Forex Medium-Term Outlook

June 30, 2022

MIZUHO

Overview of Outlook

In June, USD/JPY continued to rise and eventually hit the 137 level, a 24-year high. In the previous month's edition of this report, I emphasized that an appropriate level of correction was healthy, but that it was still too early to predict a peaking of USD/JPY while there was no change in the fundamental factors contributing to JPY weakness. My prediction appears to have come true, with a revival in JPY selling. The major factors driving JPY weakness since March this year have been (1) the BOJ's especially relaxed monetary policy compared with central banks around the world, and (2) the expansion of Japan's trade deficit amid high resource prices. Both these factors are continuing strong as of the present time. In connection with (1), the Swiss National Bank (SNB) raised interest rates in a surprise move earlier in June, leaving JPY behind as potentially the only currency with negative interest rates during 2H of the year. As the world enters a phase of apparent competition for currency strength, JPY's isolation is increasingly conspicuous. As for factor (2), with the government focusing more on power saving than on power generation, the prospects for the resumption of nuclear power generation appear to be fading. It seems likely that the expansion of the trade deficit amid rising resource prices will be disregarded. There are no calls for a complete lifting of restrictions on inbound tourism either. Under such circumstances, there is not even the faintest sign of a change in the JPY supply-demand balance, which currently leans toward a net JPY selling. It has to be said, under these circumstances, that USD/JPY seems more likely to hit the 140-level rather than return to the 125-level or lower. If anything can change this trend, perhaps it is the end of the Fed's policy normalization process, but the Fed has clearly indicated its willingness to go overboard in an effort to control inflation, so its policy normalization process seems unlikely to end during the current fiscal year at any rate. It may be at least another year before the weak JPY trend begins to reverse.

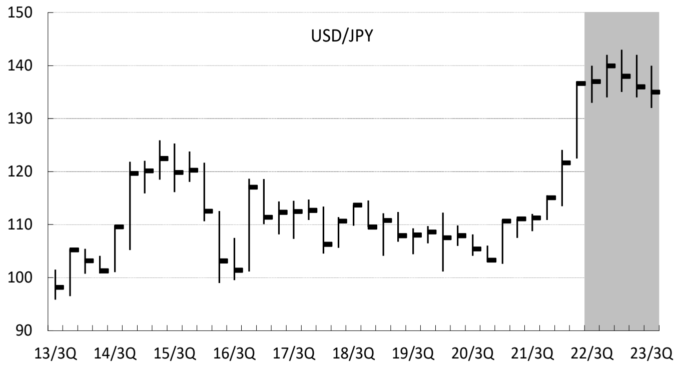
Meanwhile, EUR seemed to drift aimlessly in June. Since the blogpost by ECB President Christine Lagarde toward the end of May, a rate hike in July and a return to positive interest rates by the end of September has been the established hawkish policy stance of the ECB. However, the Bank's response to market segmentation suddenly became the focus of attention in June, putting it in the tricky position of balancing hawkish and dovish communications simultaneously. Naturally, the ECB's fundamental position remains hawkish, but its difficulty in following this position through appears to be hindering EUR buying. Given the rock-solid demand for EUR, underpinned by the world's largest current account and trade surpluses as it is, an increase in EUR interest rates would make buying EUR a no-brainer in terms of the fundamentals, so this report still predicts an increase in EUR rates going forward. However, the euro area is also at the center of geopolitical tensions, and this puts its real economic performance in an uncertain position. Therefore, the risk of the ECB's hawkish stance collapsing at an early stage during the current forecasting period cannot be ruled out altogether. Incidentally, within Europe, the SNB is also forecast to strengthen its hawkish stance, as though in competition with the ECB. This could create a structure where JPY is the only remaining currency with negative interest rates, and could turn out to be a key development that firmly establishes a weak JPY trend.

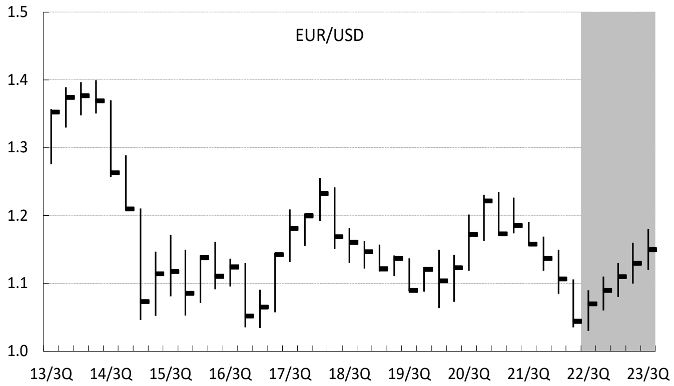
Summary Table of Forecasts

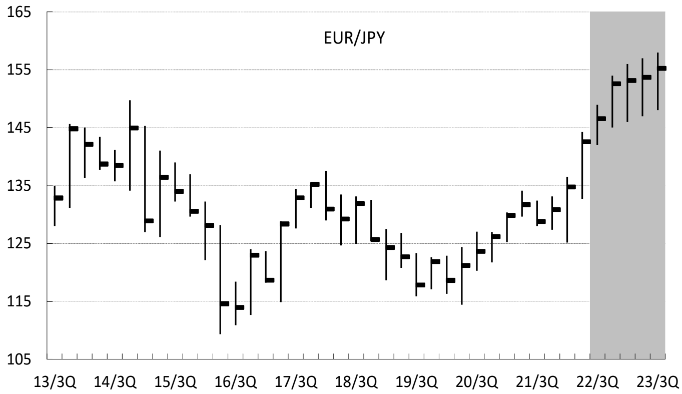
	2022 Jan -Jun (actual)	Jul-Sep	Oct-Dec	2023 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	113.47 ～ 137.00 (136.59)	133 ～ 140 (137)	134 ～ 142 (140)	135 ～ 143 (138)	134 ～ 142 (136)	132 ～ 140 (135)
EUR/USD	1.0349 ～ 1.1495 (1.0441)	1.03 ～ 1.09 (1.07)	1.06 ～ 1.11 (1.09)	1.08 ～ 1.13 (1.11)	1.10 ～ 1.16 (1.13)	1.12 ～ 1.18 (1.15)
EUR/JPY	124.41 ～ 144.30 (142.63)	142 ～ 149 (147)	145 ～ 154 (153)	146 ～ 156 (153)	147 ～ 157 (154)	148 ～ 158 (155)

(Notes) 1. Actual results released around 10 am TKY time on 30 June 2022. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts







USD/JPY Outlook – World Enters Phase of Competing for Currency Strength

Competition for Currency Strength Suddenly Gains Momentum – JPY Likely to Suffer as the Sole Currency with Negative Interest Rates

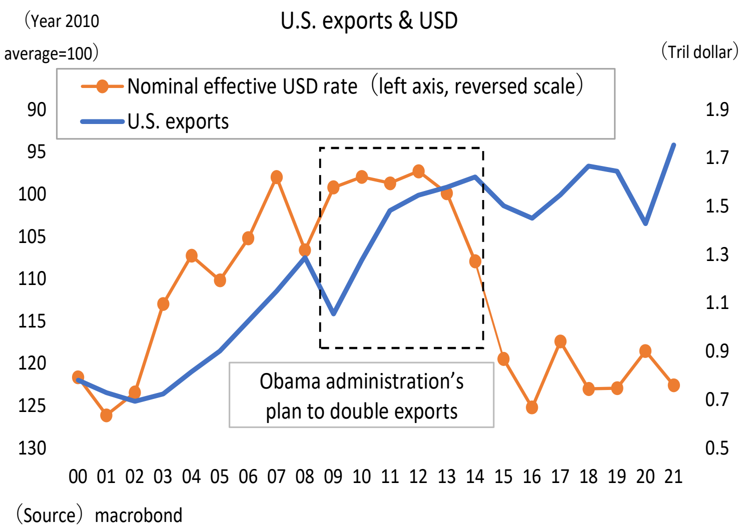
Competition for Currency Strength Around the World

Addressing the U.S. House of Representatives Committee on Financial Services on monetary policy on June 23, Fed Chair Jerome Powell made the headlines by admitting that recession was a possibility. While this is an important point, the U.S. economy at the current time is in a place where it may not be possible to rein in service prices without creating a great deal of unemployment. Therefore, the GDP growth rate being low or negative does not address the essence of the problem. Rather, from the perspective of forex rates, Powell's clear statement to the effect that USD strength resulting from an increase in U.S. interest rates has a moderating effect on inflation is quite significant. Of course, one gets the impression Powell merely told the truth in response to a question asked, but to go so far as to say that the Fed's commitment to combating inflation is "unconditional" seems to suggest a willingness to use any means necessary to rein in high inflation, and USD strength is naturally included in this.

Around the world, similar remarks, though perhaps not as strongly worded, were heard from senior officials. A senior ECB official (Governor of the Bank of France, François Villeroy de Galhau) remarked that a strong EUR in real effective terms would contribute to keeping inflation in check. Meanwhile, the SNB, which once conducted unlimited currency selling intervention while emphasizing the need for a weak domestic currency, recently implemented a rate hike and declared the possibility of proactive intervention in the forex markets, this time by buying its own currency, if the need arose. It is possible that Powell's clear message has triggered competition for currency strength around the world.

Until 10 Years Ago, Countries Were Competing for Currency Weakness

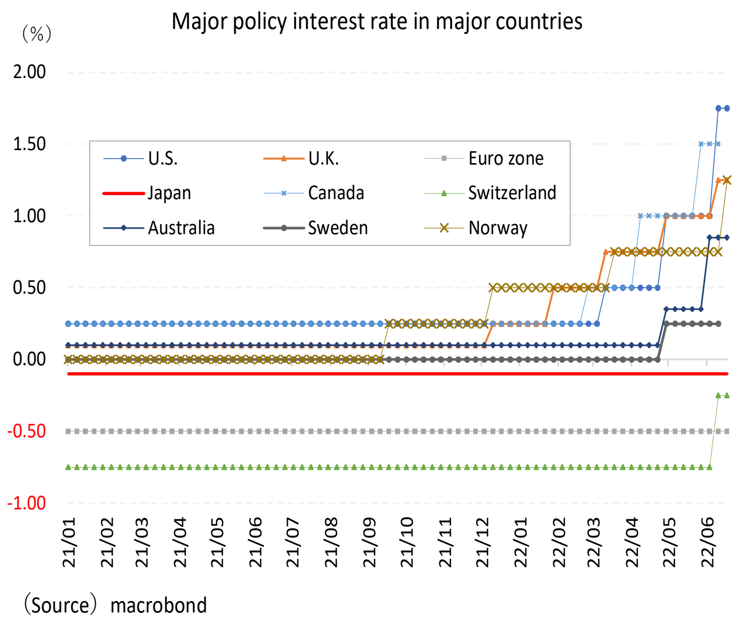
Going by recent developments, we seem to be in a different era altogether compared with around 10 years ago. Following the collapse of Lehman Brothers, countries around the world committed, as though in concert, to guiding their currencies weaker using unconventional monetary policy measures and by pursuing beggar-thy-neighbor policies. There was a strong sense that the whole world was competing for currency weakness. Symbolic of these developments was the Obama administration's plan to double exports, announced in September 2010. Under the plan, bold measures were formulated to double the nominal value of exports by 2015, taking 2009 as the base year. In the event, exports did not double in five years, rather growing by just over 1.5%, but the plan itself was widely seen as a tacit attempt to weaken USD. The figure plots the nominal effective USD rate against U.S. export volumes for the five years in question (2009-14). The attempt to keep USD stably low is clearly visible during 2009-13, and this undeniably seems to have coincided with a dramatic rise in exports. Of course, some of this may simply be coincidental rather than causal, but when the president of the United States declares his intent to double exports, the forex markets moving in line with intent is unsurprising. This climate of competing for a weak currency gradually began to change from 2013 onward, when the Fed shifted track and moved to normalize policy. In other words, until around 10 years ago, central banks around the world, led by the Fed, were firmly implementing currency and monetary policies in the direction of greater monetary accommodation and currency weakness.



By contrast, the Fed Chair's current critical mission is to suppress inflation, and USD strength is being cited as an effective means to achieve this. The Biden administration is bound to be in support of this policy as well, given that the inflation rate and popular support for the administration are said to be inversely related to each other. As the figure shows, the nominal effective USD rate is at its highest in over 20 years, but not conspicuously high. Given that the real economy is currently faced with unprecedented levels of inflation as well as rate hikes, there is both economic and political justification for a further strengthening of USD.

Lessons from the BOJ Under Former Governor Shirakawa

It must be noted that Japan suffered the greatest damage in the competition for currency weakness following the collapse of Lehman Brothers. As the currency backed by the world's largest current account and trade surpluses, JPY was forced to appreciate as a counterbalance to other world currencies depreciating, causing it to soar to unprecedented strengths (75.25 to the dollar). While some criticized then BOJ Governor Masaaki Shirakawa's policy operation, the fact is that the situation itself was quite conducive, even in theory, to JPY buying. Still, if one wanted to find fault, one could focus on what level of JPY appreciation would have been appropriate, but I will refrain from going into that here as it will detract from the main intent of this report. The gist of the public criticism leveled against Shirakawa at that time was that he was going against the global trend in hesitating to implement monetary accommodation. In fact, the BOJ under Shirakawa was doing more or less the same thing as it is currently doing under current BOJ Governor Haruhiko Kuroda, but its communication skills certainly left something to be desired, and trying to provide a theoretical explanation to a public already on edge over JPY strength would have been like adding fuel to the fire.



The current situation is the exact opposite. Leaving aside the validity or otherwise of the Kuroda-led BOJ's claims, the fact is that the BOJ is going against the global trend in its hesitation to implement monetary tightening even as public opinion turns against JPY weakness. If the ECB and the SNB go ahead and implement their recent policy assertions, JPY will very likely be the only currency to still have negative interest rates by the October-December quarter of this year (see figure). Added to this is the fact that Japan's trade deficit remains enormous. If there was some discussion of Japan's energy composition in favor of resuming nuclear power generation, there could be a let up in JPY selling pressure resulting from the demand for fossil fuels, but there seems little hope for this going by the present administration's enthusiasm for power saving rather than power generation. Under such circumstances, the bigger picture points to the possibility of JPY bearing the brunt of the global trend of competing for currency strength in the current phase just as it bore the brunt of the global trend of competing for currency weakness following the collapse of Lehman Brothers. I am often asked about the possibility of forex intervention by the Japanese authorities, but I think it would be unreasonable to discuss currency policy when the monetary policy is accommodative. What kind of country would require currency policy and monetary policy to both be facing the same direction? It would be difficult, both theoretically and practically, to consider a change in currency policy (from JPY weakness to JPY strength) while the BOJ's stance under Kuroda remains unchanged.

Turmoil in Emerging Nations also an Issue Going Forward

As a rule of thumb, during phases when U.S. interest rates and USD begin to rise in a mutually coordinated manner, the damage is first felt in the currency markets of emerging economies, which have vulnerable external economic sectors. Since December 2015, it has occasionally happened that the Fed has had to halt its policy normalization because of the severe drain of capital away from emerging economies during phases of Fed rate hikes. This time, however, that kind of consideration does not seem likely. As a result, emerging countries may be forced into rate hikes in self-defense. In this sense, the BOJ is likely to be under scrutiny for its inability to change track not just compared with developed economies but even compared with emerging economies. Of course, in the case of emerging economies, raising interest rates is an act of self-harm that could result in an economic slowdown and trigger a large-scale selling of their domestic currencies. However, Japan's unique position as the only country with negative nominal interest rates going forward will be one of the strongest factors facilitating a JPY selloff.

In this midst, Japan's one remaining strength is the fact that it still has all its rate hike policy space left. Market movements are mostly determined by the size of the gap between expectation and reality. Given the volume of JPY that has been sold so far based on the assumption that the BOJ is unlikely to make a move, there could be an equally dramatic buying back of the currency should the BOJ embark on an earnest phase of monetary austerity. And given that higher prices are beginning to cut into the public approval rate for the government, there may be some incentive for the Kishida administration to find a way to shift the responsibility for price rises onto the BOJ and get the Bank to formulate policies to address the problem. Perhaps this is a realistic JPY appreciation risk scenario for the forex markets.

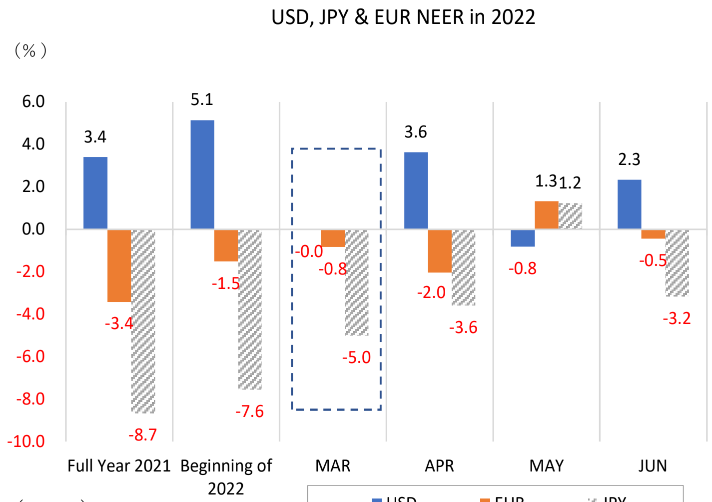
JPY Rates Now and Going Forward – JPY Weakness Not Just the Result of USD Strength

The Weak Currency of a Weak Economy

In the forex markets in June, USD/JPY hit 137.00 at one point, renewing its year-to-date high. The 137-level is the highest USD/JPY has been in around 24 years, since September 1998. There remain few reasons, either in terms of interest rates or supply and demand, for JPY to be bought – perhaps the only reason to buy back the currency is because of a sense that it has been oversold. The year-to-date monthly average trade deficit is well over -JPY 1 trillion, but the Kishida administration continues to impose restrictions on inbound tourism, which offers a valuable opportunity for earning foreign currency. The reasons for this are unclear – perhaps the administration believes that this is what the public wants. Decisions on the trickier issue of resuming nuclear power generation naturally remain shelved. This is not the policy operation method of a government that sincerely wants to alleviate the downward pressure on JPY resulting from its supply-demand climate – it has to be said that the government lacks a sense of crisis. Given the current administration's clear stance of wanting to deal with power shortage through power saving rather than power generation, it seems inevitable that the domestic economy will continue to be downsized going forward. Naturally, if the economy is weak, its currency is likely to be weak as well.

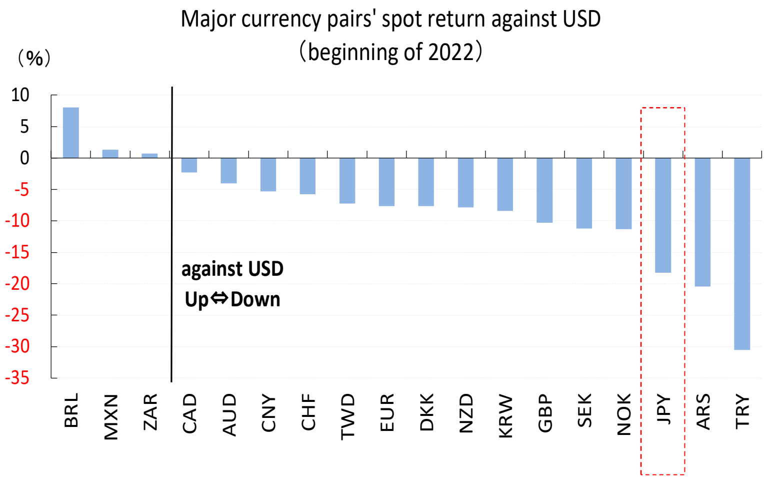
JPY Began to Weaken in March, USD Began to Strengthen in April

In addition to the aforementioned weaknesses of Japan, USD has recently been strengthening across the board in forex markets, in tandem with U.S. interest rates. As I have repeatedly pointed out in this report, it was around late April that USD (nominal effective exchange rate, NEER) began to appreciate clearly – this was two months after it became clear that JPY was beginning to weaken in earnest, sometime in early March. This seems to indicate that the current phase of JPY depreciation is not the result of an increase in U.S. interest rates or the associated appreciation of USD. As the figure shows, it is only since late April that USD's NEER and JPY have been in an inverse relationship with each other. In March, JPY was falling rapidly while USD was more or less level (or gently weakening, to be precise). I believe these NEER trend shows that the current phase of JPY weakness is not really attributable to USD strength.



(Source) macrobond

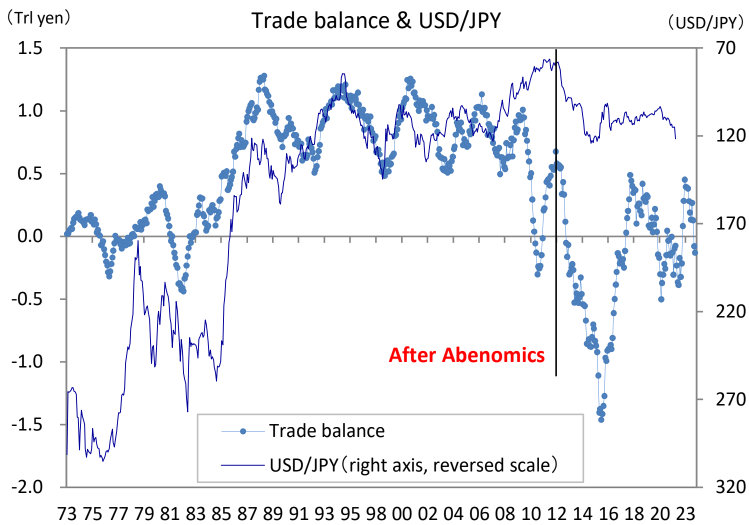
Further, JPY weakness is quite conspicuous even when compared with the year-to-date movement of a wide range of other currencies against USD. As the figure shows, most currencies have weakened against USD, but JPY sales against USD appear to be markedly large compared with most other currencies, beaten only by the Argentine Peso (ARS) and the Turkish Lira (TRY). Both these countries have experienced +60~70% yoy increase in their consumer price indexes (CPIs) and are chronically plagued by doubts regarding the neutrality of their central banks and the sustainability of their government debts. Most market participants would not buy into the reasoning that the significant weakening of these currencies is merely a by-product of USD appreciation. Meanwhile, the margin of JPY depreciation is similar to that of these two currencies. Could it not be that JPY should be grouped together with ARS and TRY into the category of currencies that have been sold off not just as a result of USD appreciation but also due to domestic factors? To repeat, the current phase of JPY depreciation is difficult to fully explain away as a by-product of USD appreciation.



(Source) macrobond (Note) up to 21JUN2022

JPY Depreciation Trend in 1998 Ended with Fed Rate Cuts

The JPY depreciation phase of 1998, which is often compared with the current one, found some respite when the Fed called an emergency meeting and embarked on a series of emergency rate cuts (FF rate cut by a total of 75 bps over three rate cuts between September and October 1998) following the Russian LTCM crisis. If we assume that the Japanese government and the BOJ are unlikely to take any action in response to the current situation, perhaps the end of the Fed's normalization process would present an opportunity for an end to the JPY depreciation phase (my main scenario in this report has long been based on this assumption). However, to what extent JPY can recover as a result is a different question. The switch to JPY appreciation after the Fed's rate cuts in 1998 was explained as being driven by a rollback in JPY carry trade, but in those days, Japan was an export powerhouse. The fundamentals of the Japanese economy were pointing to JPY strength, which is a big difference

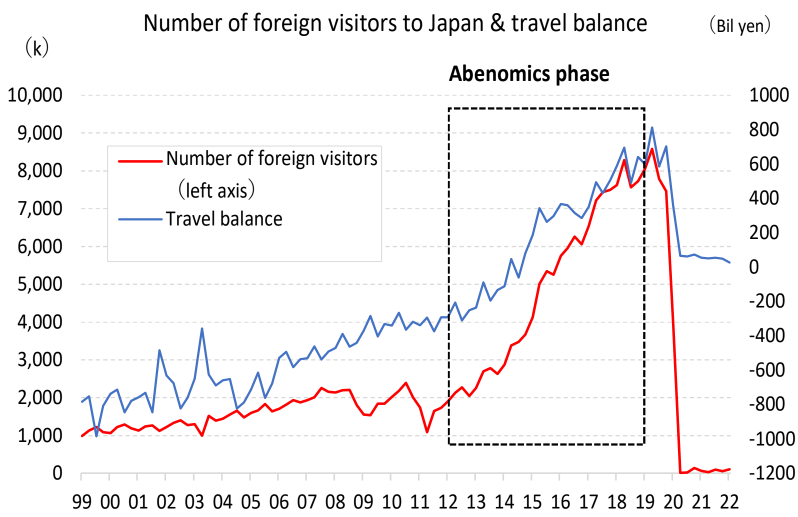


(Source) Bloomberg
(Notes) Trade balance is presented two years in advance and is based on a six-month moving average.

compared with the present. Of course, given that Japan subscribes to a floating exchange rate system, the unilateral JPY depreciation trend is bound to end at some point. However, the reversal of the trend may end up being no more than superficial. Given that Japan's trade deficit has expanded a whole notch over the past two years, it is also possible USD/JPY has entered a new rate range. Taking a longer view of the matter, one also gets the strong impression that the disappearing of Japan's trade surplus around 2012 has since prevented the formation of a JPY appreciation trend (see figure).

The Travel Surplus and JPY Supply and Demand

There was a key development in June that informs my analysis of JPY's supply and demand situation. Starting June 1, the Japanese government significantly relaxed its COVID-related border control measures and expanded its daily upper limit of arrivals into Japan from 10K previously to 20K. Further, arrivals from 98 countries/regions with infections under control were allowed to enter the country without airport testing or home/hotel quarantine requirements so long as they were able to show a negative certificate on a pre-departure PCR test. Further, starting June 10, Japan resumed the acceptance of inbound foreign tourists for the first time in around two years. In this context, I have been receiving a larger number of inquiries regarding the impact of this development on forex rates from the perspective of a travel surplus recovery. It must be noted here that, at its peak in 2019, the travel surplus hit around +JPY 2.7 trillion, with the number of foreign tourists to the country reaching around 32 million that year. The travel surplus for calendar year 2021 was less than one-tenth of this, at +JPY 208.4 billion – it would not be an exaggeration to say that it had nearly disappeared. The current account balance for 2021 was around +JPY 15.5 trillion for the calendar year and +JPY 12.6 trillion for the fiscal year. Against these figures, the +2.7 trillion travel surplus posted during the 2019 peak is not inconsequential, and it is quite understandable that there would be interest in the impact of the recent relaxing of inbound tourism restrictions on JPY rates.



(Source) INDB & Bank of Japan

No Impact

Given the upper limit on daily arrivals at 20K, it may be no exaggeration to say that the relaxation of inbound tourism restrictions will have close to no impact on JPY rates. A simple calculation based on the figure of 32 million tourists a year during the peak shows a daily arrival of around 88K tourists. Capping daily arrivals at 20K implies accepting less than a fourth of the potential demand for inbound tourism. At this pace, the travel surplus will amount to around +JPY 680 billion in a year and a monthly average of around +JPY 57 billion. The year-to-date monthly average of Japan's trade deficit, which is cited as one of the key factors driving JPY weakness, is currently -JPY 1.3 trillion. With a cap at 20K inbound tourists a day, the travel surplus for an entire year can at best cancel out half a month's worth of trade deficits. There is already talk of raising the cap to 30K arrivals per day starting July, but this is still a drop in the ocean. The current policy of national isolation Japan is ridiculed for is difficult to justify, either scientifically or economically.

Inbound Tourists Will Come from Free Countries

In the past, 30% of all inbound tourists to Japan were from China, which is currently obsessed with a zero-COVID policy. Therefore, even if Japan were to lift all entry restrictions, one would still have to assume a lack of demand from China, so that a full recovery of inbound tourism to its peak status would be difficult. Of course, with JPY's purchasing power dropping to its lowest level in 50 years, the purchasing power of other currencies relative to JPY has increased a notch. Therefore, even if the number of inbound tourists declines, perhaps the amount spent in Japan per tourist will increase. In other words, one may be able to expect a price effect rather than a volume effect in the recovery of the travel surplus. However, keeping in mind the wealth distribution effect inbound tourism has for regional economies, the ideal scenario would also include a large volume of inbound tourism, and in this sense the cap on daily arrivals is greatly damaging.

Further, Japan should avoid compelling inbound tourists to comply with its unique anti-pandemic measures. Answering questions in the Diet, Prime Minister Kishida said, "Foreign tourists would have to comply with Japan's masking rules," indicating his intent to ask foreign tourists to mask up. However, there are no clear rules mandating masks in Japan, simply a sense that one must wear them. One has to wonder whether enforcing such abstract requirements on tourists who come to Japan to have a good time is an appropriate move on the part of a country that may have to depend on tourism for its revenues going forward. Japan is further restricting tourists to small groups who come as part of package tours that are strictly monitored. To put it harshly, this amounts to treating foreign tourists, who are a source of precious foreign currency revenues for Japan, as a nuisance and turning them away at the gates. One cannot help feeling that such a policy will prove disastrous for Japan in the medium to long term. Can Japan hope to earn a satisfactory level of travel balance under such a rigid climate, with a cap of 20K or 30K arrivals per day? It will be interesting to see the trend of growth in the travel surplus going forward. It must not be forgotten that most foreign tourists will arrive from countries that are freer than Japan (i.e., in the post-pandemic phase).

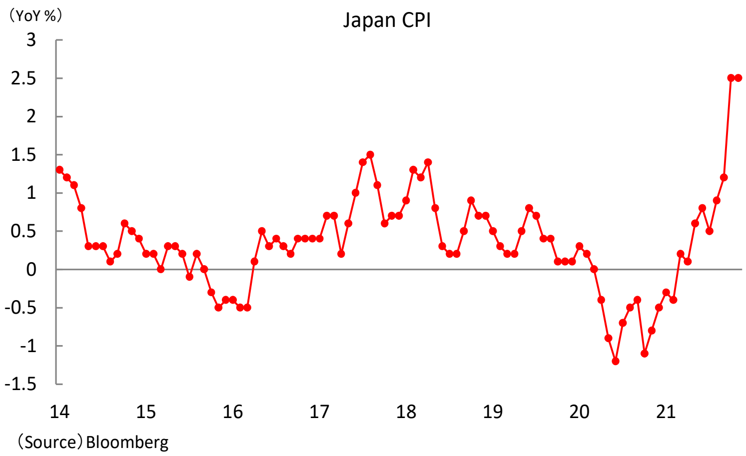
The Current State of the Japanese Economy and JPY Weakness – The End of Reflationary Policies

Curtain Call for Reflationary Policies
BOJ Governor Haruhiko Kuroda delivered a speech in Tokyo on June 6, in which he said in the context of rising product and service prices, that "Japanese households have increased their tolerance for rising prices," and described this as an "important change" when it comes to realizing sustainable price growth. This invited widespread criticism. Further, his remarks were part of a pre-prepared speech, so they cannot be brushed away as a slip of the tongue. Very simply, they were a case of lack of diplomacy.

Not to defend Kuroda's remarks, but the fact is that they do not conflict with the BOJ's hitherto policy stance. Since 2013, the BOJ's reflationary policies under Abenomics have been aimed at overcoming the stubbornly pro-deflation sentiment of Japan's private sector (especially the household sector) through fiscal and monetary expansion, thereby helping raise inflation expectations. In other words, the policies were aimed at creating a society in which inflation (in lay terms, "price increases") can take place more easily. With an increase in prices, wages were also expected to increase, resulting in economic recovery. Clearly, it is perverse to consider "price increases" to be the cause and "economic recovery" to be the effect, but this policy concept received passionate support from the private sector nine years ago. Under its banner, the BOJ has persevered with monetary easing despite a global rise in inflation concerns, and pushed ahead with fixed-rate operations disregarding the weak JPY trend. Irrespective of whether right or wrong, the one thing that can be said of the BOJ's policies under Kuroda is that they have been consistent.

Kuroda's remark that "Japanese households have increased their tolerance for rising prices" was probably meant to imply that inflation expectations are slowly beginning to increase. However, what with media headlines reporting it as Japanese households are increasingly "accepting price increases," it triggered a major backlash, with many newspaper, magazine, television, and other media reports criticizing it. To be honest, the whole incident does seem like an overreaction to Kuroda's words in some ways, but it has also decisively shown how unwilling Japanese people are to accept price rises. The policy was passionately accepted when introduced in 2013, following the switch from a Democratic Party of Japan administration, but the recent public-opinion backlash just as it comes to fruition appears to have brought the policy to an end in some ways. I would like to believe that the recent incident is a curtain call for the BOJ's reflationary policies, which have been continuing since 2013.

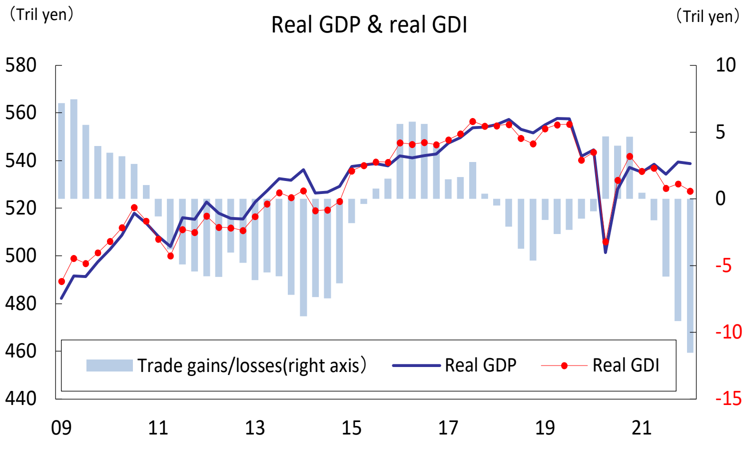
Not "Accepting" but "Resigned to" Price Increases
Kuroda withdrew his own remark on June 7, when he addressed the House of Councillors Financial Affairs Committee, saying, "I did not intend to say that households were voluntarily accepting price rises. I apologize for inviting a misunderstanding." To be sure, even though the import of his remark may have been based on the BOJ's policy intentions over the past 9 years, the tone was quite inappropriate. The problematic remark was referring to the results of a questionnaire survey implemented by Tokyo University professor Tsutomu Watanabe in April – the survey asked respondents what they would do if the price of product they frequently purchased at a store they frequently visited was increased by 10%, to which over 50% of respondents answered that they would accept the price rise and continue to purchase the same product at the same store. In other words, Kuroda's remark was based on the truth, but as many people have pointed out, the behavior of these respondents is better characterized as "being resigned to" the price rise rather than "accepting" it. As the Consumer Price Index (CPI, figure) shows, prices of everyday products have been increasing in general for society as a whole, even without specifying "frequently purchased product" at a "frequently purchased store." Even under these circumstances, households still have to consume and invest in order to live. "Not accepting price rises and refusing to consume/invest" is increasingly no longer an option given inflation in present-day Japan. Coming at a time like this, it has to be said that Kuroda's remark was lacking in sensitivity.



(Source) Bloomberg

Harsh Income Climate as Seen from the Real GDI
Another reason Kuroda's remark came across as tone deaf was because it revealed a lack of awareness of how much the real income climate has deteriorated for the household and corporate sectors. At the present time, the income climate is visibly deteriorating across all sectors of the Japanese economy, so, it should be obvious to anyone that people are being forced to accept price rises. A look at the real GDI (gross domestic income) makes this very clear. Compared with the real GDP, which is an indicator of the economy's production climate, the real GDI, an indicator of the economy's income climate, is a more revealing indicator of the problems the Japanese economy is currently

battling. As I have mentioned in past issues of this report, Japan's real GDI has been much more conspicuous in its stagnation than its real GDP (gross domestic product). The difference between GDI and GDP is the terms of trade (i.e., trading gains or losses), so GDI declines with an increase in income outflow from the economy (trade losses). This naturally also indicates a deterioration of the real income climate through an increase in prices.

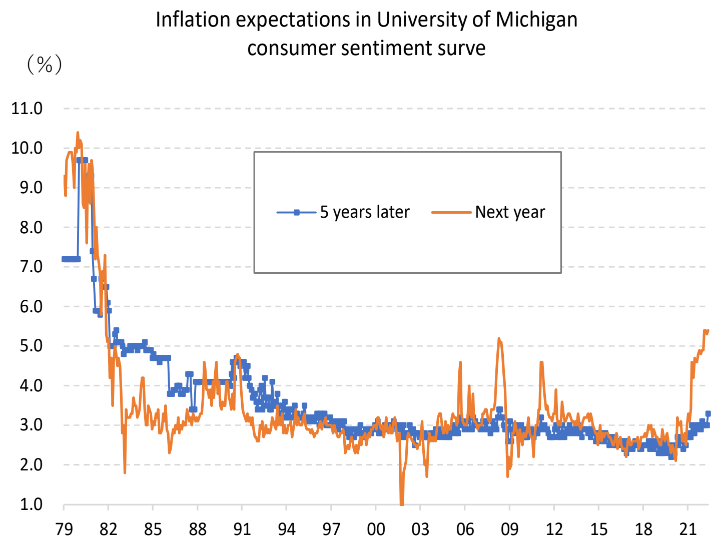


(Source) Cabinet Office

The widely rumored "undesirable JPY weakness" also ultimately just reflects the fact that the cost of JPY weakness is being borne by the household sector. One could say that the gist of the problem lies in "the improvement or deterioration of real incomes" rather than on "the desirability or undesirability of JPY weakness." As JPY weakness functions to expand trade losses through an increase in import prices, it becomes easy to criticize it as being "undesirable." Of course, it could also be seen as "desirable" from the perspective of, say, large corporations and export firms, which profit from a weak JPY, but it is perhaps more "undesirable" than "desirable" if one goes by the number of economic entities affected, which is probably the reason behind such a strongly pessimistic mood surrounding JPY weakness and price increases. At any rate, the recent furor has had the effect of connecting the two issues of "public distaste for price increases" and the "BOJ's monetary policies" – something the government and the BOJ wanted to keep from happening. It will be interesting to see how this changes the actions of the government, which had until recently remained unconcerned with monetary policies.

U.S. Monetary Policies Now and Going Forward – Overkill Continues

Overkill Continues



(Source) macrobond

At the much-anticipated FOMC meeting, it was decided to raise the FF target rate range by +75bp, to 1.50-1.75%. In other words, the Fed further accelerated its pace of rate hikes from the previous time's +50bp to +75bp this time following the June 10 release of the U.S. May CPI, which had accelerated more than expected, and the June University of Michigan Consumer Sentiment Index, which posted its worst ever on record. This is the first time in 27 years and 7 months, since November 1994, that the Fed has increased the FF rate by 75bps. Powell specifically mentioned that the "Michigan [survey] reading…was quite eye-catching," and that the increase in inflation expectations revealed by the survey was "one of the factors in our deciding to move ahead with 75 basis points." Following such a clear statement, it seems inevitable that the University of Michigan index will become an important economic indicator to focus on alongside the CPI from next time onward (see figure on previous page). In fact, one-year-ahead inflation expectations are soaring in a nonlinear manner, and there is a strong possibility that there will be a move to set new prices for goods and services based on this.

Of course, there remain concerns how the Fed's acceleration of rate hikes based on a single month's economic indicator releases will affect the real economy from next year onward, but it seems likely that the tight employment and wage markets may be beginning to make inflation sustainable. If so, the current phase may be conducive to increasing the number of jobless persons (i.e., the unemployment rate), and perhaps this is the real reason the Fed refuses to stop going overboard with monetary tightening. As Powell mentioned in his press conference, it is pointless to discuss a tradeoff between rate hikes and economic slowdown during this phase, with excess demand driving inflation, so it may be reasonable to view this as a phase of attempting to contain inflation by encouraging an economic slowdown.

Soft Landing May be Possible Given Job and Wage Situations

As for the FF rate projections of Policy Board members (the dot plot), the median of projections for the end of 2022, 2023, and 2024 were 3.375%, 3.750%, and 3.375%, respectively, indicating the possibility of a rate cut in 2024. Still, compared with the previous time (March), the projections this time had increased significantly, by 1.50pp, 1.125pp, and 0.75pp, respectively. Despite an increase in the neutral interest rate from 2.25% to 2.50%, the policy path for the current forecasting period is still projected to realize monetary tightening beyond the neutral interest rate level. Further, a total of 1.75pp worth of rate hikes would have to be implemented over the remaining four meetings for this year to realize the dot plot projection for the end of the current year. A +50 bp increase at each of the July and September meetings will bring the FF rate up to the neutral interest rate level, and given the high likelihood of another +75bp rate hike in July, it seems very likely that U.S. interest rates during the October-December quarter this year will be higher than the neutral interest rate level.

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

FOMC Date	2022	2023	2024	Longer run
Jun-21	0.125%	0.625%	n.a.	2.500%
Sep-21	0.250%	1.000%	1.750%	2.500%
Dec-21	0.875%	1.625%	2.125%	2.500%
Mar-22	1.875%	2.625%	2.625%	2.250%
Jun-22	3.375%	3.750%	3.375%	2.500%

(Source) FRB

When this happens, the word “recession” is likely to be heard much more frequently. However, though I repeat myself, a significant economic slowdown may be a necessary condition for bringing the raging inflation under control. The Summary of Economic Projections by Policy Board members (SEP, see chart to the right) also indicates a significant reduction in real GDP growth rate during the current forecasting period, while the unemployment rate projections (4.0% median value) remain mostly below the natural unemployment rate. It has to be said that, if the current situation really continues this way, the U.S. economy may achieve a soft landing despite the rapid pace of monetary tightening. The main concern is – will the job and wage situations deteriorate as gently as assumed?

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

	2022	2023	2024	Long-term
Real GDP Growth rate	1.7	1.7	1.9	1.8
as of MAR	(2.8)	(2.2)	(2.0)	(1.8)
Unemployment rate	3.7	3.9	4.1	4.0
as of MAR	(3.5)	(3.5)	(3.6)	(4.0)
PCE inflation rate	5.2	2.6	2.2	2.0
as of MAR	(4.3)	(2.7)	(2.3)	(2.0)
Core PCE inflation rate	4.3	2.7	2.3	
as of MAR	(4.1)	(2.6)	(2.3)	

(Source) FRB

Impact on FX

How should one interpret the possible impact of such actions by the Fed on the forex markets? For some time to come, an important factor to take into account when analyzing forex market trends is that, not just the Fed, but also the ECB, the SNB, and other central banks (which had been with the BOJ in the same group of central banks implementing negative interest rates) are embarking on policy normalization one after the other. The policy interest rates of the major nations are already as shown in the figure on P.4, with the BOJ conspicuously remaining the only central bank to show no interest in rate hikes as of the moment. The ECB has not yet begun to increase its rates, but it has already announced the intention to return to positive interest rates starting September, while the SNB, which had the deepest negative interest rate level, moved to increase its rates in June (details later).

By contrast, Kuroda recently remarked that the BOJ would support the economy by being “unwavering in its stance of maintaining powerful monetary easing.” <u>In the forex markets, where currency rates are determined on a relative basis between a pair of currencies, this is too wide a gap in stance between the BOJ and other central banks</u>. Under these circumstances, the BOJ will become increasingly isolated as the only central bank to employ negative interest rates. JPY could be sold off simply based on expectations of future carry trade, whether or not such transactions actually take place in the event. Moreover, unlike during the previous phase of brisk JPY carry trade in 2006-07, Japan is no longer a major trade surplus country, but a major trade deficit country (the May trade surplus was the second largest ever posted, at over -JPY 2 trillion). <u>The fundamentals, including JPY interest rates and demand, are bolstering the justification for a weak-JPY trend by the minute</u>.

Risks to My Main Scenario – Intensifying Indications of a Pseudo-Currency Crisis

Non-Japanese Market Players Temporarily Depress USD/JPY

The BOJ Monetary Policy Meeting (MPM) on June 16-17 decided to maintain the current level of monetary easing. The Swiss National Bank (SNB) announced a surprise 50bp interest rate hike a day before the meeting, and speculation that the BOJ would follow the SNB’s example caused USD/JPY to drop considerably, but USD/JPY returned to its recent record high levels following the meeting. However, there were probably very few Japanese market participants who thought it likely that the BOJ would adjust the monetary easing policy it has maintained for the past nine years (despite criticism that the policy is unreasonable) in light of a single surprise interest rate hike by the SNB. It seems that USD/JPY was temporarily depressed primarily by the expectations of non-Japanese market players betting on the collapse of the BOJ’s yield curve control (YCC) system, and it appears that this presented trading opportunities for market players who had been awaiting a temporary dip in USD/JPY.

Significance of "Foreign Exchange" in MPM Statement

However, the BOJ did in fact express concern about JPY's recent depreciation. The portion of the June MPM statement discussing "risks to the outlook" includes a statement that – "it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices." BOJ MPM statements do not ordinarily use the phrase "financial and foreign exchange markets". The usual phrases employed include "international financial market trends", seen during the super-strong JPY period in 2011, or the more-commonly used "financial and capital market trends" phrase. Since it is unusual for the BOJ to specifically mention the sensitive topic of "foreign exchange", many observers consider that phrase's use to be a clear indication that the BOJ is particularly concerned about it. For example, the statement for the MPM meeting held on September 19, 2012 (in the month before JPY reached a record high level) included the sentence – "financial and foreign exchange markets need to be careful about the impact of financial and foreign exchange market trends on the economy and prices". Thus, the recent use of the "foreign exchange markets" phrase appears to be a subtle indication that the BOJ is approaching its peak level of concern regarding foreign exchange markets.

In his most recent his appearance before the Diet, Kuroda warned that JPY was depreciating rapidly and described it as a negative trend. The use of the "foreign exchange markets" phrase in the MPM statement is just a written confirmation of that warning. One may wonder if the warning's written confirmation might suggest that some countermeasures will be taken, but it may well be that no such countermeasures are being planned. Observers will naturally have various tentative theories about what might be planned, but my basic understanding is that we have no choice but to wait and see, since it is hard to conceive of a realistically good policy response, and the responses that emerge are likely to be no more effective than temporary placebos. On the other hand, additional easing was approved at the time of the abovementioned September 2012 statement, and further additional easing was approved in the following month. This suggests that there may indeed be a possibility that some measures are being considered when the BOJ employs the "foreign exchange markets" phrase. In fact, the actual timing of countermeasures (monetary tightening in this case) is generally understood to be determined by when it becomes politically unacceptable not to take countermeasures. In this regard, it is noteworthy that public opinion polls conducted during June by national Japanese newspapers (Nikkei and Mainichi) showed signs that support for the Kishida government was being undermined by the trends of JPY depreciation and price rises.

While it may be unusual for the BOJ to explicitly mention foreign exchange trends, it is obviously normal for central banks to pay close attention to such trends. For example, when EUR exchange rates fluctuate significantly, the ECB usually points out that "exchange rate volatility" is a risk factor. Currency exchange rates indicate the external value of a currency just as a country's domestic price index (CPI) indicates the domestic value of that currency, so it stands to reason that central banks aiming to stabilize prices will be concerned about exchange rate fluctuations. In fact, currency exchange rate fluctuations should naturally be among the principal indicators that all central banks closely monitor. In Japan, it is considered somewhat of a taboo for the BOJ to explicitly concern itself with foreign exchange trends because of the formal division of roles between the Ministry of Finance (responsible for currency policy (external currency value)) and the BOJ (responsible for monetary policy (internal currency value)), and this is a division of roles that is common throughout the world.

A Pseudo-Currency Crisis

Regarding future monetary policy management, at his most recent press conference, Governor Kuroda dismissed the possibility of raising the upper limit of the YCC 10-year interest rate to above 0.25%, saying he was not considering such a possibility as it would weaken the effect of monetary easing. In fact, even if the 0.25% limit were raised to 0.30%, it would only encourage the markets to begin pushing for additional hikes to 0.35% or 0.40%, so it can be understood that totally abstaining from such dialog with the markets is an approach that has its virtues. Moreover, so long as the BOJ says it will buy unlimited volumes of Japanese government bonds (i.e., unless the BOJ discontinues the actual implementation of that policy), overseas speculators' bond selling activities aimed at driving down bond prices will not be successful, although they are attracting considerable attention.

On the other hand, even if the government bond market cannot be destroyed, if the general trend of JPY selling in forex markets continues, there is speculation that the BOJ will take measures with an eye toward alleviating associated damage to the Japanese economy. However, it is probably impossible to countervail factors promoting JPY selling by merely including "it is necessary to pay due attention … to developments in financial and foreign exchange markets" in an MPM statement. The history of international finance is replete with examples of currency crises that began with the fixing of exchange rates at inappropriate levels and decisions to maintain those levels at all costs but then led to selling by speculators that drove the exchange rates down. The outcome is frequently the abandonment of the fixed exchange rate level in question by means of a devaluation. No matter how determined a central bank may be to take reckless measures to counter forex market fundamentals, it will be fighting a losing battle. Japan is now recording huge trade deficits and it is about to become the world's only country to employ negative interest rates. In addition, while inbound tourists are a valuable means of acquiring foreign currency, such tourists are being turned away from Japan. The most troublesome thing about the current trend of JPY selling is that it is in line with forex market fundamentals, and it is not something that the BOJ can countervail alone.

While the BOJ is fixing interest rates rather than exchange rates, it can be argued fairly convincingly that the situation is comparable to the abovementioned currency crisis example. JPY depreciation is now believed to be damaging Japan’s economy, and it is also believed that the YCC system’s expansion of the Japan-US interest rate differential is promoting the JPY depreciation trend. If this problematic JPY selling trend continues, it seems reasonable to anticipate that the BOJ will one day embark on a monetary easing adjustment (a move toward tightening) that promotes JPY appreciation. It should be easy to profit by continuing to sell JPY based on rumors (speculation) and then buying it back based on facts (monetary tightening decisions). Since Japan has a floating exchange rate, there is no question of “abandoning a fixed exchange rate level” even if JPY selling continues, but if JPY depreciation generates problems for Japan’s economy that are deemed to be approaching the tolerance limit, it is impossible to preclude the possibility that these problems will dictate the abandoning of the YCC system’s desired 10-year interest rate level. Since USD/JPY entered the 130-135 range, it appears that the market is attempting to bring about that scenario. In a sense, it may be reasonable to consider the current situation to be a kind of pseudo-currency crisis. Of course, it is up to the Kishida government to determine when JPY depreciation reaches a level that impacts Japan’s economy to an intolerable degree, and the basis for that determination will probably be the government’s approval rating. The lower the government’s approval rating becomes, the more feasible the speculative scenario. Price increases have already begun affecting the government’s approval rating, and the key issue to watch is whether this trend will begin intensifying from July.

Modest Adjustment to Allow Interest Rates to Move Above 0.25%?

Are there any signs the BOJ might move in the direction of monetary policy normalization? As long as the Kuroda system continues, it will be difficult to discontinue negative interest rates, so it seems that the only policy adjustment moves the BOJ would consider might be minor revisions to the YCC system. It was apparently expected that the BOJ’s April decision to undertake fixed-rate JGB purchase operations every business day would be smoothly accepted and not become a factor promoting JPY selling, but in light of the now-evident potential for a pseudo-currency crisis, it seems that the main battlefield for struggles with speculators has been prepared. Although it cannot be expected based on Governor Kuroda’s latest press conference, since the act of setting the 0.25% interest rate level as a level to be defended at all costs itself provokes speculation, there may be minor modifications to the YCC system so that it can flexibly work to counter price movements pushing interest rates above 0.25% without openly specifying that level as the absolute allowable limit. While such a modification might spur headlines simplifying the significance to something like “BOJ accepts rising interest rates”, it would have a positive effect with respect to the goal of restraining JPY depreciation. The YCC system already has an allowable deviation range of ±25 bps from the target levels, and if that were adjusted to ±30 bps, it could probably be successfully defended as a minor adjustment of the deviation range rather than of the policy itself (although it will be challenging to make that argument successfully.)

Since last year, I have been persistently arguing that that JPY depreciation is likely to affect BOJ monetary policy management as soon as it alarms the public and begins depressing the government’s public approval rating, and the actual situation now seems to be bringing that scenario closer to realization. Perhaps the BOJ will argue that conducting fixed-rate operations at 0.25% or higher is not a policy relaxation but an introduction of greater “flexibility”, but while some people will accept that argument, the financial markets will not be confused about the BOJ’s motives. If adjustments are undertaken in this manner, I think Governor Kuroda will also find the increased flexibility to be convenient.

EUR Outlook – ECB Awakens to Urgent Need for Normalization

EUR Area Monetary Policies Now and Going Forward – Restless Lagarde-Style Management

Blog-Confirming Policy Decisions

As expected, the ECB's June Governing Council meeting confirmed the content of ECB President Lagarde's controversial blog post on May 23. Specifically, the meeting's statement states there will be a 25bp rate hike in July, suggests a possibility of a larger hike (by perhaps 50bp) in September, and hints that additional rate hikes will be implemented from October. In light of the suggestions or hints, it can be said that the statement contained more information than the blog post. The statement clearly explains that net asset purchases under the asset purchase programme (APP) will be discontinued on July 1, and, although this decision does not contradict the previous guidance indicating that APP will end during the July-September period, one gets a clear impression that the ECB was rushing to end the program. In any case, the ECB has officially declared the normalization of quantitative easing and can now move forward with the normalization of interest rates. Plans call for the July 21 Governing Council meeting to raise the deposit facility interest rate (-0.50%), the major refinancing operation interest rate (0.00%), and the marginal lending facility interest rate (+0.25%) by 25bp each.

Of course, <u>if the interest rate hike range and schedule have been set for six weeks already, one wonders why the Governing Council did not simply approve the planned moves at the June meeting</u>. It appears that the Governing Council has been seeking to maintain its commitments to both "raising rates after the end of the APP" and "ending the APP during the July-September period" (the actual interest rate hike decisions have to follow the July APP termination decision), but in order to respond to urgent inflation concerns it expedited its announcements of upcoming interest rate hikes. Looking back, it seems the Governing Council should have hinted at the APP termination timing when the PEPP was terminated, but it was still mistakenly planning at that point to achieve a soft-landing by temporarily doubling the amount of monthly purchases. It is always difficult for central banks manage policies with a truly forward-looking perspective.

The factor prompting the ECB to accelerate its progress toward normalization is the unexpected rise in prices. This is clearly explained at the beginning of the June Governing Council meeting's statement. The statement's third paragraph begins by saying – "In May inflation again rose significantly" – and goes on to point out that the euro area Consumer Price Index (HICP) surged greatly in May. That paragraph explains that the increased inflation was "mainly because of surging energy and food prices" but also notes that "inflation pressures have broadened and intensified", and this clearly indicates that the ECB has modified its previous view that inflation was a transient, product price-led phenomenon. As explained below, the new Eurosystem staff projections have elevated prospective HICP levels throughout the forecast period, and this situation has required the Governing Council to take countermeasures

Prospective Rate Hikes Every Three Months?

As mentioned above, the statement gave specific information regarding the policy interest rate's prospective trajectory. It first states – "Accordingly, and in line with our policy sequencing, we intend to raise the key ECB interest rates by 25 basis points at our July monetary policy meeting." The inclusion of the "in line with our policy sequencing" phrase reflects the ECB's emphasis on operating in accordance with its forward guidance. The statement goes on to say – "we expect to raise the key ECB interest rates again in September. The calibration of this rate increase will depend on the updated medium-term inflation outlook. If the medium-term inflation outlook persists or deteriorates, <u>a larger increment</u> will be appropriate at our September meeting." So, the September rate hike may be revised depending on the outlook as of September and, <u>based on this, the markets now appear to be anticipating a 50bp interest rate hike in September</u>.

The statement goes on to say – "beyond September, based on our current assessment, we anticipate that a gradual but sustained path of further increases in interest rates will be appropriate." So it appears that hikes of 25bp in July and 50bp in September are the default routes, while the subsequent "gradual but sustained path" hints at what the ECB anticipates the September staff projections will indicate. Once the ECB has implemented its first 50bp interest rate hike, it may be difficult for it to return to 25bp increments, <u>suggesting a possible base scenario of 50bp hikes every 3 months</u>.

The ECB has also added "data-dependence" to its three principles of conduct (optionality, gradualism and flexibility). As this seems to have further increased the importance of the quarterly staff projections, a reporter at the post-Governing Council-meeting press conference asked whether it is reasonable to anticipate quarterly rate hikes, to which President Lagarde responded that – "we are not going to put ourselves in a straitjacket of only taking decisions when we have projections." However, <u>since it has been made clear that staff projections indicating that "the medium-term inflation outlook persists or deteriorates" will serve as the basis for expanding the rate hike margin to 50bp in September, it is inevitable that there will be anticipation of possible rate hike adjustments at the time of the staff outlook revisions (March, June, September, December)</u>.

Balance Sheet Scale to be Discussed in the Future

The ECB has already shifted considerably toward hawkishness, and it seems that the its balance sheet (BS) scale will inevitably become the next focus of policy adjustments. Currently, the ECB plans – "to reinvest the principal payments from maturing securities purchased under the PEPP until at least the end of 2024". – and this policy appears to be based on the idea that the stock effect of BS scale maintenance was more important than the flow effect of net asset purchases. Given the ECB's current fear of inflation, it would seem dangerous to leave this policy as it is, but the June Governing Council meeting decided to maintain the policy. A reporter at the press conference naturally posed a question about whether maintaining the policy is truly appropriate or not, to which President Lagarde responded – "It is a matter that we will be discussing within the Governing Council, which we have decided not to debate today. We had, as I said, plenty to do already in the last couple of days. But we will be looking at it[.]" <u>This response suggests that the reinvestment policy decision may perhaps have been postponed because the June Governing Council meeting already had diverse issues on its agenda, but this is an extremely important issue that may well have a considerable effect on financial markets going forward.</u>

Can the ECB Become More-Similar to the Fed or the BOE?

A key question is whether the ECB will sustain its shift toward hawkishness. The Fed and the Bank of England (BOE) have positioned inflation countermeasures as a top priority regardless of trends in economic conditions, and it appears that their monetary policies will be highly predictable at least this year. As the ECB is overseeing a euro area economy that includes relatively fragile economies (particularly in Southern European countries), however, there are doubts about whether it will be able to maintain the kind of resolute postures adopted by the Fed and BOE. In fact, some observers are suggesting that the lack of discussion about the reinvestment policy reflects the views of some Governing Council members who are particularly concerned about the impact tightening the financing environment may have on those relatively fragile economies.

ECB staff outlook（JUN 2022） (%)

	2022	2023	2024
HICP	**6.8**	**3.5**	**2.1**
（Previous：MAR 2022）	5.1	2.1	1.9
Real GDP	2.8	2.1	2.1
（Previous：MAR 2022）	3.7	2.8	1.6

(Source)ECB (Note) EURUSD is assumed to be 1.07 year 2022 and 1.05 year 2023 - 2024

Nonetheless, <u>given the ECB's apparent commitment to increasing interest rate hike margins if staff projections (revised every three months) indicate that "the medium-term inflation outlook persists or deteriorates", it seems that the ECB is likely to maintain its shift to hawkishness so long as there is no major change in the projections</u>. At the press conference, President Lagarde stated that the ECB is – "very attentive to wages, wage negotiations and to the risk of second-round effects and potential spiralling." but "We are not seeing the risk of spiralling at all[.]" – however, given the widespread upward pressure on the HICP, it will be increasingly dangerous for her to discount the likelihood of spiraling going forward. The latest staff projections anticipate that HICP will decelerate significantly over the next twelve months but will be +3.5% in 2023 and +2.1% in 2024, remaining above the 2% target level. The June Governing Council meeting's statement notes in this regard that – "This means that headline inflation at the end of the projection horizon is projected to be slightly above our target." With this outlook, it would be hard for the ECB to rationalize a shift to more-dovish policies in the near future. As the Fed and BOE are doing, the ECB seems likely to continue tightening its policies unless there is a clear respite in the pace of problematic HICP and employment/wage trends. ECB policy decisions are thus expected to be based largely on economic fundamentals, and this is likely to make the policies easier to anticipate.

Of course, since the euro area's economy is not as strong as those of the United Kingdom and the United States, which are benefitting from strong domestic demand, there is a high possibility that the ECB's shift to tighter monetary policies may lead to overkill with respect to the euro area economy. However, my basic view is that the ECB is unlikely to consider revising its relatively hawkish stance unless the entire euro area falls into a technical recession (negative growth for the two consecutive quarters). I do not think the ECB would have hurried to announce its relatively hawkish stance via a blog post if it were not prepared to cope with a certain amount of economic repercussions. By the way, I was surprised to see that there was no mention of the issue of information dissemination via blog posts at the most recent press conference, and I suppose that this may indicate that reporters consider such blog post information dissemination to be somewhat justified in light of recent circumstances. In any case, the euro area's economic and financial situations are generally acknowledged to be in a critical state requiring rapid response measures.

Significance of Emergency Governing Council Meeting

On June 15, about a week after the above-mentioned regular Governing Council meeting, the ECB hurriedly issued a press release entitled "Statement after the ad hoc meeting of the ECB Governing Council". The main focus of the ad hoc meeting was "resurgent fragmentation risks" within the euro area – such fragmentation risks are regularly noted on the occasion of each crisis the ECB faces. Ever since it began moving toward normalization last December, the ECB has repeatedly indicated that it is prepared to take flexible measures to counter fragmentation, and it reiterated that point at the June 9 regular Governing Council meeting prior to the ad hoc meeting. The ad hoc meeting's agenda thus appears to be consistent with the ECB's previous information dissemination. <u>As the regular Governing Council meeting was held just a before the ad hoc meeting, however, one gets the impression the ECB has begun undertaking ad hoc policy management (explained in greater detail below)</u>.

As the ECB frequently uses the phrase “market fragmentation”, it merits a bit of supplemental explanation. Financial market conditions are often different in different euro area countries but, especially at times of crisis, the vulnerabilities of euro area countries in southern Europe and elsewhere are frequently accentuated, causing some countries’ government bond yields to show sharp increases. The ECB generally devises a single monetary policy for 19 countries’ disparate financial markets, and it sometimes faces situations in which its ordinary policy measures are unable to effectively counter such exceptional fluctuations. The ad hoc meeting’s statement notes that – “The pandemic has left lasting vulnerabilities in the euro area economy which are indeed contributing to the uneven transmission of the normalization of our monetary policy across jurisdictions.” – which is essentially saying that the ECB’s existing policies are unable to realize their intended effects.

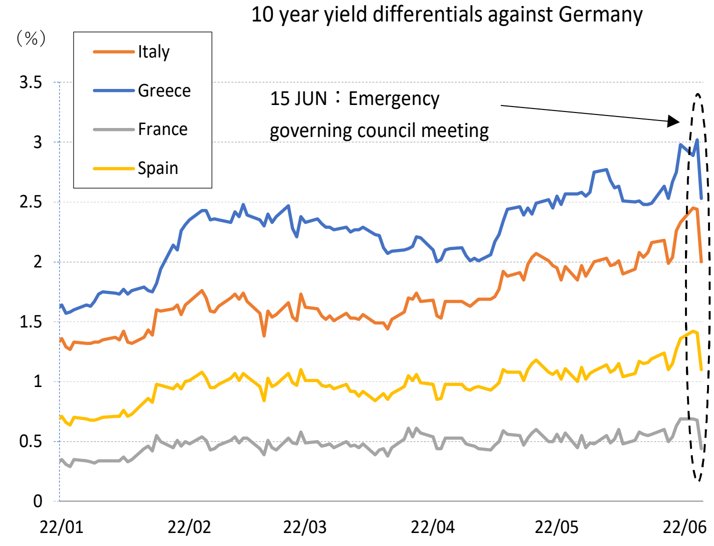
Such market fragmentation situations were often considered problematic during the European debt crisis, when interest rates in Southern European countries did not fall even after monetary easing policies were implemented. The ECB’s first asset purchasing program was the securities markets programme (SMP), which was introduced in May 2010 to respond to market fragmentation during the early stage of the European debt crisis. The SMP subsequently evolved into the outright monetary transactions programme (OMT) announced by former ECB President Draghi in September 2012 in his famous “whatever it takes” speech. (The OMT replaced the SMP.) <u>Interest rate disparities within the euro area that the ECB believes are not justified by fundamentals are considered to be evidence of fragmentation, and the ECB works to countervail such fragmentation through measures (purchases) focused on the government bonds of specific countries</u>.

Anti-Fragmentation Measures

The recent ad hoc Governing Council meeting was convened to respond to a sharp rise in the yields on the government bonds of Italy and other southern European countries. Although the meeting’s statement does not go into detail about the response measures, it does specify that the Governing Council will (1) “apply flexibility in reinvesting redemptions coming due in the PEPP portfolio” and (2) “mandate the relevant Eurosystem Committees together with the ECB services to accelerate the completion of the design of a new anti-fragmentation instrument”. For the time being, it is believed that measure (1) will call for most of the PEPP reinvestment funds to be allocated for purchases of southern European countries’ bonds.

As the graph shows, the level of Germany-Italy and Germany-Greece bond yield differentials had been rising since late April, with a noteworthy surge for a week in June. The ECB has probably been particularly intent on responding to the increase in Italian government bond yields. After the June 9 Governing Council meeting, Italy’s 10-year Treasury yields exceeded 4% – a level not seen since late 2013, when the European debt crisis had not yet been completely resolved. Concerns about the possibility of a populist government taking control of Italy began gradually increasing during 2022 following that country’s presidential election in January, and a similar scenario has emerged in Spain. (Both Italy and Spain are scheduled to hold general elections next year.) Of course, the EU has established its Next Generation EU recovery fund (NGEU), and the ECB will seek to continue holding large quantities of government bonds purchased through the PEPP, but it is somewhat inevitable that the level of euro area government bond yields will tend to rise after the significant interest rate hike planned for July. The graph shows that bond yields in such semi-core euro area countries as France are relatively stable, so it is expected that funds from the redemption of such countries’ bonds will be flexibly reallocated to the purchase of southern European countries’ bonds. <u>However, it will not be possible to supply such preferential support without obtaining certain concessions in return. As always, it will be impossible to gain the support of Germany and other relatively strong euro area countries for such preferential support without attaching such conditions as those related to fiscal spending consolidation and structural reforms.</u> There will always be time-consuming struggles regarding the determination of such conditionality terms, and this may explain why the ECB has not yet announced specific anti-fragmentation measures.

10 year yield differentials against Germany



(Source) macrobond

Restless Lagarde-Style Communication

It is worth noting that just a week before the ad hoc meeting, Governing Council expressed its intention to adjust existing policies as needed to prevent fragmentation via the June 9 regular Governing Council meeting statement, and President Lagarde reiterated that intention at the post-meeting press conference. Nevertheless, it appears that the sharp rise in Italian government bond yields was perceived as being a reflection of the markets’ disappointment about the lack of announcement of concrete measures at the regular Governing Council meeting and that the emergency meeting was hurriedly convened to attempt to diminish that disappointment. In a sense, this can be considered a mistake.

The actual information announced following the ad hoc Governing Council meeting was almost the same as that announced on June 9. It has been pointed out that the ECB may have felt a particular need to reiterate its anti-fragmentation stance in light of growing expectations of a 75bp interest rate hike by the FOMC. As was the case regarding the May 23 blog post, however, the question of why the ECB does not simply concentrate its communications in statements at regular Governing Council meetings continues to be asked, and it continues to be pointed out that the Lagarde-led ECB's communication dissemination activities are being conducted in a conspicuously restless style. There is due cause for concern that discounting the communication dissemination role of regular Governing Council meetings (intended to be the ECB highest decision-making body) will eventually make it more difficult for the ECB to effectively undertake "dialog with the markets".

July Governing Council Meeting Agenda Predetermined

In late June, after the regular and ad hoc Governing Council meetings, a series of top ECB officials made remarks reiterating the message that an interest rate hike was coming in July. First, President Christine Lagarde said in testimony at the European Parliament on June 20 that the ECB intends to raise its policy rates by 25bp at the July Governing Council meeting, and she also expressed her desire to raise the rates further in September. At that time, she emphasized that – "we also have to make sure that our monetary policy is transmitted throughout the entire euro area." – and confirmed that the ECB was accelerating – "the design of a new anti-fragmentation instrument". That same day, ECB Executive Board member and chief economist Philip Lane is reported to have said that – "The European Central Bank will not revisit its decision to raise interest rates by 25bp at its July 21 meeting." – and to have gone on to say that negative interest rates were no longer appropriate. The ECB's negative interest rates will be lifted in two stages, with the deposit facility interest rate currently at -0.50% slated to be elevated to -0.25% in July, and it appears quite possible that rate will be raised by a larger margin in September. In light of the statements of the ECB's president and chief economist, it seems clear that the July 21 Governing Council meeting will make decisions on two points – (1) a 25bps interest rate hike and (2) the creation of a new anti-fragmentation instrument. In light of the momentum of events, it seems possible that discussions of point (1) may even extend to consideration of an interest hike by more than 25bp.

Possible Anti-Fragmentation Measures

I have recently been receiving numerous inquiries regarding the above point (2). This possible anti-fragmentation measures can be broadly divided into (a) flexible responses within the PEPP framework and (b) responses utilizing a completely new framework. While the nature of possible new frameworks are not yet known, it seems possible that the ECB may consider a new government bond purchase program focused on Southern European countries. Such a focused program cannot be gratuitous – its utilization will have to be predicated on the imposition of some kinds of conditions (such as those requiring fiscal spending consolidation and structural reforms). Depending on those conditions' degree of rigor, the program may become akin to an "ace up the sleeve" similar to the current outright monetary transactions programme (OMT). (There is also a basis for arguing that OMT should be used as the anti-fragmentation framework.) In fact, on June 20, Banque de France Governor Francois Villeroy de Galhau told an Italian newspaper that – "The more credible such instrument, the less it may have to be used in practice. This is how a backstop works." – and one gets a clear impression that he would rather not employ such an instrument. The ECB's ideal scenario is that government bond yields will be pushed downward by the mere fact that an anti-fragmentation framework has been created, but it may not be so easy this time as many countries' bond yields may be rising on parallel trajectories. As explained below, going forward, the ECB will be attempting a difficult task of concurrently playing hawkish and dovish roles.

On the other hand, regarding the abovementioned point (1), the ECB has been stating since last year that it intends to utilize flexibility regarding the reinvestment of funds from the redemption of assets purchased through the PEPP. Therefore, it is conceivable that the ECB will be able to depress Southern European government bond yields while maintaining a stable balance sheet size through such measures as those to take funds from the redemption of German government bonds and invest them in Italian government bonds. This is perhaps the easiest to implement anti-fragmentation countermeasure, and the key challenge would be deciding how much yield-depressing effect can be achieved by using it in combination with (2) the creation of a new anti-fragmentation instrument. Alternatively, it may possible to implement the reinvestment of funds in Southern European government bonds ahead of schedule, before additional funds are generated by actual bond redemptions. In such a case, the ECB will have to be careful to implement sterilization measures so that the overall monetary easing effect is not inadvertently strengthened, and there will arise difficult questions about the extent to which the reinvestment of funds from prospective government bond redemptions should be allowed to precede the actual redemptions.

Concurrently Playing Hawkish and Dovish Roles

Regardless of the precise nature of its anti-fragmentation countermeasures, the ECB will have to shoulder the difficult task of concurrently disseminating both hawkish and dovish information. As has already been decided, net asset purchases under the asset purchase programme (APP) will be discontinued on July 1. In addition, the third series of targeted longer-term refinancing operations (TLTRO3) will end at the end of June, and the balance of associated assets will decrease due to early repayments. The end of these programs will cause the ECB's balance sheet to tend to shrink. Such a balance sheet reduction will be consistent with the ECB's interest rate hikes, but the purchase of additional government bonds as an anti-fragmentation measure will countervail the ECB's overall shift toward tighter monetary policies.

Since the main purpose of fragmentation countermeasures is to alleviate "the uneven transmission of the normalisation of our monetary policy", the countermeasures should be designed with an eye to avoiding conflict with the ECB's overall monetary policy posture, and clarifying that the countermeasures' utilization will be focused or targeted as they are in the case of TLTROs should facilitate an effective "dialog with the markets". In this case, if the problematic government bond yields are curtailed through the "ECB → Private Banks → Southern European Government Bonds" route, private banks will end up holding more Southern European government bonds than necessary and relevant countries' private banking sectors will accumulate higher levels of sovereign risk that may be problematic from the perspective of regional bank supervision. In light of that and given that the need to countervail rising inflation rates is urgent, rather than taking such a roundabout approach through private banks, it may be preferable for the ECB to directly purchase the bonds in question, which could expected to immediately generate beneficial effects.

In any case, the ECB cannot abandon its plans to hike interest rates, so the associated rise in government bond yields will have to be tolerated. By the end of the year, the ECB will be addressing the challenging task of continuing to tighten its overall monetary policies while also seeking to align the rates of interest rate increases in countries with different economic fundamentals.

Supplement: Swiss National Bank Monetary Policy Management Puts Japan in a Difficult Position

ECB and SNB Policy Rates Rising in Tandem

While the Swiss National Bank (SNB) had previously adopted the deepest negative interest rate (-0.75%) among developed countries, on June 16 it raised its policy interest rate by 50bp to -0.25%. Looking back at its history, it is clear that the SNB's policy management tends to be greatly influenced by that of the ECB, and it is anticipated that the SNB will follow the ECB's suit in progressively raising interest rates further going forward. This means that the BOJ will become a clear outlier in maintaining an unusually low policy rate in stark contrast not only to the Fed and the Bank of England (BOE), but also to the ECB and SNB. The SNB's announcement of its interest rate hike includes the sentence – "It cannot be ruled out that further increases in the SNB policy rate will be necessary in the foreseeable future." The ECB has announced it will terminate its negative interest rate era in September, and the SNB appears to have made following the ECB's lead its default route.

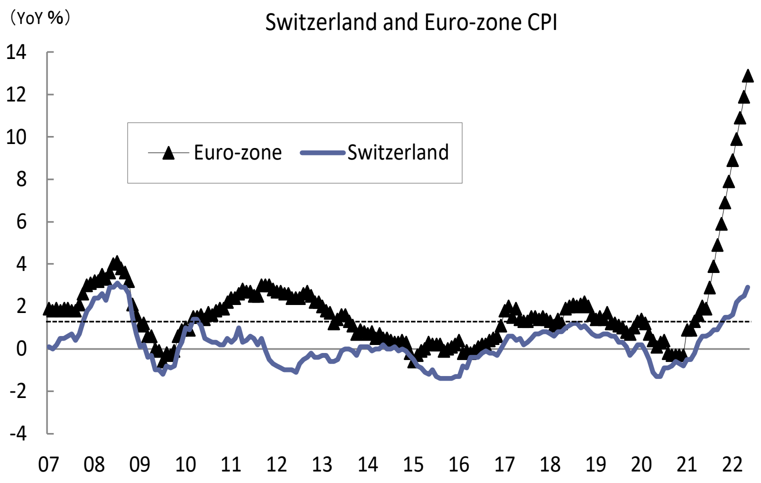
Additional Interest Rate Hikes Inevitable

Switzerland is one of the world's most economically developed countries, but because it has a relatively small and open economy, the Swiss National Bank's (SNB's) evaluations of Switzerland's economic and financial situation is greatly influenced by economic trends in other countries, particularly those in the euro area, and it places great weight in its evaluations on the Swiss Franc (CHF) forex trends that take shape owing to the economic trends in other countries. The first paragraph of SNB's announcement of its recent interest rate hike concludes with – "To ensure appropriate monetary conditions, the SNB is also willing to be active in the foreign exchange market as necessary." – thereby clearly expressing its commitment to intervening in the foreign exchange market. In light of this and Switzerland's need to countervail accelerating inflation rates, one should probably be aware that the SNB is prepared to actively undertake forex market intervention by buying CHF. SNB's consumer price index (CPI) forecast includes figures projected before the interest rate hike (-0.75%) and after the hike (-0.25%) for the four quarters from the April-June 2022 period through the January-March 2023 period. In the former case (forecast as of March), the figures were "+ 2.2% → + 2.1% → + 1.8% → + 1.2%", while in the latter case (forecast revised in June), the figures were significantly increased to "+ 2.9% →". + 3.2% → + 3.0% → + 2.8%". Despite the + 50bps interest rate hike implemented in response to sharp price rises during the past three months, the SNB still anticipates that Switzerland's inflation rate will exceed 2% through early 2023, so it appears that that an additional SNB rate hike is inevitable. At its next monetary policy meeting in September, the SNB is very likely to boost its policy rate out of the negative range.

Global Currency Appreciation Competition

Foreign exchange market participants have clear memories of the unlimited interventions Switzerland undertook to curb CHF appreciation caused by EUR depreciation during the European debt crisis. After the European debt crisis began in 2009, JPY and CHF appreciated considerably owing to their reputation for being safe assets at that time. For geographic reasons, Switzerland is prone to being inundated by "flight-to-safety" money flows from the euro area, and at that time it was struggling with chronic pressures promoting CHF appreciation as well as associated deflationary pressures. Accordingly, the SNB in September 2011 set an upper limit (EUR 1 = CHF 1.20) on CHF's exchange rate against EUR, and decided to defend this level by means of unlimited CHF selling and foreign currency buying intervention. In December 2014, aiming to widen the gap between Swiss and euro area interest rates, the SNB introduced negative interest rates. This move was also a response to the ECB's introduction of negative interest rates in June 2014. Despite these measures, however, the SNB proved unable to halt the CHF appreciation trend, so in January 2015 it suddenly decided to abandon its policy of defending the EUR/CHF upper limit with unlimited intervention, and CHF subsequently appreciated considerably. The sudden forex rate fluctuations that occurred during that period were so severe that there were concerns about systemic risks associated with European financial institutions.

What is about to happen is the opposite of what happened in the 2014-2015 period. In line with its history of undertaking monetary easing measures to counter the ECB's easing measures, the SNB can be expected to undertake tightening measures to keep pace with the ECB's tightening measures. The ECB is intensifying its hawkish policy stance by raising its policy rates with the goal of countervailing accelerating inflation rates. In fact, the euro area Consumer Price Index (HICP) has been attaining record high levels every month recently, and the ECB cannot relax its countermeasures until that trend peaks out (see graph). As the ECB tightens its monetary policies, it will promote capital outflows from Switzerland to the euro area (the opposite of the flows seen during the European debt crisis) along with a trend of EUR appreciation against CHF.



(Source) Bloomberg

This prospect is clearly undesirable from SNB's perspective given its desire to restrain inflation within Switzerland – SNB Chairman Thomas Jordan recently stated at a press conference that he would like to prevent the negative impact CHF depreciation could cause by boosting the prices of imported products. He said that he expected the SNB's interest rate hike to have an economic tightening effect due to the rise in lending interest rates but also expected the hike to have the effect of promoting CHF appreciation and thereby restraining import prices. So the SNB is explicitly intending to promote CHF appreciation.

As the ECB, the Fed, and the BOE all appear to desire currency appreciation to greater or lesser extents, it seems that a global currency appreciation competition is taking shape. Against this backdrop, the BOJ is conspicuous outlier in asserting that JPY depreciation is a net positive factor for Japan's economy as a whole and in apparently accepting the JPY depreciation trend. Given this and the fact that forex rates always involve two currencies, and the currency offering relative high interest rates is theoretically the more likely to see a future strengthening, it is hard to imagine a JPY repurchasing trend taking shape in the foreseeable future. When preparing forex forecast scenarios, it is highly important to recognize and emphasize that global developments are creating an environment in which further JPY depreciation is almost inevitable.

Daisuke Karakama
Chief Market Economist
Derivatives & Forex Department
Mizuho Bank, Ltd.
Tel: +81 3 3242 7065
daisuke.karakama@mizuho bk.co.jp