Forex Medium-Term Outlook

May 1, 2023

MIZUHO

Overview of Outlook

USD appreciated steadily against JPY in April. Despite the international financial turmoil of March, the Fed's suspension of rate hikes, and the ECB lowering the pace of its rate hikes, USD/JPY never once fell below 130. Further, while we are still only four months into the year, the JPY appreciation forecast that dominated late last year/early this year has not come true so far. It would seem that JPY trends are not determined solely by interest rates after all. Japan's trade deficit has already surpassed -JPY 5 trillion within the first three months of the year. Considering that the trade deficit for all of 2019 was -JPY 1.8 trillion, and that the average annual trade deficit for the years 2011-15, when Japan posted trade deficits for five years in a row, was -JPY 3.7 trillion, a deficit of over -JPY 5 trillion within a 3-month period is on a scale that is unprecedented. This supply-demand climate involving a strong JPY selling bias cannot be overlooked as the background to USD/JPY being unable to stabilize below 130 – this has been my consistent position right from the start. Further, looking at the details of Japan's Balance of Payments, at least half of Japan's current account surplus seems unlikely to directly result in JPY buying. Perhaps it is time to realize that it is no longer possible to argue for JPY's strength based solely on Japan's current account balance. One must also keep in mind that, when it comes to supply and demand in its external economy, Japan may now be a trade deficit country. The future of the U.S. and European commercial real estate markets could be a risk factor for my main forecast scenario, but even that is dependent on the Fed and the ECB pivoting to interest rate cuts; there is unlikely to be any change in the fundamental JPY supply and demand balance. I will, therefore, maintain my prediction of USD/JPY hitting the 140 level again within the year.

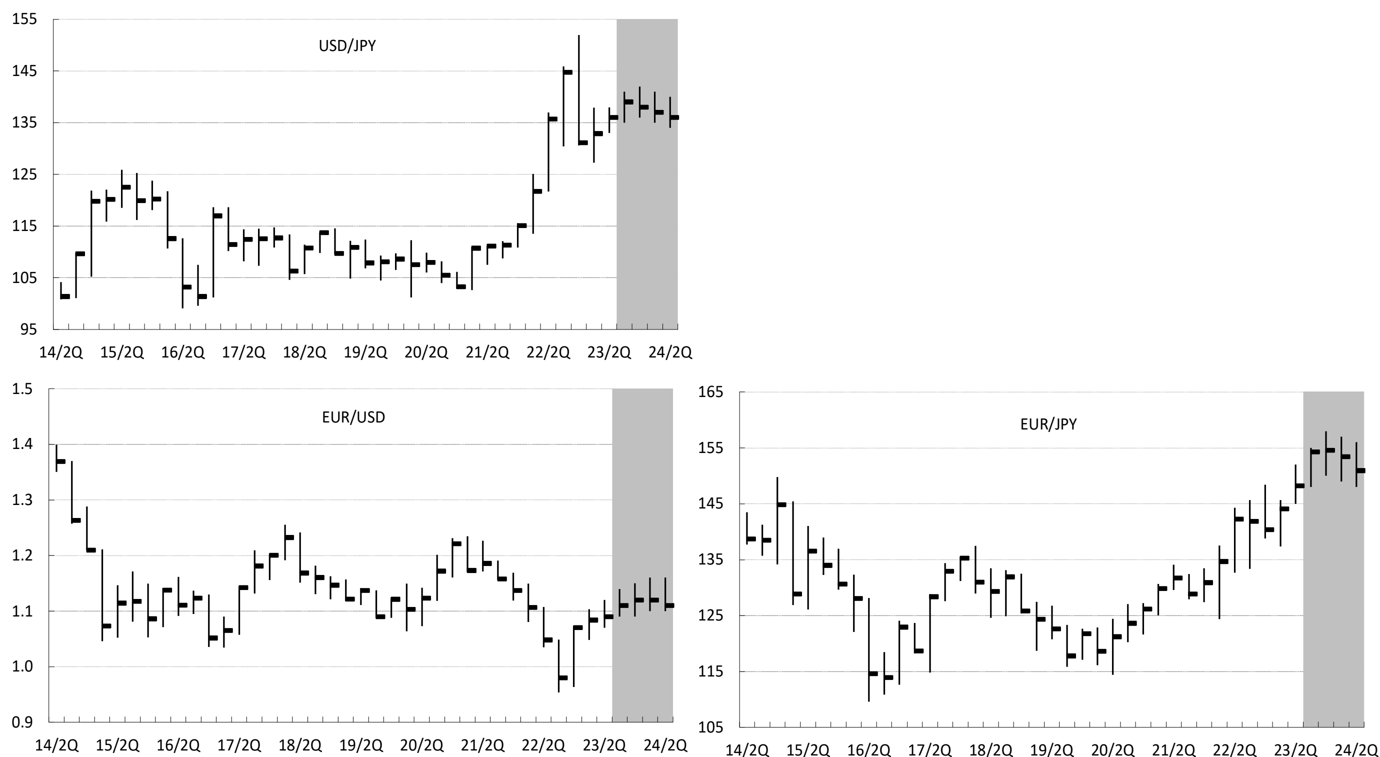
EUR also remained strong in April. While there was no ECB Governing Council meeting in April, information gleaned from the Account of the March meeting and other sources indicates stubborn inflation concerns, so even if the ECB were to shrink its rate hike margin to +25bp, the end of rate hikes may still be some distance away. For the time being, policy rates may continue to be increased together with suggestions that the overall judgement is based mainly on credit conditions. Of course, it is not just interest rates that are propping up EUR. Germany's trade balance has swung markedly toward a surplus against the backdrop of falling natural gas prices due to the mild winter, and this has contributed to EUR's strength. The improvement in trade balances is obvious across the euro area, and this report's basic understanding is that demand conditions, in addition to interest rates, are contributing to EUR buying. On the other hand, EUR's vulnerability in terms of its reliance on natural gas prices seems to have been exposed, and there remains a risk of the currency collapsing as a result of developments pertaining to Russia or the weather. I believe EUR could appreciate against USD from the second half of the April-June quarter through the July-September quarter, when the U.S.-Europe interest rate gap draws attention, but as winter approaches, the mood could switch to prompt another energy crisis, and we could see another period of EUR selling.

Summary Table of Forecasts

	2023 Jan-Apr (actual)	May-Jun	Jul-Sep	Oct-Dec	2024 Jan-Mar	Apr-Jun
USD/JPY	127.22 ～ 137.90 (136.65)	133 ～ 138 (136)	135 ～ 141 (139)	136 ～ 142 (138)	135 ～ 141 (137)	134 ～ 140 (136)
EUR/USD	1.0482 ～ 1.1075 (1.1005)	1.07 ～ 1.12 (1.09)	1.09 ～ 1.14 (1.11)	1.09 ～ 1.15 (1.12)	1.10 ～ 1.16 (1.12)	1.10 ～ 1.16 (1.11)
EUR/JPY	137.45 ～ 150.40 (150.45)	145 ～ 152 (148)	148 ～ 155 (154)	150 ～ 158 (155)	149 ～ 157 (153)	148 ～ 156 (151)

(Notes) 1. Actual results: until 1 MAY 2023. (): as of 10 AM 1 MAY 2023. 2. Source by Bloomberg.
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts



USD/JPY Outlook – Structural JPY Weakness is the Truth

BOJ Monetary Policies Now and Going Forward – No Impact on My Weak-JPY Trend Forecast

Direction Indicated by Confusing BOJ Statement

At the April 27-28 BOJ Monetary Policy Meeting, the first under new BOJ Governor Kazuo Ueda, monetary policy was kept unchanged. Going by the upward revision of price forecasts in the recently released Outlook for Economic Activity and Prices (Outlook Report) as well as the changes expected in overseas conditions going forward, I would not have been surprised if a last-minute decision to end the yield curve control (YCC) policy had been made despite it being the Ueda administration's first meeting. There are bound to have been at least a few other market analysts with the same expectation, even if they were not in the majority. The communications following the meeting, both through the monetary policy statement and Governor Ueda's press conference, were dovish in tone overall. Perhaps the new administration felt that its future communications with the market would be handicapped if dramatic monetary policy changes were made right from the get go.

This time, there were two noteworthy points. One was the announcement that "the Bank has decided to conduct a broad-perspective review of monetary policy [conducted over the past 25 years], with a planned time frame of around one to one and a half years." The other was the elimination of forward guidance regarding policy interest rates. The latter involved deleting the last two sentences from the statement, namely: "For the time being, while closely monitoring the impact of COVID-19, the Bank will support financing, mainly of firms, and maintain stability in financial markets, and will not hesitate to take additional easing measures if necessary" and "it also expects short- and long-term policy interest rates to remain at their present or lower levels." With COVID-19 scheduled to be downgraded to a Class 5 disease similar to the seasonal flu from May 8 onward, deleting the portions in question seems reasonable.

However, the deletion of sentences indicating a rate-cut bias from the statement is somewhat contrary to the overall dovish tone of the meeting itself, and may be somewhat confusing. However, the statement did retain the sentence "The Bank will continue to maintain stability of financing, mainly of firms, and financial markets, and will not hesitate to take additional easing measures if necessary," so, rather than fretting that the deletion of statements indicating a rate-cut bias may signify the switch to a hawkish stance, it would seem correct to assume that the Bank's monetary easing stance remains unchanged without being limited to the pandemic. The fact that JPY selling remained the predominant trend in the markets following the meeting suggests that not many market participants took the former view. It is my conjecture, however, that many market participants may have found it somewhat difficult to understand the intended monetary policy direction of the new Ueda administration.

Relation Between Long-Term Review and Short-Term Monetary Policy Operation

Following the recent BOJ meeting, many market participants may be wondering how the long-term review to be conducted over up to the next year and a half might be related to the Bank's policy operations in the near term. To put it simply, people may be wondering if, perhaps, monetary policy will remain mostly unchanged while the review is underway. In this context, it is useful to note Governor Ueda's comments at his inaugural press conference to the effect that monetary policy may be changed from time to time as necessary even during the review period, emphasizing that the option of policy normalization had not been sealed off for the next year and a half. Of course, the former Haruhiko Kuroda administration also reflected on its own policies from time to time, with YCC being introduced in 2016 following a "Comprehensive Assessment" of monetary easing, and cash flow "inspections" being conducted in 2021. However, these were mainly short- to medium-term reviews of the administration's own policies, not a grand review of monetary easing over the past 25 years. The review proposed by the Ueda administration is not intended to help determine the Bank's next move, but may be more similar to "strategy reviews" that are conducted over a period of 1-1.5 years by the Fed or the ECB to review the ideas that form the foundation of their monetary policy operations.

To give an example, following a recent strategy review conducted over the course of a year, the Fed adopted a new monetary policy framework called Flexible Average Inflation Targeting (FAIT) in August 2020. While some observe that this delayed the recent phase of rate hikes, such a criticism is not widespread in the markets. Not many made the direct connection between the strategy review and ongoing monetary policy operation. The ECB, for its part, completed an 18-month strategy review in July 2021 that resulted in the acceptance of inflation over 2%, which many viewed as a shift toward a more dovish stance. However, coming right in the middle of the pandemic as it did, it was difficult to tell how much the pandemic had impacted the results of the review.

At any rate, it is unlikely that a review to be conducted over a period of 12-18 months would hold up monetary policy operation required to regulate economic and financial conditions in the near term. I believe, therefore, that the BOJ's next move must be considered separately from its proposed review.

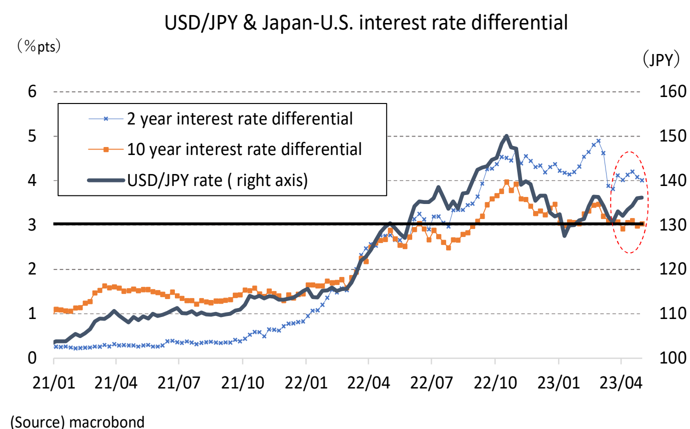
YCC Could Still be Abolished This Year

There is still the risk that we might wake up one day to find the YCC suddenly gone. This could even happen before the end of the year. With the price forecast in the Outlook Report upwardly revised and the U.S. and European central banks also retaining hawkish stances, the recent meeting seemed like a good opportunity to do away with YCC. However, I do believe that, irrespective of the Outlook Report, Governor Ueda is essentially in favor of abolishing YCC if it is judged to have serious side effects. It would be desirable, of course, to pick a time when JPY interest rates are declining in tandem with U.S. and European interest rates so that YCC abolition does not coincide with an increase in JPY interest rates. If YCC is abolished without the cover of price forecast upward revisions in the Outlook Report, the Bank would have to specifically explain that its move does not amount to a rate hike, so it would be important to pick the right time, to ensure that JPY interest rates remain level or decline following the abolition of YCC. In that sense, I believe there could still be opportunities for YCC abolition during 2H of the year, when the Fed and ECB seem likely to soften their monetary policy stances.

Incidentally, the recent BOJ monetary policy statement clearly states the need for wage increases: "(The Bank) will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases." Perhaps the idea is to wait and watch until July how things turn out following the spring offensive. As the language in the statement seems to suggest that action is conditional on wage increases, some are wondering if the BOJ plans to introduce wage targets, and this would be nothing new, given that a virtuous cycle involving an improvement in employment and wage conditions was mentioned as a necessary condition for the correction of monetary easing even by the previous administration. It seems unlikely, however, that Governor Ueda would support the simplistic idea that nominal wages can be increased simply through monetary policy, so perhaps all he wanted to do was emphasize that monetary accommodation would not be withdrawn simply based on cost-push inflation.

Impact on USD/JPY

USD/JPY soared to the 136-yen level as excessive hopes of policy normalization from the new Ueda administration faded. This report's forecast of JPY weakness is based more on JPY's supply and demand balance, which is structurally tilted in favor of JPY selling, and I believe that the recent speculation-driven JPY depreciation is quite likely to be reversed. However, the financial markets seem to be interpreting the BOJ's proposed long-term review as more dovish than expected, and the JPY selling impact of this may continue for a while. Given that Governor Ueda directly acknowledged the possibility of correcting monetary accommodation while the review is still underway, I think JPY selling prompted by the long-term review may not be a stable trend, but as there are no occasions for further explanation at least until the next meeting in June, it may be prudent to assume the continuation of the JPY depreciation trend until then. As it is, the USD/JPY level has been a notch higher regardless of financial conditions since April (see figure on previous page). At any rate, there is almost no change to this report's main forecast scenario, which has consistently predicted JPY depreciation since last year. The new developments make it difficult to rule out the possibility of the currency pair hitting the 140-yen level again before the end of the year.



(Source) macrobond

The Global Economy Now and Going Forward –Asset Price Outlooks and Geopolitical Risks

"A Rocky Recovery"

On April 11, the IMF released the latest edition of its World Economic Outlook (WEO) publications. As a risk scenario, the WEO's view is that – "Overall, the estimated probability of global growth in 2023 falling below 2.0 percent – an outcome that has occurred on only five occasions since 1970 (in 1973, 1981, 1982, 2009, and 2020) – is now about 25 percent:" – and it specifies that such a scenario could take shape if financial instability were to promote a credit disruption and stock price drops at the same time. Regarding financial instability, the WEO notes that there is now an increasing perception of progressive growth in individual financial institutions' problems, and the global economic growth forecast has thus been lowered to 2.8%, down 0.1 percentage point compared to the January forecast. The WEO states that – "A hard landing – particularly for advanced economies – has become a much larger risk." – as countries struggle to concurrently address problems associated with high inflation rates, which calls for interest rate hikes, and with financial stability, which calls for interest rate cuts. The WEO offers an in-depth explanation of the IMF's forecasts. While small, the downward revision to the forecast growth rate should be perceived as suggesting hidden risks of great magnitude. The latest WEO features the subtitle "A Rocky Recovery", which is a good summary description of the IMF perceptions that underlie the entire WEO forecast.

Fragmentation of Foreign Direct Investment Activities

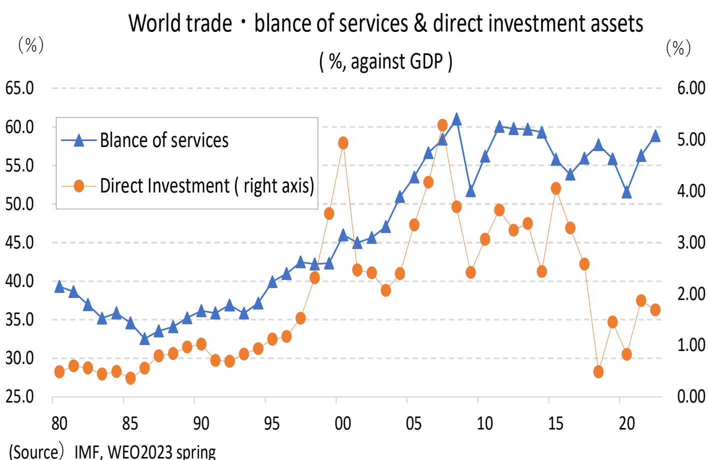
Looking at individual issues within the latest WEO, one finds a very interesting discussion in Chapter 4, entitled "Geoeconomic Fragmentation and Foreign Direct Investment". As evident in U.S.-China trade frictions, there has been a confrontation between the West and China since quite some time before 2019. International supply chains were physically disrupted by the COVID pandemic in 2020, and when those disruptions seemed to be nearing their end in 2022, Russia shifted to a more-confrontational stance toward the West, causing particularly severe constraints in commodity markets. In just the last three years, many of the supply chains enabling the global economy's efficient operation have been severely damaged, and while the pandemic is finally winding down, there are still no signs of a decrease from the new, higher level of geopolitical risks.

Under these circumstances, the international corporate sector has been forced to modify its business strategies related to cross-border operations, and a particularly noteworthy trend toward the rolling back of foreign direct investment (FDI) activities has been gaining momentum. While corporate FDI activities have become quite common, such activities have recently inspired major political controversies. One conspicuous example of anti-FDI policies is former U.S. President Donald Trump's "America First" policy, which sought to promote production and marketing operations within the U.S. (The WEO also notes that France is advocating a "Made in Europe" strategy to counter the domestic production subsidies recently introduced by the United States.) While the "West vs. China" frictions may be the most conspicuous example of geoeconomic fragmentation, there are also considerable political and economic divisions among Western countries.

The latest WEO attempts to analyze how geoeconomic fragmentation of direct investment activities will affect the global economy as a whole. The general conclusions are that, in addition to a significant slowdown in global FDI in recent years, there has been a trend toward the increasing concentration of FDI in geopolitically friendly countries, particularly within such strategic fields as semiconductors. Thus, as companies modify their FDI strategies, countries (mostly emerging countries) that are politically distanced from the home countries of companies undertaking FDI activities (mostly developed countries) are likely to be impacted by FDI decreases and outflows. If this trend becomes extreme, the gap between "countries with FDI inflows" and "countries with FDI outflows" will widen, causing a decrease in overall output (production volume) that will make the world poorer overall, in the IMF's view.

The Accelerating Trend of "Slowbalization"

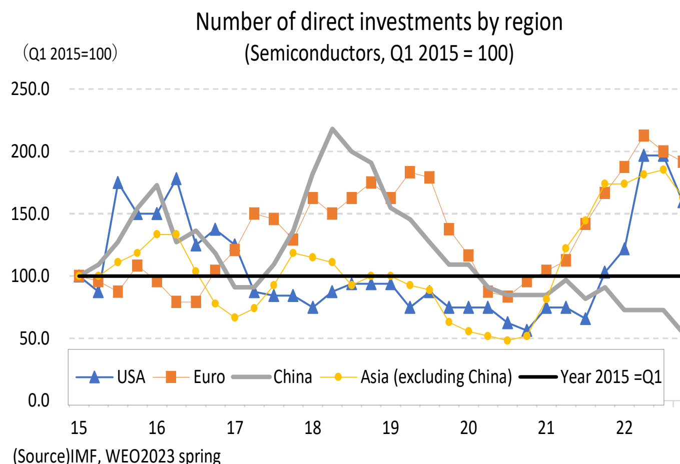
The situation is causing a slowdown in the trend of globalization, which the IMF describes as "slowbalization." Slowbalization is not new, however, and it has been progressing in some countries since the global financial crises triggered by the 2008 bankruptcy of Lehman Brothers in the United States. For example, the graph shows that FDI increased to 3.3% of world GDP in the early 2000s but has fallen to 1.3% of world GDP in the period from 2018 through 2022. So slowbalization has been going on for some time, but it seems to have been accelerating in recent years due to heightened geopolitical risks. The IMF argues that – "the fragmentation of capital flows along geopolitical fault lines and the potential emergence of regional geopolitical blocs are novel elements that could have large negative spillovers to the global economy. Firms and policymakers are increasingly looking at strategies for moving production processes to trusted countries with aligned political preferences to make supply chains less vulnerable to geopolitical tensions." As already noted, the brunt of the impact of this trend will be borne by emerging economies that have previously been the targets of advanced economies' FDI activities. The graph shows that the size of the global economy's international trade and services balance has not significantly



(Source) IMF, WEO2023 spring

changed but the momentum of direct investments has considerably declined. Direct investments have been providing greatly beneficial economic opportunities to emerging countries, but if the current trends continue, it appears likely that the number of countries and regions benefitting from cross-border commerce will become more limited than previously.

The WEO estimates the impact of FDI fragmentation on individual countries and regions. Particularly conspicuous in this regard are U.S. companies' moves to shift away from bases in China and disperse associated activities to other bases around the world, and to a lesser extent, the same trend was observed with respect to Europe-based companies. Similarly, China appears to be withdrawing FDI from various places and increasing the concentration of investments within its own borders. Such trends are particularly conspicuous in such strategic fields as semiconductors – both the United States and Europe are promoting the creation of domestic production bases for such strategic products. As the graph shows, direct investments in China have been sharply decreasing since 2018, while direct investments in Europe, the United States, and Asian countries other than China have considerably increased since 2020. It is increasingly apparent that, to a great extent, both the globalization and slowbalization trends have centered on corporate strategies regarding the shifting of business activities to and from China.



(Source)IMF, WEO2023 spring

Considering Slowbalization from a Cost-Benefit Perspective

Chapter 4 of the WEO concludes by warning that the world will become poorer if current trends continue, saying – "a fragmented global economy is likely to be a poorer one." However, the IMF itself admits that the WEO's analysis focuses only on the demerits of the slowbalization accompanying the fragmentation of FDI and does not consider the merits of FDI fragmentation. There have been good reasons for applying the brakes to globalization. For example, it has long been advocated that globalization should be slowed in light of such goals as strengthening a given country's economic security and securing technological superiority over competing countries (restraining FDI can help prevent technology outflows). The WEO analysis focuses on the "cost" of how much global economic growth is lost due to the disruption of optimized global supply chains, and it is clear that slowbalization has only disadvantages regarding the goal of increasing the global economy's growth rate. In light of various political factors, however, it can be argued that the cost with respect to global economic growth is a "reasonable price" that should be paid to enable the robust defense of crucial national interests. As was particularly evident during the global pandemic, the disruption of global supply chains and difficulty of obtaining strategic goods can have a huge impact on the growth of individual countries' economies and, in some cases, can even lead to severe domestic societal destabilization. If one recognizes that it is sometimes worthwhile for countries to proceed with strategic decoupling even when there is an associated price to be paid, it is clearly irrational to completely ignore the potential benefits of the slowbalization trend.

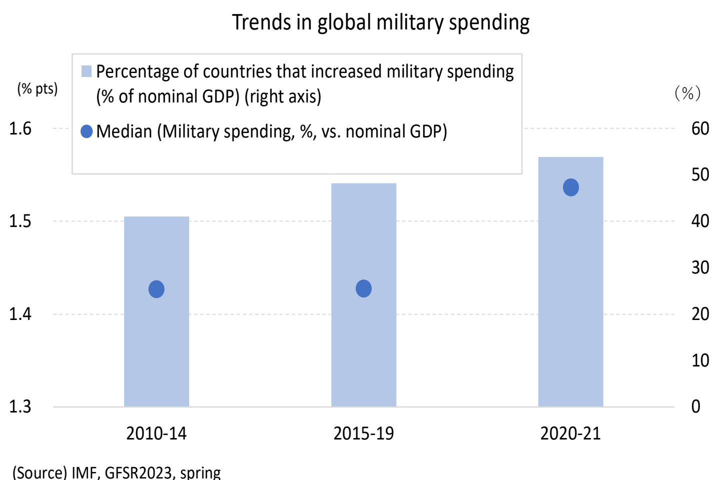
Of course, it would be best if the globalization trend could be maintained by means of the preservation of global peace. For example, if international affairs could be managed through such multilateral fora as the G20 in such ways that would dissipate the general sense of uncertainty, it might not be impossible to sustain the globalization trend, and the IMF recommends efforts to create such a scenario. Amid the current situation (where military and economic clashes are occurring intermittently in various parts of the world), however, it should be recognized that the ideal conditions required to sustain globalization's momentum are lacking in reality. For the time being, it appears that the major trend of slowbalization will dictate that the global economy somehow manages to function in a "world with higher cost levels". Given the likelihood of that scenario, it is worth considering the possibility that the roots of the rising inflation rates governments and central banks around the world are currently trying to suppress may actually be much deeper than they superficially appear to be.

Although slowbalization may seem to be a somewhat abstract and slow-moving phenomenon exerting its effects over a relatively long-term time frame, it should be recognized that slowbalization has already become an important issue that should be kept in mind when analyzing day-to-day changes in monetary policies as well as associated trends in interest rates, exchange rates, and stock prices.

Increasing Relevance of Geoeconomics

As explained above, the latest WEO had a lot to say about the issue of geo-economic division, and the unwinding of globalization via "slowbalization" along with related issues are also discussed in Chapter 3 (entitled "Geopolitics and Financial Fragmentation: Implications for Macro-Financial Stability") of the IMF's Global Financial Stability Report (GFSR), which was released the day after the latest WEO. The first paragraph of Chapter 3's introduction section notes that – "The escalation in geopolitical tensions has raised concerns about greater geoeconomic fragmentation – a policy-driven reversal of economic and financial integration, often guided by strategic considerations – that could be costly for the world economy."

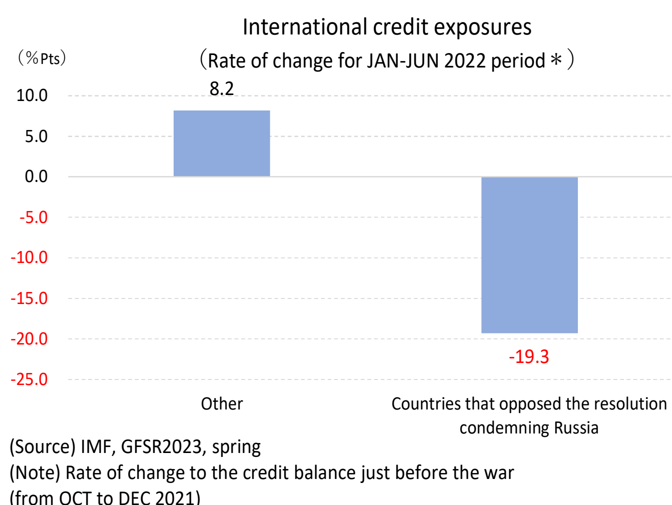
Geopolitics has traditionally been an academic discipline that analyzes and considers international relations with a primary focus on military and diplomatic matters, and people in that field continue to do very useful work. In recent years, however, geoeconomics has attracted increasing attention as an academic discipline focusing on the use of economic means to achieve geopolitical goals. In light of the recent rise in geopolitical tensions accompanied by growth in the military expenditures of countries around the world (see graph), geoeconomic thinking frameworks are becoming increasingly relevant. Growth in individual countries' military spending has become significantly more widespread since 2020, with half of the world's countries showing signs of increasing military spending as a percentage of their nominal GDP.



(Source) IMF, GFSR2023, spring

Geoeconomic Division Seen in Direct Investment, Securities Investment, and Bank Lending

The latest WEO highlighted the fact that cross-border corporate activities, particularly direct investments, have markedly decelerated owing to geopolitical tensions. The latest GFSR also presents various data to measure the extent to which FDI and portfolio investment is being shifted away from countries that are less politically and diplomatically friendly ("with more distant foreign policy outlooks") and toward countries considered more friendly, or less distant. For example, the graph on the right shows rates of change in international credit balances (cross-border banking claims) between the period immediately before Russia's invasion of Ukraine (the fourth quarter of 2021) and the first two quarters of 2022. It can be seen at a glance that lending to countries that "rejected" the motion to condemn Russia's invasion of Ukraine at the March 2, 2022, UN General Assembly meeting considerably decreased, while lending to other countries (countries that were "absent" or voted "abstain" or "accept" on the motion) grew. The division between the Western camp and other countries is becoming increasingly apparent with respect to bank loans as well as to corporations' direct investments and investments in securities.



(Source) IMF, GFSR2023, spring
(Note) Rate of change to the credit balance just before the war (from OCT to DEC 2021)

Two Channels of Systemic Risk

The GFSR is a report focusing on the current and prospective stability of the global financial system, and the latest edition of the GFSR therefore analyzes how geopolitical tensions may generate risks that undermine the financial system's stability (≈ systemic risks). This analysis centers on <u>two channels by which geopolitical tensions could promote financial instability – the financial channel and the real channel</u>. The financial channel – "is triggered by restrictions placed on capital flows and payments (such as capital controls, financial sanctions, and international asset freezing) or through an increase in uncertainty and investors' risk aversion to future restrictions, the escalation of conflict, or expropriations." Cross-border capital flows will become more active based on the classification of countries as "less distant" countries (which capital flows into) and "more distant" countries (which capital flows out of). As a result, asset prices will fall in some countries, and investments and loans will be withdrawn from others, thereby causing a progressive financial fragmentation process. The GFSR notes that frequent and sudden capital flow disruptions – "could generate liquidity and solvency stress in the financial and nonfinancial sectors by increasing funding costs or debt rollover risk and by reducing asset values and overall profitability, thereby threatening macro-financial stability." This is the financial channel of geopolitical tensions, and the application of associated sanctions is an issue that should be considered in the context of geoeconomics.

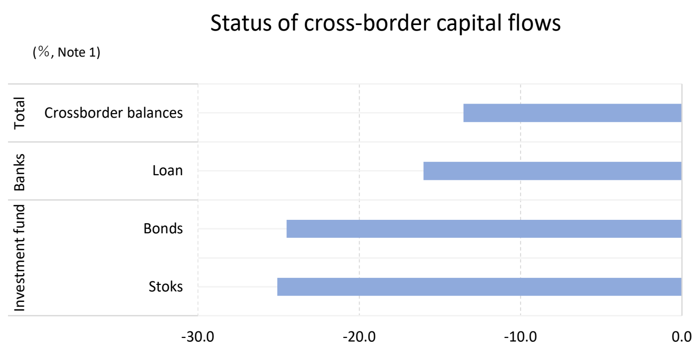
These financial channel risks may be exacerbated through real channels. Specifically, rising geopolitical risks may directly present obstacles to the real economy – "triggered by restrictions on international trade and technology transfer and by disruptions to supply chains and commodity markets" – that should also be considered in the context of geoeconomic risks. As seen during the past three years owing to the global pandemic and the Russia-Ukraine conflict, in a world with highly efficient international commerce, the unintentional malfunctioning of trade transactions, supply chains, and other systems can quickly cause real economies to face serious supply constraints. If people and goods cannot move smoothly, it is only natural that production activities will stagnate.

Consequentially, the real economy may stagnate even as supply shortages increase inflationary pressures. Such stagflation could adversely affect the profitability of nonfinancial corporations, increasing the credit risks faced by financial corporations (the banking sector). Such increased credit risks may lead to stricter lending attitudes and the

stagnation of business activities, which might depress the real economy as a whole. Naturally, the banking sector's financial strength may decline, causing an increase in systemic risks. Rising geopolitical or geoeconomic risks often make resource exchanges between hostile countries difficult, further increasing inflationary pressures, which in turn encourages central banks to hike interest rates. Interest rate hikes promote declines in asset prices and tighter conditions in non-financial corporations' financing environment. These are various aspects of real channel risks.
In these ways, it is feared that the financial channel and the real channel will be mutually reinforcing in amplifying systemic risks. Increased financial fragmentation stemming from rising geopolitical tensions are likely to decrease the diversity of cross-border transactions and increase systemic risks from both financial and physical channels. These are the points the IMF appears to be most concerned about.

Geoeconomics an Important Basis for Analyzing Asset Prices

In April, the IMF showed that geoeconomics is an important basis for analyses both within the WEO (focused on the global economic growth outlook) and within the GFSR (focused on the international financial system's stability). As discussed above, there is a growing tendency for capital flows to be determined by the degree of closeness between nations rather than by economic rationality, and this makes the increasing importance of geoeconomics quite clear.
In this regard, the IMF has developed its own model to estimate how much investment in securities (bonds, stocks, etc.) and bank lending will be affected when the geopolitical distance between countries increases. This model estimates that greater geopolitical distance may cause a roughly 15-to-25% shrinkage of cross-border capital flows in one year. As the graph from the GFSR shows, investment funds' investments in bonds and equities tend to be the most sensitive to geopolitical risks. It is believed that countries with mature financial markets and countries with large net balances of foreign assets are relatively resistant to such outbound capital flows, and this suggests that China, which has the world's highest level of foreign exchange reserves and the world's third largest net balance of foreign assets, may be strongly positioned to deal with outbound capital flows. In any case, it is clear in light of the two most recent IMF reports' extensive geoeconomic analyses that, when examining the medium- to long-term outlook for asset prices, it is becoming increasingly important to consider the geopolitical positioning of the country in which the asset is located and what strengths (or weaknesses) that country may have from a geoeconomical perspective.

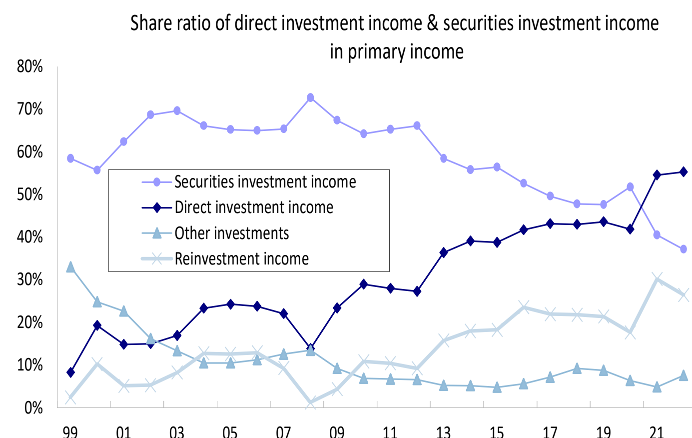


(Source) IMF, IMF, GFSR2023,spring
(Note 1) Estimates of the rate of change in each case when the geopolitical distance, calculated from divergences in resolutions at the General Assembly, moves by one standard deviation in a year.

JPY Basic Supply and Demand – Structural JPY Weakness is the Truth

Structural JPY Weakness is the Unmistakable Truth

The Ministry of Finance released Japan's February Balance of Payments in April, revealing a +2.1972 trillion current account surplus, the first surplus in two months. With trade-deficit-inducing seasonal factors already behind us, the current account balance seems likely to continue positive from here on. Looking at the breakdown, Trade and Services posted a -JPY 824.5 billion deficit, while Primary Income posted a +JPY 3.4407 trillion surplus. However, as I frequently state in this report, it is difficult to predict JPY supply and demand simply based on whether the current account is positive or negative (in surplus or deficit). Over the past 10+ years, Japan's external economic sector has been undergoing a very clear change. <u>To be blunt, the Japanese economy has been earning less and less foreign currency; i.e., it has become easier than before for JPY to weaken, or more difficult for it to appreciate – these are facts that must be faced</u>.



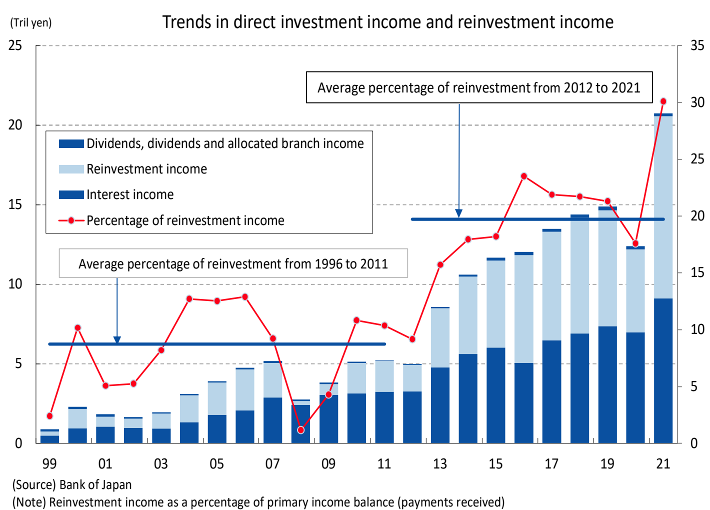
(Source) Bank of Japan (Note) Payments received

When discussing Japan's Balance of Payments, in addition to (1) the country's large trade deficit, and (2) its primary income surplus not contributing to demand for JPY buying, this report has also recently focused on (3) Japan's large "Other services" deficit. Point (2) tends to be simplistically interpreted as "earnings mostly getting reinvested as foreign currency," and this report has also explained it as such so far. This time, I would like to provide a more detailed explanation using specific figures. First, the primary income surplus is divided between Compensation of employees and Investment income, but is mostly synonymous with the latter (for instance, in 2022, the Primary Income balance was +JPY 35.1857 trillion, and Investment income was nearly the same, at +JPY 35.2479 trillion). Investment income is further made up of Direct investment income, Portfolio investment income, and Other investment income. Income in

each of these investment categories is calculated by subtracting payments made from payments received. Needless to say, Japan being the world's largest net external creditor, it receives an overwhelming amount of payments from overseas. Breaking this down further, until around 2010, 60-70% of the Primary Income balance (payments received; same for all instances discussed below) was made up of Portfolio investment income (see figure). However, starting 2010 or so, the ratio of Direct investment income increased markedly. Direct investment income overtook Portfolio investment income in 2021 for the first time since records began, and expanded its lead further in 2022.
In this way, the Japanese economy's external investment income sources have shifted from securities investment to acquisition of foreign companies over the past 10 years. Over the next 10 years, perhaps Direct investment income will comprise 60-70% of Japan's Primary income balance. It is a fact that Japan's external economic sector is undergoing structural changes, and this is bound to impact JPY forecasts now and going forward. There is stubborn resistance to the idea of a structural JPY weakness in some quarters, but amid changes in currency-related supply and demand trends, this is the unmistakable truth. Japan's external economic sector is facing structural changes.

About Half Results in JPY Buying

Taking into account the aforementioned structural changes in Japan's Investment income (≒ Primary Income balance), how do we compute their impact on JPY rates? A simple method is to figure out what percent of this income is converted to JPY. Let us take a look based on recent years' Direct investment income. Direct investment income is made up of three components – dividends and distributed branch profits, reinvested earnings, and interest income. Dividends and distributed branch profits are repatriated to Japan (i.e., give rise to JPY buying), which offers some hope for JPY appreciation, but reinvested earnings are reinvested as foreign currency, without being converted to JPY, so contribute nothing to supply or demand in the forex markets. In other words, half of Japan's Direct investment income does not return to Japan (does not lead to JPY buying). To give specific figures, payments received as part of Direct investment income in 2022 amounted to JPY 27.5950 trillion, of which reinvested earnings comprised 47% (JPY 13.410 trillion). The percentage of reinvested earnings in Direct investment income has been steadily rising over the past 10 years, clearly showing an increase in "JPY that does not return to Japan" (see figure).

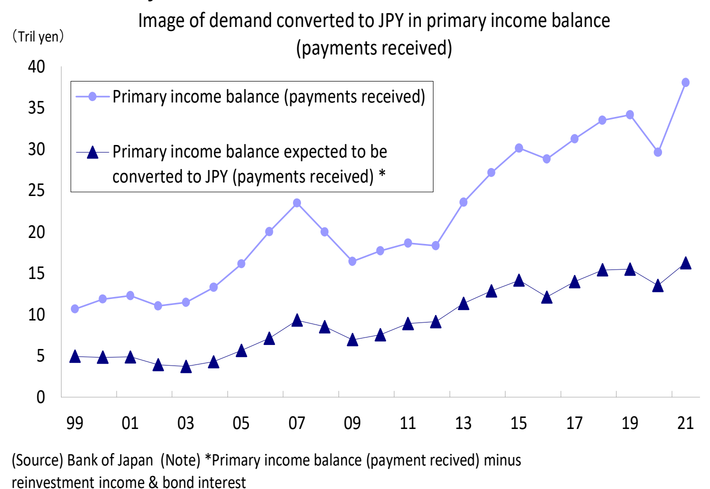


(Source) Bank of Japan
(Note) Reinvestment income as a percentage of primary income balance (payments received)

What about Portfolio investment income? Portfolio investment income comprises dividends and interest earned on bonds (both short-term and medium- to long-term bonds), with interest income from medium- to long-term bonds comprising 70% of the whole. In contrast to reinvested earnings, it is difficult to judge whether or not these will be converted to JPY, but interest income from overseas securities investment (e.g., U.S. government bonds) is ordinarily reinvested without being converted to JPY. To give specific figures, payments received as part of Portfolio investment income in 2022 amounted to JPY 18.5230 trillion, of which 62% was interest income from bonds, amounting to JPY 11.4886 trillion. This portion does not result in JPY buying. To sum up the situation, conversion to JPY cannot be expected from the total of reinvested earnings and bond interest income amounting to JPY 24.5296 trillion. As payments received as part of the Primary Income balance in 2022 totaled around JPY 49.9161 trillion, one could say roughly half does not get converted to JPY.

In Terms of Supply and Demand, Japan is Now a Trade Deficit Country

This state of affairs, where half the payments received as Primary Income do not return to Japan, has not changed in the past few years. However, because of the severe drain of foreign currency from Japan due to the Trade and Other services deficits, it is easy for JPY to weaken despite a Current Account surplus, given that half of the Primary Income surplus is not repatriated to Japan. This was painfully obvious in 2022, which saw the largest ever Primary Income surplus at +JPY 35.1857 trillion, but also the largest ever Trade and Services deficit at -JPY 21.1623 trillion, resulting in a Current Account surplus of +JPY 11.5466 trillion. While a Current Account surplus of +JPY 11 trillion is quite large compared with the global average, one must also consider the possibility that half of the approx. +JPY 50 trillion Primary Income surplus (i.e., about +JPY 25 trillion) may never have been converted back to JPY. With a Current Account surplus of +JPY 11 trillion, and +JPY 25 trillion worth of income not resulting in JPY buying, the reality was that more JPY was sold than bought.

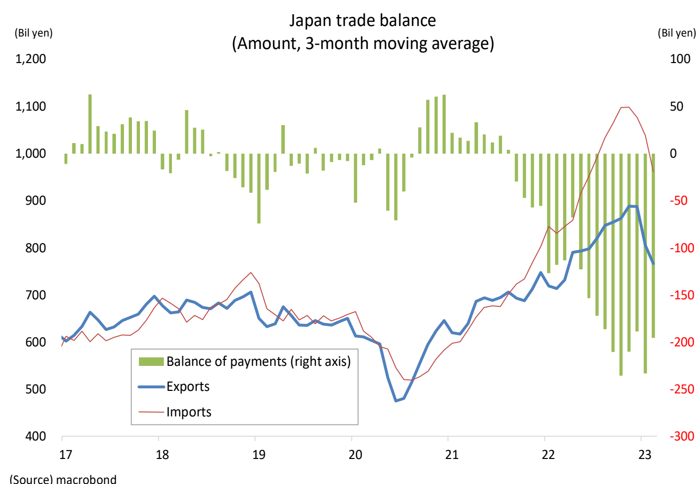


(Source) Bank of Japan (Note) *Primary income balance (payment recived) minus reinvestment income & bond interest

To keep things simple, my explanation assumed that JPY conversion could not be expected from Reinvested earnings and Bond interests, but the Dividend portion of Portfolio investment income (approx. JPY 7 trillion received in 2022) also tends mostly to be reinvested. If so, it would not just be half of the Japanese economy's earnings that fails to be converted to JPY. At any rate, perhaps it is time to realize that it is no longer possible to argue for JPY's strength based solely on Japan's Current Account surplus. One must also keep in mind that, when it comes to supply and demand in its external economy, Japan may now be a deficit country.

Trade Deficit Surpasses JPY 5 Trillion in 3 Months

Japan's Trade deficit, which receives the most direct focus when considering forex outlooks, posted -JPY 754.5 billion, the 20th consecutive month of deficit, in March. The headlines are focusing on the -JPY 22.7285 trillion deficit for FY 2022 being the largest ever recorded since the start of records in 1979. However, given that the deficit for calendar year 2022 was already about -JPY 20 trillion, there seems no need to be too surprised at the size of the deficit for the fiscal year. Rather, when it comes to forecasting forex trends for the current year, it seems more important to focus on the trade deficit for the first three months of the year (January-March) surpassing the -JPY 5 trillion mark (-JPY 5.1590 trillion). For instance, looking back at past figures, the trade deficit for 2019 was around -JPY 1.8 trillion, while the average annual trade deficit for the years 2011-15, when Japan posted deficits for five years in a row, was -JPY 3.7 trillion. Even considering that exports tend to be sluggish during the January-March quarter due to the Chinese New Year, a deficit of over -JPY 5 trillion over a period of three months is unprecedented and worthy of mention.

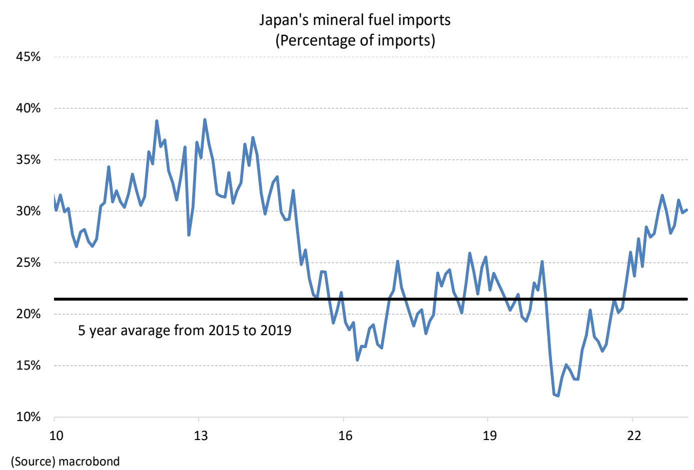


Looking at both exports and imports for March, the export value grew by +4.3% yoy (yoy for all figures below unless otherwise specified), maintaining the positive growth trend for the 25th month in a row, but export volume posted negative growth for the sixth consecutive month, at -8.1%. Even though JPY weakness has been boosting the value of exports (price x volume), the volume of exports has been lackluster amid sluggish external demand. Unless the volume of exports increases, a domestic virtuous cycle of increase in production → increase in income → increase in consumption cannot be expected. Meanwhile, the import value grew by +7.3%, posting the 26th consecutive month of increase, while the volume of imports declined by -2.6%, the fifth consecutive month of decline. Import value is also being pushed up by JPY depreciation, with a slight time delay. Add to this higher resource prices, and it is easy to see why imports continue to grow faster than exports. Naturally, the situation is not conducive to the trade balance improving. As shown by the figure, which plots three-month moving averages of both imports and exports, both imports and exports peaked at the same time, providing no opportunity for an improvement in the trade balance. With both JPY depreciation and resource price appreciation peaking, an improvement in Japan's trade balance was expected for 2023, but this has not happened, thanks to a global economic slowdown and persistently high commodity prices. Of course, in terms of seasonally adjusted figures, the trade deficit seems to be shrinking since October 2022, but the general sense is that the JPY depreciation trend has not undergone as strong a correction as expected, nor have crude oil prices fallen as much as expected, so the trade deficit, while smaller than last year's, may still end up being quite large.

Exports to China Remain Yoy Negative

As explained above, the sluggish growth in exports seems to be preventing trade balance improvement. In this context, looking at exports by country/region, one notes that exports to China (and Hong Kong) fell by -5.2%, the fourth consecutive month of negative yoy growth. While the margin of decline is gradually shrinking, the sluggishness of exports to China (which accounts for almost 18% of Japan's total exports) continues to weigh down Japan's exports overall. Further, as discussed in the previous section, from geopolitical and geoeconomic perspectives, there is great uncertainty as to whether the scale of Japan's commercial transactions with China will ever recover to their peak level. If this is taken to be the new normal, then one is forced to admit that, similar to the increase in commodity prices, the expansion of Japan's trade deficit may also be structural. Of course, exports to countries/regions other than China are also lackluster, with export growth slowing from +18.6% to +5.1% in the case of the U.S. and from +14.9% to +9.4% in the case of the EU. If exports to Japan's major trading partners fails to grow despite the real-effective weakness of JPY, voices of concern regarding the damage to Japan from JPY weakness may become more strident.

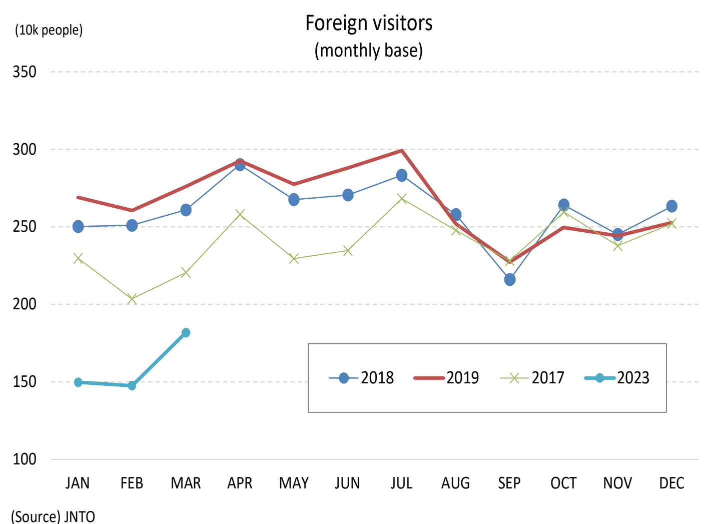
Mineral Fuel Imports Now Account for 30% of All Imports



The improvement of Japan's trade balance, however, depends more on import than on export trends. Needless to say, import trends are strongly determined by mineral fuel imports, which includes crude oil. Mineral fuels, which used to comprise a fourth of Japan's imports, now comprise roughly 30% (see figure). Considering that mineral fuel imports comprised an average of 21.4% of Japan's imports during the five years (60 months) immediately preceding the pandemic, it is clear that the amount of foreign currency Japan must spend toward energy procurement has increased. To simply calculate the relationship between crude oil prices and import value, a +1% increase in the price of crude oil causes an increase in Japan's mineral fuel import value of over +8%. Assuming that mineral fuel imports account for 30% of Japan's total imports, a +1% increase in the price of crude oil increases Japan's total import value by 2.4% (8% x 0.3). The average price of crude oil in the five years before the pandemic was USD 60/barrel, but the average price so far this year is close to USD 80/barrel. In other words, crude oil prices have gone up by about +30%. Therefore, using the aforementioned calculation, Japan's mineral fuel import value must have expanded by over +240%, causing the overall import value to increase over 70%. Of course, these calculations assume that all other conditions remain unchanged. In fact, the import value for all of 2022 amounted to JPY 118 trillion compared with the JPY 79 trillion average for the years 2017-19, which amounts to an about +50% increase. While the figure does not exactly match my calculations, the fact remains that Japanese import value has increased significantly, driven by crude oil prices. Moreover, one must keep in mind that this may not be a temporary situation. Resource prices not being my area of specialization, I cannot forecast crude oil prices, but it seems true at least to some extent that, going forward, the global economy must plod along in a world where things take more time and cost more money. Part of the background to this is the need for buying more expensive resources amid an inability to rely on Russia and China. I do not know whether a +30% increase in crude oil prices compared with pre-pandemic prices is appropriate, but I feel that it is important to accept, from a structural perspective, that resource prices may have increased a notch. Viewed this way, it becomes obvious that geopolitical and geoeconomic risks could decrease Japan's exports and increase its imports, and it is important to consider current and future prospects for JPY based on this perspective.

The Japanese Economy Now and Going Forward – How to Read the Ongoing Recovery of Inbound Tourism

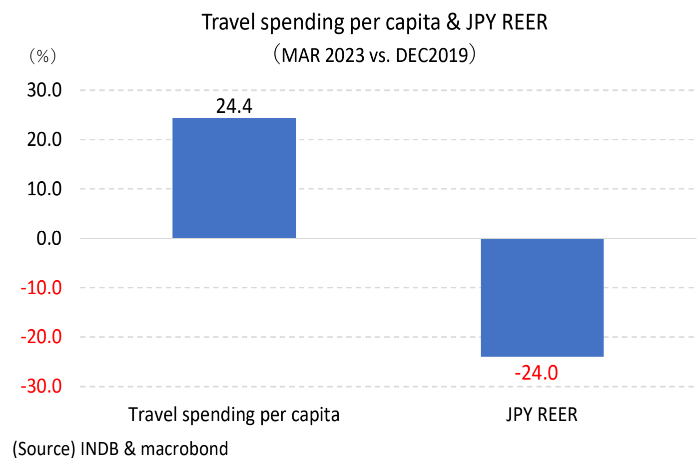
Inbound Visitor Numbers from Some Countries Back to Pre-Pandemic Levels



Japan's recovering inbound tourism (foreign visitors to the country) is grabbing headlines. When examining the demand for inbound tourism to Japan and its impact on the Japanese economy, it is important to consider both quantity (i.e., the number of foreign visitors to Japan) and quality (i.e., travel spend per visitor). While the former tends to draw most of the attention, the latter is more important when considering impact on the economy.

Taking a look at quantity first, the number of foreign visitors to Japan in March was 1.817 million, which is 65.8% of the figure recorded in March 2019, before the pandemic began. Visitor numbers have surpassed 1.5 million for the first time in over three years, since January 2020, just before the pandemic began and tourism hit rock bottom. The cherry blossom viewing season in Japan and the resumption of cruise ship operation are among factors that appear to have given tourism a boost. With flight services also gradually returning to normal, it could be said that inbound tourism, which tends to peak between April and July, is recovering nicely. Looking at figures by country of origin, there has been an increase in the number of tourists compared with March 2019 (i.e., higher than pre-pandemic figures) from Singapore (+20.6%), Vietnam (+11.9%), Australia (+2.3%), the U.S. (+15.0%), Mexico (+1%), and the Middle East (+4.9%). It is heartening to a full recovery in tourism from countries such as the U.S. and Australia, from where the volume of tourism to Japan is quite large. However, the reason Japan has still not managed to fully recover pre-pandemic tourism numbers overall is because package tours from China, which comprise roughly 30% of all inbound tourism to Japan, are not yet being allowed. Taking geopolitical and geoeconomic risks also into account, it is difficult to see how inbound tourism can make a full recovery.

Increase in Consumption ≒ Decline in REER



(Source) INDB & macrobond

While the number of visitors (quantity) is important, how much each visitor spends or invests in Japan (quality) is also important to take into account. Considering that JPY's real effective exchange rate (REER) is lower than it has ever been in the past 50 years, it is natural to expect that foreign visitors would find it easy to spend more in Japan (from the perspective of Japanese people) than before the pandemic. Indeed, an improvement in spending (i.e., quality) can be seen. According to the Japan Tourism Agency's "Consumption Trends of International Visitors" survey results for the January-March 2023 period, an average of JPY 211,957 was spent per visitor, which is a +24.4% increase compared with the JPY 170,434 per visitor spent in October-December 2019.

However, perhaps it is too early to rejoice whole-heartedly at this apparent improvement in quality. To explain, JPY's REER as of March 2023 is -24% weaker than it was in December 2019, which more or less coincides with the increase in amount spent per visitor in Japan (see figure). In addition to signifying Japan's lower purchasing power overseas, the decline in JPY's REER also signifies an increase in the purchasing power of foreign visitors in Japan. From the perspective of shoring up the Japanese economy, an increase in the amount per visitor spent in Japan would be very welcome.

However, most of the increase in spending seems to be the result of a weaker JPY, with the amount of foreign currency leaving the wallets of foreign tourists not changing that much. In other words, the amount spent may simply seem higher in JPY terms. Of course, this makes no difference to Japanese people, but another way to look at it is that the prices of goods and services made available to foreign tourists in Japan may be too low. If things continue this way, the amount spent by foreign visitors in Japan for all of 2023 could easily be higher than before the pandemic began, but (from a global perspective) it could be said that this is the result of things being sold too cheap. This is similar to how, with the depreciation of JPY, Japanese cars and electrical appliances can post higher sales despite local prices remaining unchanged.

Price Increases Going Forward?

Taking all this into account, perhaps a natural development amid consistently high demand for inbound tourism will be an increase in domestic prices? Unless the government goes back to imposing restrictions on inbound tourism similar to last year's isolationist policies, international demand for tourism to Japan, which continues to provide high-quality products and services at internationally low prices, is bound to continue strong. As a result, it seems likely that prices may begin to increase in Japan, starting from central Tokyo and for products/services of greatest interest to foreign visitors. Already higher prices can be seen for some food and accommodation services. Even if Japanese providers of food and accommodation services to foreigners increase their prices slightly, the prices for foreign visitors will merely go from being "very cheap" to "cheap," which is unlikely to impact demand for inbound tourism all that much. Most tourists are unlikely to be affected by it.

Of course, there is also the separate question of whether Japanese consumers will be affected by these price increases. However, the sale of both goods and services are business transactions, and their trends are dictated by what is economically rational rather than how Japanese people feel. Perhaps a positive future development Japanese people can look forward to is the revitalization of inbound tourism and a resultant tightening of the labor market, which may finally change the domestic economic climate characterized by no change in nominal wages. In the process, the phrase "excessive tourism," which indicates a negative impact from tourism on the lives of local residents, may come into vogue, but whether or not Japan wants it, it seems extremely likely that the path for the country to earn foreign currency through inbound tourism will continue to expand going forward. As the travel balance is one of the few remaining options for Japan to actively increase its foreign currency earnings in the future, a tourism-averse national policy is not prudent. Inbound tourism is an industry that Japan as a whole must nurture while grappling with its ill effects in the short term.

Risks to My Main Scenario – Financial Crisis Brewing in the Commercial Real Estate Sector?

Could CRE Investments Trigger the Next Crisis?

Almost two months have passed since the Silicon Valley Bank (SVB) collapsed, causing considerable worries that the event's ramifications might be comparable to those of the bankruptcy of Lehman Brothers in 2008 and, while the mood in financial markets has subsequently become more calm, there remains a heightened state of wariness about what kind of event might spur the next major financial crisis. In the United States, it has long been pointed out that the risks associated with such commercial real estate (CRE) investments as those in offices and hotels have the potential to cause major disruptions. In particular, many observers are noting the potential import of plunges in prices of commercial mortgage-backed securities (CMBSs, securities backed by bundles of CRE loans), and there are deep-rooted fears that the growing losses of institutional investors holding CMBSs might cause a crisis. The perceived financial instability of small and medium-sized U.S. banks has increased since the SVB bankruptcy, and since many

CRE investments are dependent on loans from such banks, it is becoming difficult to dispel concerns about how the banks' problems could exacerbate the CRE investment situation.

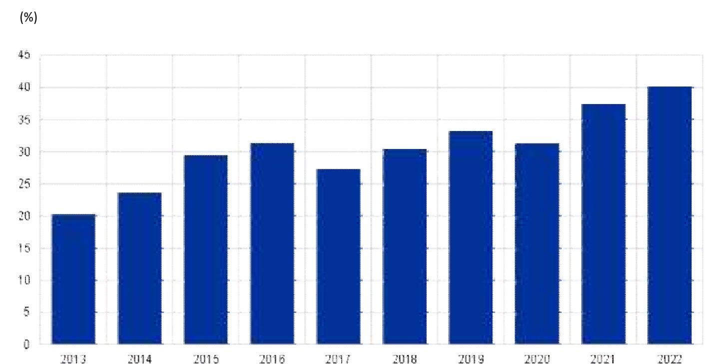
In fact, European CRE investments face problems similar to those seen in United States, and the ECB has recently been sounding alarms about related dangers. On April 3, the ECB posted an article on its website entitled "The growing role of investment funds in euro area real estate markets: risks and policy considerations", which notes that euro area CRE markets have grown significantly over the past decade and now pose a risk to the region's financial stability. Real estate investment funds (REIFs) currently have large market footprints in several euro area countries, and there are concerns that REIFs will become unstable as conditions in those countries' real estate markets worsen. As explained below, the ECB is pointing out that funds in the fast-growing REIF sector face a "liquidity mismatch" that has the potential to cause financial instability. Many REIFs are open-ended funds that allow investors to request redemptions, and there is concern that they will have to cope with extremely sudden and large-scale fund withdrawals at times when current and prospective conditions in the real estate market deteriorate. From a balance sheet standpoint, such REIFs' customer deposits can be characterized as highly liquid.

REIFs may need to sell some of their CRE holdings to fund high volumes of redemptions, but CREs, owing to the nature of their assets, are not easy to sell. In other words, the liquidity of REIF balance sheet assets is low. If REIFs are forced to hurry the sales of low-liquidity assets, they may be forced to resort to fire sales, which could amplify CRE market stress and result in progressively growing losses. However, since a serious liquidity disruption will cause an REIF to perish, REIFs are not positioned to stop selling even if the sales cause them to suffer great losses. The ECB's concern is that such liquidity mismatches could cause REIFs to face severe financial difficulties and go bankrupt, thereby promoting widespread financial instability in the euro area. Since the SVB bankruptcy, an increasing number of observers have begun arguing that the CRE sector has the potential to trigger the next financial crisis, but it is rare for a central bank to explicitly make similar arguments.

Potential for a CRE Crisis to Cause Systemic Risk

According to the ECB, the share of euro area CRE markets accounted for by the REIF sector has doubled over the past decade (rising from 20% in 2012 to 40% in 2022), and the potential problems associated with the REIF sector's size have become too large to disregard (see graph). The large size of REIFs' CRE market footprint has created an interdependent relationship in which CRE market instability directly promotes REIF instability and REIF instability also directly promotes CRE market instability. Given that such financial institutions as banks and securities companies have exposure to the CRE market, CRE market instability appears likely to lead to financial instability. In this way, the CRE situation has come to be seen as having the potential to trigger a major financial crisis accompanied by systemic risk. The destabilization of financial institutions would cause the institutions to tighten their lending policies, creating a credit crunch that would exert downward pressure on the real economy. In light of such events outside the euro area as the SVB bankruptcy and the Credit Suisse restructuring, it appears that the ECB is beginning to recognize that there is a significant likelihood of such developments eventuating.

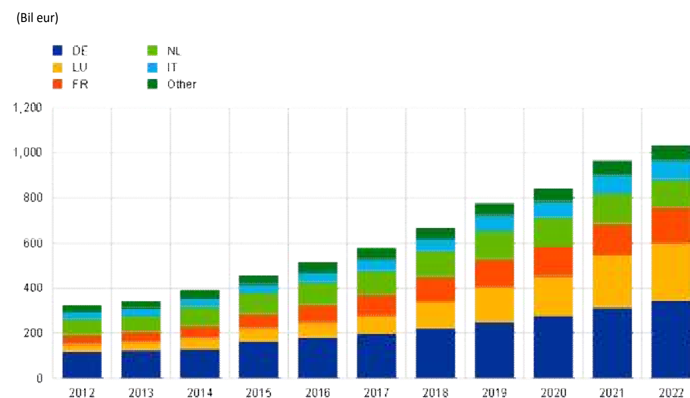
Share of real estate value held by REIFs in Euro-zone CRE market (Source: ECB)



The ECB article noted that, in the United States, the Blackstone Real Estate Income Trust (a real estate investment trust (REIT) of the leading asset management company Blackstone) recently faced a surge in redemption requests and had to limit redemptions in line with its own withdrawal limits, undertake substantial property sales, and source new investment to ease liquidity pressures. The article referred to similar situations affecting many REIFS in the United Kingdom, and pointed out the possibility that the incidence of such cases will increase in the future. It goes without saying that REIFs facing redemption request surges will not only sell their real estate holdings to secure liquidity but also work to raise additional funds, promoting a general rise in the cost of raising funds in financial markets. As explained below, such developments may increase the likelihood of interest rate cuts in the near future.

A Crisis Beginning to Materialize

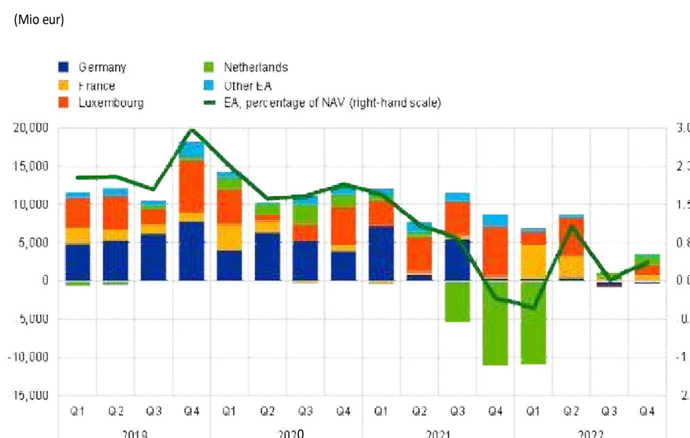
Net assets of real estate investment funds and their location (Source: ECB)



Over the past decade, there has been tremendous growth in euro area CREs and REIFs. As mentioned above, euro area REIFs' CRE market share doubled over the past decade, and those REIFs' net asset value (NAV) tripled during that period – rising from EUR323 billion in 2012 to EUR1.04 billion in 2022 – and open-ended REIFs (which allow investors to submit redemption requests at any time) are said to account for roughly 80% of that NAV figure. Euro area REIFs are concentrated in five member countries (Germany, Luxembourg, France, the Netherlands, and Italy; see graph), where the article states that – "the real estate assets of REIFs represent over 30% of the value of the national CRE market. However, this figure includes exposures to real estate held through financial instruments (namely debt securities and equities) that are more likely to relate to cross-border investments." The existence of cross-border investments means that the impact of CRE and REIF destabilization would not be limited to those five countries, which could be considered bad in that the impact would be wider-spread but could be considered good in that the impact is less likely to be geographically concentrated to the extent that it would cause more-severe local crises. The article notes that the CRE market was negatively affected by pandemic-induced behavioral changes, such as the shifts towards remote work and e-commerce, but also points out the importance of post-pandemic rises in interest rates, which have caused funding costs to begin rising. CRE prices were rising quite rapidly just prior to the pandemic, and the article opines that those price increases – "may have resulted in overvaluation in CRE markets, creating space for a large price correction in the event of adverse shocks." It appears that CRE-related transactions have sharply declined since the last quarter of 2022, and the article notes that this trend is likely to reflect a considerable softening of CRE prices. While there remains leeway for further deterioration in the CRE market, it can be said that a CRE crisis has already begun to materialize.

Measures to Alleviate Key Liquidity Mismatch Problems

Net inflows and outflows to REIFs (Source: ECB)



As mentioned at start of this section, the key vulnerability likely to be the cause of whatever CRE crisis may occur isthe "liquidity mismatch" problem faced by REIFs if they are flooded with redemption requests. When an REIF's redemption terms (the time required to implement requested redemptions) are significantly shorter than its liquidation periods (the time required to sell portfolio assets), the associated liquidity mismatch may cause the REIF to face severe cash flow problems. It is currently difficult to identify euro area countries vulnerable to liquidity mismatch crises, but a study conducted this year by the European Systemic Risk Board (ESRB, which monitors financial stability in the euro area) found that REIFs with liquidity mismatches accounted for as much as 31% of the total open-ended open-ended REIFs market as at the third quarter of 2021. The ECB article notes that the study also found that – "in some countries where REIFs account for a substantial part of the CRE market (for instance France, the Netherlands and Ireland), the majority of such funds have an open-ended structure, while cash buffers are relatively low. In contrast, the vulnerability is expected to be of a magnitude lower in countries where cash levels are higher or where more funds are closed-end (for instance Italy and Portugal). As conditions in CRE markets have become more challenging, flows into REIFs have started to slow and have even turned negative in some jurisdictions [such as the Netherlands]." The graph on the previous page clearly shows the dramatic change in REIFs' operating environment, and it seems obvious that such an environment is making REIFs more vulnerable to shocks. Recent monetary policy tightening measures and the banking industry turmoil that has persisted since March are trends pouring salt on the wounds of the CRE market and the REIFs whose main battlefield is that market, so it is not surprising that the ECB is quite concerned.

A Basis for Reducing Interest Rate Hike Margins?

As noted above, as many REIFs start preparing to cope with liquidity mismatches they are likely to step up their asset sales and fund raising measures, and those steps can be expected to promote asset price declines and funding cost increases. In light of that, the final section of the ECB article presents policy options for addressing REIFs' vulnerabilities. The article notes that REIFs have the ability to suspend redemptions when necessary but are often reluctant to use that ability given the associated stigma and costs. Accordingly, the ECB is advocating the introduction and consistent usage across funds of such liquidity management tools (LMTs) as the introduction of redemption fees, longer minimum holding periods, and longer redemption notice and settlement periods. The ECB also mentions the regulatory approach of allowing only closed-end REIFs and not permitting open-ended REIFs whose ease of investment redemptions are a key basis of liquidity mismatches. Given that REIFs by their nature are characterized by the holding of low-liquidity real estate assets, raising the hurdles to redemptions is an essential means of alleviating liquidity mismatches, and measures to raise those hurdles have already been introduced in some countries. It appears that the implementation of such regulatory measures is likely to intensify in the future.

The above-mentioned CRE-related risks have been pointed out and discussed in the United States for some time, and the financial markets have a high level of interest in them. How are policy interest rate trends likely to be affected by the increasing attention drawn by the CRE crisis? If central banks concur with the above argument that the behavior of REIFs fearing a liquidity crisis is almost certain to promote increases in funding costs, which could directly generate systemic financial risks, then it is hard to imagine that the central banks will not do anything in response to that situation. Over the medium-to-long term, it is likely that such REIF management regulatory revisions as those mentioned above will be implemented. At the same time, however, as a short-term means of forestalling a crisis, it will be more feasible for the central banks to lower policy interest rates that represent risk-free interest rates.

The use of the "CRE crisis" phrase has not yet become common, but if a true CRE crisis is generally recognized to be taking shape, there is a risk that central banks may quickly adjust their policy stances by moving away from interest rate hikes, even if that undermines their efforts to countervail current inflation trends. Sudden changes in central bank policy rates are liable to boost market volatility and generate unnecessary market turmoil. As CRE market trends are a factor that could force the ECB and the Fed to make an unexpected policy course adjustment (and also cause unexpected JPY appreciation), they should be acknowledged to be an important element of the prospective risk scenario.

EUR Outlook – Interest Rate Hike Turning Point Finally in Sight?

EUR Area Monetary Policies Now and Going Forward – Possibility that Credit Environment Tightening May Restrain Interest Rate Hikes

March Governing Council Meeting Emphasized Policy Persistency

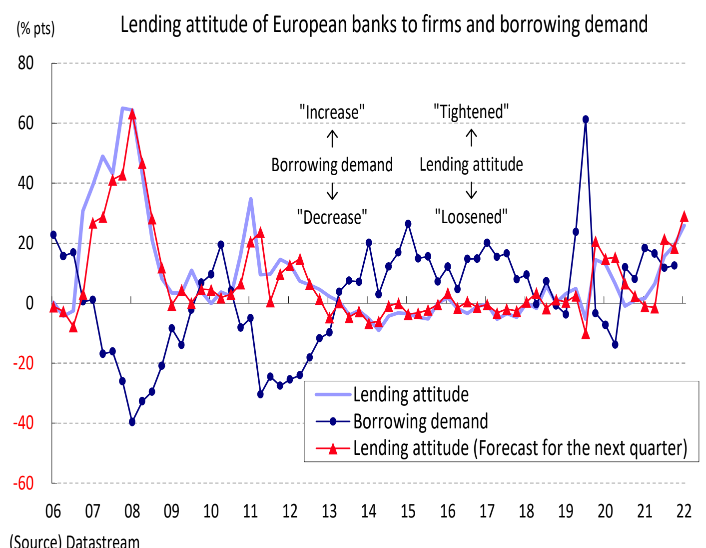
There was no ECB Governing Council meeting in April, but the Account of the March 15-16 Governing Council meeting was released on the April 20 and, given the lack of an April meeting, the Account is a good source of recent information useful for predicting the ECB's behavior. The March meeting was held amid heightened concerns about the financial system owing to such factors as the collapse of Silicon Valley Bank (SVB) and the restructuring of major financial institutions in continental Europe. Looking back at that time, the ECB was seen to be maintaining a proactive stance in the midst of growing uncertainty, and attention was focused on the possibility that its behavior might have some kind of influence on the Fed and the BOJ. The March Governing Council meeting decided to implement the 50bp deposit facility interest rate hike that had been announced at the February meeting. On the other hand, since the February Governing Council meeting's forward guidance promising a March 50bp interest rate hike barring a "quite extreme" scenario was not renewed, the March Governing Council meeting was also a meeting at which the policy outlook for the next meeting (May 4) and beyond was becoming increasingly uncertain.

In light of that uncertain policy outlook, it is important to see what kind of information about the outlook can be gleaned from the Account of the March meeting. The approval of the 50bp hike was not unanimous – the Account said the hike was approved by a "very large majority" of members, but – "Some members would have preferred not to increase the key rates until the financial market tensions had subsided and to conduct a comprehensive re-evaluation of the stance at the Governing Council's next monetary policy meeting, in May. It was stressed that markets were volatile and the positive opening of the financial markets on the second day of the current meeting could not be taken as evidence that financial stability risks had receded."

It seems that there was still a high level of awareness of the problematic fact that, while growth in inflation rates had peaked out, the rates themselves remained worrisomely high. <u>This point was clearly communicated in the March Governing Council meeting's statement, which 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</u>[.]" The Account noted that – "While inflation expectations appeared to remain broadly anchored, developments in market-based measures of inflation compensation had been moving in the wrong direction for much of the period since the February monetary policy meeting, and there was a risk that high inflation could become more persistent, with core inflation still increasing." – so it was concluded that "persistent inflation dynamics" required persistent monetary policies and that postponing rate hikes would send the wrong message to the markets. <u>Regarding the revised ECB staff macroeconomic projections released in March, some members expressed their concern that that inflation might not return to low levels as quickly as the projections indicate, and it appears this was a key factor convincing the governing council to maintain a hawkish stance.</u> It seems that the idea that persistent inflation must be countered by persistent monetary policies was a dominant theme at the March Governing Council meeting.

Importance of the Bank Lending Survey

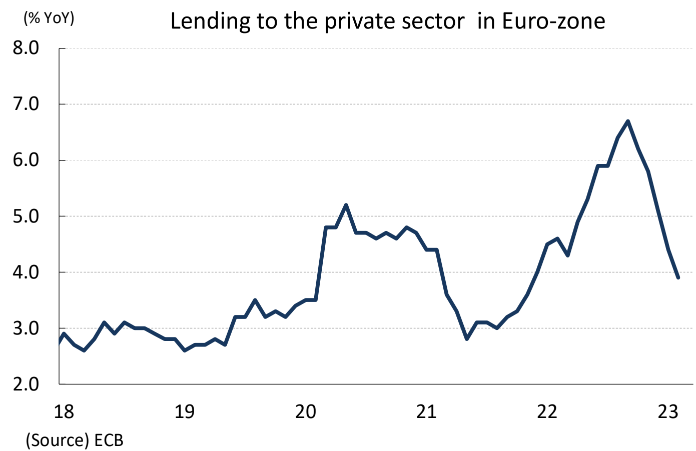
Regarding the March Governing Council meeting's decision to approve the 50bp rate hike proposed by ECB Executive Board member and chief economist Philip Lane, the Account notes that – "It was acknowledged that in the current situation of heightened uncertainty a decision had to be taken with imperfect information." In light of this, when forecasting what the ECB's the next policy move might be, it will be important to see what data made available after the March meeting might help alleviate the uncertainty and imperfection of information. <u>The results of the ECB's Euro Area Bank Lending Survey (BLS), which this article closely monitors, are likely to provide key data in this regard. The Account also indicates the governing council discussed how monetary policy tightening effects can be expected to affect corporate lending with a lag</u>. The graph on the previous page shows BLS data through the fourth quarter of last year, at which time it had already been confirmed that lending



(Source) Datastream

postures had tightened (shrinking the supply of loans) and borrowing demand had declined.

The BLS data will be updated on May 2, two days before the May Governing Council meeting. It is highly likely that the BLS data for the first quarter along with forecasts of second quarter BLS data will indicate additional lending posture tightening, and this can be expected to promote ECB dovishness. In fact, there has already been a clear drop in lending to the private sector in the euro area (see graph). As this will restrain money flows into the real economy and can thereby be expected to countervail inflation, a basis for greater ECB dovishness seems to be taking shape. The Account specifically mentions the BLS as a representative example of the newly available information that will serve as the basis for policy decisions in the future.



Potential Slowdown to a 25bp Hike in May

Based on the above information, what should one be expecting from the May 4 Governing Council meeting? It appears likely that the ECB will reduce its interest rate hike margin from 50bp to 25bp, which would be the smallest rate hike margin during the current rate hike phase. This expectation is based on the theory that rate hike margins will inevitably become smaller as the credit environment tightens, as explained above, as well as on the fact that the ECB itself began from early April to sound the alarm about the CRE market, as noted in the Risks to My Main Scenario section of this article. I find it somewhat peculiar that the ECB, even while it is pointing out such systemic risks, has not made any changes to its monetary policy stance.

Of course, the ECB is unlikely to stop hiking interest rates while the employment and wage situations are acknowledged to remain quite tight, but it may decrease its rate hike margins to 25bp so as to protract its period of hikes as long as possible without reaching the point of overkill. Updated BLS data will become available along with preliminary April Harmonised Index of Consumer Prices (HICP) figures on May 2nd. It will thus will be difficult for market participants to finalize their forecasts until the very last minute, as crucial information underlying forecasts will not become available until just before the May 4 Governing Council meeting.

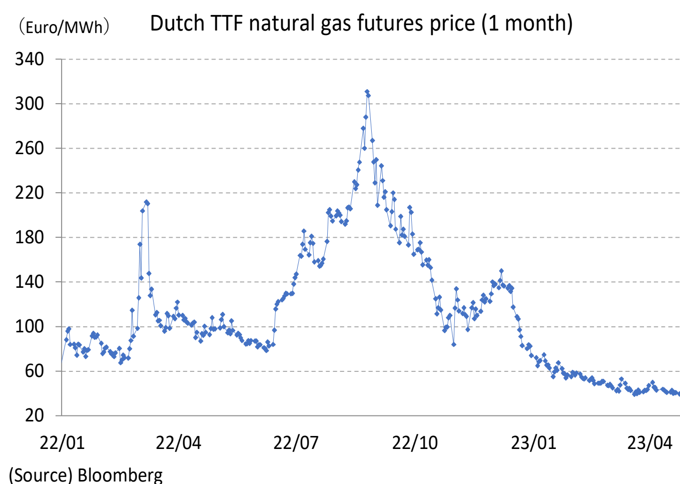
EUR Now and Going Forward – Tailwinds from both Interest Rate and Supply/Demand Situations

EUR/JPY Reaches Highest Level in 100 Months

In April, EUR/JPY temporarily attained the high JPY148-149 range, its highest level in about eight years and four months (since December 2014). Although EUR/JPY has receded since then, I think it worth examining the background factors enabling it to reach its highest level in 100 months. As this article has since last year anticipated that EUR/JPY would exceed JPY150 by the end of 2023, the recent record high level is not actually so surprising. Many publicly expressed theories about this argue that it is merely reflecting the contrast between expectations of higher euro area interest rates and expectations of lower JPY interest rates, but the situation is not that simple. EUR/JPY is indeed highly sensitive to the disparate policies of the ECB, which is likely to raise interest rates longer than the FRB, and the BOJ, which is likely to continue easing even under its new leadership, and EUR/JPY's recording its highest level in more than eight years does reflect that disparity. However, EUR's strength against JPY is similar to EUR's strength against USD, as EUR/USD has recently been hovering around USD1.10, its highest level since the beginning of the year. In the forex market as a whole, the fact that the ECB has maintained a "relatively hawkish" position compared to other central banks has led to interest rate trends that have been promoting EUR appreciation, and this has been emphasized in this article since the beginning of the year. In fact, EUR/USD has long been highly correlated to trends in Europe-U.S. interest rate differentials, and one can understand the thinking of those of seeking to understand the EUR appreciation and USD depreciation trends seen since last fall purely based on interest rate trends. As a consensus has formed that even with its new leadership the BOJ will continue its easing policies, EUR appreciation against JPY can be considered inevitable.

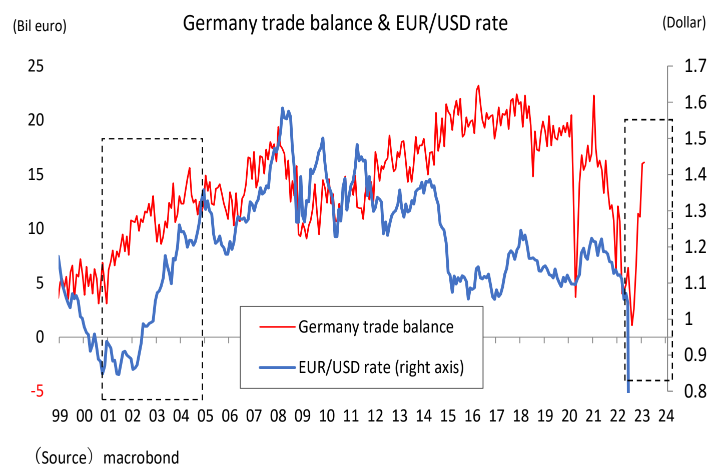
Supply-Demand Environment Promoting EUR Appreciation

Besides interest rate trends, however, the tailwind factors promoting EUR appreciation include an improvement in the EUR supply-demand environment. It is important to note that the EUR supply-demand environment in the euro area has been improving markedly against the backdrop of the fall in natural gas prices owing to unexpectedly warm winter weather. As mentioned above, the ECB has been maintaining its "relatively hawkish" policy stance, and the directionality of EUR interest rates has been keenly monitored by the forex market, particularly because, although a decrease in euro area GDP had been confidently anticipated in the fourth quarter of 2022, the warm winter helped enable that GDP figure to remain roughly stable. Essentially, the euro area economy was supported by a substantial improvement in the income environment caused by falling natural gas prices. The key reason for EUR's current firmness is that weather factors have caused both interest rate trends and EUR supply-demand environment trends to shift from those promoting EUR selling to those promoting EUR buying. Regarding euro area natural gas prices, these were in the USD10-to-25/MWh range before the pandemic, so the current level (around USD40/MWh) is still far from normal (see graph).



(Source) Bloomberg

The impact of the natural gas price drop on the EUR supply-demand environment can be easily understood if one takes a quick glance at trends in Germany's trade balance and EUR/USD (see graph). The EUR depreciation trend that started just over a year ago caused EUR to fall below parity with USD (EUR1 = USD1) for a protracted period at the end of last September. The ECB had already raised its policy interest rates by 75bp around this time, but the associated interest rate movements were not appreciated by the forex market, and this lack of appreciation appears to reflect EUR supply-demand trends, particularly the erosion of Germany's trade surplus (see portion of graph within dotted lines). At that time, EU countries (particularly Germany) were receiving dwindling supplies of natural gas from Russia and were forced to purchase LNG at relatively high spot prices. That caused deterioration in euro area countries' trade balances, promoting decreased trade surpluses or trade deficits. That was clearly the reason for EUR weakness at that time and, moreover, EUR weakness itself increased the EUR-denominated expense of imports and thereby caused further deterioration in euro area countries' trade balances. While Germany boasted the world's largest trade surplus from April to May last year, that surplus almost disappeared. (Although there were media reports based on preliminary data that claimed the surplus had disappeared last May, the finalized data figures indicated that a slight surplus had actually been maintained.) However, as the graph on the previous page shows, Germany's trade surplus has shown a dramatic rise since the end of last year, and EUR exchange rates appear to be reflecting that rise.



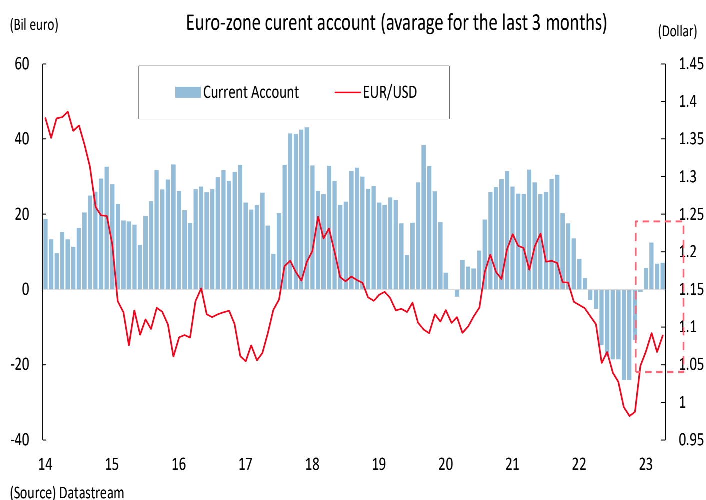
(Source) macrobond

This is not the first time EUR exchange rates have risen and fallen against the backdrop of drastic changes in the EUR supply-demand environment. Soon after the EUR was launched, EUR fell below parity with USD during the period from 2000 to 2002. As it was widely recognized even before EUR's launch that the euro area did not constitute an optimal currency area (OCA), the forex market was initially somewhat doubtful about EUR's sustainability, and the market's doubts were reflected in the exceptionally low EUR valuations. There is no single reason for EUR's recent trend of appreciation, but it should be noted that the economy of Germany (which had begun to be referred to as "the sick man of Europe"[1]) has been showing signs of a strong recovery and Germany's trade surplus has clearly been trending upward (see portion of graph within dotted lines).

[1] The December 2003 edition of the Economist gave the German economy the epithet "Sick man walking". Subsequently, the Economist referred to the German economy with such titles as "Germany on the mend" (November 2004) and "Sick man no more" (July 2007), reflecting Germany's steady economic recovery.

EUR and JPY -- Contrasting Situations Regarding Both Interest Rates and Supply-Demand Situations

Besides Germany, the EUR supply-demand environment improvement has also been evident for the euro area as a whole – the region's current account balance has improved markedly since the beginning of the year, with the expected result of promoting EUR appreciation. One may be skeptical about whether forex trends have truly been so strongly influenced by natural gas prices but, just as when forecasting JPY exchange rates, it is clearly important when considering EUR exchange rates' current situation and outlook to carefully monitor both interest rate trends and EUR supply-demand trends. When analyzing the reasons why EUR/JPY has reached its highest level in more than eight years, after considering interest rate trends, it is necessary to give due consideration to the contrasting situations of Japan, which continues to suffer from persistent trade deficits, and Germany, which is steadily restoring its trade surplus to world-leading levels.



The Euro Area Economy Now and Going Forward – EU-Russia Trade Halved

EU-Russia Trade Halved

The latest editions of the IMF's WEO and GFSR, released in rapid succession in mid-April, confirm that geopolitical and geoeconomic thinking will become increasingly important for analyzing global economic and financial situations. The reports sorrowfully note that the world will become poorer overall owing to an ongoing trend in which countries increasingly prefer to allocate securities investments, direct investments, and bank loans to countries considered politically close and give precedence to the unwinding of investments and loans in countries that are politically distant. Around the same time, on April 12, the ECB published an blog post entitled "A year of international trade diversion shaped by war, sanctions, and boycotts" that, like the IMF publications, focuses on the rise of geopolitical risks and associated economic and financial trends and argues such trends are unfavorable for all the world's countries. I think it is worth overviewing this blog post here.

Sources: Eurostat and ECB staff calculation.

Note: Exports from the euro area to Russia and imports to the euro area from Russia measured in volumes, i.e. adjusted for price developments. Last observation: December 2022.

Since Russia invaded Ukraine last February, the EU and its allies have imposed restrictions on exports of machinery and transport equipment to Russia. European companies and households are moving to reduce or freeze transactions with Russian companies, and the EU and the G7 are currently taking such steps as those to restricting the sea transport of Russian oil and to set ceilings on Russian oil transaction prices. The ECB blog argues that such measures are causing Russia's trade relations with the EU and with the rest of the world to undergo fundamental changes. It notes the fact that Russia had been an important trading partner for the EU. Before the war, in 2021, Russia purchased about 3% of the goods exported by euro area countries, and about 5% of the goods imported by euro area countries came from Russia. Russia was the source of almost half of the EU's essential energy commodities – accounting for 25% of EU crude oil imports, 40% of its natural gas imports, and 50% of its coal imports – and Germany was subjected to criticism for its particularly high level of reliance on Russian energy commodities. The impact of the war in Ukraine on Russia-EU trade can be seen at a glance from the graph, which shows that the euro area's exports to and imports from Russia both fell to half their previous levels in just over a year after the war's start. As noted at the end of this article, it is undeniable that the economies of both sides have become more vulnerable as a result. The situation is examined in greater detail below.

Russia Forced to Import Lower Quality and Higher Priced Goods

Regarding the high-profile case of Russia's supplies of natural gas supply to the EU, as of this past February, such supplies had been reduced by more than 90% from the pre-war average level, as the EU has turned to alternative supplies of natural gas from such countries as Norway, Algeria, and Azerbaijan. Since the start of the war, the EU has sought to increase its procurement of liquefied natural gas (LNG) from all over the world – by the end of 2024, the EU's LNG import capability is expected to reach 130% of the level at the end of 2021, at which point the EU will

account for 10% of global demand for LNG. As discussed below, however, there is still no prospect for the EU to resolve its energy shortage during 2023.

The loss of the EU as a major customer is also changing the structure of Russia's trade transactions. Immediately after the outbreak of the war, Russia's imports not only to the EU but also to other countries were halved, but as time passed, countries not participating in anti-Russia sanctions increased their exports to Russia, and Russia's total imports had returned to pre-war levels as of early 2023. The most distinctive change to Russian imports relates to China, which had increased its exports to Russia to a level accounting for half of Russia's imports as of January 2023. However, the ECB blog post notes that – "While Russia has now largely restructured its supply chains and its goods imports have recovered, what remains unclear is whether the new imports are of the same quality as those that were lost. Russian industry relied heavily on high-tech goods from western trading partners before the war. The sanctions imposed on these products have meant that they are either unavailable, have been replaced by low-quality substitutes, or have become much more expensive. This setback will likely weigh on productivity growth in Russia, reducing the economy's long-term growth prospects."

On the other hand, the structure of Russia's exports is also undergoing major changes, and this also largely relates to China. In fact, Russia's oil exports have continued increasing on a volume basis even after the war began, reflecting the fact that declines in exports to the EU and G7 countries have been more than compensated for by increases in exports to China, Turkey, India, the Middle East, and Africa. The increase in Russia's oil exports is noted to be on volume basis, as Russia has begun selling crude oil at lower prices in order to find new customers. Russia's Ural crude was trading at an average price of USD48 per barrel as of February this year, well below the global crude benchmark of USD83 per barrel for Brent crude. Russia has found it more difficult to redirect its gas exports, as they require extensive pipeline infrastructure, but it has partially compensated for the drop in exports to Europe by increasing pipeline flows to China and selling more LNG to the world market. Nevertheless, Russian gas exports in 2022 were around 25% lower than in 2021, reflecting the large impact of losing EU customers.

Geopolitics Making Economies More-Vulnerable

It is thus apparent that economic sanctions and boycotts by European companies are dramatically changing the nature of trade between the EU and Russia, and the significance of this from the Russian perspective and the euro area perspective is quite different.

From Russia's point of view, the significance is that Russia will continue being forced to rely on the somewhat limited array of trading partners who are not going along with anti-Russia sanctions. As mentioned, China is the prime representative of this array. However, dependence on trade with a single or a limited number of countries will naturally increase the overall vulnerability of a given economy. For example, a weakening of the Chinese economy may be likely to weaken the Russian economy. Moreover, Russia has not been able to find another country or region to completely replace the euro area as an export destination, as the euro area had been Russia's main customer for its resource exports. As mentioned above, no matter how much Russia increases its exports on a volume basis, if it must lower export prices to develop new customers, it will be forced to engage in export business with relatively low profit margins. Furthermore, the difficulties Russia faces in obtaining high-tech goods necessary for economic activities reduce the likelihood that it will be able to realize productivity improvements.

Of course, the euro area will suffer the same kinds of damage to its economy. While this article has made this point numerous times, it bears repeating that the euro area was extremely fortunate to enjoy warm weather during the 2022-2023 winter season but has not yet finished an energy procurement system restructuring enabling a complete shift from Russian supplies to supplies from other countries and regions. As mentioned above, the EU is seeking to replace Russia natural gas by augmenting its LNG procurement, but it takes at least three years to create the new facilities required for receiving imported LNG. (It is said to take more than 5 years to obtain the requisite permits and construct storage tanks and vaporization units on land, and while floating bases can be built more quickly, even such bases take about 3 years to create.) As we approach the mid-point of 2023, there is a high possibility that the euro area's concerns about its energy supplies will increase again when the next winter season approaches, as was the case last year.

Looking at EU-Russia trade trends, one cannot help noting that if heightened geopolitical risks continue causing the issuance of additional series of economic and financial sanctions, there will inevitably be a progressive unwinding of the economic and financial globalization trends. Optimistically referring to this unwinding as "slowbalization", the IMF anticipates that such an unwinding will make the world poorer, and it appears that it is clearly correct in that appraisal. A process of global economic fragmentation involving such resource-rich countries as Russia will obviously exacerbate supply constraints (particularly in the energy sector) and augment inflationary pressures worldwide, and that is what the world has already been suffering from over the past year.

In the very long term, it is possible that the global economy will weaken and deflationary pressure will increase (in fact, Chapter 2 of the WEO discusses that possibility), but on a shorter time scale, it is thought highly likely that the global economy will be forced to suffer from slower growth rates and a tendency toward stagflation. It appears that the trend of increase in geopolitical frictions may be fated to continue for some time despite the economic irrationality and costs those frictions generate, and it is hard to imagine how the trend can be reversed unless many countries and regions become impacted to an extent that motivates them to undertake the very difficult efforts required to effectively resolve those geopolitical frictions.

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