Forex Medium-Term Outlook

September 30, 2022

Overview of Outlook

In September, USD/JPY once again renewed the year-to-date high. The government and BOJ's JPY-buying intervention managed to arrest the currency pair's further ascent, but JPY-selling pressure remains persistently strong from both interest-rate and supply & demand perspectives, and the intervention failed to have much of a corrective impact. One can guess at the strength of JPY selling pressure if one of the world's largest currency interventions proved only briefly effective. As I have repeatedly argued, the current phase of JPY weakness is supported by the fundamentals, and one must not forget that JPY selling is justified in of itself. Of course, many in the markets are predicting that the current phase of JPY weakness could come to an end following a reactionary decline in U.S. interest rates and USD when the Fed ends its rate hikes sometime in January-March 2023, but I am skeptical about such predictions. To be sure, there could be phases during which USD/JPY dips as a result of Fed actions between now and next spring, and these phases could even be sustained for some time. However, if the Fed turns dovish, share prices will rise, and market volatility will decline. Moreover, assuming that the Fed does not cut interest rates in 2023, there will remain a significant cross-border interest rate differential. In other words, the forex markets will see the coinciding of two key conditions for carry trade to flourish – namely a sufficient interest rate differential and low volatility. Could JPY remain strong under such circumstances? After a temporary dip in USD/JPY next spring, one must prepare for the possibility of another bout of JPY selling aimed at reaping the benefits of an interest rate differential.

EUR also continued to weaken in September. Suspended operations of Nord Stream 1 were already cause for concern, but the concern was compounded by news of damage to the pipelines in September. While there are many theories as to how the pipelines were damaged, what is certain is that the EU's energy crisis has intensified. In September, European Commission President Ursula Gertrud von der Leyen delivered a State of the Union Address to the European Parliament and announced countermeasures to the energy crisis, but there seemed no effective countermeasures for the coming winter, which is of immediate concern – it appeared that there would be no choice but to save energy. In fact, energy saving efforts have already begun, and Germany has been storing gas as a matter of course, but such efforts come at the price of economic growth and have their limits. Further, the stored gas could also dwindle unexpectedly if Russia were to restrict supply. As energy prices soar, the euro area's current account balance has turned red, reducing the actual-demand buttress that had so far been holding up EUR to a rubble. Looking back, EUR's recovery after it fell below parity against USD in the early 2000s coincided with the recovery of Germany's trade surplus, but current developments seems to be the exact reverse of that. If Germany's trade deficit widens due to soaring energy prices, EUR could even sink below 0.9 against USD. During the second half of the current forecasting period, I predict phases of stable energy prices, easing up of energy supply concerns, and a revision of high interest rates.

Summary Table of Forecasts

	2022		2023			
	Jan -Sep (actual)	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	113.47 ～ 145.90 (144.65)	141 ～ 148 (146)	142 ～ 150 (145)	140 ～ 148 (145)	140 ～ 148 (147)	142 ～ 150 (148)
EUR/USD	0.9528 ～ 1.1495 (0.9825)	0.94 ～ 1.00 (0.97)	0.91 ～ 0.98 (0.95)	0.92 ～ 1.00 (0.96)	0.95 ～ 1.03 (1.00)	0.97 ～ 1.05 (1.01)
EUR/JPY	124.41 ～ 145.63 (142.15)	137 ～ 145 (142)	135 ～ 143 (138)	135 ～ 143 (139)	138 ～ 148 (147)	140 ～ 150 (149)

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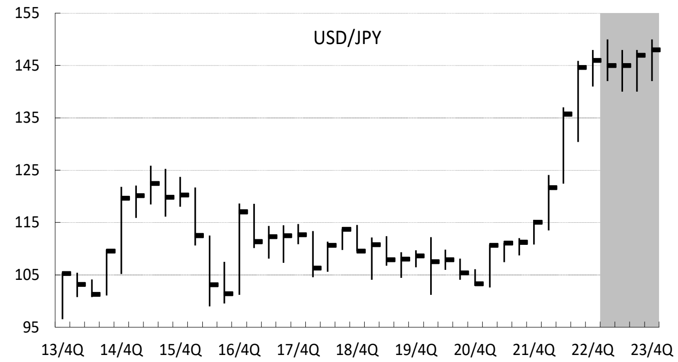
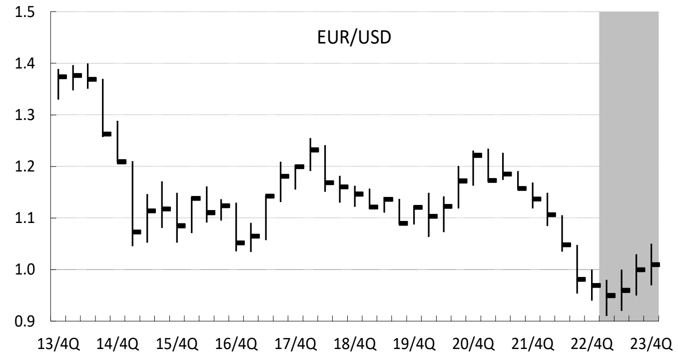
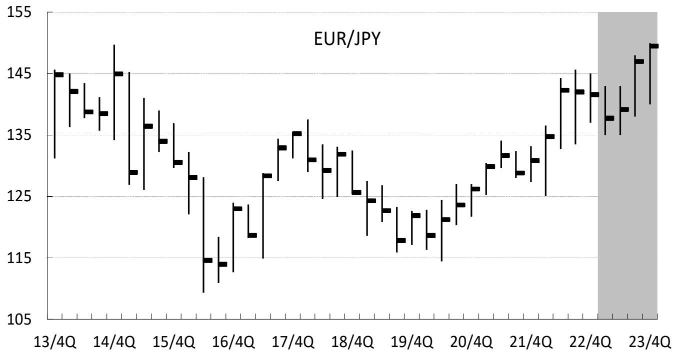
Exchange Rate Trends & Forecasts







USD/JPY Outlook – Why JPY Strength Corrections Do not Last

JPY Rates Now and Going Forward – Will the JPY Depreciation Trend Really End Next Spring?

Increase in Inflation Projections Modest Compared with Dot Plot

USD/JPY continued to rise in September, but its ascent was finally stemmed through a JPY buying/USD selling currency intervention by the authorities as the currency pair approached the 146 level. A large fluctuation in the rate was seen through the evening of September 22 (Japan time), but the source of the fluctuation was the FOMC meeting held on the previous day. Following the meeting, the target range for the federal funds (FF) rate was increased by +75bps to 3.00~3.25%. This is the first time in around 14 years, since January 2008, that the FF rate has exceeded 3.00%. While the rate was not increased by +100bp, as forecast in some quarters, the median of FF rate projections by FOMC members (the dot plot) was upwardly revised to +100bps in 2022, +87.5bps in 2023, and +50bps in 2024 (see figure). The change in the final target rate (i.e., the FF rate at the end of the current round of rate hikes) could be interpreted to mean a wider margin of individual rate hikes, a prolonging of the rate hike phase, or both. Going simply by this, the Fed's stance appears quite hawkish.

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

FOMC Date	2022	2023	2024	Longer run
Jun-21	0.125%	0.625%	n.a.	2.500%
Sep-21	0.250%	1.000%	1.750%	2.500%
Dec-21	0.875%	1.625%	2.125%	2.500%
Mar-22	1.875%	2.625%	2.625%	2.250%
Jun-22	3.375%	3.750%	3.375%	2.500%
Sep-22	4.375%	4.625%	3.875%	2.500%

(Source) FRB

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

	2022	2023	2024	Long-term
Real GDP Growth rate (as of JUN)	0.2 (1.7)	1.2 (1.7)	1.7 (1.9)	1.8 (1.8)
Unemployment rate (as of JUN)	3.8 (3.7)	4.4 (3.9)	4.4 (4.1)	4.0 (4.0)
PCE inflation rate (as of JUN)	5.4 (5.2)	2.8 (2.6)	2.3 (2.2)	2.0 (2.0)
Core PCE inflation rate (as of JUN)	4.5 (4.3)	3.1 (2.7)	2.3 (2.3)	

(Source) FRB

On the other hand, looking at the Summary of Economic Projections (SEP) by Fed staff members, the personal consumption expenditure (PCE) deflator projections for 2022, 2023, and 2024, respectively, are +5.4%, +2.8%, and +2.3%, indicating only a +0.1~0.2pp increase compared with the projections last time (June), which is a relatively modest increase compared with the dot plot. If the Fed raises interest rates in accordance with the dot plot, we may see a mere +25bp increase in 2023 and a +50bp increase in 2024. Assuming that the rate hikes take place essentially during 1H, the rate will remain unchanged during 2H, and the Fed may begin to contemplate the right time to begin cutting rates from 2024 onward. While I would not go so far as to say that the end of rate hikes is in sight, I would like to draw attention to the modest increase in PCE deflator projections and the fact that Fed Chair Jerome Powell mentioned a slower pace of rate hikes going forward in his press conference. Of course, all he did was to acknowledge the obvious, but the fact is that, until recently, he would have strictly avoided saying anything to make the markets complacent. His acknowledgement this time seems to indicate that inflationary concerns have at least somewhat stabilized.

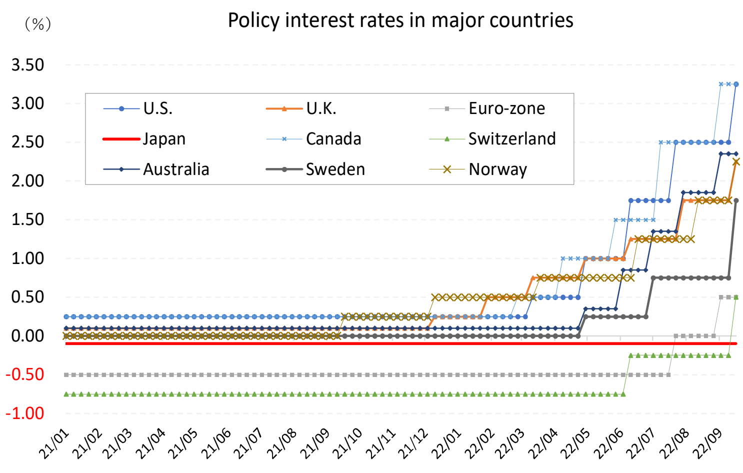
First Intervention in 24 Years; Discrepancy Between Currency and Monetary Policies

At its Monetary Policy Meeting (held on the morning of September 22) immediately following the aforementioned FOMC meeting (held in the early hours of September 22), the BOJ decided to continue with its accommodative monetary policy as expected by the majority of market players. This caused USD/JPY to sail past the 145-yen milestone quite easily. JPY selling clearly accelerated following such remarks by BOJ Governor Haruhiko Kuroda at his press conference: “We will not increase interest rates for the time being;” “By ‘the time being,’ we do not mean a few months, but rather 2-3 years.” These statements were disturbing to me, as it is abnormal for a BOJ governor to commit to interest rate policies beyond his own term in office so openly. USD/JPY soared to just under 146 as a result of this press conference, forcing the government/BOJ to implement their first JPY buying/USD selling currency intervention in around 24 years since June 1998. There are suspicions that Kuroda may have made these remarks deliberately to enable the Japanese authorities to buy JPY at a profitable price.

The currency intervention amount has not been revealed as of the time of writing this report, but going by the current account balance as announced by the BOJ, it would seem that the intervention amounted to JPY 3.6 trillion, which is the largest one-time currency intervention in history. Despite this, JPY strengthened only momentarily, after which it immediately weakened again, evidencing deep-seated JPY selling trends consistent with the fundamentals of the Japanese economy. As many in the markets point out, there is a discrepancy between the government’s currency policy, which is aimed at strengthening JPY, and the BOJ’s monetary policy, which is aimed at weakening JPY (i.e., monetary accommodation), and unless the government and the BOJ speak with one voice, it is logical (and normal) for any intervention by the government to have only a small impact – the truth of these arguments have been borne out by events. In other words, the JPY-buying intervention would have had a greater impact if it had been implemented as a set with the BOJ revising its monetary accommodation stance, i.e., if monetary and currency policy had been pointing in the same direction.

Cross-Border Interest Rate Differential Will Remain in 2023; Carry Trade Expected to Strengthen Going Forward

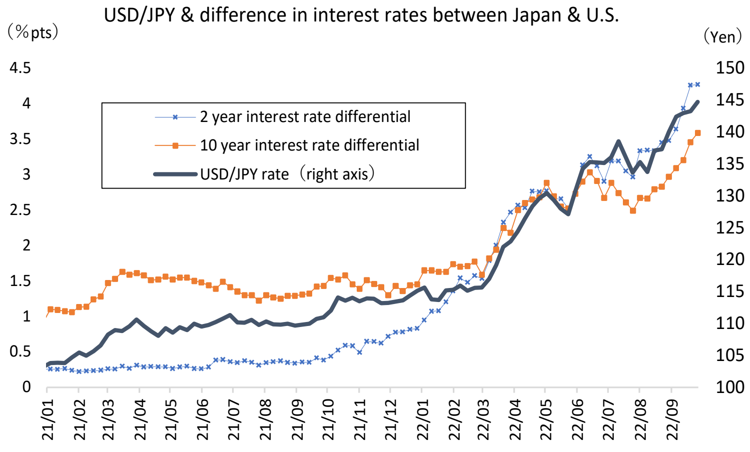
At any rate, JPY seems likely to continue being sold in the forex markets against the backdrop of the aforementioned discrepancy and an expanding cross-border interest rate differential. However, my impression is that this trend is yet to truly gain momentum, and will do so going forward. As the chart shows, JPY is the only currency in the world that does not pay an interest rate at the time of writing this report, and it seems almost certain that this contrast in terms of policy interest rates between JPY and other key currencies will only become sharper in the coming months. Even a year from now, it seems likely that most foreign central banks will at the very least have the same interest rates as they do now if not higher rates following further rate hikes. Even a year from now, it seems likely that there will be a substantial gap between JPY vs. foreign interest rates.



(Source) macrobond

Most market participants at the present time are probably predicting as follows: U.S. interest rates and USD will begin their reactionary decline as an end to the Fed’s rate hike phase comes into view in January-March 2023; this will arrest JPY selling and bring an end to the current phase of JPY depreciation. In other words, in their view, the weak JPY trend will end next spring. Is such a view really reasonable? To be sure, while the demand-side factor (represented by trade deficits) is also likely to be playing a significant role in weakening JPY, the correlation between USD/JPY and the U.S.-Japan two-year interest rate gap is quite stable at the moment. Many market participants are focusing on this, and it is quite possible that a shift in the Fed’s policy stance would cause a decline in U.S. interest rates→USD selling→JPY buying. However, there are doubts whether such a trend could be sustained. As mentioned above, major central banks around the world are forecast to either keep their interest rates unchanged or to raise them, with rate cuts being quite unlikely. If so, there will remain a substantial interest rate gap between JPY and key currencies. Meanwhile, if there are signs of an end to rate hikes, the stock markets are likely to regain stability, which would make the financial markets less volatile.

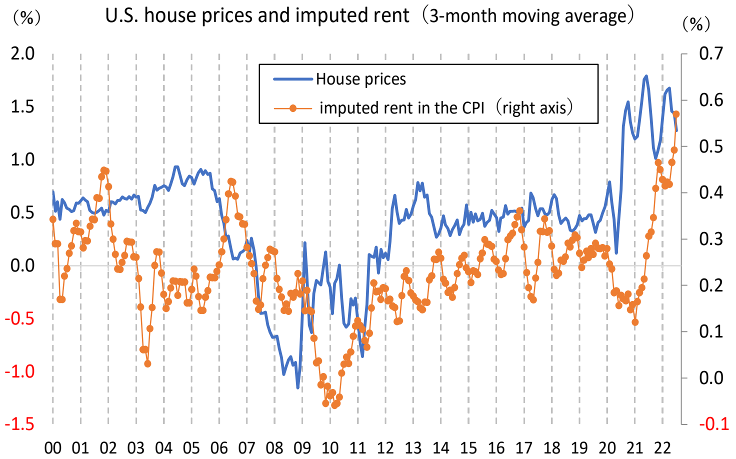
Assuming the above developments in the markets, from spring 2023 onward, forex markets will see the coinciding of two key conditions for carry trade to flourish – namely a sufficient interest rate differential and low volatility. If that happens, highly liquid, low-interest-rate key currencies would become preferred funding currencies. At the current rate, the most preferred currency would be JPY, perhaps followed by CHF. At any rate, so long as there is a possibility of carry trade gaining momentum in 2023, I cannot ride the wave of optimism suggested by the prediction that the current phase of JPY depreciation will come to an end next spring.



(Source) macrobond

To Begin With, an End to Rate Hikes Next Spring is not Guaranteed

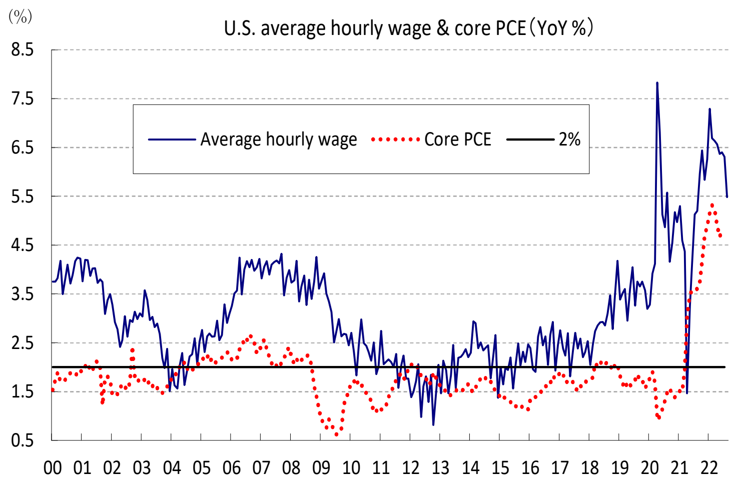
It has to be pointed out that there is no guarantee that the Fed will signal an end to its rate hikes in January-March 2023. Although home sales have already peaked, this has not led to any marked correction in housing prices, which could be more accurately described as "stubbornly high." For housing prices to be reflected in imputed rent, and thereby in CPI growth, involves a time lag of six months to a year (see figure). In this sense, even if there is downward pressure on CPI from housing prices, it will not be right away.



(Source) macrobond

(Note) Imputed rent: Owners' equivalent rent of residences

As of the present time, the unemployment rate is also extremely low, so tight conditions continue in the labor market and with regard to wages. While the average hourly wage is showing signs of peaking, a further substantial slowdown must take place before the core PCE deflator can be assumed stable at around 2% (see figure). If the SEP is to be believed, we may have to wait until 2024. For instance, six employment situation reports are scheduled to be released between now and the end of March 2023, but even if we assume a slowdown in hourly wage growth by an average of -0.3pp per release (which would be quite a steady decline), that would still only amount to a -1.8pp decline at the end of six months. From the current point of departure, that still amounts to a +3.7% yoy growth in hourly wages. This is still too high a rate to allow us to forecast Core PCE deflator stabilization at around 2%.



(Source) Datastream

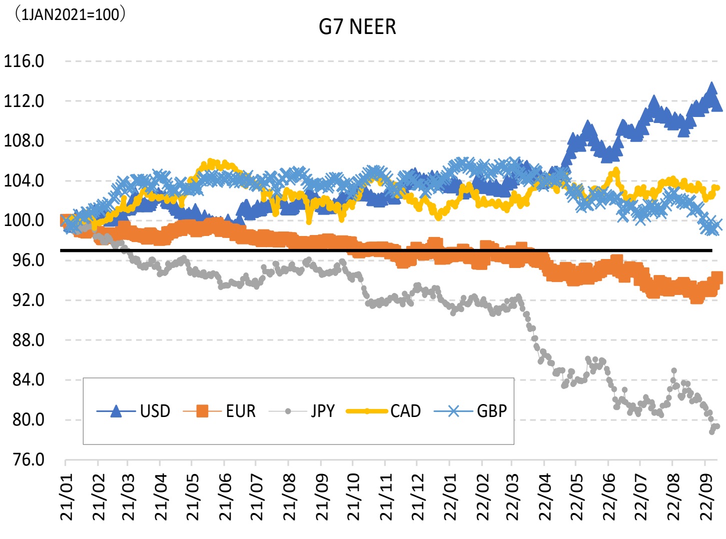
(Note) Using pre-seasonal production and non-management payrolls for which a longer time series is available

Apart from this, there is no guarantee that resource prices will continue to fall. As winter approaches, demand for fuel will inevitably rise – or is there is no need for concern because dramatic economic slowdown is expected to sufficiently slash demand for energy? Too many uncertainties still exist for anyone to declare that inflationary pressures will have receded sufficiently to enable an end to rate hikes within the next six months. One must take into account the significant likelihood that the Fed will judge inflationary pressures as having receded, but not sufficiently. In this sense, the majority consensus that the JPY depreciation trend will end next spring seems to be riddled with blind spots. It is definitely possible that an end to the Fed's rate hikes will come into view in January-March next year, triggering a decline in U.S. interest rates and the advent of a phase of USD depreciation. However, if the Fed were to go on to become more earnestly dovish in its stance at that point, this could lead to carry trade gaining momentum, which would drive another phase of JPY selling. I would like to incorporate this possibility into my main forecast scenario.

JPY Supply and Demand Now and Going Forward – Japanese Version of HIA as Measure to Arrest JPY Depreciation

Tools Required to Address Supply and Demand

At the time of writing this report, USD/JPY remains in its year-to-date high range despite the government/BOJ's policy response. Under such circumstances, people are beginning to wonder once again exactly what could arrest JPY depreciation, and I do, in fact, receive numerous inquiries in this regard. Many analysts, reasonably so, want to describe the current weakness of JPY as "USD buying" rather than "JPY selling," but the fact remains that JPY's depreciation against USD is markedly stronger, both in nominal and real exchange rate terms, than that of other currencies. It is, therefore, unacceptable to me to explain away the current JPY depreciation trend as something caused just by USD-related factors. As the figure clearly shows, JPY rates this year have broken through previous record lows (see figure). Of course, USD is strong across the board too, but no other currency has weakened to the extent JPY has. It becomes necessary, therefore, to look for JPY-specific factors.

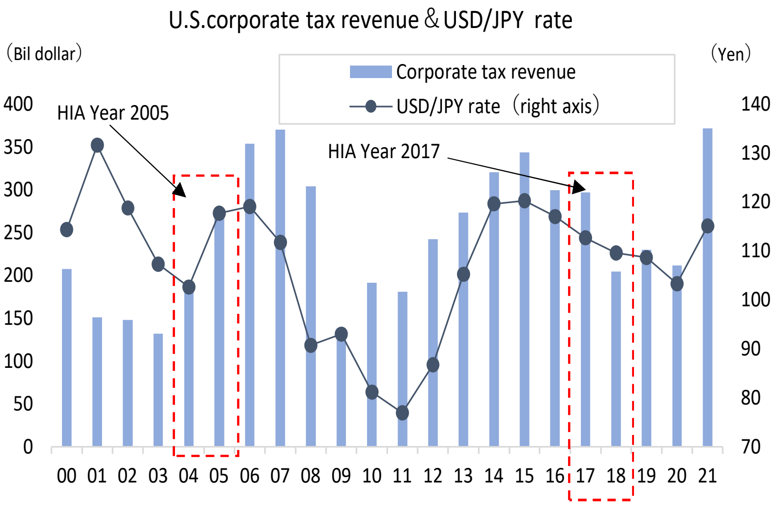


(Source) macrobond

The change in JPY's supply-demand situation is worth taking a look at. Already, within the first eight months of this year, the trade deficit has hit -JPY 13 trillion, and chances are that the trade deficit for the entire year will be the highest ever recorded. Further, the seasonally adjusted current account balance has also turned red. Such facts imply a supply-demand situation wherein most market participants in the Tokyo foreign exchange market are lining up to sell JPY. This is precisely why some thought should be given to possible ways for Japan to address this supply-demand situation. Of course, as mentioned above, the JPY depreciation trend may end once U.S. interest rates begin to decline as we approach spring 2023. However, to depend on this turn of events, which are not guaranteed to begin with, is to be fatalistic. Intuitively, JPY-buying currency interventions could be seen as a way to directly tweak the supply-demand balance, but the fact is that even a currency buying intervention worth JPY 3.6 trillion was unable to reverse the trend. Other ideas involve cutting fuel imports by resuming nuclear power generation and increasing the demand for JPY by removing all the restrictions on inbound tourism. However, going by how easily the impact of the largest ever currency intervention was reversed, one cannot help feeling that neither of these will be the clincher either.

Reducing Taxes on Income Repatriated to the U.S. Succeeded in Strengthening USD

However, if one wanted simply to increase JPY buying, there are also other ways of doing it. Using foreign currency reserves to prompt JPY buying amounts to currency intervention and is politically concerning, but encouraging Japanese companies to repatriate their overseas foreign currency assets back to Japan can beget the same results. In this context, one is reminded of former president George Bush's 2005 Homeland Investment Act, which was a one-time tax holiday aimed at encouraging repatriation of foreign earnings. Back in 2005 (and right until the Trump administration amended the law in 2017), U.S. multinational companies had to pay a tax on any foreign earnings by their overseas subsidiaries they wanted to repatriate back to the U.S. As the earnings of overseas subsidiaries were also taxed in the countries of their location, this amounted to double taxation and encouraged U.S. companies to retain their earnings from overseas subsidiaries outside the U.S. It was with the aim of getting companies to repatriate their overseas earnings back to the U.S. and use them to fund capital investment, jobs, and stock buy-backs that the Bush administration enacted the HIA. However, as this flow of capital inevitably resulted in foreign currency selling and USD buying, the HIA became famous in the forex markets as a USD strengthening policy. I provide a brief summary of the policy below.



(Source) Bloomberg& Congressional Budget Office (CBO)

The Bush administration enacted a measure that cut taxes from 35% to 5.25% for one year for U.S. companies repatriating the earnings of their overseas subsidiaries back to the U.S. Given the significant reduction in taxes and the one-year limit, the impact of the measure was tremendous, resulting in an enormous increase in corporate tax revenues from 2004 through 2005. Specifically, while the average annual corporate tax revenue for the three years from 2002 through 2004 was USD 156.4 billion, that for 2005 was 1.7 times that at a whopping USD 278.3 billion, indicating the magnitude of funds that were repatriated. As for what use the repatriated earnings were put to, it is thought that they were mostly invested in stock buy-backs, triggering an increase in U.S. share prices in 2005. Further, thanks to the "one year" time limit, a large volume of repatriation was made within a short period, which caused USD to appreciate across the board in the forex markets; USD appreciated by over +6% both in nominal and real effective terms, appreciating from 103 to 118 against JPY in 2005 (see figure). Subsequently, the Trump administration also signed the Tax Cuts and Jobs Act (TCJA) of 2017 into law in December 2017, and this attracted a great deal of attention as the return of HIA. TCJA's reform proposal, however, involved taxing profits made by overseas subsidiaries just once, in their overseas location, and permanently doing away with taxes on earnings that were repatriated to the homeland. Specifically, under the new law, U.S. companies would be taxed just once (at the rate of 15.5% for cash and other liquid assets, and 8% for fixed assets) as a transitional measure when repatriating their retained earnings from overseas subsidiaries back to the U.S. However, because the margin of reduction was not as dramatic as that in 2005, and given that the new law was permanent rather than time-bound, it did not trigger that much of a rush to repatriate.

It is only when there is a concentrated flow that any impact on the forex markets can be seen, so the lowering of taxes on repatriated earnings under the Trump administration had almost no impact on the forex markets (perhaps this was also due to the Trump administration's bias toward a weaker USD against the backdrop of trade frictions with China.)

Orthodox Way to Curtail JPY Depreciation

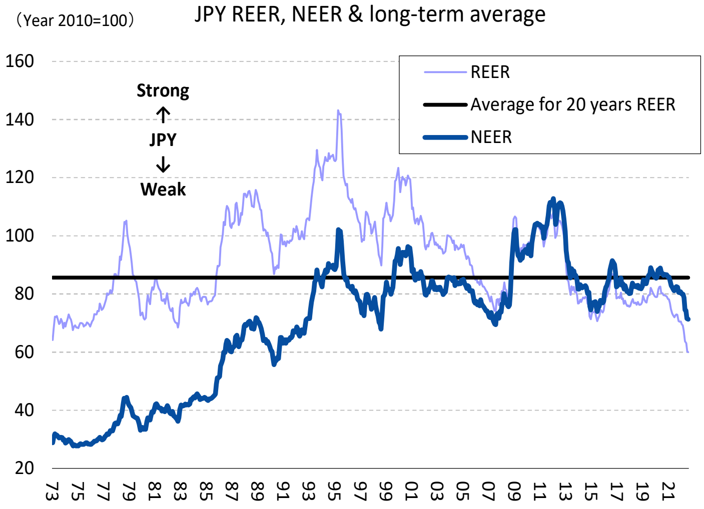
Could the U.S. experience with HIA in 2005 not be replicated in Japan? According to the Ministry of Economy, Trade and Industry's 2020 Basic Survey on Overseas Business Activities, the balance of retained earnings of Japanese companies' overseas subsidiaries amounts to around JPY 37.6 trillion. As a result of the dramatic increase in foreign direct investment over the past 10 or more years, many Japanese companies have come to retain overseas earnings in overseas locations in foreign currency. It may be worth considering the establishment of a system for encouraging these companies to repatriate their earnings back to Japan. Such a system could even be made to align with the stated missions of the Kishida administration – which, going by the administration's messaging related to "a new form of capitalism," could involve wage rises and jobs. Of course, capital investment as a condition could also be considered for boosting economic growth. 10% of the total balance of retained earnings of Japanese companies would amount to JPY 3.8 trillion, 20% would amount to JPY 7.6 trillion, and 30 percent would amount to JPY 10 trillion worth of JPY buying. As JPY 10 trillion is an amount that nearly matches Japan's (roughly JPY 12.2 trillion) trade deficit for January-August 2022, it could work as a significant force to cancel out one of the factors of JPY weakness.

In the history of the Japanese economy, with its chronic dread of excessive JPY strength, it has been difficult to proactively discuss the prospect of lowering taxes on repatriated earnings, but excessive JPY strength is no longer an issue. To use the profits earned by one's own country as capital to fund the purchase of the domestic currency, and to further use repatriations as the starting point to stimulate domestic demand by raising wages or through capital investment is an orthodox path that other countries could not object to either. Rather than playing cheap monetary policy tricks and ending up in a speculation war with the market, it seems more respectable think of a way to repatriate back to Japan the foreign reserves the Japanese economy has.

Risks to My Main Scenario – Stirrings in the Household Sector and JPY Depreciation Risk

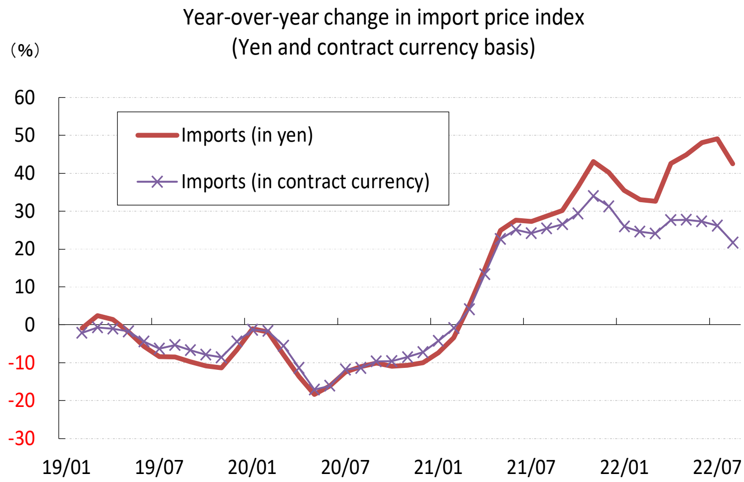
Households Pushed by Weak Japan

The September 6 edition of the Nikkei Shimbun reported that there was a sharp rise in individuals opening foreign currency fixed-deposit accounts. Some major online banks are reported to have witnessed an 80% increase in monthly new deposits into these accounts compared with six months ago. While this sharp rise in deposits may be partially attributed to the attraction of higher interest rates following rate hikes by foreign central banks, it seems likely that it is the "capital gains" (foreign exchange gains) rather than the "income" aspect of asset management that is more strongly responsible for the trend. If one argues that the trend is attributable to the pandemic, one could point out the marked devaluation of JPY compared with January 2020, the associated narrative that supports the idea of "cheap Japan," and other facts too numerous to enumerate. No doubt, such an atmosphere is fueling the household sector's desire to invest in foreign currency.



(Source) BIS

Let us take a look at some figures. During the period from January 2020 to the end of August (see figure), JPY has fallen by -16% in terms of its nominal effective exchange rate (NEER), and -23% in terms of its real effective exchange rate (REER). Incidentally, the rate of change from early 2020 to recent days is also around -25%. The nominal value of USD-denominated assets falling by over 20% without any action on the part of investors combined with the cross-border price differential (most of which is attributable to cross-border wage differentials) is creating a situation wherein the price of foreign products have gone up for Japanese consumers. Of course, <u>the impact of JPY weakness cannot be overlooked, but the disparities in wage growth between Japan and other parts of the world can also make standard overseas product prices seem expensive from the perspective of Japanese consumers</u>. For luxury goods that consumers around the world desire, such as the iPhone, luxury cars, and luxury watches, standard prices are set without taking into account the domestic situation in Japan. This is because, in the case of such products, including smartphones and watches, which can easily be transported across national borders, consumers are able to exercise discretion when it comes to location of purchase. This would make it difficult for product manufacturers to, for instance, sell the product cheaply just in Japan.



(Source) Bank of Japan

If the increase in prices was restricted to luxury items, there would be a limited awareness of the problem among the general population. However, as is widely known, price increases are now affecting even essentials, centering on food products, due to a combination of JPY weakness and high resource prices. Of course, the large part of the increase in food prices can be attributed to resource prices rather than JPY weakness, <u>but thanks in part to daily media reports, it is easy for people to get the impression that JPY weakness is to blame</u>. On the other hand, the import price index is clearly showing that while contract currency (i.e., foreign currency) prices are peaking out, JPY prices are continuing to accelerate (see figure). Therefore, <u>though it is not correct to lay all the blame for the recent rise in prices at the feet of JPY weakness, some of the blame certainly can be</u>.

Steady Shift of Household Sector to Foreign Currency

Under such circumstances, the shift from JPY to foreign currency at the individual level mentioned at the start of this section is quite predictable. The latest data we have regarding the composition of financial assets held by the Japanese household sector is from the end of March 2022. As per this data, 95% or more of the financial assets of individuals is still held in JPY-denominated assets, with 50% or more held as cash equivalents earning almost no income. There has been essentially no change in this structure over the past 20 years. Specifically, the financial assets of Japanese households as of the end of June 2022 amounted to JPY 2007 trillion, an increase of +600 trillion compared with end of March 2000 (see figure). However, over half of this increase (approx. +JPY 350 trillion) is in the form of JPY cash equivalents. Shares and investments, which represent risky assets, comprise only around 10%, and this figure has remained more or less the same for many years. The NISA system (tax exemption scheme for small investments), which was introduced with great fanfare in 2014, has not proved all that effective at encouraging the shift from “savings to investment.” It would seem that Japanese households still have an extremely high level of confidence in JPY. At least as of the end of June 2022, one still feels that the financial assets of Japanese households are the last stronghold propping up the value of JPY.

Financial asset composition of the Japanese household sector (end of JUN 2022)

	Amount (trillion yen)	(%)
Total assets	2,007.1	100.0
Foreign currency	64.0	3.2
Foreign currency deposit	6.7	0.3
Foreign securities investment	22.3	1.1
Investment trust	34.9	1.7
JPY-denominated	1,943.1	96.8
Cash and deposits (excluding foreign currency deposits)	1,095.4	54.6
Government bond, etc.	25.2	1.3
Stocks and investments	198.9	9.9
Investment trusts (excluding the foreign currency portion)	56.2	2.8
Insurance and pension reserves	538.5	26.8
Deposit, etc.	28.9	1.4

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

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

Changes from the end of MAR 2000 to the end of JUN 2022

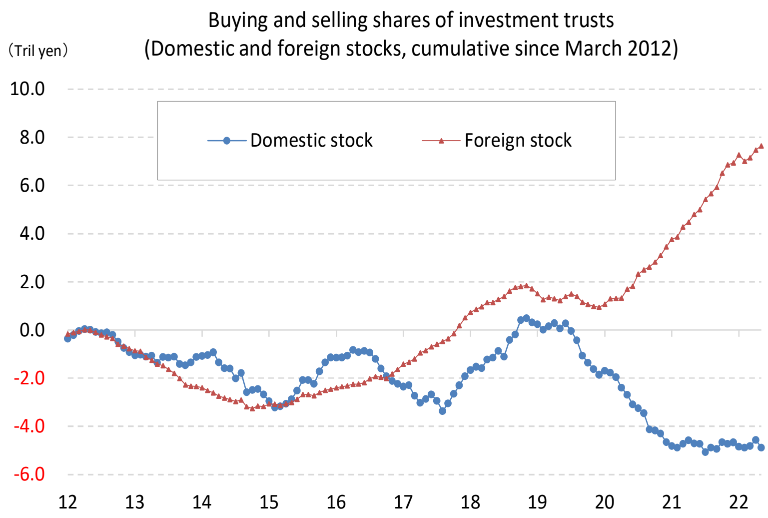
Amount (trillion yen)	(%)
606.0	
50.8	2.2
3.6	0.1
17.6	0.8
29.6	1.4
555.2	▲ 2.2
353.8	1.6
▲ 25.3	▲ 2.4
60.5	0.0
4.0	▲ 0.9
168.6	0.4
▲ 6.4	▲ 1.1

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

However, there are also stirrings that indicate change. As the chart shows, deposits, foreign securities investment, and investment trusts – the three components of foreign-currency-denominated assets – have all increased their share within household financial assets compared with the end of March 2000. In terms of the actual amounts, deposits have seen a 2.2-fold increase, foreign securities investments have seen a 4.7-fold increase, and investment trust have seen a 6.6-fold increase. JPY cash equivalents still comprise 55% of all financial assets, but while the actual amount has increased by +JPY 350 trillion since March 2000, the increase in share is a mere +1.6 pp. Meanwhile, based on my own estimations, the increase in the share of foreign-currency-denominated investment trusts alone is probably +1.4 pp, with foreign securities investment increasing by +0.8 pp, and foreign currency deposits increasing by +0.1 pp. As a result, one could say that there has been a +2.2 pp shift away from JPY-denominated assets to foreign-currency-denominated assets. During the same period, there has been no marked increase in JPY-denominated shares and investment trusts (their share is likely to either be unchanged or have decreased). This seems to imply that rather than a shift from “savings to investment,” what has happened is a shift from “JPY to foreign currency.” While JPY cash equivalents have an overwhelmingly large share overall, it is worth noting that interest in foreign assets has been steadily increasing.

No Reason to Remain Conservative Forever

As I have argued many times in previous editions of this report, it cannot be denied that the Japanese economy’s external accounts (current account balance, net external assets, and other trends) are undergoing some sort of structural change. Although it is difficult to pinpoint cause and effect in forex markets, where the concept of fair value does not apply, Japan’s trade surpluses vanished around 10 years ago, and its trade deficits have been expanding. The rapid expansion of Japan’s foreign direct investments also began at around the same time, i.e., 10 years or so ago. It is probably safe to assume that these demand-side changes are not unrelated to the fact that JPY is weaker against USD than it has ever been in the past 24 years, that JPY’s REER is weaker than it has been in 50 years, and that purchasing power parity (PPP) disparities are rapidly expanding. There is no question that the climate surrounding JPY-denominated assets has changed dramatically since 2000, or even since 2010. If, in addition to this, the devaluation of JPY can be felt by the general public through frequent price rises, it is possible that the Japanese household sector would make some changes in response. There is no reason to believe that its conservative approach to money management, which has been the default historically, will continue going forward. Incidentally, the history of Japan since its shift to a floating exchange rate system has also been a history of deflation and JPY strength. Therefore, Japanese households’ strategy of putting their funds in JPY cash equivalents during this period of JPY strength is not impossible to view as a prudent money management strategy. At any rate, the household sector is a rational economic entity and has no reason to continue keeping its funds in unprofitable assets indefinitely.



(Source) Investment Trust Association (Note) as of JUN 2022

The Japanese household sector has tended, right from the start, to be more interested in foreign exchange margin trading and trading in crypto currencies, which are closer to speculation than to investment, but my understanding is that there is no deep-seated aversion to investment among Japanese households. In fact, the steep appreciation in U.S. share prices seen since 2020 reflects Japanese households' desire to bet on foreign economies rather than on the Japanese economy. As the figure shows, Japanese households' investment appetite for foreign shares has taken the place of their investment appetite for Japanese shares. To some extent, it is probably inevitable that the "savings to investment" trend promoted by the Kishida administration will accompany a "JPY to foreign currency" trend. As of the writing of this report, there is no clear evidence that a flight of capital from Japan owing to the household sector's investment activities will accelerate any time soon. However, Japan is a society where, once a certain trend catches on, everybody follows along with alacrity. Even if only 10% of the flow of funds is shifted away from cash equivalents (excluding foreign currency deposits), that would amount to selling JPY worth JPY 100 trillion. This is the equivalent of 5-6 years of Japan's current account surplus (calculated at the rate of +JPY 18 trillion, which is the average for the recent-most five years, i.e., 2017 through 2021). Unlike in the past, when one had to visit a bank and pay a hefty commission to be able to purchase foreign currency, foreign investment is no longer a difficult process. One can convert any amount of JPY to foreign currency at any time using just a smartphone. The investment appetites of Japanese households will change as the conservative older generations go on to be replaced by younger generations.

The foreign currency investment trend among Japanese investors, recently the subject of discussions, involves no more than a small part of the over JPY 2000 trillion worth of financial assets owned by Japanese households, but the sudden interest in foreign investments, centering on U.S. shares, may be the prelude to a shift away from domestic assets. As the chart on the previous page shows, this trend has been steadily gaining strength over the past nearly quarter of a century, since 2000. The Kishida administration has clarified its stance on promoting financial education as a national strategy. However, there is no guarantee that JPY-denominated assets will be chosen as a result of this financial education triggering the shift away from savings toward investment. This turn of events must also be taken into account by administrators in a climate where the damage resulting from JPY weakness is being pointed out.

EUR Outlook – EUR Deprived of its Solid Supply-Demand Environment

EUR Area Monetary Policies Now and Going Forward – ECB Fights Stagflation

"Adverse Scenario" Already Realized for 2022 Inflation

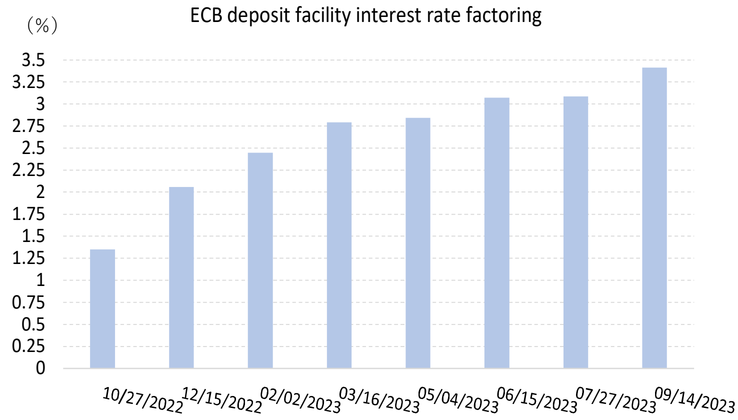
ECB staff outlook （SEP2022）

	Outlook SEP 2022			Adverse scenario		
	2022	2023	2024	2022	2023	2024
Real GDP	3.1	0.9	1.9	2.8	-0.9	1.9
HICP	8.1	5.5	2.3	8.4	6.9	2.7

（Source）ECB

The ECB's September 8 Governing Council meeting decided to raise the ECB's deposit facility interest rate 75bp – from 0% to +0.75%. This 75bp rate hike is the largest rate hike the ECB has ever implemented. The September Eurosystem staff projections of the euro area consumer price index (HICP; base scenario) for 2022/2023/2024 are +8.1%/+5.5%/+2.3%, and figures for each year have been adjusted upward from the +6.8%/+3.5%/+2.1% June projections. Although both June and September outlooks anticipate that HICP will descend to a 2.1-2.3% range in 2024, the +8.1% base scenario figure for 2022 is already worse than the adverse scenario figure for 2022 (+8.0%) as of June. It seems clear that the 2022 HICP situation has already worsened more than what was considered an "adverse scenario" only a few months ago. The September projections also include an "adverse scenario" designed to be more-accurate in the case of negative developments regarding such factors as Russian natural gas and oil supply disruptions (and a lack of progress in obtaining alternative energy supplies), further increases in commodity prices, external demand decreases, and funding environment deterioration. The September adverse scenario outlook HICP figures have been revised upwards to +8.4%/+6.9%/+2.7%, but these figures are not actually so different from the base scenario figures. However, in the adverse scenario, the real GDP growth rate forecast for 2023 is -0.9%, indicating that the euro area will suffer a recession. All this suggests that the region will be facing a worsening stagflation situation.

Number of Additional Rate Hikes "More Than Two but Less Than Five"

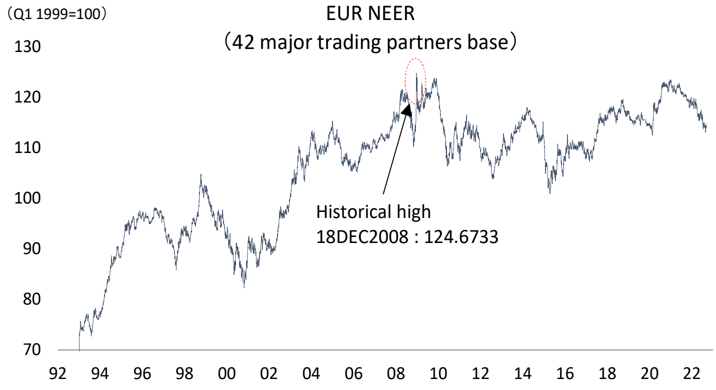


（Source） Bloomberg

At the post-Governing Council-meeting press conference, a reporter asked if there were arguments presented within the Governing Council for raising interest rates "by 50 or 100 basis points", and ECB President Lagarde responded that – "We had different views around the table, a thorough discussion but the outcome of our discussion was a unanimous decision." President Lagarde argued that energy is still the dominant source of euro area inflation but also expressed concern that – "we also have an inflation that spreads across the whole range of products in particular in the service sector, where supply factors are less prevalent and where demand plays a role." This suggests that the 75bp rate hike decision may have been prompted by the fact that service sector inflation is often directly linked to wage inflation. Regarding criticism that the ECB may be lagging behind the curve in its responses to economic developments, President Lagarde denied that the ECB was lagging behind, pointing out that the ECB has been implementing a normalization "journey" since last December. Moreover, with respect to the ECB's fight against inflation, she said – "we have more journey to cover going forward." However, since President Lagarde dismissed the possibility of an interest rate hike in 2022 as "very unlikely" from last year to the beginning of this year, there are undoubtedly some unforeseen circumstances that have forced the ECB to adjust its journey. It was previously said that interest rate hikes would start in September at the earliest, but that projection turned out to be behind the curve, so it is inevitable that some people will point out the possibility that the July-September +125bp interest rate hike may also be behind the curve.

Regarding the trajectory of prospective interest rate hikes, the statement says – "over the next several meetings we expect to raise interest rates further" – and this suggests that several rate hikes are promised. Of course, attention has been focused on the specific number of times "several" refers to, and on this point President Lagarde said – "It's probably more than two, including this one, but it's probably also going to be less than five." If one assumes that it will be four times, it may be reasonable to anticipate hikes in October, December, January, and February. It can be said that the ECB's situation is similar to that of the FRB, as the emerging consensus opinion is that the FRB's rate hikes will end in the January-March 2023 quarter. The market forecast is for the interest rate to steadily rise to 2.75% by March 2023 and subsequently, by means of intermittent hikes, reach 3.25% by September 2023. Another question posed at the press conference was about whether the neutral interest rate would be the end point of the rate hikes, and President Lagarde avoided giving a cogent response, saying – "what I know today is that zero is not the neutral rate and that where we are is not the neutral rate. We are heading in that direction." Neither President Lagarde nor the ECB have provided any information about the ECB's definition of the neutral interest rate, so while the ECB is apparently moving interest rates upward toward that neutral rate, there is no basis for projecting how high that rate may be considered to be.

EUR Depreciation a Factor Related to Interest Rate Hikes



(Source) macrobond
(Notes) EU 19 countries vs 42 major trading partners base

The Governing Council meeting's statement includes the sentence – "The depreciation of the euro has also added to the build-up of inflationary pressures." At the press conference, President Lagarde noted that, since the start of the year, EUR has depreciated by 12% against USD and by 4% on a nominal effective (NEER) basis relative to other currencies in general and that this will contribute to euro area inflation after a lag. She said – "I don't have a decomposition right now of how much exactly [EUR depreciation] contributed to the inflation as it stands, but it will be available in the documentation that will be published later on." – and it will be very interesting to see that documentation. Currently, EUR depreciation appears to be stemming not only from interest rate differentials but also from the fact that, among developed countries, the euro area real economy's outlook is egregiously poor. Even the staff projections' base scenario forecasts the euro area's real growth rate will fall below 1% in 2023, and as the forex market gives due attention to the underlying economic strength of each currency's region, it is currently difficult to anticipate an increase in EUR buying. EUR is certainly trending downward against USD, but looking at NEER figures, one finds that EUR has not fallen to a remarkably low level by historic standards. It appears there remains downside leeway for EUR to depreciate further on a NEER basis.

ECB Faces Stagflation for the First Time

Among the world's three leading economies – those of the United States, Europe, and Japan – there is no doubt that it is the euro area economy that is facing the greatest threat of incipient stagflation. In ordinary times, the ECB has to make difficult choices about whether to prioritize economic stimulation or inflation control, but it currently has no choice but to emphasize measures to countervail the inflation upswing, even though it is generally understood that this current inflation upswing is largely attributable to cost pushes rather than demand pulls. As mentioned above, the inflation fighting moves may be also intended to promote EUR appreciation, particularly against USD, but it will be difficult to promote a rise in EUR/USD so long as the FRB continues raising interest rates. In this respect, EUR's situation is similar to that of JPY, as the United States ultimately has the power to determine the currencies' value against USD (although it may be argued that JPY would have a stronger basis for defending its value if only Japanese interest rates were raised).

It should be recognized that the nature of the ECB's policy management going forward will largely depend on trends in the German economy. It is generally understood that if Germany actually begins facing serious natural gas shortages, regulations will be put in place to prioritize the supply of gas to users – such as ordinary households, hospitals, fire departments, police, schools and supermarkets – that are not significant contributors to the country's economic dynamism. It will be a situation similar to pandemic-related quarantines and lockdowns that restrict the activities of economic entities that are politically judged as being non-urgent and not absolutely necessary. Even with such countermeasures, however, it seems likely that, if there is a shortage of gas, the price of gas and alternative energy sources will be pushed up, and HICP will not fall. I still position full-scale stagflation as an adverse scenario rather than a base scenario in my forecast of the euro area economy's future, but one cannot avoid getting the impression that the likelihood that the adverse scenario will eventuate is now significantly higher than it was three months ago.

EUR Now and Going Forward – EUR at the Mercy of Nord Stream

Gas Supplies via Nord Stream 1 Not Resumed

While the sharp rise in USD/JPY has been attracting considerable attention, EUR has also depreciated sharply since the beginning of September. Since late August EUR had been showing a tendency to fall below parity with USD for the first time in about 20 years (since 2002), but more recently EUR plummeted to the USD0.95-0.96 range, making it necessary to consider the possibility that it may once again descend to its all-time record low level (USD0.8269). There are several factors driving the EUR depreciation trend, but one key trigger was the momentous September 2 announcement that Russia's state-owned natural gas company Gazprom would postpone the resumption of natural gas supplies to Europe through the Nord Stream 1 gas pipeline. Originally, Gazprom had suspended gas supplies through Nord Stream 1 for three days – from August 31 to September 2 – citing a need for routine maintenance and the repair of a gas turbine. Gazprom said the postponement was necessitated by an oil leak found in an electrical circuit connection of the turbine, but it is not clear how long such a problem would justify continuing to suspend operation of the turbine.

While equipment-related problems were the official reason for operational suspension decisions, it is worth noting that it was on the same day as the second decision (September 2) that the G7 finance ministers set an upper limit on Russian oil import prices (to be effective from this December) – many observers consider Gazprom's September 2 natural gas supply resumption postponement announcement to be a Russian response to the G7 move. From December 5, Western insurance companies will be prohibited from providing insurance services for the marine transport of Russian oil priced at levels above the ceiling price, and this is intended to halt the shipment of Russian crude oil sold for more than a certain price. The goals of the scheme are to prevent Russia from profitably selling oil and thereby undermine Russia's ability to fund military forces, stall Russia's military operations, and present serious challenges to Russia's real economy. It has been reported that the G7 may be planning to expand the scope of such price ceilings to include natural gas as well as oil. Subsequently, on September 27, Russia's Nord Stream 1 and 2 pipelines were deliberately sabotaged, and many people are accusing Russia of having done this. Increasing concerns about supply constraints have been pushing natural gas prices upward.

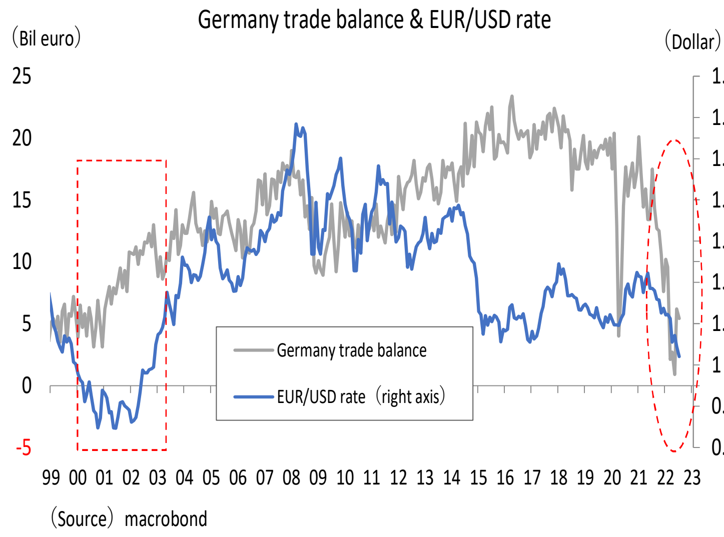
Progressive Realization of the "Adverse Scenario"

The euro area's current economic and financial situation and the prospective possibility that the supply of natural gas from Russia to Europe may be completely cut off suggests that the "adverse scenario" that the European Commission and the ECB had been wary of is progressively taking shape. (Only about 40% of natural gas supplied by Russia to Europe has been provided via Nord Stream 1.) As shown in the table on page 11, the September Eurosystem staff projections of HICP (base scenario) for 2022/2023/2024 are +8.1%/+5.5%/+2.3%, and figures for each year have been adjusted upward from the +6.8%/+3.5%/+2.1% June projections. Reflecting the energy-related issues mentioned above as well as other factors, the euro area is exposed to a risk of severe stagflation.

In light of the prospect of critical energy supply shortages, Germany has begun considering restarting the operations of mothballed coal-fired power plants and protracting the operations of three nuclear power plants that were scheduled to be decommissioned by the end of this year. If the country's gas shortages become extreme, there are rumors that the authorities' response will entail reducing gas supplies to the corporate sector to enable sustained supplies to the household sector, and it is obvious that such an eventuality could have a large impact on Germany's GDP growth rate. On September 4, the German government announced it will implement approximately EUR65 billion in inflation countermeasures in line with its policy goal of reducing the burden of utilities-related expenses on the household sector. Germany recently launched a summertime program enabling unlimited travel on local and regional public transport vehicles for only EUR9 per month during the period through August 31, and there are now calls for the protracted operation of a similar unlimited public transport program involving lower government subsidies and somewhat-higher-priced monthly tickets. The current energy crisis has completely transformed the nature and scale of Germany's austerity programs.

The shortage of natural gas supplies along with the fundamental instability of such supplies has been keeping the price of gas and other energy products very high. Even if Russia's supplies of energy to Europe are not completely disrupted, the euro area's HICP is already surging at a rate that makes it inevitable that it will exceed the "adverse scenario" projection level, and it can be expected that this large-margin HICP increase will be reflected in the base scenario projection figures announced by the ECB and the European Commission in the future. In any case, the increasingly serious concerns about prospective stagflation trends in the euro area are a major factor promoting EUR selling.

Emerging Theme of German Trade Deficits



The Nord Stream pipelines' operational status will inevitably affect the ECB's policy management decisions, particularly regarding the expected interest rate hike trajectory. In light of the postponement of the reopening of Nord Stream 1 along with the evidently intentional damage inflicted on Nord Stream 1 and 2 in late September, at the time this article was written, Europe appears to be facing a risk of a chronically protracted increase in its inflation rates. As is well known, there is currently an atmosphere in which it is taken for granted that accelerating rises in headline inflation rates will spur consideration of larger interest rate hike margins. As already discussed, the suspension of gas supplies via Nord Stream 1 appears to have played a role in causing the September 8 ECB Governing Council meeting to hike interest rates by +75bp rather than by +50bp. From the forex market's perspective, it appears that the Europe-Japan interest rate differential is forestalling a sustained trend of EUR depreciation against JPY, but the situation is continuing to fluctuate. (This fluctuation reflects the low level of the market's evaluation of JPY's fundamental strength.) On the other hand, <u>the widening Europe-U.S. interest rate differential and real economy disparities (that are likely to widen further going forward) are attracting more attention,</u>

and it is expected that EUR/USD will descend to historical new low levels. Regarding inflation rates, some observers are starting to argue that U.S. inflation rates have already begun peaking out, and if that peaking out is sustained it is likely to further increase the attention given to the euro area's inflation plight.

Going forward, there is a possibility that the progressive weakening of Germany's trade balance and potential for trade deficits will impact EUR exchange rates (see graph). Although preliminary figures for May seemed to suggest that Germany had recorded a trade deficit that month, the confirmed statistics for that month indicate that the country had avoided slipping into what could possibly be the start of a chronic deficit situation. As natural gas supplies become tighter ahead of the full-scale arrival of winter, however, it can be expected that Germany's energy costs will rise even further, and seems inevitable that the country will begin recording trade deficits. As the graph (on the previous page) clearly shows, Germany has long sustained a general trend of increase in its trade surpluses since EUR recovered from its persistent tendency to fall below parity with USD in the early 2000s – but what is happening now seems to be the opposite of that situation in the early 2000s. With regard to energy supplies, there is no doubt that Japan is also facing challenges, as reflected in the government's recent request (it is rumored that companies not complying may be fined, so it may be more accurate to characterize this as a requirement) that the corporate sector reduce electric power consumption. However, Japan's difficulties differ from the euro area's in that the latter's prospects largely hinge on hard-to-predict decisions made in Russia – but this is just one aspect of the challenges the euro area will be facing over the long term, and it seems that the financial markets are not very confident that the region will be successfully overcoming those challenges. While JPY is now basically the "weakest" of the world's major currencies, considerable attention will be focused on the question of whether EUR (and GBP; discussed below) may deteriorate to similarly feeble conditions over the next year.

EUR Area Energy Policies Now and Going Forward – Many Slogans but No Decisive Action this Winter

EU Energy Policy Replete with Slogans

On September 14, European Commission President Ursula von der Leyen presented her State of the Union address to the European Parliament, in which she announced her course of action for the next year and overviewed measures designed to help the euro area cope with its increasingly serious energy-related problems. Her speech touched on a wide range of subjects, but the idea (discussed below) of taking a portion of energy businesses' profits and distributing those funds to other companies as well as to households attracted particularly great attention. In addition, quantified and mandatory power conservation targets have been announced, and EU energy ministers at the Extraordinary Transport, Telecommunications and Energy Council (Energy) meeting on September 30 agreed on a regulation to address high energy prices and discussed further measures to mitigate high gas prices. The key point is that the situation is so dire that there is general agreement that intervention in private economic activities will be necessary.

The European Commission's Energy-Related Programs

	Issue	Details
(1)	The European Green Deal	Announced when the von der Leyen-led European Commission was inaugurated in November 2019, European Green Deal is designed to achieve net zero greenhouse gas emissions (≈ climate neutrality) by 2050 and it also seeks to promote a decoupling of economic growth and resource usage. Generally defining the future direction the EC wants EU society to develop toward, the European Green Deal is positioned as a basic policy platform that indicates the high priority to be given to various kinds of social policies as well as economic policies.
(2)	REPowerEU	Announced in May 2022, REPowerEU is a plan to reduce the EU's dependence on Russian fossil fuels. Its goal is to significantly reduce EU dependence on Russian fossil fuels by the end of 2022 and completely eliminate such dependence by some time before 2030.
(3)	Fit for 55	A plan to promote swift transition to renewable energy sources in line with the REPowerEU program, Fit for 55 aims reduce the EU's net greenhouse gas emissions by at least 55% compared to 1990 levels by 2030. Implementing "Fit for 55" is expected to require EUR210 billion of funding by 2027, and it is assumed that the NextGenerationEU recovery fund (NGEU) will be the source of the funding.

Source: Based on EC materials as well as news media reports

The EU's energy policy also features many slogans. When the von der Leyen-led European Commission was inaugurated in November 2019, it announced a large-scale "European Green Deal" program that has the goal of achieving "climate neutrality" by 2050. Besides achieving net zero greenhouse gas emissions (≈ climate neutrality) by 2050, the program seeks to promote a decoupling of economic growth and resource usage. Generally defining the future direction the EC wants EU society to develop toward, the European Green Deal is positioned as a basic policy platform that indicates the high priority to be given to various kinds of social policies as well as economic policies.

This past May, the European Commission also announced "REPowerEU", a plan to reduce the EU's dependence on Russian fossil fuels in view of the deterioration of EU-Russia relations triggered by the Ukraine situation. REPowerEU calls for the EU to significantly reduce its dependence on Russian fossil fuels by the end of 2022 and completely eliminate such dependence by some time before 2030. The EU is planning to concurrently realize a rapid transition to renewable energy in a way that enables it to reduce its net greenhouse gas emissions by at least 55% compared to 1990 levels by 2030. The policy package designed to attain this goal is called "Fit for 55". Implementing "Fit for 55" is expected to require EUR210 billion of funding by 2027, and it is assumed that the NextGenerationEU recovery fund (NGEU) will be the source of the funding.

In this way, the EU has set itself various goals and coined slogans to represent associated programs – the Von der Leyen-led EC's main policy platform theme is the "European Green Deal", but the "Repower EU" is a policy theme that has come to be emphasized since the emergence of the Ukraine crisis, while "Fit for 55" is a package of policies designed to help realize the Repower EU targets. Even if the Ukraine crisis had not occurred, the "European Green Deal" would have entailed the promotion of alternative energy sources along the lines of REPowerEU, but the crisis has made it necessary to further accelerate the implementation of related programs. In short, the EU's energy strategy includes a short-to-medium-term goal of completely eliminating energy dependence on Russia by 2030 and a long-term goal of achieving net zero greenhouse gas emissions (≈ climate neutrality) by 2050.

Key Emphasis on Reducing Electric Power Consumption

In her State of the Union address, President von der Leyen also mentioned other topics – such as that she would proceed with FTA negotiations with Australia and India and that Ukraine would be recognized as a candidate for joining the EU – but it was the energy-related topics that attracted the greatest attention.

Particularly noteworthy topics as they relate to the current and future development of the EU's energy policies include, (1) electric power consumption reduction obligations, (2) the collection of funds from renewable energy companies, and (3) the establishment of the European Hydrogen Bank. However, the only direct response to the current situation, which can be called an severe energy crisis, is the request for electric power conservation measure within topic (1), and no specific measures to ensure such conservation is realized have been decided on yet. Despite the impressive array of program names, longer-term targets and slogans, however, when it comes to the short-term crisis during the upcoming winter months, the EC's approach boils down to an appeal to "do your best to conserve energy and endure the inevitable tribulations". Of course, the collection of a portion of renewable energy and fossil fuel businesses' profits and distribution of those profits to the struggling entities in the household and corporate sectors in topic (2) should not take too much time to implement. But it remains questionable how much this approach can it really lighten the suffering EU residents and economic entities will be undergoing this winter. Regarding topic (3) regarding the promotion of hydrogen utilization, as advocated in the European Green Deal, it is unlikely that the EU's economy and society will come to enjoy associated benefits in the foreseeable future. Reflecting that, the European Hydrogen Bank is a topic that has rarely been talked about in the financial markets.

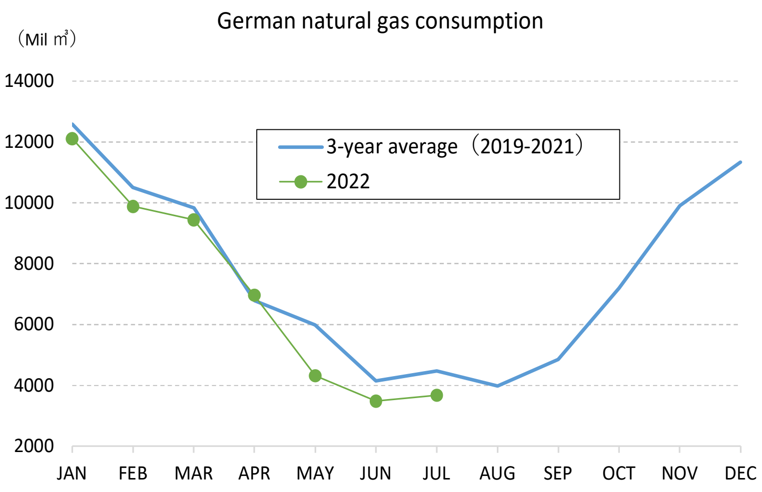
European Commission President's State of the Union Address (Key Energy-Related Issues)

	Issue	Details
(1)	Electric power consumption reduction obligations	Peak-hour power consumption reductions of 5% will be required with the goal of achieving at least 10% overall energy consumption reductions, although concrete measures have not yet been decided on.
(2)	Collection of funds from renewable energy companies	Electric power charges for power from renewable energy and nuclear power generation units that generate electricity at lower cost than gas units will be capped at EUR180/MWh, with payment receipts above this level to be collected by EU member states. For fossil fuel power generation units, member states are to collect 33% of the portion exceeding "20% of the average profit of the past three years" as a solidarity fee. EUR140 billion is to be distributed to households and businesses.
(3)	Establishment of the European Hydrogen Bank	Considering the development of next-generation energy sources to eliminate energy dependence on other countries. Announced the establishment of the "European Hydrogen Bank" to promote the use of hydrogen and plans to invest EUR3 billion to develop the hydrogen market.

(Source) Based on EC materials as well as news media reports

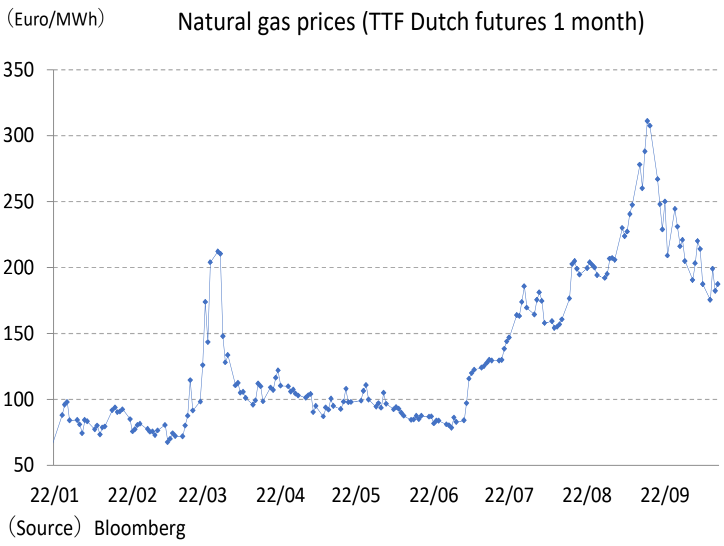
Power Shortages Have Same Effect as Lockdowns

Before the State of the Union address, there were rumors that the EU would set a price ceiling on all natural gas prices, but it turned out that this was not mentioned in the address. If such a price ceiling were to be set, it could be expected that not only Russia but also suppliers in the United States might hesitate to provide the EU with natural gas, so it is not hard to imagine that the EU's natural gas receipts could become unstable and generally diminish. It is understood that worldwide demand for liquefied natural gas (LNG) exceeds supply capabilities, and there is no apparent reason why suppliers would be willing to provide LNG to Europe at a prices lower than market prices. While it may seem overly simplistic, one gets the impression that the EU perceives the need to restrain energy prices as being so urgent that it must utilize all conceivable approaches to restraining energy prices even with respect to approaches that seem obviously destined to fail.



(Source) Eurostat

As mentioned above, the European Commission is requesting that all EU member countries take measures to reduce their electric power consumption but, needless to say, each country has already started to take action. As a result, the amount of natural gas stored in those countries has been steadily increasing as winter approaches. However, this is the result of restraining economic activity to lower than normal levels. <u>The graph shows that Germany's monthly natural gas consumption figures have recently been significantly below the average levels for the last three years (2019-2021), and it is expected that the gas consumption reduction will be accompanied by general declines in propensities to consume and invest</u>. The next graph shows that natural gas prices have fallen markedly since the beginning of September, but this is because Germany and other countries are restricting their consumption – in other words, they are abandoning their customary desires to promote economic growth. On September 12, the EU announced that it had made progress in its negotiations aimed at increasing cooperation with Norway – which has now become the EU's largest gas supplier – aimed at bringing more Norwegian gas to the EU. However, Europe's energy demand will rise to peak levels during the cold winter months, and it can be assumed that Russia understands that and might possibly choose to further reduce its provision of natural gas to Europe during those months for strategic reasons. For this and other reasons, there has been intermittent concern that German power shortages may become extremely severe, and if that happens Germany may finally be forced to introduce an electric power rationing system. In that case, meeting the power requirements of fundamentally essential societal elements (such as ordinary households, hospitals, fire departments, police, schools, and grocery stores) will given top priority while the priority of supplies to manufacturing units and other corporate facilities will be subordinated. <u>The economic impact of this may become comparable to that of the recent anti-pandemic lockdowns. This time, rather than a virus, it will be electric power shortages that will be the factor deemed to necessitate a kind of lockdown on macroeconomic activities</u>.



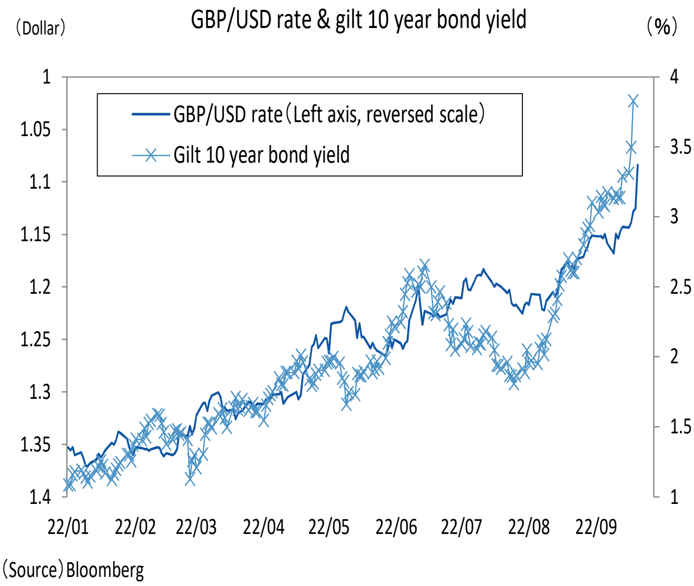
(Source) Bloomberg

It is believed that the EU has postponed further discussions about setting an upper limit on natural gas procurement prices in light of the recent trend of stabilization in natural gas prices, but if Russia were to further reduce its supply of gas to Europe it could tighten the supply-demand situation in a way that causes the EU to renew its consideration of such a price ceiling. Of course, the setting of such a price ceiling might cause suppliers to simply decide to discontinue their sales of gas to the EU. At a time when solidarity among the Western countries is more important than ever, there is due cause for concern that the energy crisis has the potential to become a wedge that divides and weakens the Western countries. It goes without saying that that would be very convenient for Russia. <u>Overall, it is clear that Europe's upcoming winter will be fraught with increasing potentials for dangerous developments with respect to both politics and economics</u>.

U.K. Economy Now and Going Forward – Risks Associated with the World's Second Largest Net External Debtor Country

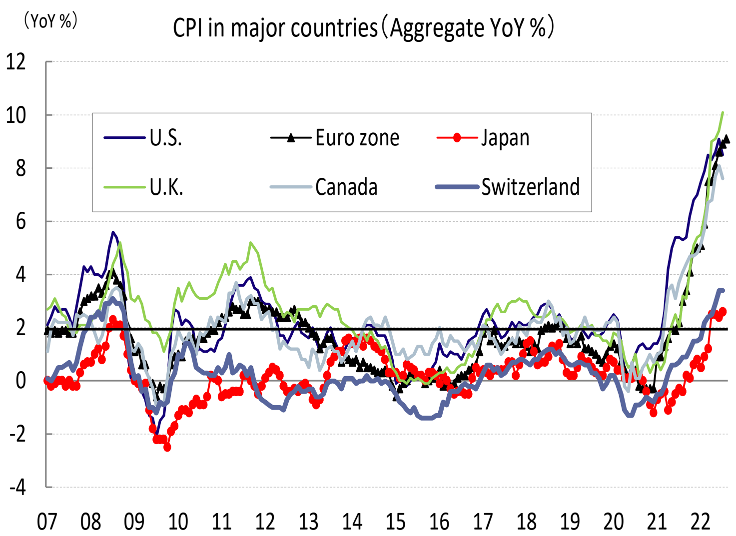
Market Confidence Essential for the World's Second-Largest Foreign Debtor

On September 23, financial markets suffered a general collapse, with the trend beginning in London and then spreading to European and U.S. markets. That day in the U.K. House of Commons, U.K. Chancellor of the Exchequer Kwasi Kwarteng announced an economic package that emphasized expansionary fiscal policy measures and includes personal income tax rate reductions and a freeze on corporate tax rate hikes. European fiscal policy makers are currently focusing on countervailing rising burdens associated with surging energy prices, as seen in the European Commission's recent high-profile moves to place ceilings on energy prices and mandate electric power conservation measures. The U.K. is also considering "pain relieving" policies to alleviate the impact of energy cost surges (ordinary households' energy bills are to be capped at GBP2,500 a year),



(Source) Bloomberg

but it appears the U.K. government is putting more emphasis on policies that "promote high rates of economic growth that make pain forgotten" than on "pain relief" policies. The U.K. government's recently announced economic measures are dubbed a "growth plan," and it is clear that the government intends to devote itself to stimulating demand rather than suppressing it.



(Source) Bloomberg

But there is no guarantee that the Truss government's growth plan will work, and the reaction of financial markets, especially bond and currency markets, indicates that the markets are not optimistic about the plan's success. Following the announcement that the Truss government's fiscal package will cost GBP161 billion (approximately JPY25.5 trillion) over five years, U.K. two-year government bond yields rose above 4% to reach their highest level in about 14 years (since October 2008). However, GBP was generally sold despite the rising level of GBP interest rates, and GBP/USD temporarily fell to its lowest level in 37 years. As this was naturally accompanied by a drop in stock prices, the U.K. suffered a triple depreciation of currency, bond, and stock values. As discussed below, the "expanded fiscal spending + monetary tightening" policy mix is not necessarily unsustainable, but it lacks force as a way of expressing a country's intentions to curb inflation. Chancellor of the Exchequer Kwarteng justified the expansionary fiscal policy in parliament by saying it was in line with the Conservative Party's promise to prioritize growth and a new approach for the new era, but even fresh new approaches may be unsustainable if the financial markets consider them to be extremely problematic.

As the U.K. is the world's second largest net external debtor country after the United States (with net external debts amounting to roughly JPY113.7 trillion at the end of 2021), the stability of its domestic financial markets depends on the city financial district's ability to attract inflows of international capital. Because of this situation, so long as international financial markets remain pessimistic about the U.K, the value of GBP-denominated assets will be forced downward. To overcome this problem, the U.K. government must seek to restore confidence in itself by correcting market participants' expectations that unsustainable debt levels will lead to further interest rate hikes and economic deterioration. Looking at the consumer price indexes (CPIs) of European countries and the United States, however, one finds that the U.K.'s CPI is the only one growing at double-digit rates. Although the BOE was the first G7 central bank to start raising rates (in December 2021), the impact of rising energy prices has caused U.K. inflation rates to go out of control. In light of this, the government's decision to prioritize promoting growth over controlling inflation is perceived as dangerous.

Unreasonable Policy Mix and Likening to Emerging Countries

Policy mix combinations

	Monetary policy	Fiscal policy	Currency policy	Policy intent	Examples
①	Easing	Easing	Currency depreciation	Breaking out of recession, avoiding deflationary spiral	
②	Easing	Easing	Currency appreciation	Unsustainable	Japan
③	Easing	Tightening	Currency depreciation	Economic support	
④	Easing	Tightening	Currency appreciation	Unsustainable	
⑤	Tightening	Easing	Currency depreciation	Unsustainable	
⑥	Tightening	Easing	Currency appreciation	Reducing current account surplus and preventing economic overheating (But weaker than (8))	U.K.
⑦	Tightening	Tightening	Currency depreciation	Unsustainable	
⑧	Tightening	Tightening	Currency appreciation	Prevention of overheating	U.S., Eurozone,Canada,etc.

(Source) Karakama, Mizuho Bank

So there is an incongruity in the United Kingdom, in that the BOE is desperately using monetary policy to control inflation while the government's fiscal policy seems designed to promote inflation. On the other hand, Japan also has an incongruous combination of a government currency policy that favors currency appreciation through forex interventions along with a BOJ monetary policy that favors currency depreciation through continued easing. This kind of incongruous combination is generally known as an unsustainable policy mix (see the table on the next page). While Japan's policy mix is clearly unsustainable, the U.K.'s combination of expansionary fiscal policy and interest rate hikes is not actually unsustainable, theoretically speaking, but it is a policy mix that raises doubts about whether the country truly is seriously intending to fight inflation. In light of the global trend toward giving greater priority to controlling inflation, the fact that the U.K. government is demonstrating by means of its fiscal policy that it may be reluctant to take the measures required to curb inflation is causing concerns, and those concerns in of themselves can affect inflation expectations and other expectations.

Regarding the U.K.'s current policy mix, it is often pointed out that the United States implemented a combination of fiscal expansion measures and interest rate hikes during the 1980s, when the Fed was led by Chairman Paul Volcker. At that time, the United States was suffering from a "twin deficit" (current account deficit and budget deficit) triggered by high interest rates and the strength of USD. (The excessive strength of USD was eventually corrected by the 1985 Plaza Accord.) While the United Kingdom is now adopting the same policy mix that the United States utilized in the 1980s, the forex markets have reacted in a diametrically opposite way to the U.K. policy mix, leading to GBP depreciation. An expansionary fiscal policy that drives economic growth despite high interest rates can be expected to attract capital (and promote the appreciation of the relevant country's currency) in the case of developed countries, but this is not currently the case regarding the United Kingdom. As financial markets panicked, former U.S. Treasury Secretary Larry Summers said in an interview with Bloomberg Television that – "It makes me very sorry to say, but I think the U.K. is behaving a bit like an emerging market turning itself into a submerging market." – and this can be said to be a straightforward assessment of a situation in which rising interest rates and sharp currency depreciation coexist. Summers went on to say that – "It would not surprise me if the pound eventually gets below a dollar, if the current policy path is maintained."

Looking back at history, one finds that at times when a country faced a genuine currency depreciation crisis (including previous GBP depreciation crises), a central bank interest rate hike has never acted as a decisive brake on the problematic currency depreciation. Some are predicting the November meeting of BOE Monetary Policy Committee (MPC) will approve an 100bp interest rate hike, but if the government's policy stance is not adjusted, it can be expected that the general trends in U.K. financial markets will remain unchanged following such a move. The United Kingdom's Truss-led government seems to be asserting itself by reversing the hikes in national insurance premiums and corporate taxes introduced by the previous government led by Boris Johnson, and it appears that this reflects internecine strife within the ruling Conservative Party that cannot be expected to quickly resolved. Although forex market trends are driven by diverse factors, the current situations of GBP and JPY seem to demonstrate the fact that currency values will ultimately move to levels that reflect a given country's economic dynamism as well as the competency of the governments that oversee that country's economy.

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