Forex Medium-Term Outlook

July 28, 2022

MIZUHO

Overview of Outlook

USD/JPY continued to rise in July, hitting the 139 level for the first time in 24 years. Of course, there has been a significant correction subsequently, which I see as a healthy development, given that JPY has weakened by over 25 on a year-to-date basis already. While some suggest that the correction is merely due to a rollback in previous JPY selling by speculators, the fact is that such trades peaked in May and have since been ebbing. In fact, there have even been speculators who bucked the trend and bought JPY over the past two months, and it is despite this that JPY weakened to the 139 level. Even assuming that the currency could strengthen due to a rollback in the JPY short position, the trend may not be sustainable. Irrespective of the direction of speculative trading, the important point to note is that JPY selling is the direction of trade justified by the fundamentals, namely interest rates and demand. With regard to interest rates, from September onward, JPY will become the only currency with negative interest rates. As for demand, Japan posted its largest ever trade deficit at -JPY7.9 trillion for 1H of 2022. In connection with the former, especially, there is a further possibility of JPY selling for carry trade purposes if there is a decline in volatility. Changing the fundamentals will require the Japanese authorities to take direct action in the form of monetary policy, energy policy, policy related to inbound tourism, and so on, but the Kishida administration has shown no signs of taking substantial action even since the end of the Upper House elections, and there is no significant change in the climate surrounding the JPY market. The authorities are continuing with an emotional response to the pandemic, which has been behind the Japanese economy’s low growth rate over the past year and a half, and there is no sign of entry restrictions being abolished. Unfortunately, such a situation is not conducive to JPY buying.

Meanwhile, EUR continued to weaken against USD through July, falling below parity during some phases. One factor behind this is the fact that the worst fear of the European Commission (EC) and ECB, namely Russia cutting off supply of natural gas to Europe, is beginning to come true. This suspension of natural gas supply will worsen real incomes in Germany, a net importer of resources, and dampen the euro area economy as a whole down the line. The situation is promoting EUR selling due to doubts whether the ECB can carry through its hawkish policy stance. In this context, even if the ECB accepts economic recession without complaint, it is likely to forge ahead with efforts to contain inflation, so an increase in interest rates is expected. In terms of demand, however, one cannot overlook the fact that Germany, which boasted the world’s largest trade surplus, recently posted a trade deficit in the wake of high resource prices. In the early 2000s, EUR strengthened to emerge from below parity against the backdrop of an increase in the German trade surplus and the ECB switching to rate hikes. The narrative that EUR would become the world’s second key currency was also being pushed, raising expectations regarding the currency. None of these background factors apply this time around, so EUR buying momentum will have to be generated by underlying economic strength. I would like to predict that EUR will appreciate during the second half of the current forecasting period amid expectations of higher future interest rates following the ECB’s delayed start of policy normalization.

Summary Table of Forecasts

	2022 Jan -Jul (actual)	Aug-Sep	Oct-Dec	2023 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	113.47 ～ 139.38 (136.18)	133 ～ 140 (137)	134 ～ 142 (140)	135 ～ 143 (138)	134 ～ 142 (136)	132 ～ 140 (135)
EUR/USD	0.9952 ～ 1.1495 (1.0187)	0.97 ～ 1.04 (1.02)	0.98 ～ 1.06 (1.03)	1.02 ～ 1.07 (1.05)	1.04 ～ 1.10 (1.08)	1.06 ～ 1.14 (1.11)
EUR/JPY	124.41 ～ 144.30 (138.70)	136 ～ 143 (140)	140 ～ 148 (144)	142 ～ 150 (145)	144 ～ 152 (147)	144 ～ 152 (150)

(Notes) 1. Actual results released around 10 am TKY time on 28 July 2022. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end level
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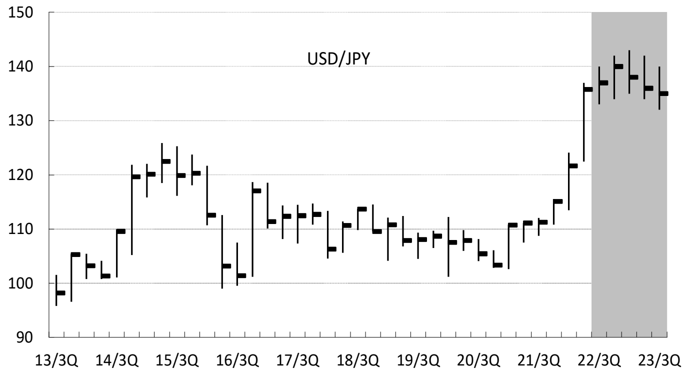
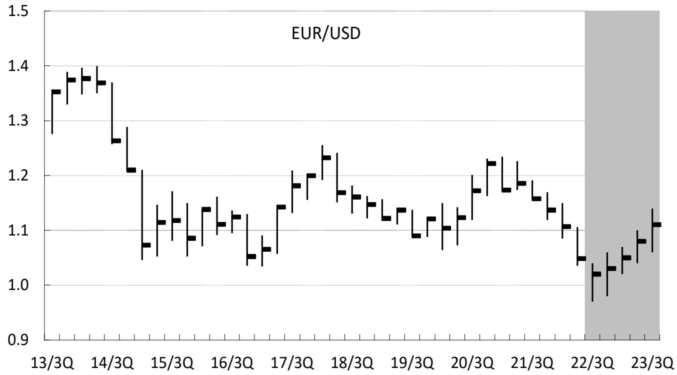
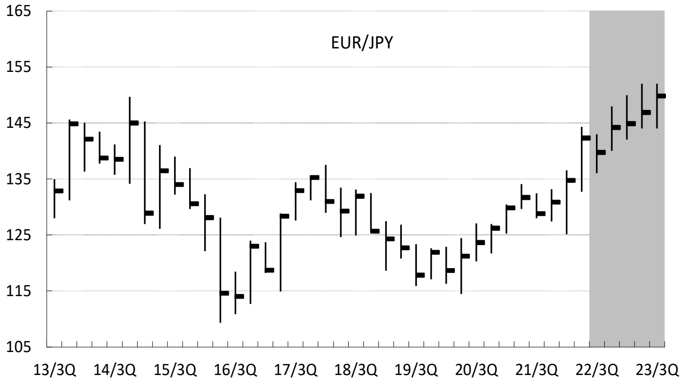
Exchange Rate Trends & Forecasts





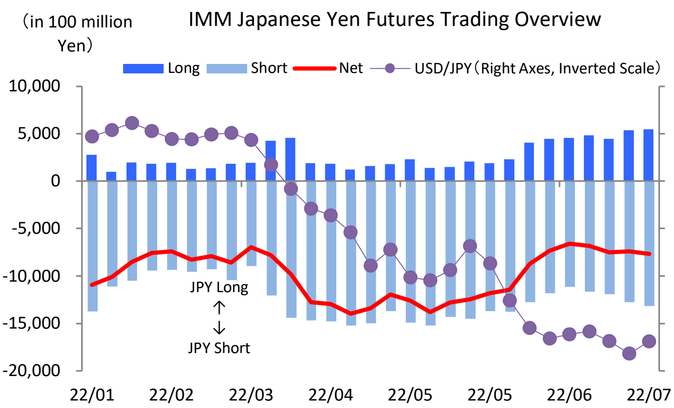


USD/JPY Outlook – Rate Range Widest Since 1998; Where Next?

JPY Rates Now and Going Forward – Future Milestones to Watch Out For

Speculative JPY Selling Peaked in May

USD/JPY plunged by over 3 yen from just under 139 to the 135 level in one day between July 21 and July 22. This happened against the backdrop of concerns regarding U.S. economic recession and the accompanying decline in U.S. interest rates and USD. A similar correction took place in May, and I was flooded by inquiries whether the JPY depreciation phase had finally ended. However, as I have been saying right since then, the current phase of JPY selling since March has features of "selling Japan," and so long as there are no Japan-side factors that trigger a change, I am afraid the weak-JPY phase may continue.



(Sources) Bloomberg

Going forward, it seems likely that JPY will become the only currency with negative interest rates. This means that, once the markets become less volatile, it would be a rational choice for investors to engage in carry trade using JPY as the funding currency. One wonders how the forex markets will react when JPY becomes the sole currency with negative interest rates after the Swiss National Bank (SNB) finishes its rate hike process to exit negative interest rates in September. As for demand, the fact that Japan's trade deficit for 1H of 2022 has been its highest ever says it all. Irrespective of the fate of the U.S. economy going forward, business corporations wanting to sell JPY are in the majority in the Tokyo foreign exchange market, which itself will buoy up USD/JPY. Given that the rate trend has been so one-sided for so long, it is understandable to expect a change, but in the case of JPY, the only possible reason for a change in the trend is that JPY has been oversold. However, looking at the IMM currency future transactions, it becomes clear that speculative JPY selling peaked in April-May this year and has been on the decline since – in other words, the degree to which JPY has been oversold has been on the decline. Rather, the gross position shows an increase in the JPY long position. Despite this, JPY depreciated against USD through June and July, indicating, it would seem, that speculators who bucked the trend and bet on JPY buying lost to JPY selling based on the fundamentals.

Milestones Based on the PPP, Etc.

Even if we take it that the direction of USD/JPY will continue to favor JPY weakness, predicting the exact level of JPY weakness remains a difficult task. Frankly speaking, it is difficult to present any meaningful milestone in the direction of a weaker JPY. During phases of JPY appreciation against USD, various kinds of purchasing power parity (PPP) based on cumulative price differentials over the years formed the different milestones (although these are also only somewhat reliable), and were taken up by the forex markets for discussion at different times. As one can tell from the chart on this page, PPPs based on ordinary price indicators are all in the region of USD/JPY below 100. The JPY "theoretical value," which is periodically calculated and published by the Nihon Keizai Shimbun (Japan Economic Research Center) based not just one prices but also on such factors as supply and demand and government debt, was weaker than the PPP-based value at around 110 to the dollar during January-March this year, but even that level is very far from the current reality.

Major Milestone for USD/JPY Spot Level in the Past

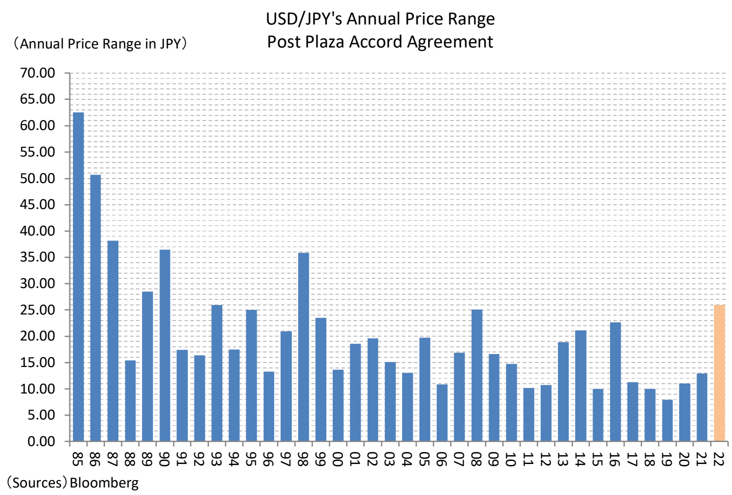
in JPY	Evaluation Metrics
0.0	Purchasing Power Parity (Export Pricea, based on metrics of 1973, June 2022)
0.0	Purchasing Power Parity (Export Prices, based on metrics of 1980, June 2022)
0.0	※1. Purchasing Power Parity (Medium of Export Prices and Corporate Goods Prices, based on metrics of 1973, June 2022)
75.7	Big Mac Purchasing Power Parity (The Economist Magazine, UK, July 2022)
0.0	*Purchasing Power Parity (Corporate Goods Prices, based on metrics of 1980, June 2022)*
0.0	*Purchasing Power Parity (Corporate Goods Prices, based on metrics of 1973, June 2022)*
0.0	*Purchasing Power Parity (Consumer Prices, based on metrics of 1980, June 2022)*
100.4	*Purchasing Power Parity (the World Bank, 2021)*
100.4	*Purchasing Power Parity (OECD, 2021, GDP base)*
101.5	Break-even Rate as of March 2021 (Japan Cabinet Office「2021 Annual Survey of Corporate Behavior」)
106.9	Purchasing Power Parity reflected by Processing and Assembly of Industrail Products (Japan METI, 2019 Survey)
0.0	Purchasing Power Parity (Consumer Prices, based on metrics of 1973, June 2022)
109.7	*Equilibrium rate calculated by Japan Center for Economic Research, through the period of 2022 January to March*
111.2	Projection of Future Rate in a Year as of March 2019 (Japan Cabinet Office「2021 Annual Survey of Corporate Behavior」)
121.6	Purchasing Power Parity reflected by Materials of Industrial Products (Japan METI, 2019 Survey)
136.1	***USD/JPY rate as of 2022/7/22***
138.2	Purchasing Power Parity reflected by Composite Industrial Products (Japan METI, 2021 Survey)
148.7	Purchasing Power Parity reflected by Industrial Services (Japan METI, 2021 Survey)
198.2	Purchasing Power Parity reflected by Industrial Energy (Japan METI, 2021 Survey)

(Sources) generated based on multi-sources. ※1. served as a downside support line for over 10 years in the

The Ministry of Economy, Trade and Industry (METI) Survey on Foreign and Domestic Price Differentials for Industrial Goods and Services provides a few milestones that point at a USD/JPY rate that is higher than the present, but there is substantial room for debate how seriously to take such yardsticks calculated against a backdrop of differing business practices. JPY seems to be excessively weak relative to PPPs based on common price indicators, but there are no longer very many domestic export companies that can benefit from this weakness, and the Kishida administration appears to have renounced any desire to utilize it to earn a travel surplus either. While the government is feeling some pressure to correct JPY weakness as prices continue to rise, it seems to be currently mulling over how to do so.

First Time since 1998

Even if there are no logical bases for these, there are some superficial milestones based on past levels and ranges that the forex markets may look toward. In particular, the calendar-year USD/JPY movement range (highest rate - lowest rate for the year) tends to draw attention. The movement range has no logical significance of its own, but it is worth keeping in mind that the forex market is an impulsive world driven by self-fulfilling prophecies, where things happen so long as enough people believe they will. Taking rates entered into the EBS as references, this year's range is 25.9 so far (139.38 - 113.48). This is the widest range since 1998 (35.81), when the Russian LTCM crisis took place the year after the Asian currency crisis (see figure). Further, in the 38 years since the 1985 Plaza Accord, the movement range has exceeded this year's 25.9 yen only six times (in 1985, 1986, 1987, 1989, 1990, and 1998). As one can tell at a glance, these were mostly years immediately following the signing of the Plaza Accord (from 1985~1990), with 1998 being the exception. In other words, the volatility during the initial years following the Plaza Accord was the result of international policy coordination. It may be unreasonable to compare that with purely forex-market-based fluctuations. Incidentally, none of the above ranges was in the direction of JPY depreciation except in 1989, which was when foreign securities investment peaked. Foreign securities investment regulations had been progressively relaxed during the 1980s, resulting in roaring foreign securities investment as well as direct investment. In that sense, that situation was fundamentally different from the weak-JPY-strong-USD situation this year.



Taking a more detailed look at 1998, the appreciation of JPY against USD that year is usually seen as resulting from the rollback in carry trade accompanying the sharp decline in U.S. interest rates. In that sense, it had the same root cause as the extreme JPY appreciation following the collapse of Lehman Brothers in 2008. Incidentally, the USD/JPY movement range in 2008 was also quite large (25.07). This was also the result of a rollback in JPY carry trade. When Japan was a large exporting nation, it was taken as a fact that any major shock would cause volatility in the direction of JPY appreciation. In 1998, Japan's trade surplus was +JPY 14 trillion, and even in 2008, when the surplus was eroded by high resource prices, it was +JPY 2 trillion (incidentally, the 2007 trade surplus was +JPY 10.7 trillion). For many years, the ground rule for understanding JPY rate trends was that JPY was sold speculatively and bought based on actual demand. The ultra-strong JPY trend following the collapse of Lehman Brothers and at a time when countries were competing for currency weakness was the result of the extremely robust JPY buying peaking due to actual demand. Unfortunately, the lessons learned at that time are no longer applicable today.

Given that Japan posted a -JPY 7.9 trillion trade deficit for 1H of 2022, JPY is now the currency of a very different country. It would be difficult to expect a USD/JPY movement range of similar magnitude in the direction of a strong JPY – the opposite direction seems more likely. As mentioned above, the year in which USD/JPY posted an even larger movement range in the direction of a weak JPY than this year was 1989, when the Japanese economy was robust – the rate movement that year was the result of aggressive overseas risk-taking by Japanese investors. By contrast, what is worrying about the current JPY depreciation trend is that firms and households may be moving to sell JPY based on the fact that the Japanese economy is not doing well.

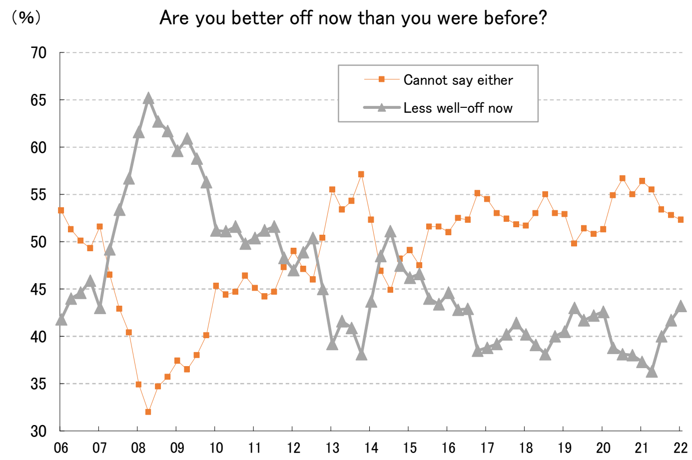
At any rate, this year's movement range is undeniably historical, and it is natural to want to analyze JPY rates and the possibility of a structural change in the Japanese economy based on it.

BOJ Monetary Policies Now and Going Forward – Bitter Public Opinion and the Scapegoating of the BOJ

Inflation Expectations Could Dampen in 2H

In its July 20-21 Monetary Policy Meeting (MPM), the BOJ decided to maintain large-scale monetary easing. In the Outlook Report, the FY 2022 Core Consumer Price Index (CPI) (i.e., CPI excluding fresh foods) forecast was raised from +1.9% to +2.3%. BOJ Governor Haruhiko Kuroda, while acknowledging this increased price pass-through and noting that a commensurate increase in wages was necessary, strongly emphasized the need for continued monetary easing and rejected outright any possibility of a rate hike. This was more or less what the markets had expected, so it triggered no evident further selling of JPY. In recent days, I am frequently asked, "To what level does JPY have to weaken before Kuroda and the BOJ change their stance?" To answer that question bluntly – that is probably something Prime Minister Kishida, rather than Kuroda, will decide. The present phase of JPY weakness is viewed negatively by the public as a market phenomenon that promotes prices rises. Once it becomes obvious that higher prices are substantially hurting the government's approval rating, Kishida is likely to begin rethinking the wisdom of a total commitment to monetary easing. That is the only way the BOJ will correct its accommodative monetary policy.

In this context, the June 2022 Opinion Survey on the General Public's Views and Behavior, released by the BOJ on July 6, was quite thought-provoking. It was especially interesting because it is BOJ-published data showing exactly what people think of the higher prices, and it came not long after the backlash against Kuroda's statement that the people are "accepting" higher prices. First, in response to the question "How do you think prices have changed compared with one year ago?" 89.0% of respondents thought they had "gone up," which is a significant increase from the 81.2% in the previous (March) survey. This figure is approaching the highest ever posted in September 2008 (94.6%).



(Source) macrobond

Taking into account Kuroda's controversial remark, it becomes important to find out how the public perceives the impact of rising prices on their everyday lives. In this context, 43.2% of respondents thought their household circumstances had "become worse off," compared with 41.7% in the previous survey. Further, those who answered as above were asked why, and the top reason chosen was "prices have risen," at 78.9%, which was far ahead of the second most chosen reason: "My salary and business income have decreased" (49.7%). In addition to the above, of those who had responded that they thought prices had gone up compared with a year ago, when further asked what their opinion of this was, 82.9% responded that it was "rather unfavorable." To summarize, that the majority of the Japanese public feel that prices have gone up, that this increase in prices is impoverishing them, and that the situation is unfavorable. Perhaps the real intent behind Kuroda's controversial statement was different, but given the aforementioned social conditions, making the headlines as having said "The public is accepting higher prices" is bound to invite a public backlash. Public sentiment with regard to higher prices is probably more honestly described as being "resigned to" or "forced to accept" them.

Higher Prices Shake Public Support for Administration

Public discontent at rising prices has begun to impact the approval rate for the Kishida administration. Of course, most of the increase in prices is due to high resource prices, and the Kishida administration is not to blame for it, but public opinion is not usually based on calm reflection. When people find themselves facing hardships, they begin to blame the current administration for it. This is true everywhere in the world, with the Biden administration facing the same challenges. However, as I have emphasized in past issues of this report, some part of the recent increase in prices can certainly be attributed to the JPY selling trend invited by the Kishida administration's masochistic economic policies, and given that JPY weakness amplifies the impact of high resource prices, public discontent at the administration is not altogether misplaced.

Looking at the various public opinion polls conducted in July, the approval rate for the Kishida administration seems to be recovering, thanks partly to the LDP's major victory in the Upper House elections (and, possibly, the emotional response to the assassination of former Prime Minister Shinzo Abe, which is said to have been behind it). However, the opinion polls conducted in June showed slipping approval rates. Specifically, the approval rate was 41% (-12 pp mom) as per the Mainichi Shinbun poll (June 25-26), 57% (-7 pp mom) as per the Yomiuri Shimbun poll (June 22-23), and 56.9% (-4.6% mom) as per the Kyodo News poll (June 11-13). The different polls show different approval rates, but the one thing common to them all is a trend of falling support. While it is less persuasive to withdraw support because of "price increases (resulting from high resource prices)" than due to "the administration's inaction," which can be righteously criticized, it seems certain that political intervention of some sort will become necessary if the current high prices continue. In a poll conducted by the Nikkei Shimbun on June 19, 69% of respondents said they "did not think highly" of the government/ruling party's measures to check rising prices, so public opinion seems to be clearly urging concrete measures.

BOJ may be Scapegoated

Under these circumstances, one possible development post the Upper House elections is that the BOJ will be scapegoated for political ends. The recent higher prices are based mainly on high resource prices, which in turn are due to major global phenomena and trends, such as the crisis in Ukraine and decarbonization. Therefore, it is useless to seek a fundamental solution to it through domestic politics. However, thanks in part to the recent remark by Kuroda, which drew widespread attention, many people have come to assume that the BOJ's accommodative monetary policies are causing JPY to weaken, which in turn is causing prices to rise.

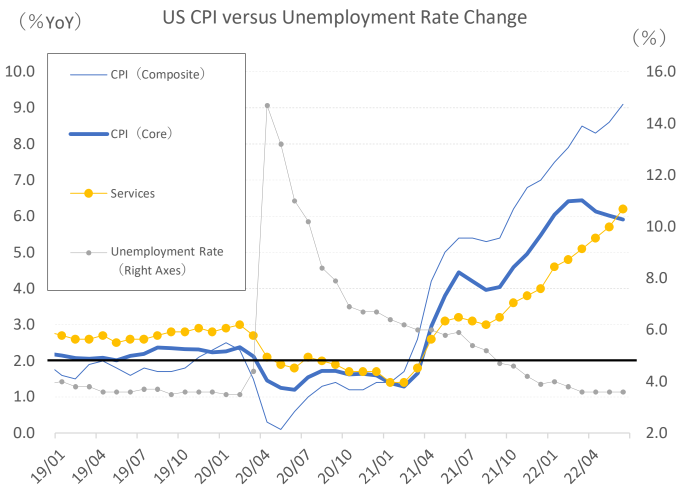
This sentiment comes through also from the aforementioned June opinion poll conducted by Nikkei Shimbun, in which 46% of respondents said the BOJ ought not to continue its monetary accommodation, as opposed to only 36% who said it ought. The survey also revealed that, of those who said they could "not accept" price rises, 53% said that the BOJ ought not to continue its monetary accommodation.

Taking this state of public opinion into account, revising monetary policy may come up as a subject of interest when the Kishida administration considers measures to counter the rising prices. This is not yet part of the main forecast scenario for forex market participants, but following the Upper House elections, it will be useful to keep an eye out for words and actions by senior government officials indicating pressure on monetary policy authorities to revise monetary accommodation. Even if for political reasons, any talk of revising the current monetary accommodation levels is likely to become a trigger for buying back JPY.

U.S. Economy Current Status and Future Prospects – CPI and the Housing Market

JPY May Remain Weak Until U.S. Economy Begins to Slow in 2023

The U.S. June CPI, released on July 13, was higher than market forecasts (+8.8% yoy) at +9.1% yoy, and the highest in the over 40 years since November 1981 (+9.6% yoy). Mom growth had also accelerated (1.3%) compared with May (+1.0%), with no sign of economic recession due to rate hikes apparent from inflation figures. On the other hand, Core CPI, which excludes food products and energy, fell below 6% (5.9% yoy) for the first time in six months, and appears to have peaked in February (see figure). However, so long as service prices, which are regulated by wage trends, continue to accelerate, the indication for monetary policy will continue to be "need for further tightening." At its July 26-27 meeting, the FOMC decided to implement its second +75-bp rate hike in a row and hinted at another similar hike in September. While there is some indication that the severity of economic recession going forward will be taken into consideration, the Fed seems unshakable in its determination to continue with rate hikes at least through the end of this year.

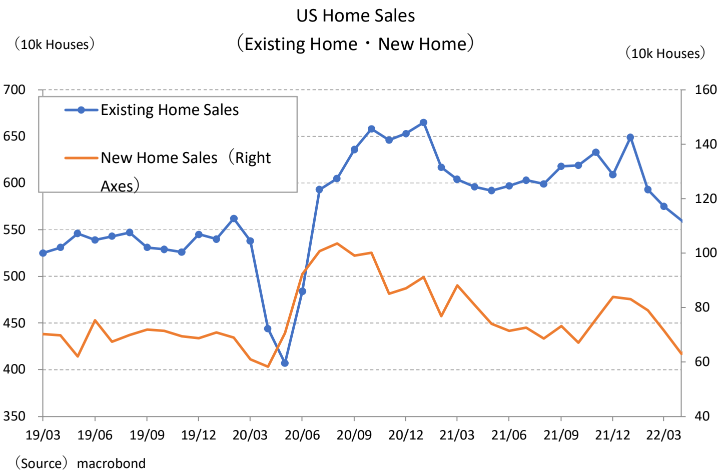


(Source) macrobond

Of course, given that the effects of monetary policy become apparent a year later, the dramatic rate hikes this year will directly result in a major U.S. economic slowdown (or recession) in 2023. It seems likely, therefore, that the prospect of rate cuts in 2023 may begin to be discussed during 4Q of this year. However, how much JPY can recover as a result of all this is an altogether different question, given that recent JPY weakness is strongly driven by a sense of "selling Japan."

Change Apparent in the Housing Market, Though Subtle

If the federal funds (FF) rate is sharply raised in response to rapid inflation, this will naturally be reflected in an increase in U.S. bond yields, and further, in an increase in housing loan interest rates. U.S. housing loan interest rates are currently up almost 100% yoy, and home sales (both of new and existing homes) accordingly peaked at the end of last year (see figure). The increase in housing loan interest rates comes on top of already high selling prices amid supply constraints both in terms of materials and construction-related labor, so it seems likely that the decline in home sales will continue. As is generally known among economic analysts, housing investment makes up for only 3-5% of the U.S. economy, but there is also the consumption of durable and semi-durable goods (cars, refrigerators, washing machines, etc.) associated with home sales, so the rise and fall of housing market performance tends to dictate turning points for the economy as a whole. Predictions of a U.S. economic recession going forward are, therefore, not altogether groundless, as there are certainly signs of concern over the waning of consumption/investment appetites originating in housing investment.

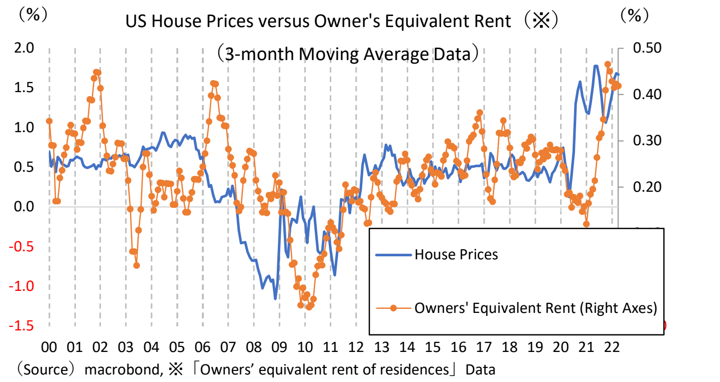


(Source) macrobond

Looking at the relationship between house rents and CPI (details below) makes one think that housing-related indicators should be given as much importance as the CPI and employment-related indicators as fundamental economic indicators.

CPI and Imputed Rents Going Forward

Returning to look at the CPI, trends related to imputed rent, which accounts for 30% of CPI, are strongly affected by housing price trends. Imputed rent is the rent one would pay for living in one's own house, and it is a statistical datapoint that is counted as part of service expenditure. As the figure shows, imputed rent peaked around the end of 2021. Assuming that food and energy prices will not climb significantly going forward, it seems likely that headline CPI will show a clear slowdown in early fall, which is when the base effect is also expected to fade away. Since commodity prices strengthened considerably during spring and fall of 2021, unless that seasonal pattern is repeated this year, the yoy rate of change is likely to see a downswing.



(Source) macrobond, ※「Owners' equivalent rent of residences」Data

Of course, there is no marked decline in housing prices – they have merely stopped accelerating. "Persistently high" may be a more apt description. Moreover, even if housing prices do decline sufficiently, it would take a few months before any marked decline in CPI becomes evident, so, it seems unlikely that there will be any dramatic improvement in the inflation situation in the near term unless the Fed changes its policy stance for this year drastically.

There is also a risk scenario – namely, a further deterioration in the supply constraints plaguing the housing market. The U.S. housing market's supply constraint woes are due not just to the shortage of construction materials in the wake of the pandemic and the crisis in Ukraine, but also because of delays in the goods and labor supply chains connected with containers, dock workers, and truck drivers. If there is no marked improvement in this situation, or if indeed there are signs of it worsening, inflationary pressures (an increase in housing prices in this case) will not let up no matter how much the Fed increases rates in an effort to dampen demand. The main forecast scenario for the U.S. housing market going forward assumes a gradual improvement in supply conditions combined with a steady decline in demand, and the Fed seems to be hoping that this will bring down housing prices. However, in the event that supply-side problems worsen and the situation deteriorates further, inflation will continue to soar over a protracted period.

Addendum: Current Status of and Future Prospects for Reflationary Policies – Things that End with Abenomics, and Things that Must be Urgently Revived

Reflationary Policies Must be Discussed Separately from Abe's Legacy

In a heinous incident that will go down in Japanese history, former Prime Minister Shinzo Abe was shot dead during a campaign speech on July 8. As many market participants know, the second Abe administration, which began in December 2012 had quite a special connection with the financial markets compared with other administrations. This administration, which was the longest in the history of constitutional governments in Japan, left its mark in various arenas, but among its various achievements, Abenomics – a set of economic policies Abe advocated – is something that even the person on the street with not much connection to the financial markets is bound to have heard of.

Subsequently, similar terms ("Suganomics" and "Kishidanomics") were promoted, but the fact that they did not gain much traction is also evidence of what a major force Abenomics was. The current BOJ regime under Kuroda, who is set to become the first ever BOJ governor to have completed two full terms (10 years), is also a product of Abenomics. Whatever one may say about reflationary policies, which aim first and foremost to increase prices and were already on their way out, it is undeniable that the second Abe administration left its mark not just on domestic politics and international diplomacy, but also on economics and finance.

In the wake of Abe's assassination, I am frequently asked to provide an overview of his reflationary policies and my impressions regarding their prospects. However, Abe's assassination and the end of his reflationary policies must not be conflated. As not just market participants but also the general public could probably tell, even before Abe's assassination, reflationary policies were on their way out as a result of public discontent over JPY weakness and increasing prices. It would not be an exaggeration to say that they were already on their way to becoming a thing of the past.

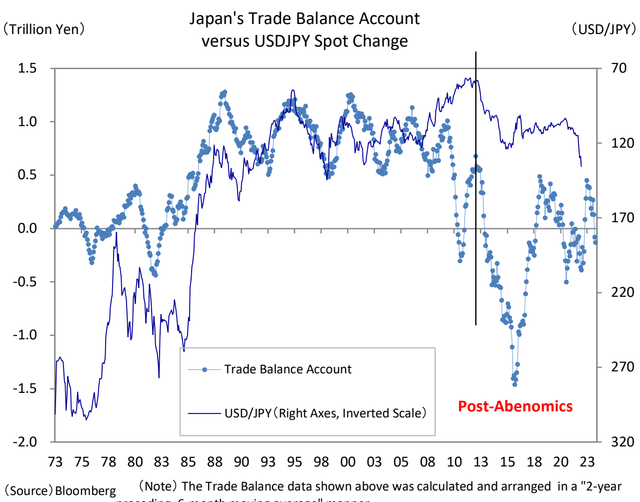
In last month's issue of this report, I discussed Kuroda's statement to the effect that the public was accepting higher prices, and how it practically spelled the end of reflation. As I mentioned at that time, the basic idea behind reflationary policies (that higher prices would be the "cause" of economic recovery) received public support when they were first introduced only because rising prices had not yet become the reality. Now that prices are, indeed, rising, Kuroda's statement to the effect that people were "accepting" this met with an explosive public backlash, and there are even signs of price increases eroding public support for the current administration. The current yield curve control (YCC) framework makes it difficult for the BOJ to change tack on monetary policy, and the ongoing JPY selling trend in the market, which has made JPY the weakest it has been in the past 24 years, is undoubtedly based on market participants having seen through this. While Abe certainly left behind a great legacy, his reflationary policies themselves had already been fading in significance for a while, and I would like to draw attention to the fact that their overall significance had more or less ended.

Going forward, if prices continue to rise and further erode public support, the Kishida administration will have no choice but to take action. It may not be possible to remedy persistently high resource prices, but it may be possible to appease the public to some extent by taking measures to rein in JPY depreciation. As far as the public is concerned, support for the administration probably includes support for monetary policy, so there is a strong possibility of the government scapegoating the BOJ and presenting itself as having taken measures to control price rises. Some are of the view that Abe's demise has made it difficult for the Kishida administration to celebrate parting ways from Abenomics. While one understands the sentiment, it would be politically difficult to disregard rising public discontent over rising prices. At the very least, half a year from now, the switch to a post-Kuroda regime will start being discussed, and in the current climate, with the public viewing JPY weakness and rising prices unfavorably, it seems within the scope of market forecasts that the next BOJ governor will distance himself/herself from reflationary policies.

At any rate, fiscal and monetary policies in Japan had already clearly been headed toward a search for post-reflation measures, so the move away from reflation must not be seen as having any causal relationship with the recent sad event of Abe's assassination.

The Achievements of Abenomics

Having said all the above, I do not believe reflationary policies were altogether useless. The extreme JPY strength and share-price weakness under the preceding Democratic Party of Japan (DPJ) leadership changed overnight with the rousing cry of Abenomics. Of course, the ultra-strong JPY trend would very likely have been corrected naturally (see figure) even without the help of Abenomics, given that the timing coincided with the end of the European sovereign debt crisis and the Fed entering policy normalization, and more importantly, with Japan becoming unable to earn trade surpluses (2012-13). It cannot be denied, however, that the ostentatious parading of reflationary policies did contribute to a dramatic weakening of JPY and strengthening of share prices, and the Japanese economy, which was beginning to be seen as a spent force, began to attract international interest once again.



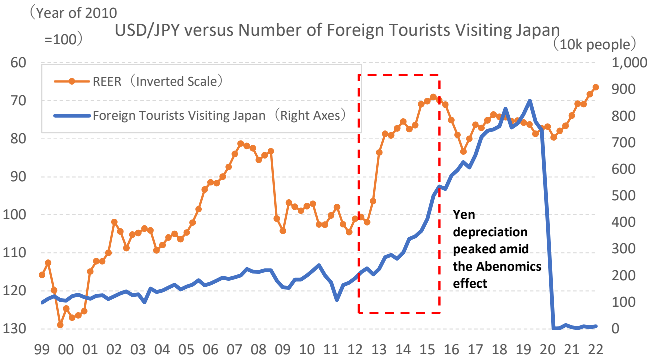
（Source）Bloomberg （Note）The Trade Balance data shown above was calculated and arranged in a "2-year preceding, 6-month moving average" manner.

In my field of work, too, there were numerous opportunities to brief overseas clients during 2013-15, as a large number of foreign market participants saw signs of change in the Japanese financial markets – that much interest in the Japanese economy has not been seen since. It is perhaps because of the vivid memory of Abe's economic policies (Abenomics) that so many messages of condolence from all over the world have been pouring in for the former prime minister. One does have the impression that his policies applied the brakes on the downward slide of the Japanese economy's global status.

Still, labor market reforms, which were considered the most fundamentally important component of the three "arrows" of Abenomics (monetary policy, fiscal policy, and structural reforms) were unable to be achieved, resulting in a failure to achieve even the long-time goal of a nominal wage increase. Abenomics, which came to symbolize monetary accommodation, began to lose steam starting 2016. In September that year, the BOJ introduced YCC and moved away from the limelight (I believe this was on purpose). Even in theory, given that lending (money supply) fails to grow commensurately with monetary easing in Japan, it is difficult to see how inflation can be increased simply by increasing the amount of base money; and in fact, inflation did not increase. In hindsight, had Abenomics been reviewed in around 2015, when the CPI began to regularly post positive growth, it is possible that subsequent assessments of it would have been significantly constructive.

Kishida Administration Reviews Demand for Inbound Tourism

Unlike in the field of monetary policy, where discussions from different viewpoints abound, the positive economic contribution from efforts to attract inbound tourism can be applauded freely. In December 2012, less than a week after its inauguration, the second Abe administration began work on relaxing visa requirements, gradually relaxing them for tourists from China and ASEAN nations. This increased the appeal of Japan as a consumption/investment destination for the rising middle class in Asia, unlocking a latent demand. That was an altogether different universe compared with the present, when foreign visitors are turned away at the gates in the name of COVID-19-related border controls.



(Source) Bank of Japan, INDB

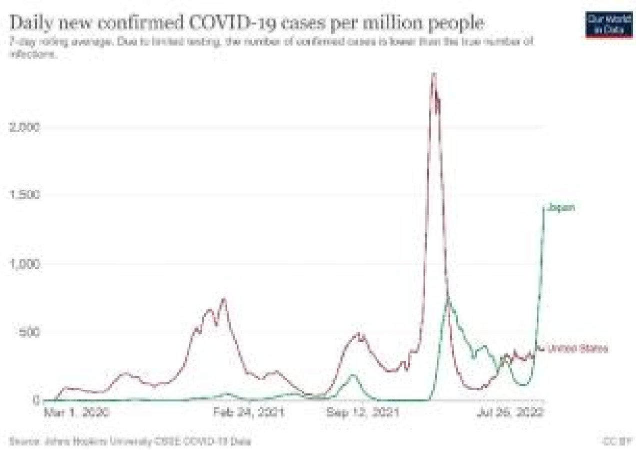
JPY weakness under Abenomics did not result in an increase in export volumes or a trade surplus for Japan, or even in any significant improvement in the domestic wage situation, but it did unlock the potential demand for inbound tourism. It is only right to positively evaluate the speed with which that happened. Right now, the only way for the Japanese economy to use the otherwise increasingly painful JPY weakness to its advantage is to export services targeting the demand for inbound tourism, and one of the achievements of Abenomics is that it laid the groundwork for this.

One can only hope that the Kishida administration can look back on this past experience and create an environment in which the current JPY weakness can be used to promote the export of services (improve the travel balance). It has been a whole two months since Kishida promised to ease entry restrictions to G7 levels in his City of London speech in May, but Japan remains as "isolationist" as before. At Abe's demise, Kishida said, "We will inherit his will and tackle the issues he had to leave unachieved." One hopes that he will follow through on those words.

Risks to My Main Scenario – Pandemic Countermeasure-Related JPY Appreciation/Depreciation Risks

Simplistic Focus on Number of Infections

The number of new coronavirus infections increased in Japan during July, causing widespread concern about the government's prospective responses and the impact of those responses on the forex market. Shigeru Omi, chairman of a government subcommittee responsible for Japan's covid-19 responses said the country "had no doubt entered a seventh wave of the spread of infection," and it appears that this is indeed the case. At the time this article was written, Chairman Omi, Prime Minister Kishida, and other high-level government officials were denying that there was a need for behavioral restrictions, and it is hoped that the government's response to the seventh wave will be less drastic than those to previous waves. Ultimately, however, I do not think it so unlikely that the government will once again repeat its previous mistakes. In fact, the situation this past January was similar to that in July. When the number of omicron covid-19 infections rose in January, Chairman Omi denied that there was a need to impose additional people-movement restrictions, but in the end, focused measures aimed at preventing the spread of infections were announced. A protraction of this pattern of overreaction is fully possible so long as the government believes that excessively strict pandemic countermeasures will tend to directly boost its approval rating. It is worth noting that the number of new covid-19 infections per million people in Japan has recently surged to a level more than twice as high as that in the United States (see graph). Given the reality that there are more infected people in Japan (despite the population's heroic determination to continue wearing masks under the scorching sun and to maintain social distancing efforts) than in the United States (where people are returning to almost-normal daily lifestyles), it is ordinary common sense to doubt the effectiveness of conventional pandemic control measures. I am opposed to the protraction of such conventional pandemic control measures because it seems clear that the cost of their obstruction of private economic activities is much higher than their actual benefits. I can only hope that Japan's government and ruling party will behave more-intelligently this time by avoiding pandering to the excessively conservative tendency perceived in Japanese public opinion.



As I have consistently emphasized in monthly editions of this article as well as in lectures and study sessions over the past year, my forex outlook is based on the premise that Japan will generally continue mistakenly imposing excessive pandemic countermeasures. The Japanese government's policies have become chronically centered on excessively strict pandemic countermeasures designed to appeal to conservative elderly voters, and even following the recent Upper House elections it continues to appear very unlikely that there will be any significant change to those policies. So long as it continues to believe that strict pandemic countermeasures will boost its voter support levels, it is unlikely that the Kishida administration will shift its policy focus to economic growth-promoting policies. At the time of the Kishida administration's inauguration, a Mizuho Market Topic article (October 4, 2021) entitled "Need for Kishida Administration to Discontinue Excessive Emphasis on Pandemic Countermeasures" emphasized the importance of moving away from excessively strict pandemic countermeasures so as to enable Japan's economic revival. Subsequent issues of this article have continued to warn that JPY and Japanese stocks would continue weakening unless the government increased its emphasis on promoting economic activities.

This article's JPY/USD forecast range (133-142) is based on the assumption that Japan will continue repeatedly imposing restrictions on private economic activities whenever the number of covid-19 infections increases, thereby further depressing the country's economic growth rate and strengthening the international Japan-avoidance trend. These "restrictions on private economic activities" encompass immigration restrictions, which at this point appear very likely to be maintained. In addition, so long as the government maintains a simplistic focus on the number of infections (without considering the mildness or severity of those infections), Japanese society will have to be constantly prepared for the re-imposition of countermeasures whenever the number of infections rises, and the need for such preparedness itself constitutes an indirect intervention in the country's economic activities. The need for such preparedness will continue significantly hindering private economic activities in Japan, even when states of emergency and other actual pandemic countermeasures are not imposed, and this hindering of private economic activities is likely to continue for the time being. Moreover, it appears likely that some local governments in Japan will continue ignoring lessons learned during the past two and a half years and will impose human movement restrictions based on a rather dubious putative correlation between human movements and the spread of infections.

There remains some hope that, now that the Upper House election has been completed, the Kishida administration might abandon its conservative posture and move toward proactive policy management focused on promoting economic growth. If that were to happen, there would indeed be a possibility of a trend toward more-positive evaluations of Japanese stocks and JPY. However, this prospective scenario is an upside risk scenario, not the main scenario. For this article's forex forecast, a Kishida administration shift toward placing greater emphasis on economic growth is a JPY appreciation risk factor. On the other hand, although the number of newly infections is increasing in Europe and the United States, it is not anticipated that special behavioral restrictions will be imposed in those regions, as the regions' governments are expected to give due consideration to the currently low percentage of severe infections as they undertake cost-benefit analyses with respect to behavioral restrictions. Consequently, it is anticipated that the widening gap between economic conditions in Japan and elsewhere will widen still further, giving JPY sellers an additional sense of security. Currently, Japan's real GDP level is roughly 4% lower than in the July-September 2019 period prior to the pandemic's outbreak (and immediately before Japan's consumption tax rate hike). The value of JPY in forex markets has inevitably come to reflect this gap between economic conditions in Japan and elsewhere, and the main scenario of this article's forecast anticipates that this situation will continue going forward.

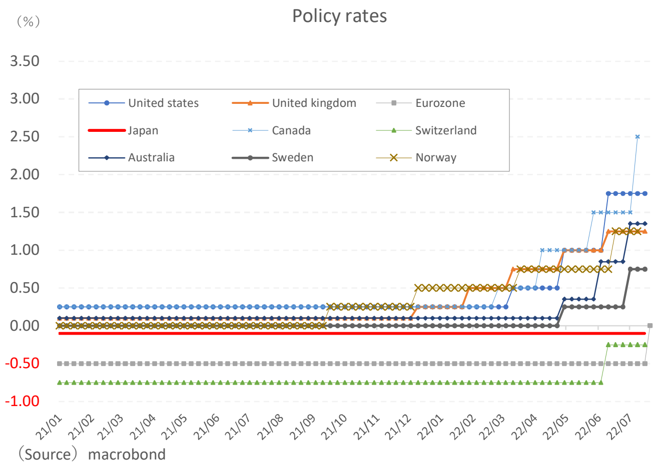
Japan's Lag Behind Other Countries and Downside Risks

Again, if the Kishida administration were to make a sharp turn toward economic growth-focused policies, Japan's growth rate could recover and the BOJ would be able to start considering moving toward monetary policy normalization, and these developments would pose a JPY appreciation risk. While this article does not anticipate such developments, such developments would be positive factors with respect to the Japanese economy, so in that sense they can be said to constitute an upside risk factor.

On the other hand, there is also a downside risk factor. While it had been hoped that Japan's use of the covid-19 "state of emergency" phrase had become a thing of the past, the phrase was again used at a July meeting of the Ministry of Health, Labor and Welfare's panel of pandemic experts.
The Japanese economy has been lagging behind global economic trends of recovery from the impact of the pandemic for some time, and it is hard to believe that the Japanese government is still considering the possibility of declaring states of emergency owing to the pandemic, but if it were to do that, the state of the Japanese economy relative to the global economy could become even more dire. The current global economic environment is quite different from the environment two years ago, particularly with respect to the trend in central banks' policy interest rates. Japan's

excessively strict pandemic countermeasures have previously been considered somewhat justifiable in light of the fact that Japan's economic growth rates and inflation rates have long been lower than the corresponding rates of other countries – that Japan has chronically had relatively low levels of growth and inflation has been generally understood and accepted. Six months ago, the BOJ was not such an obvious outlier in its policy stance – other leading central banks had also not yet begun hiking interest rates – and although there were disparities between the real economic conditions in Japan and in other countries, the BOJ's monetary policy was not so conspicuously different. Since various pandemic countermeasure restrictions in Japan were eased this spring, however, the Fed and many other major central banks have begun implementing interest rate hikes. At the time this article was written, the only leading central banks to retain negative interest rates were the BOJ and the Swiss National Bank (SNB), and it is generally believed that the SNB is almost certain to hike its policy interest rates to non-negative levels at its September meeting. With respect to interest rate hikes, the BOJ is now falling increasingly far behind the Fed, the Bank of England (BOE), and the Bank of Canada (BOC). While uptrends in the number of pandemic-related infections have been seen in the countries overseen by those central banks, those countries have not carefully counted the number of "waves" of infections, and the re-imposition of behavioral restrictions has not been considered in those countries in light of the fact that the share of severe infections has remained low. It seems that Japan and China are the only major countries still considering the re-imposition of such behavioral restrictions.

If Japan were to stubbornly persist in re-imposing restrictions in response to each substantial rise in the number of infections and thereby abandon hopes of effectively boosting its economic growth rate, the gap between Japan and other countries regarding policy interest rate levels will become even wider. It can be said that this prospect constitutes an unexpected JPY depreciation risk factor. <u>Unless one does not recognize (or feigns not recognizing) that Japan's adoption of an extreme "human safety before economic vitality" stance is an indirect cause of JPY selling, one should recognize the downside risk that the "bottom" of the JPY depreciation trend may turn out to be unexpectedly deep.</u>

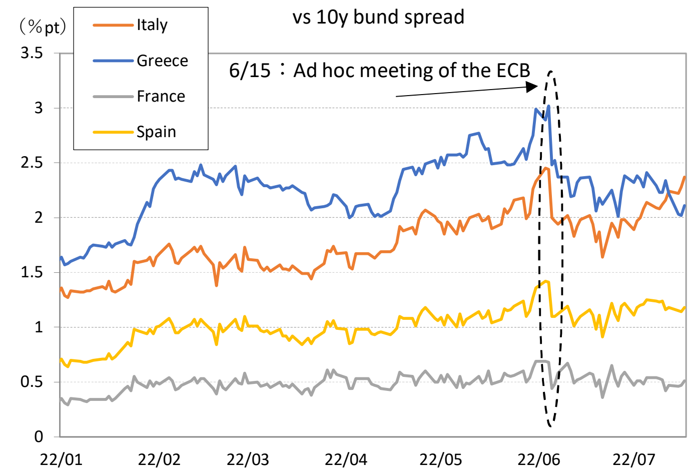


(Source) macrobond

EUR Outlook – Significance of EUR Falling Below Parity with USD

EUR Area Monetary Policies Now and Going Forward – Inflation at Front Gate, Recession at Rear Gate

Two Months of Confusing Information Dissemination
The ECB's July 21 Governing Council meeting raised the deposit facility interest rate 50bp, from -0.50% to zero percent. This was the ECB's first rate hike in about 11 years (since July 2011) and the ECB's first +50bp rate hike in about 22 years (since June 2000). It also marks the end of the ECB's negative interest rates, which were introduced in June 2014 and persisted for eight years. The meeting also approved the creation of the Transmission Protection Instrument (TPI), which is designed to counter financial market fragmentation risks. Strictly speaking, the ECB's "first line of defence" against fragmentation risks entails leveraging the flexibility of the Pandemic Emergency Purchase Program (PEPP), while TPI is a secondary defense instrument. ECB President Christine Lagarde praised these decisions, saying – "I think it's a rather historical moment for me" – and emphasized that the decisions were unanimous, but as explained below, the financial markets appear to be skeptical about the TPI's prospective effectiveness.



(Source) macrobond

It is encouraging to see that the Governing Council was able to reach consensus decisions, but it should also be recognized that ECB's information dissemination activities leading up to the decisions were not very smoothly implemented. At this point, I would like to overview the ECB's information dissemination activities during past two months. First, on May 23, the ECB utilized an unusual format known as the "ECB Blog" to suggest that interest rates would be hiked 25bp in July and by a greater margin (probably 50bp) in September. The May 23 blog post also announced that the Asset Purchase Program (APP) would be terminated on July 1. The regular Governing Council meeting held two weeks later (June 9) confirmed the content of the blog post but did not announce the kind of concrete anti-fragmentation measures targeting Italian and other vulnerable euro area government bonds that a portion of financial markets had been anticipating, causing a further rise in the yields of certain euro area government bonds. In light of that rise in bond yields, the ECB hurried to convene an ad hoc Governing Council meeting on June 15, less than a week after the regular Governing Council meeting, at which it expressed an intention to address "resurgent fragmentation risks" within the euro area but did not announce any concrete countermeasures. However, yields on Italian and other vulnerable euro area government bonds continued to be restrained by financial markets' expectations that such concrete countermeasures would be approved at the July 21 Governing Council meeting. At that point, the markets still expected that the July rate hike would be by a margin of 25bp in line with the ECB's previously disseminated information, but speculative media reports that a 50bp hike was also being considered emerged just before the July 21 Governing Council meeting (on July 19), and those reports were confirmed at the July 21 Governing Council meeting. Italian government bond yields actually increased in response to the announcement of the TPI, rising to levels higher than immediately after the June 15 ad hoc Governing Council meeting. It appears that the financial market's assessment of the TPI and other ECB anti-fragmentation measures is not as high as President Lagarde's assessment.

Why a 50bp Interest Rate Hike?
There are many issues regarding the July 21 Governing Council meeting and subsequent press conference worth discussing, but the key points are (1) why the interest rate hike margin was increased from 25bp to 50bp, and (2) whether TPI will truly be an effective anti-fragmentation tool.

Regarding point (1), since the interest rate hike margin was increased to 50bp despite the ECB's previous information dissemination suggesting a 25bp hike, it is natural that a reporter would pose the question – "Did the monetary conditions in the euro zone deteriorate that fast, or is the agreement on TPI giving you the ability to go further than you anticipated?" In response, President Lagarde said the rate hike margin was boosted to 50bp because (1) the ECB had a "clear realisation of upside risk to inflation", and (2) the ECB judged that the PEPP flexible reinvestment policy and introduction of the TPI would maintain the effectiveness of its monetary policy transmission. The lengthiness of her explanation of point (2) makes that explanation somewhat difficult to understand clearly, but in short, it seems that she argued that even if the interest rate hike margin is increased, the yields on Italian and other vulnerable euro area government bonds would not rise owing to the existence of the PEPP flexible reinvestment policy and the TPI, and it appears that this argument was sufficient to persuade dovish Governing Council members to go along with the 50bp rate hike margin. As explained below, however, the TPI triggering conditions appear to be quite strict, and the financial markets are therefore quite skeptical about the TPI's deployability and effectiveness.

Addressing concerns about the future interest rate hike trajectory, President Lagarde stated that – "from now on we will make our monetary policy decisions on a data-dependent basis, will operate month by month and step by step." She also pointed out that the forward guidance presented at the June Governing Council meeting – "If the medium-term inflation outlook persists or deteriorates, a larger increment will be appropriate at our September meeting." – is no longer applicable. However, the removal of the forward guidance will not have a large impact on market expectations, as it is generally understood that the decision about whether to hike interest rates by 50bp or 75bp will be made depending on the September update of the Eurosystem staff projections.

A more-important issue is whether the fact that the initial interest rate hike was by 50bp instead of 25bp can be interpreted as suggesting that the ECB may elevate the level of what it considers the neutral interest rate, which is the end point of the rate hikes. In this regard, a reporter frankly asked – "what interest levels are considered normal by the ECB?" President Lagarde responded – "If you are asking me next 'What is the neutral setting?' At this point in time I don't know. What I can observe is that it has changed over the course of the last few years for a reason of factors having to do with demographics, with productivity and all the rest of it." One naturally wonders whether the ECB has a consensus view that the euro area's potential growth rate is roughly in the 1-2% range, as the euro area's actual growth rate could conceivably reach that level by the end of the year.

Feasibility of TPI Utilization

While the TPI was introduced with considerable fanfare, the program appears to indeed have the shortcomings about which many observers have expressed concerns. In 2012, former ECB Governor Draghi responded to a regional bond market crisis by making his famous statement – "The ECB is ready to do whatever it takes to preserve the euro." – and introducing the outright monetary transactions programme (OMT). The OMT scheme was designed to be an anti-fragmentation countermeasure, and the fact that it could also be employed at this point was pointed out before the July meeting. In this regard, President Lagarde said that – "We have OMT, which gives us a tool to deal with unwarranted impairment to transmission that are caused by redenomination risks and that are country-specific." – and she also noted that, in contrast – "under [the] TPI all members of the euro area can be eligible; all of them."

Even after reading the explanations presented at the press conference, however, it is not very clear how the OMT differs from the TPI. In fact, President Lagarde said that the ECB has a toolbox with three currently operational tools for stabilizing the regional bond market: flexible PEPP reinvestments, the OMT, and the TPI. The official statement explaining the details of the TPI also mentions the existence of the OMT, and there does in fact appear to be a possibility that the OMT could be employed to address current market fragmentation concerns. As mentioned, the PEPP flexible reinvestment policy is the ECB's first line of anti-fragmentation measures, and the TPI appears to be designed to be held in reserve. President Lagarde made this clear when she said – "I can assure you that we would rather not use TPI." It appears that the ECB's true intention is to induce lower yields in the euro region by showing that it has many tools in its toolbox and is prepared to make use of them if necessary.

However, as shown by the graph on the previous page, Italian government bond yields actually rose following the Governing Council meeting. This suggests that many financial market participants have decided that it will prove impossible to employ the TPI because the eligibility criteria are too strict. These criteria include (1) compliance with the EU fiscal discipline framework, (2) absence of severe macroeconomic imbalances, (3) recognized fiscal sustainability, and (4) sound and sustainable macroeconomic policies. After confirming that these eligibility criteria are met, the Governing Council can activate the TPI based on a comprehensive assessment of market and transmission indicators. However, <u>one could logically argue that euro area countries that meet all four eligibility criteria should not really have a need to make use of the TPI.</u> The same argument was made when the OMT was introduced, and so far, the OMT has remained unused with a status akin to an "ace up the sleeve". To market participants who have been watching the ECB for a long time, the TPI seems to essentially be a replay of the OMT strategy.

Inflation at Front Gate, Recession at Rear Gate

In any case, as it is anticipated that the rate of HICP growth will considerably exceed 2% over the next two years or so, it would not be realistic to expect the ECB refrain from efforts to restrain inflation. In light of the current situation, I often receive inquiries about whether the ECB might discontinue monetary tightening measures to avoid causing a recession, but I do not think avoiding protracted monetary tightening measures will be feasible. Service prices are now beginning to boost inflation rates in the euro area, albeit not as much as in the United States. Rather than discontinuing monetary tightening to avoid a recession, I think the ECB will actually be willy-nilly forced to protract its monetary tightening measures until a recession takes place so as to promote a decline in HICP growth rates toward the 2% target level. <u>Even in an "inflation at the front gate, recession at the rear gate" situation, the ECB will still have no choice but to augment its inflation countermeasures, and this could be said to be true for the central banks of all developed countries other than Japan.</u>

Concern that ECB Policies Will Eventually Generate Political Risks

As the euro area encompasses 19 countries with diverse economic conditions, however, it can be anticipated that there will be a similar diversity in the severity of the recessionary conditions caused by monetary tightening – individual euro area countries' will experience recessions with various levels of depth. During the monetary policy tightening process, some vulnerable countries will be unable to cope with higher interest rates and may fall into extremely severe recessions, and there is due cause for concern that such recessions may considerably increase support for both left- and right-wing populist parties in such countries. While the TPI is designed to prevent that from happening, the key question is whether the TPI will be deployed quickly enough to forestall such scenarios. As mentioned above, many market participants appear to believe it reasonable to anticipate that deploying the TPI in a sufficiently timely manner will be quite difficult.

In the past, the European Commission-led measures to resolve the European Debt Crisis were seen to cause upswellings of anti-EU sentiment in various euro area countries. The formation of governments led by the anti-austerity and anti-international-aid extreme left-wing SYRIZA party in Greece and the right-wing League (Lega) party in Italy repeatedly caused turbulence in financial markets. While it is the ECB rather than the European Commission that is undertaking inflation control measures this time, there remains a risk that some euro area countries will feel strongly that they are unduly suffering owing to an unreasonably uniform policy response imposed by the EU/euro area policy-setting framework. <u>From the perspective of ordinary people facing severe economic challenges in their daily lives, the European Commission and the ECB are the same in the sense that they are institutions that impose EU policies, so there is due cause for concern that the political crises seen during the resolution of the European Debt Crisis will be repeated.</u>

EUR Now and Going Forward – German Trade Deficit Promotes EUR Plunge

High Likelihood of ECB's Downside Scenario

The plunge in EUR/USD attracted considerable attention in July and, on July 13, EUR fell below parity (EUR1 = USD1) for the first time since November 2002. There are various factors promoting EUR selling, but one major factor is believed to be the increasing likelihood of a cut-off of energy supplies from Russia (considered the biggest risk to the euro area economy), which has been inspiring growing doubts about whether the ECB will be able to implement its policy normalization plans. The June Eurosystem staff projections include a baseline scenario as well as a downside scenario that – "assumes a complete cut in Russian energy exports to the euro area starting from the third quarter of 2022, leading to a rationing of gas supplies, significantly higher commodity prices, lower trade and intensified global value chain problems."

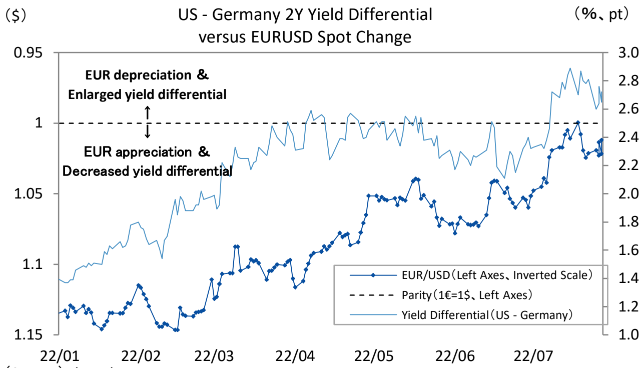
The downside scenario anticipates that the above-mentioned problems will trigger commodity price increases and supply chain turmoil, causing the euro area's the real GDP growth rate to be significantly reduced compared to the baseline scenario – from +2.8% to +1.3% in 2022 and from +2.1% to -1.7% in 2023. It also anticipates that HICP growth will surge compared to the baseline scenario – from +6.8% to +8.0% in 2022 and from +3.5% to +6.4% in 2023. This worsening economic scenario could be characterized as stagflation (see chart). In fact, as of May, Russia had stopped supplying gas to Bulgaria and Poland and it was feared that Russia would sanction Gazprom Germania (a former German-based subsidiary of Russia's state-owned gas giant Gazprom) making it impossible for Russian natural gas to enter Germany. On June 22, the International Energy Agency (IEA) warned that Europe should prepare for a discontinuation of gas supplies from Russia, making it impossible to deny that the ECB's downside scenario is realistic. Fears that gas supplies via the Nord Stream 1 pipeline would be completely cut off did not eventuate during July, but the volume of gas supplied through that pipeline has been reduced, and even that lower level remains in jeopardy.

ECB staff projections （June 2022, %）

	Baseline projections			Downside scenario		
	2022	2023	2024	2022	2023	2024
Real GDP	2.8	2.1	2.1	1.3	-1.7	3.0
HICP	6.8	3.5	2.1	8.0	6.4	1.9

（Source）ECB

Given the preexisting deep concerns about the euro area's real economy, there is certainly cause for worrying about the additional impact on the economy that may result from the ECB's shift toward relatively hawkish policies. In light of the recent parallel movements in the US-Germany two-year interest rate differential and in EUR/USD, a "euro area recession → ECB shift to more-dovish policies → regional interest rate decline → EUR selling/USD buying" scenario would appear quite likely (see graph). Given the acceleration of HICP growth anticipated in the downside scenario, however, it may not be realistic to expect that the ECB will consider relaxing its monetary policies in response to economic slowdowns or recessions, and this may explain why the ECB decided to hike interest rates by 50bp in July rather than by 25bp. It appears that this kind of hawkish policy stance including relatively rapid interest rate hikes will be the ECB's default route for the time being.



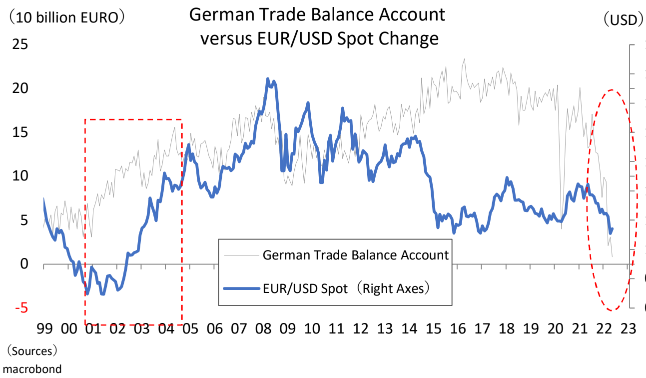
（Source）Bloomberg

Key Importance of Trade Balances

Interest rates and supply-demand trends are the primary bases for forex rate fluctuations, and the above discussions are focused on interest rates. EUR’s falling below parity with USD on July 13 reflected the announcement of an unexpected acceleration of growth in the US June Consumer Price Index (CPI), which led to the expansion of the subsequent FOMC interest rate hike margin, from 75bps to 100bps. Basically, it may simply have reflected speculation that there would be increased EUR selling due to the widening Europe-U.S. interest rate differential. However, the Europe-U.S. interest rate differential has been widening for some time – it is not a new trend. During the past year, the ECB’s normalization process has never been ahead of the Fed’s, so US interest rates have been consistently higher than euro area interest rates. Despite that, it appears that a sharp drop in EUR was avoided because the euro area’s recording of the world’s largest current account (trade) surpluses has sustained a supportive EUR supply-demand situation.

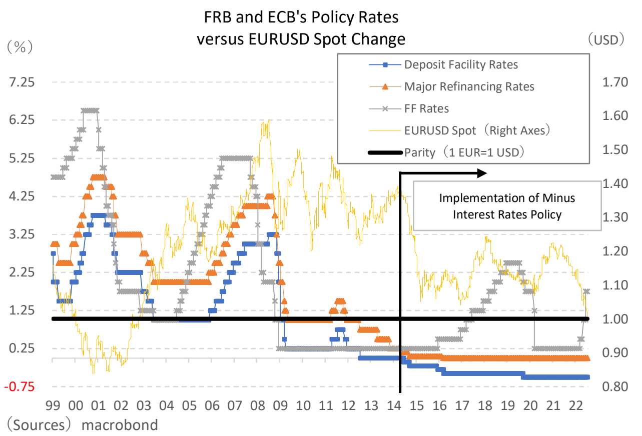
Owing to the surging of natural resource prices, however, Germany recorded a trade deficit in May (the first such deficit since June 1991). As shown in the graph on the next page, EUR/USD has been fairly stable, and EUR fell below parity with USD only in the 2000-2002 period, soon after the currency’s launch. As it was widely recognized even before EUR’s launch that the euro area did not constitute an optimal currency area (OCA), forex markets were initially somewhat doubtful about EUR’s sustainability, and the markets’ doubts were reflected in the exceptionally low EUR valuations seen during the 2000-2002 period. Numerous factors caused EUR valuations to move upward subsequently, but one particularly important factor was the progressively strengthening economy of Germany (which had previously been widely referred to as the “sick man of Europe”[1]) along with striking growth in Germany’s trade surplus (the time period within the square configuration of red dotted lines in the graph). On the other hand, EUR’s sharp depreciation has taken place at a time when Germany’s trade surplus has disappeared (the period within the oval configuration of red dotted lines). If Germany and the rest of the EU loses access to steady and relatively inexpensive natural gas supplies from Russia, the EU will be forced to purchase LNG at relatively high spot prices, and the region’s deteriorating supply-demand environment can be expected to cause the EU countries to record smaller trade surpluses or begin recording trade deficits. The EU’s recording of trade deficits since mid-2021 has become a factor promoting sharp EUR depreciation, and that sharp EUR depreciation itself can be expected to further boost the EU’s imports and thereby expand the EU’s trade deficits going forward.

This vicious cycle can be expected to be protracted unless political or other measures are taken to procure stable and reasonably priced supplies of natural gas, and Japan is facing a similar vicious cycle owing to the global rise of natural gas prices exacerbated by JPY depreciation. Thus, both Germany and Japan seem to have no choice but to overcome their reluctance to resuming nuclear power plant operations, even if only on a temporary basis. However, the situations of the euro area and Japan are quite different insofar as the ECB has decided to hike interest rates to restrain EUR depreciation even if it is at the cost of promoting a recession, while the BOJ remains dedicated to monetary easing even if it is at the cost of promoting JPY depreciation.



Learning from the History of EUR Trends

As mentioned above, EUR values below parity with USD have only been normalized during the 2000-2002 period. That was a period in which there were still widespread doubts about EUR’s long-term viability, and there was believed to be an urgent need to take measures to prevent EUR from collapsing soon after its launch. Accordingly, Japan, the United States, and Europe cooperatively undertook EUR buying intervention measures from September 2000. The last cooperative forex intervention program undertaken since that time was a JPY-selling intervention that took place from March 2011 in response to the super-strong state of JPY following the Great East Japan Earthquake. The EUR depreciation trend was not quickly halted even after the cooperative EUR buying intervention was begun, however, and on October 26, 2000, EUR/USD temporarily descended to USD0.8252, the lowest level ever recorded. Going forward, if natural gas supplies via the Nord Stream 1 pipeline are diminished to a degree that portends disastrous trends in the euro area economy, some people may begin considering that record low EUR/USD’s



[1] The Economist magazine used the phrase “Sick man walking” to describe the German economy in December 2003. As the German economy subsequently sustained steady improvement, the magazine shifted to the phrases “Germany on the mend” (November 2004) and “Sick man no more” (July 2007).

prospective lower bound or landmark level.

The graph on the right overviews the history of EUR/USD movements along with the contemporaneous policy rates of the ECB and Fed. As the ECB's major refinancing operation interest rate was often considered to be the ECB's "policy interest rate" until the introduction of negative interest rates on the ECB's deposit facility from June 2014, the graph shows two types of interest rates for the ECB. During the 2000-2001 period, the ECB implemented interest rate hikes to prevent EUR depreciation from elevating euro area inflation rates, but the United States also implemented significant interest rate hikes, preventing the euro area/U.S. interest rate differential from narrowing, and factors including fears about the euro area's viability as a currency area caused the EUR depreciation trend to continue.

Subsequently, however, the Fed drastically reduced interest rates in response to the IT bubble's collapse, causing the euro area/U.S. interest rate differential to enter an inversion phase through 2004. As mentioned above, this era was also a period in which Germany was successfully striving to shed its "sick man of Europe" status (≈ the period when Germany's trade surpluses began increasing), and it is worth noting that the U.S. economy was then facing challenges associated with the IT bubble's collapse as well as terrorist attacks. Essentially, the 2001-04 period when EUR was able to re-surmount parity with USD was a period in which the euro area/U.S. interest rate differential narrowed significantly (eventually becoming inverted) and Germany began showing its capability to record world's largest trade surpluses. It can be said that EUR was reevaluated during that period based on its increasing strength with respect to both interest rate and supply-demand factors.

Short-Term Trends Largely Dependent on Russian Natural Gas Supplies

The current situation is the exact opposite of that during the 2001-2004 period. Although it is possible that the ECB may at some point begin seriously emulating the Fed in significantly hiking interest rates, it seems unlikely that it will significantly shrink the euro area/U.S. interest rate differential. Moreover, the euro area's economy is so much more fragile compared to its state in the early 2000s that one has to wonder whether it will actually be able to cope with higher interest rate levels. In the early 2000s, doubts about EUR's viability were quickly dispelled and replaced by a generally optimistic mood after the euro area economy successfully survived the 2002 process of putting EUR banknotes and coins into circulation. That optimistic mood was so strong it was sometimes characterized as "euroforia" ("euro" + "euphoria"), and a strange situation appeared in which long-term interest rates in Germany and Greece were at roughly the same level. Although southern European countries were experiencing disproportionate economic overheating, optimistic speculation about EUR's future as the world's second most important key currency promoted considerable EUR buying.

<u>At this time, however, there is a conspicuous dearth of optimistic speculation about EUR's future, so any prospective resurgence of EUR buying will have to be based on concrete interest rate and supply-demand factors.</u> The key situation with a potential for positively affecting those factors is the German trade balance, and it is hard to imagine how that trade balance could improve unless a way is found to resume supplies of natural gas (particularly via Nord Stream 1) from Russia to Germany and then onward to other European countries

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