices expressing disapproval of JPY depreciation are more conspicuous. Of course, if the higher revenues for large global enterprises due to JPY weakness are passed on to SMEs and households in the form of wage rises through an increase in domestic demand, it may become possible to say that a weak JPY is a benefit for the Japanese economy, but as JCCI Chairman Mimura pointed out, this cannot be expected in the case of Japan at the present time – one reason pointed out being the country's rigid employment system, which is not a problem that can be resolved overnight.

The Question is not "Will" but "Can" JPY Rates Return to Normal

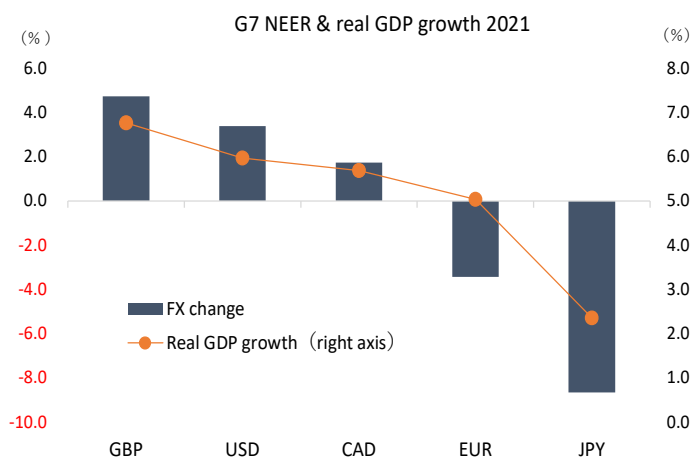
With leading figures from the business world also beginning to point out the risks of JPY weakness, it may be difficult to indefinitely peddle the view that JPY weakness is a "benefit for the economy overall." However, it is quite possible that an essentially accommodative monetary policy and an essentially non-nuclear energy policy will be continued due to high public support for such policies. This possibility cannot be ruled out in light of the fact that Japan has continued to make by-and-large irrational decisions to counter the pandemic. While the rest of the world has moved on from pandemic concerns to inflation concerns, Japan still remains obsessed with daily case numbers. Unfortunately, it seems likely that the government will continue to impede growth through the imposition of movement restrictions while disregarding the value of the domestic currency. It is symbolic that JPY is already at its lowest real effective exchange rate (REER) in half a century.



However, there are no signs yet of economic hardships resulting from higher resource prices or JPY weakness reflecting badly on public support for the government. Japan, which has suffered from chronic deflation (an increase in the currency's value) is inexperienced when it comes to inflation (a decline in the currency's value) troubles. Perhaps there is a deep-seated sense of optimism that the current JPY weakness will soon be corrected. Of course, Japan follows the floating exchange rate system and has enormous net external assets, so that there is bound to be a swing-back following any duration of current levels of JPY weakness. However, to what extent can JPY recover when that does happen? There is no "fair value" when it comes to currency rates, but when seen in light of the PPP, USD/JPY has clearly been too high since 2012, while the recent level of JPY weakness against USD bears a close resemblance to levels immediately prior to the Plaza Accord (see figure). In other words, at the current level of JPY weakness, rather than waiting for the rates to "recover naturally," some sort of policy intervention to restore JPY rate levels would not be unwarranted. In fact, if the rates are left to move in the natural course of things, so long as resource prices remain high, Japan will continue to post enormous trade deficits, which would drive JPY depreciation, leaving very limited scope for JPY appreciation.

Nations and People Both Only Learn the Hard Way

Japan seems poised to chronically be obsessed with some or other wave of infections, and one cannot rule out the possibility of movement restrictions being imposed yet again. I have frequently argued that this kind of approach to anti-pandemic measures is resulting in low growth rates and contributing significantly to JPY depreciation (see figure), but this causal relationship appears not to have made much of an impact on the people on the streets (the reason why strict movement restrictions enjoy strong public support). Perhaps when it starts becoming difficult for the average person to afford food, the government will finally go beyond the "monitoring/consideration" stages and make and implement decisions to change the course of its monetary and energy policies. Ultimately, it may be true for both people and nations that they only learn the hard way. To put a positive spin on the situation, perhaps the impending marked rise in prices will finally rid Japan of its deep-rooted anti-deflationary mindset. I would like to take a chance and view the ongoing situation in a positive light in that one aspect – the fact that Japan may finally be about to experience the "extremely natural economic phenomenon" of inflation after all these years.



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

The World Economy Now and Going Forward – Pandemic Wounds Festering in Japan Alone

War may Change My Main Scenario

The IMF released its Spring World Economic Outlook (WEO) in mid-April. As expected, growth rate forecasts for 2022 have been downgraded for almost all countries/regions around the world, with the global forecast being downgraded from +3.6% as of January to -0.8% this time. Inflation concerns against the backdrop of resource prices, which have been high for some time now, were already seen as a burden on the world economy,

G7 & China growth ratio trajectory from 2020 to 2023 (YoY%)

	2020	2021	2022		2023		Revised (JAN→APR)		
	Actual	Estimate	as of JAN	as of APR	as of JAN	as of APR	2022(①)	2023(②)	①+②
U.S.	-3.4	5.7	4.0	3.7	2.6	2.3	-0.3	-0.3	-0.6
Euro-zone	-6.4	5.3	3.9	2.8	2.5	2.3	-1.1	-0.2	-1.3
Germany	-4.6	2.8	3.8	2.1	2.5	2.7	-1.7	0.2	-1.5
France	-8.0	7.0	3.5	2.9	1.8	1.4	-0.6	-0.4	-1.0
Italy	-8.9	6.6	3.8	2.3	2.2	1.7	-1.5	-0.5	-2.0
Japan	-4.5	1.6	3.3	2.4	1.8	2.3	-0.9	0.5	-0.4
Canada	-5.2	4.6	4.1	3.9	2.8	2.8	-0.2	0.0	-0.2
U.K.	-9.4	7.4	4.7	3.7	2.3	1.2	-1.0	-1.1	-2.1

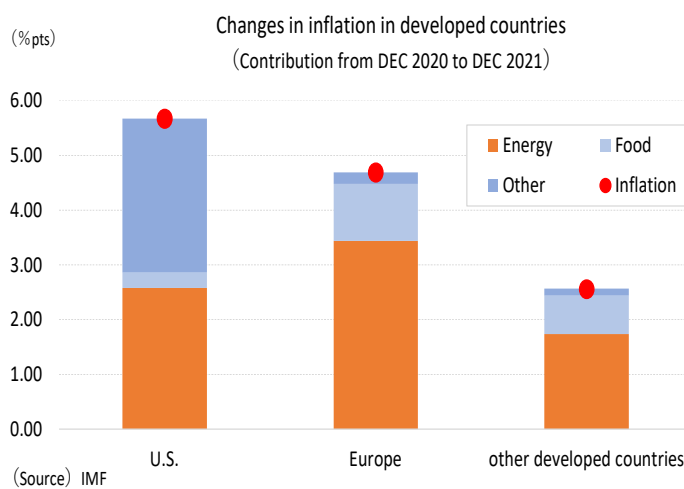
(Source) IMF "World Economic Outlook" (APR 2022)

but since the January forecast, two additional downside factors have been added to this – the crisis in Ukraine and the increasingly hawkish stance of central banks around the world. Following the dramatic decline in growth as a result of the pandemic in 2020 and the sharp recovery in 2021, it was thought that the main challenge in 2022 would be to stabilize inflation by reining in robust demand continuing from 2021. However, thanks to the Ukrainian crisis, there is now no end in sight to high resource prices, and supply constraints remain for factors of production other than resources also. As a result, there is no end in sight to inflation growth either, and central banks around the world are being compelled to raise interest rates in an effort to achieve equilibrium at reduced levels. The WEO subtitle this time describes the current situation aptly: "War Sets Back the Global Recovery." Originally, it was thought that the supply constraints on resources and other factors of production would be relieved by mid-2022, and central banks were expected to conduct a gradual policy normalization based on the stance that inflation was temporary. The Fed did begin to lean toward a more hawkish stance at the end of November last year, but certainly not as dramatically as to implement 7 rate hikes within a year and shrink the balance sheet during 1H of the year. The crisis in Ukraine may force me to revise my main risk scenario.

Gap between U.S. and Europe Made Obvious

Looking at the revised IMF forecasts by economy, Europe has been significantly downgraded for obvious reasons, being the epicenter of geopolitical tensions. For 2022, the euro area's growth rate forecast as a whole has been downgraded by 1.1 pp from +3.9% to +2.8%. Further, the UK's growth rate has been downgraded by 1.0 pp from +4.7% to +3.7%. The euro area and the UK are the only two economies for which 2022 growth rate forecasts have been downgraded by 1.0 pp or more. Looking at the individual member states of the euro area, among the Western European member states, Germany is most affected by the crisis in Ukraine, so its growth rate forecast has been downgraded by nearly half from +3.8% to +2.1% (-1.7 pp), while the forecast for Italy, which lacks fundamental economic strength to begin with, has also been downgraded significantly, by 1.5 pp, from +3.8% to +2.3%. By contrast, the forecast for the U.S. and Canada have been downgraded by a mere 0.3 pp, from +4.0% to +3.7%, and 0.2 pp, from +4.1% to +3.9%, respectively. These reflect the fact that the U.S. and Canada are not just geographically removed from Ukraine, but also have some strength as resource-rich countries.

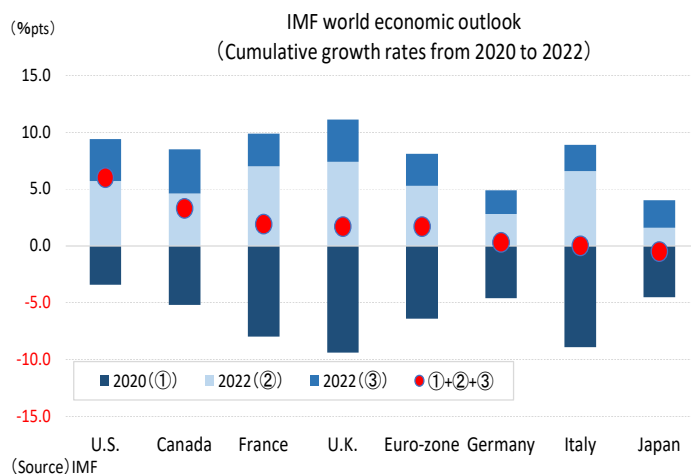
ECB President Christine Lagarde misses no opportunity to bring up this economic and financial disparity between the U.S. and Europe, which is obvious even from the breakdown of inflation over the past year. The figure to the right shows the change in inflation between December 2020 and December 2021 for the U.S., Europe, and other developed economies. Overall, it would be correct to assume that the trend is driven by energy prices, but in the case of the U.S., over half of its increase in inflation is already attributable to categories other than energy. U.S. inflation figures reflect the rise in service prices against the backdrop of higher wages and persistently high imputed rent as a result of an increase in housing prices. The contribution from the rise in energy prices is under 50%, at 46%. Meanwhile, in Europe and other developed economies, 73% and 68%, respectively, of the rise in inflation are attributable to energy prices, marking a clear difference between these economies and the U.S. While the Fed's recent hawkish turn might seem dramatic at first glance, it becomes more understandable in light of this difference in growth rate and inflation figures between the U.S. and other economies.



Japan Continues to let Pandemic Wounds Fester

What about Japan? Japan's growth rate forecast was also downgraded by 0.9 pp, from +3.3% to +2.4%, so the level of damage is closer to that incurred by Europe than that by the U.S. or Canada. Because of Japan's dependence on resource imports from overseas, its weaknesses are structurally similar to those of Europe, and the revision of forecasts is as expected. Moreover, given the sharp devaluation of JPY starting March, it is thought that the damage is likely to be even greater than that forecast in the recent WEO.

Incidentally, while the forecast for most countries/regions was downgraded this time, downgrades have been the default course of action in the case of Japan right from 2020, when the pandemic began. Even in 2021, when the forecasts for all of Europe and the U.S. were being upgraded, Japan's forecast was repeatedly downgraded in view of its frequent movement restrictions, and the country was left behind all by itself, having failed to ride the wave of the global economic upturn. In this context, rather than going by the WEO's recent forecast, it may be fairer to assess the Japanese economy in terms of its performance over the past two years (2020-21) and its forecast for the current year (2022). Despite their slower growths this year, the U.S. and Europe are starting from higher points, having achieved strong growth in 2021. This is the reason they are in a position to discuss and implement monetary policy normalization. The figure above shows the cumulative result of actual GDP growth rates for 2020-21 and forecasts for 2022.



The U.S. has the highest cumulative growth, at +6.0 pp, while Japan has the lowest at -0.5 pp, and Japan is the only one with negative growth. Some people argue that the U.S. and Europe posted strong recoveries in 2021 because their economies had sharply declined in 2020. While this is true, there is also the objective fact that Japan is the only country that has not fully recovered the growth lost in 2020. Even in Europe, nuclear-power-averse countries, such as Germany and Italy, are faring the worst, bombarded by the increase in resource prices, and it may not be a

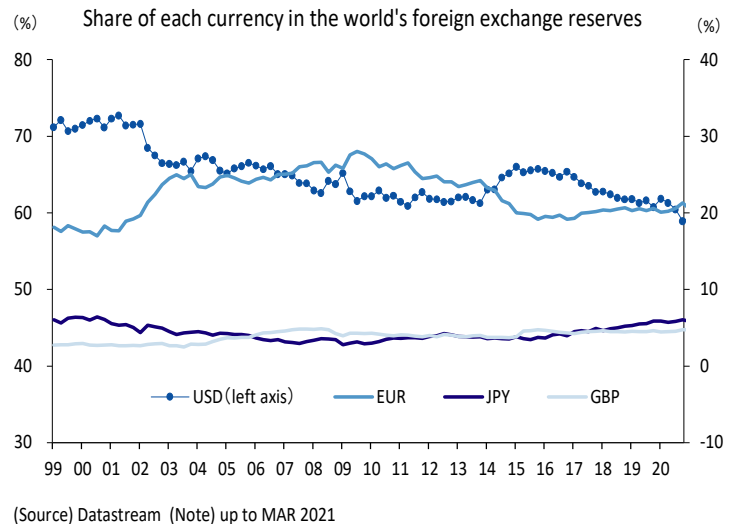
coincidence that France, known to be a nuclear-power heavyweight, is among the euro area nations that has been able to maintain a high growth rate.

Japan, with its poor growth rate on top of the dramatic currency devaluation, would do well to revise its energy policy to include the resumption of nuclear power generation as well as revising its monetary policy in the direction of a tighter policy, which is almost viewed as a taboo. I believe these are the economic policies required at the current time to limit the draining out of income from Japan, but “considering and monitoring while avoiding controversial discussions” has become the long-term status quo in the country. Given that Japan is the only country still suffering from the wounds inflicted by the pandemic, the government ought to take swift action to formulate the necessary measures, but as of the current time, there seems no sense of crisis. My basic understanding is that the ongoing JPY depreciation trend is, in part, sounding the alarm regarding Japan’s political and economic situation.

Supplement: Global Foreign Exchange Reserves Trends – USD Ratio Reaches New Record Low

USD Ratio Reaches New Record Low

On March 31, the IMF released its Currency Composition of Official Foreign Exchange Reserves (COFER) data covering the period through the end of 2021. This article frequently overviews and analyzes COFER data, at they are an important basis for forecasting the forex market’s medium- to long-term outlooks. Total global foreign exchange reserves increased to USD12,937.3 billion at the end of the fourth quarter of 2021, representing a rise of USD80 billion qoq and the third consecutive qoq increase in that figure. Looking at the change from the start of the fourth quarter to the end of that quarter, one finds that the U.S. 10-year interest rate rose only about +20bps (from about 1.3% to about 1.5%) but the nominal effective USD exchange rate (NEER) ascended significantly (+1.8%). Accordingly, there are grounds for speculating that the USD value of non-USD foreign currency reserves may have diminished owing to price effects. During the same interval, the U.S. two-year interest rate rose by +50bps (from about 0.2% to about 0.7%), and concerns had already begun emerging about the possibility that the Fed’s normalization process would promote interest rate rises to the point of overkill. That interval was also a period in which observers began noting rapid rises in the prices of crude oil and other commodities.



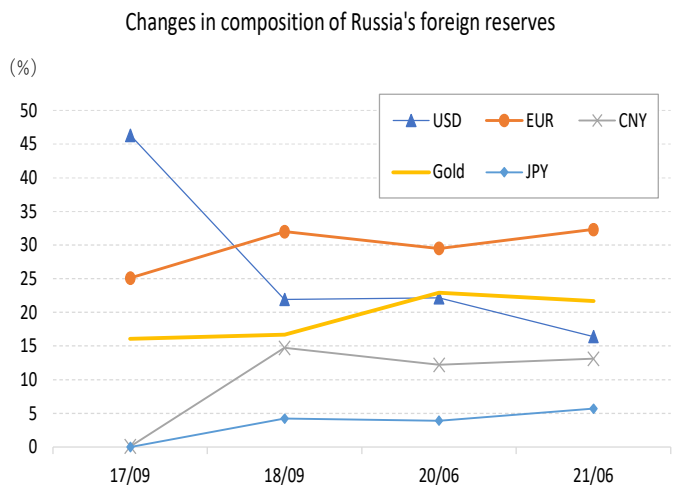
In recent years, COFER data has indicated a trend of decrease in the USD-to-total-forex-reserves ratio (the USD ratio) and, as the USD ratio intermittently reaches new record low levels, this trend has become a hot topic of discussion. The USD ratio descended from the 58.92% level recorded at the end of 2020 to a 2021 year-end level of 58.81% – its first new record low level (since this statistic has been calculated) in four quarters. It is noteworthy that the USD ratio has fallen below 60% for five consecutive quarters (since the end of 2020) and that such levels were previously unprecedented. As discussed below, the prolonged sanctions related to the Ukrainian crisis may give additional momentum to the global foreign exchange reserves de-dollarization trend. It is also worth noting that only two currencies’ shares of global foreign exchange reserves decreased during the fourth quarter of 2021 – USD’s share decreased 0.40 percentage point (59.21% → 58.81%) and JPY’s share declined 0.12 percentage point (5.69% → 5.57%) – and those decreases appear to have caused evenly distributed increases in the shares of other currencies. This is consistent with the recent trend of JPY depreciation even at times of USD weakness.

Looking at ratios of other currencies to total global foreign exchange reserves, one finds that the EUR ratio increased 0.07 percentage point to 20.64%, the GBP ratio rose 0.09 percentage point to 4.78%, the RMB ratio advanced 0.11 percentage point to 2.79%, the CAD ratio rose 0.17 percentage point to 2.38%, the AUD ratio edged up 0.02 percentage point to 1.81%, the CHF ratio was flat at 0.20%, and the “other currency” ratio grew 0.05 percentage point to 3.01%. As previously noted, USD was strong during the October-December period, so it could be expected that price factors would promote an increase in the USD ratio, yet that ratio still declined, and it is therefore suspected that this result reflected the quantity factor of USD selling.

It is noteworthy that the RMB ratio and the CAD ratio both reached record high levels of 2.45% and 2.11%, respectively. Looking at forex rate fluctuations against USD during the fourth quarter of 2021, one finds that RMB appreciated significantly, by 1.4%, so it is possible that price factors played a role in elevating the RMB ratio. On the other hand, CAD was almost flat against USD, edging up only 0.3%. It appears that the currencies of countries with both resource-rich country and developed country characteristics may have been positively evaluated amid the intensifying trend of surging commodity prices.

Ukrainian Crisis Could Intensify De-dollarization Trend

The de-dollarization of the world's foreign exchange reserves is a pre-existing long-term trend that may be further strengthened following the recent start of the Ukraine crisis. Reflecting this, the Russian central bank (boasting the world's fourth highest level of foreign exchange reserves) has reduced its USD ratio by about 30 percentage points (46.3% → 16.4%) over the past five years while considerably increasing its RMB ratio (0.1% → 13.1%) during the same period. These changes do not appear to be rational foreign currency reserves rebalancing measures by conventional standards, but it is clear that they align with Russia's political and diplomatic agenda. It is also interesting to note that Russia has significantly elevated its EUR and JPY ratios (see graph). These movements suggest that Russia may not have anticipated an emergency situation in which Japan, the United States, and Europe simultaneously impose sanctions on it. In any case, the Russian central bank's adjustments of its reserve are generally in line with recent trends seen in COFER data.



(Source) Central Bank of Russia

Of course, even though Russia's central bank's forex reserves are huge (about USD630 billion at the end of 2021), they account for just under 5% of total global forex reserves, so Russia's changes are not capable of determining the overall COFER trend. However, two months have passed since the decision to block Russian banks' access to the SWIFT network (which has been described as being akin to a "financial nuclear weapon"), and it appears unlikely that this blockage will be lifted unless President Putin changes his stance. Prolonging this situation may well be detrimental to the robustness of USD's global hegemony. Ever since the recent package of sanctions was imposed, it has been pointed out that blocking Russian bank's access to the SWIFT network, which mainly processes USD settlements, will encourage Russia to make greater use of China's Cross-Border Interbank Payment System (CIPS). If the greater usage of CIPS becomes a new normal, it could be considered the thin edge of a wedge driven into USD's global hegemony.

While the SWIFT blockage is having an enormous impact, it is inevitable that Russia will over time adapt to a "world without SWIFT" (because it could not otherwise continue to exist). The fact that Russia has to some extent adapted to the SWIFT blockage is comforting for other countries around the world¹, almost all of them currently enjoying the convenience of SWIFT-based USD settlements, and it can be assumed that many of those countries harbor fears of being the next victim of SWIFT-blockage sanctions, even though they might not express such feelings aloud. USD's global "hegemony" may appear to be a natural and immutable situation, but once some countries demonstrate that they can survive in a "world without SWIFT", it seems inevitable that the hegemony will eventually undergo some changes, even if only gradually.

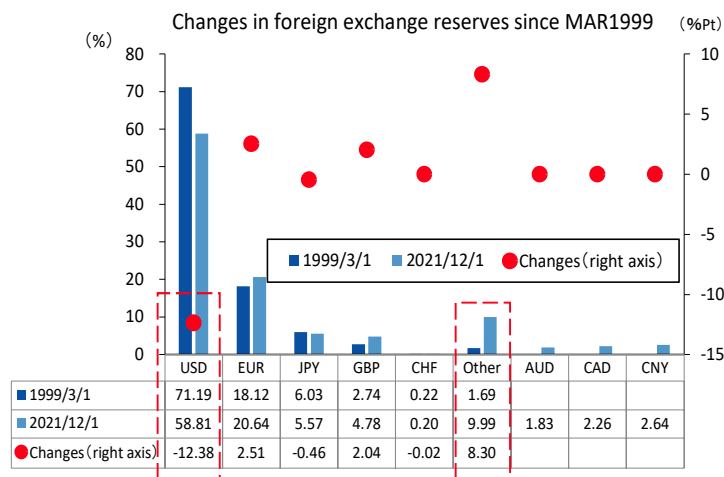
One country liable to fear U.S. financial sanctions in the event of an emergency situation is China, which has about USD3.2 trillion of forex reserves. While it is unclear what percentage of those reserves are in the form of USD, even 60% of those reserves would amount to about USD1.9 trillion. In light of that, it is highly likely that China is considering (or implementing) forex reserves diversification measures similar to those of Russia. It is worth noting that China and Russia's combined forex reserves total about USD3.8 trillion and account for about 30% of global forex reserves, so forex reserves diversification measures by those two countries could have a considerable impact on COFER data.

Background of De-dollarization

Over the past 20 years, the global USD ratio has fallen by about 12 percentage points – from about 71% to about 59%. While many people previously assumed that the EUR ratio was likely to rise in line with the USD ratio decline, the EUR ratio has increased by only about 3 percentage points – from about 18% to about 21%. In fact, the gap has been filled by RMB and other currencies in the "other" category, and the "other ratio" has surged by 8.3 percentage points – from about 1.7% to about 10.0%. There has in fact been a clear trend in forex reserves over the last quarter century that has the theme of "shifting away from USD and toward currencies of emerging and resource-rich countries".

¹ In 2019, the Sweden-based V-Dem Institute (V-Dem represents 'Varieties of Democracy') found that the world contained 87 democratic and 92 non-democratic countries and regions in the world, with the non-democratic countries and regions comprising the majority for the first time in 18 years.

Various background factors have been promoting the de-dollarization trend. Desires to counter USD hegemony (1) have been considered a main factor, but other factors promoting forex reserve diversification include the development and issuance of digital currencies (2) and the emergence of NextGenerationEU recovery fund (NGEU) bonds (3). Moreover, factor (2) is closely related to factor (1). Those promoting the development and issuance of central bank digital currencies (CBDC) in such countries as China and the United Kingdom as well as the euro area have frequently emphasized that such CBDCs would help counter USD hegemony, and it is widely believed that China’s rush to develop and introduce the digital RMB was largely designed to prepare to deal with such situations as a SWIFT blockage. Many observers anticipate that China will encourage countries participating in the “One Belt, One Road” initiative to use the digital RMB, with an eye to creating a “digital RMB economic zone” and eventually internationalizing RMB. In the future, China may consider offering incentives to encourage economic entities to employ the digital RMB and CIPS.



(Notes) AUD, CAD and CNY were not disclosed as of MAR 1999. "Other" in the table includes these three currencies

(Source) IMF, Datastream

Also, as previous editions of this article have discussed, if NGEU bonds, which have already begun to be issued and procured, become a permanent form of jointly issued euro area bonds in the future, that will also contribute to the decline in the global USD ratio. Previously, German government bonds have been practically the only truly safe EUR-denominated assets, causing many entities to prefer investing in U.S. Treasuries. If the NGEU bonds issued by the European Commission are made permanent, however, it would seem justified from a historical perspective to consider them assets with a level of safety second only to U.S. Treasuries.

Of course, the international monetary system has long been dominated by USD and will not change significantly overnight, but the SWIFT blockage imposed on Russia has presented the world with a small-scale simulation of how a “future without USD” scenario might function, and it may prompt some countries to undertake additional adjustments of their forex reserves structures. The significant decline in the global USD ratio seen in the COFER data illustrates a worldwide trend of decreasing demand for USD for use in countries’ forex reserves, and it is becoming increasingly important to thoroughly analyze this trend and gain a better awareness of its numerous potential ramifications.

Risks to My Main Scenario – Truly Fearsome Potential of Household Sector JPY Selling

JPY Supply-Demand Changes Reflecting Corporate Sector JPY Selling

As this article has repeatedly discussed, the background factors promoting JPY’s depreciation to its weakest level in over 20 years include the orthodox issue of the Japan-U.S. monetary policy gap as well as changes in the JPY supply-demand environment. However, the JPY supply-demand environment has many aspects, including (1) the expansion of Japan’s trade deficits mainly owing to high resource prices, and (2) the increase in foreign direct investments by Japan’s corporate sector, which generate considerable JPY selling pressure. Factor (1) represents outright JPY selling/foreign currency buying that occurs on a regular basis every month, while factor (2) represents large-volume JPY selling that occurs at times of overseas corporate acquisitions. As a result of the increasing momentum of factor (2) over the past 10 years, half of Japan’s net foreign assets are now directly invested. Once upon a time, Japan’s net foreign assets were predominantly securities investments. When risk aversion moods intensify, one may anticipate that Japanese companies will sell a portion of their overseas securities (≈ sell foreign currency/buy JPY), but it is difficult to imagine similar moves to sell acquired overseas companies at times of intensifying risk aversion moods. While the progressive shrinking of Japan’s trade surpluses has naturally diminished the power of “risk-off JPY buying”, it is thought that growth in Japanese foreign direct investment also has made a considerable contribution to the trend of decline in the power of “risk-off JPY buying” over the medium to long term. Changes in factors (1) and (2) can also be seen as outflows in Japan’s basic balance (current account balance + capital account balance (direct investments)).

Truly Fearsome Potential of Household Sector JPY Selling

The remarkable increase in Japan’s foreign direct investment has largely been based on rational corporate management decisions to expand overseas operations rather than investing in Japan, which has a shrinking domestic market. The foreign direct investment increase represents a kind of corporate sector capital flight, in that decisions were made to expand operations overseas rather than in Japan based on expected rates of return on investment. However, this is not a purely negative trend for Japan, as it can be expected that profits from Japanese companies’ successful overseas operations will be repatriated to Japan. It is well known that Japan’s current account surplus is being supported by the country’s primary income balance surplus. Moreover, even if Japan’s trade deficit is

temporarily inflated due to high resource prices, this is theoretically the result of the optimal international division of labor – one should not always assume that surpluses are good and deficits are bad. There are good reasons for the shrinking of Japan’s trade surpluses during the past decade (although I will refrain from discussing those reasons in detail in this edition of this article).

In other words, corporate sector JPY selling such as that owing to the above-mentioned factors (1) and (2) is not always a bad thing. On the other hand, the potential consequences of household sector JPY selling are much more fearsome than those of corporate sector JPY selling. If the household sector begins to consider the holding of JPY-denominated assets to be risky, it will be of little benefit to the Japanese economy, as household sector JPY selling is merely a self-defensive action. The current atmosphere does not seem to be one in which a surge of household sector JPY selling appears likely. The Kishida government has maintained a very high approval rating, and many observers believe this largely reflects the government’s efforts to tailor policies to the needs of the elderly, who are a large share of Japan’s population. This view seems to be quite accurate, as evidenced by such developments as the government’s recent proposal to make one-time JPY5,000 payments to pensioners. The government’s obsession with new covid-19 infection numbers and the alacrity with which it has instituted pandemic-related behavioral restrictions also reflect its desire to appeal to the high demographic share of elderly people who have a limited range of activities compared to young people and are likely to be strongly critical of pandemic-related policies they consider overly lax. While the government’s protraction of extremely conservative pandemic-related policies has contributed to sluggish GDP growth, the inflexible policy posture of the BOJ, and JPY depreciation, that situation is not clearly perceived by most of the population.

So long as the status quo continues, however, it can be confidently expected that the relative value of JPY-denominated assets will deteriorate. Owing to Japanese people’s conservative temperament and lack of financial literacy and perhaps to some other factors, more than 95% of Japanese people’s personal financial assets are still held in the form of JPY-denominated assets, and more than half of those assets are in cash or bank deposit accounts that generate almost zero interest income (see chart). As of December 31, 2021, Japan’s household financial assets amounted to JPY2,023 trillion, up JPY620 trillion from March 31, 2000. However, more than half of the increase (JPY343 trillion) is in the form of JPY-denominated cash and deposits. The share of Japanese household financial assets invested in risk assets has hardly increased at all since 2000 – investments in stocks (a representative form of risk assets), remained roughly unchanged at around 10%. Looking at the composition of JPY-denominated assets, it is clear that efforts (such as the launch of the Nippon Individual Savings Account (NISA) system in January 2014) to promote a shift from savings deposits to investment have not been successful at all.

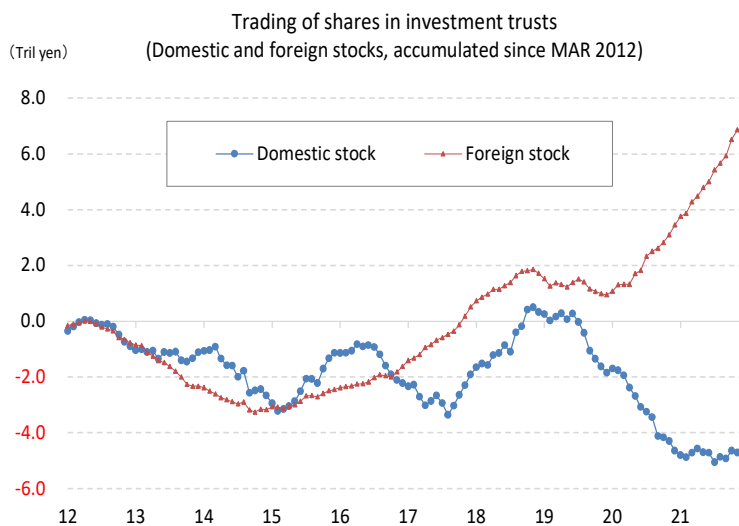
However, although the share of foreign currency assets within Japan’s household financial assets remains small, it has clearly increased (from 0.9% to 3.4%), and there have been considerable surges in the JPY value of foreign currency investment trusts (up more than 700%) and foreign securities investments (up almost 500%). While the share of JPY-denominated cash and deposits within Japan’s household financial assets remains overwhelming, interest in overseas assets is steadily increasing. In light of such developments as the greatest depreciation of JPY against USD seen in 20 years, the greatest depreciation of JPY on a real effective exchange rate (REER) basis in half a century, JPY’s inability to recover from its depreciation on purchasing power parity (PPP) basis, the progressive shrinkage of Japanese trade surpluses, and the surge in Japan’s foreign direct investments, it should be recognized that objective facts associated with JPY assets are quite different from those seen 10 years ago and even more different than those seen 20 years ago. As it becomes ever-more clear that such easy-to-understand changes in the environment are all sending the same message regarding JPY assets, even the most Japan-centric and financially conservative of Japanese households may finally begin restructuring their assets. Even people with extremely high risk aversion levels will not always cling to the same investment strategies when they recognize that the nature of the risks they face has greatly changed.

Financial asset composition of the Japanese household sector (end of DEC 2021)			Financial asset composition of the Japanese household sector (end of MAR 2000)			Changes from the end of MAR 2000 to the end of DEC 2021	
	Amount (trillion yen)	(%)		Amount (trillion yen)	(%)	Amount (trillion yen)	(%)
Total assets	2,023.0	100.0	Total assets	1,401.1	100.0	621.9	
Foreign currency	68.9	3.4	Foreign currency	13.2	0.9	55.7	2.5
Foreign currency deposit	7.1	0.3	Foreign currency deposit	3.1	0.2	4.0	0.1
Foreign securities investment	22.9	1.1	Foreign securities investment	4.7	0.3	18.2	0.8
Investment trust	38.9	1.9	Investment trust	5.3	0.4	33.6	1.5
JPY-denominated	1,954.1	96.6	JPY-denominated	1,387.9	99.1	566.2	▲ 2.5
Cash and deposits (excluding)	1,084.6	53.6	Cash and deposits (excluding)	741.6	52.9	343.0	0.7
Government bond, etc.	25.7	1.3	Government bond, etc.	50.6	3.6	▲ 24.9	▲ 2.3
Stocks and investments	211.6	10.5	Stocks and investments	138.3	9.9	73.2	0.6
Investment trusts (excluding)	60.1	3.0	Investment trusts (excluding)	52.2	3.7	7.9	▲ 0.8
Insurance and pension reserv	540.1	26.7	Insurance and pension reserv	369.9	26.4	170.2	0.3
Deposit, etc.	32.1	1.6	Deposit, etc.	35.3	2.5	▲ 3.2	▲ 0.9

(Source) Bank of Japan "Flow of Funds Accounts."

JPY Selling Associated with Investments in Overseas Equities

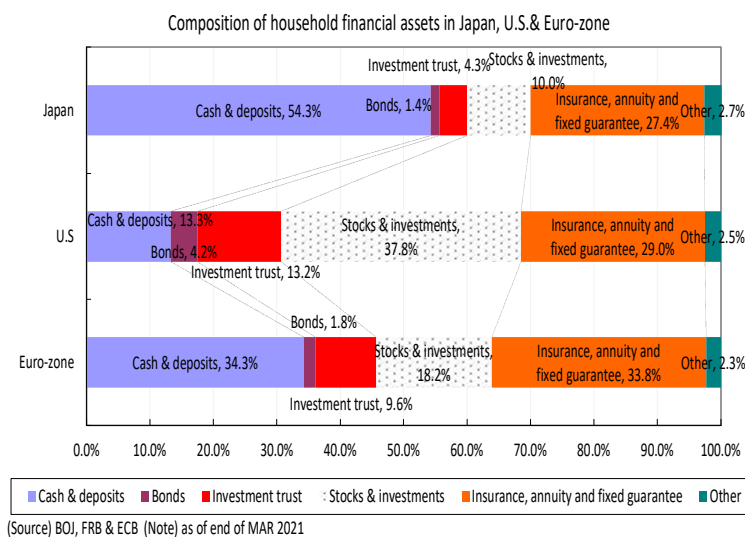
There has been a noteworthy surge in Japanese households' investment in U.S. equities, as described in an interview with the president of a major online securities company published by Nihon Keizai Shimbun December 28, 2021 in an article with the title "Young People's Investment with a Consumption Sense". It can be said that this surge is taking place because steady returns can be expected from U.S. equities investments, while the popularity level of Japanese stocks is embarrassingly low. A Nikkei CNBC viewer survey conducted in late January (January 27-31, 2022) found that 95.7% of respondents answered negatively to the question – "Do you support the Kishida administration?" – and this result became a hot topic of discussion. However, sales of equity investment trusts in recent years offer even more dramatic evidence of the low level of confidence in Japan, as the amount of domestic investment in overseas stocks has been rapidly rising while that in domestic stocks sinks (see graph). Currently, such investments in foreign equities still account for a very small share of the over-JPY2,000 trillion of Japanese household financial assets, but in light of the fact that the Japanese household sector's risk aversion tendency is widely considered excessively strong, one can view the surge in investments in U.S. equities as either an incipient correction of that excessive risk aversion tendency or perhaps an incipient redefinition of the "safe assets" concept. If you go to a Japanese bookstore nowadays, you will find numerous books on investing in U.S. equities placed in high stacks in store areas reserved for best sellers, and I have never seen evidence of such a high level of interest in books on foreign investment in the past. It should be kept in mind that almost all Japanese household investments in U.S. equities will entail JPY selling.



(Source) The Investment Trusts Association, Japan

Possibility of a Sudden Surge in JPY Selling

An overview of the structure of household financial assets in different countries also suggests there is considerable leeway for changes in Japan's household financial asset structure. The graph shows that slightly less than 40% of U.S. household financial assets are invested in stocks and that the figure for the euro area (where indirect finance is relatively dominant, as in Japan) is slightly below 20%. Households in Japan (which is about half the size of the euro area) are clearly quite conservative in their investment proclivities – it is unusual in the world for the share of cash and deposits to exceed 50% of household financial assets². However, JPY has depreciated against USD by nearly 10% during the three and a half months since the beginning of this year, and it has depreciated against USD by nearly 20% since the beginning of last year. Meanwhile, Japanese household assets denominated in USD, even those in foreign currency bank deposits, have been largely unscathed by those forex rate movements, and they are also likely to have generated higher levels of interest income than JPY-denominated assets. Because interest income from Japanese foreign currency deposits is considered miscellaneous income, some minor adjustments are necessary, such as taking income tax into consideration, but most Japanese view foreign currency deposits as falling within the scope of what they consider safe assets. On the other hand, it can be said that bank deposits have been a rather terrible investment option from the perspective of asset value defense since last year.



(Source) BOJ, FRB & ECB (Note) as of end of MAR 2021

Most Japanese people will probably not evaluate their JPY-denominated assets by comparing them with foreign-currency assets, but amid increasing discussions of the "Cheap Japan" concept (although much of such discussions are focused mainly on anecdotal evidence), one may expect there will inevitably be a gradual increase in awareness of JPY depreciation's effects with respect to people's financial assets – particularly when those assets are drawn on for consumption activities. Amid the general uptrend in prices, people are likely to notice that the real value

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² Since U.S. fund circulation statistics do not distinguish between domestic and foreign securities, we refrain here from comparing levels of holdings of foreign and domestic securities.

of their non-diversified JPY-denominated assets is diminishing, and when the degree of diminishment reaches a certain level, people may begin recognizing that their ordinary and fixed-term JPY deposits have turned out not to be as safe as they had anticipated. As Japan's economy is fundamentally integrated with the international economy, it is inevitable that the effects of JPY depreciation will eventually become more evident to ordinary Japanese.

Of course, there is no certainty that a major acceleration of the shifting of Japanese household sector assets into non-JPY-denominated investments will ever happen on a scale worthy of being called "capital flight", but I do think the time has come to take warnings of the possibility of such a shift very seriously. This article has repeatedly discussed the fact that the objective conditions that would form a basis for such a shift are beginning to fall into place, and it should be kept in mind that, in Japan, once everyone starts running in a given direction, the progress of associated trends tends to gain momentum very quickly. Even if only 10% of ordinary and fixed-term JPY deposits were to be shifted into non-JPY-denominated investments, it would entail roughly JPY100 trillion of JPY selling. That is equivalent to 5-to-6 years of Japan's current account surpluses (based on the approximately JPY18 trillion average current account surplus level during the past 5 years). As undertaking investments in foreign assets is not so difficult in today's world, it should be understood that the notional figure of JPY100 trillion of JPY selling is fully possible. Japanese trends tend to take shape only when the underlying moods have been cultivated over a certain period of time, but if and when the perception that holding JPY is a risky and losing proposition becomes dominant in the future, there is due cause for concern that household sector JPY selling will cause additional JPY depreciation. Such a trend has recently been seen in Russia, and similar trends have been seen previously in Greece and elsewhere. The most important basis for the risk of sharp JPY depreciation going forward may be related to this kind of trend.

EUR Outlook – Anticipating Prospective Interest Rate Hikes

EUR Area Monetary Policies Now and Going Forward – Key Decisions Likely in June

EUR/USD at Lowest Level in Five years but ECB Policy Stance Remains Unchanged

The April ECB Governing Council (GC) meeting reaffirmed that it would proceed with its policy normalization process in line with the plan announced at the March GC meeting. Regarding the prospective termination of the asset purchase programme (APP) during the July-September period, the meeting's statement says – “the incoming data since our last meeting reinforce our expectation that net asset purchases under our asset purchase programme (APP) should be concluded in the third quarter” – and because ECB President Lagarde reiterated that during the post-meeting press conference, saying – “there is a much stronger affirmation of our assessment of the data” – it seems reasonable to conclude that clear progress is being made toward the APP termination, although it seems that President Lagarde purposely avoided mention of a specific termination timing. 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, there are two possibilities – (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.

This modest policy revision is quite dovish compared to financial markets' expectations of interest rate hikes (two this year and eight by the end of 2023), and EUR has depreciated against USD to its lowest level in five years. Overall, the ECB's policy projections haven't changed, however, so it would be more accurate to say that the market's over-expectations have been somewhat adjusted in the correct direction. At the press conference, some reporters pointed out the disparities between ECB policies and those of the Fed and asked whether the ECB might consider moving closer to the Fed's stance, but President Lagarde dismissed that possibility, saying – “Comparing our respective monetary policies is comparing apples and oranges. We are not applying policies to the same economic situations at all.”

Clarification of APP End Date at June Governing Council Meeting

The main focus of the latest Governing Council meeting was on confirming the APP termination schedule, so questions at the press conference naturally also focused on this point. Representative of such questions was the first question to be posed at the press conference, which asked – “Did some of your colleagues call for a more definite end date for the APP [...]?” President Lagarde declined to be more specific, noting that only five weeks had passed since the previous meeting and that the April was an “interim” meeting with no new Eurosystem staff projections to work with. On the other hand, she also pointed out that the next (June) Governing Council meeting will have new staff projections and that the Governing Council would “determine exactly the timing of such conclusion of the net asset purchases under the APP” at that meeting. So it appears that, depending on the inflation statistics in the June staff projections, the June Governing Council meeting will somewhat clarify the APP termination date as well as the associated timing of subsequent interest rate hikes.

During the press conference, President Lagarde made frequent use of the word “journey” – in such phrases as “We are on a journey”, “we started the monetary policy normalisation journey back in December”, “the journey has begun” – and it seems clear that her intention was to emphasize that the ECB intends to progress with its policy normalization process in a gradual manner. In fact, the normalization process that started last December was reconfirmed in February, the prospective APP termination schedule was announced in March and confirmed in April, and now the plan calls for further clarifying the APP termination schedule in June. So the ECB is in fact moving gradually but making steady progress toward normalization. This gradual process presents a stark contrast with the Fed's approach of suddenly stepping on the normalization process accelerator, but given that the euro area includes 19 countries, it may be that it would be impossible for the ECB to proceed with speed comparable to that of the Fed.

Timing of Prospective Interest Rate Hikes Also to Become Clear in June

Since clarification of the APP termination schedule has been postponed, there is no new information regarding the timings of prospective interest rate hikes. It has been said that the first rate hike will be “some time after” after the APP is terminated, but the precise meaning of this is unclear. President Lagarde has merely stated that “some time after” could be “anywhere between a week to several months” and has not provided additional hints about the likelihood of more-specific timings within that range. She herself stated at the press conference that – ““Some time after” is intended to serve our determination to have both optionality, gradualism and flexibility” – and this makes it clear that the phrase is designed to be unclear because the ECB does not wish to be clear. However, President Lagarde also noted that if the June staff outlook enables the June Governing Council meeting to finalize the APP termination schedule, then the path to rate hikes would be self-evident. Thus, the June Governing Council meeting will be an important meeting, and EUR and euro area bond markets can be expected to fluctuate significantly in June.

Wages Situation OK?

This article has been focusing on the risk that euro area wages (which have remained restrained so far) will increase in a non-linear manner, and a reporter at the press conference also raised this possibility by posing the question – “How far is the Governing Council worried about a wage price spiral with inflation getting out of control?” The question essentially expressed concern about the kind of “second-round effects” that the ECB has traditionally watched very closely and, in this regard, President Lagarde pointed out the wages situation is a lagging indicator and that the longer inflation rates remain high, the more likely it will be that wage negotiations and other factors will cause wage increases in the future. She also noted differences between countries, saying “In some countries it seems that unions or employees and employers are managing to reach agreement which take into account the risk of redundancy and threat to the economy. In other countries there are much higher demands for wage increases and wage renegotiations.” – and said the ECB would continue monitoring that – “extremely carefully and be attentive to potential second-round effects as a result of that”.

Another reporter posed a slightly ironic question – “how confident are you about the ECB's forecasting models and how accurately they can capture the current situation created by the war?” President Lagarde responded by noting that the ECB is improving its model analyses as much as possible but admitting that the models are not perfect and sometimes fail, so “we have [...] humility, and we recognise that we have to not only look at forecasting models, but also look outside the window and try to figure out what is happening and what is the likely impact.” It was not made clear how such humility and looking outside the window might affect policy management (President Lagarde frequently excels at making statements that do not convey clear meanings), but many questions posed during the press conference suggested dissatisfied suspicions that the ECB's forecasts may be too optimistic, and it seems likely that President Lagarde could clearly perceive those suspicions.

Significance of Emphasis on “Flexibility”

The last line of June Governing Council meeting's statement was slightly modified version of the last line of the previous Governing Council meeting's statement. The previous statement concluded by saying – “We stand ready to adjust all of our instruments to ensure that inflation stabilises at our two per cent target over the medium term.” – emphasizing that the ECB is ready to take all steps needed to stabilize prices over the medium term. The June meeting's statement – “We stand ready to adjust all of our instruments within our mandate, incorporating flexibility if warranted, to ensure that inflation stabilises at our two per cent target over the medium term” – includes the new clause, “incorporating flexibility if warranted”.

President Lagarde pointed out at the press conference that the ECB's emphasis on flexibility is designed to make sure the avoidance of “unwarranted fragmentation”, which she recognizes is a frequent problem within the euro area financial system. The fragmentation problem refers to situations in which the effects of monetary policy are not evenly distributed throughout the euro area, reflecting the fact that the euro area includes countries with vulnerable real economies coexisting with countries with strong real economies. For example, at the time of the European debt crisis, it was only the credit situations of Southern European countries that became severely problematic, and it was difficult for the ECB to devise policies that would be suitable for those countries as well as for countries with relatively strong credit situations. The current situation is conducive to the emergence of gaps among euro area countries regarding the pace of their recovery from pandemic-related challenges, and the ECB has stated that such gaps will be addressed, if necessary, by flexibly undertaking reinvestments under the Pandemic Emergency Purchase Program (PEPP), which has already stopped making new asset purchases. This posture of preparedness for greater policy flexibility when needed is an issue separate from the moves being made toward monetary policy normalization, and while it seems to be a modest posture, there is a possibility that it may become an important issue from the perspective of ECB watchers.

Financial Markets Anticipating Early Rate Hikes

Following the above-described events at the April Governing Council meeting, the euro area money market showed signs of heightened expectations of relatively early interest rate hikes, with anticipation of hikes beginning in July and continuing in September becoming predominant. Moreover, the first rate hike is expected to be by 25 bps, and interest rates are expected to rise 50 bps over three months. Over the roughly seven years since the June 2014 introduction of negative interest rates, the ECB's deposit facility interest rate has been reduced to -0.50%, but if the money market's expectations prove correct, then negative interest rates will be eliminated within 3 months. The financial markets are expecting additional interest rate hikes after the first three months, anticipating that the deposit facility interest rate will be raised to 1.50% by the end of 2023. One wonders whether the ECB will in fact be capable of implementing such a sharp policy adjustment akin to the adjustment the Fed has already initiated.

July Rate Hike Expectations Realistic?

The expectations the financial markets are factoring in are not baseless. In an April 21 interview, ECB Vice-President Luis de Guindos stated that the June Governing Council meeting should be able to phase out asset purchases in July to pave the way for an interest-rate increase as early as that month. According to the ECB's current forward guidance, a July rate hike is theoretically not impossible. The ECB has announced that its default route calls for ending the APP during the July-September period, but it has not specified whether the APP termination might be in July, August, or September. On the other hand, the ECB has stated that interest rate hikes may begin “some time after” after the APP is terminated. According to President Lagarde the meaning of “some time after” could be “anywhere between a week

to several months". In other words, a policy decision to terminate the APP in July and raise interest rates immediately (in July?) would not be inconsistent with the ECB's forward guidance. However, this point appears to be a tenuous basis for anticipating a rate hike timing that would seem too inconsistent with the manner in which President Lagarde has been emphasizing that APP termination and rate hike initiation are quite separate policy decisions. As noted above, the ECB appears firmly committed to gradualism in its normalization process. Although a July rate hike would not technically conflict with the prescribed "APP termination → rate hikes" sequence, one gets the strong impression that President Lagarde would consider it excessively precipitous to implement both the APP termination and rate hikes in July. While Vice-President Guindos did say – "I see no reason why we should not discontinue our APP programme in July." – he also said regarding interest rate hikes that – "July is possible and September, or later, is also possible. We will look at the data and only then decide." This latter statement clearly means that there has not yet been a decision to hike interest rates in July. In fact, the statement by Vice-President Guindos is quite similar to President Lagarde's "between a week and a few months" phrase. I think it wise to assume that nothing will be decided until the Governing Council can examine the revised staff projection in June.

Fundamentals Do Not Justify July Rate Hike

Currently, I do not think a July interest rate hike is likely. Leaving aside the fact that such a move would contrast too starkly with the ECB's previously disseminated information, it would seem that such a clear shift to hawkishness would be difficult to justify in light of the euro area economy's current situation and prospects. It is true that the Fed has actually managed to implement such a policy shift, but as pointed out above, comparing the real economies of the euro area and the United States is akin to "comparing apples and oranges." The ECB seems to have no intention of tightening its policies at a pace similar to the Fed's.

Moreover, as discussed in detail on page 5 of this article, the latest (April 2022) edition of the IMF World Economic Outlook indicates that the economic growth rates of Germany and other major euro area countries have significantly declined. Inflation in the United States is already being driven by factors other than energy and food prices, and that is a quite different situation from that of Europe, where most of the inflationary pressure is stemming from energy prices. While "non-transient inflation" is clearly evident in the United States, Europe is not yet concerned about "non-transient inflation". The EUR's current weakness may reflect the fact that expectations of an ECB shift to hawkishness are not as strong in the forex market as they are in the money market.

Main Forecast Scenario – Interest Rates Hikes from September

In light of the ECB's statements and their lack of harmony with market expectations so far, the most likely scenario seems to be for the June Governing Council meeting to announce that the APP will be terminated in July and that the first interest rate hike will be implemented in September if it is consistent with the revised staff projections available at that time. As the ECB's asset purchase operations are ordinarily paused during Europe's summer vacation period, ECB purchases have traditionally been minimal during August. Given that, ending the APP in July rather than in September would not significantly reduce the total amount of asset purchases, and it appears that the ECB has a strong desire to terminate the program as early as is practicable. It seems that the most rapid policy shift that can reasonably be anticipated is a scenario in which the ECB raises interest rates by 25bps in September, pauses to evaluate economic conditions in October, then raises interest rates by another 25bps in December if it is consistent with the revised staff projections available at that time, thereby returning to a zero interest rate level by the end of the year. So long as the ECB continues to advocate gradualism, it does not seem likely that the ECB would hurry to implement a rate hike in July. My basic understanding is that EUR buying will increase from the July-September period in anticipation of the ECB's prospective rate hikes.

Daisuke Karakama
Chief Market Economist
Derivatives & Forex Department
Mizuho Bank, Ltd.
daisuke.karakama@mizuho-bk.co.jp

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