

September 1, 2022

Overview of Outlook

USD/JPY was very volatile in August, plunging temporarily to the 130 level, then recovering again to nearly 139 by the end of the month. Given the historical year-to-date appreciation of USD against JPY this year, it is not surprising to see significant corrective fluctuations as part of the process, and it would be unwise to view brief JPY appreciations as indicating a trend reversal. There are likely to be more instances of JPY appreciation going forward, when market participants sell off USD in response to a fall in U.S. interest rates. However, as I have said also in past reports, not all the background factors in the current phase of JPY weakness have to do with USD strength. Over the past eight months of U.S. interest rates rising, USD being bought, and JPY weakening, there is also the fact of Japan's trade deficit ballooning to historical proportions. Even if U.S. interest rates (the factor propelling USD buying) stop rising, Japan's trade deficits (the demand-based factor propelling JPY selling) will remain. JPY weakness could be used to Japan's advantage in earning a service (travel) surplus, but the Kishida administration's interest in doing so remains lukewarm. Of course, even with a full recovery to its highest level (+JPY 450 billion a month), a travel surplus would offset barely half the current monthly trade deficit (-JPY 944.8 billion). Still, the current Japanese policy of deliberately turning foreign visitors away, thereby further distorting the JPY supply-demand balance toward JPY selling, is nothing if not painful. There was some expectation that Japan's current emotional approach to preventing the spread of the pandemic, the reason behind its low growth rate, would be revised once the Upper House elections were over. However, the Kishida administration has given no indication of any significant change, and the situation, sadly, remains un conducive to recommending JPY buying.

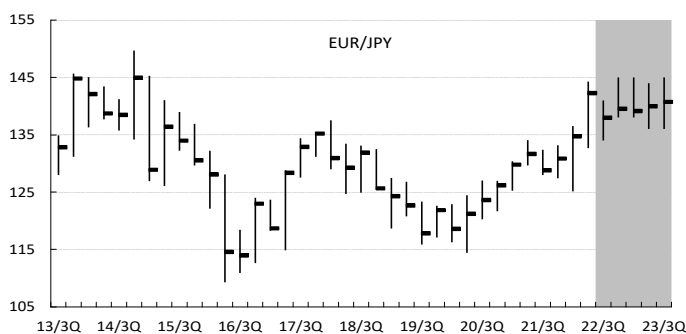
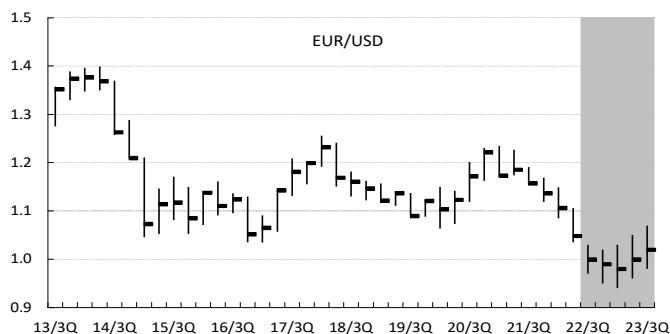
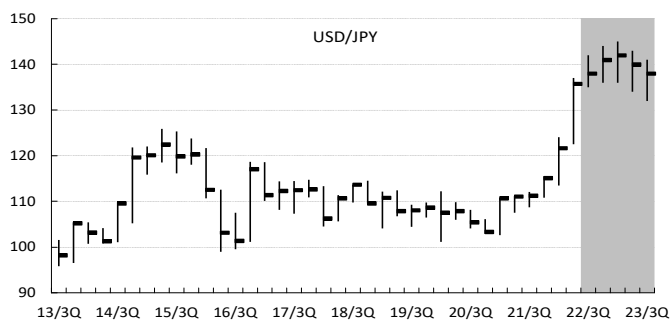
EUR also remained weak during August. On top of the existing energy supply crisis, with Russia suspending gas flows via Nord Stream 1 again, yet another unforeseen challenge surfaced in the form of low water levels in the Rhine, which make it difficult to transport coal. This situation poses a significant risk when it comes to demand for EUR, so the EUR outlook may have to be downwardly revised. For instance, the Rhine was considered an alternative route by which the energy supply to Europe could be ensured in the face of disruptions in Russian supplies. To the extent that this route is now cut off, Europe will have to depend on Russia for its energy. If energy imports from Russia at current premium spot prices expand further, Germany's trade surplus will shrink dramatically and could even turn into a deficit, and without the German trade surplus, an EUR crash may become inevitable. Moreover, unlike in the U.S., where inflation is beginning to peak, there are no such indications in the euro area; there are concerns that the euro area may be relatively alone in experiencing runaway inflation through the second half of the current forecasting period. A marked improvement in the energy supply situation is an essential requirement for the EUR rate trend to begin reversing, but there are no reasons to view this as a possibility as of the current time.

Summary Table of Forecasts

	2022			2023		
	Jan -Aug (actual)	Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	113.47 ~ 139.38 (138.63)	135 ~ 142 (138)	136 ~ 144 (141)	136 ~ 145 (142)	134 ~ 143 (140)	132 ~ 141 (138)
EUR/USD	0.9901 ~ 1.1495 (1.0028)	0.97 ~ 1.03 (1.00)	0.95 ~ 1.02 (0.99)	0.94 ~ 1.03 (0.98)	0.96 ~ 1.05 (1.00)	0.98 ~ 1.07 (1.02)
EUR/JPY	124.41 ~ 144.30 (139.01)	134 ~ 141 (138)	138 ~ 145 (140)	138 ~ 145 (139)	136 ~ 144 (140)	136 ~ 145 (141)

(Notes) 1. Actual results released around 10 am TKY time on 31 August 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

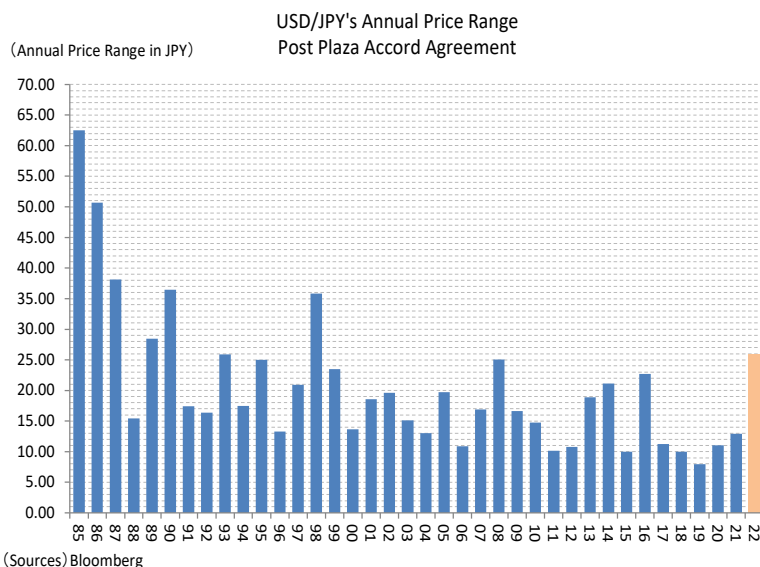


USD/JPY Outlook – Why JPY Strength Correction Does not Last

JPY Rates Now and Going Forward – Corrections Bound to be Significant Given Historical Depreciation of JPY

Corrections Bound to be Significant Given Historical Depreciation of JPY

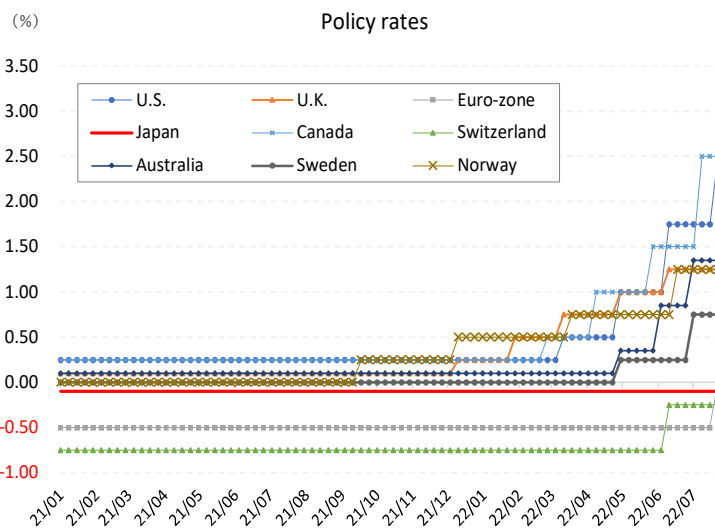
USD/JPY fell to the 130 level at one point in August, sinking by around 9 yen, or over 6%, compared with the year-to-date high of over 139 posted on July 14, so the media’s use of verbs such as “plummet” and “plunge” is understandable. However, the fact is that USD/JPY had risen by around 26, or over 20%, from its 115 level in early March over a period of four and a half months. The year-to-date movement range is already 25.91, the largest in the weak-JPY direction since 1989 (when the range was 28.45). In 1989, the Japanese economic bubble was at its peak, and the JPY depreciation seen that year was a positive development partly resulting from JPY selling by Japanese investors following the deregulation of foreign securities investment. This time again, going by the increase in Japan’s trade deficit and foreign direct investment, JPY depreciation is partly driven by Japanese investors selling JPY, but it is harder to find anything positive about it. At any rate, given the historical rise in USD/JPY over the first 7.5 months of 2022, it is not surprising to see significant corrections punctuating this trend.



Are We Likely to See JPY Appreciation also During Risk-On Phases?

As to why JPY appreciated during August, many analysts seem to think this is because expectations of further interest rate hikes by the Fed have receded in view of recessionary risks for the U.S. economy, leading to a decline in U.S. interest rates and USD selling. However, regardless of the near-term response, if expectations of further rate hikes by the Fed recede and prospects of rate cuts emerge, financial market volatility is likely to head toward a stable low, which is generally known to result in a “Goldilocks market” situation, with bonds, stocks, credit, and all other classes of assets appreciating. Currencies that tend to be bought in such situations are often high-interest-rate currencies represented by the currencies of resource-producing countries, with investors focusing on policy interest rates even when it comes to choosing among the currencies of developed economies.

It is difficult to imagine JPY being proactively bought in such a scenario. Historically speaking, JPY has tended to be strong during phases of global economic cooling, especially risk-off phases characterized by protracted share-price weakness. This past August, despite China’s firing of missiles into Japanese waters, what we saw was the perplexing development of “JPY buying during a risk-off phase.” Going forward, if we see “JPY buying during risk-on phases,” that would suggest JPY buying during both risk-on and risk-off phases, but the situation is unlikely to be that rosy. The interest rate differential between Japan and other countries seems poised to widen further (see figure). If the hawkish policy stances of U.S. and European authorities give way to more dovish policy stances, the resulting decline in volatility could cause low-interest-rate currencies to further weaken due to their role as funding currencies.



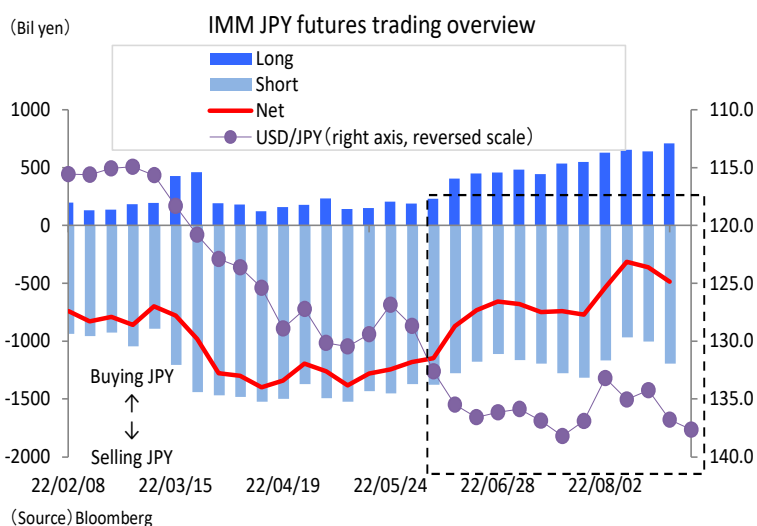
(Source) macrobond

JPY Buying During Risk-Off Phases a Vestige of Past Forex Market Trends

Meanwhile, it is doubtful how sustainable the trend of JPY buying during risk-off phases really is. China began conducting military drills near Taiwan on August 4, and five of the ballistic missiles fired landed inside Japan’s exclusive economic zone (EEZ), as was widely reported. This was the first time Chinese ballistic missiles had landed in Japan’s EEZ, clearly making this a significant incident in Japan’s neighborhood. Despite this, JPY strengthened. The same pattern is seen when North Korea test fires missiles toward Japan. It is not immediately clear why confidence in JPY strengthens every time a missile is fired toward the country.

Of course, in the past, when Japan boasted large current account and trade surpluses and most of its net foreign assets comprised marketable securities, buying back JPY in order to reduce (forex) risk was a conceivable course of action. At the present time however, not just is the country’s trade deficit expanding at its highest pace ever (-JPY 7.9 trillion in six months), the composition of its net external assets is dominated by direct investment, which are not easily repatriated. Perhaps the tendency to buy JPY during risk-off phases is a vestige of past forex market trends, but, unlike in the past, it is no longer backed by a significant repatriation of assets, so is unlikely to be sustainable. It must also be noted that JPY was not bought at all, but rather heavily sold off, during the Russian invasion of Ukraine, which was an extremely significant risk-off event. This makes it even more difficult to explain JPY buying triggered by the Taiwan incident. Ultimately, it may simply be that speculative trends pertaining to each incident determine whether JPY will be bought during that particular risk-off phase. The key is to note that, unlike in the past, JPY buying during a risk-off phase is no longer backed by any real flow of assets.

It does not, however, appear that JPY rates are being dictated by speculative trends. The weakening of JPY from June through July this year took place against investors unwinding their net JPY short positions in IMM currency futures transactions (see figure). The fact that JPY depreciation accelerated despite speculators moving to buy the currency seems to suggest that the impact of actual-demand-based flows, such as securities investment, resulting from the trade deficit or foreign-to-domestic interest rate differentials, was stronger. Perhaps the pace of JPY depreciation accelerated because the direction of flows resulting from speculative trade coincided with that resulting from actual demand during March and April. If it is true that “JPY buying during risk-off phases” is now no more than a vestige of past forex market trends driven by speculative trading, it may be prudent to assume, for the time being, that it will not greatly impact JPY rate trends.



(Source) Bloomberg

JPY Supply and Demand Now and Going Forward – Rapidly Declining Current Account Surplus

Lowest in Eight Years for 1H

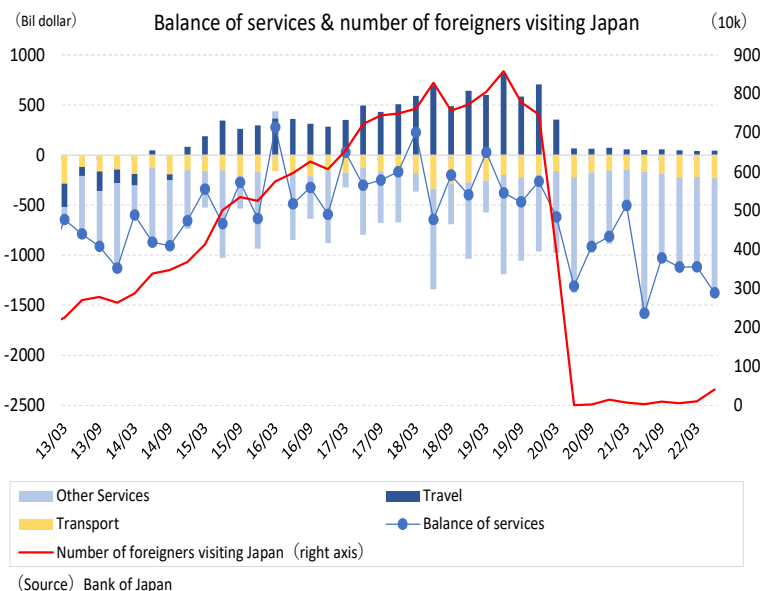
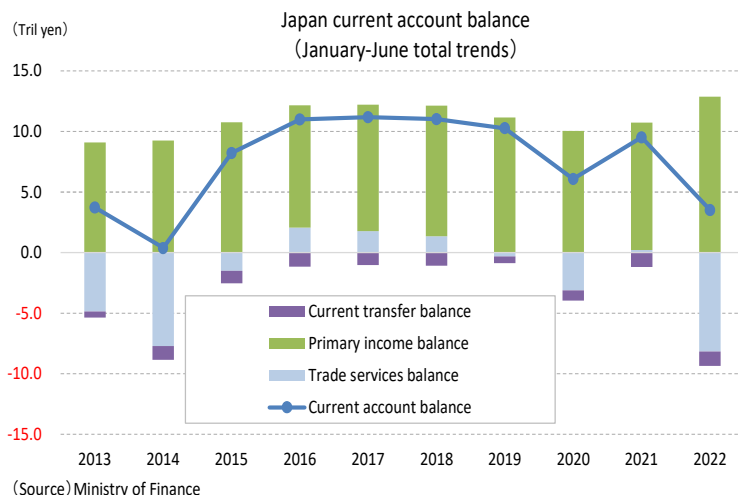
In August, the Ministry of Finance released Japan's June balance of payments. Based on this, the current account surplus for 2022 1H was reported to be +JPY 3.5057 trillion, the lowest in eight years (since 2014) for the first half of the year, and less than 40% of the 2021 1H current account surplus (+JPY 9.5077 trillion). This is, very simply, due to the expansion of Japan's trade deficit amid higher resource prices and a weaker JPY. 2022 1H saw the largest ever trade and services deficit at -JPY 8.1634 trillion. As I often emphasize in this report, the interpretation that "JPY strengthened during August because of USD selling prompted by lower U.S. interest rates" is too simplistic in that it overlooks the aforementioned fundamental JPY supply-demand situation. The expansion of the trade deficit implies an increase in JPY selling by

the Japanese (Japanese import firms), which is a factor contributing to JPY depreciation. Over the past six months, the expansion of the trade deficit has coincided with an increase in U.S. interest rates, so it is difficult to say precisely how much each factor has contributed to JPY depreciation, but I believe it is inappropriate to dismiss such major changes in JPY supply and demand and discuss rate trends merely from the perspective of interest rate differentials.

While it is tempting to compare the recent current account surplus deterioration with that of 2014 1H, one must remember that the situation now is completely different from what it was then. In 2014 1H, not just was there rush demand ahead of an increase in consumption taxes (especially during January through March), there was also an increase in crude oil imports ahead of an environmental tax increase (a one-off increase in taxes on coal and petroleum products to check global warming) starting April 1 of that year. As in the present case, early 2014 was characterized by a marked depreciation of JPY in the early days of Abenomics, but the factors causing the current account balance to shrink were clearly transient. In fact, the current account surplus did recover starting 2H of that year onward.

Factors Behind Present Situation May not be Transient

This time around, the current account surplus has shrunk because of the trade deficit expanding as a result of resources prices increasing and JPY depreciating. While both the resource price increase and JPY depreciation trends appear to have leveled off for now, there has been no marked correction in either. This means import values remain high. While the increase in imports may have been arrested, there are few prospects for an increase in exports, given that both the U.S. and European economies are on the brink of a recession. Japan could add to its current account surplus by taking advantage of JPY weakness to earn a travel surplus (inbound tourism), but in reality, its service balance (which includes the travel balance) for 2022 1H was a deficit of -JPY 2.5 trillion. This is the result of refusing inbound tourism. Incidentally, the service balance for 2019 1H was -JPY 350 billion, i.e., around one-seventh that of 2022 1H. Hardly any other countries around the world are imposing travel restrictions at the present time, but the Kishida administration seems blissfully unaware of this fact, so the prospects for an improvement in demand for JPY based on inbound tourism seem bleak. These present circumstances of Japan make it difficult to declare that the recent current account surplus deterioration is transient, the way it was in 2014.



Evidence of the Strength of Japan's Current Account Balance?

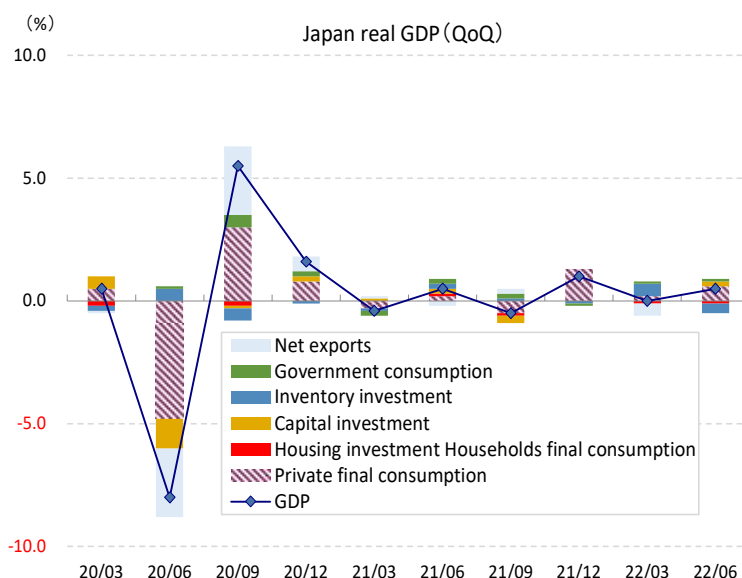
It must be noted, however, that the drop in current account surplus levels as a result of shrinking trade surpluses is a common phenomenon among net resource-importing countries around the world – Germany, which is fast losing its current account surplus, is another example. To look at it another way, perhaps it is evidence of the strength of Japan's current account that the country is able to post a surplus despite the recent resource price increase and JPY depreciation. Thanks partly to its inflation in JPY terms due to JPY depreciation, Japan's primary income surplus for 2022 1H was at its highest ever, at +JPY 12.8729 trillion. Compare this with +JPY 9.2466 trillion in 2014 1H. The current account surplus for 2014 1H was over JPY 3 trillion lower than this time, at +JPY 3.5057 trillion, and this difference can very simply be attributed to the (approx. JPY 3.6 trillion) difference in primary income surplus between the two. The trade and service deficit this time is -JPY 8.2 trillion, which is higher than the -JPY 7.7 trillion in 2014 1H, making clear that it was the higher primary income surplus this time that put the recent current account surplus slightly higher. (Though depending on resource prices and forex rates going forward,) Japan's primary income surplus may be the one factor that stands in the way of a regular current account deficit trend for Japan and prevents it from slipping, symbolically, into the "asset liquidator" stage.

Of course, the primary income balance gets mostly reinvested without being converted back into JPY, so despite preventing a Japanese current account deficit, it is unlikely to contribute directly to propping up JPY. However, given that the forex markets tend to be driven by impulse, JPY's status as a safe asset is probably based to a large extent on Japan's status as the world's largest net external creditor. The fact that Japan, thanks to its primary income surplus, posted a current account surplus for 2022 1H despite facing so many major adversities seems to have significant implications for the outlook of Japan's current account balance going forward.

The Japanese Economy Now and Going Forward – "Recovery Beyond Pre-Pandemic Levels" is a Lie

"Recovery Beyond Pre-Pandemic Levels" a Convenient Lie

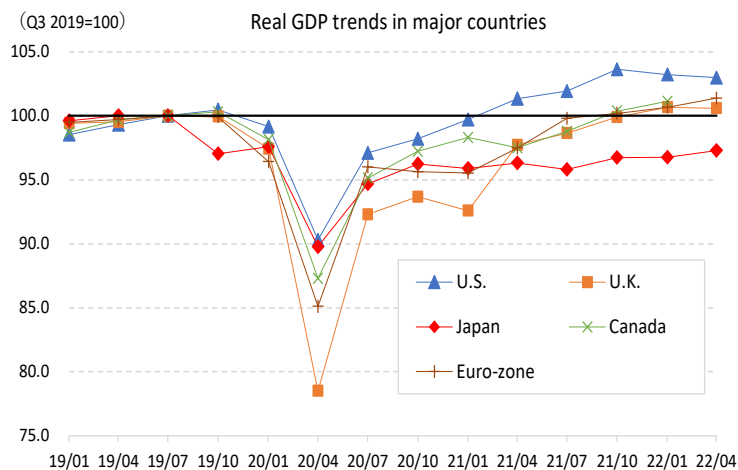
Japan's April-June 2022 Real GDP, released by the Cabinet Office on August 15, had grown by +2.2% annualized qoq (+0.5% qoq), falling slightly short of the median of market forecasts (+2.5% annualized qoq). This was partly because personal spending did not grow as strongly as expected, but also because of the significant -0.4pp negative contribution from inventory investment, reflecting the higher-than-expected drawing down of inventory amid severe supply constraints. Even so, the results serve to reaffirm that positive GDP growth, driven by private spending and investment (personal spending, fixed investment), can be maintained when the government does not impose movement restraints. As the figure shows, Japan's GDP growth has alternated between positive and negative growth over the past year or more, and this is consistent with the government's imposition and lifting of movement restrictions in accordance with infection trends. However, it would be no exaggeration to say that this is quite a unique growth pattern, globally speaking.



(Source) Japan Cabinet Office

The news headlines following the recent GDP release were by and large optimistic in reporting "recovery beyond pre-pandemic growth levels." However, as I have repeatedly argued in this report, this interpretation is quite misleading. The quarter that is frequently used as a benchmark of "pre-pandemic" growth levels is October-December 2019, but this quarter posted -14.3% annualized qoq (-2.80% qoq) growth thanks to the consumption tax hike and Typhoon Hagibis. If we compare the April-June 2022 real GDP with the quarter before that, i.e., July-September 2019, we see a negative -2.7% growth, and similarly a negative -2.6% growth when compared with the average of the three quarters from January through September 2019. Even if we use the average for the entire calendar year 2019, growth still falls short by -1.9%, indicating that there is still some way to go.

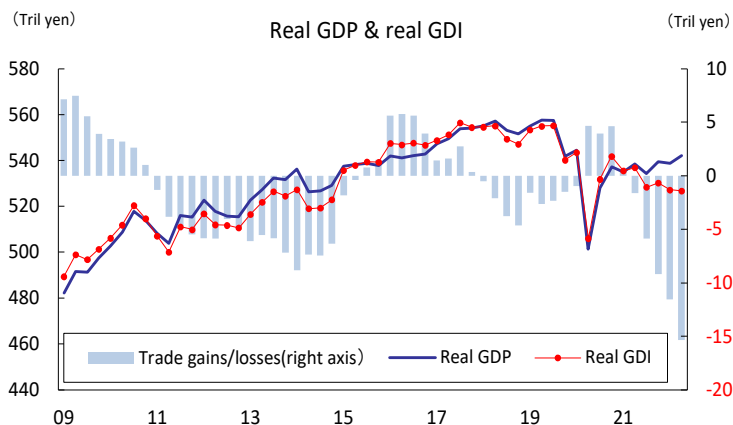
Among key countries/regions, taking the July-September 2019 quarter to be the base quarter, Japan is the only one that has not recovered this level, a distinction that must be noted (see figure). Defining pre-pandemic growth levels as growth during the October-December 2019 quarter and emphasizing a return to normalcy based on this is no more than a convenient lie, and cannot be taken at face value. Even more ridiculous is this touting of a return to a “pre-pandemic” state while still imposing entry restrictions in the name of border control measures. As of the writing of this report, Japan has reported the largest number of new cases in the world for four weeks in a row, so if anything, it should be at the receiving end of border control measures rather than the other way round. I believe the administration ought to be ashamed of its policies and remedy them with immediate effect, but the relaxation of rules implemented in August seem very unlikely to succeed (details follow).



(Source) macrobond (Note) We consider Q3 2019 to be pre-pandemic (100) to avoid Japan's sales tax hike and a downturn caused by Typhoon 19

Real GDI is the Better Indicator

As is obvious from the various recent opinion polls, the vast majority of Japanese people are unlikely to be happy with the current state of affairs, with prices rising rapidly despite no increase in nominal wages. Naturally, people are not experiencing a recovery in real economic performance. As I argued in a past issue of this report, real GDP is a measure of production volume. The indicator you get by additionally taking into account the improvement/deterioration in terms of trade (trade gains/losses) to understand the purchasing power of the domestic economy is the real Gross Domestic Income (GDI). The real GDP can show the production volume of the Japanese economy, but it does not show changes in the Japanese economy's purchasing power accompanying a change in the terms of trade. It is not difficult to see, even intuitively, that there can be no improvement in business sentiment without an improvement in real GDI. Of course, even without going into the details of the theory, people are bound to be experiencing an undesirable increase in prices with the simultaneous appreciation of resource prices and depreciation of JPY. Perhaps the real GDI can be seen as an indicator that quantifies what people are experiencing.



(Source) Cabinet Office

It is clear at a glance from the figure on the right that the gap between real GDP and real GDI has widened considerably. Real GDP is recovering, if only at an extremely gentle pace, but real GDI has clearly fallen a notch. There have been several phases of resource price appreciation or JPY depreciation since the collapse of Lehman Brothers, and the gap between real GDP and real GDI has been seen as problematic during each of these phases, but this time the gap is conspicuously wider. Incidentally, as a percentage of GDP, trade losses for the recent quarter amounted to -2.8%. Over the past year, let alone improve, the pace of deterioration has accelerated, going from -0.4% in April-June 2021 to -1.1%, -1.6%, -2.0%, and finally -2.8%. In theory, whether measured in terms of production (added value = GDP), distribution (income = GDI), or expenditure (demand = GDE), the economic activity of a nation must come out to be the same (the principle of equivalence of the three aspects of national income), but this is clearly not so in the case of Japan.

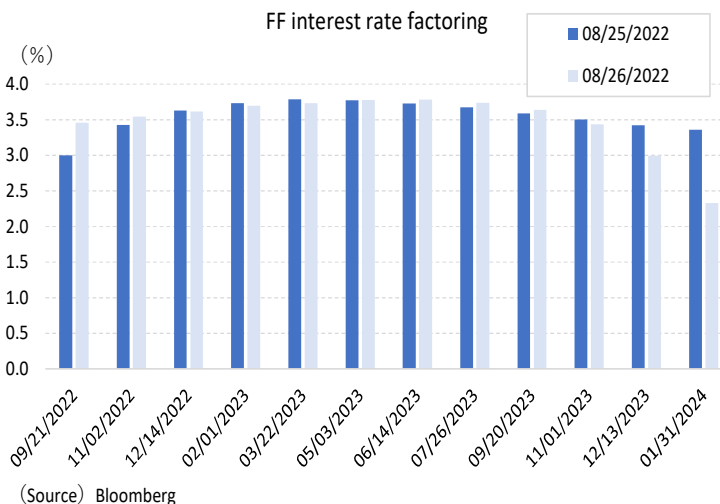
This is thought to be the direct result of the Japanese economy being based on processing trade – i.e., importing crude oil and other mineral fuels as well as other kinds of raw materials, which it then processes into other products and exports – which makes it easy for the terms of trade (i.e., GDI) to deteriorate when import prices increase (there are various views in this regard, but I will discuss then on another occasion). If export prices could be increased in accordance with import prices, the terms of trade would not deteriorate, but Japan is unable to do that. For one thing, it is frequently pointed out, increasing export prices would make it difficult to export products, i.e., lower export competitiveness. Overseas, Germany is another big exporter that imports resources, but terms-of-trade deterioration is not a big problem in its case. This is likely because Germany has a high trade ratio within the euro area and its circumstances make it easier for it to increase export prices (i.e., pass on the increase in costs).

At any rate, there is no doubt that the Japanese economy faces challenges that make it difficult to measure performance accurately based just on real GDP trends, which have been hogging the headlines in recent days, but easier to understand when seen in terms of the deteriorating real GDI (i.e., purchasing power) trend. An accurate understanding of the current state of the Japanese economy can only be obtained by looking at both the real GDP and real GDI together.

U.S. Monetary Policy Now and Going Forward – Relentless Pursuit of Hawkish Policy Path

No Change Assumed in Overall FF Rate Path

The much-anticipated speech by Fed Chair Jerome Powell at the August 26 Jackson Hole Economic Symposium lasted a mere 8 minutes, but its message was clear. The tone was clearly hawkish – “Restoring price stability will likely require maintaining a restrictive policy stance for some time,” “The historical record cautions strongly against prematurely loosening policy,” etc. The slowdown of the consumer price index (CPI) and some other fundamental economic indicators in August briefly gave rise to speculation that the Fed would soften its stance, causing U.S. interest rates to fall and share prices to soar, but there were statements discouraging such optimism from several regional Federal Reserve Bank presidents immediately ahead of the Jackson Hole Symposium.

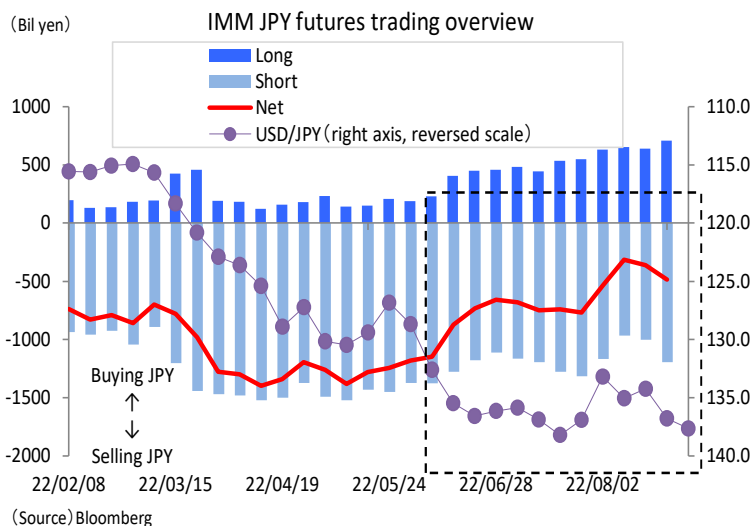


In that sense, there was nothing surprising about the contents of Powell's speech. Some news headlines reported an upswing in the outlook for U.S. interest rates, but as the figure shows, despite an increase in the extent of factoring in a September FOMC rate hike on August 26 (the day of the speech) compared with August 25, the larger forecast scenario of rate hikes until March 2023 followed by rate cuts during the second half of the year has not changed. Rather, as the figure shows, the expected pace of subsequent rate cuts shows a steeper decline on August 26. Even before the speech, market participants had factored in a near-term hawkish policy stance while being concerned about the subsequent reaction to it, but their concern regarding the subsequent reaction seems to have intensified following the speech.

While one can say that assumptions regarding the policy path remain unchanged by and large, market participants are increasingly factoring in a median 75bp increase in interest rates at the September FOMC, which is less than a month away, while U.S. 10-year interest rates remain stable at the 3% level. As a result, the share markets have been very volatile and USD is being bought in the forex markets. For some time to come, the forex markets are likely to reflect the principle that USD strengthens when U.S. interest rates increase, i.e., be led by U.S.-based developments, primarily interest rates.

JPY Trend not Determined Solely by U.S. Interest Rates

Assuming forex market trends driven by developments in the U.S., USD appreciation is likely to end in January-March 2023, when FF rate hikes end and U.S. interest rates fall in reaction. This is a key point I have been emphasizing in this report. However, while speculative trade is typically sensitive to interest rates and policy trends, the relationship between the USD/JPY and speculative trade trends has not really been stable during the ongoing JPY depreciation phase. The portion within the dotted square in the figure, which shows IMM currency futures transactions since late May, shows a steady decline in JPY sales in the net JPY position. Despite this, USD/JPY has fluctuated violently in the 130-140 range, and remains stubbornly high overall.



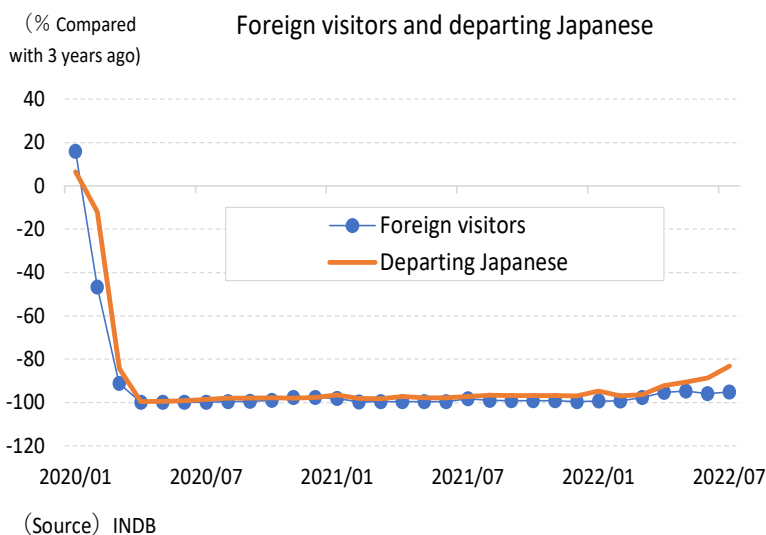
Looking at the gross position trend, the JPY short position has been gently falling while its long position has been gently rising, indicating an increase in speculators betting on an autonomous recovery of JPY, which has so far consistently weakened with a decline in U.S. interest rates. However, as the figure shows, USD/JPY has been stable at a high level contrary to speculative trade positions.

While U.S. interest rate trends are important, one must ultimately also take into account the historical expansion of Japan's trade deficit, which could cause JPY to remain weak even after the strong-USD trend has ended. When the year-to-date rate movement rate is as high as 26 yen, a 5-yen or 10-yen correction is not surprising. It is important to note, however, that JPY has become so undervalued over the past 8 months that anything below 130 to the dollar seems like JPY strength.

Risks to My Main Scenario – Continuing the National Isolation Policy and Spurning Potential Benefits from JPY Depreciation

Tourists Disinclined to Visit “Unfree Countries”

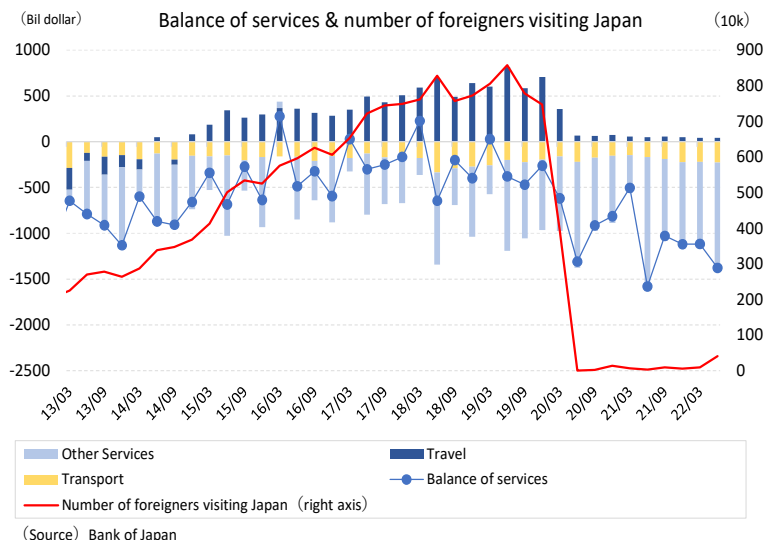
USD/JPY was quite volatile during August. Even when JPY temporarily strengthened in May, I have continued to emphasize in this article that I do not believe that the JPY-weakening phase is over. I reiterated this view in a Mizuho Market Topic article when USD/JPY descended to the JPY131 level in early August. The basis for this view is that, even if the factor of rising U.S. interest rates promoting JPY depreciation were to disappear, the JPY supply-demand environment promoting JPY depreciation is unlikely to change for the time being. While the end of Japan's trade deficit expansion is finally in sight owing to the peaking out of natural resource prices, that trade deficit has already exceeded JPY9 trillion in the first seven months of this year, causing many economic entities to undertake JPY selling. Under these circumstances, it is inevitable that JPY will weaken in line with the actual supply-demand situation.



In addition to the trade balance, the JPY supply-demand situation is importantly affected by trends in the “services” portion of Japan's current account balance – particularly trends in the travel balance. On August 17, the Japan National Tourism Organization (JNTO) announced that the number of foreign visitors to Japan in July 2022 was 144,500. This figure is down 95.2% from the pre-pandemic level in July 2019 (2,991,189 people). The margin of this drop was roughly unchanged from the previous month (June), when number of foreign visitors was down 95.8% compared to the June 2019 level. Although Japan has gradually been increasing its acceptance of foreign tourists (so-called inbound tourists) since June 10, the scale of the increase so far has been incomparably small relative to pre-pandemic levels. The Japan Tourism Agency's “Guidelines for Accepting Foreign Tourists” ask inbound tourists to take basic infection prevention measures such as wearing a mask, disinfecting one's hands, and avoiding the “Three Cs” (closed spaces, crowds, and close-contact situations). They also recommend such measures as taking out private medical insurance policies. The guidelines hint that if it is found that these requests are not being complied with by participants in a given tourist group, that group's tour may be canceled. Moreover, at the time this article was written, Japan limited the number of people entering the country (including business travelers) to 20,000 per day. Given this situation, it is impossible to expect a sudden large surge in the number of foreigners coming to Japan. Numerous countries have already rescinded their pandemic-related immigration restrictions, and the share of people wearing masks has become quite low in many countries. In general, most countries have become “freer” than Japan with respect to pandemic countermeasures, and most people are not inclined to spend their time and money travelling from a “free country” to a “non-free country”. The statistics on numbers of tourists travelling to various destinations reflect this basic disinclination to seek less freedom. Although it is difficult for foreigners to enter Japan, it is noteworthy that other countries' removal of pandemic-related restrictions has supported a moderate uptrend in the number of Japanese going abroad, which compared to 2019 were down 90.7% in May, 88.7% in June, and 83.3% in July. The number of people leaving Japan in July was 277,900 – the first time since March 2020 that monthly departures surpassed 200,000 – and it is quite likely that the number increased further in August when many Japanese enjoyed their summer holidays. It is becoming increasingly clear that Japan believes it to be acceptable for Japan residents to reenter the country but does not want foreigners to come.

Travel Balance Worse Now than Soon after the Pandemic Began

If the current “Japanese re-entrants are fine, but foreign entrants are unwelcome” attitude is maintained, Japan’s travel balance will naturally be associated with greater JPY selling and less JPY buying. In terms of forex flows, there will be an increase in JPY selling and foreign currency buying. This is a discussion of trends in the services balance (particularly the travel balance) within Japan’s balance of payments. Based on balance of payments statistics that currently cover the period through June, the graph shows changes in Japan’s services balance and in the number of foreign visitors to Japan through the first half of 2022. The number of foreign visitors to Japan has begun increasing slightly, but the current number is not even comparable to the numbers recorded during the inbound tourism peak period in 2018 and 2019.



Surprisingly, Japan’s travel balance so far this year has been even worse than it was in 2020 and 2021, soon after the pandemic began. The travel surplus in the first half of 2022 was JPY82.8 billion, while it was JPY420.7 billion in the first half of 2020 and JPY106.2 billion in the first half of 2021. Although JPY depreciation and the worldwide relaxation of immigration restrictions create an environment in which it would be quite easy for Japan to expand its travel balance surplus, the travel balance is actually deteriorating due to the national isolation policy. Amid the JPY depreciation trend, only Japanese people are allowed to travel abroad and return, increasing the travel balance outflow, while the rejection of foreign visitors is decreasing the travel balance inflow. There is clearly no basis for expecting improvement in the travel balance.

Killing Two Birds with One Stone by Lifting the Inbound Tourist Ban

Japan’s current government led by Prime Minister Fumio Kishida is not likely to move to fully relax immigration restrictions so long as public opinion polls reflect Japanese society’s and media headlines’ continued focus on estimating the number of new infections based on thorough testing programs. As explained below, the Kishida government on August 24 made a high-profile announcement about immigration restriction relaxation measures, and the Prime Minister announced that his government plans to – “[G]radually ease border controls to allow entry procedures to be as smooth as those of other Group of Seven countries.” – but very little progress has been made toward that goal. It had been hoped that the central government’s relaxation of its COVID infection statistics methodology would be leveraged to countervail the effect of media reports’ sensationalistic tone, but it was ultimately decided to delegate the authority for adjusting the methodology to local governments, and Tokyo’s government (the most important of Japan’s local governments) has made it clear that it will not adjust its methodology. Consequently, Japan’s domestic pandemic countermeasure policies will remain essentially unchanged from September, and it appears unimaginable that the country would completely discontinue its restrictions on inbound tourism in the foreseeable future.

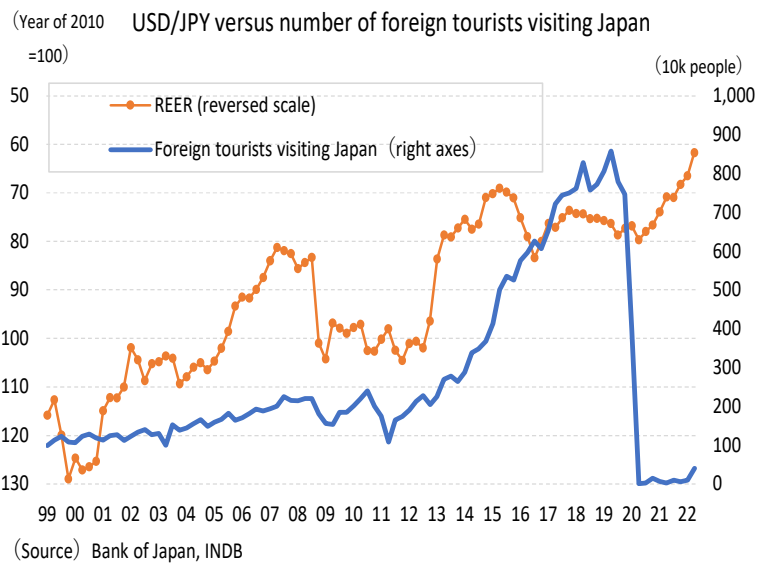
As a result, it continues to be impossible to anticipate a recovery in Japan’s travel balance surplus. Japan’s travel balance surplus was about JPY2.7 trillion in 2019, and given that the country recorded a current account surplus of only about JPY3.5 trillion in the first half of this year, the travel surplus should no longer be considered to be a current account item that can be taken lightly. Of course, there is no prospect of Japan’s travel surplus returning to its former level so long as China, which previously accounted for 30% of inbound tourists, maintains its zero-coronavirus policy. Rather than being distracted by such uncontrollable situations in the external environment, however, one should focus on the fact that Japan itself – by rejecting inbound tourism – is promoting excessive JPY selling and deterioration of the JPY supply-demand environment. In the first half of 2019, Japan recorded travel balance surpluses averaging JPY450 billion per month. In the first half of 2022, however, the average monthly travel balance surplus was only JPY13.8 billion – about 3% of the previous level. In addition, Japan’s trade balance was securely in the black during the first half of 2019, with a monthly surpluses averaging JPY5.4 billion, while the country recorded monthly trade deficits averaging JPY944.8 billion during the first half of this year. In other words, even if the travel surplus were to re-attain its heyday level (JPY450 billion per month), it would only be able to offset half the country’s current trade deficit (JPY944.8 billion per month). Despite this challenging situation, it should be recognized that banning inbound tourism is further distorting the JPY supply-demand environment in the direction of JPY selling.

If there was a rational basis for Japan’s strict immigration restrictions, then one might find it reasonable to accept the negative effects of banning inbound tourism on the JPY supply-demand environment. However, when half the world’s daily new infections are being recorded in Japan, it is hard to justify the strict immigration restrictions. While many other countries have abandoned immigration restrictions and mask-wearing rules, it appears that Japan no longer has the ability to make calm judgments about what countermeasures are scientifically justifiable – it seems to be basing its policies largely on emotion-based superstition. Japan’s reluctance to move forward stems from the prioritization of

emotional superstition over rational thinking, and this is probably the main reason why the Japanese economy is the only one of the world's leading economies unable to re-attain its pre-pandemic GDP level (July-September 2019). It is to be hoped that after grasping the statistically measurable magnitude of strict immigration restrictions' economic side effects, Japan's leaders and population will seek to reopen the country to the international community as soon as possible. Discontinuing Japan's national isolation policy can be justified as a measure that would kill two birds with one stone – helping curb JPY depreciation while also stimulating domestic demand.

50,000 Daily Arrivals Not so Bad

Amid these circumstances, the Kishida administration announced on August 24 that the government would begin gradually easing its pandemic countermeasures. Particular attention was drawn to the fact that Japan's immigration restrictions – widely ridiculed as being the strictest and perhaps most-unscientific such restrictions among G7 countries – are finally beginning to be moderated. The headlines of media reports on the announcement largely focused on the plan to elevate the daily arrivals limit from 20,000 to 50,000. Having received numerous inquiries about my perspective on this plan, I think it worth pointing out that, at this point in time, it is not possible to justify having a daily arrivals limit of whatever level. In early May this year, Prime Minister Kishida himself announced in London that he would strive to make Japan's immigration restrictions on par with those of other G7 countries by June. As no other G7 country has a daily arrivals limit, Japan's retention of its daily arrivals limit is clearly not in line with the prime minister's statement.



In light of well-known nature of the Kishida administration, which strives to be conservative in all matters, however, one can consider the hiking of the daily arrivals limit to 50,000 to be a fairly positive initiative. When Japan's inbound tourism peaked in 2019, about 32 million people visited Japan annually – roughly 88,000 people per day. Of those 32 million people, 9.59 million (about 30%) were Chinese. It is generally understood that, owing to China's zero corona policy, one cannot currently expect many people to travel from China to Japan in the near future. If one reduces the 2019 figure of roughly 88,000 inbound visitors per day by 30% to reflect the lack of visitors from China, one gets a level of about 62,000 inbound visitors per day. Roughly speaking, that is the potential level of inbound travelers that Japan can hope to attract at this time. Given that, it can be seen that, while hiking the daily arrivals limit to 50,000 is not a sufficient easing measure, it is a quite significant one that could enable Japan's inbound tourism to recover to fairly close to its 2019 level.

It is also worth noting that Japan's travel balance surplus in 2019 was about JPY2.7 trillion, so if 70% of that surplus is considered feasible, one can imagine that Japan's travel balance surplus might recover to about JPY1.9 trillion. However, JPY's real effective exchange rate (REER) has fallen to its lowest level in half a century, meaning that the purchasing power of foreigners in Japan has increased. Even if the number of foreign visitors to Japan does not increase, however, one can anticipate that the higher purchasing power will tend to boost the spending of individual visitors in Japan to a level higher than that in 2019. Thus, it may be overly pessimistic to estimate the potential travel balance surplus level by simply subtracting the number of Chinese travelers from Japan's total number of inbound tourists in 2019. JPY's most recent REER level (60.0 in July 2022) is 24% lower than the average REER level in 2019 (79.4). The Japan Tourism Agency estimates that the consumption of foreigners visiting Japan in 2019 was approximately JPY4.8 trillion, or JPY159,000 per person, and it would not be surprising to find that the visitors' per capita consumption of Japanese goods and services will be increasing going forward owing to JPY's record-low REER level. The potential number of foreigners who may visit Japan in the near future is lower owing to the lack of potential visitors from China. If visitors in Japan are encouraged by the 24% lower level of prices to increase their per capita consumption, however, then even with an upper limit of 50,000 inbound visitors per day one has a strong basis for anticipating considerable recoveries in the total consumption of foreigners visiting Japan and in Japan's travel balance.

Daily Arrivals Limit Not the Main Problem

But the daily arrivals limit is not the main problem. The number of people who entered Japan for tourism purposes in July was 7,903. Since this was roughly 250 per day, it is clear that the daily arrivals limit is not the main constraint on arrivals. There remain three intimidating barriers to foreigners seeking to enter Japan: (1) a requirement to document a negative COVID test performed within 72 hours prior to boarding flights to Japan; (2) a requirement to obtain a tourist visa, and (3) a requirement that visitors travel in group tours with tour guides. It has been announced that requirement (1) will no longer be applied to "fully vaccinated" visitors (three shots), but if requirements (2) and (3) are retained, it is possible that they may prevent a significant rise in the number of visitors. Currently, only people coming from 102 countries and regions considered to have the lowest COVID infection risks

(such as the United States and South Korea) are permitted to enter Japan for tourism purposes. Moreover, all tourists without exception must obtain tourist visas, including those with nationalities that Japan allowed visa-free entry to prior to the pandemic. It seems obviously irrational for a country that was steadily recording roughly half of the world's new COVID infections at the time that this article was written to impose entry requirements based on the infection risk level of other countries. That aside, it seems unlikely that there will be a surge of visitors soon if the current round of regulatory relaxation measures do not eliminate the visa requirement. Moreover, it is unclear when the requirement that visitors travel in group tours with tour guides will be eliminated to enable individual tourists to travel in Japan by themselves. It seems quite obvious that, rather than the daily arrivals limit, it is the visa and group tour requirements that are playing the main roles in keeping foreign visitors away. Other factors that will probably continue discouraging potential visitors include Japan's obstinate approach to domestic pandemic control measures, such as those to encourage voluntary enrollment in medical insurance and those that force people to wear masks. Many prospective visitors to Japan will be coming from countries that are more free than Japan regarding such measures, and it is natural that they would be generally averse to once again subjecting themselves to restrictions that have been eliminated some time ago in their home countries.

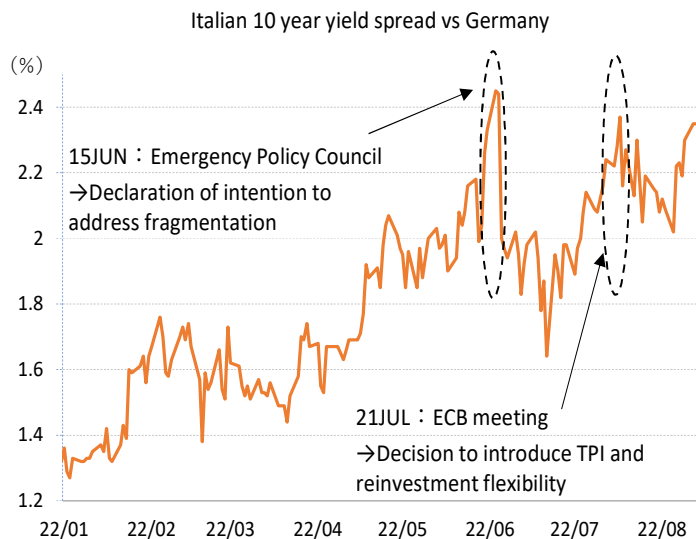
For Japan, lifting the ban on inbound tourism will offer an opportunity to kill two birds with one stone; (1) restoring its travel surplus and correcting the JPY supply-demand environment while also (2) promoting a rise in domestic demand and stimulating the stagnant domestic economy. As the number of COVID infections in Japan is already at a high level compared to other countries in the world, the logical basis for advocating pandemic-related entry restrictions has clearly disappeared. Although it is understandable that politicians will cater to the conservative trends they see in public opinion polls, pandemic-related entry restrictions can no longer be considered a rational infection control measure nor can they be considered worthwhile in light of their large negative economic impact. It may be in view of these realities that the ruling party recently decided to announce some tentative pandemic-related entry restriction easing measures against the backdrop of a decline in its approval rating. However, until the government bites the bullet and eliminates the abovementioned requirements (2) and (3), it is likely that the process of restoring Japan's travel balance surplus will continue to be very difficult and the associated beneficial effects on JPY exchange rates and the Japanese economy will be limited. In view of the JPY depreciation trend and other countries' moves to re-open themselves to the world, it would seem clear that Japan's government should be seeking to restore its services balance and to thereby help improve the JPY supply-demand environment, but it appears that the Kishida administration's inherent devotion to conservative policies will continue to forestall measures aimed at achieving those goals.

EUR Outlook – EUR’s Future Bereft of Its Formerly Invulnerable Supply-Demand Environment

EUR Area Monetary Policies Now and Going Forward – Testing the PEPP Reinvestment Policy’s Limits

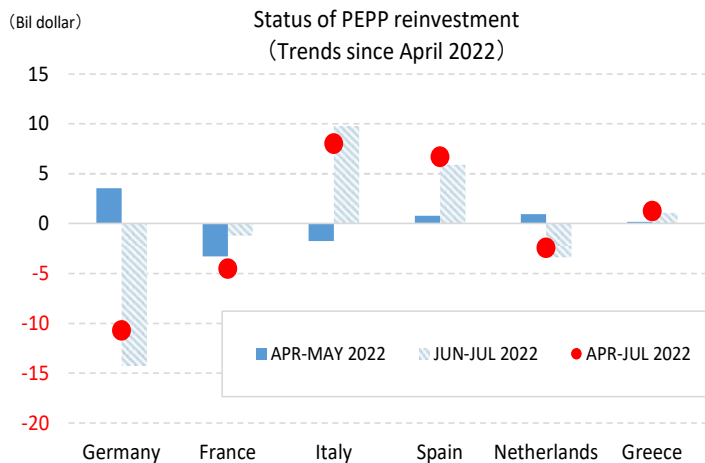
Clear Approach of Selling German Bonds and Buying Italian Bonds

The ECB’s July 21 Governing Council meeting approved the creation of the Transmission Protection Instrument (TPI), which is designed to counter financial market fragmentation risks associated with interest rate surges limited to certain euro area countries. The ECB is thus seemingly positioned to use the TPI to purchase unlimited amounts of national and local government bonds in the secondary market. This phrase “seemingly positioned” reflects the fact that the conditions for triggering the TPI are widely perceived as being excessively strict, causing deep-rooted speculation in financial markets that the TPI will probably not be used. At the post-Governing Council-meeting press conference, ECB President Christine Lagarde herself said – “I can assure you that we would rather not use TPI.” Just as was the case regarding the outright monetary transactions programme (OMT) announced in 2012, it seems that the TPI is expected to remain unused with a status akin to an “ace up the sleeve”, but there are now strong concerns about the stubbornly high level of Italian government bond yields (see graph).



(Source) macrobond

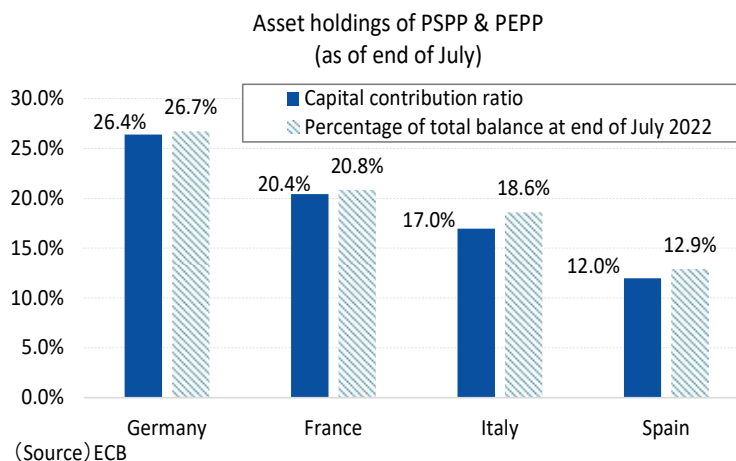
President Lagarde clearly explained that the ECB’s “first line of defence” against fragmentation risks entails leveraging the flexibility of the Pandemic Emergency Purchase Program (PEPP), while TPI is a secondary defense instrument or “ace up the sleeve”. Thus, for the time being, attention will be focused on the PEPP management figures the ECB announces once every two months. The PEPP’s flexibility enables the ECB to use the program to take redemption proceeds from healthy countries’ sovereign bonds and reinvest them in fragile countries’ sovereign bonds. New asset purchases under the PEPP have been suspended since April, so the scope of the PEPP management figures will be narrowed down to how funds from the redemption of existing PEPP assets are reinvested and how the overall balance of PEPP assets invested in individual countries’ bonds changes. The PEPP management figures are announced every two months, so the data on reinvestments undertaken during June and July was released in early August. As the graph shows, the balance of PEPP holdings of government bonds of Germany, France, and the Netherlands decreased significantly in June and July, while PEPP holdings of government bonds of Italy, Spain, and Greece grew considerably, indicating that flexible reinvestment of PEPP redemption proceeds has already begun. In particular, net selling of German government bonds amounted to EUR14.3 billion, which is roughly equal to total net buying of Italian and Spanish government bonds, which amounted to EUR15.7 billion. Looking at the four months since new PEPP purchases were suspended in April, one finds that net selling of German, French, and Dutch government bonds amounted to EUR17.7 billion, while net buying of Italian, Spanish, and Greek government bonds amounted to EUR16.0 billion. It can be seen that the ECB has kept the total balance of PEPP assets stable while progressively restructuring the PEPP balance sheet by buying and selling the government bonds of the six countries shown. In particular, the ECB is clearly placing emphasis on the selling of German bonds and buying of Italian bonds.



(Source) ECB

How Much Capital Key Deviation is Acceptable?

There is a potential problem in that if the ECB continues to concentrate its PEPP reinvestments in the government bonds of certain countries, it will progressively deviate from the capital key that the ECB's asset purchases are generally required to accord with. When purchasing assets under the PEPP and other programs, the ECB seeks to make the share of purchases of individual countries' assets correspond to the percentage of the investment that each country has contributed to the ECB (the capital key). As noted above, if the ECB deliberately pursues an asset rebalancing policy involving the selling of healthy countries bonds and the buying of fragile countries bonds, the proportions of healthy and fragile countries in the ECB's holdings will naturally converge.



In fact, the divergence from the capital key has already begun to become conspicuous. The magnitude of capital key deviations is not assessed for the PEPP alone but is used to comprehensively evaluate the Public Sector Purchase Program (PSPP), the ECB's regular government bond purchasing program. The PSPP has a longer history than the PEPP, so it naturally holds a relatively greater volume of government bonds, and it is not possible to discuss the actual state of the ECB's government bond holdings without taking this into consideration. Looking at the graph, which shows the ECB's holdings of government bonds purchased through PEPP and PSPP, one will see that Italian bond holdings are already diverging from the capital key by +1.7 percentage point. The graph shows figures for only the four major euro area countries, but the overall balance reflects downward deviations from the capital key with respect to the holdings of bonds from other euro area countries, including the Netherlands and Greece. If the reinvestment pace of PEPP holdings seen since April is maintained, the holding ratio of Italian government bonds may approach 20% by the end of the year, which is on a par with France's capital key proportion.

Of course, the PEPP framework was designed to enable greater "flexibility", meaning it allows for temporary deviations from the capital key, so the existence of such deviations is not unexpected. However, the ECB's emphasizing of the flexibility of its PEPP reinvestment policy has caused considerable speculation among financial market players regarding exactly how much flexibility the ECB intends to allow for. The ECB has not given any clear hints on this point, but considerable market turmoil can be expected if the value of Italian bond holdings reaches the same level as that of German government bond holdings. It seems that the ECB is strictly adhering to a "selling German to buy Italian" policy, and if this policy were to be sustained without modification, it appears inevitable that Italian bond holdings would eventually reach the level of German bond holdings. For example, if the current rebalancing pace were sustained throughout this fiscal year (until March 31, 2023), the possibility of such a development would begin to seem realistic. Such a development is not impossible. This reflects the fact that Italian government bond yields have not fallen significantly since July, giving the impression that the ECB is barely restraining a rise in those yields. In June and July alone, the ECB bought EUR12.2 billion of Italian government bonds – EUR2.4 billion through the PSPP and EUR9.8 billion through the PEPP – and it appears that even that much purchasing was barely capable of restraining the yields. In light of this, there is a possibility that the "selling German to buy Italian" policy may be further accelerated going forward.

An "Ace up the Sleeve" that Cannot be Utilized

The pace of the ECB's future reinvestment in Italian bonds will largely be determined by the results of the Italian general election held on September 25. At the July 21 press conference, a reporter asked if the TPI was designed to counter Italy-related problems, and President Lagarde countered that the TPI "is available to all countries of the euro area" and does not address political risks, but it is objectively apparent that Italy is the only euro area country with bond yields stubbornly high enough to perhaps require the use of the TPI. Among financial market players, it is generally accepted as a fact that Italy's high bond yields are attributable to the Italian political situation. It appears that financial markets consider Italy's near-term political situation to be quite alarming.

Italy's political stability under the Draghi administration ended after just one and a half years, and the political situation in Italy has now become fluid. As always, it will be difficult for a single party to establish a government after an Italian general election. Currently, two right-wing populist parties have high voter approval ratings – Brothers of Italy (Fratelli d'Italia) and League (Lega) – and there is strong speculation that these parties may join with the center-right political party Forza Italia to create a populist coalition government. Such a coalition would be likely to have internal policy disagreements, but it is undeniable that under such a coalition anti-EU views would be likely to become increasingly prominent in Italian politics going forward. It appears inevitable that Italy will to some extent express opposition to the austerity and structural reform policies promoted by the European Commission and the ECB.

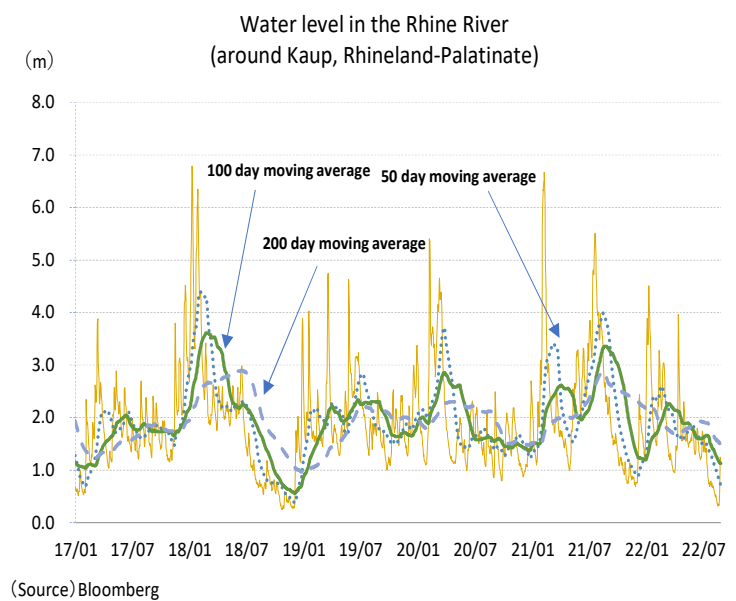
Activating the TPI with respect to a given country will only be possible if that country complies with the EU's austerity and structural reform policies and, given the prospective establishment of a new coalition government in Italy, there are concerns that the regional bond market will start forming prices based on the assumption that activating the TPI for Italy will be difficult. While the TPI may be considered the ECB's "ace up the sleeve", it may turn out that the ECB will be unable to actually play that card. In light of these political risks, there appears to be a strong likelihood that the ECB will be forced to "sell German and buy Italian" at a faster pace than it did in June or July. The financial markets will proceed with trading activities that may test the ECB's capital key deviation margin limits, and one should keep in mind the possibility that this situation will put downward pressure on EUR.

EUR Now and Going Forward – Clogging of "Main Economic Artery" Promotes EUR Selling

Western Europe's "Main Economic Artery" in Danger of Clogging

As the EU's relations with Russia have deteriorated in the wake of the Ukraine crisis, the euro area is facing a very serious energy crisis. The global energy crisis has impacted the euro area's economic and financial situation considerably more than it has affected other countries and regions, and the ECB has clearly been forced to modify its policies based on recognition that high inflation rates can no longer be considered temporary cost-push-based phenomena. This is reflected in the fact that the European Commission and the ECB have prepared separate forecasts for scenarios in which energy supplies from Russia are cut off.

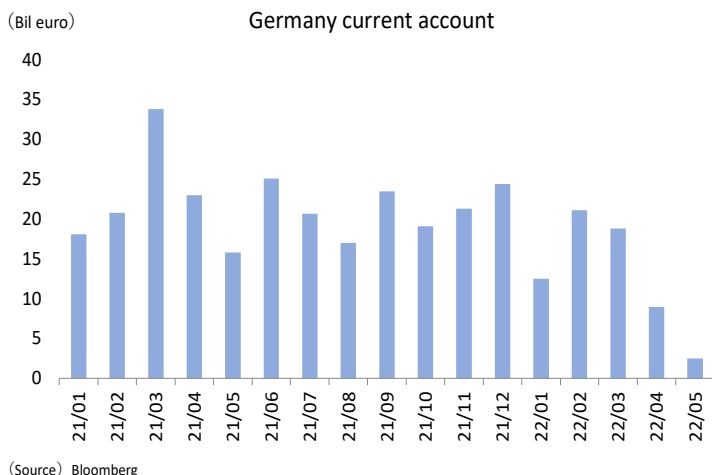
Moreover, low water levels in the Rhine river has emerged as yet another factor worsening the euro area's energy situation. Water levels in the Rhine – the key component of Germany's domestic ship and barge transport operations – have fallen due to drought conditions accompanied by extremely hot weather, and it is expected that the water will drop to levels that make ship and barge transport impossible. It is generally understood that the Rhine is a crucial transport route for Germany as well as the rest of Europe. Starting from Swiss mountains and passing by major German cities before reaching Rotterdam (Europe's largest port city, in the Netherlands) and flowing into the North Sea, the Rhine plays an important role in the transportation of such goods as fuels (particularly coal) and such commodities as iron ore as well as chemical products and automobile components. Being a route that is more-efficient than land routes for shipping large-volume goods, the Rhine is often referred to as western Europe's "main economic artery", but the usability of this route is being severely threatened.



On August 10, the water level around Kaub (a city in western Germany that represents a bottleneck for shipping as the Rhine runs narrow and shallow there) had dropped to around 50cm (40cm is the crucial level required for much of the transport along the river), although rainfall boosted the level back to 100cm as of August 30 (see graph). The question of whether the Rhine will remain navigable or not will depend on the weather, but given that the river has historically shown seasonal water level drops in early autumn (September through October), there remains a possibility that the Rhine may become unnavigable and exacerbate energy-related problems by tightening supply constraints. For example, much of the coal Germany consumes is shipped there via Rotterdam and the Rhine. In response to the curtailment of natural gas supplies from Russia, Germany is deemphasizing its decarbonization policy and augmenting its coal-fired power generation. An inability to ship coal on the Rhine would cause electric power shortages that will place a heavy burden on Germany's economy, as the only alternative to using that coal is to purchase natural gas at very high spot prices. While Germany's energy situation is already expected to be very severe this winter, there is now considerable concern about the possibility that the situation may be even worse than anticipated. Besides impacting the energy sector, the worsening situation is expected to have a negative effect on the automobile industry, which is already suffering from conspicuous delays in manufacturing and delivery operations. The drought in the Rhine River is said to be the result of extreme heat and insufficient rain, but many consider the extreme heat to reflect climate change. Germany has been promoting decarbonization as a means of alleviating climate change, but as mentioned above, the country's decarbonization campaign is practically collapsing. If Germany truly wants to overcome its energy crisis while maintaining its decarbonization policies, it seems that its only practical option is to restart its nuclear power plants, and it has been reported that 80% of the German public would support such a move.

Prospective German Current Account Deficits and EUR Depreciation

One cannot ignore the impact of all this on EUR. As mentioned, the Rhine is one of the key routes needed to compensate for the reduction of energy supplies from Russia, so its blockage would increase pressures to seek additional energy supplies from Russia. In May, Germany recorded a trade deficit for the first time in 31 years. The country's current account surplus has also been significantly shrinking and now on the verge of falling into the red (see graph). If the volume of energy imports procured from Russia at relatively high spot prices rises above the current level, Germany's trade deficit will naturally expand further, and the country's current account balance may finally become a deficit.



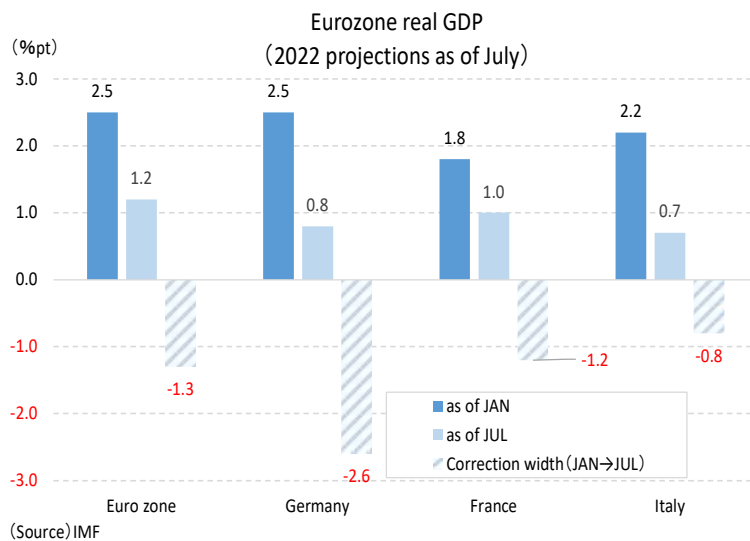
Germany's current account was last in the red on a monthly basis in January 2003, more than 19 years ago, at a time when Germany was recovering from challenges that led to its acquisition of the "sick man of Europe" appellation. The worsening of energy-related supply constraints can be expected to directly lead to a slump in Germany's economy and, in turn, a general slump in the euro area economy. These and other factors are generating serious anxieties about the prospective effects of the ECB's increasingly hawkish monetary policies, and there are also concerns about the likelihood that EUR will be exposed to selling pressure, reflecting the fact that EUR is associated with lower interest rates than any other major currencies other than JPY. As this article has repeatedly discussed in the past, while EUR interest rates are low, sharp EUR depreciation has been prevented by the strong EUR supply-demand environment stemming from the world's largest current account and trade surpluses that Germany and the euro area have been recording. The Ukrainian crisis has been negatively affecting that supportive EUR supply-demand environment and thereby promoting EUR depreciation recently, and the recent drop in the Rhine's water level can be seen as an additional factor weakening EUR.

Moreover, continued unanticipated EUR depreciation can be expected to increase the prices of euro area imports and would thereby be likely to promote further rises in the area's inflation rates. Ultimately, however, it appears that the ECB will have no choice but to tighten its policies even if it anticipates that the tightening will push the euro area into a recession. Because the ECB started its monetary policy normalization later than the Fed and is likely to be continuing to normalize when the Fed completes its normalization, I had anticipated that EUR would be more liable to be bought than USD at some point, but that expectation was based on the premise that the euro area would continue recording huge current account and trade surpluses. Now that this premise has collapsed, I see a need to reexamine the EUR outlook with greater attention to the potential for EUR depreciation.

The Euro Area Economy Now and Going Forward – European Economic Conditions Deteriorating

Increasing Likelihood of a German Recession Scenario

While only time will tell what effect lower water levels in the Rhine will have on the euro area's economic growth, it is worth noting that forecasts of the euro area's economic growth rate this year have already been reduced to roughly half their level at the beginning of the year. Among the forecasts of major institutions, the latest available forecast is the IMF's World Economic Outlook (WEO), which was revised on July 26. This revision does not take the possibility of a decline in river water levels into account nor does it anticipate a complete disruption of energy supplies from Russia. (Although it did consider the latter to be a risk factor.) So far this year, Germany's real GDP growth rate has already fallen to about one third that predicted by the WEO as of this January (+2.5% → +0.8%), and the growth rate for the full year is currently expected to fall below +1%. This is a fairly large downward growth rate forecast adjustment compared to the adjustments made to the prospective growth rates of other euro area countries and the euro area as a whole (see graph).



In addition to this current challenging situation, if one factors in the possibility of a severe winter in which navigating the Rhine is impossible, one can anticipate that factories' lower capacity utilization rates due to electric power shortages will become a further drag on economic conditions. Problems related to the procurement of fuels from Russia have not been resolved, and there is an increasing likelihood that the German economy will record zero growth or enter a recession in 2022. The outlook has completely changed since the beginning of the year, when a +2% growth rate was forecast.

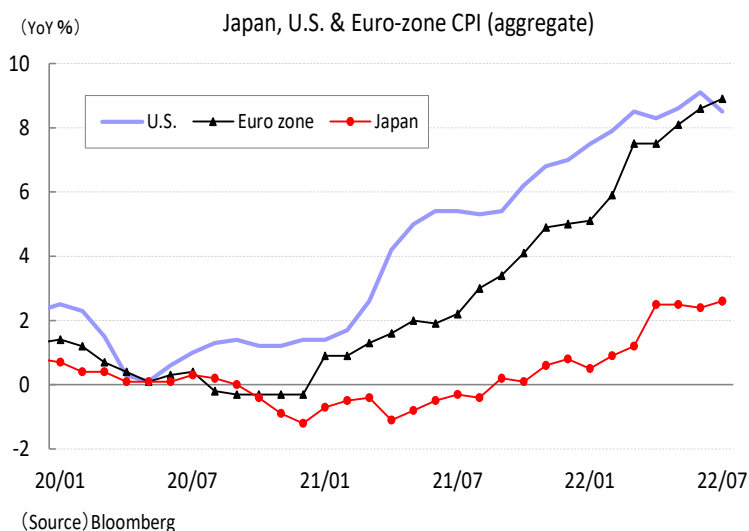
Testing of Commitment to Decarbonization

The drought in the Rhine River is said to be the result of extreme heat and insufficient rain, and this may reflect the climate change trend that Germany and other euro area countries have been seeking to countervail by means of decarbonization programs in recent years. Under current circumstances, however the reduction of energy supplies from Russia has been dictating the greater use of coal-fired power generation plants regardless of such plants' incompatibility with decarbonization programs. However, the lowering of water levels in major rivers owing to the heat wave-induced drought has made coal transportation difficult, and there is a possibility that this will impede normal operations at coal-fired power plants. If this situation becomes sufficiently dire, Germany may be forced to recognize that nuclear power generation is the only major alternative means of power generation compatible with decarbonization.

Germany's current Schultz administration has a policy of continuing to pursue the goal (set by the former Merkel administration in 2011) of totally discontinuing nuclear power plant operations by the end of 2022, and many people believe it will be extremely difficult to abandon that goal given that the Green Party is a key member of Germany's coalition government. However, public opinion polls indicate that roughly 80% of Germans already support moves to protract nuclear power plant operations, and it is said that nearly 70% of Green Party supporters also support such moves. For voters fearing that their life-supporting infrastructure is in danger, surviving this winter probably seems to be a far more important objective than striving to perhaps lower the earth's temperature by one degree at a distant date in the future. The potential need to make such a choice has long been pointed out by those concerned about the excessive momentum of decarbonization programs, but unfortunately many decarbonization supporters were not able to conceive of such a possibility until they faced the immediate consequences of the current crisis. It has thus been demonstrated that even the most idealistic supporter of noble ideas may quickly abandon those ideas when their lives, livelihoods, and lifestyles are in immediate jeopardy, and there are grounds for doubting whether the momentum of decarbonization programs will be fully restored after the current emergency situation is alleviated.

Euro Area Inflation Rates Not Peaking Out

I sometimes receive inquiries about my views on the peaking out of inflation in the United States and the likelihood of a similar peaking out trend in the euro area. My opinion is that it is still impossible to predict what will happen regarding the euro area's inflation situation. It has been reported that the U.S. inflation rates have already peaked out on core CPI and PCE deflator bases, and the most recent July data has made the question of whether U.S. inflation is decelerating on a comprehensive CPI basis a hot topic (see graph). Looking at different countries' comprehensive CPI figures for July (yoy rates), one finds that the euro area's level (+8.9%) is higher than that of the United States (+8.5%). This is the first time in 27 months (since April 2020) that the euro area's figure has exceeded the U.S. figure. Even when forecasting the euro area consumer price index (HICP) over the near term, one must take into account the potential for sudden risk scenarios in which supply constraints are caused by such events as the suspension of Nord Stream 1 operations by Russia or a sharp drop in the Rhine's water level, so the trend of euro area inflation rates exceeding U.S. rates could be a theme this autumn and beyond.



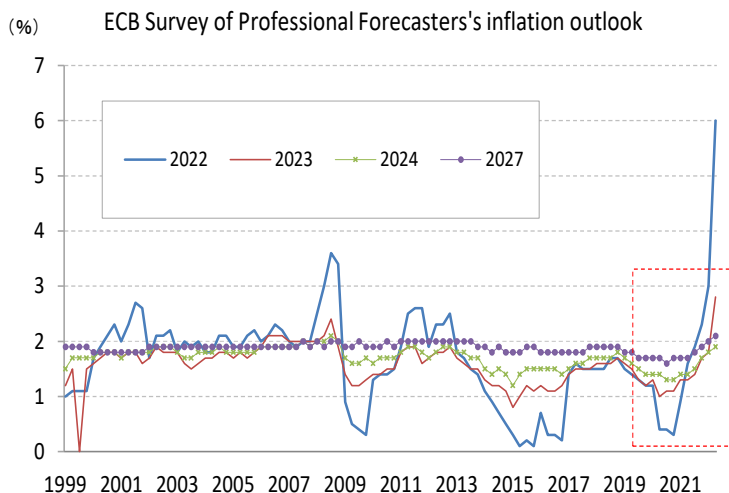
Surge in Survey-Based Inflation Expectations

The euro area's inflation expectations level and employment and wage situation also suggest a basis for continued concern about the area's inflation trends going forward. The five-year in five years inflation swap break-even inflation (5-year BEI) rate that the ECB has traditionally emphasized has peaked out, but there is no sign of weakening in survey-based inflation expectations, which actually are showing an accelerating upturn. The level of 1-year-forward inflation expectations in the ECB's quarterly Survey of Professional Forecasters (SPF) has shown a surge unprecedented in the history of that survey (see upper graph). Moreover, the euro area's labor market continues to be tight, and this is causing a sharp increase in service prices as well as in wage increase margins, which will determine future service prices (see graph). Based on consideration of inflation trends alone, it is clear that the ECB is not

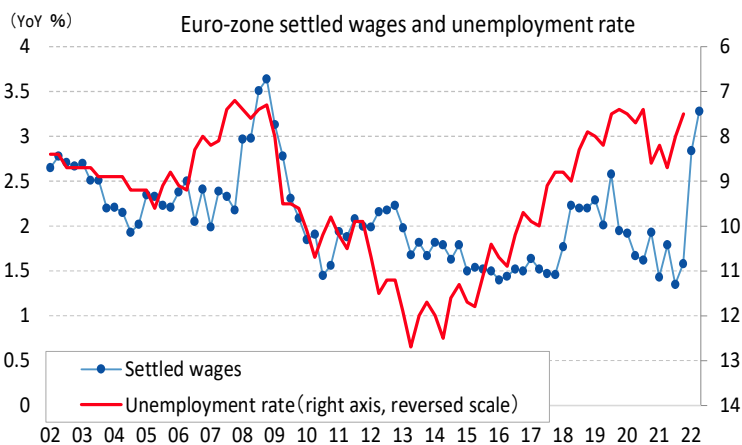
in a position to relax its hawkish stance, and it would not be surprising if it were to accelerate the pace of interest rate hikes. The Lagarde-led ECB's information dissemination activities have recently become more irregular – as seen in President Lagarde's high-profile blog article published in May and the ad hoc Governing Council meeting in June – and it seems quite possible that the ECB may undertake similar sudden information dissemination activities when dealing with uncontrollable inflation situations going forward.

European Economic Conditions Deteriorating

The euro area may indeed be facing higher levels of recession risk than other countries and regions. As of August, the euro area's manufacturing PMI had been below the neutral level of 50 (the dividing line between expectations of economic expansion and contraction) two consecutive months. Given that the manufacturing PMI of the United States and Japan remain stable at levels above 50, one can deduce that the euro area's real economic conditions are perceived as relatively dismal. Even in China, where the country's economic deceleration has become a hot topic, the manufacturing PMI has not yet fallen below 50 (see graph). The lower euro area manufacturing PMI level probably reflects the abovementioned fact that the euro area's inflation situation is still harder to forecast compared to that of the United States, which is already showing signs of peaking out. The potential for stagflation appears becoming an increasingly real risk for the euro area.

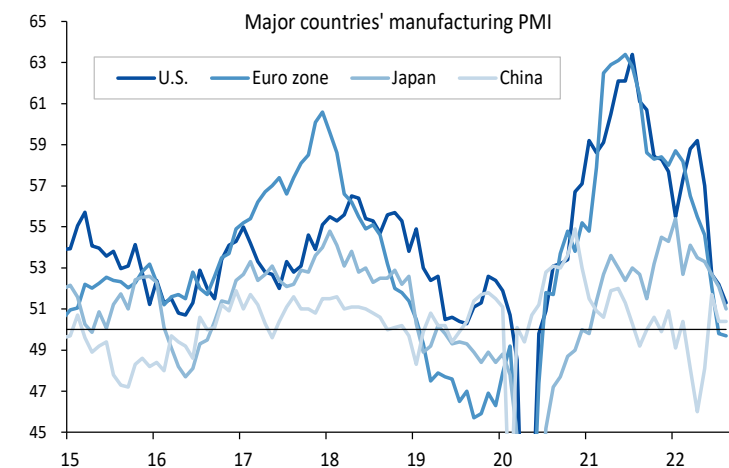


(Source) ECB



(Source) Macrobond

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



(Source) Bloomberg, Markit

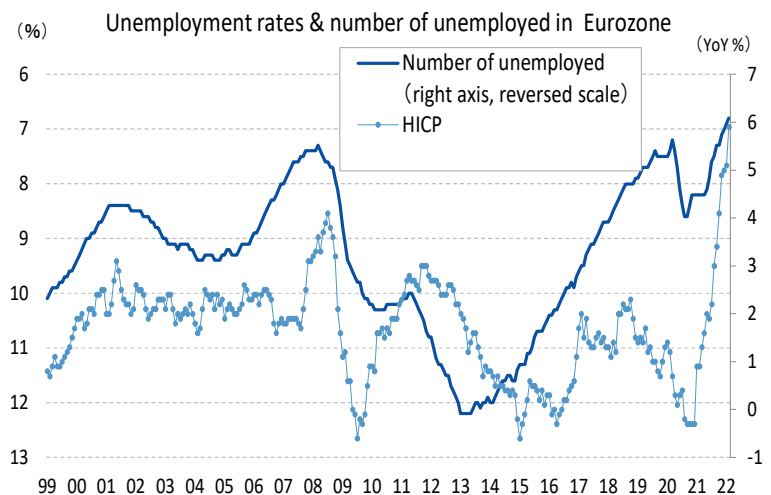
(Note) The lower limit is being cut down on purpose due to the Covid-19 pandemic

As is generally understood, the unsettled state of the euro area's inflation situation is largely attributable to the persistently high level of concerns regarding energy supplies. Natural gas supplies from Russia have been unstable for some time, but recently the Nord Stream 1 pipeline has been intermittently ceasing to operate, and it is not possible to anticipate how stable or intermittent supplies from that pipeline will be going forward. That problem has been compounded by the Rhine's dropping water level, which is hindering the transportation of the coal that could potentially be used as a substitute for the unreliable natural gas supplies. Some observers believe that the worst of that situation is behind us as increased rain in late August has brought the Rhine's water level back up, but it is worrisome that fate of the euro area economy over the short-term will largely be determined by coal-fired power generation capabilities that, in turn, will require supportive weather trends that are impossible to forecast very far in advance. As the Rhine is important means of transporting auto components and chemical products, if it becomes unnavigable, Germany and the rest of the euro area economy will face various supply constraints and price increases.

Risk of a German Recession

In an August 20 interview with a German newspaper, German Bundesbank President Joachim Nagel was asked what would happen to Germany's economy if the Rhine's water level were to further drop and worsen supply constraints or if natural gas supplies were cut off. He replied – "The German economy still performed quite well under difficult conditions in the first half of the year, and if the current trend continues, the 2022 growth rate can be expected to be slightly below 2%. However, if further delivery problems are added, for example due to prolonged low water levels, the economic prospects for the second half would deteriorate further. If the energy crisis worsens, a recession seems likely next winter." Regarding energy supplies, the euro area economy is in a more perilous situation than the United States, which is a resource-rich country, or even Japan, despite Japan's concerns about electric power shortages.

Inflationary pressures in the euro area have already spread beyond energy-related prices to service prices, and the rate of service price growth in the euro area consumer price index (HICP) has recently been reaching new all-time peak levels every month. It is safe to assume that these service prices reflect wage increases. In the above interview, President Nagel was frankly asked if he was concerned about a wage-price spiral, and he replied – "Currently the most important thing is to determine whether we are facing a wage-price spiral." – but he went on to say – "A general rise in prices will trigger demand for higher wages, not the other way around." – and – "It will be crucial to keep medium-term inflation expectations stable at 2%." But soon after that, he said – "I am convinced that the Governing Council of the ECB will take the necessary monetary-policy measures." – so it does not appear that he thinks the euro area faces uncontrollable inflation stemming from a wage-price spiral. As the graph on the previous page shows, however, the euro area unemployment rate has been reaching new record-low levels each month, so the employment and wage situation is certainly tight. It is easy to see how that situation is liable to promote rises in service prices and, in turn, in comprehensive basis HICP growth rates.



(Source) Macrobond

In general, there are no signs that euro area inflation is peaking out, and there are some signs of inflation acceleration. (Governor Nagel warned that inflation rate could accelerate to 10% in the autumn months.) Of the world's leading economies, it currently appears that euro area economy is at the highest risk of seeing a stagflation trend become established. As this article has discussed in the past, the euro area's high-cost energy structure is undermining the area's greatest strength – the solid EUR supply-demand environment it has created by maintaining the world's largest current account and trade surpluses – and the EUR's recent persistent tendency to fall below parity with USD appears to be a reflection of the euro area's inability to find a means of restoring that environment. Moreover, it appears that the progressive expansion of the EUR selling/USD buying trend throughout forex markets is playing a role in supporting ever-higher USD/JPY levels.

In any case, it is thought that concerns about the euro area's energy supplies will need to be considerably alleviated before any opportunities to reverse current EUR exchange rate trends could be capitalized on, but in light of those persistent concerns and the fact that the euro area will soon be facing harsh winter weather conditions, it will be difficult to actively undertake EUR buying for the time being.

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

These materials and the content of any related presentation are confidential and proprietary and may not be passed on to any third party and are provided for informational purposes only. Assumptions have been made in the preparation of these materials and any such presentation and Mizuho Bank, Ltd. ("**Mizuho**") does not guarantee completeness or accuracy of, and no reliance should be placed on, the contents of these materials or such presentation. Nothing in these materials or any related presentation constitutes an offer to buy or sell or trade and the terms of any transaction which may be finally agreed will be contained in the legal documentation for any such transaction, with such transaction being priced at market rates at the relevant time (the rates herein or in any related presentation being purely illustrative). (As a general rule you will not have a right to terminate early any transaction entered into – if you wish to do so, losses may be incurred by you.) These materials and any related presentation should not be considered an assertion by Mizuho of suitability for you of any transaction, scheme or product herein or therein. Mizuho has no duty to advise you on such suitability, nor to update these materials or contents of any related presentation. You must determine in your own judgment the potential risks involved in the transactions outlined herein or in any related presentation (taking professional financial, legal and tax and other advice) and whether or not you will enter into any transaction that may arise from these materials or related presentation. Nothing herein or in any related presentation should be construed as providing any projection, prediction or guarantee of performance or any financial, legal, tax, accounting or other advice. Mizuho shall have no liability for any losses you may incur as a result of relying on the information herein or in any related presentation. "MHBK provides this information for free. Please request for cancellation of subscription if you do not want to receive free-of-charge information from MHBK."