Forex Medium-Term Outlook

March1, 2023

MIZUHO

Overview of Outlook

In February, USD/JPY rose sharply, which I view as an indication of my forecast in this report having come true early. Since last year, based on the understanding that the markets have been too quick to factor in U.S. rate cuts and also on the fact that JPY weakness is partly due to the enormous JPY supply-demand imbalance (Japan's trade deficit), this report has distanced itself from the prevailing view that JPY will strengthen against USD. Also, while financial market forecasts of JPY appreciation relied too heavily on the Fed ending its rate hikes this spring, this report factored in the possibility of rate hikes continuing beyond spring, thus considering the lack of a USD buying opportunity (JPY strength/USD weakness) even during the January-March quarter as a risk scenario. Of course, one cannot say anything for certain barely two months into the year, but it does appear that my original risk scenario may be coming true. Meanwhile, Japan's enormous trade deficit, one of the factors behind JPY depreciation in 2022, expanded to an unprecedented JPY 3.5 trillion or so in January 2023. While this level of trade deficit is unlikely to be normalized, the fact is that a new problem of declining exports is rearing its head even as the existing problem of ballooning imports comes to an end. This report has previously discussed the upward pressure on JPY from speculative trading and downward pressure on it from actual supply-demand, and I have pointed out that even if JPY appreciates against USD due to the decline in U.S. interest rates, its appreciation will be hindered by the supply-demand climate. However, as early as February of this year, U.S. interest rates began to rebound with no change in the JPY supply-demand bias toward JPY net selling. As a result, the JPY depreciation trend seems to have resumed earlier than expected even from the perspective of this report, which views JPY depreciation as its main forecast scenario. While one must watch for the possibility of a rebound in the near future, there is no change in this report's main forecast scenario of USD/JPY returning to the 140 level.

EUR weakened somewhat in February. The regional economic/financial climate continues to improve against the backdrop of a mild winter, and the ECB seems unlikely to slow the pace of its rate hikes, but the resurfacing of inflation concerns in the U.S. in February strengthened expectations of higher U.S. interest rates going forward, and this caused expectations of higher EUR interest rates to lose some of their appeal. However, one cannot say for sure that EUR will continue to be sold going forward. While the region's headline inflation rate seems to be coming down, thanks to declining energy prices, inflation continues to accelerate for non-energy items. ECB President Christine Lagarde herself sounded uncertain regarding the possibility of wage-price spiral, so there are no indications of the ECB suddenly pivoting to a more dovish stance. Moreover, the German trade balance is expected to continue improving markedly amid the continued downward trend in natural gas prices, making it easier for EUR to be bought due to actual demand. EUR could be sold off during some phases against the mutually inspired rise in U.S. interest rates and USD, but there are no inherent reasons for EUR to be sold off either from the interest rate or supply and demand perspectives. In fact, given that euro area inflation is higher than U.S. inflation, my prediction is that EUR will be the somewhat more dominant of the two currencies during most of the current forecasting period.

Summary Table of Forecasts

	2023 Jan (actual)	Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2024 Jan-Mar
USD/JPY	127.22 ～ 136.92 (136.37)	133 ～ 138 (136)	130 ～ 139 (138)	132 ～ 142 (140)	133 ～ 143 (136)	130 ～ 138 (134)
EUR/USD	1.0482 ～ 1.1034 (1.0568)	1.04 ～ 1.08 (1.07)	1.07 ～ 1.12 (1.09)	1.07 ～ 1.12 (1.10)	1.09 ～ 1.15 (1.12)	1.09 ～ 1.16 (1.14)
EUR/JPY	137.45 ～ 145.46 (144.10)	141 ～ 148 (146)	143 ～ 152 (150)	144 ～ 155 (154)	144 ～ 154 (152)	145 ～ 155 (153)

(Notes) 1. Actual results: until 1 MAR 2023, (): as of 10AM 1 MAR 2023 . 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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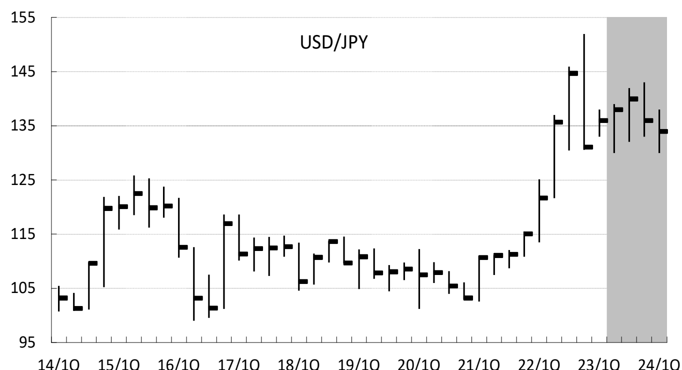
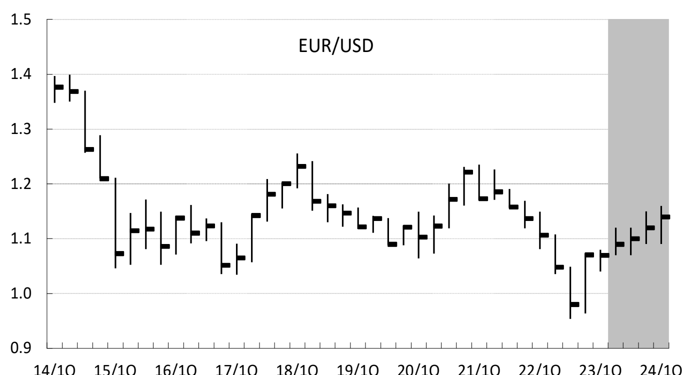
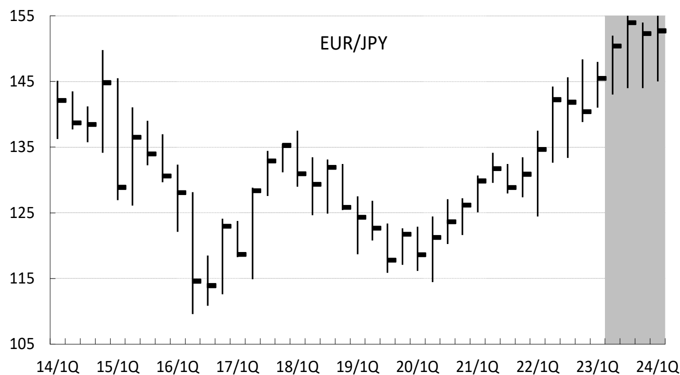
Exchange Rate Trends & Forecasts





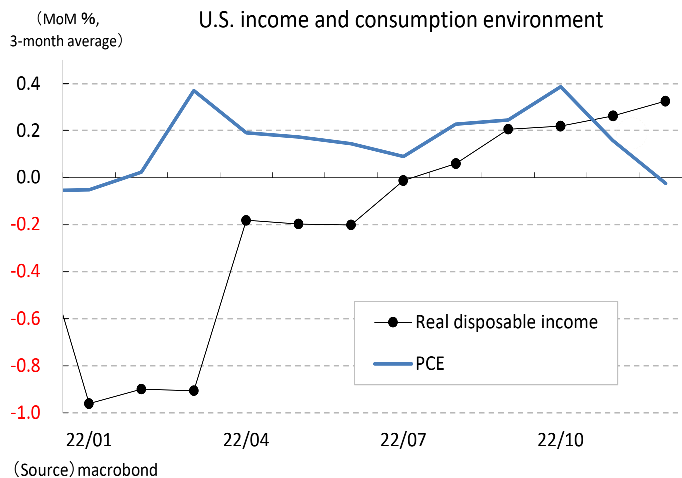


USD/JPY Outlook – JPY Depreciation Resumes

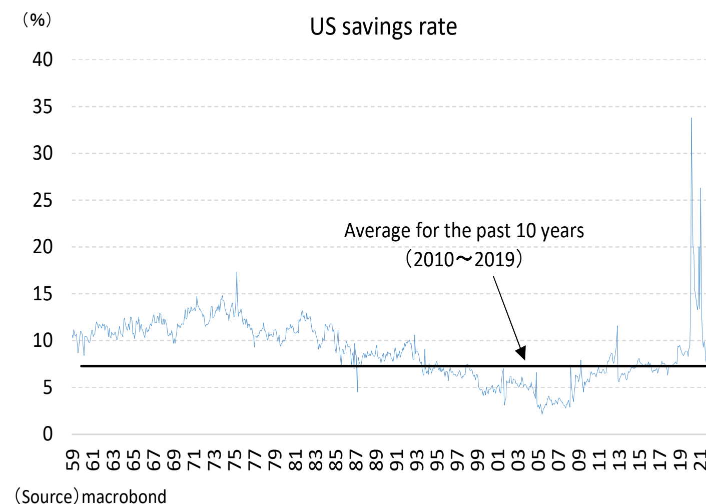
Basic Understanding of USD/JPY – JPY Depreciation Resumes as Expected

U.S. Real Income Situation Improving

Miraculously, things have been developing exactly as forecast in this report. Since last year, this report has distanced itself from the prevailing view that JPY will strengthen against USD based on the understanding that the markets have been too quick to factor in U.S. rate cuts and also on the fact that JPY weakness is partly due to the enormous JPY supply-demand imbalance (Japan's trade deficit). In the first Market Topics for this year, titled "Reviewing the Key Assumptions and Paths Forecast for 2023," I pointed out that the financial markets were basing their predictions of USD/JPY on the assumption that the Fed would end its rate hikes this spring, but if this assumption were to collapse and "the Fed continued to hike rates after spring, then perhaps it would be difficult to expect USD buying opportunities (JPY strength/USD weakness) during the January-March quarter." Of course, nothing can be said for sure barely two months into the year, but since the release of the extremely strong U.S. jobs report for January, speculation is gradually strengthening that U.S. rate hikes may not end until May. Real wages, which are calculated simply based on the average hourly wages (+4.4% yoy for January) in the Employment Situation Summary report and the consumer price index (CPI, +6.4% for January), are still showing negative growth, but real disposable income, which is used for calculating the GDP, is trending upward (see figure, top). The simply calculated real wages above are also bound to turn positive going forward as the headline CPI has already peaked. With the worst of the real wage situation in the past, the resurgence of



(Source) macrobond

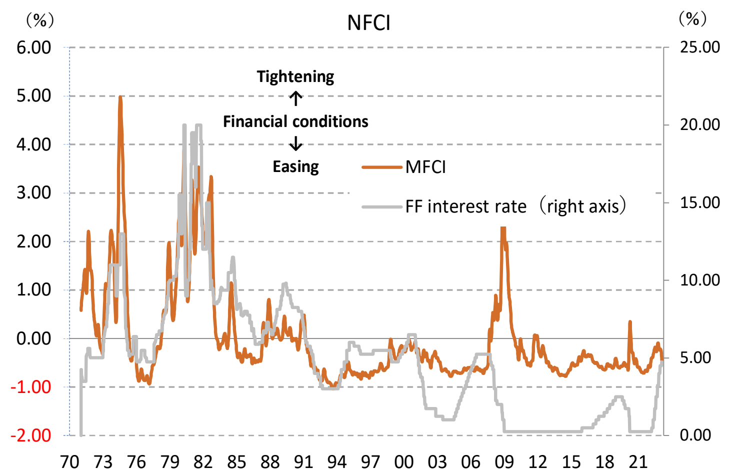


(Source) macrobond

consumption/investment appetites becomes a matter of concern from the perspective of containing inflation. Incidentally, the savings rate (savings ÷ disposable income) has also fallen significantly compared with the pre-COVID 10-year average (see figure, bottom). Going by demand trends in the household sector, it is difficult to conclude that inflation is being effectively contained.

NFCI Indicates Easing

Even though the Fed, with its rate hikes, has been creating tight monetary conditions, the National Financial Conditions Index (NFCI), published by the Federal Reserve Bank of Chicago, continues to remain negative, reflecting a state of accommodative monetary conditions. "CPI slackening → stronger expectations of pivot toward dovish stance → increase in share prices" being a series of developments that contribute to depressing the NFCI (an increase in share prices is considered accommodative, while a decline is considered tight), the Fed has no choice but to be hawkish in its communications. As is generally understood, over 30% of household assets in the U.S. are in equities, the wealth effect caused by rising share prices is feared to fuel consumption/investment appetites. The argument that high share prices push up inflation expectations applies convincingly to the U.S. economy, and is something the Fed cannot afford to overlook when attempting to contain inflation. This is a point I have emphasized in last year's issues of this report as well as in my Market Topics reports, and, in fact, Fed Chair Jerome Powell himself warned against taking inflationary conditions lightly, but the markets did not listen. Of course, there is good reason for the markets to have lost confidence in the Fed's message after the latter abruptly changed its message at the end of November 2020 to announce that inflation was not temporary, but this time around, I strongly feel that the Fed's communication is based on facts.



(Source) macrobond
(Note) NFCI: National Financial Conditions Index

Situation Suggests Possibility of Reviving +50bp Hikes

Starting late February, the Fed has made numerous communications warning about inflation and, consequently, the need to continue with rate hikes. For instance, on February 17, Federal Reserve Governor Michelle Bowman is reported to have said, "I don't think we're seeing what we need to be seeing, especially with inflation. (…) I think we'll have to continue to raise the federal funds rate until we start to see a lot more progress on that." The same day, President Loretta Mester of the Federal Reserve Bank of Cleveland explained the insufficiency of the +25bp interest rate hike at the January FOMC meeting saying, "I saw a compelling economic case for a 50 basis-point increase." On February 17, again, President James Bullard of the Federal Reserve Bank of St. Louis said he would not rule out supporting a +50bp interest rate hike at the March FOMC meeting, hinting at the possibility of another expansion in the margin of rate hikes. Of course, not all communication from the Fed is of the same bent, with some senior officials voicing the opposite opinion. For instance, President Patrick Harker of the Federal Reserve Bank of Philadelphia, said during a talk given on February 14, "In my view, we are not done (with rate hikes) yet…but we are likely close."

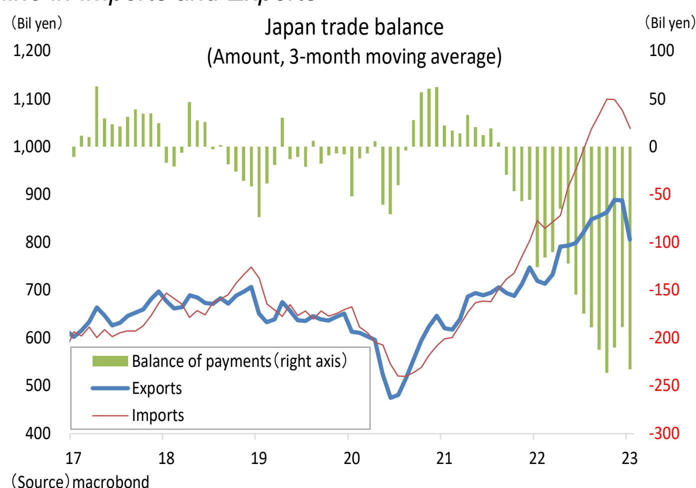
However, given the strengthening of fundamental economic indicators, it seems unlikely that rate hikes will be ended altogether. Even if the margin is not increased to +50bp, rate hikes at the pace of +25bp will probably continue. Moreover, the reason so many forex market participants predicted JPY appreciation against USD in 2023 was because they assumed that signs of rate cuts by the Fed would emerge earlier than expected. This, however, has now begun to seem quite unlikely. Rather, it seems more likely that the terminal interest rate will rise to 6%. Taking into account the time lag before monetary policy takes effect, it is not quite appropriate to waver over whether to increase or decrease the margin of rate hikes based on a single month's economic indicators, but it does seem unreasonable to hold on to a main forecast scenario of U.S. interest rate decline and USD depreciation based on expectations of an early start of rate cuts under circumstances that suggest a re-expansion of the rate hike margin, and this is a development I have feared since the beginning of the year. I would like to continue with my basic forecast scenario of JPY depreciation this year, keeping in mind the possibility of USD/JPY returning to the 140 level before the end of the year amid persistently high FF rates, and robust JPY carry trade triggered by it.

Incidentally, in last month's issue of this report, I explained in the section titled "Speculation Promotes JPY Appreciation; Actual Supply-Demand Promotes Depreciation" that even if JPY appreciated against USD as a result of a decline in U.S. interest rates, JPY's further appreciation would be hindered by the JPY supply-demand balance. However, even the decline in U.S. interest rates (one of the few factors that could have promoted JPY appreciation) seems to be undergoing a reversal earlier than expected. As a result, the JPY depreciation trend seems to have resumed earlier than expected even from the perspective of this report, which views JPY depreciation as its main forecast scenario. The pace is somewhat hasty, and if one assumes that a decision not to go ahead with rate cuts will be made within the year at any rate, it seems wise to be prepared for a rescheduling of the USD/JPY buying opportunity that was originally expected to arise. Of course, USD/JPY may not take a direct line to the 140 level either.

JPY Basic Supply and Demand – After the Rise in Imports, the Decline in Exports Emerges as a Problem

Trade Balance Fails to Improve Amid Simultaneous Decline in Imports and Exports

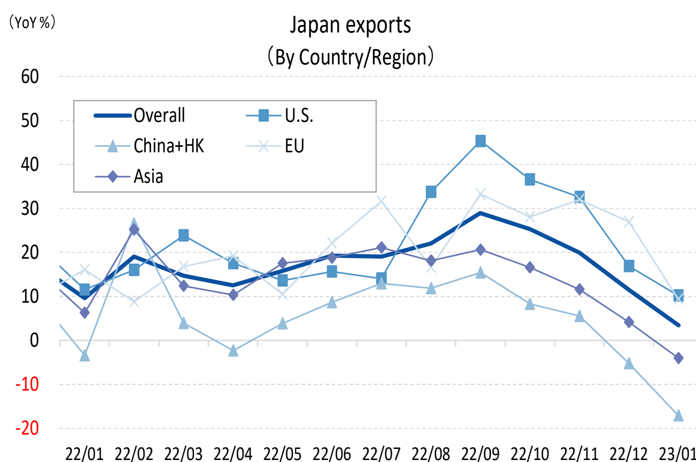
Japan's January trade deficit, which was published in February, turned out to be its largest ever trade deficit for a single month at -JPY 3.4966 trillion. The figures for the previous month (December 2022) grabbed headlines for having made Japan's trade deficit for the entire year (2022) the largest annual trade deficit ever, while this month's figures are in the news for being Japan's largest ever single month trade deficit posted. Of course, it is often the case that the trade deficit expands (exports remain lackluster) in January due to special factors, such as the Chinese New Year, but as I will explain in detail later, this year, exports to countries/regions other than China have also slowed significantly. Regardless of the reasons, a trade deficit adding up to almost -JPY 3.5 trillion is quite shocking, and something that cannot be overlooked when discussing the outlook for JPY. As I have explained repeatedly in this report, so long as there remain numerous economic entities wanting to sell JPY, JPY depreciation cannot be reversed meaningfully regardless of U.S. interest rate trends. Both interest rate trends and actual demand for the currency must be considered in a balanced manner when formulating the currency outlook.



Looking at the breakdown of the trade deficit, imports grew by +17.8% yoy to +JPY 10.0478 trillion, while exports grew by +3.5% yoy to +JPY 6.5512 trillion. Incidentally, I wrote in a January issue of Market Topics titled "How to Interpret 'Largest Ever' – Import Increase followed by Export Decrease" that even as the rise in imports is finally peaking, there seems to be an emerging trend of decline in exports amid a global economic slowdown, resulting in the possibility that the trade balance will not improve as much as expected. As the figure shows, both export and import growth have recently begun to slow down, with the result that the trade deficit has not shrunk as much as expected. Going forward, the impact of a decrease in resource prices will be factored in significantly, so it seems quite likely that the trade balance will continue to improve, but its impact in terms of correcting JPY weakness has not been as strong as many market participants expected.

Export Growth to All Countries/Regions Clearly Slowing

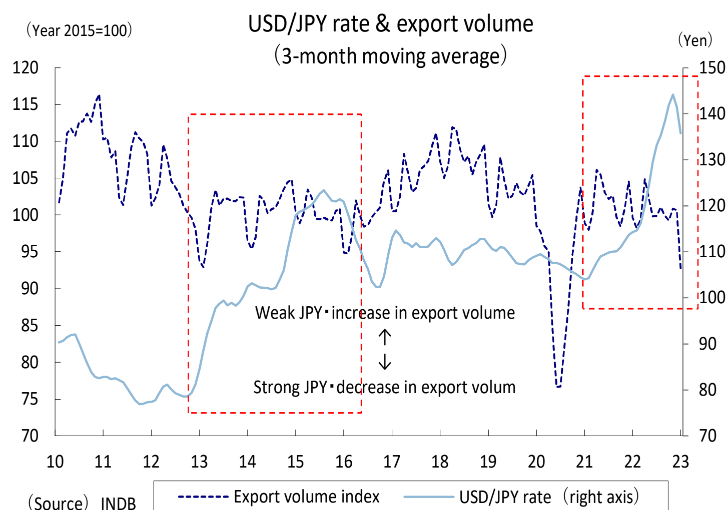
To look at the details, in the case of imports, coal, liquid natural gas (LNG), and crude oil continue to drive the increase in imports (contributing +11.1 pp), while in the case of exports, auto parts, semiconductor and other manufacturing equipment, and plastics have declined markedly (contributing -1.5pp). These are, therefore, the main categories preventing trade balance improvement. As the figure to the right shows, Japan's exports to some countries/regions have already fallen below the previous year's actual growth figures, with the pace of deceleration increasing for Europe and the U.S. also recently. As mentioned above, the Chinese New Year fell in January this year, and while the actual impact of this can be understood only by viewing the combined figures for January and February, the slowing down of exports aimed at all countries and regions around the world, including the U.S. and Europe, must be taken seriously. Japan's GDP for the October-December quarter of 2022 was released this past week, and it showed significant dampening of GDP growth by Change in Private Inventory, which is thought to have been a result of the aforementioned deterioration in the external demand climate and the consequent shrinking of corporate production activities as companies enter a phase of adjustment.



Going forward, it will be important to see how much exports can recover in accordance with the bottoming out scenario indicated by the IMF's January World Economic Outlook (WEO) report. Based on the recent trend of reappraising the U.S. economy, there is some hope. Of course, there is also the view that the impact of recent rate hikes is yet to be fully factored in, so one cannot afford to take anything for granted. In reality, however, some are beginning to say that rate hikes may need to be continued even after June (in this report, I have frequently pointed out the possibility of this happening), and if the U.S. economy is, indeed, as strong as reported, one can expect some revival of exports from Japan to the U.S.

No Increase in Export Volume

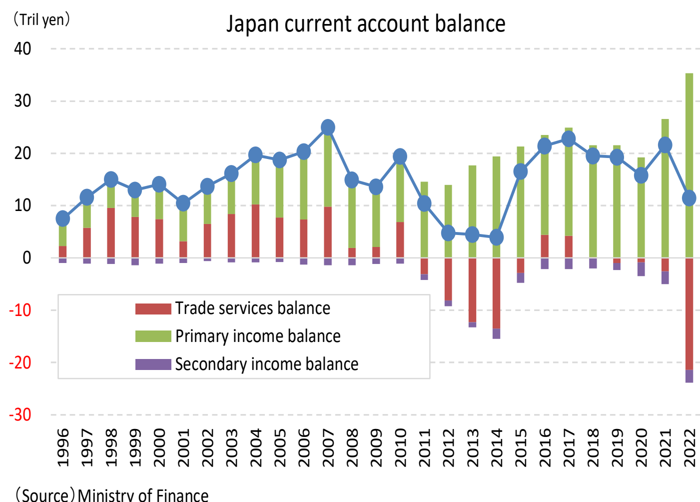
In the context of exports failing to rise, one would do well to take a look at the role played by JPY weakness. While JPY has strengthened considerably from its weakest at 152 to the dollar, the currency still remains around 14% weaker against USD in yoy terms. However, looking at the yoy rate of change in export volume, there has been an average deceleration of -7.4% yoy for the past three months (November 2022 through January 2023), -3.3% yoy for the past six months (August 2022 through January 2023), and -2.5% yoy for the past 12 months (February 2022 through January 2023). While not something that needs reiterating, it seems clear that the traditional path of utilizing JPY weakness to stoke export volume growth, thereby triggering a virtuous economic cycle, is no longer available to Japan (see figure).



This fact has been confirmed many times in the past 10 years, since the beginning of Abenomics, and is a good reason to revise monetary policy, but previous phases of JPY weakness were not severe enough to create social awareness of its negative implications, and therefore failed to stir up public opinion in favor of revising monetary policy. In 2022, however, Japan's monetary policy and the consequent JPY weakness drew so much public attention that "undesirable JPY weakness" came into vogue as a popular phrase. Roughly speaking, therefore, one could conclude that one of the achievements of the Kuroda BOJ has been to awaken a large part of Japanese society to the fact that JPY weakness is not a remedy for all ills. Objectively speaking, the impact of JPY weakness on the real economy is an increase in domestic prices via import price increase, a deterioration of the real income climate due to deteriorating terms of trade, and the whittling away of consumption and investment appetites, all of which is consistent with the lackluster performance of the Japanese economy. At any rate, "demand-led JPY selling" seems poised to remain the theme for discussing the Japanese economy in 2023 as it was in 2022.

Performance Typical of a Mature Creditor Nation

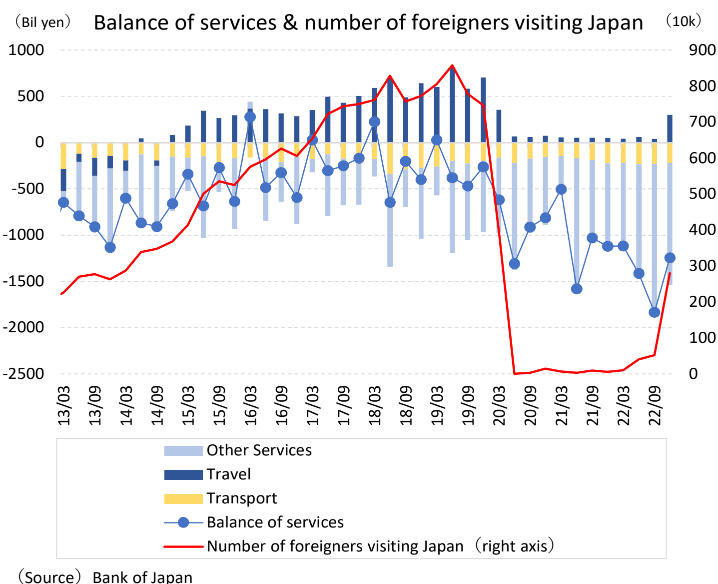
The implications of Japan's Balance of Payments are also important for discussing the basic supply and demand of JPY from a comprehensive perspective that includes the Trade balance. In this context, Japan's whole year Balance of Payments for 2022 was released in February. As already reported, the Current Account balance posted a surplus of +JPY 11.4434 trillion, the lowest in eight years since 2014 (when it was +JPY 3.9215 trillion) – see figure. This decline in Current Account surplus is, needless to say, due to JPY weakness and high resource prices, which caused the Trade and Services balance to post a record-breaking deficit of -JPY 21.3881 trillion. Despite this, one of the reasons the current account surplus was higher than in 2014 was due to Japan's Primary Income surplus, which shot past the +JPY 30 trillion mark for the first time to post +JPY 35.3087 trillion. The Primary Income surplus (which is the revenue generated by assets held overseas) expanded amid historical JPY weakness. The enormous amount of foreign currency assets held by Japanese companies and investors is perhaps the last remaining strength of the Japanese economy. To summarize the situation, Japan's Balance of Payments statistics are very typical of a mature creditor nation that earns not through goods and services but through investment.



Ambushed by "Other Services" Deficit

Over the past year, the two points related to the Japanese economy that have drawn attention are (1) the expansion of Japan's trade deficit due to JPY weakness and high resource prices, and (2) the shrinking (annihilation) of Japan's travel surplus owing to its isolationist policies. However, a third point has recently become conspicuous, and this is (3) the expansion of the "Other services" deficit. To be sure, the overall trend of the 2022 Balance of Payments was dictated by Japan's enormous trade deficits, making that naturally the most important point. However, looking just at the Services balance, one notices an enormous deficit worth -JPY 5.6073 trillion (the largest since the -JPY 5.6521 trillion posted in 2002).

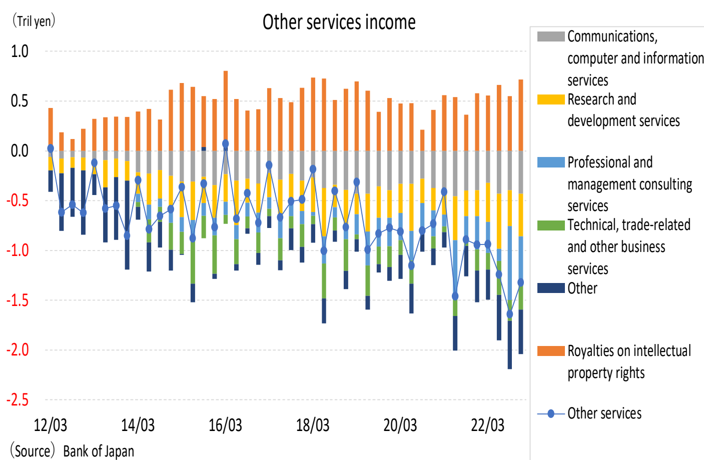
The Services balance comprises the combined balance of Travel, Transport, and Other services. As many people will understand, under ordinary circumstances, the extent of JPY weakness seen last year would have helped Japan earn a significant Travel surplus as a popular tourist destination. However, in 2022, baseless entry restrictions for tourists were imposed for the first nine months of the year. To this day, those seeking entry into Japan are required to show a PCR negative certificate or proof of having received three doses of vaccine, so restrictions have not yet been fully lifted. As a result, Japan posted a Travel surplus of no more than +JPY 436 billion for 2022, which is smaller even than the Travel surplus posted in 2020, the first year of the pandemic (+JPY 555.2 billion; see figure). The situation is unfortunate, but the Travel balance remains in surplus in spite of it. The question then is – why is the Services deficit expanding? This is what leads to point (3), the expansion of the "Other services" deficit. The Services balance, as mentioned above, comprises the combined balance of Travel, Transport, and Other services, of which the balance of Other services posted its largest ever deficit since records began at -JPY 5.1451 trillion. As the figure shows, the Travel balance managed to post a surplus for 2H of the year, but the Other services deficit continued to expand throughout the year, and it is clear that this is what depressed the Services balance overall.



(Source) Bank of Japan

What is the Balance of "Other Services"

What, then, is the balance of "Other services"? Other services include a diverse variety of services, but all of them excluding "charges for the use of intellectual property n.i.e." have been posting a deficit. In recent years, "telecommunications, computer, and information services" (which includes fees for the use of cloud services paid to Google, Apple, Facebook, Amazon (GAFA) and other IT giants) and "insurance and pension services" have posted major deficits (see figure on next page). However, the largest portion of the deficit, amounting to -JPY 4.3689 trillion, is owing to "Other business services." Specifically, "Other business services" comprise "Research and development services," "Professional and management consulting services," and "Technical, trade-related, and other business services." For 2022, these posted deficits of -JPY 1.7355 trillion, -JPY 1.6666 trillion, and -JPY 966.8 billion, respectively. Research and development services include, in addition to services related to R&D, transactions related to the use of industrial property rights (patent rights, utility model rights, design rights), etc. Professional and management consulting services include the purchase/sale of advertising space on websites, sponsorship fees for sporting events, etc. Finally, Technical, trade-related, and other business services include construction/engineering and other technical services, agricultural services, mining services (for instance, petroleum or natural gas exploration/mining services), operational leasing services, trade-related services, etc. Lacking familiarity with these areas, I am unable to discuss them at length here, but I can say that the Balance of Payments statistics seem to clearly be confirming what has been said in recent years regarding the U.S. economy's strength versus the Japanese economy's weakness in areas such as cloud services, research and development, website advertisement sales, etc.



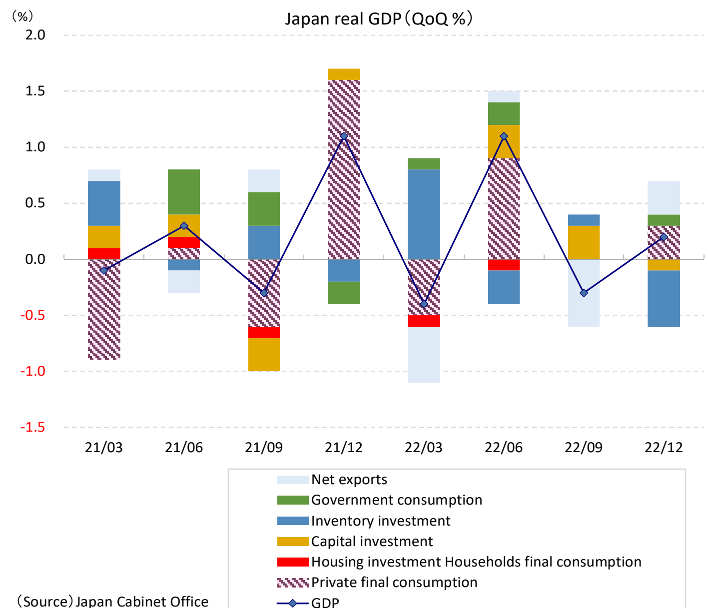
(Source) Bank of Japan

Given that the Other services deficit has been expanding over the past 10 years, even if Japan were to recover 2019 levels of Travel surplus (roughly JPY 2.7 trillion), the Services balance itself would still post a significant deficit. So far, in discussing Japan's current account balance overall, it was common sense to monitor the Trade deficit and Travel surplus trends, but one would do well to recognize that the Other services deficit trend has also acquired a presence that can no longer be overlooked.

The Japanese Economy Now and Going Forward – Still Haunted by the Pandemic

Change in Inventories Reflects Corporate Cautiousness

Japan's October-December 2022 quarter real GDP (first preliminary estimates) published by the Cabinet Office fell significantly short of the median of market forecasts (+1.8% qoq, annualized; all qoq annualized figures hereafter unless otherwise specified) at +0.6% (+0.2% qoq). This was the first positive growth in two quarters, but has not been able to recover the previous (July-September 2022) quarter's negative growth by -1.2%. October 2022 was when Japan greatly relaxed its border control measures and also began nationwide tourism support measures, so stronger headline performance had been expected.



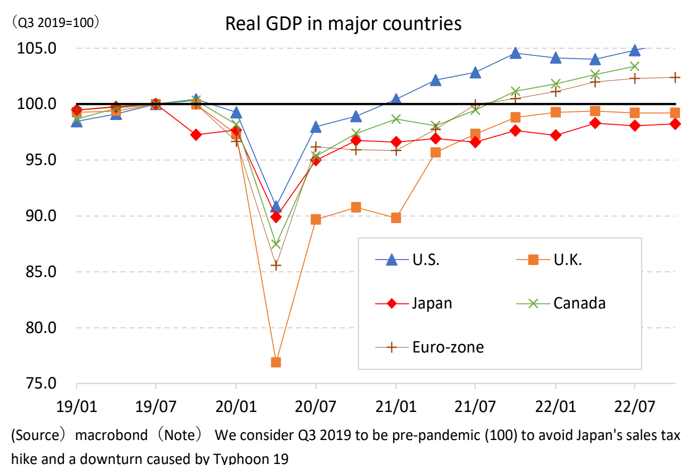
（Source）Japan Cabinet Office

By demand category (qoq), thanks to the aforementioned nationwide tourism support measures, service consumption rose sharply from -0.1% to +1.4%. Thanks partially to this, Private Consumption, which was level at +0.0% for the previous quarter, recovered to post +0.5% growth. On the other hand, the other pillar of Private Consumption, Private Non-Residential Investment, fell from +1.5% previously to -0.5% this time, posting negative growth for the first time in three quarters. Apart from this, Government Consumption increased from +0.1% previously to +0.3% this time, but the greatest contribution to this time's real GDP growth rate was from Change in Private Inventories, at -0.5 pp. This negative change in (dissolution of) private inventories could be the springboard for recovery via a positive change in (buildup of) private inventories in the coming months, but it could also reflect companies reining in their investments with a view to cutting back on production in anticipation of a weak real economy, making it difficult to assess positively.

As I have discussed in past issues of this report, since last fall, the deterioration in overseas economic conditions has resulted in a slowdown in exports, so companies shrinking their inventories as part of an attempt to adjust production could be an advance sign of things to come. This kind of inventory-investment-driven dampening of GDP growth should be closely monitored going forward. Further, as mentioned above, domestic demand categories in total made a -0.2pp negative contribution to GDP growth this time, but external demand (which contributed +0.3pp) helped achieve an overall positive growth rate. Again, as mentioned above, goods exports have not been increasing, but services exports have as a result of the relaxation of border control measures starting October.

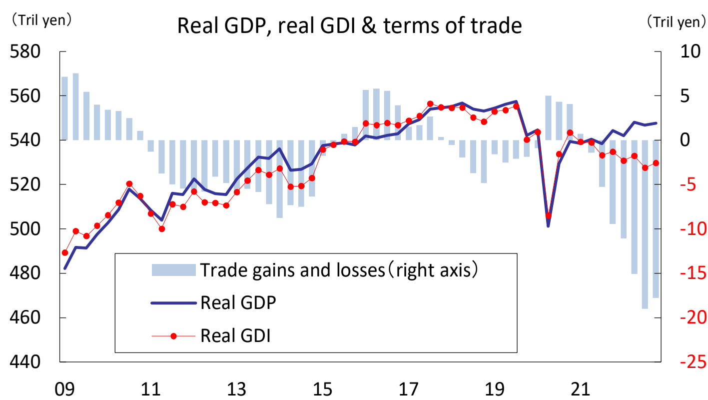
First Positive in Two Quarters, but Pre-COVID Growth Remains Unrecovered

Incidentally, one of the focuses of attention each quarter is on whether pre-COVID growth has been recovered, but unfortunately the answer to that question is still no. In the case of Japan, it is reasonable to define "pre-COVID" conditions not by performance for the October-December 2019 quarter, when growth suffered due to the increase in consumption taxes and the impact of Typhoon Hagibis, but the quarter before that, i.e., July-September 2019, or else by the average quarterly growth rate for 2019. In this context, <u>the October-December 2022 quarter posted -1.8% negative growth compared with the July-September 2019 quarter, and -0.9% negative growth compared with the average quarterly growth for 2019 as a whole, indicating that pre-COVID growth rates have not yet been recovered. Among the key countries of the world, Japan and the UK are the only two that are still falling short of July-September 2019 growth rates (see figure)</u>. However, given the structural difference between the UK (which has implemented rate hikes worth a total of +275bp since December 2021) and Japan (which is stubbornly sticking to its accommodative monetary policy path), Japan's performance seems more unfortunate (moreover, between Japan and the UK, Japan's performance is worse). Three years since the start of the pandemic, Japanese society is still debating whether or not to keep masks on, which seems consistent with domestic demand remaining lackluster. Both the U.S. and the euro area, though currently battling inflation, recovered pre-COVID growth levels a long time ago, and their economies have since continued to accelerate. Since last year, the domestic-foreign interest rate differential has been pointed out as one of the factors causing JPY weakness (of course, I do not believe it is the only factor). Assuming this is true, the current domestic-foreign growth rate differential will inevitably lead to a further expansion of the interest rate differential, which makes one think that the JPY depreciation trend will not end easily.



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

More Important – Real GDI Expected to Finally Bottom Out



(Source) Cabinet Office

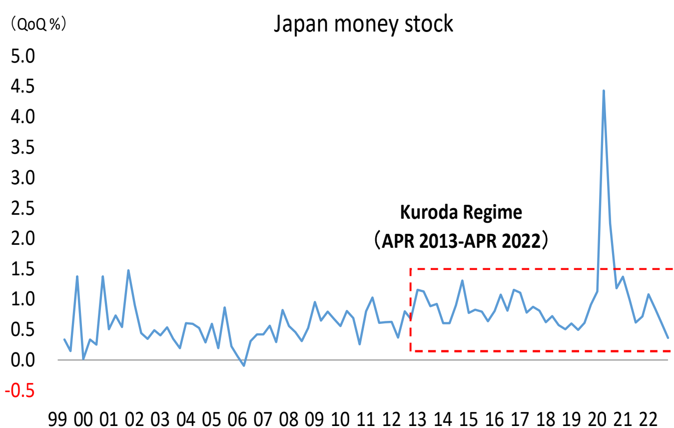
The one positive aspect of the otherwise lackluster October-December GDP data is related to the real gross domestic income (GDI) trend. For the past year, every time GDP data is released, it has been pointed out that real GDI is currently a more reliable measure of the economy than real GDP. While real GDP is a measure of production volume, real GDI is a measure of purchasing power. Real GDI is derived from the real GDP by additionally taking into account the improvement/deterioration in terms of trade (i.e., trade gains/trade losses). It is real GDI rather than real GDP that better reflects the economic experience of the person on the street. As is generally known, crude oil prices peaked in mid-2022, while JPY weakness peaked around October 2022. Now finally, Japan's terms of trade (export deflator ÷ import deflator), which had been depressing Japan's real income climate, are beginning to improve as the import deflator begins to fall. Specifically, trade losses (as a percentage of GDP), which represent income draining away from Japan, shrank for the first time in 10 quarters since April-June 2020, at -3.3% for the October-December 2022 quarter compared with the -3.5% for the quarter before that. As a result, the real GDI growth rate improved significantly from the previous quarter's -3.9% to +1.6%, finally showing signs of a trend reversal. However, with regard to real GDI, it is important to honestly acknowledge that the damage received so far has been really serious. The figure to the right shows this at a glance. For instance, adding up the (qoq) growth rate from the January-March 2020 quarter, real GDP has grown by a total of +1.5pp, while real GDI has posted negative growth by a total of -1.6pp. This significant gap reflects the remains of the deterioration in the real income environment as experienced by the people of Japan, so it will take quite some time before the improvement in the terms of trade can translate into positive public sentiment sufficient to boost personal consumption. Further, as of the time of writing this report, JPY has begun to depreciate against USD again, while crude oil prices do not show signs of falling much more. It is therefore difficult to be confident that real GDI will continue to improve, and domestic demand may, consequently, remain lackluster.

BOJ Monetary Policies Now and Going Forward – The Shift from Realism to Idealism

New BOJ Regime – A Solid Lineup

In February, it was reported that the government had decided to appoint economist and former BOJ Policy Board Member Kazuo Ueda as the successor of current BOJ Governor Haruhiko Kuroda following the latter's retirement on April 8, 2023. If realized, this will be the first time in post-war Japan that an economist has been appointed to the post of BOJ Governor. It is said that current Deputy Governor Masayoshi Amamiya, who had previously been rumored to be a favorite and also as having been sounded out, refused the post, saying a new perspective was required for monetary policy operation going forward. The choices for the two deputy governors of the BOJ under Ueda have also been announced as Shinichi Uchida, current BOJ executive director, and Ryozo Himino, former commissioner of the Financial Services Agency. With Ueda forming the theoretical pillar of the BOJ's unconventional monetary policies so far, Uchida being fully aware of the current policy framework, and Himino excelling in prudence policies and an international perspective, the gubernatorial and deputy gubernatorial lineup for the new BOJ regime is quite solid. At the very least, the new regime seems unlikely to simply be working on an experiment while lacking the ability to communicate with the financial markets – something the Kuroda regime was criticized for.

Summarizing the Kuroda Regime



(Source) macrobond

Before discussing the upcoming regime, I would like to recap the achievements of the current regime simply. The Kuroda regime's achievements were significant, in that it literally tested the limits of monetary policy and exposed the effectiveness (or rather ineffectiveness) of its policies in broad daylight for everyone to see. Had it not stuck to the ineffective policies to the bitter end, successive regimes may have adhered to these monetary policy ideas indefinitely, and it would have been impossible to eliminate arguments bordering on religious dogma that insisted every social and economic problem could be solved by monetary policy. Such attitudes have still not been eradicated completely, but they have been made much feebler. In the past 10 years, money stock has not accelerated at all. Considering it began with complete denial during the Shirakawa period, there are no signs that the amount of money flowing into

the real economy has accelerated (see figure on next page; the only time in all these years that the money flowing into the economy accelerated was when the government made cash payouts during the pandemic). Another achievement of the 10 years of the Kuroda regime is that it managed to changed Japanese society's understanding of JPY weakness.

10 years ago, anyone who pointed out that JPY depreciation no longer increased export volumes, but only inflicted great damage by draining income out of Japan invited harsh criticism. Now, however, the damage resulting from JPY weakness has become so widely recognized in Japanese society as to cause "undesirable JPY weakness" to be chosen the phrase of the year. Of course, the BOJ's monetary policies are not solely to blame for JPY plummeting so steeply in 2022, but the fact that Kuroda continued to state in the face of extreme JPY depreciation that JPY weakness had a positive effect on the Japanese economy served to clearly increase the frictions between the BOJ and society at large. In the sense that it gave Japanese society a taste of the fear of the domestic currency depreciating, it can be said that the Kuroda regime changed Japanese society's standards regarding forex trends.

However, as a result of buying Japanese government bonds (JGBs) over the past 10 years, the BOJ's JGB holdings have more than quadrupled from JPY 125 trillion in March 2013 to JPY 583 trillion as of January 2023, and account for over 50% of all long-term government bonds issued. In addition to this, the BOJ's outstanding holdings of exchange-traded funds (ETFs) has also exploded from JPY 1.5 trillion to JPY 36.9 trillion, putting the BOJ on the principle stockholders lists of numerous listed companies. Leaving aside the causal relationship of this with monetary policy, inflation in 2022 rose as desired by the BOJ, but this only resulted in social resentment. To think that the Kuroda regime had been receiving overall public support for its reflationary policies over the past 10 years simply because its inflation target had not yet been met!

The Shift from Idealism to Realism; Pointlessness of a Dichotomy

What stance will the Ueda regime, born in the aftermath of monetary policies that could be termed a "social experiment," take? In a word, in contrast to the Kuroda regime, which consistently pursued an "ideal" outcome envisaged by its reflationary policies, perhaps the Ueda regime will pursue realism. Since his announcement as the next governor of the BOJ, Ueda's time as a Policy Board member (April 1998 through April 2005) and his more recent comments regarding monetary policy have been in the spotlight, but his impressions regarding the current policy framework, published in the July 6, 2022 edition of "Economic Classroom" by the Nihon Keizai Shimbun, are noteworthy: "The future of the current unusual monetary policy framework, which has been protracted much beyond most people's expectations, needs to be considered seriously." Public opinion, led by the media, tends to assess monetary policy simplistically in terms of the "hawkish" or "dovish" dichotomy. The Kuroda regime, having labeled the Shirakawa regime "hawkish," almost seemed to find its raison dêtre in completely rejecting hawkishness and positioning itself as "dovish." Coming right after this, the upcoming Ueda regime will also be forced into a dichotomous stereotype of either hawkish or dovish.

As a result, there may initially be a strong tendency to label the incoming Ueda regime "hawkish" based on the aforementioned comment by Ueda. Especially given that the new regime's very first move may be to normalize monetary policy, this label seems even more likely to be applied. However, given that Ueda has, in the past, upheld the theoretical pillar supporting unconventional monetary policies including the zero interest rate policy, forward guidance, and quantitative easing, he seems unlikely to be a dyed-in-the-wool hawk. Rather, it may be reasonable to describe him as someone who can implement realistic monetary policy based on the requirements of the real economy.

It must also be noted that Yale University Professor Koichi Hamada, who has been quoted time and again since the early days of Abenomics as an authority on reflationary monetary policies, sought an interview with Professor Ueda for his work *Economic Policy in the 21st Century*, but was rejected saying, "I cannot argue with someone like you, who has already decided that a certain policy will work rather than assessing whether or not it works in a balanced manner." This statement alone gives one hope that the Ueda regime will make timely and appropriate decisions rather than behave in a single-track or impulsive manner like the reflationists. It also seems likely that the new regime will consider careful communication with the markets.

Risks to My Main Scenario – Increasing Likelihood of JPY Depreciation Risks

Shifting from Unconventional Easing to Conventional Easing

If the BOJ's new Ueda-led regime undertakes a shift from idealism to realism it can probably be expected to determine the optimal monetary policy path in line with that shift, which is an extremely important factor to consider when considering the JPY exchange rate outlook. Simply put, the default course would be to abolish the yield curve control (YCC) framework, which forces the BOJ to purchase government bonds without limit, and to discontinue negative interest rates, which have been noted to exert various negative influences on the overall financial system. At a lower Diet chamber hearing held on February 24, Mr. Ueda said he – "would like to conduct an assessment [of the current monetary policy framework] if the need emerges" – and appeared to show an unwavering posture of being prepared to question and verify whatever seemed in need of reassessment. Regarding the continuation of the YCC framework, for example, Mr. Ueda said – "It cannot be denied that there are various side effects." – and went on to state – "We would like to take sufficient time to repeatedly discuss the situation and determine the most desirable policy form" – thereby confirming his inclination to reassess the BOJ's policies. He also mentioned that shortening the YCC's target maturity from 10 years to 5 years would be "one of the options", although he had appeared to criticize that option in an "Economic Classroom" article published in the Nikkei Shimbun in July 2022, in which he argued that a small-margin increase in the interest rate cap could lead to even-more-massive bond selling in anticipation of the next interest rate

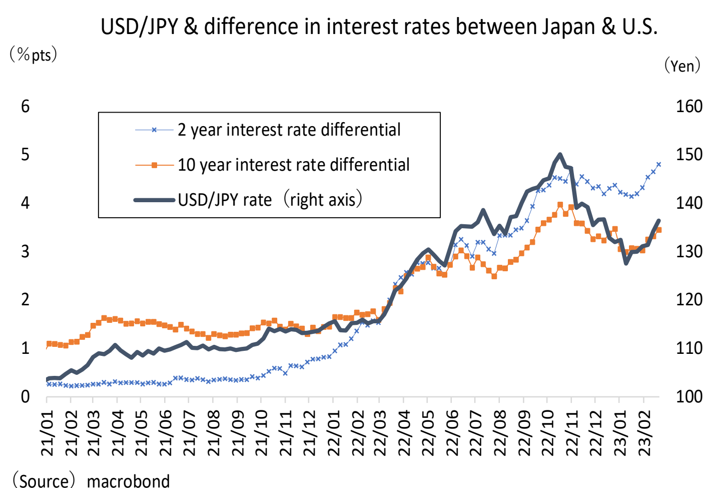
hike and that proposals to shorten the YCC's target maturity from 10 years toward 7 or 5 years might possibly create the same problem. It seems to me that there is only a low likelihood that Mr. Ueda would propose such minor revisions to the YCC's target maturity.

Mr. Ueda may already have some monetary policy revision plans in mind, but it is unlikely that he will provide hints about those plans in advance. He stated at the Diet hearing that – "There are various possibilities on what YCC could look like in the future. But I won't comment on what specific action the BOJ could take, as doing so could cause unintended market impact." – suggesting that increasing expectations of possible changes to the YCC framework could cause speculative selling of JGBs that would necessitate additional BOJ JGB purchases. A decision to discontinue the YCC could be made abruptly and without warning, and there is no guarantee such a discontinuation might not be as early as in April. If considerable JPY appreciation were to be seen in the April-June period, it may possibly appear that conditions are ripe for such an early discontinuation. Even in the event of such an early discontinuation, however, it will only cause the BOJ's unconventional monetary easing to become normal easing, so it would not contradict Mr. Ueda's statement at the Diet hearing that – "At present, it's important to support the economy and create an environment where companies can raise wages. It's important to maintain monetary easing to achieve the BOJ's inflation target in a sustainable and stable fashion, accompanied by wage hikes."

Moreover, considering that Mr. Ueda seems to have concluded that negative interest rates have reached reversal rate levels that can have a monetary tightening effect, the discontinuation of the YCC could even have somewhat of a monetary easing effect. We are hoping that discontinuing negative interest rates is another element of the BOJ's prospective default route. On the other hand, it appears that the Ueda BOJ's normalization measures may be limited. As mentioned above, when he was a BOJ Governing Council member, Mr. Ueda voted against the August 11, 2000 decision to discontinue the BOJ's zero interest rate policy, which is remembered as one of the BOJ's greatest mistakes of this century. It can probably be anticipated that, as BOJ governor, Mr. Ueda will continue to striving to realize optimal monetary policy management based on timely and appropriate decisions in line with the economic and financial conditions of the times. There is a strong possibility that, as the YCC and negative interest rate policies are clearly being judged to be inappropriate, only those policies will be corrected and that, as Japan cannot expect to realize sustained increases in nominal wages, the country will choose to maintain a normal monetary easing policy posture.

Increasing Likelihood of JPY Depreciation Risks

So, what are the implications for exchange rates? I initially thought the prospect of the discontinuation of YCC and negative interest rates might somewhat increase the risk of USD/JPY descending below my forecast's lower limit of JPY125 and entering the JPY120-125 range. The prospective changes are insignificant in light of Japan-overseas interest rate differentials, of course, and I also anticipated that USD/JPY would regain upward momentum owing to conditions in the JPY supply-demand environment. In the event, at the time this article was written, there were few apparent hints of a swing back toward JPY appreciation. Following the February 24 Diet hearing regarding the nomination of Mr. Ueda to become BOJ governor, similar hearings were held for the two deputy governor nominees – Shinichi Uchida and Ryozo Himino – but these hearings did not affect the forex market. While the prospect of BOJ policy changes that Mr. Ueda might undertake depressed USD/JPY to the JPY127 level at one point in mid-January, the USD/JPY downtrend was actually reversed in February, when a fuller picture of potential moves by the Ueda BOJ became evident. Forex markets should already have factored in prospective BOJ discontinuations of the YCC framework and negative interest rates, but USD/JPY has surpassed the JPY130 level and is now fluctuating slightly above JPY135. In light of these trends, it seems there may no longer be any need to prepare for BOJ-related JPY appreciation risks.



JPY's depreciation in February stems from issues unrelated to the BOJ. It has been caused by the overlap of two unexpected events – (1) US inflation rates have not fallen as expected (causing an additional rise in US interest rates) and (2) Japan's trade deficit has grown by an unexpectedly large margin. Regarding event (2), as mentioned above, there is a strong possibility that the JPY supply-demand environment will continue to be characterized by JPY overselling, as Japan's imports remain flat and the country's exports decelerate. Most events up to this point remain within the scope of this article's main forecast scenario, but event (1) is somewhat unexpected. The recovery of USD/JPY early this year has clearly been promoted by the re-expansion of Japan-US interest rate differentials (see graph). I noted in a previous issue of this article that it is much easier to reduce the U.S. consumer price index (CPI) growth rate from 10% to 5% than it is to reduce the rate from 5% to 2%, and it seems that this difficulty differential is a factor related to event (2). While many observers believe in the seemingly realistic theory that the Fed will discontinue interest rate hikes in June rather than in May, to me it now seems more likely that the discontinuation of interest rate hikes may be delayed until July or perhaps September.

This article noted last December that, although the consensus forecast for the Fed's terminal interest rate was in the 4.75%-5.25% range, it was quite possible that the Fed might continue implementing quarterly 25bp interest rate hikes from June. If that possibility eventuates, the terminal rate could end up approaching the 6% level. Over a year ago (at

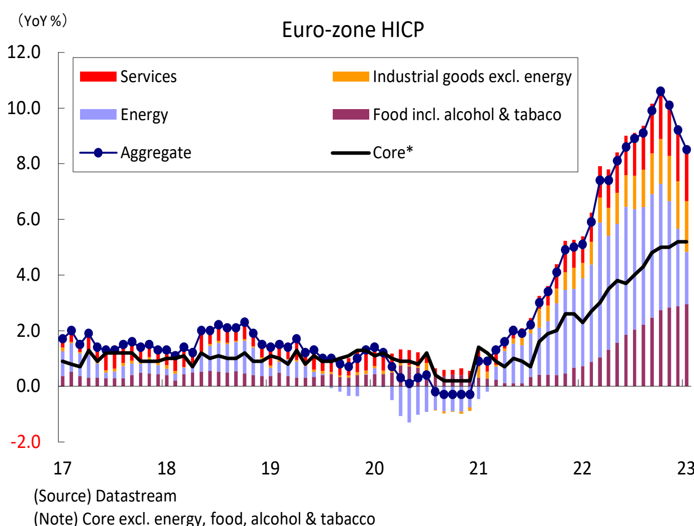
the end of November 2021), Fed Chairman Powell abruptly disavowed his previous belief that the surge in U.S. inflation was a temporary phenomenon, causing a big shock to financial markets. Compared to that November 2021 reappraisal, the prospect of a decision to sustain interest rate hikes at a moderate pace without stopping in the January-March quarter does not seem so shocking. Although that possibility is not encompassed by the main forecast scenario, it is worth considering as a risk scenario that might promote an unexpected degree of JPY depreciation.
It seems likely that the JPY depreciation trend in February reflected awareness of this risk scenario. Japan-overseas interest rate differentials and the JPY supply-demand environment are expected to promote JPY depreciation during 2023 just as they did in 2022, although it seems that the depreciation pace has recently become somewhat more rapid. This article's main forecast scenario has since last year anticipated the possibility of USD/JPY returning to the JPY140 level by the end of 2023, and recent developments suggest there is a need to consider the possibility that the JPY depreciation may progress even further during the year.

EUR Outlook – EUR Supported by Expectations of Rising Euro Area Interest Rates

EUR Area Monetary Policies Now and Going Forward – No Signs of a Halt to Interest Rate Hikes

Focus Shifts to Post-April Moves

The ECB's February 2 Governing Council meeting was the second consecutive Governing Council meeting to raise interest rates by 50bp, increasing the deposit facility interest rate from 2.00% to 2.50%. This is the highest level seen since immediately after the Lehman Shock (December 2008). In line with a previous decision not to reinvest all the principal payments from maturing securities in the asset purchase programme (APP) portfolio, the meeting confirmed plans to decrease the APP portfolio's size by EUR15 billion per month from March. Although the ECB was relatively late to begin interest rate hikes, it is noteworthy that the ECB has overtaken the Fed regarding the margin of individual hikes. As discussed below, such interest rate-related moves are being closely followed by forex market players. <u>Among the February meeting's most notable points was the announcement in the statement that the ECB intends to raise interest rates by another 50bp at the March Governing Council meeting</u>. It is unusual for central banks to announce in advance their intentions with respect to future rate hikes and their margins. In this regard ECB President Christine Lagarde said at the post-meeting press conference that – "An intention is not, as I said, a 100% commitment, but it's a pretty strong determination[.]"



(Source) Datastream
(Note) Core excl. energy, food, alcohol & tabacco

Although the euro area Consumer Price Index (HICP) has stalled on a comprehensive (headline) basis, core base HICP is plateauing and the overall euro area inflation situation is unpredictable (see graph). President Lagarde noted at the press conference that – "this is the highest that core inflation has been in our part of the world. So it's true that headline inflation has gone down, [...] [b]ut underlying inflation pressure is there, alive and kicking, which is why we are committing as we are – intending as we intend [to further hike interest rates] – in this monetary policy statement, and this is why I say that we have more ground to cover and we are not done." These remarks are reminiscent of the "[further hiking interest rates] significantly at a steady pace" phrase that was repeatedly spoken at the December Governing Council meeting. At the December press conference, President Lagarde explained 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." Given the guidance to anticipate rate hikes for "a period of time", this article previously forecast that the ECB's default course would be 50bp interest rate hikes for at least the first two Governing Council meetings after the December meeting (the February and March meetings), and it is now clear that that is what is in the cards.
Currently, attention is shifting to the question of whether the ECB's interest rate hikes will continue in April and subsequently. At the press conference following the December Governing Council meeting, President Lagarde said – "Our staff projections, that embed and incorporate the market expectations of our terminal rate [a policy rate of 3%], do not certainly allow a return to the 2% inflation target that we have in a timely manner. So more needs to be done[.]" If this statement is still valid, then the ECB's interest rate hikes cannot be expected to come to an end even after the deposit facility interest rate is raised from 2.50% to 3.00% in March. <u>I am anticipating the possibility of one or two more 25bp rate hikes from April</u>.

Signs of Inflation Indicator Stabilization

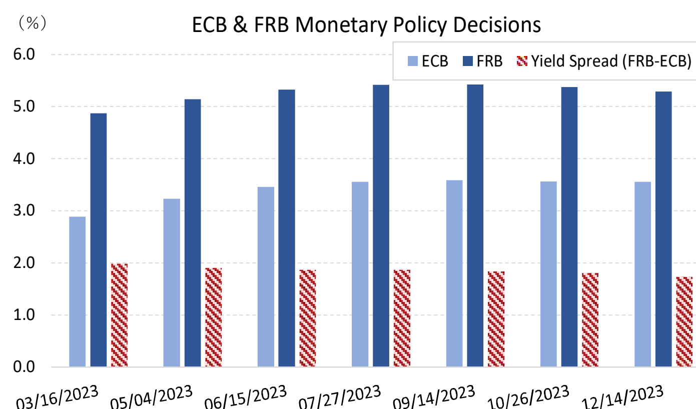
A closer look at the ECB Governing Council's inflation assessments certainly seems to indicate that the level of concern is on the decline. The December Governing Council meeting's statement notes that – "recent data on wage dynamics have been in line with the December Eurosystem staff projections. Most measures of longer-term inflation expectations currently stand at around two per cent[.]" The five-year in five years inflation swap break-even inflation rate (5-year BEI, see graph) that the ECB has traditionally emphasized has recently been at high levels from a historical perspective but has remained in the 2.0%-2.5% range, much lower than HICP, which has continues significantly growing, and this seems to give the ECB a sense of security. Moreover, the future inflation risks situation was recognized as improving compared to December, with inflationary and disinflationary risks becoming increasingly balanced. Given that it is now reasonable to anticipate another drop in energy prices, it is still possible that the headline inflation rate could decline.

(Source) Bloomberg

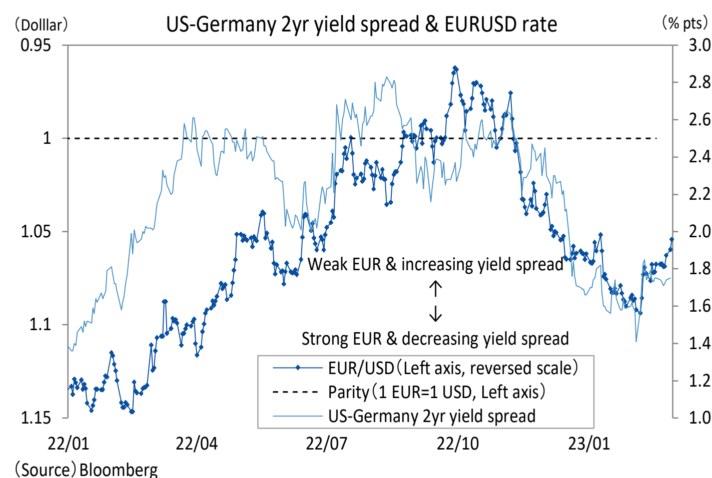
On the other hand, the ECB is naturally taking into account the risk of further increases in inflation rates. For example, President Lagarde mentioned the possibility that China's shift away from its zero-corona policy may cause a surge in that country's domestic demand, pushing up international resource prices. She also mentioned that the drop in energy prices partly reflects euro area countries' price restraint measures, and that prices may resume their upward trajectories after those measures are discontinued. Overall, the ECB's view appears to be that upside and downside inflation risks are becoming more balanced, but there is still no compelling reason to relent regarding monetary tightening policies. As this article has repeatedly discussed, the fact that the euro area economy has not decelerated as much as expected despite the continued monetary tightening policies is a key factor that provides the ECB with an environment in which it can concentrate on fighting inflation.

Continued Noteworthy Improvement in EUR-Supporting Circumstances

I have often argued that, from forex markets' perspective, the narrowing of U.S.-Europe interest rate differentials will prompt a greater level of sustained focus on EUR's strength. The gap between the policy interest rates of the ECB and the Fed as factored in by financial markets has been steadily narrowing since last year. The markets are clearly factoring in a Fed interest rate cut within this year, and they are also factoring in the prospect of the ECB keeping euro area rates at high levels (see upper right graph). Of course, the ECB was relatively late to begin hiking interest rates, and one should avoid overly simplistic ECB-Fed comparisons, since the forex market tends to focus on the atmosphere and flows within a given time period. If the Fed continues hiking rates by 25bp increments while the ECB continues hiking rates by 50bp increments, the forex market will be more likely to focus its main spotlight on the ECB's hawkishness. The rise of EUR/USD since last November is thought to be largely due to the market's reaction to policy interest rate forecasts, and in fact, one can see a fairly stable relationship between EUR/USD and the U.S.-Germany interest rate differential (see lower right graph). If one anticipates that fuel prices may fall when warmer spring weather begins and that such a fuel price fall may promote a recovery of Germany's trade surplus, one may also expect to see a EUR tailwind effect owing to the changing EUR supply-demand situation. Such speculative EUR-buying positions as those seen in IMM currency futures trading appear to be accumulating in a one-sided manner, and this market situation may make EUR likely to weaken once again. Other than the fact that EUR has been overbought, however, it seems difficult at this point to find any compelling reasons for EUR selling.



(Source) Bloomberg as of 1MAR2022
(Notes) The dates are the scheduled meetings of the ECB Governing Council.
The FRB data is from the FOMC projection materials



(Source) Bloomberg

ECB Officials Explicitly Deny Disinflation

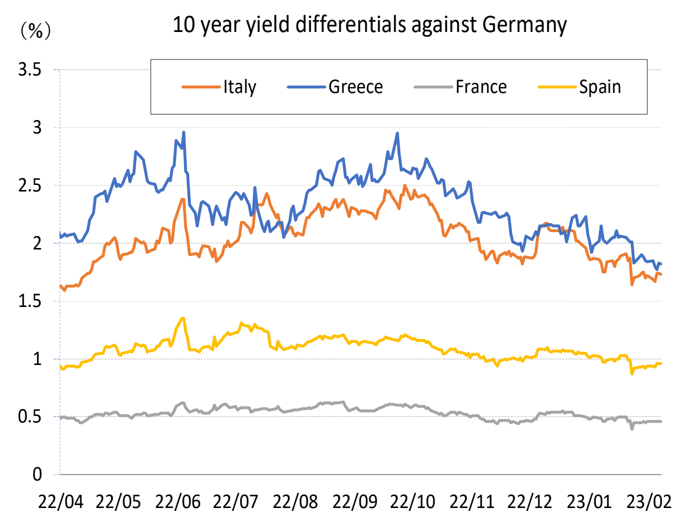
On February 15, President Lagarde testified to the European Parliament that – "Overall, price pressures remain strong and underlying inflation is still high." – and that – "wages are growing faster [...] with the main theme in wage negotiations becoming how wages can to some extent catch up with high inflation." She said that although there were not yet clear signs of a wage-price spiral, such a spiral was definitely a possibility and would become an additional factor exerting upward pressure on prices, and that the most alarming possibility was that wage levels might begin paralleling energy prices. As already noted, comprehensive basis HICP growth is peaking out but core basis HICP growth is accelerating. There is still no evidence that an out-of-control wage-price spiral has begun, but President Lagarde acknowledges that such a spiral is clearly possible.

Under these circumstances, what policy interest rate trends should we be anticipating? As noted above, it has already been announced that the March 16 Governing Council meeting will approve a 50bp rate hike, so the next question is whether or not a 25bp rate hike will be approved at the May 4 Governing Council meeting. In this regard, ECB Executive Board Member Isabel Schnabel (from Germany) said in a February 17 interview with Bloomberg that – "We are still far away from claiming victory on inflation." She warned that the euro area economy could become less sensitive to rate hikes than it has in the past, and that – "We may have to act more forcefully if transmission turns out to be weaker." Fed Chairman Powell's mention of disinflation at the February FOMC meeting fueled dovish speculation in financial markets (although such speculation proved mistaken), but in her interview Schnabel stated that – "A broad disinflation process has not even started in the euro area." – and later said that – "we need to look at incoming data for evidence that our policy is being restrictive."

By explicitly denying "disinflation" (a popular word in financial markets since the February FOMC meeting), Ms. Schnabel appeared to be emphasizing that the ECB is quite concerned about the current situation and that the ECB is intent on forestalling mistaken expectations that it might shift toward dovishness in the near future. In line with this, she expressed strong confidence that the March Governing Council meeting will implement a 50bp rate hike.

Emergence of the Usual North-South Frictions

On the other hand, ECB board member Fabio Panetta (from Italy) stated at a February 16 event that – "By smoothing our policy rate hikes – that is, moving in small steps – we can ensure that we calibrate both elements more precisely in the light of the incoming information and our reaction function." – implicitly suggesting that it would be better to narrow the upcoming rate hike margin from 50bp to 25bp. That same day, Bank of Greece Governor Yannis Stournaras asserted that the ECB's interest rate hikes had already had an effect, suggesting that inflationary pressures were easing amid moderate expansion of economic activities, and urged that the interest rate hikes be slowed down (or halted). Now that the ECB's policy interest rates have been raised by a total of 250bp since last July, it seems that the euro area's usual north-south frictions are slowly emerging. Currently, gaps between German government bond yields and Italian and Greek government bond yields have narrowed significantly (see graph on previous page), so it cannot be said that monetary tightening has proceeded to an obviously detrimental degree in that regard. While it is undeniable that repeated interest rate hikes will eventually exacerbate the euro area's north-south frictions, it should be kept in mind that Italian government bonds have benefited from the flexibility of Pandemic Emergency Purchase Program (PEPP) reinvestments. Italian government bond yields are currently being restrained by the ECB's redemption of German government bonds – a peculiar consequence of quantitative easing policies (QE) the ECB has not completely rolled back despite its concerns about inflation. It is undeniable that Italy and other southern euro area countries will criticize the ECB's hawkishness, increasing north-south frictions, but it appears unlikely that a major rift will arise within the Governing Council on this issue any time soon, as the ECB has already made considerable efforts to alleviate those frictions. Potential strife seems more likely to occur when it becomes necessary to consider how long the flexible PEPP reinvestment policy can be sustained, at which point the Southern European countries can be expected to campaign for the protraction of that policy.



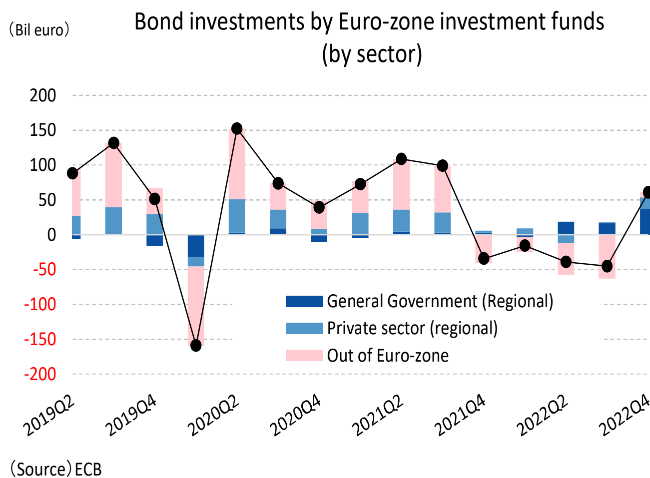
(Source) macrobond

Interest Rates Making Euro Area Bonds Relatively Attractive

A comparison of the ECB and FRB policy interest rates during 2023 factored in by financial markets suggests that the Fed is likely to suspend interest rate hikes midway through the year and perhaps then begin reducing interest rates, while the ECB appears likely for the time being to continue hiking interest rates and maintain relatively high rates. Given the stable relationship between EUR/USD and the Europe-U.S. interest rate differential (similar to the stable relationship between USD/JPY and the U.S.-Japan interest rate differential), if the financial market expectations turn out to be correct, forex market players' anticipation of EUR appreciation appears likely to pay off. Another noteworthy point is that, concurrently with its interest rate hikes, the ECB plans to reduce its balance sheet (QT) by EUR15 billion each month from March. President Lagarde has explained that the EUR15 billion figure "represents roughly half the

redemptions over that period of time" and is "an appropriate number" the ECB determined based on advice from market participants, but it is undeniable that the ECB's quantitative policies will soon have the effect of placing additional upward pressure on euro area interest rates. When explaining the portfolio reduction plan, President Lagarde emphasized that "the key tool is the interest rate" while balance sheet streamlining is a complementary measure, and it seems highly likely that the portfolio reduction pace will be revised when Eurosystem staff projections are revised in March, June, September, and December. Depending on future inflation trends, the ECB may naturally be considering accelerating that pace. At that time, it will be important to consider how much accelerated balance sheet streamlining will push up euro area interest rates and how capable southern euro area countries will be of coping with such higher interest rates. It seems clear that relatively fragile euro area countries will inevitably suffer under the combined impact of interest rate hikes and balance sheet streamlining.

According to the "Euro area investment fund statistics" published by the ECB once every quarter, all categories of investors have been net euro area bond buyers since the fourth quarter of 2022 (see graph). In particular, the fourth quarter of 2022 was the first period since the third quarter of 2021 that investors from outside the euro area have become net buyers of euro area bonds. It was during last year's fourth quarter that many investors began speculating that inflation trends in the euro area would continue to be more severe than those in the United States, causing increased attention to be directed at the likelihood that the ECB would become relatively hawkish. Previous issues of this article have focused on EUR buying accompanying improvement in Germany's trade balance, and it is now possible to confirm from the data that portfolio investment flows from outside the euro area are also likely to promote EUR appreciation. Unlike 2022, it seems that both the interest rate differential and the supply-demand situation are now positioning EUR to strongly contend with USD during 2023.



The Euro Area Economy Now and Going Forward – Current and Prospective Trends in Inflation Expectations

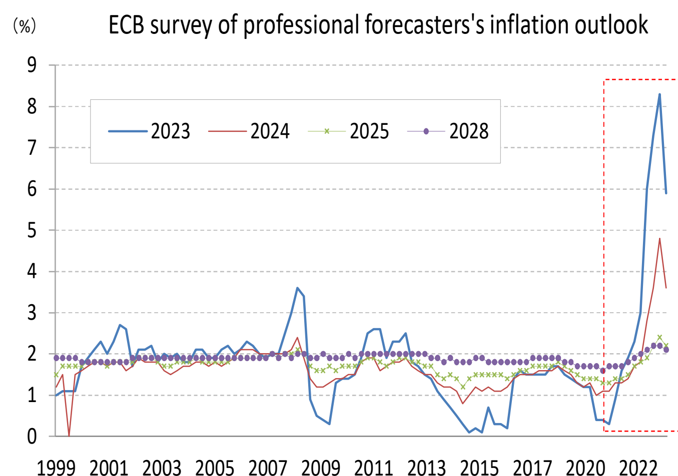
Market-Based Inflation Expectations Stable

The euro area's economic and financial conditions have been relatively firm since last year, and one gets the impression that EUR is strengthening as a result. The solid performance of the euro area's real economy is welcome, but given the ECB's current struggle to curb inflation, there are naturally concerns that economic recovery promote the persistence of relatively high inflation rates. Reflecting this, it was reported in February that German Bundesbank President Joachim Nagel was strongly arguing for greater ECB interest rates hikes, saying – "The interest rate step announced for March will not be the last. Further significant interest rate steps might even be necessary afterwards, too." As noted above, although comprehensive basis HICP has begun to peak out, there remains considerable upward pressure on core basis HICP, and it is impossible to dispel suspicions that core basis HICP uptrend will prove to be a sustained one.

If the rate of growth in core basis HICP continues to be high, it is feared that it may become impossible to prevent inflation expectations from remaining high or rising. Broadly speaking, inflation expectations fall into the categories of market-based expectations, reflected in break-even inflation rates (BEIs), and survey-based expectations, measured by questionnaires and other surveys. With respect to market-based expectations, as noted above, the ECB has traditionally focused on the five-year in five years inflation swap break-even inflation rate (5-year BEI). The 5-year BEI has been generally stable in the 2.0%-2.5% range over the past year, so it does not seem to indicate an uncontrollable inflation situation going forward. Given that the European debt crisis greatly reduced euro area inflation expectations and even promoted persistent deflationary trends, it is possible to conclude from recent 5-year BEI trends that market-based inflation expectations are beginning to normalize. It appears that the ECB would ideally like to keep the 5-year BEI at approximately its current level while lowering actual inflation rates.

Survey-Based Inflation Expectations Difficult to Interpret

On the other hand, survey-based inflation expectations appear to have declined from recent historically high levels, but the reality is that the direction of survey-based inflation expectation trends is still hard to predict. To assess survey-based inflation expectations, ECB has traditionally focused on the quarterly Survey of Professional Forecasters (SPF) reports, the most recent of which was released on February 3. As the graph shows, the SPF's current calendar year (year of survey) inflation expectations and one-calendar-year-forward inflation expectations jumped to unprecedented levels at the end of 2022 but are starting to show signs of peaking out in the latest survey (for the January-March 2023 period). Looking at the specific numbers, however, one finds that expected inflation rates are still quite high – at 5.9% for this year (2023) and 3.6% for the next year (2024) – and it seems somewhat unlikely that such levels of inflation will permit the ECB to undertake a policy pivot. Looking further ahead, the SPF forecasts anticipate that inflation rates will finally become relatively controlled, descending to 2.2% in two years (2025) and to 2.1% in five years (2028).

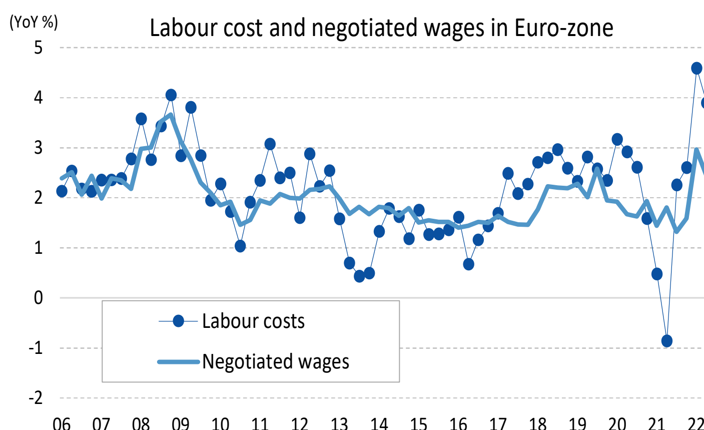


(Source) ECB

Compared to the SPF's 4th quarter 2022 survey, the 1st quarter 2022 survey has revised inflation rates for 2023 and 2024 upward – "Respondents indicated that the upward revisions reflect recent data outturns, ongoing stronger and broader than expected indirect effects as well as higher forecast wage growth." It appears that the euro area economy's biggest problem at this time may be the ongoing shift in principal inflation-boosting factors, from energy factors to non-energy factors.

ECB Considers Overkill Better than Underkill for the Time Being

At the time this article was written, the latest HICP growth figures (for January) were 8.6% on a comprehensive basis and 5.3% on a core basis, neither of which would justify a ECB policy pivot. As explained above, market- and survey-based inflation expectations are more important than actual HICP figures from the perspective of forward-looking monetary policy management, and while market-based inflation expectations may be considered moderate, the height of survey-based inflation expectations is alarming. If inflation expectations remain strong, there is concern that firms may proactively increase their selling prices and thereby promote wage inflation. If a price-wage spiral begins, it will take a considerable amount of time to subdue it. In light of this, it appears that the ECB still has a strong incentive to sustain its interest rate hikes based on the view that overkill is less dangerous than underkill.



Source: Macrobond
Notes: It differs from the actual labour cost growth due to unsettled wages.

Looking ahead, it is hard to imagine that the ECB would moderate its hawkish stance until it can clearly confirm that SPF-based inflation expectations have considerably diminished and that negotiated wage statistics (released quarterly) show that the buds of wage inflation have been completely eliminated. This upshot is that that no matter how far headline HICP growth rates descend, one cannot expect an ECB policy pivot based on that factor alone. The currently prevailing assumption in the interest rate futures market is that the ECB will continue hiking interest rates even if the Fed discontinues its interest rate hikes, and this is a solid basis for expecting EUR exchange rates to remain firm this year.

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

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