Forex Medium-Term Outlook

June 1, 2022

Overview of Outlook

In May, the USD/JPY market finally saw a lull in JPY selloff. The currency pair, which had rocketed to around 131 at the end of April, cooled off somewhat and temporarily fell to the 126.5- to 127.0-level, giving rise to speculations of a peaking. Of course, given its sudden dramatic increase by 15 yen in the space of two months (which is significantly higher than the 10-yen or so average annual range of rate movements for USD/JPY over the past five years), an appropriate correction is a healthy development. However, the sudden weakening of JPY starting March was the result of market participants zooming in on (1) the BOJ's increasingly solitary monetary accommodation stance in contrast to central banks around the world, and (2) the expansion of Japan's trade deficit amid higher resource prices. Therefore, while these factors remain unchanged, it may be dangerous to declare the peaking of USD/JPY. While additional factors may be necessary for USD/JPY to become firmly established at the 130 level, given that there have not emerged any reasons to buy JPY, it may be wise to prepare for "sticky" rates at the level of 125-130. If Japan were to make some fundamental changes to its approach, such as lifting all restrictions on inbound tourism, leading to a recovery in travel surplus; resuming nuclear power generation, resulting in the shrinking of trade deficits; or the BOJ revising its accommodative monetary stance, there may be a halt in the JPY-selling trend in the markets, which has acquired the characteristics of "Japan selling." However, the Kishida administration does not seem to have the leadership required to make any of these decisions. Once there is an end in sight to the Fed's policy normalization process, the stabilization of U.S. interest rates may help halt the weak-JPY trend, but whether or not USD/JPY can return to pre-March rates of 110-115 is another story. The abnormally conservative mood pervading the Japanese political and economic scenes seems unlikely to change in any fundamental manner. Perhaps it is only appropriate for JPY, as the currency of a country that has given up on growth, to suffer from weakness rather than strength.

Meanwhile EUR rebounded in May. The ECB had already been in the process of establishing a hawkish policy stance, but toward the end of May, in an unusual development, ECB President Christine Lagarde gave notification of a rate hike in July and a return to positive interest rates by the end of September through the uncharacteristic medium of a blogpost. The true intent behind this is still unclear, although some speculate that perhaps there is increasing caution over regional employment and wage trends, which have so far been more stable than those in the U.S. At any rate, it is natural that market participants should buy EUR based on its fundamentals if, in addition to its strength in terms of having the world's largest current account and trade surpluses, EUR's interest rates also look set to increase. On the other hand, Europe is also at the center of a tense geopolitical conflict, which is a cause for concern regarding its real economy, and this is a weakness and a reason for market participants to stay away from the currency. Starting with Germany, euro member states with higher levels of reliance on Russian natural gas will see an increased outflow of income, which will directly lead to the downgrading of their growth forecasts – something that cannot be taken lightly. In this context, it cannot be denied that the ECB's hawkish stance could well collapse at an early stage. Having said that, the mood in the forex markets strongly favors currencies with rising interest rates, and I think there is a strong chance of EUR being propped up for the rest of this year by the change in the ECB's policy stance.

Summary Table of Forecasts

	2022 Jan -May (actual)	Jun	Jul-Sep	Oct-Dec	2023 Jan-Mar	Apr-Jun
USD/JPY	113.47 ～ 131.35 (128.91)	127 ～ 132 (130)	128 ～ 134 (132)	130 ～ 136 (133)	131 ～ 137 (134)	130 ～ 137 (132)
EUR/USD	1.0349 ～ 1.1495 (1.0728)	1.05 ～ 1.10 (1.09)	1.07 ～ 1.13 (1.10)	1.09 ～ 1.15 (1.12)	1.11 ～ 1.17 (1.13)	1.12 ～ 1.18 (1.15)
EUR/JPY	124.41 ～ 140.00 (138.31)	136 ～ 144 (142)	139 ～ 148 (145)	142 ～ 151 (149)	143 ～ 152 (151)	145 ～ 154 (152)

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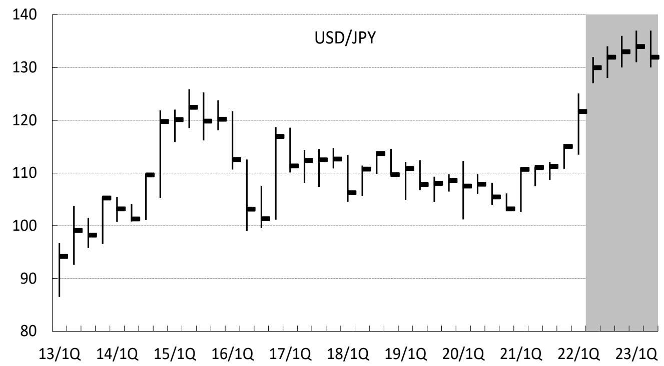
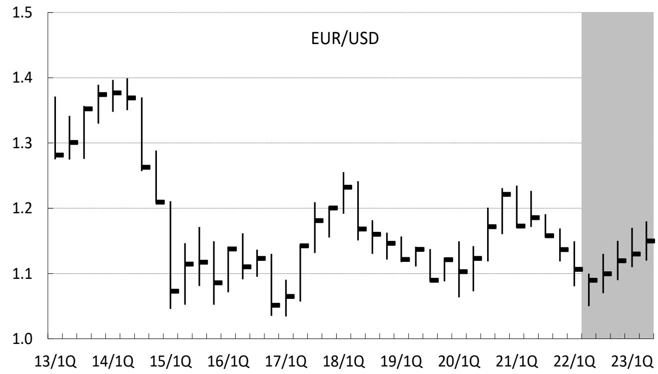
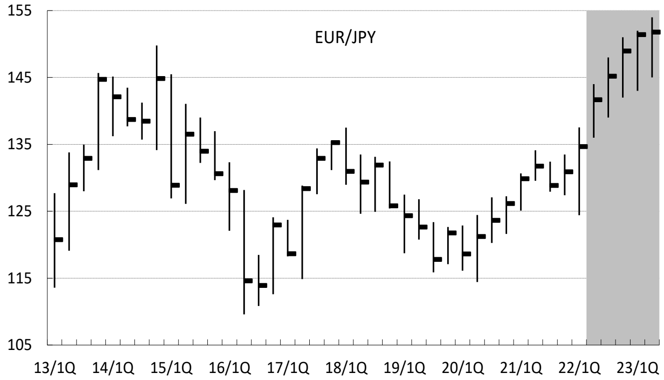
Exchange Rate Trends & Forecasts



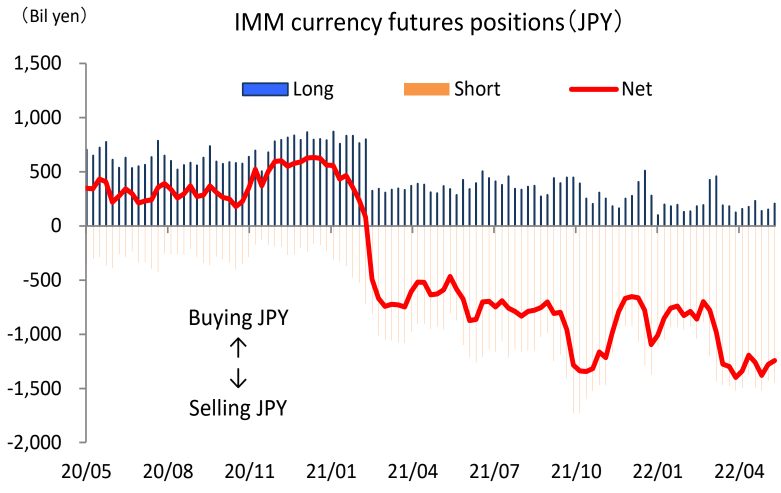




USD/JPY Outlook – Has Weak-JPY Trend Peaked?

JPY Rates Now and Going Forward – The May Correction and Inefficacy of the Theoretical Value

Has JPY Weakness Peaked? – Future Outlook Depends on Political Will from Summer Onward



(Source) Bloomberg

Toward the end of May, USD/JPY sank below 127 at one point, strongly suggesting a peaking of the weak-JPY trend, which hit 131.25 on April 28. I continue to receive numerous inquiries in this regard asking if the weak-JPY trend has peaked. To get right to the point, it may be too early to arrive at that conclusion. An orthodox assumption regarding the lull in the weak-JPY trend could be that, amid the decline in U.S. interest rates (increase in U.S. bond prices) accompanying the sharp fall in U.S. share prices, investors have been exiting the JPY short positions they had been accumulating. Looking at transactions in IMM currency futures, as of May 24, the JPY position was net short by -USD 1.3807 trillion. This is the largest net short seen since the start of the pandemic, and certainly a level that warrants correction. Having said that, the JPY net short position was similarly large during the weak-JPY phase in September-October last year (see figure; in fact, the JPY gross short position was even larger last October). Subsequently, that short position was rolled back (JPY was bought back), until it began to build up again starting mid-March this year. Taking into account Fed Chair Jerome Powell's stance (details later), <u>the excessively accumulated JPY short position may continue being rolled back for some time to come, but it may be unwise to assume the end of the weak-JPY phase based on this.</u>

To What Extent Could JPY Recover?

To begin with, following its dramatic surge by 15 yen in two months, it would be unnatural for there not to be a correction in USD/JPY rates. Last year, the currency pair increased its level by around 5 (from 110 to 115) within a month between September and October. Following this, rates remained sticky at around 115 for the five months until March. Even assuming that USD/JPY could increase further, the excessively lopsided JPY speculative position first needs some time to balance out. The Fed, as of the present, shows no sign of slowing its pace of rate hikes (details later), so we may intermittently see phases of “concerns over the Fed’s hawkish stance→U.S. share price volatility→decline in U.S. interest rates→USD selling” going forward; and it seems likely that the rollback in the JPY short position may also be forced to move in tandem with this.

However, as I repeatedly argue in this report, the recent increase in USD/JPY is driven not by USD buying but by JPY selling, so it remains unclear to what extent JPY can recover even during phases of USD selling in the markets.

Japanese Political Will is the Key Driver

During the May correction phase, USD/JPY managed to fall below the lower bound (128 yen) I had predicted in this report last month, but it seems too early to predict a further fall to below 125. The weakening of JPY since March is based on a few new factors, namely, (1) the BOJ’s increasingly solitary monetary accommodation stance in contrast to central banks around the world, and (2) the expansion of Japan’s trade deficit amid higher resource prices. These factors remain unchanged as of now, and factor (2), especially, could become more significant going forward. While additional factors may be necessary for USD/JPY to become firmly established at the 130-level, given that there have not emerged any reasons to buy JPY, it may be wise to assume a phase of “sticky” rates at the level of 125-130. If the Japanese government were to lift all restrictions on inbound tourism to take advantage of higher demand during the summer holiday season, JPY buying could receive a boost in view of the recovery in travel surplus, but going by the Kishida administration’s stance so far, this does not seem to be a likely scenario. As for the real economy, contrast between a stagnant Japan and progress in the rest of the world may be the predetermined path for the rest of the year, and my basic understanding is that there is not much likelihood of USD/JPY returning to pre-March rates of 110-115.

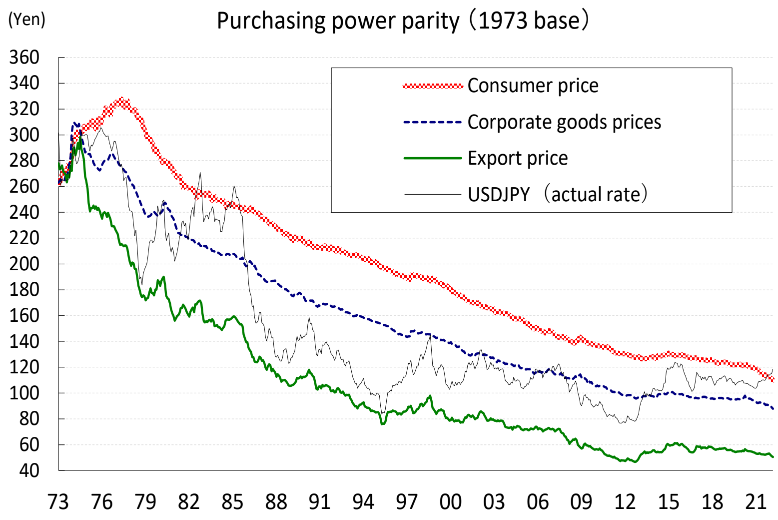
If, in addition to the lifting of all restrictions on inbound tourism, there emerged the additional prospect of the trade deficit shrinking as a result of resuming nuclear power generation, and the BOJ were to revise its accommodative monetary stance with a change in regime, the market’s reasons for “Japan selling” will fade away to a large extent. However, even assuming such developments can take place, they would only do so after the election of the House of Councillors in July. It remains to be seen whether or not the Kishida administration, which so far seems unable to do anything but “monitor” and “consider,” can turn over a new leaf after the Upper House elections. The key driver for USD/JPY right now may be Japanese political will.

Theoretical Value of USD/JPY

Following the brief lull in JPY depreciation in May, many began to point out the difficulty of the continued rise of USD/JPY. On May 21, The Nihon Keizai Shimbun ran an article titled “JPY actual market rate lower than theoretical value of 106.7 against USD; 2021Q4 JPY NIKKEI EER.” The article said that, as of October-December 2021, JPY’s actual market rate (114 to the dollar or so) was significantly weaker than its 106.7-yen NIKKEI equilibrium exchange rate (EER), as calculated by Nikkei and the Japan Center for Economic Research (JCER) once every quarter. The Nikkei EER for October-December had been revised in the direction of a stronger JPY compared with the previous quarter (107.8 for the July-September quarter), but ironically, it was during October-December that JPY depreciated markedly against USD. The details of the regression equation used to calculate the theoretical value have not been made public, but roughly speaking, domestic macroeconomic indicators including government debt, net external assets, the spread between domestic and foreign interest rates, terms of trade, and comparison between prices of traded and non-traded commodities are used as variables to compute the effective rate for JPY, followed by the computation of its rate against USD based on the trade-weighted exchange rate used when calculating the weighted average of JPY against a basket of currencies. According to the statement released by JCER, “The EER of JPY against USD was pushed up from the previous period by the delay in the reduction of the US government debt and the decline in US real interest rates, as well as the relative increase in Japan’s net foreign assets.” However, U.S. real interest rates rose sharply in 2022 1Q, while Japan’s trade surplus dramatically declined (posting the second largest ever trade deficit for January 2022). It would appear, then, that JPY’s theoretical value may have declined again.

PPP No Longer Useful

It must be noted, however, that this is not the first time that actual market rates have deviated from the theoretical values. As there are no fair values in the forex market, the most standard theoretical measure used is purchasing power parity (PPP). PPP levels can also differ dramatically depending on which indicator one uses – the consumer price index (CPI), the purchaser price index (PPI), or export price index, etc. However, calculating all three aforementioned PPPs and attempting to find the real USD/JPY rate somewhere within a band formed by these figures is the traditional approach used in USD/JPY rate analyses. The figure, however, shows the marked upward deviation of USD/JPY from its PPP for the past 10 years or so. As of March 2022, the CPI-based PPP was JPY110, the PPI-based PPP was JPY88, while the export-price-based PPP was JPY50. The current market rate (JPY125-130) is quite far removed from all of these values.



(Source) Datastream

Until around 10 years ago, the PPP was quite a useful measure. As the figure on the previous page shows, from the 1985 Plaza Accord right until 2013 or so, the PPI-based PPP tended to be the upper bound of USD/JPY movements. This began to change around the year 2013, eventually forming a trend of USD/JPY moving within a range of the PPI-based PPP as its lower bound and CPI-based PPP as its upper bound. I believe this shifting up of real USD/JPY rates starting 2012-13 may have some connection with Japan transitioning from a young creditor to a mature creditor with the loss of its trade surplus. Excessive JPY weakness relative to the PPP can only be called that if Japan posts a sufficient volume of exports, resulting in trade surpluses, which would eventually lead to JPY buying. Now that Japan is no longer a strong exporting nation, the situation is no longer conducive to discussing the relative strength or weakness of JPY based on PPP, which is a measure derived from cumulative past price differentials. These days, one must interpret deviations from the theoretical value more leniently.

Correction of JPY Weakness – Ball in BOJ's Court

As the figure on the previous page shows, the last time real USD/JPY was higher than the CPI-based PPP was during the first half of the 1980s, before the signing of the Plaza Accord. In this sense, one feels that JPY has weakened against USD enough to warrant policy coordination. The big difference between then and now, however, is that in those days, the Japanese economy was structured such that, the weaker JPY got, the better the competitiveness of Japanese exports, resulting in Japan building up its trade surplus. The only reason for the Plaza Accord was because JPY weakness was hurting U.S. economic interests. Returning to the present, with inflation control being the critical mission at hand for U.S. authorities, it is fundamentally unlikely that a strong USD would pose a problem for the U.S. economic or financial situations. Moreover, should it really be judged necessary to correct USD/JPY in the direction of JPY appreciation against USD, the first expected move would obviously be to revise Japanese monetary policy. Currency interventions or forex rate guidance by the monetary authorities in concert with the political administration tend to attract public attention, but it would be irrational to embark on government-initiated currency policy response without first revising monetary policy. As of the present time, one does not get the impression either the Japanese or the U.S. governments are significantly concerned about JPY weakness, but it is important to keep in mind the objective fact that if anything, the ball is in the BOJ's court.

JPY Supply and Demand Now and Going Forward – Discussions on Lifting of Inbound Tourism Restrictions

Lifting Inbound Tourism Restrictions - A Good Chance to Exit the Pandemic

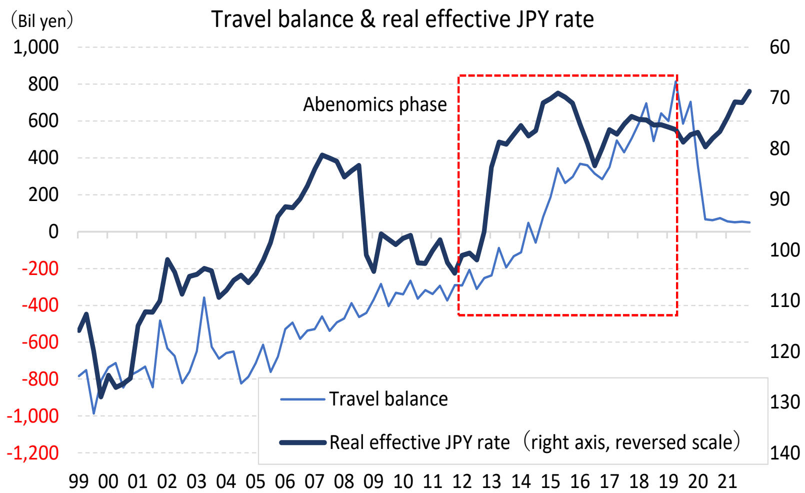
During his visit to the UK in May, Prime Minister Fumio Kishida touched upon the possibility of relaxing Japan's border control measures (which are harshly criticized by the business world as a policy of "national isolation") as part of a phased revision of COVID measures. As of the time of writing this report, the government has indicated its policy of raising the cap on daily arrivals to 20,000 and permitting foreigners to enter Japan for the purpose of tourism (inbound tourists) starting June 10, so long as they are in small tour groups. Previously, Kishida had promised to open up the country to match G7 levels, but the fact is that Japan is the only G7 country to be imposing any entry restrictions. Whether the cap on daily arrivals is 10,000 or 20,000, the administration should be aware that the very fact that there is a cap is behind the times. There is absolutely no logic to why foreign tourists cannot enter Japan even though Japanese people can travel abroad and return to Japan – the latter makes border controls ineffective in any case.

Lifting all restrictions on inbound tourism would be a good opportunity to utilize foreign pressure to reconsider Japan's "Galapagos-ized" response to the pandemic and give economic recovery a much-needed boost. The image of Japan, which persists in wearing masks outdoors under the blazing sun, or in sports facilities and gyms, is quite strange from the perspective of the rest of the world. It would be unreasonable to compel foreign visitors to follow the same protocol. Speaking to the Budget Committee of the lower house of the Diet on May 27, Kishida said, "Foreign tourists would have to comply with Japan's masking rules." However, it is only Japanese people who would willingly submit to pressure on rules that are not legally enforceable. Japanese society's awareness around the pandemic has become too rigid for any self-reflection to be possible, so it may be wise to revise pandemic-related measures as a set with lifting restrictions on inbound tourism. To put it another way, those who cannot change themselves must allow others to change them. Japan's exit from the pandemic may be further delayed if this opportunity is not taken.

Two Benefits – Containing JPY Depreciation and Shoring up the Economy

In addition to encouraging the normalization of pandemic-related measures, lifting the restrictions on tourism can also contribute to the "new capitalism" (i.e., wealth distribution) the Kishida administration professes to uphold. If restrictions on tourism are lifted, foreigners are bound to visit various parts of Japan and consume/invest in local economies. Rather than the "Go To" and similar campaigns that are dependent on fiscal expansion, allowing unrestricted tourism would be much more effective at reviving the restaurant and bar, accommodation, and travel industries in a healthy manner, which in itself would serve to revive the regional economies. This could not be a bad thing from the perspective of the Kishida administration, which has expressed interest in wealth distribution policies.

However, the biggest benefits that can be expected from a complete lifting of restrictions on inbound tourism are that it would arrest the JPY depreciation trend and shore up the economy. There is no scope for doubt in this regard. As I argued in last month's issue of this report, recovering the travel surplus by lifting all restrictions on inbound tourism is the best way to offset the increase in import prices due to JPY weakness (and the accompanying decline in real incomes). With the loss of domestic production bases, JPY weakness no longer results in an increase in the export of goods from Japan. It is, therefore, natural for the country to attempt to earn foreign currency through the export of services in the form of a travel surplus. Ultimately, the main reason for the rise in popularity of the phrase "undesirable JPY weakness" is because the opportunities for experiencing the benefits of JPY weakness have become scarce. For any country, the advantage of a weak domestic currency is that it improves the country's relative competitiveness and increases earning opportunities. The disadvantage is that it increases the prices of imports. Right now, Japan has voluntarily eliminated the advantage of JPY weakness through its policy of national isolation, so all that remains is its disadvantage, making it quite understandable why the current phase of JPY weakness is widely considered undesirable.



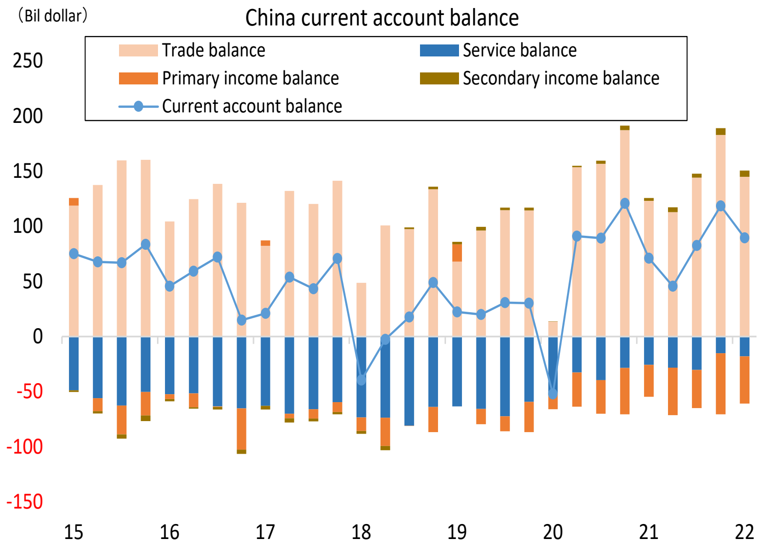
(Source) Bank of Japan

Japan's travel balance posted its first calendar-year surplus in 2015, at around +JPY 1.1 trillion. Four years later, in 2019, it had expanded to three times that amount, at around +JPY 2.7 trillion. In 2019, around 32 million foreign tourists visited Japan. This amounts to around 88K tourists a day. That gives one some idea how big a loss it is to set a cap of 20K a day on tourist arrivals starting June 10. As the figure shows, going by the pace of increase seen during those years, Japan could have renewed its highest ever travel surplus by now had the pandemic not happened (more than anything, one regrets the lost opportunity from the Tokyo Olympic Games not being held under normal circumstances). Taking a more detailed look at the figures, Japan's current account surplus for 2021 was around +JPY 15.5 trillion, which is JPY 4 to 5 trillion lower than the +JPY 19.9 trillion average for the five years preceding the pandemic (2014~2019). It seems likely the figure will be even smaller for 2022.

The reason for this decline is, needless to say, the expansion of the trade deficit, which signifies an actual increase in the JPY selling flow. Going by past performance, the travel surplus (around JPY 2.7 trillion for 2019) could have absorbed a significant portion of JPY selling resulting from the expansion of the trade deficit. Given that the current JPY weakness is explained against the backdrop of JPY supply and demand leaning toward net selling of JPY, lifting restrictions on inbound tourism can be expected to arrest the weak-JPY trend at least to some extent. Naturally, in addition to arresting JPY depreciation, it could also shore up the economy. According to figures released by the Japan Tourism Agency, foreign tourists to Japan had spent around JPY 4.8 trillion in the country in 2019, renewing the all-time-record high for the seventh year in a row. Given that JPY's real effective exchange rate is lower than it has ever been in the past half a century, prices in Japan are bound to seem that much more attractive to foreign tourists, resulting in potentially higher consumption going forward. One must take note of the fact that the potential purchasing power of inbound tourists in Japan has increased since the beginning of the pandemic.

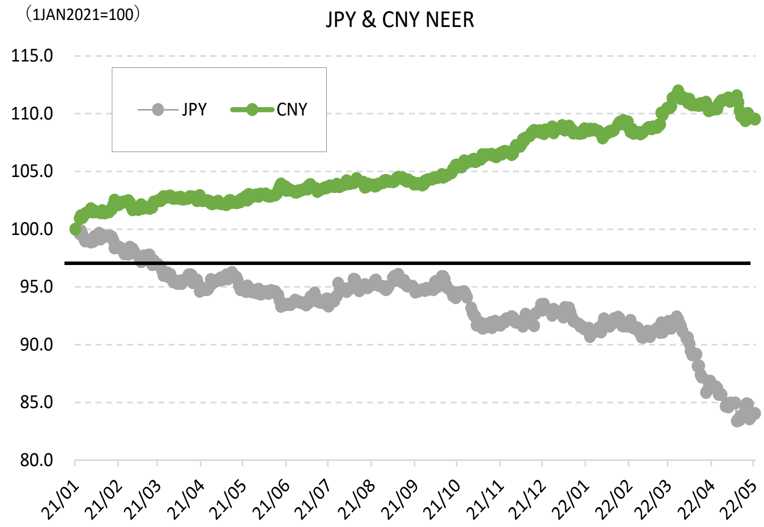
Contrast Between China and Japan

As with forex rates, trade balances also involve two parties. The majority of inbound tourism to Japan comes from China, with around 30% (9.59 million) of the 31.88 million foreign tourists to Japan in 2019 being Chinese. However, as is generally known, China is obstinately following a zero-COVID policy, and its pandemic measures have been even more economically self-destructive than Japan's (of course, China had recovered its pre-pandemic GDP growth rates in 2021, so it starts from a higher point than Japan does). <u>For Japan to enjoy the full benefits of a complete lifting of restrictions on inbound tourism, China will have to end its zero-COVID policy as well</u>.



(Source) Macrobond

Further, as the figure shows, China's current account surplus level has increased a notch compared with pre-pandemic levels. <u>This is because, in contrast to Japan, China's service deficit has shrunk, thanks mainly to the improvement in its travel balance</u>. Needless to say, this is the result of Chinese people being unable to travel abroad due to the pandemic, which annihilated their overseas consumption activities, often described from the Japanese perspective as "shopping sprees." In terms of nominal effective exchange rate in the forex markets, I would like to draw attention to the fact that CNY and JPY movements are in contrast to each other, <u>perhaps reflecting the rollback in forex spent in Japan (CNY selling, JPY buying) by Chinese tourists (see figure)</u>. If this is indeed the case, there is an even stronger possibility of arresting the JPY depreciation trend by lifting inbound tourism restrictions. Even going by just the above, the assumed benefits of lifting inbound tourism restrictions include (1) correcting pandemic measures, (2) strengthening wealth distribution, and (3) arresting JPY depreciation and spurring economic growth. On the other hand, the one argument against lifting restrictions is that it could bring new variants of COVID into the country. However, this is a rather emotional argument, the grounds of which are difficult to verify. If Japan protractedly continues with its entry restrictions, treating foreigners wishing to visit the country as "virus carriers," the status of the blockaded Japanese economy is unlikely to improve. One can only hope for useful political decisions based on scientific grounds to be promptly made for the sake of the country's future.



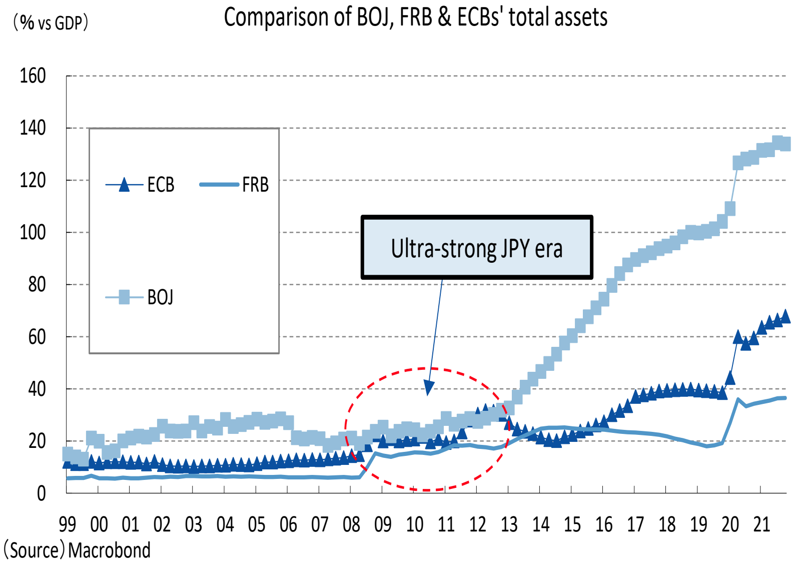
(Source) macrobond

BOJ Monetary Policies Now and Going Forward – On the Financial Health of the Central Bank and Confidence in the Currency

On the Tendency to Link JPY Weakness with the BOJ's Financial Health

Because I have been arguing over the past year that JPY weakness seems to have taken on the characteristics of "selling Japan," an increasing number of clients have been asking me if it is possible that the crashing of government bonds due to inflation and, consequently, doubts over the BOJ's financial health could be behind the recent JPY selling trend. My answer is that I do not believe this to be the case. <u>To begin with, it is not all that simple to directly connect the financial health of a central bank with confidence in the domestic currency</u>.

Following the collapse of Lehman Brothers, emergency responses by the central banks of countries around the world became normalized. This inevitably resulted in both the scale and composition of central bank balance sheets becoming quite tricky to operate. The BOJ's ETF purchases are somewhat unique among central bank operations, but the ECB's purchase of Southern European bonds during the European sovereign debt crisis (especially in 2011~12) were also seen as problematic at that time. However, these purchases did not result in EUR selling spurred by concerns over the ECB's financial soundness each time. Looking at Fed, ECB, and BOJ balance sheet sizes as ratios of their GDPs, they were all at similar levels during the 2007-12 period. In fact, the BOJ's balance sheet was the largest of the three, but JPY was appreciating across the board in the forex markets in those days (soaring to JPY 70-level against USD), as is well known. This would be hard to explain if currency strength depended on the central bank's financial soundness. It is also true, of course, that the BOJ's quantitative and qualitative easing under Governor Haruhiko Kuroda put it on a path that stood out from the rest, and JPY weakened dramatically around that time (2013-15). However, neither the BOJ's financial soundness nor confidence in JPY were a focus of market attention during that phase of JPY weakness. If I remember right, the discussion centered around the difference between the BOJ and the Fed's monetary policies, with the latter working to normalize policy even as the former continued with large-scale monetary accommodation. In fact, praise for the Kuroda regime's novel monetary policies and what it represented (i.e., Abenomics) was the more prominent reaction. Naturally, there were no mainstream pundits attempting to criticize JPY weakness during that time as having anything to do with the BOJ's financial health. Had there been a direct link between the central bank's financial health and confidence in the domestic currency, it would be strange for this not to have been pointed out at that time, when the BOJ's balance sheet was expanding at quite a dramatic pace.



(Source) Macrobond

Switzerland and Germany – Case Studies

There are other examples to show that there may not be a direct connection between central bank financial soundness and confidence in the currency. One is reminded of the Swiss National Bank (SNB), which added an enormous volume of foreign-currency-denominated assets (foreign currency reserves) to the asset side of its balance sheet through protracted unlimited currency selling interventions (selling CHF/buying foreign currency) with a view to curbing the appreciation of its domestic currency. Against the backdrop of the European sovereign debt crisis, which broke out in 2009, currencies such as JPY and CHF had been appreciating strongly as safe-haven currencies. CHF, additionally, was in a geographically convenient position to be a receptacle for funds fleeing from the rest of Europe. Worried how to respond to the situation, the SNB set an upper bound of CHF's exchange rate against EUR (at 1.20 CHF to 1 EUR) in September 2011, and decided on a policy of maintaining its currency at this rate through unlimited CHF selling and foreign currency buying interventions. It further went on to introduce negative interest rates in December 2014 in an attempt to expand the CHF vs. euro area interest rate gap. Despite all this, the SNB failed to curb the appreciation of CHF, and in January 2015, when it abruptly ended these policies, CHF went through the roof. The currency soared so dramatically that resultant systemic risks to European financial institutions were rumored.
Naturally, the enormous volume of foreign-currency-denominated (i.e., euro-denominated) assets that had been taken on would suffer massive exchange losses as a result of this rapid appreciation of CHF. Specifically, because of the loss of weight in terms of CHF of the foreign reserves added to the asset side of the balance sheet, the institution would fall into a state of insolvency in accounting terms. In other words, excessive market confidence in CHF led to insolvency, thereby dealing a blow to the financial health of the central bank. Another case that is widely known is that of the German federal bank (The Deutsche Bundesbank), which became insolvent due to the German mark's excessive appreciation, which triggered a decline in the value of Germany's foreign currency reserves.

The above are two examples of central banks becoming insolvent as a result of excessive confidence in their domestic currencies, but the causal relationship here is not one of financial strength of the central bank determining confidence in a currency, but rather of confidence in a currency determining the financial strength of the central bank. Those who doubt the financial soundness of the BOJ are mainly concerned that the large volume of the BOJ's government bond holdings combined with a decline in the value of these bonds could cause the BOJ to become insolvent, thereby resulting in JPY depreciation amid a loss of confidence in the currency. However, going by the above examples from Switzerland and Germany, there does not seem to be much of a causal relationship between the central bank buying a large volume of government bonds and loss of its financial health, nor does a loss of the central bank's financial health seem to directly result in a loss of confidence in its domestic currency.

More Worrisome Examples…

Of course, there are also examples of the excessive liabilities of a central bank being viewed critically. In a 2003 lecture entitled "The Role of Capital for Central Banks"[1] when he was a Member of the Policy Board, Tokyo University Professor Kazuo Ueda said, "The maintenance of a sound balance sheet is, in general, neither a necessary nor a sufficient condition for fulfilling a central bank's responsibility, but there have been cases where an unhealthy balance sheet became a major obstacle to price stability." Ueda went on to point out cases of central banks in Latin America, including Venezuela, Argentina, and Jamaica, that had, in the past, been insolvent and suffered from high rates of inflation concurrently. For instance, during the 1980s and 90s, the central bank of Venezuela tightened its monetary policy in order to halt the surge in inflation accelerated by expansionary fiscal policy. However, the bank's issuance of high-interest-rate debt for liquidity absorption purposes at that time resulted in profit-squeezing, which forced it to abandon tightening policy and leave inflation unattended.

The domestic currency's strength in the case of Switzerland and Germany and mistaken government policies in the case of Central and South America, therefore, were the main factors behind making their central banks insolvent. As it is (theoretically) easy to change a currency appreciation trend into a currency depreciation trend, it is easy to see why the insolvency of the Swiss or German central banks was considered temporary and not seen as a major cause for concern. Meanwhile, as can be seen from the case of Central and South American nations, when mistaken government policies remain unchanged, inflation is left unattended, and the central bank falls into insolvency in the process of responding to this, resulting in a situation where inflation rages on even as the central bank becomes insolvent. However, <u>the financial health of a central bank ultimately relates to its fiscal and monetary policies, and unlike in the case of corporations, insolvency in and of itself does not have any definitive implications for a central bank. Again, there is no rationale for a causal relationship between central bank insolvency and asset prices, including forex rates, either. While desirable for its own sake, of course, the financial soundness of a central bank does not have many other implications</u>.

A Possible Future Theme

While I do not believe the financial health of the BOJ is the driver of the current weak-JPY trend, given the intuition-driven world of forex markets, the possibility of "confidence in JPY" becoming a future theme cannot be ruled out. There is no "fair value" to speak of in the forex markets, and there are certainly times when popular themes give rise to trends. It would be difficult to conclude based on the Swiss and German examples that JPY is also going to be unaffected. If the financial soundness of central banks becomes a theme in the forex markets, JPY is probably the easiest currency to target, going by the figure on the previous page. However poorly Japan may be doing, it is still an important member of the G7, and JPY trading volumes are also considerably large, given that it comprises over 5% of the world's foreign reserves. This means targeting JPY can make or break markets.

In the above lecture, Professor Ueda notes, "An important question here is whether insolvency has interfered with any of these central banks' conduct of monetary policy." In other words – <u>have financial markets still trusted the monetary policies of such central banks?</u> If it can be acknowledged that the central bank, despite becoming insolvent, is still implementing policies that contribute to price stability, there is no reason to fear a shaking of confidence in its currency. For instance, the BOJ could become insolvent in the process of tightening monetary policy if the Kuroda regime's accommodative monetary policies promoted economic recovery and inflation surged past 2%. However, this would be a small loss in the face of a great achievement. On the other hand, it is equally possible that, while avoiding insolvency, a central bank continues with monetary policy operation that disregards loss of confidence in its currency amid soaring inflation. For instance, if, as in the case of Turkey, the central bank implements monetary policies based on the president's personal theories about curbing inflation with monetary accommodation, inflation is bound to surge and the currency bound to crash. Coming back to the present situation, the BOJ's stance of persisting with monetary accommodation despite concerns about the disadvantages of JPY weakness is not altogether unsimilar to that of the Turkish central bank. However, to repeat my previous point, <u>I do not believe that doubts over the financial health of the BOJ are causing a loss of confidence in JPY as of the present time. It seems more likely that the expansion of the trade deficit and the gap between domestic and foreign monetary policy are behind the current weak-JPY trend, and it seems only right to point out that there is no sign of the BOJ moving to take any measures even against these</u>.

BOJ Powerless to Curb Fiscally-Driven Inflation

As of the present, many of the concerns linking JPY weakness with a crash in Japanese government bond (JGB) prices following inflation or with the financial health of the BOJ are based on the fact that that government debt in Japan is on the rise. If concerns over enormous Japanese government debt were to cause JPY depreciation or high inflation, the BOJ would be reluctantly forced to tighten monetary policy to rein in an "undesirable inflation" in the absence of economic improvement. In that process, the BOJ could become insolvent as a result of JGBs crashing or as the result of a sharp increase in JPY yields and the amount of interest rate payments the BOJ has to make (private-sector banks). However, this would all be attributable to unbridled expansionary fiscal policies by the government, and is not a problem the BOJ, which pursues monetary policy, can solve. In such a scenario, the most far-reaching measure that could be taken would be government fiscal reforms, with all other measures simply playing complementary roles. The BOJ would probably continue to purchase JGBs to assist with a soft landing, but it could not do so too brazenly, as that would generate further distrust.

[1] October 25, 2003, lecture at the Japan Society of Monetary Economics.

Ultimately, the financial health of the central bank is merely a numerical indicator reflecting fiscal or monetary policies, and the indicator itself is not significant enough to be discussed as the potential epicenter of a crisis. The same can be said about the BOJ's capital adequacy ratio, which comes up for discussion now and again – that it does not have any major significance in and of itself.

Giving Up on Growth is the Real Problem

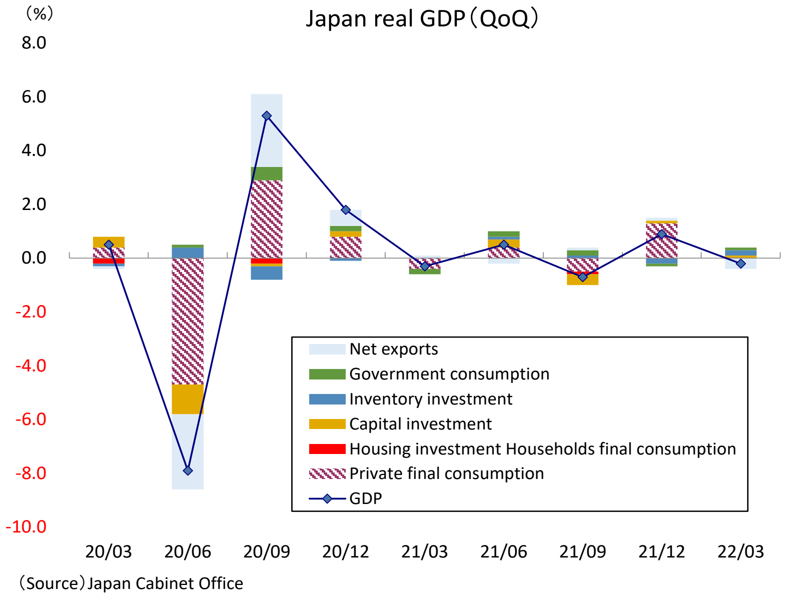
When we talk about confidence in a currency under the current managed currency system, it is literally the result of this "confidence in and acknowledgement of" the currency that is reflected in prices of financial market assets including forex rates, shares, and bonds. I would not go so far as to say that the financial health of the central bank is unimportant, but it is not something anybody worries about or reports on so long as the real economy is performing well. In fact, even among market participants, very few are likely to be aware of the BOJ's latest capital adequacy ratio or balance sheet status. Nor do we worry about the financial soundness of the BOJ when we go shopping for daily necessities. The status of the central bank's balance sheet is merely the result of its operations supporting the real economy.

The more important concern for Japan under the pandemic is the whole range of policies that voluntarily sacrifice economic growth (such as excessive measures to check the spread of the pandemic and tabooing the use of nuclear energy) that have been adopted and implemented with almost no public criticism. It is because of such policies that the BOJ is facing a risk of insolvency – the sequence of cause and effect here must be correctly understood. The cause is government policies, the effect is poor financial health of the central bank; it is important not to get the sequence mixed up.

However, for professional speculators who would like to generate a JPY selling trend in the forex markets, anything that could pass for a transaction motive will do, and the financial health of the BOJ, which frequently comes up for criticism, is as rewarding a theme as any. If such a scenario were to play out, it could be dangerous, so one can only hope that the Kishida administration will take quick action to put economic growth back on the track to recovery.

Japanese Economy and JPY Depreciation – What Happens to the Currency of a Country that has Given up on Growth

A Country that has Given up on Growth with the Approval of its People



（Source）Japan Cabinet Office

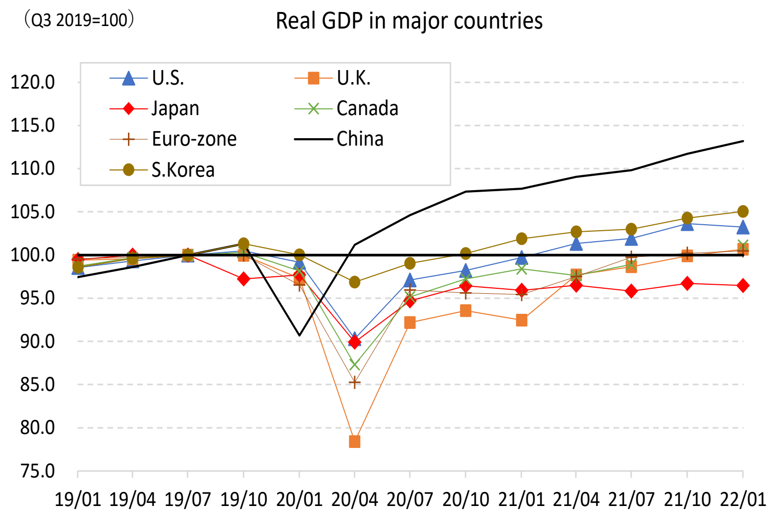
Japan's real GDP growth rate (first preliminary report) for the January-March quarter of 2022, as released by the Cabinet Office on May 18 (see figure), was negative for the first time in two quarters at -1.0% annualized qoq (-0.2% qoq), compared with the previous quarter's high growth rate (+3.8% annualized qoq). The economy has been posting alternate quarters of positive and negative growth since January-March 2021, and it is quite clearly still struggling, unable to exit the pandemic. However, perhaps "struggling" is not the correct word. Japan is still obsessed with absolute numbers of new cases and unwilling to let go of masks. Masks, now a strange sight elsewhere in the world, are still a regular feature of life in Japan. Not, of course, that wearing masks contributes to low economic growth rates. The key point here is that masks symbolize Japan's excessive obsession with infections, which is decimating consumption and investment appetites. The "putting lives ahead of the economy" path followed over the past two years steadily continues to destroy the real economy, and going by the Kishida administration's approval rate, this approach has the support of the majority of Japanese people. Perhaps the gentle pace of economic deterioration makes it difficult for people to perceive it in real time, but as I will explain going forward, the Japanese economy is in quite a bad state for a developed economy, and it is with the approval of its people that Japan has given up on economic growth.

Strong Personal Consumption Shows Citizens Wise to Posturing?

Needless to explain, but the January-March quarter negative growth was the result of movement restrictions imposed yet again following the spread of infections due to the Omicron variant. However, it was surprising that personal consumption remained level rather than declining, which limited the extent of the negative GDP growth. January and February marked the peak of Omicron infections, so perhaps there was a resurgence in consumption in March in anticipation of the lifting of restrictions, but the reasons are not entirely clear. Perhaps people were less cooperative regarding voluntary restrictions, having realized that movement restrictions are mere posturing. During the pre-emergency status period, several media reports noted that there seemed no reduction in crowds. This was then confirmed by the data in the Regional Economy (and) Society Analyzing System (RESAS) provided by the Cabinet Secretariat Digital Den'entoshi National Concept Realization Office – there was no reduction in movement during the COVID-19 pre-emergency status period, which coincided with the rapid rise in infections from the Omicron variant. Going forward, if there are new waves of infection, the government may have to device more effective movement regulations using new incentives. Further, in the case of a major restaurant chain suing the Tokyo government for damages over an order to cut its business hours, the court ruled on May 17 that the government order had not been "not particularly necessary" and was "illegal." The order issued to the restaurant was part of the movement restriction measures. One hopes that the government can weigh the consequences of formulating pandemic countermeasures of dubious effectiveness that involve issuing illegal orders.

Japan Left Well Behind

As is generally known, the COVID-19 pre-emergency status was fully lifted toward the end of March, and Golden Week saw a considerable resurgence of crowds in early May. Warnings of a potential new wave of infections two weeks after Golden Week did not come true, either. One has to say there seems very little correlation between the flow of people and the spread of infections. If things continue this way, the GDP growth for April-June will rebound considerably, led by personal consumption. According to JCER's ESP forecast, the April-June quarter GDP is expected to accelerate to +5.918% annualized qoq. However, given Japan's excessive pandemic awareness, growth may remain volatile. If the pattern of the past two years is any indication, one can visualize the April-June quarter growth being labeled the result of "letting one's guard down," and self-destructive, low-growth policies (movement restrictions) being adopted all over again in the event of another wave of infections in July-September.



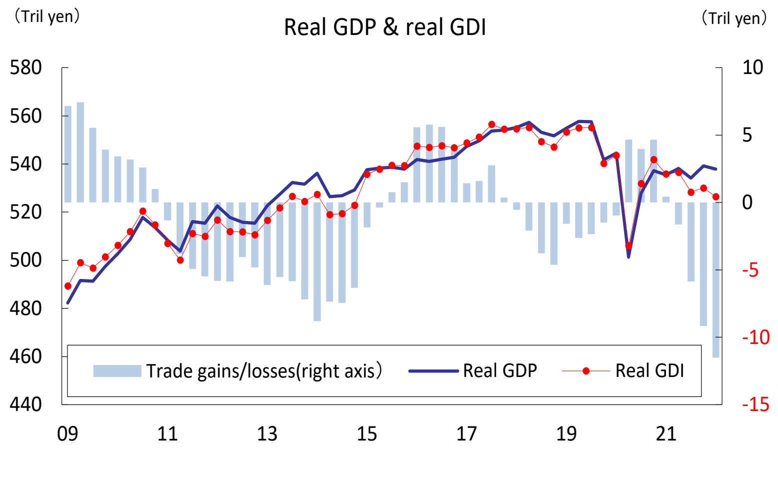
（Source） macrobond

Practical policies are required for exiting the vicious cycle, but given the deeply entrenched public support for a path of putting lives ahead of the economy, the government and ruling party have no reason to change their stance, and a repeat of the past couple of years cannot be ruled out. One would think protecting against infections is not the main goal of life, but in Japan, this seems to have become the case. The figure shows the trend of real GDP growth levels for key countries compared with July-September 2019, which is taken as the reference period and assigned a value of 100. The reason for taking July-September as the reference quarter rather than October-December is to avoid comparing against a quarter when Japan's GDP growth was dampened by the rise in consumption taxes and the effect of Typhoon Hagibis (both of which took place in October). Compared with the growth level of July-September 2019, Japan's recovery is still -4% short. A look at the graph is enough to show how abnormal this pace of recovery is. Calling Japan a country that has given up on growth is no exaggeration – it is the plain truth; and the dramatic decline in JPY's real effective exchange rate and the Nikkei Stock Average's clearly inferior performance compared with other indices cannot be unrelated to this.

Astonishing Deterioration in Purchasing Power as Indicated by Real GDI

An indicator that more accurately reflects the current state of the Japanese economy is the gross domestic income (GDI), which is calculated by adding the change in terms of trade (i.e., trade gains/losses) to GDP. Compared with the January-March quarter real GDP, which had declined by an annualized rate of -1.0% qoq, real GDI for the same quarter had declined by close to three times that, at -2.7% annualized qoq (see figure). This reflects the extent of income outflow from Japan as a result of soaring resource prices and JPY weakness, and the resultant loss of the Japanese economy's purchasing power. As explained before, real GDP has been showing alternative quarters of positive and negative growth, resulting in what could be described as "stagnant growth" overall, but real GDI has been on a continuous decline. As is generally known, JPY's real effective exchange rate (REER) recently hit a half-century low and was widely discussed as symbolizing "cheap Japan." Real GDI is similarly an indicator of "cheap Japan" or even "poor Japan." The "undesirable JPY weakness" impression among the general populace is a direct reflection of the increase in cost burdens for households due to JPY weakness, so in this context, real GDI, which captures the state of income in Japan, reflects economic realities better than real GDP, which merely captures the state of domestic production.

The problem is that real GDP may recover significantly if Japan were to revise its excessively strict countermeasures against the pandemic and stop imposing movement restrictions of any sort, but amid persistently high resource prices, there seem no prospects for a GDI recovery. Resource price increases as a result of the crisis in Ukraine have been ongoing since late February, but the full impact of this may emerge only starting the April-June quarter GDP. This is expected to be accompanied by a further weakening of real GDI, thereby resulting in a further shrinking of household consumption and investment appetites. Possibly, this will then go on to further weigh down real GDP. The external circumstance of high resource prices is not something Japan can help, but the government can at the very least formulate domestic policies that avoid holding the country back.



(Source) Cabinet Office

U.S. Monetary Policy Now and Going Forward – 50bp to 25bp Slowdown is Key

Important to Watch for Signs of an Upcoming Slowdown from 50bp to 25bp Rate Hikes

At the May 3-4 FOMC meeting, it was decided to continue with rate hikes from the 25-bp hike in March. This time, the rate was increased by 50 bps, the largest in 22 years, resulting in a 75-bp increase in interest rates within the space of less than two months. This raises the target federal funds (FF) range from 0.25-0.50% to 0.75-1.00%. At the same time, the it was decided to begin quantitative tightening (QT, or "run-off" as the Fed calls it) by reducing portfolio assets starting June. At his press conference, Fed Chair Jerome Powell explained that, though rate hikes did increase the burden on households, inflation was negatively impacting the real economy as a whole, so it was necessary to focus on controlling inflation. He appeared almost to be seeking the markets' understanding on this. Could this be because of a determination to continue with rate hikes for some time and knowing that this could face opposition? Powell also stated, "additional 50-basis-point increases should be on the table for the next couple of meetings," but noted that "a 75-basis-point increase is not something the Committee is actively considering." This triggered share purchases immediately after the meeting. However, the fact is that interest rate increases, whether by 25 bps or 75 bps, do weigh down share prices, so the strength of U.S. share prices for the whole month of May was extremely significant.

Going forward, the markets should watch out for the timing at which the 50-bp rate hikes slow down to 25-bp hikes, signally an eventual end to the policy normalization process. As of the present time, the Fed seems intent only on pressing the accelerator, with no signs of pressing the brake any time soon. For both share and forex markets, the brake action could be a watershed moment, and I suspect this could come either at the September or at the November FOMC meeting this year. The meeting minutes published on May 24 confirm that a 50-bp rate hike is the predetermined path for both the June and July meetings this year, but also noted that "expediting the removal of policy accommodation would leave the Committee well positioned later this year to assess the effects of policy firming," <u>subtly hinting at the possibility of a slowdown in the pace of rate hikes from 50-bp hikes to 25-bp hikes or, depending on circumstances, altogether ending rate hikes in the second half of the year</u>. Perhaps these are indications of a gradual change in the FOMC's strongly hawkish stance.

However, the neutral interest rate level (currently estimated to be 2.50%), which is key to predicting the trend of rate hikes going forward, is unclear, and the Fed may have no choice but to continue communicating its stance of not hesitating to further increase rates if necessary.

Minutes Suggest QT has been Decided

With regard to QT, the May meeting minutes reconfirmed policies outlined in the March meeting minutes, namely, that "the Committee intends to reduce the Federal Reserve's securities holdings over time in a predictable manner primarily by adjusting the amounts reinvested of principal payments received from securities held;" that "For Treasury securities, the cap will initially be set at $30 billion per month and after three months will increase to $60 billion per month" and "For agency debt and agency mortgage-backed securities, the cap will initially be set at $17.5 billion per month and after three months will increase to $35 billion per month." The minutes further noted that Treasury bills would be redeemed to the extent that coupon principal payments were less than the monthly cap. All the above details are the same as in the March meeting minutes, with no surprises. At any rate, the Fed's plan appears to be to arrest the flattening of the yield curve by concurrently implementing rate hikes and starting QT, and it will be worth watching to see if the strategy succeeds.

Risks to My Main Scenario – Forex and Interest Rate Risks Related to the Doubling Asset-Based Incomes Plan

Doubling Asset-Based Incomes Plan's True Significance

While visiting the United Kingdom, on May 5, Japan's Prime Minister Fumio Kishida delivered a speech in London's financial district (the City) during which he explained that concrete measures to be undertaken under his new economic policy (which he calls a "new form of capitalism") will include a "Doubling Asset-Based Incomes Plan" designed to encourage a shift of Japan's roughly JPY2,000 trillion of personal financial assets from savings toward investments. The Prime Minister noted that more than half of Japan's personal financial assets are in the form of cash and deposits and went on to state that – "As a result, while household financial assets have tripled in the U.S. and increased 2.3 times in the UK over the past decade, in Japan they have increased only 1.4 times. This is a waste – but also a source of future potential." He was emphasizing the potential benefits derivable from such a huge volume of investment resources. The speech can be considered surprising in that Prime Minister Kishida's consideration of financial income tax revisions soon after he took office caused a sharp downturn in Japan's stock market. Moreover, the Kishida administration has continued to provoke negative reactions from the stock market by suggesting the possibility of such policies as those to restrict share buybacks, abolish quarterly disclosures, and emphasize wage increases rather than shareholder returns. Such policy proposals make it difficult to grasp the true meaning of the Prime Minister's statement within his speech – "You can invest in Japan with confidence. Invest in Kishida." One can only wonder whether he plans to amend or withdraw the policy proposals that the stock market found so unappealing.

Financial asset composition of the Japanese household sector (end of DEC 2021)

	Amount (trillion yen)	(%)
Total assets	2,023.0	100.0
Foreign currency	68.9	3.4
Foreign currency deposit	7.1	0.3
Foreign securities investment	22.9	1.1
Investment trust	38.9	1.9
JPY-denominated	1,954.1	96.6
Cash and deposits (excluding foreign currency deposits)	1,084.6	53.6
Government bond, etc.	25.7	1.3
Stocks and investments	211.6	10.5
Investment trusts (excluding the foreign currency portion)	60.1	3.0
Insurance and pension reserves	540.1	26.7
Deposit, etc.	32.1	1.6

Financial asset composition of the Japanese household sector (end of MAR 2000)

	Amount (trillion yen)	(%)
Total assets	1,401.1	100.0
Foreign currency	13.2	0.9
Foreign currency deposit	3.1	0.2
Foreign securities investment	4.7	0.3
Investment trust	5.3	0.4
JPY-denominated	1,387.9	99.1
Cash and deposits (excluding foreign currency deposits)	741.6	52.9
Government bond, etc.	50.6	3.6
Stocks and investments	138.3	9.9
Investment trusts (excluding the foreign currency portion)	52.2	3.7
Insurance and pension reserves	369.9	26.4
Deposit, etc.	35.3	2.5

Changes from the end of MAR 2000 to the end of DEC 2021

	Amount (trillion yen)	(%)
Total assets	621.9	
Foreign currency	55.7	2.5
Foreign currency deposit	4.0	0.1
Foreign securities investment	18.2	0.8
Investment trust	33.6	1.5
JPY-denominated	566.2	▲ 2.5
Cash and deposits (excluding foreign currency deposits)	343.0	0.7
Government bond, etc.	▲ 24.9	▲ 2.3
Stocks and investments	73.2	0.6
Investment trusts (excluding the foreign currency portion)	7.9	▲ 0.8
Insurance and pension reserves	170.2	0.3
Deposit, etc.	▲ 3.2	▲ 0.9

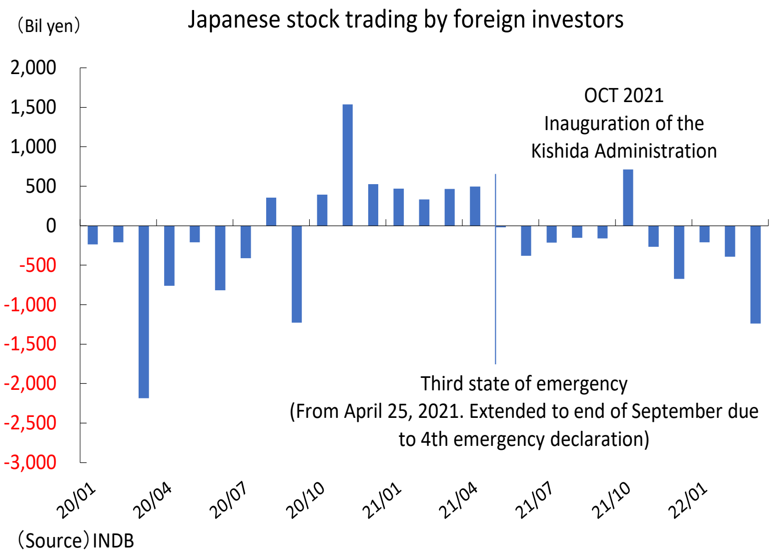
(Source) Bank of Japan "Flow of Funds Accounts."

Risks of Shifting Savings to Investments – Potential Impact on Forex and Interest Rates

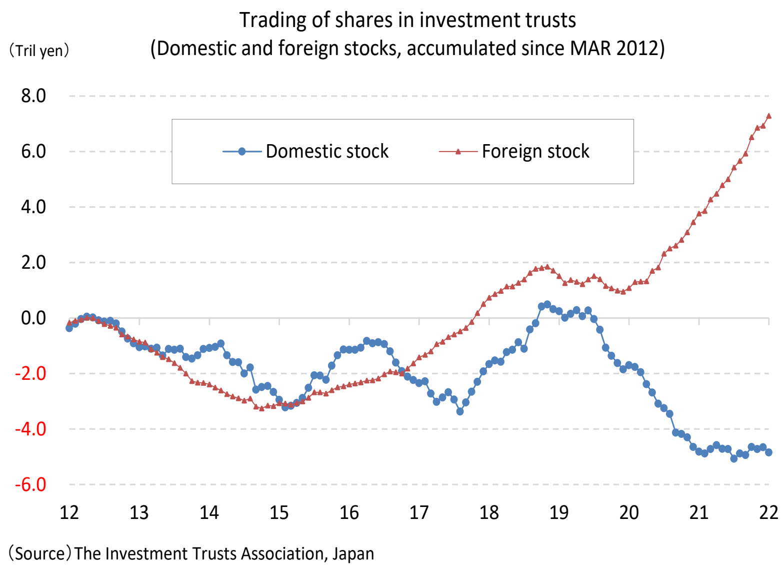
As no information on specific measures associated with the "Doubling Asset-Based Incomes Plan" has yet been made available, it is not clear what the plan's true significance will be. However, it should be noted that it may be quite dangerous for contemporary Japan to emphasize the great potential benefits of transforming unmanaged cash and deposits into investment resources. <u>There are two related issues requiring more consideration – the first is the potential effect on forex rate (JPY exchange rates) and the second is the potential effect on Japanese government bonds (JPY interest rates).</u>

First, how does Japan's ruling party and government plan to manage the effects shifting cash and deposits into investments would have on forex rates, particularly JPY exchange rates? As this article has discussed in detail in the past, there are already grave concerns about the demerits of JPY depreciation, and growth in household sector JPY selling is perhaps the biggest risk factor with a potential to promote further sharp JPY depreciation. As Prime Minister Kishida stated, more than 50% of Japan's personal financial assets are in JPY-denominated cash and deposits – as of the end of December 2021, such cash and deposits amounted to JPY1,084.6 trillion and accounted for 53.6% of Japan's personal financial assets. On the other hand, stocks and investments amounted to JPY211.6 trillion, which is only 10.5% of Japan's personal financial assets. Japan's household financial asset composition – roughly half in cash and deposits only roughly 10% in stocks and investments – has frequently been discussed as being problematic, and many people are reasonably aware of the approximate proportions. It is not difficult to understand the perspective of people advocating measures to promote a shift of accumulated cash and deposits savings into investment resources and risk assets with higher expected returns.

However, there is no guarantee whatsoever that the savings shifted in this way will be moving into JPY-denominated assets. As this article has repeatedly argued, Japan has decisively adopted an extreme “human safety before economic vitality” stance that has greatly deemphasized the promotion of economic growth, as can be seen in the country’s protracted imposition of highly strict anti-pandemic measures and its acceptance of a taboo on the restarting of nuclear power plant operations. Reflecting this, Japan is the only developed country whose GDP has not recovered to pre-pandemic levels. It is now commonly argued that this deterioration of Japan’s economic vitality has been depressing Japanese stock prices and promoting JPY depreciation. In May, Tesla CEO Elon Musk inspired many shocking news headlines by predicting Japan will “cease to exist” if it does nothing about the downtrend in its population, but even more relevant to Japan’s current situation is Musk’s assertion that lengthening human lifespans and thereby increasing elderly people’s share of a country’s population – “would cause asphyxiation of society because the truth is, most people don't change their mind. [...] we will be stuck with old ideas and society wouldn't advance.” It seems that there are many people who to some extent have a similar view of Japanese society, and this may well be a background factor causing foreign investors to stop buying Japanese stocks after the Kishida administration’s inauguration (see graph).



<u>If the Japanese household sector were to shift its assets from savings to investments amid the current situation, could it really be expected to bet on the Japanese economy’s bright future by choosing to invest in JPY-denominated assets</u>? Policies to promote investment may be generally good, but there is no guarantee that the promoted investments would be in JPY-denominated assets, so from a forex market perspective, such policies seem likely to trigger additional JPY depreciation. While there are a growing number of observers pointing out the demerits of JPY depreciation, Japan’s ruling party and government may not be duly considering the risk that promoting a shift from savings to investments will spur additional problematic JPY depreciation. It is said that Japanese households’ investment in U.S. stocks has been booming, especially since 2021. It is easy to see indications that Japanese households generally feel that, if they are investing, they might as well invest in overseas assets, and the preference for overseas assets is clear from statistics on Japan-based investment trust inflows and outflows (see graph). Of course, <u>if the Japanese government’s intention is to welcome further JPY depreciation, it may not consider these trends problematic, but if the government is even slightly concerned about JPY depreciation, it should recognize the potentially dangerous ramifications of its desire to promote a shift from savings to investments at this point in time</u>.



Who Buys Government Bonds if the Japanese Don't Save?

Another concern about the “Doubling Asset-Based Incomes Plan” is its potential impact on Japanese government bonds (JPY interest rates). <u>In particular, there are grounds for concern about the possibility that a progressive shift from savings to investments might cause the current stable system for marketing government bonds to collapse.</u> The goal of “shifting savings to investments” has been repeatedly touted in Japan’s history, reflecting suspicions that Japan’s “excessive savings and insufficient investment” situation is a significant cause of the Japanese economy’s long-term stagnation. Awareness of this factor is reflected in the common practice of referring to cash and deposits as “dead money” or “dormant money”. However, this concept is misleading. The fact that the Japanese economy has been stagnating is actually the reason why households (and companies) have chosen the least risky investment form of cash and deposits denominated in their own currency. If there are promising investment opportunities available, households (and companies) will choose investments over savings without being instructed to do so by the government.

To understand the dangers associated with promoting a shift from savings to investments in the Japanese economy today, it is necessary to understand the Japanese economy's savings-investment (IS) balance structure. I will explain this step by step. First, in response to the slump in the Japanese economy's expected growth rate, households (and companies) have been trying to preserve their assets by keeping them in the form of cash and deposits. The cash and deposits are saved in the banking sector. If they were to stay in the banking sector and not be used by anyone, they could literally be considered 'dead money', but the savings of the private sector (households and businesses) have actually been borrowed by the government sector and used for consumption and investment activities. These government sector activities cause the fund circulation structure to become balanced. Strictly speaking, there remains an excess of savings within Japan, but the Japanese overseas sector's shortage of savings (≈ current account surplus) brings the entire economy's savings and investment into balance. In this way, the 'excessive savings of Japan's private sector (households and businesses)' that has been seen for many years has become established as a symbol of the Japanese economy's sluggishness.

While Japanese banks are often criticized for merely investing in government bonds rather than lending, this criticism basically stems from an incorrect understanding of the fund circulation structure. The essential role of banks is not to lend, but to 'balance excesses and deficiencies of funds within the economy.' More specifically, the role is to mediate the flow of funds from entities with surplus funds to entities in need of additional funds. After the collapse of Japan's economic bubble, the Japanese banking sector did not increase its lending, but it mediated the flow of funds from households and companies (entities with surplus funds) to the government (an entity with insufficient funds) by means of investments in government bonds. The banks performed their role of "balancing excesses and deficiencies of funds" in a manner that was adjusted in response to the sluggishness of economic conditions. Basically, the lack of a progressive shift from saving to investments in Japan so far stems primarily from the nature of Japan's economic situation. Japan's current fund circulation structure is the natural result of banking sector-mediated fund flows that reflect the Japanese economy's sluggishness, and the "Doubling Asset-Based Incomes Plan" is trying to forcefully change this structure.

If the "Doubling Asset-Based Incomes Plan" is successfully implemented and a significant shift from savings to investments proceeds, however, the government will face a big problem – how will it be able to continue marketing government bonds? The banking sector uses cash and deposits described as 'dormant money' to purchase government bonds from private-sector banks or the BOJ. If those funds are awakened from their dormant state, there will be a need to find other economic entities to buy government bonds in their place. Will Japanese government bonds be purchased by foreigners? Japan's domestic banking sector and the BOJ will buy such government bonds despite their low interest rates, but foreign investors will not. To attract foreign buyers, Japanese government bonds will of course have to carry higher interest rates. Leaving aside the issue of whether the current Japanese government bond marketing structure (centered on the private banking sector, the government sector, and the BOJ) is good or bad, it is a solid and stable structure. If the government disrupts this structure by means of its "Doubling Asset-Based Incomes Plan", one has to wonder whether the government is prepared to accept the resulting decline in government bond prices (rising JPY interest rates)?

At first glance, the "Doubling Asset-Based Incomes Plan" seems to be a positive initiative, but given Japan's current forex and government bond marketing situations, it seems that the plan has the potential to present the Japanese economy with challenges associated with sudden undesirable changes. It is to be hoped that the government will carefully assess those challenges and prepare to manage them before executing the plan.

EUR Outlook – ECB Moves toward Normalization

EUR Area Monetary Policies Now and Going Forward – ECB Changes its Mind

'Heavy Lifting' Information Dissemination Effort

On May 23, the ECB Blog suddenly published a post by ECB President Christine Lagarde entitled 'Monetary policy normalisation in the euro area'. Within the post, President Lagarde wrote – "I expect net purchases under the APP to end very early in the third quarter. This would allow us a rate lift-off at our meeting in July, in line with our forward guidance. Based on the current outlook, we are likely to be in a position to exit negative interest rates by the end of the third quarter." Although such important news could have been announced at the Governing Council meeting just two weeks later (June 9), President Lagarde chose to disclose it in a blog post, which is unprecedented. This suggests a possibility that the ECB has begun feeling a sense of crisis about the rate of price increases and wants to expedite its monetary policy normalization measures. As discussed below, however, this seems uncharacteristic of the ECB, which has been repeatedly reaffirming its commitment to a slow and gradual normalization process, so it might seem more-logical to interpret the post as a 'heavy lifting' information dissemination effort to highlight the gradual progress. President Lagarde noted that the ECB's policy adjustment has already been proceeding over the previous six months – "But as the expected date of interest rate lift-off draws closer, it becomes more important to clarify the path of policy normalisation that lies ahead of us – especially given the complex environment that monetary policy in the euro area is facing. This is the purpose of my blog post today." However, given that her post disclosed the nature and timing of important policy decisions, she appears to have reduced the importance of the official Governing Council meetings at which one would ordinarily expect to learn about such policy decisions. Since the markets had already factored in a July interest rate hike, it would be hard to argue that she was intending to ease the shock associated with that hike. <u>Thus, it seems hard not to conclude that the post indicates that the ECB's sense of crisis about the pace of price increases has suddenly increased</u>. In fact, the post may possibly be grounds for anticipating the future emergence of problematic data about the pace of price increases. As explained below, one such type of problematic data may be the sharp qoq acceleration of euro area wage increases, which was announced soon after the blog post was posted.

Relaxed Commitment to Gradualism

Looking again at the blog post's key sentence, I have underlined the portions representing policy changes and timings.

- I expect net purchases under the APP to end <u>very early in the third quarter</u>. This would allow us <u>a rate lift-off at our meeting in July</u>, in line with our forward guidance. Based on the current outlook, we are likely to be in a position to <u>exit negative interest rates by the end of the third quarter</u>.

<u>There are three important pieces of information. One is that the APP will be ending very early in the July-September period. Another is that interest rates will be hiked in July</u>. And the last piece is that negative interest rates will end during the July-September period. Each of these points constitute important information that has not yet been released by the Governing Council. The week before the blog post, the ECB held a policy meeting that did not cover monetary policy, and one suspects that there were efforts made at that meeting to gather and coordinate participant's views. Even Former ECB President Draghi would have been unlikely to post such important information in a blog post without ensuring that his colleagues were in agreement with his views, so it is even less likely that President Lagarde (who has a reputation for being exceptionally good at coordinating views within organizations) would have decided to publish her post without doing thorough coordination work in advance (more on this later).

The ECB may have the feeling that it has not suddenly advanced greatly ahead with normalization measures and associated information disclosure. The July interest rate hike had already been factored into interest rate futures, and the ECB had previously stated that it would consider hiking interest rates during the July-September period "some time after" after the termination of the APP. President Lagarde said that the meaning of "some time after" could be "anywhere between a week to several months" and did not supply additional clarification of that issue. Therefore, the recent blog disclosures – that the APP will be terminated in early July and there will be an interest rate hike after mid-July – certainly do not contradict the previously existing forward guidance. <u>The blog post specifically pointed out that the rate hike would be "in line with our forward guidance", and this seems to have been done with the intention of forestalling accusations that previous disclosed information was misleading</u>. Regarding the temporal order of normalization measures, so long as the end of quantitative expansion precedes the rate hike, it is certainly true that the moves are in accordance with the forward guidance.

However, President Lagarde had repeatedly been emphasizing that APP termination and rate hike initiation are quite separate policy decisions and that the ECB was firmly committed to gradualism in its normalization process. <u>Then, the general policy of "terminating the APP in the third quarter and subsequently considering interest rates hikes" was suddenly changed by the blog post into "terminating the APP in early July, hiking interest rates for the first time after mid-July, and raising interest rates to positive levels in September". It is not clear that this new schedule could be characterized as being in line with gradualism</u>. It is worth noting that, in her recent blog post, President Lagarde reiterated her previous emphasis on – "gradualism, optionality and flexibility when adjusting monetary policy". Although the ECB's basic stance may generally emphasize all those three elements, it is clear that in its recent actions the ECB placed more emphasis on flexibility than on gradualism.

Progressively Adjusting Policies at Each Governing Council Meeting

It is worth noting that the ECB's February Governing Council meeting announced that the ECB would increase monthly net purchases under the APP from the then-current level of EUR20 billion to EUR40 billion from April and then gradually shrink (taper) monthly net purchases to EUR30 billion from July and to EUR20 billion from October. At the April Governing Council meeting, the ECB announced that it would taper monthly net purchases from EUR40 billion in April to EUR30 billion in May and EUR20 billion in June and hinted that the APP might be terminated during the July-September period. As of April, the ECB was still suggesting that the APP might continue from the October-December period, so there was just a gradual acceleration of the tapering process during the period from February to April. Then, without waiting for the June Governing Council meeting, the ECB announced via President Lagarde's May 23 blog post the July termination of APP along with an interest rate hike that same month and a return to positive interest rates in September. <u>It seems that the main task of the June Governing Council meeting will be to confirm the policies explained in the blog post</u>. The key points are – ECB policies will have been progressively changed at the Governing Council meetings in February, April, and June (≈ May blog post), and the announcement of the revision of the policies in place as of April was undertaken via the May blog post rather than via the June Governing Council meeting.

As mentioned above, it does not appear that there was a lack of consensus among Governing Council members regarding the surprising blog post. If there was such a lack of consensus, it might well hinder future policy management decision making. This possibility of a lack of consensus reminds one of the Governing Council's internal divisions during the President Draghi era. In June 2019, former ECB President Draghi suggested in his opening speech at the ECB's annual meeting (in the Portuguese city of Sintra) that the ECB's forward guidance could be revised, interest rates cut, and asset purchases resumed, paving the way for a subsequent return to greater monetary easing measures. In line with that speech, the ECB decided to restart the APP in October of that year. Several Governing Council members (including those from Germany, France, the Netherlands, and Austria) openly expressed their opposition to the restart of the APP, and ECB executive board member Sabine Lautenschläger (from Germany) resigned halfway through her term in response to this move. Former ECB President Draghi emphasized flexible decision making, utilizing majority votes to overcome lacks of unanimity, and was willing to face a certain amount of divisiveness within the Governing Council. (In November 2014, it was reported that a banquet was held before the Governing Council meeting to discuss internal divisions within the Governing Council along with future policy management methods.)

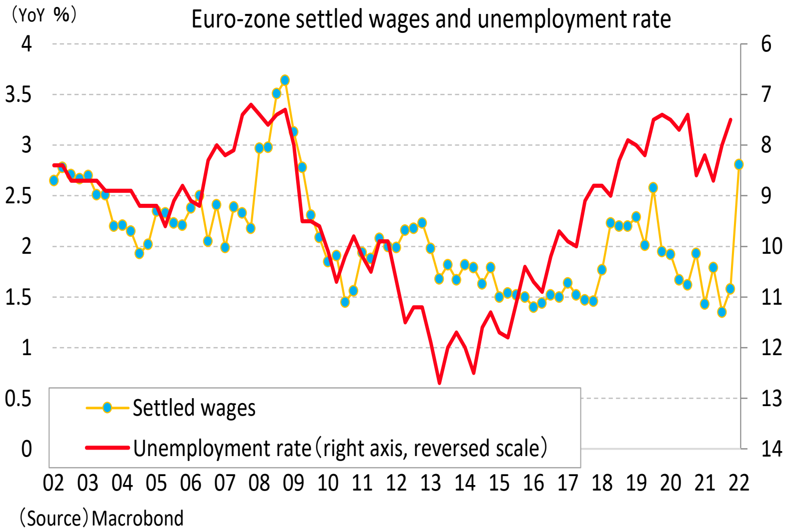
Many people believe that the choice of Christine Lagarde to succeed President Draghi was made largely in light of her proven ability to manage organizational policies without causing such conflicts. <u>In view of President Lagarde's history and talents, it can be presumed that there was consensus support within the Governing Council for recent decision to announce policy revisions in a blog post and that the Governing Council truly is feeling a sense of crisis about the acceleration of inflation rates.</u> In general, the ECB is suffering from the same kinds of changes the Fed has been facing over the past six months.

Current Focus on Prospective Interest Rate Hikes

As this article has repeatedly discussed, however, the economic and financial situations in the United States and the euro area are completely different. President Lagarde recently emphasized this difference, saying – "Comparing our respective monetary policies is comparing apples and oranges. We are not applying policies to the same economic situations at all." Roughly half of U.S. inflation rates are attributable to service prices, and the Fed is at the stage of being concerned that the inflation momentum may be perpetuated via upward pressures on wages. In contrast, euro area inflation rates are still largely energy-driven, and it appears that a quick tightening of monetary policies in response to current inflation trends will likely cause concerns about overkill. In addition, the five-year in five years inflation swap break-even inflation (BEI) rate that the ECB has traditionally emphasized is currently peaking out, and if the ECB were to raise interest rates significantly in a short period of time, there remain concerns that this would overly constrain the euro area's real economy. Thus, observers are currently focusing their attention on prospective interest rate hikes. According to President Lagarde's blog post, it appears that the ECB's current -0.50% deposit facility interest rate will be lifted out of negative territory with two rate hikes in July and September. <u>Two hikes of 25bps each will be sufficient to raise the interest rate by 50bps to 0%, just outside of negative territory.</u> If the ECB wishes to emphasize its 'progressiveness' and 'flexibility,' might choose to implement a 50bps hike in July and a 25bps hike in September. In light of the current state and outlook of the euro area economy (by no means rock solid), I am anticipating two rate hikes of 25bps each, but it must be recognized that financial markets will quickly factor in changing expectations in response to consumer price index (HICP) figures to be announced in the future, and there is an undeniable risk that the ECB may adjust its plans in light of sharp market shifts.

Wage Trends the Factor that Changed the ECB's Posture?

Although it is not clear why the above-mentioned blog post was suddenly published, it is noteworthy that January-March quarter wage statistics (on collectively negotiated wages; which are an important basis for predicting euro area wage trends) were announced the day after the blog post. The qoq rate of wage increases accelerated from 1.5% in the October-December quarter of last year to about 2.8% January-March quarter (see graph). Negotiated wage trends are generally expected to affect overall wage trends through the following year, so it is already anticipated that rapid increases in wages may persist during and after 2023. <u>The ECB would have been aware of the January-March quarter wage statistics at the time the blog post was published, and it may have been afraid that the financial markets would be shaken by those statistics</u>.

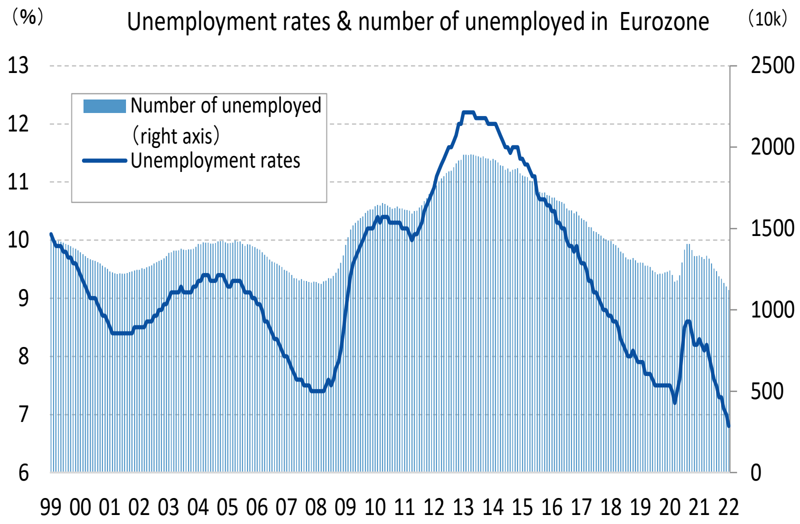


(Source) Macrobond
(Note) It will be different from the actual labor cost growth due to settled wages

The ECB has long been hesitant to launch normalization measures, asserting that gradualism is important because wages have continued to be stagnant even when the unemployment rates decreased. Announced on May 19, the Account of the April 13-14 Governing Council meeting reports that the view of dovish Governing Council members was that – "While developments in negotiated wages at the euro area level were expected to remain moderate this year, with wage agreements somewhere between 1.5% and 2.5%, evidence from different countries pointed to some heterogeneity. Furthermore, moderate wage demands were to be expected in the current uncertain environment, with workers increasingly concerned about job security." However, the actual rate of increase in negotiated wages during the January-March quarter was 2.8%, already exceeding the forecast range, so it is quite likely that awareness of wages' upward momentum has risen within the Governing Council since the April 13-14 Governing Council meeting.

Expressions of Concern about Wages at April Governing Council Meeting

The Account also explains that, in response to Governing Council members arguing that there was no need for alarm about the rise in wages, other members noted that "wages reacted with a substantial lag to price increases [...] [and] it was just a matter of time before wage growth caught up[.]" It was argued that a situation in which wages do not rise despite labor shortages could not be expected to continue. As shown in the graph on the previous page, in March, the euro area unemployment rate reached a record low of 6.8%, and the number of unemployed people in the region decreased to 11.27 million, which is also a record low level. The euro area is facing the same problem as the United States with regard to labor shortages, and one must anticipate that those shortages will eventually lead to wage increases. The Account also includes a discussion about this, in which it was noted that – "<u>the picture for the wage outlook could change very quickly, as unemployment was at record low levels, strengthening the bargaining position of employees</u>." The rate of growth in negotiated wages during the January-March quarter was certainly rapid but, looking at the graph on the previous page, it appears that the rate was actually unusually low in light of the unemployment rate and that the rate has just undergone a certain amount of appropriate adjustment. Moreover, it is quite possible that this adjustment will continue going forward.



(Source) Macrobond

The Account explains that – "there was a broad consensus that stubbornly high, and higher than expected, inflation increased the risk of second-round effects arising through wage costs. However, views differed on the extent to which such risks were likely to materialise." This differing of views about risk levels appears to have complicated policy decision making. Some Governing Council members asserted that, because the Phillips curve remains flat and there have been no structural changes in the labor market, there is no need to be very concerned about wage increases. However, other members argued that action should be taken soon, because – "Waiting for wage growth to accelerate [before responding] would [...] be misguided, as the upside risk to inflation would then already be materialising and the resulting wage-price spiral would be hard to stop." <u>While the Governing Council members relatively unconcerned about wage growth appear to have been dominant previously, it now appears that the view that wage rises merit a quick response had become dominant within the Governing Council as of May</u>.

Problematic Aspects of ECB Information Dissemination via Blog Posts

While it is good that the ECB has hastened to announce its new view on the risks of rising inflation rates, there seem to be problematic aspects of announcing such important news in the casual form of a blog post. On March 18, 2020, the ECB held an extraordinary Governing Council meeting focused on the introduction of the pandemic emergency purchase programme (PEPP) to help alleviate turmoil associated with the pandemic. The Governing Council is the top decision-making entity for euro area monetary policies, and if a situation is judged to be a real emergency related to those policies, it would be a good idea to hold an extraordinary Governing Council meeting to address that situation. In the future, financial market participants will have no choice but to expand the scope of their ECB watching activities to include blog posts that could be published at any time. When it is necessary to effectively influence markets' expectations and promote policies' effects with such communications measures as forward guidance language, prompting speculation that the ECB's message might be altered via blog posts will tend to constitute an additional noise factor that might actually reduce the effectiveness of the ECB's key messages. While the current situation is not a serious problem, there are grounds for a concern that keeping the situation as it is might cause severe problems over time. As the information in President Lagarde's blog post does not seem to have been so extremely urgent, it appears that she has taken an unusual measure with potential costs over time that may well exceed the immediate benefit.

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