Forex Medium-Term Outlook

December 26, 2022

MIZUHO

Overview of Outlook

USD/JPY continued to fall in December. Expectations of a Fed policy transition caused US interest rates to decline, prompting USD selling, and this had the expected result of promoting progressive JPY appreciation, while the unexpected timing of the BOJ’s adjustment of its yield curve control (YCC) system (regardless of the exact nature of that adjustment) spurred additional JPY buying. This article has anticipated a USD/JPY decline to around JPY130 in the first quarter of 2023 owing to USD depreciation accompanying the Fed's policy transition, but the BOJ’s behavior appears to have caused this level to be reached sooner than expected. As the size of Japan’s annual trade deficit has swelled to roughly JPY20 trillion, however, a there will continue to be a JPY supply-demand environment conducive to JPY selling for the time being. There remains a high likelihood that US interest rates will fall and USD selling will gain momentum in response to FRB information dissemination during the first quarter and the first half of the second quarter of 2023. But there will arise a problem insofar as the FRB is not likely to undertake interest rate reductions immediately after suspending its rate hikes. In the absence of such rate reductions, there may come a time, starting in the latter half of the second quarter, when the Fed's policy management will not be as powerful a forex market moving factor as it is currently. It can be expected that stock prices will rise and financial market volatility will decrease, while policy interest rates will remain high. Can JPY buying be expected to increase in such an environment? Given the magnitude of Japan-overseas interest rate differentials, it would not be surprising to see a surge in carry trades using JPY as a funding currency conducted against USD as well as other currencies. However, there remain grounds for caution about the potential for JPY depreciation dips during the first quarter and a resumption of the JPY depreciation trend from the second quarter. Also, one should keep in mind the upside risk associated with the question of whether the Fed will indeed desist from hiking interest rates from next spring.

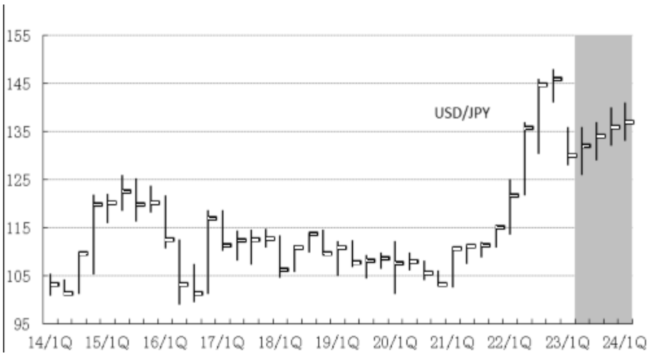
EUR continued to be firm in December. Like the Fed, the ECB appears to be moving to decelerate its interest rate hikes, but the euro area inflation situation remains unpredictable. While recent drops in energy prices are a comforting factor, there are suspicions that inflationary pressures are already impacting a wide range of goods and services in the euro area, and the credit situation in the region is also strong. Against this backdrop, ECB President Christine Lagarde stated that the ECB’s deceleration from 75bp interest rate hikes to a 50bp hike was not a “pivot” (policy transition point), and her statement strongly warned against over-interpreting the deceleration. President Lagarde also hinted that the 3% policy interest rate level anticipated by financial markets would not be sufficient and that more hikes would be needed. In light of these situations, during the forecast period, it is likely that Europe-U.S. interest rate differentials will further narrow and that EUR buying and USD selling trends will continue. On the other hand, it appears that warm winter weather may help belie last summer’s most pessimistic expectations that Europe would suffer an extremely severe energy crisis this winter. It has therefore been possible to prevent Germany's trade balance – an important determinant of EUR market trends – from falling into a deficit, so EUR’s supply-demand environment has not further worsened. In light of the risk of euro area stagflation, it would be unreasonable to expect the sustenance of EUR buying based merely on the high level of nominal interest rates, so from a long-term perspective, due attention should be given to trends related to improvement in EUR’s supply-demand environment going forward.

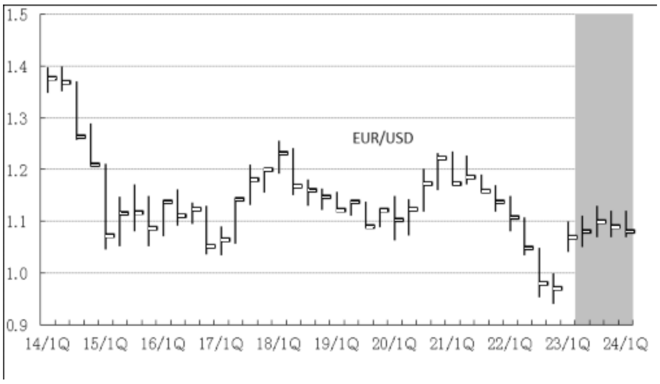
Summary Table of Forecasts

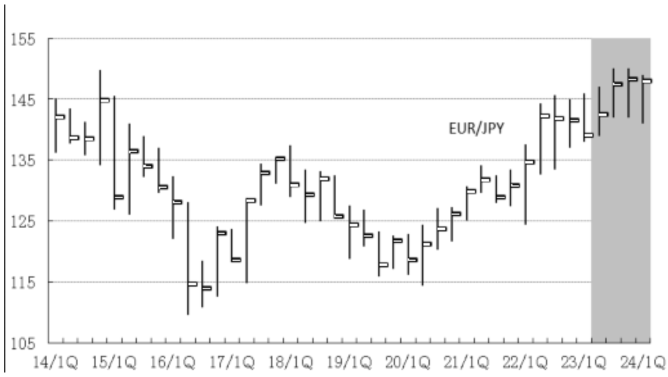
	2022 Jan-Dec (Actual)	2023 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2024 Jan-Mar
USD/JPY	113.47 ～ 151.94 (132.48)	128 ～ 136 (130)	126 ～ 136 (132)	129 ～ 137 (134)	132 ～ 140 (136)	133 ～ 141 (137)
EUR/USD	0.9528 ～ 1.1495 (1.0610)	1.04 ～ 1.10 (1.07)	1.05 ～ 1.11 (1.08)	1.07 ～ 1.13 (1.10)	1.07 ～ 1.12 (1.09)	1.07 ～ 1.12 (1.08)
EUR/JPY	124.41 ～ 148.38 (140.55)	138 ～ 146 (139)	139 ～ 147 (143)	142 ～ 150 (147)	142 ～ 150 (148)	141 ～ 149 (148)

Notes: 1. The actual results were released at around 10a.m. tokyo time on 26th Dec 2022.
2. Data source from Bloomberg. 3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts







USD/JPY Outlook – How Appropriate is it to Assume a Year of JPY Appreciation?

USD/JPY Going Forward – Main Scenario with Upside and Downside Risks

USD/JPY Main Scenario for 2023

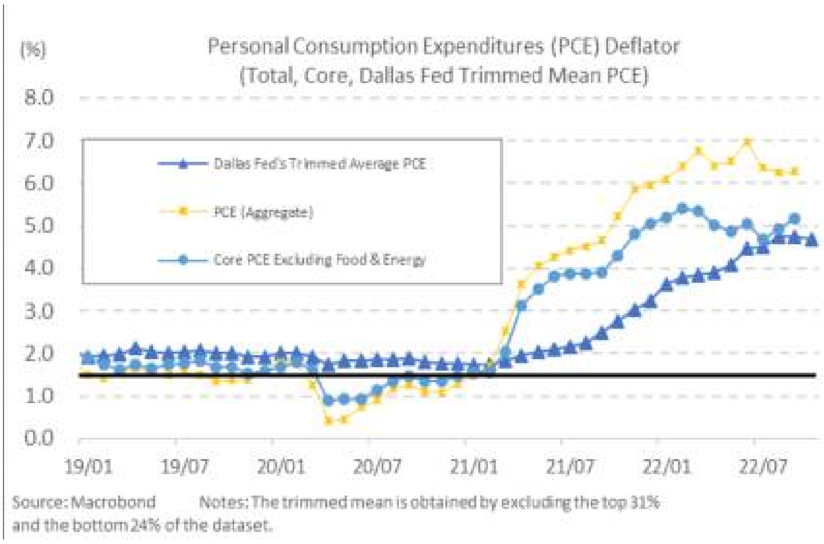
I have discussed the prospects for USD/JPY in 2023 several times in past issues of this report, but would like to take stock of the key points again. Most market participants as of the present seem to be of the view that 2023 will be a year of JPY appreciation, coming right after a year of all-time record JPY weakness. To be sure, in so far as JPY is traded in markets governed by the floating exchange rate system, it would not be surprising if it were to appreciate in 2023. However, the more important question is whether one can predict a consistent trend of JPY appreciation all through 2023. To paint a rough outline of what I think will happen going forward, JPY seems likely to appreciate in response to U.S. interest rate decline and USD weakness during the January-March quarter as the Fed's rate-hike pace or suspension of rate hikes draw attention. Many market participants are likely to share this view. I predict a lower bound just under JPY130 during this quarter, amounting to JPY recovering about half the strength it lost in 2022. However, given that the forex markets are prone to overshooting, there is a good possibility of the currency strengthening to the 125-130 range.

On the other hand, USD/JPY returning to the 112-113 level it was in in early 2022 seems fraught with difficulties. As I have discussed in the past, <u>the current phase of JPY weakness is attributable not just to USD strength, but also to an inherent JPY weakness</u>. Even if the inherent USD strength could be corrected with the Fed's pivoting to a more dovish stance, this will not correct the portion associated with inherent JPY weakness against the backdrop of Japan's all-time high trade deficits. Even intuitively speaking, it is difficult to imagine the currency of the world's only country with negative interest rates and an enormous trade deficit being bought. Of course, Japan's trade deficit in 2023 is likely to be smaller than in 2022. However, it would be difficult to eliminate it altogether. Also, taking into account leads and lags in exchange contracts, 2022 trade deficits could spill over significantly into 2023 also.

Will JPY Remain Strong from Spring on?

What about the scenario from/after April-June? Some in the financial markets are even of the view that JPY will continue to appreciate and eventually return to the level it was at in early 2022, but is this really plausible? It seems natural to doubt the sustainability of JPY appreciation if the aforementioned JPY interest rate and supply-demand climate is taken into account, but it is not just that. If the Fed's monetary policy operation goes as per the consensus, its rate hikes are likely to end in the April-June quarter. However, I believe that the next stage, i.e., rate cuts, are unlikely to realistically enter into market forecasts during 2023. However, there are several theories in this regard, and some market participants do indeed predict the start of rate cuts. Therefore, it seems that predictions for the USD/JPY outlook will diverge depending on the probability with which rate cuts are factored in. For those who are of the view that there will be no rate cuts in 2023<u>, the forecast scenario involves a relatively uneventful period for the financial markets, with no major changes expected in Fed policy</u>. What happens if that scenario comes true? Symbolically, there is likely to be a decline in volatility, accompanied by share price appreciation. Also, since this scenario involves no rate cuts by the Fed, a significant U.S.-Japan interest rate gap is likely to remain. This will be true of JPY not just against USD, but also in other cross-currency transactions.

As I have stated several times in past issues of this report, <u>a sufficient interest rate differential and low market volatility are the two big conditions for carry trade to flourish</u>. While the U.S.-Japan interest rate differential drew attention as a factor encouraging JPY selling in 2022, 2023 may offer market conditions that can drive JPY depreciation in the true sense. In a situation where JPY is the only currency with negative interest rates, it becomes extremely difficult to justify its consistent appreciation, especially as the currency of a major trade deficit country. My prediction is that USD/JPY could return to the 140 level once again in October-December 2023.



Source: Macrobond Notes: The trimmed mean is obtained by excluding the top 31% and the bottom 24% of the dataset.

Continued Fed Rate Hikes Are a Downside Risk for JPY

The previous sections discussed my main scenario, but naturally there are several risks to this scenario both on the upside and the downside. I would like to discuss one main risk on each side here. <u>First, a risk that could cause JPY to weaken more than my forecast scenario is the Fed's continuation of rate hikes</u>. Even if it is self-evident that the U.S. inflation rate has already peaked, <u>is it really certain that the Fed's rate hikes will end in the January-March quarter as many market participants seem to think they will</u>? The personal consumption expenditure (PCE) deflator is +4.7% yoy in terms of the Trimmed Mean PCE Inflation Rate calculated by the Dallas Fed, over +5% yoy on a core basis, and over +6% yoy on an aggregate basis (see figure). Is it possible that these figures will settle in the first three months of 2023 to a level where inflation can be judged to be stably at the +2% level? At the present time, the consensus regarding the terminal rate is in the 4.75~5.25% range, but there is a possibility, for instance, of rate hikes continuing, with at least one rate hike of +25bp in the quarter after June 2023. If this were to happen, the terminal rate could begin to approach 6%. Around a year ago (in November 2021) Fed Chair Jerome Powell hastily withdrew his assessment that U.S. inflation was transient, delivering a huge shock to the markets. Taking that dramatic shift in position into account, would it be all that surprising if the Fed were not to end its rate hikes in the January-March quarter as expected, but continue on with them at a gentle pace? Though this is not part of my main scenario, it is quite worth considering as a downside risk scenario for JPY.

The BOJ's Stance as an Upside Risk for JPY

On the other hand, there are also several risks that could cause JPY to appreciate more than expected, a prominent one being the BOJ's pivot to a more hawkish stance with the inauguration of a new administration. At its December 19-20 Monetary Policy Meeting, the BOJ decided to expand the permissible range for yield curve control (YCC). The official line (to be taken with a grain of salt) as of the present time, is that this amounts not to a rate hike, but to making the monetary accommodation framework more flexible. An actual tightening, i.e., a policy decision that can be described as a pivot by the BOJ, remains as a further option (possibly following a Comprehensive Assessment, as would be proper). Of course, it is not the predominant view that the new BOJ administration will make such a policy decision in one leap. As was evident from the sharp appreciation of JPY following the recent BOJ decision, there is bound to be a major price movement if the Bank does anything to negate the market assumption that it will never implement monetary tightening. At the present time, the only image the markets have of the new administration is that it may not adopt a stronger monetary accommodation stance than the current one. While several candidates for the new governor have come up, there is no consensus on how the BOJ's monetary policy stance could change depending on which candidate is finally chosen.

In this sense, it may be that the situation is conducive to surprises. There is a slightly higher possibility of a rate hike (end of negative rates) when the new administration takes over, but as of the present time, this possibility will have to be categorized as a long shot. However, thinking back to Kuroda's first press conference in April 2013 after his appointment as BOJ Governor, when he announced the decision to implement quantitative and qualitative easing (QQE) and left a strong impression regarding his strongly reflationary policies, one worries about the possibility of the reverse taking place in April 2023. Of course, given the Kishida administration's characteristic reluctance to take big decisions, a major decision such as a rate hike seems unlikely. An increase in interest rates, through the subsequent increase in housing loan interest rates, etc., will clearly be unpopular with the household sector. However, given that an effective rate hike by the BOJ in the form of an end to negative interest rates is something most forex market participants do not anticipate, one must keep it in mind as a risk that could trigger major price fluctuations in the forex markets, where there are usually few reasons to buy JPY.

BOJ Monetary Policy Now and Going Forward – Preparing the Ground for the New Administration?

Undoubtedly an "Actual Rate Hike"

At its December 19-20 MPM, the BOJ decided to make its target YCC range more flexible. While the target level for the 10-year JGB yield remains 0%, the permissible range of fluctuation has been expanded from the previous ±0.25% or so to ±0.5% or so. At the same time, the Bank announced that it would continue its fixed-rate purchase operations of 10-year JGBs at 0.5% every business day. The decision is justified as having been made essentially to facilitate encouraging the formation of a yield curve overall and to enhance the sustainability of monetary easing, and the outward messaging (as stated by Kuroda) is that this does not amount to a rate hike. However, since spring 2022, when JPY weakness and higher inflation began to cause concern, Kuroda's statements have consistently treated any increase in yields beyond 0.25% as an effective rate hike that would negatively impact the real economy. It seems rather difficult, therefore, to deny that the recent measure is anything but an effective rate hike, which is why the markets responded with a surge in JPY buying. The explanation that the recent decision does not amount to a rate hike because the target level for the 10-year JGB yield remains 0% is nothing but the outwardly stated official line, but based on previous statements by Bank officials, the opposite is true. Given how consistently the BOJ has vilified any fluctuation in yields beyond 0.25%, it cannot now complain if its recent decision is seen as a pivot on its policy stance.

Why Now?

As for why the BOJ suddenly embarked on a revision of its YCC (i.e., monetary accommodation) policy at this time (December), there are several theories, but they can be broadly categorized into the following three: (1) overseas markets had already gone into holiday season, (2) the JPY depreciation trend was already stabilizing, and (3) there was a need to prepare the ground for the new (upcoming) administration. Of these, (1) is not difficult to understand – with fewer overseas market participants active during the Christmas holiday season, there was relatively less risk of the change in policy triggering speculative trade, leading to sharp fluctuations.

In addition to (1), (2) provides an important perspective. Some will ask why a stabilization of the JPY depreciation trend should be conducive to revising monetary accommodation. As I have explained in past issues of this report, the BOJ may have been worried that any move on its part to revise accommodative monetary policy at a time when there was concern over JPY weakness was bound to trigger pain trade. If the Band had attempted to revise its easy monetary policy when USD/JPY was renewing all-time-highs on a daily basis, the markets would have seen this as an attempt to contain JPY depreciation. Let us take the example of March, when JPY began to depreciate – would an attempt by the BOJ to expand the permissible range for YCC at that time have helped arrest the JPY depreciation trend? Looking back, March 2022 was when there was speculation that the Fed may have to raise the FF rate by +50bps rather than +25bp, i.e., before the Fed embarked on its successive +75bp rate hikes; inflation rates were accelerating; and the ECB, for its part, was denying any possibility of a rate hike. Had the BOJ expanded its permissible YCC range in that midst, it would probably have done no more than temporarily rein in JPY selling, with no long-lasting effect. Each time the BOJ used one of its policy options to correct monetary accommodation, it would have triggered market demands for further action in the same direction, possibly resulting in an unwanted sharp increase in interest rates (the reverse of what happened during the Masaaki Shirakawa administration, when the BOJ was forced to progressively ease its monetary policy). Revising monetary accommodation after the JPY depreciation trend had stabilized to an extent helped prevent forex rates from becoming the central issue, and I believe that the BOJ made an intelligent decision in this respect given how troublesome it is for central banks to be at the mercy of the forex markets.

Preparing the Ground for the New Administration

Finally, coming to explanation (3), the recent BOJ decision probably also includes some element of preparing the ground for the new administration, as rumored in the markets. There is no way of knowing to what extent the government's wishes were taken into consideration in the recent policy decision. However, it is a fact that in an effort to strictly adhere to the ±0.25% fluctuation range for YCC, the BOJ's JGB holdings ratio had surpassed 50%, and the damage from the policy was beginning to be obvious, for instance, in the marked impairment of bond market functioning. Naturally, then, there may have been a sense in BOJ ranks of not wanting to pass on this uncomfortable environment to the upcoming administration. Further, if we assume that U.S. and European inflation growths do not slow down as much as expected from spring 2023 onward, the specter of JPY depreciation accompanying an increase in overseas interest rates could rise again. The BOJ would want to give itself some flexibility in terms of policy operation in preparation for that eventuality. Also, since the Kuroda administration is already seen as ineffectual, it may have been relatively easy for it to do the dirty job of implementing a policy that was bound to be called out for inconsistency with its previous stance. Moreover, by maintaining that the recent decision does not amount to a rate hike, the BOJ can deny accusations of pivoting, which allows Kuroda to save face to some extent.

What Will Happen Going Forward?

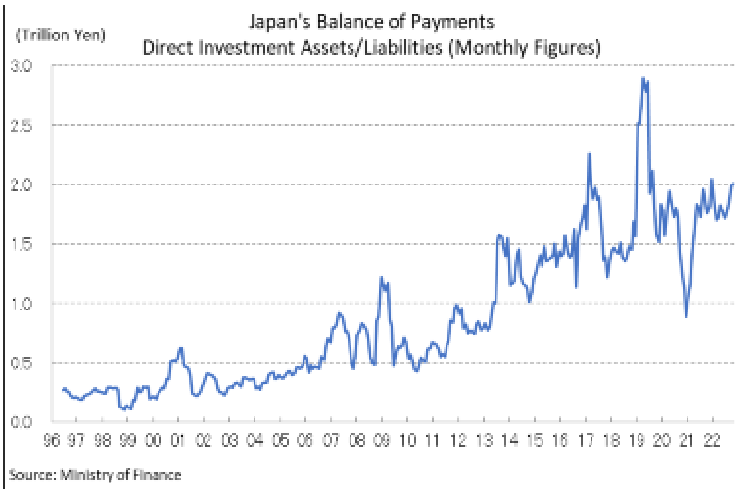
There is also considerable interest in whether the recent policy decision really signals the possibility of the new administration implementing a rate hike (ending negative rates) in the true sense. I do not believe that the new administration will take any such step in one leap. To repeat myself, the recent policy decision is not really a pivot by the BOJ. To truly make a decision of that sort, the BOJ would have to first make a comprehensive assessment of its monetary easing over the past 10 years. In April 2013, the BOJ embarked on a QQE policy "on a different dimension" with a view to achieving a 2% inflation rate as early as possible. Subsequently, following the introduction of negative interest rates in 2016, the focus was shifted from quantity to interest rates through the introduction of YCC, but only after first making a "comprehensive assessment" of its monetary easing up to that point. The proper procedure before the new administration abandons YCC or embarks on a rate hike, therefore, would be to first make a comprehensive assessment (or something similar) of the current policy framework over the past 10 years. It is difficult to imagine that such an assessment would be undertaken abruptly in April 2023; rather, it seems more likely that the right timing for such a move would be deliberated slowly, over a period of time.

Alongside the revision of monetary easing, another topic of interest is the handling of the joint statement put out by the government and the BOJ, which is taken as the government's backing for the BOJ's ongoing easy money policy. One must remember, however, that the joint statement is not a product of the Kuroda BOJ, but that of the Shirakawa BOJ. Also, there seems no real need for revising the joint statement before the current or new administration considers monetary tightening (i.e., a pivot), because the joint statement does not curtail the BOJ's actions in any way; it simply says is that the government and the BOJ "will strengthen their policy coordination in order to overcome deflation and achieve sustainable economic growth." In fact, creating a precedent for requiring a revision of the joint statement before the BOJ can revise monetary accommodation cannot be healthy either for the BOJ's policy operation or for its relationship with market participants who watch its moves. Any situation that publicly allows the BOJ's independence to be questioned is best avoided, and I suspect that neither the BOJ nor the government want to link the possible revision of the joint statement to any change in the BOJ's monetary policy. The idea that the BOJ could conduct a comprehensive assessment and take the initiative to revise monetary policy as an independent entity without any change to its joint statement with the government is not an unreasonable one.

Of course, if the BOJ were to go so far as to end negative interest rates, this could exert upward pressure on, for example, housing loan variable interest rates. Expanding the permissible range for YCC could raise fixed interest rates, while removing negative interest rates could raise the variable interest rates, and these are in addition to plans to increase tax rates, which are being promoted enthusiastically by the Kishida administration. It seems doubtful that such a policy mix can survive politically, so this makes the ending of negative interest rates a relatively unlikely risk scenario for JPY appreciation, and one that would be dangerous to incorporate into my main scenario.

The Japanese Economy Now and Going Forward – Inward FDI as a Medium- to Long-Term Measure Against JPY Depreciation

Three Ways to Use a Weak Domestic Currency to the Country's Advantage



Source: Ministry of Finance

In 2022, in addition to preparing JPY depreciation forecasts as usual, I had many opportunities to discuss ideas for using JPY weakness to Japan's advantage with businesspeople, bureaucrats, and politicians. The three top ideas that come to mind for using a weak domestic currency to the country's advantage are (1) increase the export of goods, (2) increase the export of services, and (3) increase inward foreign direct investment (FDI). Of the above, (1) has already been discussed and settled. After 2013, as part of the reflationary policies termed "Abenomics," the BOJ under its new governor, Kuroda, implemented QQE, which caused USD/JPY to rise by close to 50%. However, this did not lead to an increase in exports or a restoration of Japan's trade surplus. As at the present time, some expressed hope of a revival in domestic manufacturing industries, but nothing came of that either. Rather, despite JPY weakness, foreign direct investment (FDI) accelerated. In other words, far from JPY weakness reviving domestic manufacturing industries, it became evident that Japanese corporations had their minds set on exiting Japan in favor of overseas production bases in spite of JPY weakness (see figure).

On the other hand, after the phrase "Abenomics" became widely popular in 2013, the Japanese service balance, or more precisely its travel balance began to improve. Until 2014, it was natural for Japan's travel balance to be in the red, but the country posted an approx. +JPY1.1 trillion travel surplus in 2015, and within the next four years, by 2019, this figure had almost tripled to +JPY 2.7 trillion. But for the pandemic, Japan would have earned an even larger travel surplus in 2020, thanks to the Tokyo Olympic Games. Of course, Japan lost its travel surplus subsequently as a result of the pandemic, and figures remained weak until Japan reopened its borders in October 2022, significantly behind the rest of the world. In the coming months, one expects the travel surplus to begin increasing again, propelled by JPY's real effective exchange rate (REER) being at its weakest in half a century. However, the border control measures stubbornly kept in place by the Kishida administration through 2022 are criticized as having had no scientific basis, and are bound to have left an impression of Japan's isolationist tendencies in the minds of foreigners. The fact that visitors to Japan have to abide by special masking rules is something people around the world are aware of. To be very honest, though, even if Japan manages to build up a travel surplus, its scale would be no match to the robust trade surplus the country once earned. Ultimately, therefore, it falls to the government to do away with factors that hold Japan back, but this does not seem to be a top priority for the Kishida administration. As of the writing of this report, there is a lot of talk of recovery in inbound tourism, but overall performance will depend on numbers during the peak travel season in the April-July quarter, and I would like to reserve judgment on this subject until then.

The History and Merits of Inward FDI

Points (1) and (2) above have been discussed extensively in the ongoing phase of JPY weakness. However, unlike point (1), which involves expecting Japanese companies to invest in Japan, there is also option (3), which involves expecting investment from foreign companies (inward FDI). Instead of investment from domestic companies aware of a shrinking domestic market, investment in Japan from renowned and highly competitive international companies could create and sustainably support a virtuous cycle of domestic production, income, and consumption. The most obvious point that is made regarding JPY's REER being its weakest in half a century is that it makes shopping in Japan cheap for foreign visitors, but naturally, it also markedly brings down the cost of investing in Japan for foreign companies. In this context, a famous recent case is the Taiwanese semiconductor giant TSMC setting up a new factory in Kumamoto in November 2021. According to some reports, the economic impact of this move is expected to add up to around JPY 4.3 trillion over the 10 years starting 2022 (for perspective, Kumamoto Prefecture's nominal GDP is about JPY 6.4 trillion); 1700 new jobs are expected to be created, and the company is said to also be offering extremely attractive wages (details later).

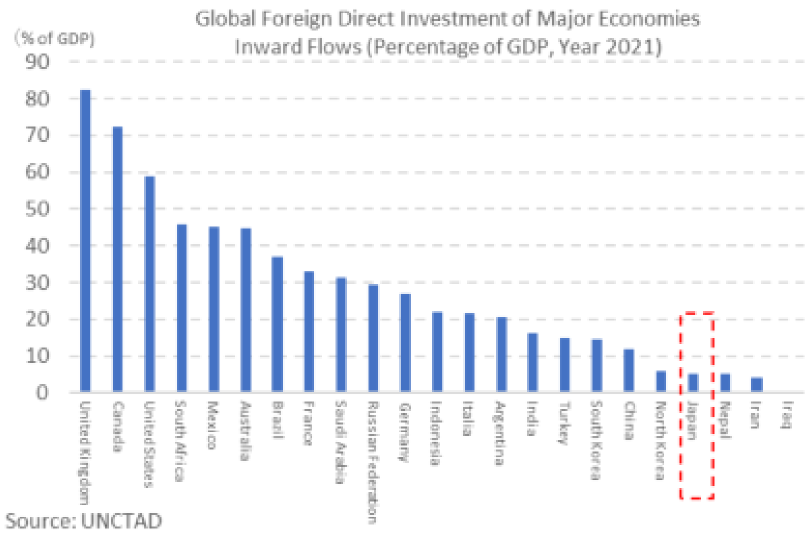
However, Japan has historically been notorious for its miniscule inward FDI. In January 2003, the then Koizumi Junichiro administration set itself a target of doubling the balance of inward FDI (from the end of 2001) within the next five years. Later that year, in May 2003, JETRO set up its Invest Japan Business Support Center under the banner of "Invest Japan." The center was designed to be a one-stop shop for all kinds of information related to investing in Japan and to simplify some of the complexities of the process for foreign companies. In April 2004, I joined JETRO as a fresh graduate and still vividly remember my official business cards containing the words "Invest Japan" on them. Incidentally, Japan's balance of inward FDI was JPY 6.8 trillion at the end of 2001, and this had increased to JPY 13.4 trillion at the end of 2006, five years later. In other words, the Koizumi administration met its target.

More recently, in June 2021, through the Council for Promotion of Foreign Direct Investment in Japan, the Yoshihide Suga administration stated its policy of aiming for inward FDI worth JPY 80 trillion by 2030, which would be double that in 2020, indicating a continued awareness of the importance of inward FDI. At the current time, a working group

established within the Council for Promotion of Foreign Direct Investment in Japan is said to be considering a concrete policy package, including measures aimed at nurturing a global workforce that can be placed with foreign companies setting up business in Japan, strengthening collaboration between foreign capital and Japanese startups, and so on. One hopes that such initiatives will lead to the discovery of more TSMC-like deals for Japan.
Tim Cook, the CEO of U.S.-based Apple Inc., visited Japan on December 12 and mentioned that his company had invested over USD 100 billion into the company's supply chain in Japan in the five years since 2018 as well as supporting the employment of over 1 million people in total through services for distributing apps for iPhones, etc. Foreign companies have a different code of conduct than Japanese companies. In addition to the popularization of advanced technologies and an increase in high-quality talent not generally seen in Japan, one can expect a positive impact from the wage standards of foreign companies. TSMC is widely known to offer markedly higher salaries (though not as high as global standards) than the standard JPY 280K for new graduates in Japan. Now, to compete with foreign companies that pay high salaries, Japanese companies would have to pay even higher salaries, so encouraging inward FDI could be an effective strategy to counter the trend of stagnant nominal wages in Japan, which is considered the root of many problems. Of course, with a larger number of production bases set up in Japan by foreign companies like TSMC and Apple, export volumes will also eventually increase, helping Japan recover its trade surplus.

Lower than North Korea

However, things are quite bleak at the present time. The meagerness of Japan's inward FDI should be evaluated based not on absolute figures, as above, but rather as a percentage of the country's economic scale (nominal GDP). In this context, the Koizumi administration set itself the goal of doubling the balance of inward FDI as a percentage of GDP by the end of 2010 (to around 5%). However, this goal was not met (inward FDI as a percentage of GDP was a mere 3.7% at the end of 2010). Incidentally, it had grown to 7.4% of GDP at the end of 2020, but even this figure is shockingly small when compared with other parts of the world. According to data compiled by the UNCTAD on the status of inward FDI as a percentage of GDP for key countries (G20 member states) as of 2021, Japan had 5.2% (slightly different from the figure published by the Ministry of Finance, Japan), which is lower than the figure for North Korea (5.9%). Among 201 countries for which 2021 data has been published, Japan ranked 198th, with only Nepal, Iran, and Iraq ranking below Japan. Incidentally, the data shows that the average for developed countries overall is 57%, while that for developing countries overall is 32%. While there is a slight discrepancy between the figures released by the MOF and UNCTAD, Japan's balance of inward FDI is conspicuously lower than levels elsewhere in the world, and this continues to earn it ridicule as being isolationist when it comes to inward FDI.



Japan Must Welcome not just Foreigners but also Foreign Companies

There are several theories regarding the backdrop to Japan's dismal inward FDI acceptance. Studies so far have not been able to identify a single determining factor.[1] For instance, the Japanese proclivity for isolationism as a national character trait (as was on full display during the pandemic) is pointed out as an abstract factor. However, if one considers that it may be difficult for the Japanese labor market, steeped as it is in lifetime employment and seniority-based wage systems, to accept the impersonal approach of foreign companies, it does not seem so abstract anymore. It relates to the concrete issue of rigid Japanese employment practices, including strict rules for employee dismissal. Japan's rigid employment system could be one of the factors hindering the entry of foreign companies, as that would involve reorganizing and restructuring industries. Of course, there probably also exist other basic factors, such as the language barrier (English is not commonly understood in Japan). Recently, with the popularization of the term "inbound tourism," it seems that Japanese society has become somewhat more accepting of the idea that foreign tourists are good for the Japanese economy, but perhaps the idea that foreign companies are good for the Japanese economy has not yet gained quite the same level of acceptance.
Of course, from the perspective of economic security (a concept that is now widely discussed), it is unwise to

[1] Kozo Kiyota Professor of Economics, Keio Economic Observatory and Graduate School of Economics Keio University, said in an article published by the Research Institute of Economy, Trade and Industry (RIETI), "Even taking into account economic scale and income levels, geographical factors, the language barrier, and historical relationships between Japan and various countries, the low level of FDI in Japan can still not be explained convincingly. It seems clear that there is some factor unique to Japan that is at play here, but it is unclear exactly what it is, and we have to make do with calling it 'Factor X' for now." See "Is Japan the Least Attractive of All Destinations?" RIETI, dated December 24, 2020.

recklessly allow the entry of foreign companies into Japan or their acquisition of Japanese companies, but as mentioned at the start, Japan's options for making use of a weak domestic currency by increasing the export of goods or services have already been discussed to the hilt. Setting aside the export of goods, there still remains some scope for increasing the export of services (by accepting inbound tourists), and I believe policy efforts should be continued to improve the prospects for this. However, this alone is unlikely to be sufficient to reverse the JPY depreciation trend through medium-/long-term forex supply and demand. On the other hand, I believe improving Japan's inward FDI (which is currently at a level worse than North Korea) has a much bigger potential. If the JPY depreciation experienced in 2022 signals the end of Japan's long history of JPY appreciation, inward FDI will definitely become important as a means to utilize this JPY weakness to Japan's advantage going forward. It is natural for a government to consider revising the tax system or implementing support measures such as subsidies, but I hope that it will also consider inward FDI as a long-term countermeasure against JPY weakness.

U.S. Fiscal Policies Now and Going Forward – Reasonable to Assume Interest Rate Hike Termination Next Spring?

Somewhat Hawkish Hike of Projected Terminal Rate

The December 13-14 FOMC meeting decided to raise the Federal Funds (FF) interest rate target range by 50bp, from 3.75-4.00% to 4.25-4.50%. While the FOMC had increased interest rates by a +75bp margin at four consecutive meetings from June, the margin of increase has been reduced – the first modulation in the Fed's current interest rate hike program. It appears that the Fed's interest rate hikes have been moderated in line with the deceleration of inflation, but FOMC members' FF projections (dot plot) indicate that the terminal rate of hikes has been raised. The FF interest rate (median forecast) projected for the end of 2023 has been raised 50bp, from 4.625% to 5.125%. Although there continues to be a prospect of shifting to interest rate cuts in 2024, it has become necessary to increase the projected interest rate level at the end of 2024. The 50bp increase in the projected terminal rate is somewhat more hawkish than had been expected, but as discussed below, the main forecast scenario is for U.S. inflation rates to continue decelerating through 2023 and for associated USD appreciation to be restrained.

FRB Economic Projections (Median Figures)

FOMC Date	2022	2023	2024	2025	Longer run
Jun-21	0.125%	0.625%	n.a.	n.a.	2.500%
Sep-21	0.250%	1.000%	1.750%	n.a.	2.500%
Dec-21	0.875%	1.625%	2.125%	n.a.	2.500%
Mar-22	1.875%	2.625%	2.625%	n.a.	2.250%
Jun-22	3.375%	3.750%	3.375%	n.a.	2.500%
Sep-22	4.375%	4.625%	3.875%	2.875%	2.500%
Dec-22	4.375%	5.125%	4.125%	3.125%	2.500%

Source: FRB

Financial markets continue factoring in the expectation of interest rate cuts starting from the fourth quarter of 2023, but the gap between this expectation and the dot plot is noteworthy. Since Fed Chairman Powell has emphasized that the Fed's policy management is "data dependent", it is certainly possible that discussions of interest rate cuts will begin when the Personal Consumption Expenditure deflator (PCE deflator, discussed below) peaks out, although it may be argued at that point that the peaking out is merely a temporary trend. The possibility of interest rate reductions will be one of the chief foci of Fed watchers in 2023.

PCE deflator in 2023 – "Core > Comprehensive"

While acknowledging signs of a slowdown in inflation rates, Chairman Powell continues to point out the existence of upside inflation risks. Looking at FOMC members' economic and inflation projections as indicated in the Summary of Economic Projections (SEP, see chart), one finds the core-basis PCE deflator during the 2023-2025 period is expected to rise by "3.5% → 2.5% → 2.1%" rates. Compared to the previous (September) SEP, the figures for 2023 and 2024 have been raised by 0.4 percentage point and 0.2 percentage point, respectively. During 2023, the rise in the core basis PCE deflator is forecast to exceed that in the comprehensive basis PCE deflator, reflecting the magnitude of fluctuations in crude oil prices and other resource prices. In the absence of such sharp resource price fluctuations as a sharp rise in crude oil prices in 2023, the "core > comprehensive" pattern is likely to remain unchanged. In light of this, one can anticipate that Chairman Powell's perception of this situation will be a key issue with respect to the FOMC's activities in 2023 – so long as the rate of rise in the core basis PCE deflator remains elevated, there appears to be a high likelihood that the BOJ will stick to its basic policy of raising interest rates.

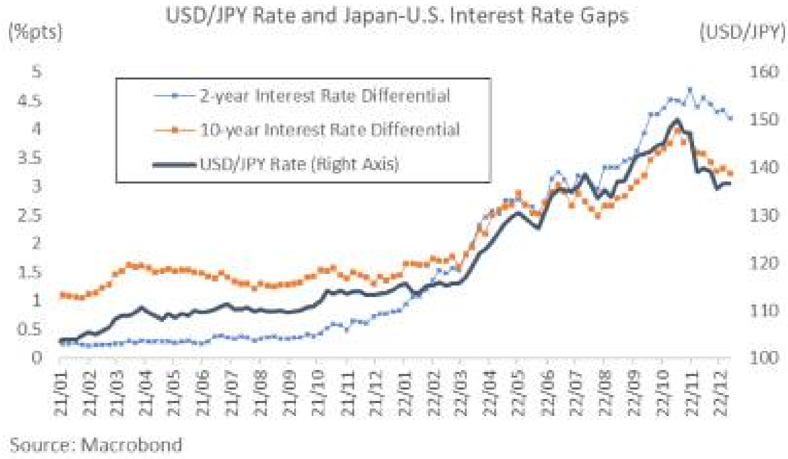
Economic Projections of FRB, December 2022

	2022	2023	2024	2025	Longer Run
Change in Real GDP (September Projection)	0.5 (0.2)	0.5 (1.2)	1.6 (1.7)	1.8 (1.8)	1.8 (1.8)
Unemployment Rate (September Projection)	3.7 (3.8)	4.6 (4.4)	4.6 (4.4)	4.5 (4.3)	4.0 (4.0)
PCE Inflation (September Projection)	5.6 (5.4)	3.1 (2.8)	2.5 (2.3)	2.1 (2.0)	2.0 (2.0)
Core PCE Inflation (September Projection)	4.8 (4.5)	3.5 (3.1)	2.5 (2.3)	2.1 (2.1)	

Source: FRB

Given these circumstances, people will continue disagreeing with each other about whether the rate hikes are really likely to end this spring, but it bears keeping in mind that it was only last June that the Fed's 75bp rate hikes began. Based on the empirical rule of thumb that the impact of interest rate hikes on the real economy will become apparent only after a lag period of six to twelve months, it appears likely that, from the first quarter of 2023, a slowdown in the real economy along with a decline in resource prices will exert downward pressure on the PCE deflator. It is questionable whether the Fed's dot plot is taking that prospective effect fully into account. If the economic slowdown is greater than suggested by the dot plot, it appears likely that when the FF rate reaches 5.00% (after hikes of 50bp in January and 25bp in March) the rate of increase in the PCE deflator will have declined to roughly the same 5.00% level. At that point, based on consideration of the cumulative effect of rate hikes, the main forecast scenario would anticipate a decision to halt the interest rate hikes.

2-Year Interest Rate Trends Worrisome with Respect to USD/JPY

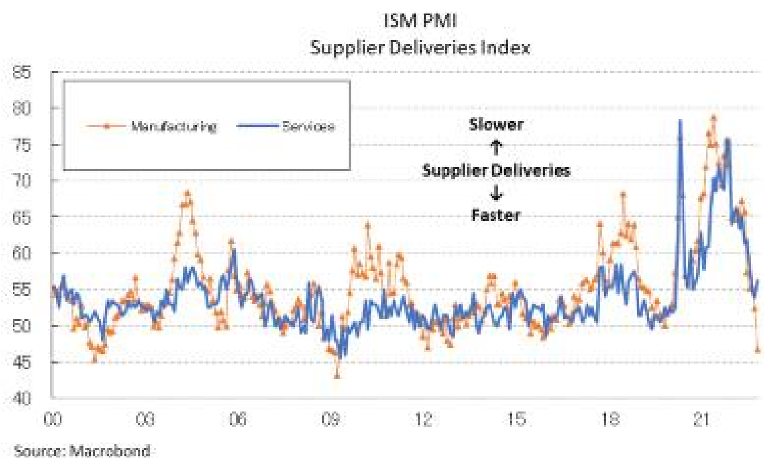


Considering the dot plot and SEP together, it is apparent that while the terminal rate level has been raised, the inflation rate still exceeds that rate. As mentioned above, a major JPY depreciation factor in 2023 is associated with the possibility that the Fed will continue hiking interest rates after the first quarter of 2023. In light of such information as that from the latest FOMC meeting statement, Chairman Powell's press conference, the dot plot, and the SEP, the likelihood of interest rate hikes being continued after the first quarter is not great but cannot be said to have been eliminated. For example, U.S. 2-year interest rates have not fallen as much as U.S. 10-year interest rates. While the narrowing of the U.S.-Japan 10-year interest rate differential is promoting trends of JPY appreciation and USD depreciation, the pace of the narrowing of the U.S.-Japan 2-year interest rate differential has been slower. Trends in the U.S. 2-year interest rate appear to strongly reflect the near-term monetary policy outlook, but it is possible that the financial markets are not confident in the outlook suggested by the Fed's dot plot? While it would not be wise to read too much into bond price movements at the end of the year when liquidity levels are declining, the U.S. 2-year interest rate trend is interesting. If future trends turn out to be in line with those suggested by the U.S. 2-year interest rate trend, there remains a possibility that USD/JPY has excessively declined.

Risks to My Main Scenario – Can a Continued Decline in U.S. Inflation Rates be Assumed?

Danger of Assuming Rapid Alleviation of U.S. Inflation Situation

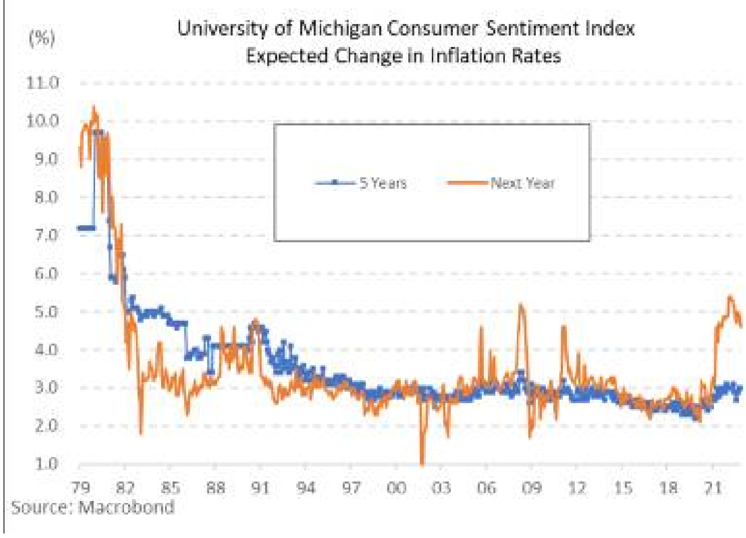
As overviewed in the Overview of Outlook section, USD/JPY will be subjected to both upside and downside risks during the forecast period. However, I think it is necessary to reconsider the U.S. inflation situation as an upside risk factor (potentially promoting JPY depreciation). Although some of this analysis may overlap with the Overview of Outlook section, I think it worth considering the situation step by step. At the time this article was written, the prevailing opinion among forex market players was that 2023 will be a year in which JPY will appreciate. It must be noted, however, that those market players' forecast scenarios are based on the assumption that the remarkable trend of decline in U.S. inflation rates seen in recent months will be sustained to a reasonable extent going forward.



Of course, U.S. inflation rates are likely to continue decelerating, and such deceleration is one of the premises of the main scenario forecast. However, one should be alert to the possibility that U.S. inflation will not be alleviated as quickly as anticipated, causing a prolongation of the Fed's interest rate hikes, as this scenario is among the risk factors that could promote unexpected JPY depreciation. In this regard, the chief fixed-income strategist at BlackRock (the world's largest asset management company) made an interesting comment reported by Bloomberg on December 19. The strategist disagreed with the bond market's expectation of a continued sharp deceleration of inflation rates, particularly with respect to the consumer price index (CPI), saying – "it's probably easier to come down from 7% to 5% than from 5% to 3%." I generally agree with this view. It was originally assumed that inflation rates approaching 10% would decelerate abruptly as the impact of supply constraints due to supply chain disruptions and rising resource prices diminished. However, such central banks as the Fed and the ECB are concerned that, amid sustained general rises in prices, people's inflation expectations will remain at high levels, corporate price increases will become the norm, and nominal wages will also rise in line with those inflation expectations and price increases. When this pattern emerges, the inflation trend can become self sustaining. The chart on the previous page shows that supply constraints indicated by the ISM Manufacturing Index (delayed supplier deliveries) have already been

mostly rectified, so it seems that blockages related to flows of goods have largely been resolved. One can expect the effects of this improvement to exert downward pressure on future inflation indicators.
However, the supply constraint situation indicated by the ISM Non-Manufacturing Index gives a somewhat different impression. Although there has certainly been a noticeable improvement in that situation, it seems the pace of improvement is being restrained.

Key Challenge of Reducing U.S. Inflation Rates Below 5%



Non-manufacturing industries include service industries for which labor costs account for a high proportion of their overall costs. Compared to manufacturing industries, non-manufacturing industries are still facing relatively large challenges in overcoming supply constraints, and it is clear that the situation is leading to wage increases. The above-mentioned BlackRock strategist cites persistent labor shortages, higher wages, and falling inventories as reasons for his anticipation that high inflation rates will persist, and <u>of course it cannot be expected that wages will decline amid labor shortages</u>. If the U.S. labor market's structure has been fundamentally changed by the pandemic – with more people migrating to the suburbs and avoiding service jobs entailing contact with people – then there are grounds for concern that the correction of the current labor shortage may not proceed as smoothly as expected and that nominal wages will not fall as expected. If the CPI stops declining at some point in the future, it may well be at a point when the path downward is obstructed by impediments associated with the employment and wage situation. One can only speculate about whether those impediments will make themselves felt when the CPI descends to 3% or 4%, or perhaps 2.5%; it is hard to predict. There is room for debate about the specific level at which the impediments will make themselves felt, but one cannot disregard the likelihood that such impediments are likely to be encountered at some point. For example, the Fed closely monitors the University of Michigan Consumer Sentiment Index, which suggests that consumers are anticipating the annual rate of inflation will be almost 5% over the next year and roughly 3% over the next five years (see graph).
In any case, is it rational to assume that bond market forecasts formed by extrapolating the recent trend – CPI decelerating from 10% to the 4-5% range – are valid? Is it actually reasonable to anticipate CPI will descend to the 2% target level next spring? <u>Based on a view that the Fed will have concerns about interest rate hikes' potential overkill effect on the real economy, I have retained the "suspension of interest rate hikes in the spring" as a main scenario assumption, but it is impossible to avoid worrying about whether this assumption will prove correct or not</u>.

EUR Outlook – Europe-U.S. Interest Rate Differentials Likely to Narrow

EUR Area Monetary Policies Now and Going Forward – A 3% Terminal Rate May Not Be Sufficient

Hiking Interest Rates "Significantly at a Steady Pace"

The December 15 ECB Governing Council meeting decided to raise the deposit facility interest rate by 50bp, from 1.50% to 2.00%. In line with this, the major refinancing operation interest rate was increased to 2.50% and the marginal lending facility interest rate was increased to 2.75%. After raising the deposit facility interest rate by 75bp at two consecutive Governing Council meetings, the ECB decided to reduce the margin of increase to 50bp (interest rate hikes have been implemented at four meetings in a row). In light of information disseminated in advance and various euro area inflation indicators, I had thought that the Governing Council was likely to sustain 75bp interest rate hikes through December. The euro area headline inflation rate is higher than that in the United States, and the euro area's consumer price index (HICP) rose 10% yoy in November – that was the second consecutive month of double digit HICP growth, which would seem to suggest that the situation merits sustained concern (more details about this are provided in the next section of this article). During the post-meeting press conference, ECB President Christine Lagarde made the noteworthy statement – "Anybody who thinks that this is a pivot for the ECB is wrong."

In fact, the meeting's statement cautioned that – "We decided to raise interest rates today, and expect to raise them significantly further, because inflation remains far too high and is projected to stay above our target for too long." The statement twice says that – "we judge that interest rates will still have to rise significantly at a steady pace [to bring inflation down to the target level.]" A reporter at the press conference to asked what this meant, and Lagarde replied that – "significant rise at a steady pace means that we should expect to raise interest rates at a 50-basis-point pace for a period of time." Of course, it is impossible to know what "a certain period of time" means specifically, but it seems reasonable to conclude that 50bp rate hikes are the default course for at least the next one or two meetings. President Lagarde herself stated that "significantly at a steady pace" is one of the meeting's key messages, and it is believed that this expression reflects the ECB's determination to take strong measures to countervail the height of euro area inflation rates.

3% Terminal Rate Perhaps Not Sufficient to Control Inflation in a Timely Manner

According to the revised ECB staff macroeconomic projections released in December, the HICP growth forecast for 2023-2025 is "+6.3% → +3.4% → +2.3%", and, compared to the previous (September) forecast, the 2023 level has been revised upward by 0.8 percentage point while the 2024 level has been revised upward by 1.1 percentage points. On a core basis, HICP growth in 2023 is projected to be 4.2%, up 0.8 percentage point from the September forecast, and in 2024 it is expected to be 2.8%, considerably higher than the 2% target. In light of these projections, it would seem highly unrealistic to anticipate a rate cut in 2023. The statement also notes that – "The risks to the inflation outlook are primarily on the upside." – and goes on to explain that, in the near term, companies can be expected to pass on price increases reflecting surging energy prices, while in the medium term, risks may stem from a persistent inflation levels above the target level as well as from rising inflation expectations and wage increases. Downside risks are only briefly noted as including the possibility that price pressures might be reduced by decline in energy costs or that there might be a further weakening of demand associated with the economic slowdown.

ECB Projections (Dec 2022, Annual % changes)

	Dec 2022 Projections			Downside Scenario		
	2023	2024	2025	2023	2024	2025
Real GDP	0.5	1.9	1.8	-0.6	0.2	2.0
HICP	6.3	3.4	2.3	7.4	3.6	2.0
HICP (Core)	4.2	2.8	2.4	4.3	3.0	2.4

Source: ECB, Dec 2022

There was also a notable remark by President Lagarde with respect to the staff projections. A reporter asked – "Investors currently expect a terminal rate of about 3%. Does that sound reasonable to you?" – and President Lagarde responded – "Our staff projections, that embed and incorporate the market expectations of our terminal rate, do not certainly allow a return to the 2% inflation target that we have in a timely manner. So more needs to be done, and as a result, new market expectations will, hopefully, be embedded in future staff projections, which will indicate that we can reach the 2% inflation target timely." In other words, while the markets are currently anticipating that the deposit facility interest rate may be about 3% by the middle of 2023, the level and pace of increase may turn out to be higher than those expectations, and that may have the result of promoting EUR appreciation.

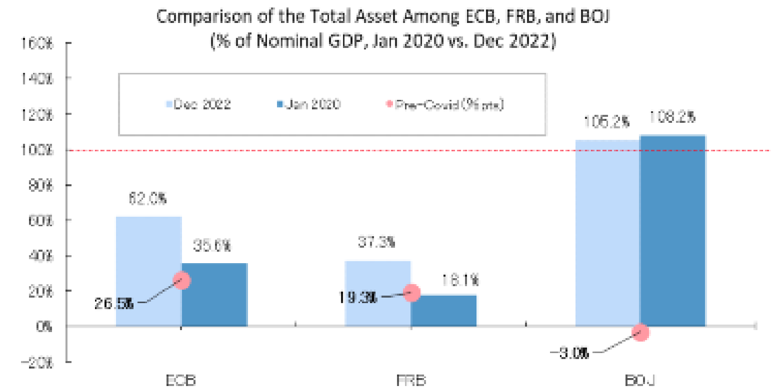
Balance Sheet Reduction Measures from March

The Governing Council meeting's statement also clearly explained the ECB's prospective balance sheet streamlining measures – perhaps the most important decision from the financial markets' perspective. From March 2023, the ECB will no longer reinvest all the principal payments from maturing securities in the asset purchase programme (APP) portfolio. This does not mean that all such reinvestment will be stopped – the statement specifies that the APP portfolio "will decline at a measured and predictable pace." Specifically, after the APP portfolio reduction is begun in March, the portfolio will be reduced at a pace of EUR15 billion per month from April to June (more-detailed information on the discontinuation reinvestments will be provided at the February Governing Council meeting). Asked at the press conference how the EUR15 billion per month rate was chosen, President Lagarde responded – "Why did we pick €15 billion? It represents roughly half the redemptions over that period of time. So it seemed, based on the advice that we received from our market people [...] it seemed an appropriate number in order to normalise our balance sheet[.]" She also confirmed that this portfolio reduction pace will be reviewed periodically in a manner similar to that used when the ECB decided to taper its asset purchases. While no specific review timing was mentioned, it is likely that the reviews will coincide with the staff projection revisions (March, June, September, and December). When explaining the portfolio reduction plan, President Lagarde emphasized that "the key tool is the interest rate" and that the balance sheet streamlining is a complementary measure.

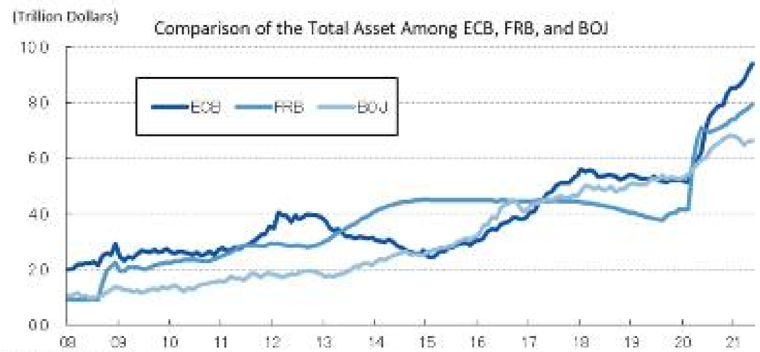
Balance Sheet Streamlining to Create "Policy Space"

Besides helping curb inflation, the ECB's efforts to expeditiously shrink its balance sheet can be expected to generate benefits from a medium- to long-term policy management perspective. This perspective is based on policy space theory considerations that are always relevant during periods of interest rate hikes. It is sometimes wise during monetary policy tightening periods to establish policy space that enables greater leeway for the use of monetary policies during a subsequent recession period. Regarding interest rates, if current trends continue, the deposit facility interest rate will reach 3.00% in mid-2023. At that point – if it is assumed that the lower limit of negative interest rates is -0.50% (which has already been tested in practice) and that individual interest rate cuts would be by a margin of 25bp – 14 rate cuts would be possible. Since there are eight Governing Council meetings annually, the ECB could respond to a recession by steadily lowering interest rates over a period of almost two years.

Having witnessed the various kinds of turmoil seen after the financial crisis, however, it is difficult to imagine that if the euro area economy were to plunge into a full-blown recession, it could be overcome simply by lowering interest rates. As mentioned in previous issues of this article, of the three major central banks, it is the ECB that expanded its balance sheet the most during the covid-19 pandemic period; moreover, it is the ECB that has made the least progress in streamlining its balance sheet (see graph). In terms of the balance sheet to GDP ratio, while the BOJ's 105% ratio is the world's largest, there is quite a large gap between the Fed's 37% ratio and the ECB's 62% ratio. Comparing current balance sheet levels to those just before the pandemic, one finds that the BOJ's level is down 3.0% and the Fed's level is up 19.3%, but there has been conspicuously larger growth in the ECB's level, which is up 26.5%. In terms of nominal value (measured in USD), the BOJ's balance sheet is about USD5.2 trillion, the Fed's is about USD8.6 trillion, and the ECB's is the world's largest, at about USD9.0 trillion (see graph). Although it is unlikely that the Pandemic Emergency Purchase Programme (PEPP) will be restarted, it is highly likely that APP will be used again at some point. The ECB could also seek to reduce its balance sheet by promoting early repayments of assets within the third series of targeted longer-term refinancing operations (TLTRO3), but that would entail obtaining the cooperation of relevant financial institutions, and it may be that such repayments are not realistically feasible amid weak conditions in the real economy, so it remains uncertain as to whether the promotion of such early repayments will be undertaken. (Many people may think it would be better to maintain outstanding liquidity by foregoing such early repayments.) In any case, as it would be best for the ECB not to continue to have world's most bloated balance sheet when it faces the next euro area recession, it is highly likely that the ECB will give priority to downsizing its balance sheet (even if it is recognized to have some negative impact on the real economy) while perhaps considering the possibility of broadening the scope of downsizing measures to encompass PEPP reinvestment and the Transmission Protection Instrument (TPI).



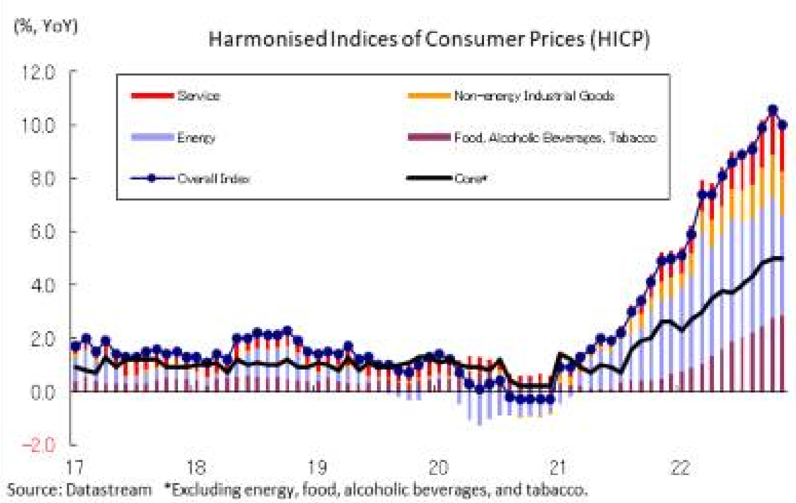
Source: Macrobond, IMF Notes: Year 2021 Nominal GDP converted to USD for comparison.



Source: Macrobond

The Euro Area Economy Now and Going Forward – Hard to Say Inflation has Peaked Out

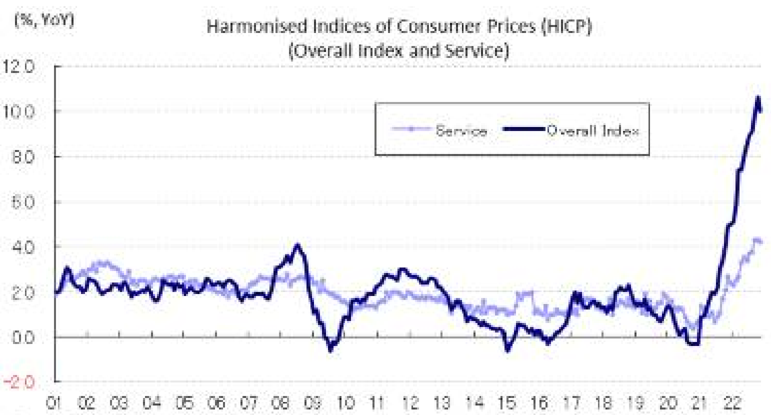
Has Euro Area Inflation Really Peaked Out?



Source: Datastream *Excluding energy, food, alcoholic beverages, and tabacco.

As mentioned above, the pace of the ECB's interest rate hikes is decelerating and there are emerging expectations that euro area inflation will peak out as U.S. inflation appears to have done. It is true that the yoy rate of increase in euro area HICP was 10.0% in November, down 0.6 percentage point from the previous month. This HICP deceleration was the first seen in 17 months, but it mainly reflected the deceleration of the energy cost inflation rate (from 41.5% to 34.9%) and, as described later, the rate of inflation in other HICP items has not significantly slowed. Moreover, it was assumed in advance that the peaking of resource prices would eventually push down headline inflation rates. At a European Parliament hearing on November 28, ECB President Lagarde cautioned against overly optimistic market interpretations of the November HICP figures, saying – "I would like to see inflation having peaked in October, but I'm afraid that I would not go as far as that. I think that there is too much uncertainty, particularly in one component – which is the pass through of high energy cost at wholesale level into retail level – to assume that inflation has actually reached its peak. It would surprise me."
To put the inflation situation into perspective, it should be noted that, even if the peaking out process has begun, the inflation rate remains in double digits, and even if the rate were to slow down by 0.6 percentage point each month over the next 12 months, it would still at that point have descended to just below 3% yoy. In light of risks associated with rising resource prices and the potential for a price-wage spiral during those 12 months, it is understandable that President Lagarde would not feel herself positioned to naively appraise the situation overly optimistically.

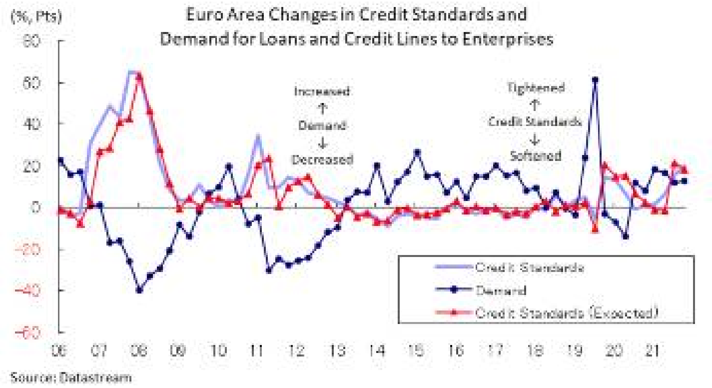
No Deceleration Other than in Energy



Source: Datastream

A closer look at the components of HICP reveals a situation that is far from one that would inspire optimism. For example, while the comprehensive basis yoy HICP growth rate declined 0.6% percentage point in November, there remains cause for concern about the rate of inflation in service prices, which decreased only 0.1% percentage point, from 4.3% in the previous month to 4.2%. Comparable deceleration in service price inflation has been seen over the past year (deceleration on an mom basis was seen last December and in January and June this year), but the basis for fearing a price-wage spiral will not have dissipated until there is a marked deceleration of service price inflation. Concerns about this point were also expressed in the Account of the October 26-27 Governing Council meeting. Looking at other HICP components, one finds that prices of mining and industrial goods other than energy were up 6.1% yoy in November, the same rate as in the previous month, while the yoy rate of increase in prices of food, alcoholic beverages, and cigarettes (excluded from core HICP due to large fluctuations) rose 0.5 percentage point, from 13.1% to 13.6%. Even if the rate of increase in energy prices slows, it currently appears that various other price increases are already being passed on to various parties after a lag. Barring a sustained deceleration of price increases for all of those items, it seems unlikely that the ECB will significantly change its monetary policy posture.

Overheated Credit Climate



Another point of concern when considering the euro area inflation outlook is the region's non-tight financing conditions. As the upper right graph shows, private-sector lending continued to accelerate up through September, paralleling HICP's trajectory. Theoretically, significant growth in the real economy's money supply will promote inflation rate increases. In addition, although euro area banks' lending postures have been tightening since the beginning of this year, there has not been a marked decline in borrowing demand (see lower right graph). <u>This credit situation appears to indicate that monetary policy tightening is not sufficient to restrain lending</u>. Since interest rate hikes and more-rigorous lending postures have not yet led to a decline in borrowing demand and lending, the ECB has no choice but to take other measures to tighten the financing environment. The fact that lending has not decreased also suggests that the enormous volume of liquidity provided by the ECB (reflected in the size of its balance sheet) continues to flow into the real economy through the banking sector. While it goes without saying that the ECB's interest rate hikes will continue, it is only natural that the ECB's balance sheet reduction measures will be attracting growing attention going forward.

It is worth noting that the United States is also suffering from the this lack of deceleration in bank lending, which can be said to be a risk factor associated with the recent U.S. interest rate decline and USD depreciation momentum. Financial market participants are ordinarily highly attentive to inflation trends, which are quite important, but they would be well advised to give additional attention to the bank lending trends that can have a large effect on inflation trends, particularly in light of the high levels of bank lending seen both in Europe and in the United States as we approach 2023.

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