Forex Medium-Term Outlook

MIZUHO

March 31, 2023

Overview of Outlook

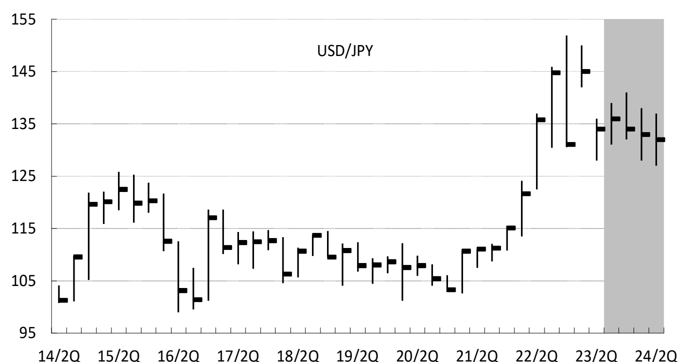
USD/JPY declined in March. However, the fact that it did not become stably established below the 130-yen rate despite the emergence of global financial fears left an impression. It is true that JPY has been appreciating against USD since November last year, but the directionality is not all that strong in real-effective terms, with the weak-JPY trend continuing since last year. Further, on the interest rate side, the phase in which +75bp rate hikes were normal seems to have given way to a phase in which there is even speculation of an early start of rate cuts – it is noteworthy that even this has not resulted in USD/JPY falling below 130. This seems to indicate the dangers of predicting the direction or level of JPY rates based solely on interest rate trends. I remain convinced of the importance of strong downward pressures on JPY from supply-demand factors in forecasting the outlook for the currency. For the first two months of 2023, Japan posted an unprecedented trade deficit worth -JPY 4 trillion. The -JPY20-trillion trade deficit it posted for 2022 is also expected to impact JPY rates this year with a slight delay. Under such circumstances, it would be natural to assume a net selling impact from demand-side factors when thinking of the outlook for JPY going forward. One scenario in which JPY could unexpectedly strengthen is if there is an increase in international financial fears, causing the Fed to switch to rate cuts earlier than planned. If this results in a marked decline in U.S. interest rates, one can expect USD/JPY to slip below the 130 level and remain there stably. Of course, going by developments since last year, JPY's stature as a safe-haven currency seems to be waning, and I would like to emphasize this qualitative difference in JPY compared to its erstwhile status.
EUR strengthened in March. In spite of the chaos resulting from the restructuring of a major European financial institution, the ECB Governing Council went ahead and implemented a +50bp rate hike in March as announced. Concerns regarding a wage-price spiral continue to smolder within the region. With a clear increase in minimum wage levels by large corporations amid a strong sense of labor shortages, the situation remains extremely unconducive to the ECB relaxing its pace of rate hikes. As of the time of writing this report, the interest rate futures markets have factored in the possibility of a +25bp rate hike by the ECB from the current +3.00% to 3.25% by June, the retention of this rate over summer, until September, and a move to cut rates from around the beginning of next year. Compared with the Fed, regarding which the markets are beginning to factor in rate cuts from July onward, the prospects for EUR as a buying currency seem more attractive from the interest rate perspective. However, realistically, rather than discussing the possibility of rate cuts by the ECB, it may be more important to consider the validity of assuming that the ECB will stop after implementing a single +25bp rate hike. The possibility of the ECB continuing to hike rates beyond summer cannot be ruled out. From the perspective of forex markets, I predict it will be easier for EUR to strengthen against USD during the second half of the April-June quarter and during the July-September quarter, when the U.S.-euro area interest-rate gap comes into focus.

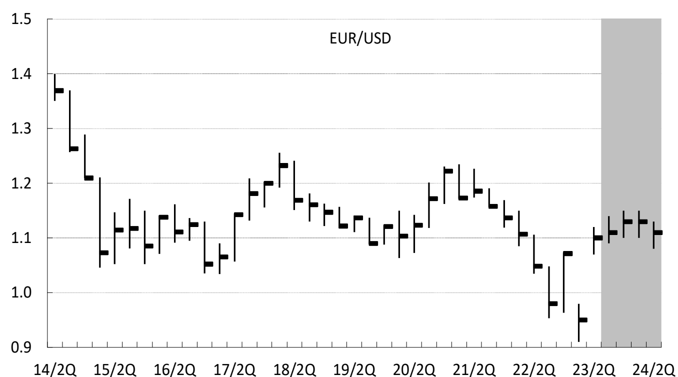
Summary Table of Forecasts

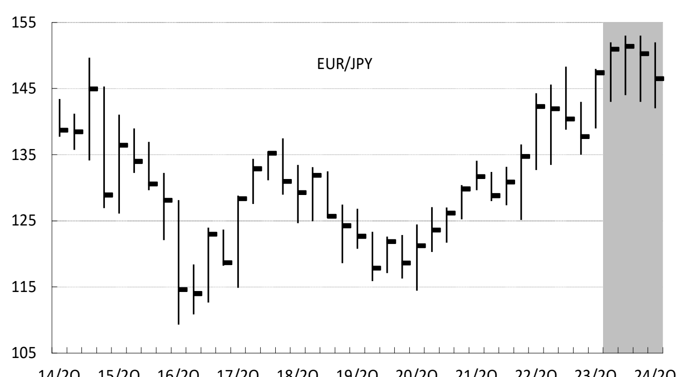
	2023 Jan- Mar（Actual）	Apr -Jun	Jul - Sep	Oct - Dec	2024 Jan - Mar	Apr - Jun
USD/JPY	127.22 ～ 137.90 (133.25)	128 ～ 136 (134)	131 ～ 139 (136)	132 ～ 141 (134)	128 ～ 138 (133)	127 ～ 137 (132)
EUR/USD	1.0482 ～ 1.1034 (1.0915)	1.07 ～ 1.12 (1.10)	1.09 ～ 1.14 (1.11)	1.10 ～ 1.15 (1.13)	1.10 ～ 1.15 (1.13)	1.08 ～ 1.13 (1.11)
ERU/JPY	137.45 ～ 145.56 (145.45)	139 ～ 148 (147)	143 ～ 152 (151)	144 ～ 153 (151)	143 ～ 153 (150)	142 ～ 152 (147)

Notes: 1. The actual results were released at around 10a.m. tokyo time on 31 March 2023. 2. Data source from Bloomberg.
3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts



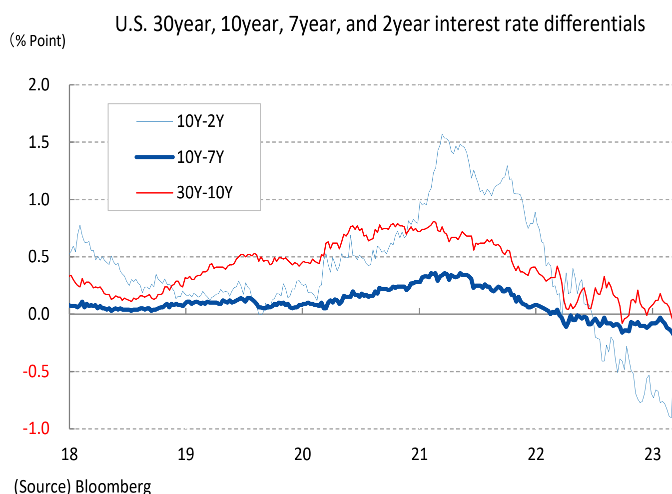




USD/JPY Outlook – Tug of War Between JPY Appreciation Effect of Interest Rates and JPY Depreciation Effect of Supply and Demand

SVB Collapse – Impact of Rate Hikes and Careless Bank Supervision

In March, international financial fears suddenly increased. On March 10, it was reported that U.S.-based Silicon Valley Bank (SVB), a major bank responsible for financing technology companies, had filed for bankruptcy. Immediately after that (early in the morning of March 13, JST), the U.S. Department of the Treasury, the Federal Reserve Board (the Fed), and the Federal Deposit Insurance Corporation (FDIC) issued a joint statement to say that they had approved actions enabling the resolution of SVB in a manner that fully protected all depositors. The statement declared "Depositors will have access to all of their money starting Monday, March 13." A chain-reaction of bank runs in the U.S. banking sector seemed to have been prevented, but as of the writing of this report (three weeks since that date), it remains difficult to declare that the situation is fully under control.



(Source) Bloomberg

I will leave detailed analyses of the current state of the U.S. startup industry and the details of SVB's finances to brighter minds, but <u>from a macroeconomic analysis point of view, the recent turn of events appears to have been the combined result of the impact of rate hikes and careless bank supervision</u>. With no marked slowdown in fundamental U.S. economic indicators, the impact of the Fed's rate hikes was not entirely obvious. In fact, until right before the collapse of SVB, the biggest focus of attention was whether or not it would be possible to increase the margin of rate hikes from +25bp to +50bp. Of course, <u>while acknowledging the strength of the real economy, the financial markets were also discussing the significant inversion of the yield curve (long-term interest rates higher than short-term interest rates) on a daily basis (see figure)</u>. The basic business model

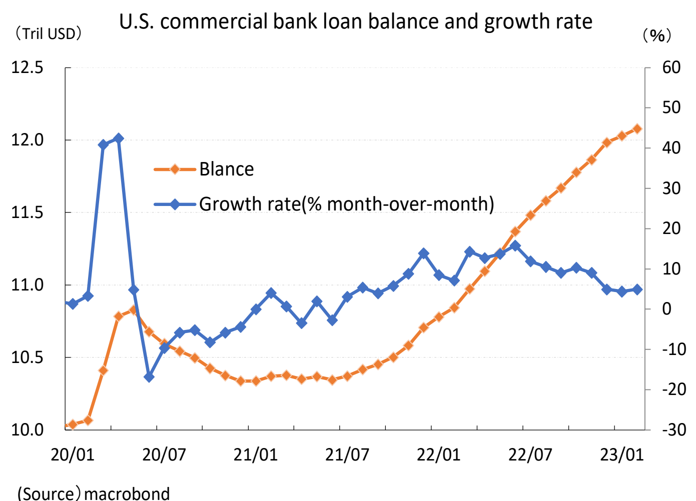
in such a scenario generally involves banks procuring short-term funds and investing them in long-term assets such as loans and securities to earn the higher long-term interest rate, and this normalization of yield-curve inversion has a fundamentally constricting effect on the banking business model, not just for banks such as SVB, but for the banking sector as a whole.

Further complicating this macro situation was the fact that SVB was a key financial institution in Silicon Valley on the U.S. West Coast. The nature of startup firms makes it easy for deposits from them to be required back within short periods. Also, given that these depositors are not individuals but companies, their withdrawals tend to be made on short notice and in large amounts. Because of this, deposits are at risk of decreasing at a marked pace from the liability side of a bank's balance sheet. For SVB, this problem was compounded by the higher cost of procuring new funds thanks to the Fed's rate hikes. While deposits were liable to melt away rapidly on the liability side, what was happening on the asset side? SVB had invested funds procured through deposits in securities with the intention of holding them till maturity. As interest rates increased, the bank became saddled with huge unrealized losses. Of course, the unrealized losses would remain unrealized if the investments were held till maturity, but the bank was forced to sell off its securities before maturity due to the rapid withdrawal of deposits. SVB attempted capital expansion in an attempt to offset its unrealized losses, but the attempts failed and led to the bank's collapse.

Ordinarily, financial institutions optimize their balance sheets and maximize revenues by balancing the interest rate risks, credit risks, liquidity risks, and other risks pertaining to their assets and liabilities. This is called Asset Liability Management (ALM). From the perspective of ALM, since deposits are short-term liabilities, the assets corresponding to them should ideally be short-term bonds and other highly liquid and highly safe assets. However, SVB had invested mainly in long-term assets such as long-term bonds and mortgage-backed securities (MBSs). This sloppy ALM by SVB and the carelessness of the financial regulatory agencies in overlooking this sloppiness are now being pointed out as the culprits behind the recent situation. Some are expressing surprise that such a bank could even exist in the stricter financial regulatory environment following the collapse of Lehman Brothers, and we could see discussions questioning the state of the U.S. financial regulatory system itself going forward.

The Fed's Dilemma – Monetary vs. Macroprudential Policy

The Fed managed to implement another rate hike in March, but it may face a big dilemma going forward for some time to come. Central banks have primarily two responsibilities. One is, of course, conducting monetary policy. The other is conducting macroprudential policy (policies for the supervision of banks). However, because the operation of monetary policy can directly affect the soundness of financial institutions, the two responsibilities frequently risk being at odds. As mentioned above, the most conspicuous verdict following SVB's collapse as a result of its balance sheet vulnerabilities (careless ALM) being overlooked by the regulatory bodies is that this was a macroprudential policy failure. Speculation in the markets about the possibility of the Fed starting rate cuts early as a result of the SVB incident is based on the assumption that the Fed will compensate for its macroprudential policy failure by revising its monetary policy. This is a typical conflict of interests that arises between the two responsibilities of the Fed, and is an inherently undesirable way to conduct policy.



The Fed retained its preplanned policy path at its March FOMC meeting (details follow). If, as U.S. monetary officials say, the collapse of SVB is unlikely to have a ripple effect on the financial system as a whole, the decision to compensate for macroprudential policy failure by revising monetary policy is not a logical one. What is the reason for conducting rate hikes in the first place? One of the reasons is to keep out economic entities such as SVB, which take careless risks. As of the present time, the credit environment is still fairly robust, and this itself poses an inflation risk (see figure). As is generally known, starting February, there were rumors of the possibility of monetary policy being further tightened in order to curb inflation. Even assuming that the rise in interest rates was one of the reasons behind the collapse of SVB, it is too much of an abrupt change to stop rate hikes at this point, leave alone switch to rate cuts, given the Fed's earlier communication to the effect that interest rates had to increase, and probably faster than they already were, in order to contain inflation. I think the reasonable thing would be for the Fed to continue with its rate hikes.

Worst-Case Scenario Would be Uncontrollable Inflation; Weak-JPY Scenario Continues

Of course, if the central bank had to choose between price stability and financial system stability, it would prioritize financial system stability in order to avoid the risk of near-term panic in the markets. However, if the systemic risks are judged not to be very significant, monetary policy is likely to be continued as planned. In the short term, the worst-case scenario would be heightened fears for the health of the financial system as a whole (as during the period following the collapse of Lehman Brothers), but in the medium/long term, the worst-case scenario would be accelerating inflation resulting from the failure to implement the necessary rate hikes out of consideration for macroprudential policy. In other words, the worst-case scenario would be the prospect of runaway (uncontrollable) inflation, necessitating another round of significant rate hikes in response to a second round of inflation accompanying a rise in wages.

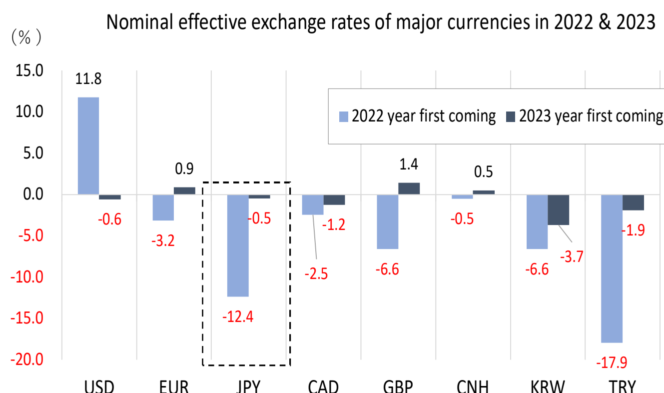
Based on the above logic, the March FOMC decision to raise interest rates was quite natural (details follow). The Fed's major theme pertaining to rate hikes since before the collapse of SVB has been "higher for longer," and it will be interesting to see going forward whether "longer" will be changed to "shorter." In other words, even assuming that the collapse of SVB does not turn into a systemic risk, it is quite possible that the collapse of an institution that served as the U.S. West Coast's economic and financial nucleus will result in the slowdown in employment and wage growth in the U.S. startup industry. Fed Chair Jerome Powell himself said at the March FOMC that this recent series of events would have an effect similar to rate hikes. In this report, I have been predicting that the Fed will begin to talk about rate cuts sometime in January-March 2024, but the recent chain of events may have served to bring that forward to the October-December 2023 quarter.

Having said that, I still see no need to overturn my basic forecast scenario so far. Although my prediction of JPY depreciation against the backdrop of an increase in U.S. interest rates/USD appreciation may have been postponed temporarily, there seems no reason to worry about an excessive JPY appreciation unless the Fed decides to start rate cuts early. As I have repeatedly explained in this report, the JPY depreciation trend since last year is not solely the result of greater USD buying, but probably also includes an element of pure JPY selling. To put it simply, even if JPY selling in exchange for USD in response to an increase in U.S. interest rates stops, JPY selling against the background of Japan's enormous trade and service deficits will not stop. Near-term interpretations of market trends tend to focus on forex rates revolving around interest rate movements, but given that Japan has, in recent years, undergone a major change in its supply-demand structure, my larger perspective remains that it will be difficult for USD/JPY to return to its previous (105-115) range.

Basic Understanding of the Forex Market – Not Much Change in JPY Depreciation Trend

The Need for a Bird's-Eye View of Key Currencies

The international financial fears that emerged with the collapse of SVB on March 10 went beyond being a U.S. regional bank's management-related problem and resulted in the reorganization of a major European financial institution. The mood in the markets, which had previously been focusing on the margin and frequency of rate hikes by the Fed and the ECB, changed instantaneously to one of closely monitoring near-term developments to ascertain whether the situation was in control. The markets are probably somewhat confident that a second global financial crisis, similar to the one in 2008, cannot take place given the stricter capital regulations, but my reading of the situation as of the time of writing this report is that they are not fully confident.



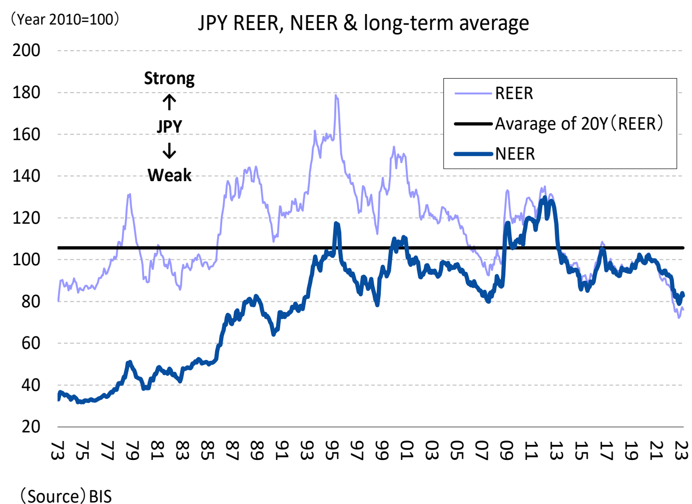
(Source) macrobond, as of 21MAR2023

When it comes to formulating forex, and especially USD/JPY, outlooks, I hope not to put myself at the mercy of near-term fears and the associated interest rate trends. The sharp decline in U.S. interest rates with the rise of global financial fears and the accompanying appreciation of JPY against USD may seem to have made it difficult to forecast JPY weakness, but as of the time of writing this report, I see no change in the overall climate favoring JPY weakness. Japan's trade deficit for the first two months of 2023 was an unprecedented -JPY 4 trillion. It must also be taken into account that the -JPY20-trillion trade deficit posted for 2022 is expected to impact JPY rates this year with a slight delay. Under such circumstances, it would be natural to assume that demand-side factors are still exerting a net selling effect on JPY. The figure provides an overview of the current state of various key currencies by comparing how much their nominal effective exchange rate (NEER) has changed since the start of 2022 (as of 21 March 2023). JPY, it is obvious, has not changed much since the start of 2022. In 2022, USD appreciated against most global currencies, but JPY's depreciation against USD was particularly marked. Most analysts seem to expect a strong rebound from the 2022 trend in 2023, but that has not happened so far. JPY's NEER plummeted against USD by double-digit figures (reminding one of the Turkish lira some years ago) and has still not fully recovered, so it should not be objectionable to say that the weak-JPY trend is continuing.

Since the peaking of USD/JPY at 152 in late October 2022, the Fed's margin of rate hikes has fallen to a third of what it was, and speculations arose of an end to rate hikes (and possibly the start of rate cuts earlier than expected). Amid all this, USD/JPY did tumble to a year-to-date low of 127.22 in January, but subsequently recovered to the 130 level, where it has remained stably since. Incidentally, the recent appreciation of JPY against USD was not just due to the Fed's policy operation but also partly due to speculations of monetary policy normalization by the upcoming new BOJ administration. As I have persistently argued in this report, while interest rate trends are certainly useful for explaining near-term JPY fluctuations, the fact is that actual demand for JPY remains very low, with a larger number of people want to sell rather than buy the currency, and my view is that this will make it very difficult for USD/JPY to return to the level it was in (113 yen to the dollar) before the ongoing JPY depreciation phase began.

REER Indicates No Correction of JPY Weakness

The sharp decline in USD/JPY from 152 to 127 over the space of a mere three months or so between October 2022 and January 2023 is bound to have made a mark on forex market participants. Also fresh in the memory is the currency pair's rebounding to around 137 in February before quickly falling back to 130 or so. However, as mentioned above, JPY has not appreciated much at all in terms of its real-effective exchange rate (REER). The figure plots JPY's NEER and REER trends starting 1973. While the NEER is currently at the same level as it was in around 2007, at the peak of the "weak-JPY bubble," REER is at the same level as it was before the introduction of floating exchange rates, in 1971 or so. When viewed over an extremely long period in this way, one gets a good understanding of the extent of JPY depreciation from 2021 through 2022, and the currency's nominal appreciation from October 2022 through January 2023 does not seem so significant. It is worth noting that JPY's REER, which still remains at the weakest it has been in 50 years, reflects Japan's capacity to buy foreign goods and services, and its level indicates no change in the "cheap Japan" situation.



Interest Rates Cannot Single-Handedly Change JPY Rate Direction or Level

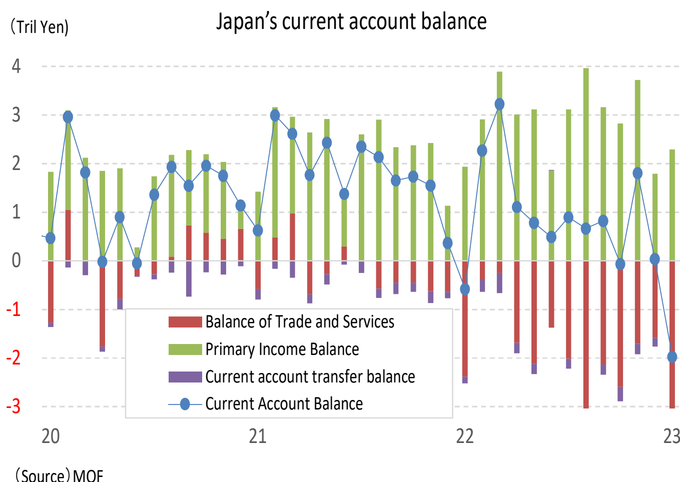
In this report, I formulate my forex outlooks based on the assumption that global financial fears will subside without further problems and the main focus will return to curbing inflation. Consequently, I am of the view that there will only be limited upward pressure on JPY from (U.S.) interest rate trends following any decision by the Fed to begin cutting rates earlier than expected. In the first place, despite the transition from a phase where +75bp rate hikes had been normalized to a phase in which there is speculation of rate cuts starting early, USD/JPY has not fallen below 130 in any stable manner. In other words, it seems dangerous to contemplate JPY rate direction and level based solely on interest rate trends. The main takeaway from this situation is that the downward pressures on JPY from the supply-demand side are extremely strong.

Of course, should global financial fears really result in an early start of rate cuts, this could be an unexpected upside risk for JPY (discussed in detail as a risk to my main scenario). However, even in such a situation, my view is that USD/JPY may barely fall to 125 or so. Moreover, even if USD/JPY falls to the 125 level, the historical weakness of JPY as indicated by its NEER and REER is unlikely to change right away. Especially when it comes to REER, which takes into account relative differences in prices, JPY is likely to remain at the current 50-year low level for some time to come. The weakness of JPY as seen from its NEER and REER does not reflect the expansion/contraction of domestic-foreign interest rate gaps so much as it reflects the structural changes in JPY supply and demand that have taken place over the past 10 years, so one must forecast the outlook for JPY while keeping the bigger picture in mind – namely that the "cheap Japan" situation is unlikely to change much.

JPY Basic Supply and Demand – Reviewing the Structural JPY Weakness Theory

Is the Structural JPY Weakness Theory Really Worth Considering?

Since February, USD/JPY movements have become unpredictable against the backdrop of changing Fed policy interest rate forecasts amid international financial fears. In his Congressional testimony in early March, Powell's specific statement, "If the totality of the data were to indicate that faster tightening is warranted, we would be prepared to increase the pace of rate hikes," drew a lot of attention and gave rise to the prospect of USD/JPY soon returning to the 140-yen mark. Following the collapse of SVB, however, the mood changed dramatically, and the main focus of attention has become "will there be a rate cut this year?" This resulted in USD/JPY falling below the 130 level intermittently during March. The phenomenon of near-term USD/JPY trends being determined by U.S. interest rate levels is not new, but as I repeatedly argue in this report, my consistent position is that interest rates and JPY supply-demand must be viewed as two distinct factors when considering the outlook for USD/JPY.



Last year, we saw the largest ever depreciation of JPY, and this was not just because of an expansion of the U.S.-Japan interest-rate gap, but also because of a change in JPY supply and demand, as symbolized by the largest ever trade deficit posted by Japan. Interest rate trends, which are directly linked to the "next move" by a central bank, tend to draw the attention of the markets more easily, but supply and demand trends are equally important. In this connection, Japan's January Balance of Payments, which were released in March, seem to suggest that it will be difficult for JPY to appreciate consistently against USD going forward. In January, Japan posted its largest Current Account deficit since records began, at -JPY 1.9766 trillion. Of course, the January Trade deficit of around -JPY 3.5 trillion (the largest ever on record) had already been released, so the Current Account deficit did not come as a surprise. One also needs to take into account the seasonal factors that tend to expand the Trade deficit in January. Having said all that, the recent results were interesting in that there were strongly reminiscent of those seen a year ago. In March 2022, the January 2022 Current Account balance was released, revealing the second largest deficit ever to be posted until then. Moreover, resource prices around the world had suddenly increased, prompting me to warn of structural factors indicating the possibility of JPY depreciation. My March 9, 2022 Mizuho Market Topics titled "Are Current Account Deficits the New Normal? – Japan's Transition into an Asset Liquidator" discussed the possibility of a JPY depreciation trend. This was met by numerous protests from those who maintained that the deterioration of the Current Account balance was temporary and that worries about structural JPY weakness were exaggerated. But what actually happened subsequently? USD/JPY, which was at the 114 level when the January 2022 Balance of Payments was released (on March 9), climbed to almost 152 over the course of the next seven months. The markets are dominated by analysts attempting to chalk this all up to the expansion in the U.S.-Japan interest rate gap, but one has to wonder – is this level of JPY depreciation warranted simply by a mere +400bp increase in the 10-year interest rate? I believe that, alongside the interest rate factor, the simultaneous dramatic change in JPY supply and demand was also responsible for JPY's depreciation.
In 2022, the structural changes in the Japanese economy as seen from the theory of the stages of economic development based on the balance of payments and the accompanying JPY depreciation drew significant attention. It does not seem all that unreasonable to assume that the unprecedented JPY depreciation seen last year was part of the process of Japan entering a new stage of economic development. At the very least, it seems reasonable to say that, a year ago (in March 2022), not many could have foreseen USD/JPY topping the 150-yen mark or Japan posting its largest ever current account deficit in January 2023. It is not all that outlandish to imagine the possibility that the Japanese economy's external sector is on the verge of a structural change.

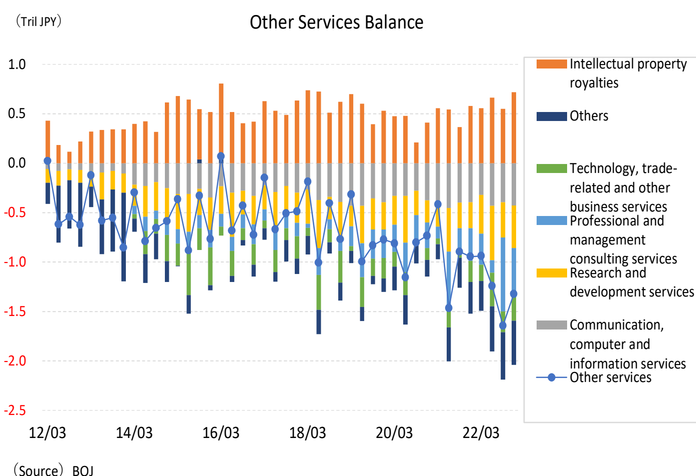
Four Observations Related to the Balance of Payments

Of course, it would be premature to make predictions for the entire year based on the figures for January alone, but going by the Balance of Payments for all of 2022, one can make the following four observations with a significant degree of accuracy: (1) the Trade deficit level has increased, (2) Japan's Primary Income surplus does not serve to arrest JPY depreciation, (3) the Travel surplus is one of the few remaining ways for Japan to earn foreign currency, and (4) the Other services deficit appears to be expanding. Of the four observations above, (1) does not need much explanation. The average price of crude oil was around USD 58/barrel during 2017-19, but had increased by nearly 60% to USD 91/barrel over the past year. As of the time of writing this report, the prices have gone down, mirroring an increase in international financial fears, but still remain around USD 70/barrel. Given that 25% of Japan's imports are mineral fuels led by crude oil, how must this roughly 20% increase in the value of mineral fuel imports be interpreted? I believe, it signifies a structural expansion of the deficit and implies an increase in market participants looking to sell JPY.
Moving on, Observation (2) is based on the fact JPY depreciated in 2022 more strongly than it ever had before despite Japan posting a total Current Account surplus of +JPY 11 trillion for the entire year. While Japan's Trade and Services balance for 2022 as a whole posted the largest ever deficit, at around -JPY 21.4 trillion, its Primary Income balance posted the largest ever surplus, at around +JPY 35.3 trillion. However, the resulting +JPY 11 trillion Current Account surplus was unable to contain the JPY depreciation trend as USD/JPY soared to almost 152. This essentially indicates that the Primary Income surplus is earned and retained as foreign currency in overseas locations and does not contribute to foreign currency flows that could stabilize JPY.
Taking all this into account, it would appear that Observation (3), that the Travel surplus is one of the few remaining ways for Japan to earn foreign currency, is one of the few bright spots in an otherwise dim scenario. Having said that, the Travel surplus was a mere +JPY 2.7 trillion even at its peak (in 2019), so it would be too much to expect it to fundamentally change the composition of Japan's Current Account balance. The first step to make the best of a bad situation is to completely abolish all border control measures in an effort to erase Japan's image around the world as a "isolationist country," which was created needlessly toward the end of the pandemic, and thereby to gradually increase the Current Account surplus level one step at a time.

Other Services Balance Contributing to Japan's Transition into Asset Liquidator?

One thing to keep in mind going forward, as discussed also in the previous month's issue of this report, is the fact that (4) the Other services deficit is expanding. The Services balance comprises the combined balance of Travel, Transport, and Other services, of which the 2022 balance of Other services was -JPY 5.1451 trillion, the largest ever deficit since the beginning of records. At this rate, even if the Travel surplus recovers to its peak level (roughly +JPY 2.7 trillion in 2019), it cannot offset more than half of the deficit posted by Other services.

Other services include a diverse variety of services, but as last month's issue of this report showed, "telecommunications, computer, and information services," which include fees for the use of cloud services paid to IT giants including GAFA (Google, Apple, Facebook, Amazon), and "professional and management consulting services," which include the purchase/sale of advertising space on websites and sponsorship fees for sporting events, have posted major deficits. The 2021-22 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 (see figure on previous page). Assuming that Japanese cloud services are unlikely to be taking the world by storm any time soon, it seems more likely than not that Other services will essentially become a major source of deficits. In the process of transitioning from a mature creditor into an asset liquidator, it is thought that a country's Trade and Services deficit would surpass its Primary Income surplus, and it appears that the Other services deficit may help usher in such a future in Japan's case.



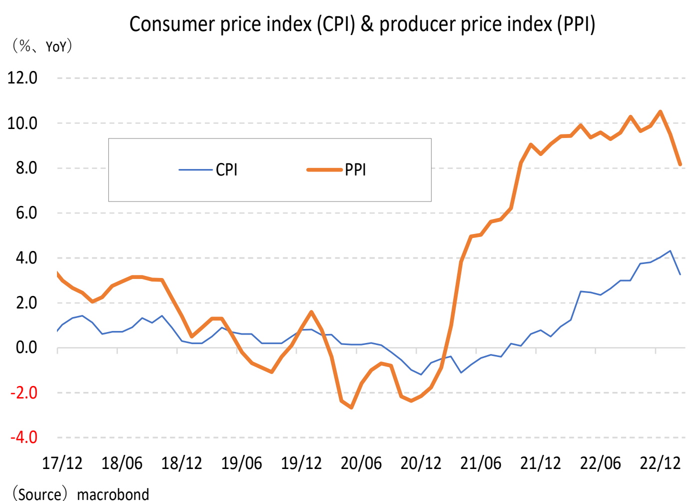
(Source) BOJ

Of course, it is unwise to draw major conclusions from a single month's Current Account balance, but looking at the bigger picture, it is obvious that the Japanese economy's external sector has been undergoing major structural changes over the past 10 years, and <u>I believe it is important to take this into consideration when formulating the medium-term outlook for JPY. At times, this factor may be even more important than the frequency or margin of the Fed's rate hikes</u>.

Japanese Economy Now and Going Forward – Scars of JPY Weakness Remain

B2B Transactions Also Impacted by Non-Energy Inflation

As of the time of writing this report, inflation has clearly peaked in the U.S. and Europe, but Japan's rate of inflation remains high. Going forward, if the SVB collapse results in a chain of events leading to U.S. and European central banks ending their rate hikes (although I consider this unlikely), Japan's continuing inflation would hint at a shrinking of the foreign-domestic interest-rate gap, and the possibility of this inviting JPY appreciation cannot be ruled out. In this context, Japan's February producer price index (PPI), which was released on March 10, was quite interesting because it confirmed the presence of residual inflationary pressures. While mom growth was -0.4%, the first negative since November 2020 and lower than the median of market forecasts (-0.2%), yoy growth remained significantly high, at +8.2%. Of course, yoy growth had also slowed down from the previous month's +9.5%, indicating some progress in containing inflation.

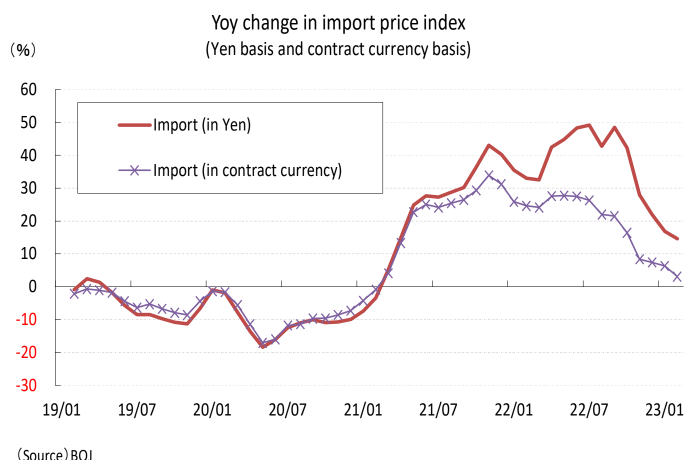


(Source) macrobond

However, one of the factors contributing to the slower growth of PPI in February is the government's "dramatic electric power and gas price relief measures," which came into effect in February. For instance, the negative mom contribution from electric power, city gas, and water is larger than the overall negative mom growth, at -0.52 pp. Apart from this, as is generally known, crude oil prices have begun to stabilize (they are not falling dramatically, just stabilizing), so that the contribution from petroleum and petroleum products is also negative, at -0.10 pp. Timber and timber products are another category that have contributed slightly negatively to mom growth, at -0.02 pp. <u>When these three product categories (electric power, gas, and water; petroleum and petroleum products; timber and timber products) are excluded, mom growth is +0.2%. From these results, it can be gauged that non-energy categories are increasingly leading inflation in business-to-business (B2B) transactions also</u>. Incidentally, the February consumer price index (CPI) also shows signs of peaking thanks to the impact of the government's electric power and gas price relief measures (falling from +4.3% in January to +3.3% in February), but it is difficult to say at the current time whether such changes indicate the stabilizing of prices as a trend.

Scars of JPY Weakness Remain

It appears that JPY depreciation more-or-less coincided with import-led inflationary pressures (details below), but the price pass-through process is still underway, and inflationary pressures seem likely to remain for downstream, i.e., final goods in the real economy. As the figure on the previous page shows, both PPI and CPI growth have begun to shrink, and high corporate costs are now beginning to be passed on to the consumers. Amid a larger-than-typical increase in nominal wages, it remains to be seen whether the trend can continue. Further, looking at the import price index, import prices on a contracting-currency basis grew by just +3.1% yoy, the lowest growth in two years, clearly indicating that the inflationary effect of soaring resource prices has finally weakened. On the other hand, import prices in JPY maintained a significant double-digit growth by +14.6% yoy (see figure).



(Source) BOJ

Import prices in JPY more closely reflect the experience of households and corporations, so it would not be inappropriate to say that cost-push inflation, which came to the fore as a social issue last year, continues to be a problem the Japanese economy faces today. As I have explained several times in this report, the question of whether JPY weakness is good or bad for the Japanese economy, which became a topic for heated discussion in 2022, needs to be viewed separately from the macro and micro perspectives. However, it must be acknowledged that, despite the end of high resource prices, Japanese consumers are still facing the practical problem of having to pay a higher price for imported goods due to JPY weakness. In this way, the deterioration of Japan's terms of trade, and thereby its real gross domestic income (GDI), is dampening consumption/investment appetites in the Japanese economy.

Ueda Administration to Carefully Consider the Scars of JPY Weakness

Despite being nominated as one of the top buzzwords (or phrases) for 2022, "unfavorable JPY weakness" seems to have stopped drawing attention after USD/JPY peaked out at 152. However, as seen above, the scars of JPY weakness remain and can clearly be seen in price and GDP statistics. It will be interesting to see how the new BOJ administration under Kazuo Ueda handles the situation. The new administration does not seem committed to the perverted reflationary theory that price rises and economic recovery have a cause-and-effect relation, with the latter being the effect of the former. It seems likely, therefore, to carefully take into consideration an analysis of the real economy, including the deterioration of the GDI and expansion of trade losses, and avoid excessive austerity in monetary policy operation.

In other words, I believe the new administration is unlikely to entertain external voices urging or expecting policy normalization amid faster or consistently high growth in headline price indicators. As I have said previously in this report, the Ueda administration's first priority will be to bury the two bad policy moves of the previous administration – negative interest rates and yield curve control (YCC), which have gone too far and require correction. Beyond this, I do not believe the administration will move to tighten monetary policy.

In that sense, the JPY depreciation since last year, which has been pushing prices up, may be viewed as a having a monetary easing rather than tightening effect by the new administration.

U.S. Monetary Policies Now and Going Forward – Rate Hikes May End in May as Planned

Impact on People's Lives is Key Issue U.S. Authorities Must Address

At the closely watched March FOMC meeting, the Fed implemented a +25bp rate hike, raising the target range for the federal funds (FF) rate to 4.75-5.00%. While some had predicted an end to rate hikes, the Fed's decision was as originally planned. From a medium- to long-term perspective, the worst-case scenario for the Fed would be accelerating inflation and the prospect of another round of significant rate hikes in response to a second round of inflation accompanying a rise in wages. In a situation where inflation became uncontrollable, social instability would be inevitable.

Specifically speaking, the biggest problem in the U.S. at the moment is the soaring prices of milk, eggs, and utilities, resulting in a continued worsening of real income for consumers. Of course, if systemic risks become a realistic problem amid financial fears, the Fed would have to suspend its rate hikes (or even begin cutting interest rates), but the majority view seems to be that this is not that urgent a problem as of now. By contrast, the deterioration of real incomes due to stubbornly high inflation rates is definitely a real-life problem, and one that is difficult to ignore even politically. Rather than bail out financial institutions that have become unstable as a result of sloppy risk management, policy operation considerate of people's lives are the need of the hour, both economically and politically speaking. It must be noted in this context that the Fed may also have been taking the Biden administration's interests into account in its recent FOMC decision.

Financial Fears not Factored into the SEP

Of course, ignoring the systemic risks that come with financial fears is bound to greatly impact the lives of the people. In this context, the FOMC statement notes, “Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity.” Given that the recent turmoil, through tighter credit conditions, is likely to dampen employment and wage growth as well as curb inflation, there is a possibility of it serving to apply the brakes on the Fed’s rate hike path. In fact, in his press conference, Fed Chair Jerome Powell stated that the recent bank collapses could be thought of as being equivalent to a rate hike and mentioned the possibility of this impacting the path of policy interest rates going forward. However, for now, the FOMC statement clearly notes that “The extent of these effects is uncertain” and that “The Committee remains highly attentive to inflation risks.” In his press conference again, Powell noted that there was a great deal of uncertainty regarding the impact of the recent bank collapses, which made it difficult to predict how it would affect the real economy. He went on to admit that the revised Summary of Economic Projections by FOMC staff members (SEP, see figure) did not fully reflect the situation. This time, the real GDP growth rate forecasts for 2023-25 were +0.4％→+1.2％→+1.9％, with the forecasts for 2023 and 2024 being lowered by -0.1 pp and -0.4 pp, respectively, but the Fed’s conclusion seems to be that it does not really know at the current time whether the upside risks or the downside risks pertaining to this forecast are stronger. Further, the core PCE deflator forecasts for 2023-25 in the recent SEP were +3.6％→+2.6％→+2.1％, with the forecasts for 2023 and 2024 being raised by 0.1 pp each. Given that inflation as a trend is expected to be significantly higher than +2% over the next two years, it can be said that taking inflation risks seriously amounts to data-based policy operation.

FRB Economic outlook (multiple forecast, %) as of MAR 2023

	2023	2024	2025	Long-term
Real GDP Growth rate as of DEC	0.4 (0.5)	1.2 (1.6)	1.9 (1.8)	1.8 (1.8)
Unemployment rate as of DEC	4.5 (4.6)	4.6 (4.6)	4.6 (4.5)	4.0 (4.0)
PCE inflation rate as of DEC	3.3 (3.1)	2.5 (2.5)	2.1 (2.1)	2.0 (2.0)
Core PCE inflation rate as of DEC	3.6 (3.5)	2.6 (2.5)	2.1 (2.1)	

（Source）FRB

Rate Hikes to End in May?

The forex markets, naturally, are interested in the future path of interest rates, especially in whether or not there will be a rate cut this year. In this context, it must be noted that the FOMC statement’s policy interest rate guidance changed from “ongoing increases in the target range will be appropriate” to “some additional policy firming may be appropriate,” indicating a shrinking in the degree of rate hikes considered necessary. In this report, I have assumed that the Fed will end its rate hikes in March at the earliest or May at the latest, and things seem to be going more or less as expected so far. The newly revised dot plot (policy interest rate projections by FOMC members) is also consistent with the statement, suggesting one more +25bp rate hike to reach the (median) FF rate projection of 5.125% by the end of 2023 (see figure).

Policy rate outlook at the end of each year (median forecast)

FOMC Date	2023	2024	2025	Longer run
Sep-21	1.000%	1.750%	n.a.	2.500%
Dec-21	1.625%	2.125%	n.a.	2.500%
Mar-22	2.625%	2.625%	n.a.	2.250%
Jun-22	3.750%	3.375%	n.a.	2.500%
Sep-22	4.625%	3.875%	2.875%	2.500%
Dec-22	5.125%	4.125%	3.125%	2.500%
Mar-23	5.125%	4.250%	3.125%	2.500%

(Source) FRB

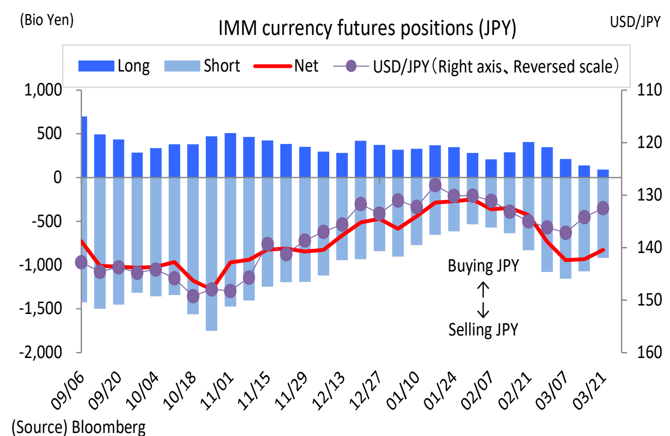
However, it is too much of a leap to predict the start of rate cuts within the year based on the end of rate hikes. I will continue to treat the start of rate cuts this year as a risk scenario rather than my main scenario. The FF interest rate futures market has already factored in the start of rate cuts during 2H of this year, but Powell made a point of mentioning that such forecasts (of a rate cut within the year) were not shared by FOMC members. While this setup, with the markets expecting rate cuts to begin early and the FOMC rejecting the possibility, has continued since last year, it does seem dangerous to forecast asset prices in anticipation of rate cuts as the main scenario when the core PCE deflator is expected to surpass +3% for the entire year. From the perspective of forecasting the outlook for USD/JPY, my basic understanding is that FF rates, having been raised to the 5% level as predicted by the dot plot, will remain there for some time to come, and that JPY selling is likely dominate during 2023 due to the domestic-foreign interest-rate gap. My risk scenario of a rate cut within the year may come true only in the event of a further intensification of international financial fears. In such an event, I predict rate cuts beginning early and USD/JPY falling to the vicinity of 125 (as of the present time, given the scale of Japan’s ballooning trade deficit, I predict this to be the extent of JPY appreciation possible).

Further, the median of FF rate projections for the end of 2024 was raised from 4.125% last time to 4.25% in the recent dot plot. It does seem as though the pace of rate cuts will be an important theme in 2024. However, I will wait for further communications from the Fed following the end of rate hikes (perhaps in May) to determine whether or not I really want to incorporate this into my main forecast scenario.

Risks to My Main Scenario – What Factors Might Cause Unexpected JPY Appreciation?

Lack of Confirmation that JPY is Still Considered a Safe Asset

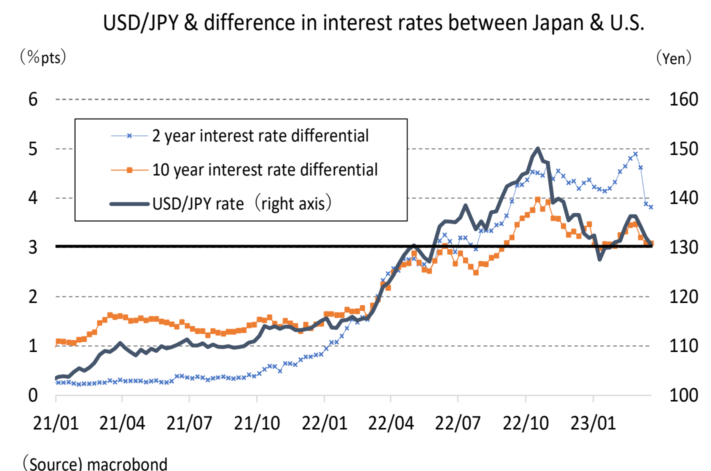
In light of the international financial turmoil seen since the start of March, financial markets have begun anticipating that the Fed will begin lowering interest rate cuts from midway through this year. U.S.-Japan interest rate differentials have consequently been narrowing, and one wonders how much this is causing speculators to increase their USD selling and JPY buying. The graph shows movements in IMM currency futures trading through March 21 – movements reflecting the financial market volatility resulting from the March 10th bankruptcy of SVB, the March 12 bankruptcy of Signature Bank, and the March 19 rescue of Credit Suisse by UBS. The magnitude of net short positions in JPY peaked in late October last year, when USD/JPY was around JPY152, but had greatly diminished by the end of January this year, when USD/JPY descended to its year-to-date low of JPY127.22. The current JPY depreciation phase began when USD/JPY was around JPY113, and it appears clear that, even if speculative JPY positions were completely liquidated, USD/JPY would only return to a level somewhat below JPY130. My basic view is that this situation reflects the expansion of Japan's trade deficit during 2022.



(Source) Bloomberg

From February, net short positions in JPY expanded again in light of additional rises in US interest rates amid fears that inflation rates were once again accelerating, and this helped boost USD/JPY back up to around JPY137. The failures of SVB and Signature Bank have caused financial markets to begin factoring in interest rate cuts by the Fed during this year, but speculative positions as of March 21 suggest that there has not been a major buyback of JPY against USD. In fact, the gross value of JPY long positions has declined considerably since mid-February, reaching its lowest level since April 2022 ($684 million) on March 21. In short, there appears to have been almost no demand for JPY as a safe haven asset amid the current turmoil. The lack of JPY repurchasing momentum despite an intensifying risk-off mood in financial markets was noted a year ago when Russia invaded Ukraine, and this seems to reflect a general decline in the perception of JPY as a safe haven asset.

Under these circumstances, it can probably be assumed that, for the time being, any significant JPY appreciation can be simply attributed to the recent increase in international financial instability and consequent rise in expectations that the Fed is likely to expedite its shift to lower interest rates. If the viability of numerous additional financial institutions in Europe and the United States becomes questionable, it seems inevitable that the Fed will come under increasing pressure to accelerate a shift to lower interest rates. The current situation suggests a high likelihood that decreasing market values of additional tier-one bonds will cause financial institutions' funding costs to trend upwards and that there will be increasingly strong demands for FF rate reductions to help offset the impact of that funding cost rise. If such developments cause the US 10-year interest rate to make a clear-cut descent below the 3.20% level, the graph seems to suggest a possibility that USD/JPY might possibly begin a stable descent below the JPY130 level. On the other hand, it may be that such a stable descent will only be possible based on previously conventional assumptions about JPY, and I have to admit my concern that the pattern of JPY appreciation during risk-off mood periods might be a thing of the past.



(Source) macrobond

EUR Outlook – Continued Emphasis on Curbing Inflation Despite Financial Stability Concerns

EUR Area Monetary Policies Now and Going Forward – The ECB Foreswears Retreat

The ECB Foreswears Retreat

As it had previously announced it would, the ECB's Governing Council decided at its March meeting to raise interest rates by 50bp, making the March meeting the third consecutive Governing Council meeting to raise interest rates by 50bp. The March Governing Council meeting's statement begins by saying – "Inflation is projected to remain too high for too long. Therefore, the Governing Council today decided to increase the three key ECB interest rates by 50 basis points[.]" This seems to be a fairly clear indication that keeping inflation in check remains the Governing Council's primary concern. During the post-meeting press conference, President Lagarde explained that the 50bp rate hike decision – "was adopted by a very large majority with three or four that did not support the decision, not in its principle because they were ready to go for that decision, but they were keen to probably give a bit more time to see how the situation unfolds and what additional data we can collect."

The first reporter to pose questions at the press conference noted the Credit Suisse failure and asked – "Did you see any risks that we are on the verge of a systemic crisis like in 2008?" President Lagarde responded by emphasizing that the ECB had implemented effective banking system reforms since 2008 and stating that – "we are monitoring current market tensions closely"– and – "I think that the banking sector is currently in a much, much stronger position than where it was back in 2008. Added to which: if it was needed, we do have the tools, we do have the facilities that are available and we also have a toolbox that has other [liquidity provision] instruments that we always stand ready to activate if and when needed." She did not specify those instruments, but the ECB has developed numerous longer-term refinancing operations (LTRO) programs with various time frames and specifications since the financial crisis. Lagarde insists the ECB has thus become better equipped to provide liquidity than the Fed, and her view on this is not merely prideful boasting without a foundation. The financial crisis that began in 2008 was the first crisis in the ECB's history and presented the ECB with numerous unprecedented challenges. At that point, the ECB was forced to hurriedly devise and implement the tools need to respond to the situation, but it is now in a position to calmly select existing instruments from its toolbox.

In fact, it may well be that the ECB was determined to maintain its previous commitment to implementing a 50bp rate hike as a means of emphasizing its perception of the euro area financial system's robustness. The ECB stated at the time of the February Governing Council meeting that it would implement a 50bp rate hike in March barring a "quite extreme" scenario, so modifying the rate hike would be tantamount to admitting that the scenario had indeed become quite extreme. In a sense, the explicit commitment to hiking rates in March barring a quite extreme scenario may have been designed to cut off a potential path of retreat from the commitment and to emphasize that such a retreat will not be considered even if there may be concerns about the viability of some euro area financial institutions going forward (particularly if the related facts are unclear and the grounds for concerns are weak). If a quite extreme scenario does take shape, however, there is a potential for the March rate hike to become considered an epochal mistake comparable to the ECB's interest rate hikes in July 2008 and April 2011. In this regard, a reporter at the press conference posed the question – "in July 2008 the ECB increased the interest rate, did an interest rate hike, just two months before the biggest financial crash in recent history. Is the ECB at risk of doing the same mistake?" As mentioned above, however, strict banking regulations have strengthened euro area financial institutions' shock resistance and, regarding Credit Suisse, ECB Vice-President Luis de Guindos asserted during the press conference that – "Looking at the exposure for instance to Credit Suisse, they are quite limited and there is no concentration." The ECB appears to have concluded that the Credit Suisse problem will not spread much within the euro area's financial system, so hiking interest rates by 50bp should not cause severe problems.

Staff Projections and the Prospective Rate Hike Trajectory

One should be paying particular attention to the ECB's moves from May, when it will no longer be bound by its "barring a quite extreme scenario" forward guidance commitment. In this regard, a reporter at the press conference posed the question – "I was wondering, could you explain a little bit how you see the path of interest rates ahead? Until a few days ago, it seemed pretty clear that interest rates would have to rise further after this meeting, but you didn't give any guidance in the statement. Does this mean it could be that we've already reached the peak in interest rates?" In her response, Lagarde acknowledged that there is an elevated sense of uncertainty but emphasized that future decisions will depend on emerging data. The key data here is that in the Eurosystem staff projections, which were just revised in March. These latest projections anticipate that the euro area's inflation rate will be 5.3% in 2023 and 2.9% in 2024, and that would seem to be a solid basis for sustaining interest rate hikes throughout this year. However, it is worth noting that the Eurosystem staff projections of the overseas economic outlook and euro area economic outlook are updated separately (the former last updated on February 15th, and the latter last updated on March 1) and turmoil related to the failure of SVB and Signature Bank as well as the Credit Suisse situation was not accounted for in the latest projections available at the time of the March Governing Council meeting. These circumstances make elements of uncertainty regarding forecast figures inevitable, and such elements of uncertainty could offer reasonable grounds for not deeming it practical to maintain such commitments as those made in February.

Core HICP Acceleration Remains a Key Issue

Going forward, the lack of conventional forward guidance on ECB policy rates will make inflation outlook analysis even more important. In this regard, President Lagarde explained at the press conference that – "the mechanism of our reaction function [...] is really the best guidance that we can provide and it is 1) the assessment of the inflation outlook in light of the incoming economic and financial data, 2) the dynamics of underlying inflation, and 3) the strength of our monetary policy transmission." This article has argued that the ECB can confidently anticipate that the continued acceleration of the core-basis euro area consumer price index (HICP) will provide a legitimate basis for additional interest rate hikes, and this argument corresponds to the second of the reaction function items listed by President Lagarde. A reporter at the press conference asked if the ECB would not discontinue its rate hikes until inflation slowed, and President Lagarde affirmed that – "it is obvious that as long as we see underlying components of inflation going up, this is not going to stop our fight against inflation."

In light of such statements, for the time being, ECB watchers should make core HICP trends their principal focus. Ideally, ECB watchers should be closely monitoring core HICP movements while giving particular attention to trends in service prices and wages. (During the press conference, President Lagarde specifically mentioned services among the "components of underlying inflation" or "other dissections of inflation" (besides core HICP) to which the ECB is giving particular attention.) By the way, the first two of the reaction function items listed by President Lagarde have been mentioned previously but the third item (strength of monetary policy transmission) is newly added. In this regard, the Transmission Protection Instrument (TPI) introduced last July is specifically designed to ensure the strength of monetary policy transmission, and President Lagarde clearly noted that the TPI might be utilized to cope with "factors that had nothing to do with the fundamentals of an economy" causing disruption within euro area markets (such as the SVB and Credit Suisse situations). However, she went on to say that such disruption is not evident at this point and that the ECB has not reconsidered the plan to partially suspend reinvestments under the Asset Purchase Programme (APP) designed to reduce the APP asset portfolio by EUR15 billion per month from March 1.

Conflicts between Monetary Policy And Banking Supervision Goals

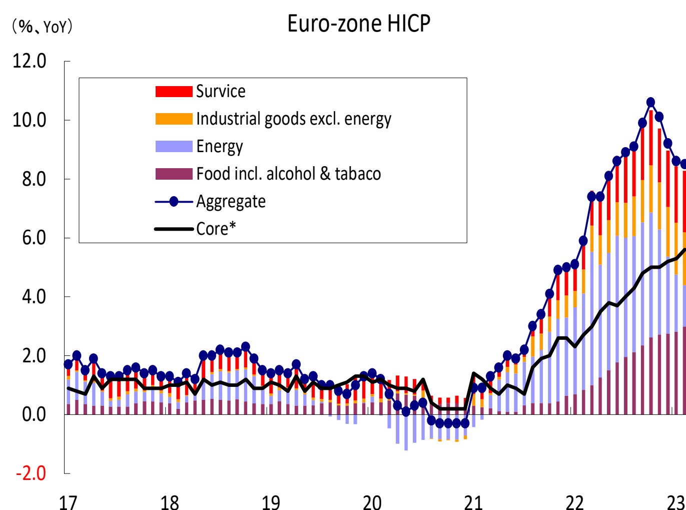
Just as is the Fed, the ECB is currently facing the question of whether it should modify its monetary policies to stabilize the financial system, and several reporters at the press conference posed queries about the ECB's view on conflicts or trade-offs between the goals of price stability and financial stability. As already discussed, monetary policies and banking supervisory policies often have conflicting objectives, and the Fed and the ECB are now being required to cope with this conflict in the wake of bank failures occurring amid inflation. In this regard, President Lagarde clearly stated that – "we don't see any trade-off between price stability and financial stability and we will address each of these two with their respective instrument." – explaining that the ECB will seek price stability by hiking interest rates while continuing to be prepared to ensure financial system stability by providing liquidity.

It appears clear that the ECB is assuming that the CS problem will not grow into a phenomenon causing a systemic risk in the euro area and that, based on that premise, the ECB does not intend to decelerate its interest rate hikes until core HICP clearly peaks out. Accordingly, at the time this article was written, I do not see a need for any significant revisions to my forecast that ECB interest rate hikes will continue supporting EUR over the next year.

The Euro Area Economy Now and Going Forward – Growing Concerns about Wage Inflation

Non-Energy Factors Driving Price Increases

Announced in early March, the euro area's February consumer price index (HICP) was up 8.5% yoy (all figures below are year-on-year), exceeding the average of market expectations (+8.3%). The rate of yoy growth in core-basis HICP (excluding food, alcoholic beverages, and tobacco) accelerated to 5.6% from 5.3% in the previous month, and this growth rate also exceeded market expectations (+5.3%). The combination of deceleration in the rate of decline in headline inflation rates and acceleration in underlying inflation rates is extremely problematic for the ECB. As the graph shows, the gap between the growth rates of comprehensive- and core-basis HICP is gradually but surely narrowing, and one cannot rule out the possibility that a spreading wave of cost increases (propelled by soaring resource prices and supply constraints) is impacting an increasingly wide range of goods and services. Looking at individual HICP component items in January and February, the rate of energy price growth continued significantly decelerating, falling from 18.9% to 13.7%; the rate of growth in prices of food and alcohol/tobacco, which fluctuate greatly, increased from 14.1% to 15.0%; the rate of growth in non-energy industrial goods prices edged up from 6.7% to 6.8%; and the rate of growth in service prices, which are of particular concern, rose from 4.4% to 4.8%. It is particularly noteworthy that the rate of growth in services prices is continuing to hit record high levels, and this is directly related to the ECB Governing Council's growing concerns about wage



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

inflation, which are discussed below. Regarding the principle drivers of price increases, there has clearly been a transition from energy factors to non-energy factors.

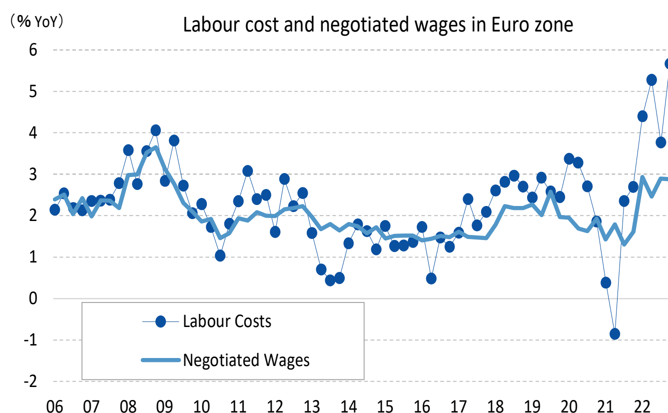
ECB Governing Council's Strong Concerns about Wage Inflation

It is safe to assume that the growth seen in service prices is largely attributable to growth in wages, and the Account of the February 2 ECB Governing Council meeting includes numerous noteworthy mentions of this situation. First, regarding the current policy interest rate level, the Account states that – "it was generally felt that concerns of "overtightening" were premature at the present high levels of inflation and in view of the likely persistence of underlying price pressures." – and this suggests that the Governing Council is strongly disinclined to halt interest rate hikes at this point. In addition, it is notable that the February Governing Council meeting's Account includes an unusually large number of references to wages. Counting the number of times the word "wage" appeared in the Account of individual Governing Council meetings, one finds 37 appearances last September, 41 last October, 19 last December, but 52 this February. Explaining the Governing Council's growing concerns about wages, the February meeting's Account notes that – "Members recalled that wage pressures were key in understanding the risks of second-round effects on inflation and in determining more persistent developments in underlying price pressures. Until a few months ago wage growth had remained moderate, but now there was a clear acceleration[.]" The Account goes on to clearly emphasize the risk that wage growth may promote further rises in inflation rates, saying – "It was also highlighted that, despite the slowdown in economic activity, the labour market remained exceptionally tight. This meant that price pressures acting on labour-intensive services were unlikely to abate soon. The wage trackers were showing very strong wage increases under newly concluded contracts, which [...] might lead to more persistent wage growth." In light of current trends in euro area wages and labor costs, it would be extremely difficult not to recognize the dangers associated with quickly relaxing monetary tightening measures at this time. (This point is elaborated on below.)

On the other hand, some Governing Council members adopted a macroeconomic perspective and expressed the view that wage growth does not necessarily lead directly to inflationary pressures, and the Account mentions this, saying – "it was also noted that wage growth for the pool of job movers should naturally be expected to be much higher than wage growth for job stayers, as the former were expected to account for the bulk of productivity growth. [Because of] intensified job churning, [...] it was natural that labour productivity and wage growth were accelerating. But this would not necessarily imply an increase in price pressures." However, the Account goes on to note that – "it was highlighted that the observed strong increase in minimum wages would add to existing wage pressures [...] increases in minimum wages could feed into wage increases further up the wage scale. [This point is also elaborated on below.] Therefore, while there was wide agreement that there were no signs of a wage-price spiral, it was argued that current wage growth was clearly not consistent with a 2% inflation target, even when taking into account trend improvements in productivity." At a time when the Governing Council is so concerned about wage trends, it would not be easy for it to decide to halt interest rate hikes.

Surging Euro Area Labor Costs

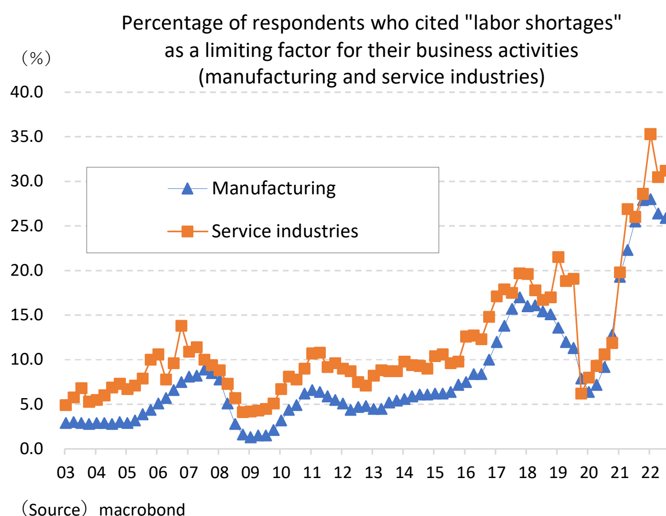
It is worth going into a bit more depth about the euro area's wage situation. For example, Eurostat's labour cost index (LCI) figures for the last quarter of 2022 (released on March 17) provide important clues regarding the possibility of a wage-price spiral, which is among the ECB's greatest concerns. Eurostat explains that its LCI – "shows the short-term change in the total hourly costs for employers to maintain their employees. In other words, the LCI measures how much the production factor 'labour' drives costs. They allow monitoring possible inflation and deflation risks arising from labour as a production factor." – and these risks are precisely what the ECB is keen to keep abreast of. LCI figures indicate that labor costs in the fourth quarter of last year were up 5.7% yoy – the largest such increase ever recorded (see graph). It is worth noting for reference that euro area HICP growth averaged 10% during that quarter, so the pace of wage growth was only roughly half the pace of inflation. Since wages lag behind general prices, it can still be said that the situation is unpredictable, but it is clearly a situation in which real wages are deteriorating, and it can be surmised that the ECB is hoping that the shrinking of demand stemming from lower real wages may work to countervail inflationary pressures. Looking at rates of wage growth by industry, one finds the highest rate was in construction (6.5%), followed by those in services (5.7%) and manufacturing (4.4%). The rate of growth in negotiated wages is still (barely) within the its historical band (+1% to +3%), but it remains to be seen whether the negotiated wages situation will become less or more volatile going forward.



(Source) Macrobond
(Notes), It differs from the actual labour cost growth due to unsettled

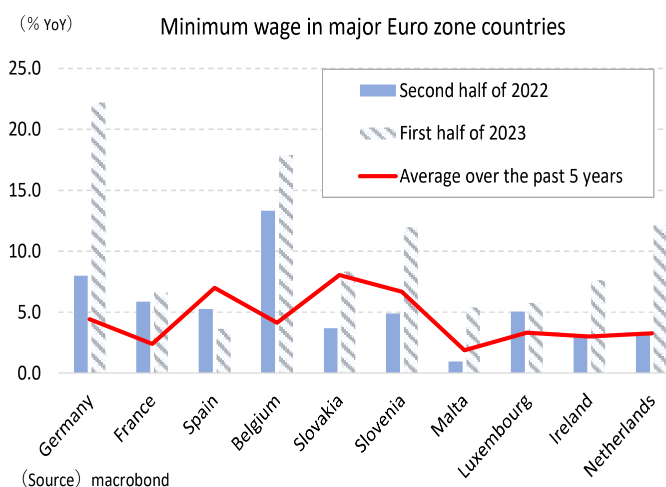
Euro Area Companies Facing a Labor Shortage

Although not often mentioned in Japanese news media, the European Commission monitors quantitative and qualitative data on euro area companies' business conditions and publishes its findings in quarterly European Business Cycle Indicators reports. These reports include capacity utilization rate figures as well as the results of various kinds of business sentiment surveys. One of these surveys asks about factors constraining companies' business activities (limiting factors), and the results are noteworthy. The latest such survey (covering the fourth quarter of 2022 and released in January 2023) found that about 25% of manufacturing companies and about 30% of service companies cited "labor shortages" as a limiting factor. As the graph shows, the share of companies citing "labor shortages" as a limiting factor has recently been at unprecedented high levels. In fact, the euro area unemployment rate has remained at a record low levels in the 6.6%-6.7% range since April 2022, the tightening supply-demand relationship in the labor market has been confirmed every month, and the European Business Cycle Indicators report offers additional corroboration of the labor shortage situation's severity.



(Source) macrobond

The euro area's prolonged labor shortage is causing a rise in minimum wage levels. As mentioned above, the Account of the February Governing Council meeting describes Governing Council members' strong concern that – "increases in minimum wages could feed into wage increases further up the wage scale." The graph (based on Eurostat data) compares average minimum wage growth rates over the past five years to minimum wage growth rates during the latter half of 2022 and the first half of 2023. It is evident that during the first half of 2023 many euro area countries' minimum wages have risen significantly above the five-year average. In Germany, which is believed to have a particularly large impact on euro area wage trends, the rate of minimum wage growth averaged 4.4% yoy during the past five years but was 22.2% yoy during the first half of 2023.



(Source) macrobond

Possibility of Summer ECB Rate Hike Suspension

At the time of this article was written, based on assumptions factored in by the interest rate futures market, it appears that the ECB is expected to raise interest rates by 25bp (from the current 3.00% level to 3.25%) by June, maintain the 3.25% rate at least through September, and perhaps begin seeking to reduce rates at some point after the start of 2024. On the other hand, financial markets are pricing in Fed interest rate cuts from July, suggesting a strong possibility that interest rate differentials will be promoting EUR buying from that point. Rather than focusing exclusively on the likelihood and timing of prospective ECB rate cuts, however, it seems more important to confirm the correctness of assumptions that the ECB will hike its policy rate by only 25bp and only one additional time. In light of the euro area employment and wage situations discussed above, it appears that the region will continue to experience considerable wage inflation along with similarly substantial service price inflation for some time, so it would be irrational to anticipate deceleration in core HICP soon. As mentioned above, it seems safe to assume that keeping an eye on core HICP trends should be ECB watchers' top priority for the time being. Given that significant minimum wage increases are quite likely to force euro area companies to begin aggressively increasing their selling prices, at this point, it seems unreasonable for projections to be focused on the timing of a prospective interest rate hike suspension let alone the timing of a shift to interest rate reductions. From a forex market perspective, as I have repeatedly argued, it appears that EUR will strengthen against USD during the latter half of the April-June quarter and during the July-September quarter, when Europe-U.S. policy interest rate differentials are likely to be emphasized.

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