# Forex Medium-Term Outlook

MIZUHO

**May 31, 2023**

## Overview of Outlook

USD/JPY continued to climb in May. As I frequently point out in this report, discussing JPY level and direction trends based solely on U.S. interest rate trends is a dangerous stance to take. Of course, given that there will be an important phase transition as the Fed pivots to rate cuts going forward, there may be good opportunities for investors waiting for JPY to appreciate against USD. In my basic understanding, however, these are likely to be brief buying opportunities punctuating an otherwise a medium- to long-term weak-JPY trend. Looking at JPY supply & demand, a number of new avenues apart from trade deficits have emerged to drain away Japan's foreign reserves, including digital technologies, consulting, and R&D, and their scale is not small by any means. Japan's current account surplus and its status as the world's largest net external creditor are facts, but whether these result in repatriation of JPY is a different question. Within Japan's primary income surplus, the weight of direct investment income has been increasing, and within that, the weight of reinvested earnings has been increasing, so despite the account books showing a surplus, the end result is that an increasing percentage of this surplus remains as foreign currency without ever being converted back to JPY. Even if there may be buying opportunities as the Fed pivots to rate cuts, one must not expect the Fed's moves alone to bring USD/JPY back to below the 120 level. Ignoring the major structural changes in JPY's supply-demand climate and attempting to formulate the outlook for USD/JPY simply based on the frequency and margin of U.S. rate hikes or monthly results of fundamental economic indicators is no longer feasible.

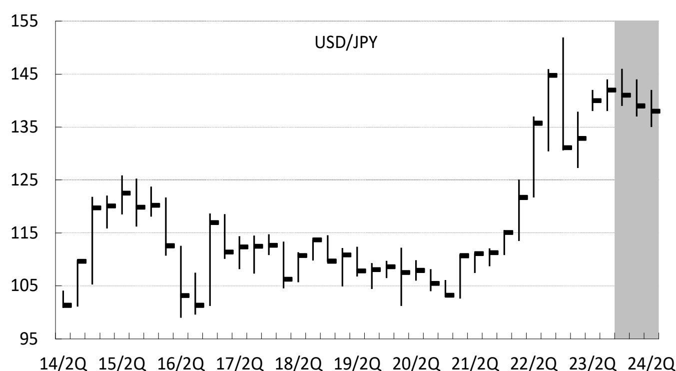
EUR weakened in May but did not suffer a significant collapse. At its May Governing Council meeting, the ECB reaffirmed its commitment to rate hikes, and it seems quite likely that rate hikes will be implemented in June and July also. There is also a sense that the Fed will continue its rate hikes longer than expected, but the situation seems to indicate a basic trend favoring EUR buying as the gap between Fed and ECB monetary policies begins to expand going forward. Further, bank lending surveys clearly show bank lending criteria getting stricter and corporate demand for loans receding, indicating that the impact of aggressive rate hikes is getting through to the real economy. It is probably also a fact that the end of rate hikes is near. Further, as discussed in last month's issue of this report, it is not just interest rates but also demand that is playing an important role in propping up EUR. Thanks to a multitude of factors, including a mild winter last year, the price of natural gas has finally fallen to or below levels seen before the Russian invasion of Ukraine. As a result, trade balances across the region, led by Germany, have improved significantly. It appears that the euro area is recovering its strength as the economy with the world's largest trade surplus. On the flip side, it remains vulnerable in the sense that the size of this surplus depends on natural gas prices. The region has not yet completed its shift away from Russia for energy procurement, so depending on how mild or severe this year's winter is, the supply-demand climate could change dramatically, and an EUR crash triggered by weather conditions is one of the downside risks to my main forecast scenario.

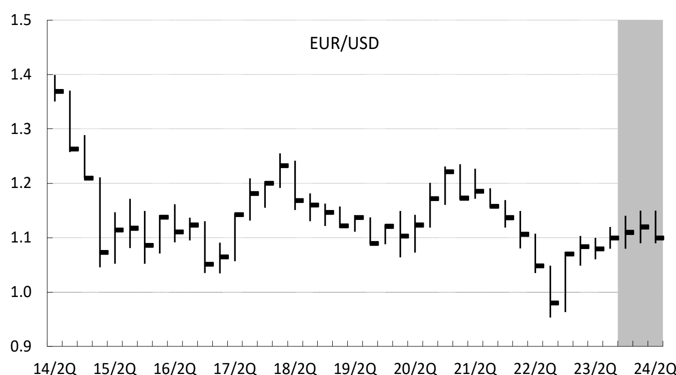
**Summary Table of Forecasts**

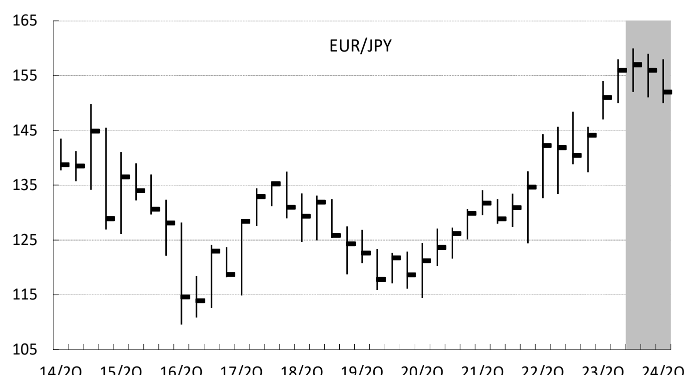
| | 2023 Jan-May (Actual) | Jun | Jul-Sep | Oct-Dec | 2024 Jan-Mar | Apr-Jun |
|---|---|---|---|---|---|---|
| **USD/JPY** | 127.22 ～ 140.93 (139.61) | 138 ～ 142 (140) | 138 ～ 144 (142) | 139 ～ 146 (141) | 137 ～ 144 (139) | 135 ～ 142 (138) |
| **EUR/USD** | 1.0482 ～ 1.1096 (1.0735) | 1.06 ～ 1.10 (1.08) | 1.08 ～ 1.12 (1.10) | 1.08 ～ 1.14 (1.11) | 1.09 ～ 1.15 (1.12) | 1.09 ～ 1.15 (1.10) |
| **EUR/JPY** | 137.45 ～ 151.60 (149.88) | 147 ～ 154 (151) | 150 ～ 158 (156) | 152 ～ 160 (157) | 151 ～ 159 (156) | 150 ～ 158 (152) |

(Notes) 1. Actual results: until 31 MAY 2023, (): as of 10AM 31 MAY 2023 . 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels

**Exchange Rate Trends & Forecasts**



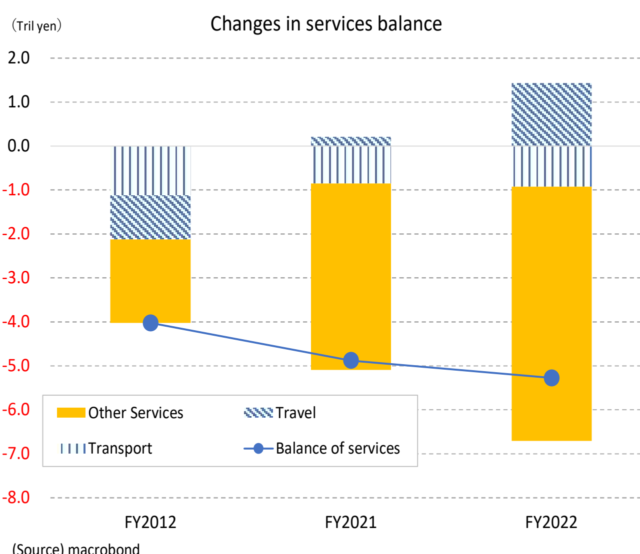




# USD/JPY Outlook – Japan Faces New Avenues of Foreign Currency Reserve Drain

## JPY Basic Supply-Demand Climate – How to Interpret Japan's Status as World's Largest Net External Creditor for 32 Years Straight

*Other Services Balance is More Important than Travel Balance*

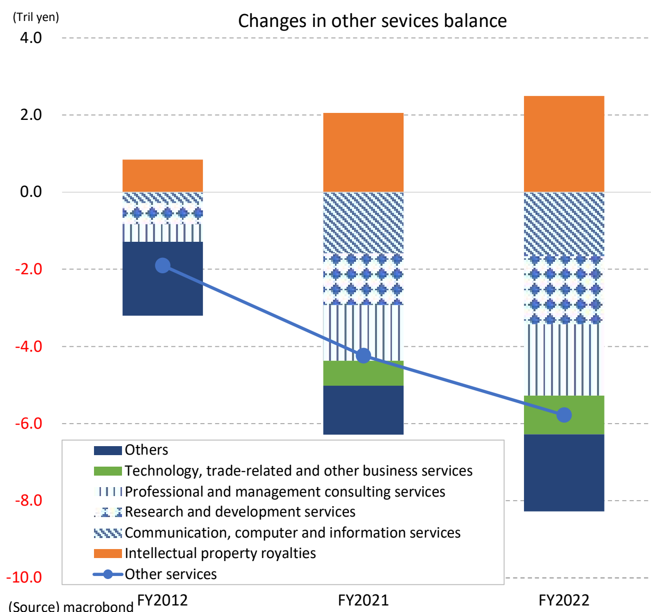



USD/JPY continued to rise in May. There are many reasons for this, but unlike the markets, which would prefer to interpret this development based on U.S. interest rate trends, I still believe it must be interpreted based on the possibility of a fundamental change in the structure of JPY supply and demand. In recent years, Japan's Travel surplus has gained widespread acceptance as a key datapoint when discussing the country's Balance of Payments, which represents JPY supply and demand. As the Travel balance is the only way remaining for Japan to actively earn foreign currency, it stands to reason that discussions would revolve around it. However, in terms of relative importance, one must not overlook the Other Services balance, which is still not widely known. In fact, even going just by the figures, the Other Services balance has a much bigger impact than the Travel balance. Taking the recently released 2022 results as an example, the Services balance posted a deficit of -JPY 5.2765 trillion. Within this, the Travel balance posted a surplus of +JPY 1.4303 trillion, the Transport balance posted a deficit of -JPY 927.1 billion, and Other Services posted a deficit of -JPY 5.7797 trillion. One could say that the Other Services balance is now in a position to determine the trend of the Other Services balance. Incidentally, even at its peak (in 2019), the Travel balance only posted a surplus of +JPY 2.4571, but the Other Services balance is already posting a deficit worth twice that.

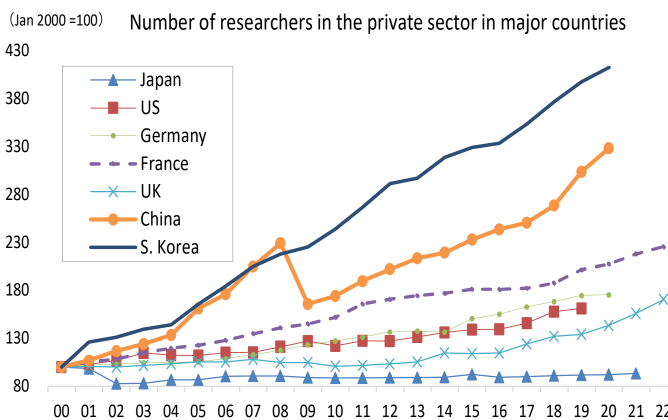
Even if the Travel balance recovers fully going forward, it is unlikely to push up the overall Services balance by much. Comparing FY2012 and FY2022 figures, it is worth noting that the Travel balance has improved from a deficit of -JPY 1.0069 trillion to a surplus of +JPY 1.4303 trillion in the space of a decade, but the Other Services deficit has tripled from -JPY 1.9206 trillion in FY2012 to -JPY 5.7797 trillion in FY2022. While there is some scope for debate as to which is more important to focus on in terms of the speed and scale of the change, one reason the Other Services balance does not attract much attention may be because of the diverse factors that drive its expansion (details below). Stepping back to take in the bigger picture, it becomes obvious that Japan's Current Account surplus has shrunk from its peak value of +JPY 22.3995 trillion (in FY2017) to +JPY 9.2256 trillion (in FY2022), with a Services deficit worth over -JPY 5 trillion led mainly by the Other Services deficit – this is not something that can be overlooked.

*Digital, Consulting, and R&D Services*

I have discussed the diverse factors behind the expansion of the Other Services deficit several times in this report. As one can tell from the fact that newspaper reports are beginning to focus on it, the impact of what is called the "Digital deficit" is significant. As mentioned above, the Other Services deficit expanded by about JPY 3.9 trillion between FY2012 and FY2022 (from -JPY 1.9026 trillion to -JPY 5.7797 trillion), but 40% of this, roughly -JPY 1.4 trillion, is attributable to "telecommunications, computer, and information services" (which ballooned from -JPY 289.2 billion to -JPY 1.6610 trillion). Apart from this, "professional and management consulting services" (data unavailable for FY2012, so the comparison is with FY2014, the earliest year for which data is available) expanded by roughly JPY 1.4 trillion (from -JPY 458.5 billion to -1.8477 trillion). Professional and management consulting services includes payments for online advertisements, so it could also be considered as contributing to the "Digital deficit." However, I would like to point out that a large part of this deficit is attributable to foreign consulting companies, which have recently been expanding their businesses in Japan, paying a specific percentage of their sales in Japan to their governments back in their home countries. In that sense, while telecommunications, computer, and information services definitely contribute to the "Digital deficit," it would be wrong to put professional and management consulting services in the same category, as the percentage of digital-related deficit attributable to the latter cannot be ascertained.



(Source) macrobond

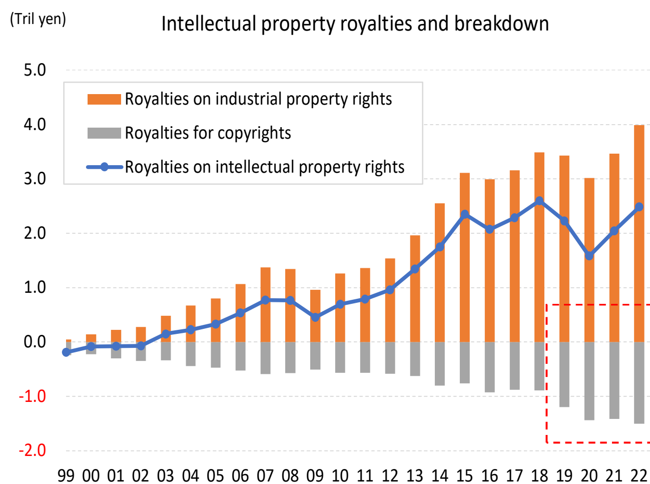


(Source) the Ministry of Education, Culture, Sports, Science and Technology Institute of Science, Technology and Academic Policy,' Science and Technology Indicators 2022' Based on, Karakama Daisuke processed and created.

Incidentally, the R&D services deficit has also expanded by around JPY 1.2 trillion between FY2012 and FY2022 (from -JPY 539.5 billion to -JPY 1.7671 trillion). There has been no growth in the number of private-sector research staff in Japan, and this is also in comparison with other countries, as already pointed out in reports, including by the Ministry of Education, Culture, Sports, Science and Technology (see figure). As Japan's status as an R&D base weakens, it is inevitable for payments toward R&D services to increase more than receipts. There seemed to be an unspoken understanding until recently that production and manufacturing may be outsourced, but brain-work is still conducted domestically, but the statistics seem to suggest that brain-work is also beginning to be steadily outsourced.

*Last Remaining Avenue for Surpluses Also Peaking*

The only category within Other Services that is still earning a surplus is "charges for the use of intellectual property n.i.e.," but here again, there is not much scope for optimism. The "charges for the use of intellectual property n.i.e." category comprises charges for the use of industrial property rights, such as patents, and charges for the use of copyrighted material, including music and video recordings. As the figure shows, Japan's surplus in "charges for the use of intellectual property n.i.e." is mainly due to charges for the use of industrial property, which continues to post a surplus, while charges for the use of copyrighted material contributes negatively, with the deficit expanding in recent years. "Charges for the use of industrial property" are royalty fees received by Japanese companies from their overseas subsidiaries, etc., and are the result of transactions between parent companies and their subsidiaries. Needless to say, the expanding surpluses in this category are the outcome of Japanese companies shifting their production bases abroad, with most of the receipts originating in Asia and North America. Charges for the use of copyrighted material include, specifically, "licenses to reproduce and distribute copyrighted materials such as computer software, music, video recordings, characters, as well as literary, academic, and artistic works." Payments made toward the use of music or video streaming services by foreign companies, which have been increasing in recent years, are included in this category. In other words, some part of this category could also be included in the aforementioned "Digital deficit." If the charges for the use of intellectual property continue to increase as a trend, the "charges for the use of intellectual property n.i.e." surplus will probably begin a gradual decline.

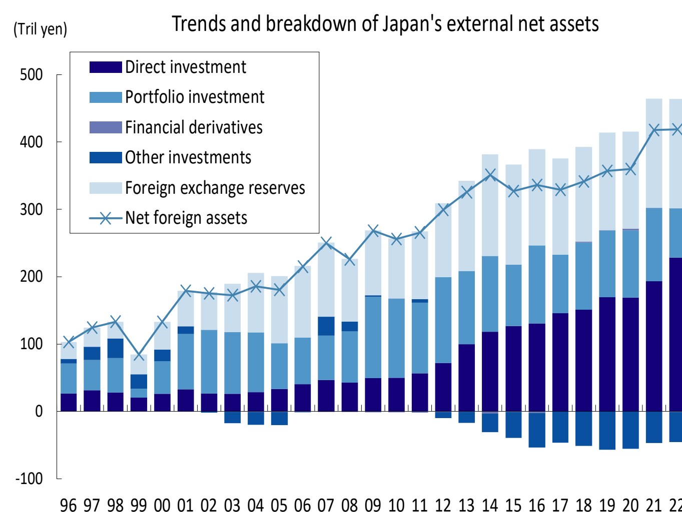


(Source) Bank of Japan

For the reasons described above, it can be said that the draining away of foreign currency through channels such as digital, consulting, and R&D-related services – areas that were not previously paid much attention – has started becoming a structural reality for Japan's external economic sector in recent years. My basic understanding is that such structural changes must also be taken into account in formulating a storyline when discussing the outlook for USD/JPY going forward.

*JPY Weakness Offsets Foreign Securities Appraisal Losses*

On May 26, the Ministry of Finance released its "International Investment Position of Japan (End of 2022)." Considering how much attention the subjects of JPY weakness and confidence in JPY have gained since last year, there is no question that Japan's status as the world's largest net external creditor, as confirmed by the above yearly statistic, is one of the few remaining grounds for viewing JPY as a safe-haven currency. In this report, I review and interpret the results of this statistic soon after it is released every year. Japan's massive net external assets are evidence of the scarcity of domestic investment opportunities, which is not necessarily a positive thing. However, it is the presence of these massive net external assets that allow the politically and economically weakening JPY to still be viewed as a safe asset.

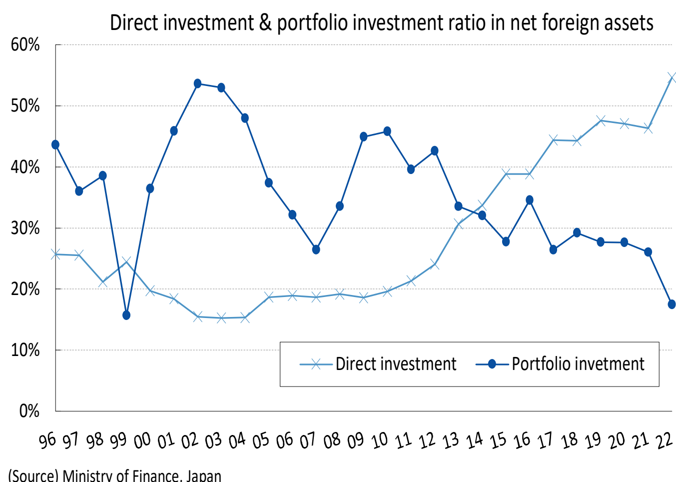


(Source) Ministry of Finance, Japan

Specifically, Japan's net external assets – derived by subtracting liabilities from the overseas assets held by the Japanese government as well as Japanese companies and individuals overseas – increased for the fifth year in a row and by +JPY 720.4 billion yoy to post JPY 418.6285 trillion (all yoy growth figures below unless otherwise specified). With this, Japan managed to retain its status as the world's largest net external creditor for the 32nd year in a row. Further, the reason yoy growth was no more than +JPY 720 billion despite the level of JPY depreciation seen since last year is because of the extremely significant foreign securities price fluctuations. Let us take a look at some specific figures. This time, Japan's net international investment position declined by -JPY 49 trillion overall. Looking at this separately in terms of volume (transaction flow) and price factors, the net position has declined by -JPY 23 trillion purely due to the volume factor. The price factor is more complex, with the forex rate factor (due to forex rate fluctuations) contributing +JPY 47 trillion, but other adjustments (asset price fluctuations) contributing -JPY 73 trillion. As is widely known, both equity and bond prices crashed last year amid dramatic rate hikes by the Fed and the ECB, and this was reflected as is in the change in net international investment position. On the other hand, it could also be said that the historical JPY depreciation was able to offset over 60% of the fall in equity and bond prices, indicating

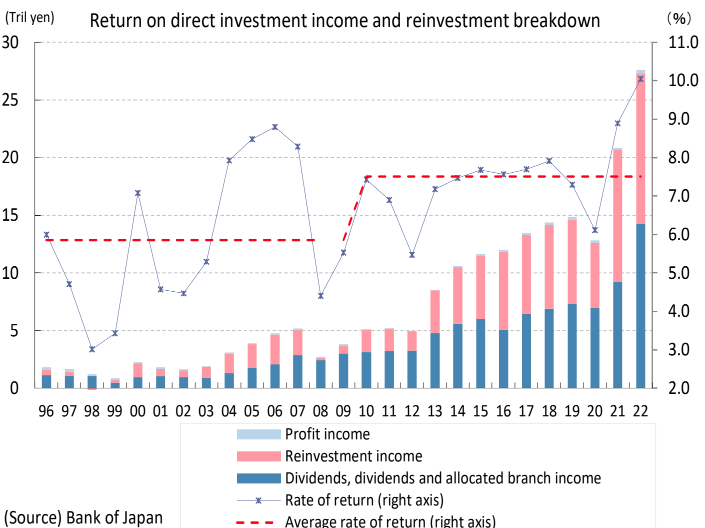
that Japan may easily not lose its position as the world's largest net external creditor even if JPY weakens further going forward (as I will explain later, however, this does not indicate that JPY's position is rock solid.)
Over the period covered by the recent release, there has been +14.8% increase in USD/JPY and a +8.1% increase in EUR/USD. Japan owns JPY 531 trillion in gross (rather than net) external assets in the form of securities investment, of which roughly 53% (JPY 282 trillion worth) are in USD-denominated assets, while roughly 12% (JPY 65 trillion) are in EUR-denominated assets. This means that for a 10% increase in USD/JPY, there would be a roughly JPY 30 trillion (JPY 282 trillion x 0.1) increase in gross securities investment. It seems likely that Japan's net external assets for 2023 will also be boosted in the same manner. As the country's Current Account surplus (a flow variable) is on the decline, it would also seem that Japan's net external assets going forward will not increase significantly unless JPY weakens.
On the flip side, if JPY appreciates significantly going forward, Japan's current account surplus may not grow as much as it is currently doing, very likely resulting in a decline in Japan's net external assets.

*Ratio of Foreign Direct Investment at its Largest Ever*
Looking at Japan's net external assets by asset category, the largest category is direct investment, which currently comprises 54.6%, its largest ever percentage since the beginning of records. Meanwhile, securities investment comprises merely 17.5%, the smallest percentage in 23 years since 1999. As a result, the gap between the composition ratio of the two investment categories has widened to a never-before extent, at 37.1 pp. As discussed repeatedly in this report, going by these developments in Japan's external economic sector, it seems reasonable to assume that the intermittent weakening of JPY may be a structural phenomenon. In the case of foreign securities investment, one could expect repatriation (return to Japan) of JPY with the intensification of a risk-off mood, but one cannot expect this in the case of foreign direct investment. While investors can easily sell their foreign securities (sell foreign currency/buy JPY) when they sense an impending crisis, it would take a great deal of discussion and time before a company can sell a foreign business corporation it has acquired. Even though Japan's status as a net external creditor has not changed in the last 32 years, there has been a steady increase in the percentage of these assets that remain sold without being converted back to JPY. This may be the reason behind JPY's persistent weakness.



(Source) Ministry of Finance, Japan

Of course, strictly speaking, there are some components of income from direct investment (hereafter: direct investment income) from which a routine foreign-currency-selling/JPY-buying flow can be expected, such as dividends and distributed branch profits. However, even though the rate of direct investment income has been increasing over the past 27 years, the percentage of this income that gets reinvested is also gradually rising (see figure). Given the rising trend of direct investment income, it seems fair to assume that direct investment growth will continue to surpass securities investment growth in the coming years. This is natural considering the disparity between economic growth rates in Japan versus other countries. However, precisely because of this, there is also less reason for companies to repatriate their direct investment income back to Japan (at any rate, where there is a strong desire to invest overseas, repatriation of those earnings to Japan is unlikely to be a very attractive option). The ratio of the reinvested portion within direct investment income was 31.8% on an average for the 14 years from 1996 through 2009, but it rose to an average of 45.9% for the 13 years from 2010 through 2022. (I split the 27-year period for which retroactive calculation was possible into two nearly equal halves of 14 years and 13 years).



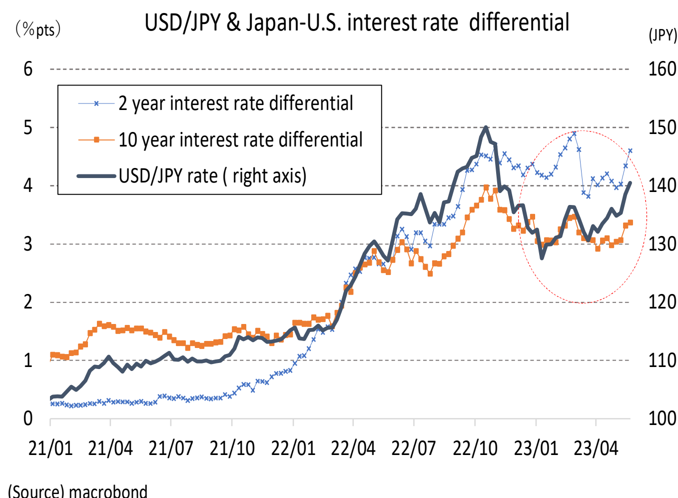
(Source) Bank of Japan

I have had the opportunity to speak directly with people who run overseas business corporations and ask them about this, and their personal experience corroborates the increase in the ratio of the reinvested portion. The situation at hand, then, seems to be that Japan's net external assets may be increasing, but the percentage of this that can be returned to JPY is on the decline. It is because of this that I believe JPY is liable to depreciate when seen from the perspective of JPY supply and demand.

## JPY Current State and Future Outlook – Growing Distance Between JPY and CHF; PPP no Longer Relevant

*No Previous Experience of U.S. Interest Rate Decline Under Massive Trade Deficits*

In May, USD/JPY went beyond the 140 level temporarily, renewing a year-to-date high. Toward the end of last year/early this year, interest-rate based predictions for USD/JPY – namely that the Fed would end its rate hikes by mid-year, and this would result in a narrowing of the U.S.-Japan interest rate differential, resulting in a USD/JPY trend reversal – were predominant. However, while U.S.-Japan interest rate differentials (both 2-year and 10-year) have shrunk dramatically at some points, USD/JPY has not fallen during those times (see figure). As I repeatedly say in this report, the recent developments seem to be the result of dramatic changes in the JPY supply-demand climate. Japan's trade deficit for all of 2022 was roughly -JPY 20 trillion, and it was already -JPY 5 trillion for the first three months of 2023. To top all this, a negative policy interest rate remains part of Japan's established monetary policy path, giving investors almost no reason to buy JPY. Despite this, most market participants have assumed and continue to assume that JPY would appreciate with a relative decline in U.S. interest rates. It must be noted, however, that their assumption has not come true as of now.

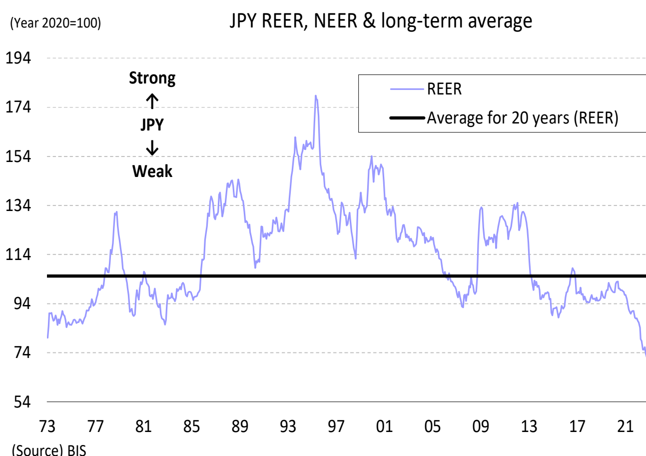


(Source) macrobond

My understanding is that one can no longer really expect JPY appreciation (or the end of JPY depreciation) simply as the result of U.S. interest rate decline, but could JPY begin to appreciate despite Japan's enormous trade deficits if the Fed were to start cutting rates? Perhaps it would appreciate to some extent. However, there is no historical precedent for U.S. interest rates declining at the same time as Japan struggles under a massive trade deficit, so it may be risky to rely too much on past experience here.

*REER's Continued Fall in 2023*

At the time of writing this report, USD/JPY is quite volatile, fluctuating between 127 and 140 to the dollar, but in terms of real-effective rates, JPY is consistently weakening. In terms of its real effective exchange rate (REER), which takes into account the domestic-foreign price differentials, JPY was 74.56 in April (weakest year-to-date; 77.27 in January, 75.30 in February, 75.21 in March). While the nominal USD/JPY exchange rate is the first thing that might come to mind for most ordinary Japan residents when forex rates are mentioned, REER is the most relevant exchange rate when Japan is seen in the context of the international community. Being an island nation, Japan has no choice but to import a variety of resources to run its domestic economy. If at all possible, Japan would like to buy these resources at cheaper prices, but the prices of imported commodities naturally reflect the wage and price levels of the country of origin. To put it simply, even if the nominal USD/JPY rate remains fixed at 100 to the dollar, if prices in the U.S. increase and those in Japan remain level, Japanese importers will be able to buy fewer U.S. commodities for 100 than they did previously. In theory, JPY would appreciate against USD to correct this discrepancy, and this is what we call purchasing power parity (PPP). However, the economy has become structurally incapable of allowing PPP to function as it should (explained later).

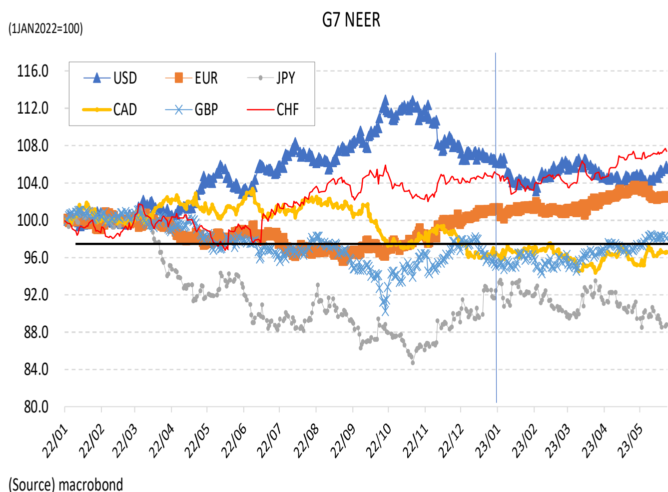


(Source) BIS

At any rate, a country's purchasing power cannot be measured based on the nominal exchange rate of its currency; it must be measured using the REER, which takes into account price differentials with other countries. The important thing here is to remember that JPY's REER has been consistently weakening, even though JPY may nominally seem to be fluctuating between 127 early in the year to 140 in recent days. There are no signs of improvement in JPY's purchasing power.

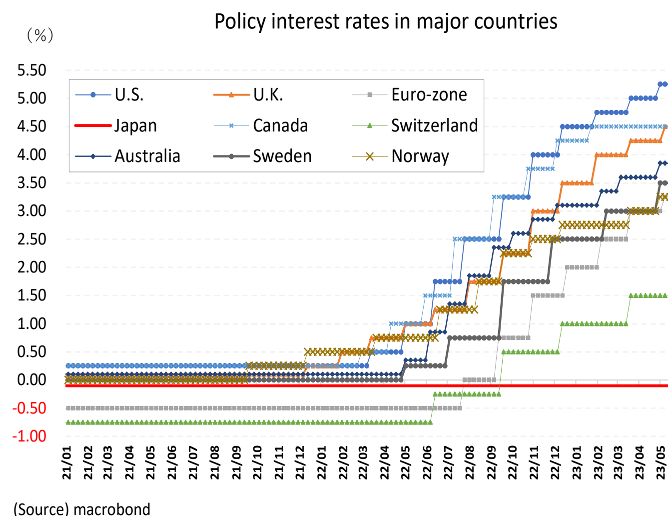
*CHF is the Strongest Currency Now*

What about the position of JPY among key world currencies? The figure to the right shows the nominal effective exchange rate (NEER) trend for G7 currencies, which I refer to off and on. The figure shows the trend between the beginning of last year and the end of May this year, and for the first time in the past one year and four months, CHF has clearly emerged as the strongest currency. In March, with the collapse of Silicon Valley Bank (SVB) and the rescue/merger of Credit Suisse, there was a period of financial insecurities in the market when USD, EUR, and CHF were difficult to buy. At that time, JPY was bought in a passive way, resulting in short-lived rumors of JPY recovering its erstwhile status as a safe-haven currency. In the event, that idea seems to have been utterly misplaced. To repeat a point I frequently emphasize in this report, JPY has been thoroughly unsuccessful in projecting its "safe asset" image either following the Russian invasion of Ukraine or during the recent international financial fears.



(Source) macrobond

Some may wonder why CHF is being bought so strongly despite Switzerland being the epicenter of the recent financial panic, but it must be noted that Switzerland is a trade surplus country and so is the euro area (the EUR is not far behind CHF in terms of strength), which moreover has the world's largest trade surplus. Further, both Swiss and euro area central banks have been implementing consecutive rate hikes. Until September last year, Switzerland had negative policy interest rates similar to Japan, but now the country's policy interest rate is already at 1.50%.

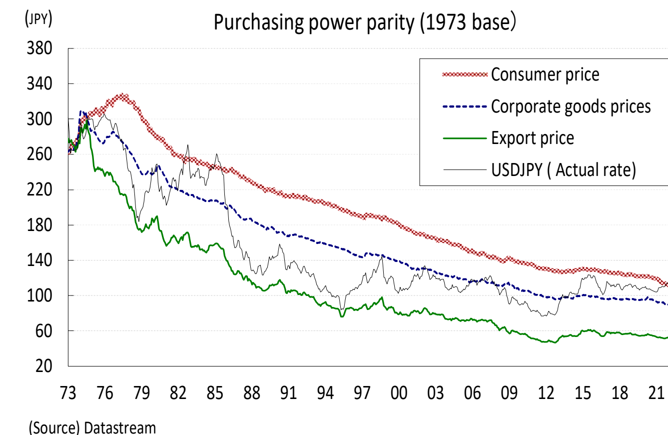


(Source) macrobond

Both from supply-demand and interest rate perspectives, therefore, CHF is no longer in the same category as JPY. Going forward, if the Fed and the ECB end their rate hikes and decide to implement a policy of maintaining existing interest rate levels, financial markets will become less volatile overall. When that happens, it would be very easy for carry trade to flourish – with low levels of volatility in the market, it becomes easier for investors to use a currency that has predictably low interest rates as the "funding currency" with which to buy currencies that offer higher interest rates, and to make a profit from the resulting interest rate gap by maintaining that position. Naturally, the currency of choice for use as a funding currency is JPY. This is a scenario I have been emphasizing since last year, and so far, it appears that the market rates are moving in accordance with my predictions.

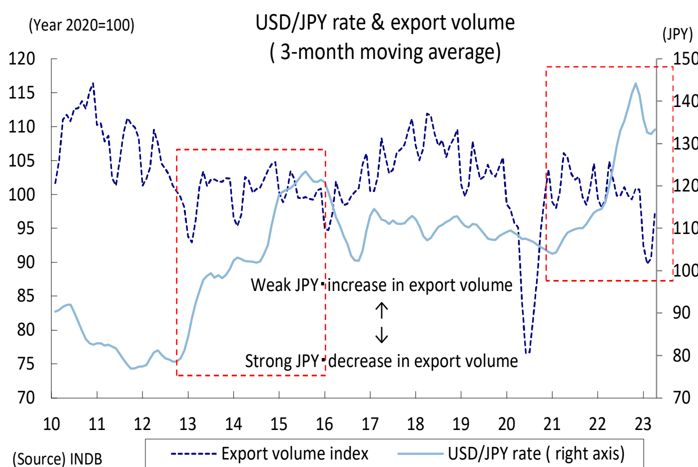
*Significance of PPP Weakening from Structural Perspective*

To repeat a point I have made before, it is no longer possible to predict JPY rate trends based on U.S. interest rate trends accompanying the Fed's policy moves. Of course, JPY will inevitably strengthen against USD when the Fed significantly pivots to a rate-cut policy stance going forward. In my basic understanding, however, this is likely to result in a brief buying opportunity in the midst of an otherwise a medium- to long-term weak-JPY trend. In this context, PPP-based rates, which offer medium- to long-term theoretical frameworks, suggests an excessively weak JPY being allowed to stay that way. Because of this, I sometimes receive inquiries as to the possibility of a swing-back in the direction of JPY strength at some point. To be sure, as the figure shows, the market rate of USD/JPY is showing a historically significant discrepancy when seen in terms of the PPP, so concerns about potential upward pressure on JPY are understandable.



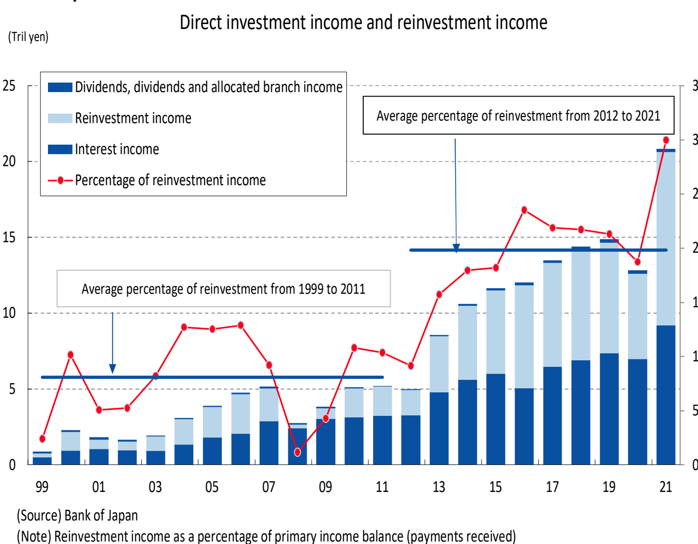
(Source) Datastream

However, JPY weakness from the perspective of PPP-based rates can only be considered "excessive" when there is a mechanism whereby the JPY weakness boosts the volume of exports from Japan, expands Japan's trade surplus, triggers an increase in outright JPY buying (foreign currency selling), and results in JPY appreciation, thereby bringing about an awareness that JPY was originally "too weak." In Japan at the present time, this mechanism is not working. As the figure shows, neither Abenomics in 2013 nor the largest ever depreciation of JPY seen since 2022 have been able to boost Japan's exports significantly. Simply speaking, this is because Japan no longer has the production capacity to increase exports during weak-JPY phases. The traditional path of JPY weakness leading to higher exports, which then served to ignite the real economy, is now a thing of the past. The significance of PPP is, therefore, waning from a structural perspective.




*Primary Income Surplus Expansion Replaces Trade Surplus Expansion*

While Japan's export surplus does not seem poised to recover, Japan today has become a major earner of Primary Income surplus. Japan's Primary Income surplus for 2022 was around +JPY 35 trillion, of which 65% (roughly +JPY 23 trillion) was Direct Investment income. Incidentally, the Primary Income surplus ten years ago (in 2012) was about +JPY 14 trillion, of which Direct Investment income comprised roughly 29% (+JPY 4 trillion). These are the results of a dramatic increase in foreign direct investment by Japan's corporate sector, clearly indicating that Japan has transformed from a country that earned by exporting goods using the weak domestic currency as a weapon to a country that earns through investment. Thanks to Japan's structural transformation into a "mature creditor nation," even if there were to be a correction of JPY's "excessive weakness" (JPY appreciation) from the perspective of PPP-based rates, it is unlikely to be due to a trade-surplus-led JPY buying as a result of an increase in exports. Moreover, breaking down the Direct Investment income even further, it becomes obvious that the ratio of the portion reinvested as foreign currency (reinvested income) is increasing with time (see figure). It seems that Japan's Direct Investment income has continued to increase even as its Trade surplus has continued to decrease, and it may be unwise to expect upward pressure on JPY to arise under these conditions.




Incidentally, as the figure on the previous page shows, from around 2012-13, USD/JPY became stably established above the corporate-price-based PPP, which had until then been functioning as a ceiling of sorts. This coincides with the time starting which Japan became incapable of earning a Trade surplus as a trend. Naturally, there is a strong correlation between Japan's transformation from a young creditor nation (earning through both Trade and Primary Income surpluses) to a mature creditor nation (earning though Primary Income surpluses while posting Trade deficits) and JPY's inability to make a turn around from a depreciation to an appreciation trend. I think it is pointless to ignore this major structural change and continue to talk about USD/JPY trends simply based on the frequency and margin of U.S. rate hikes or monthly results of fundamental economic indicators.

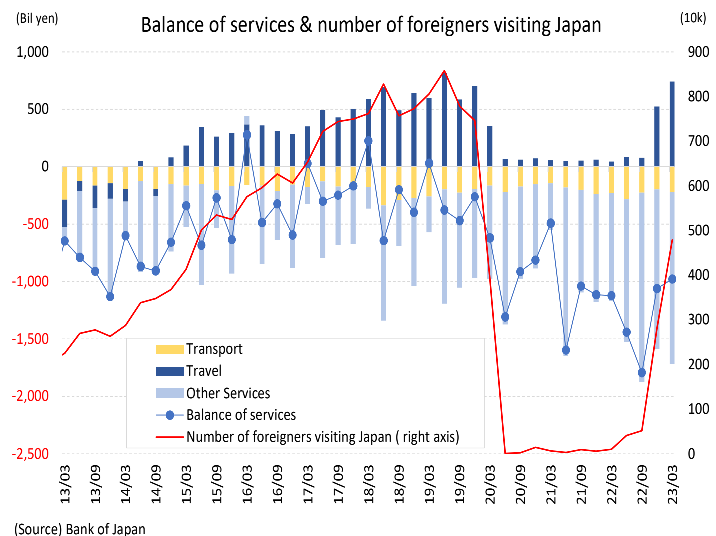
*Going Forward, PPP Rate Level Could Approach Market Rate Level*

Will the discrepancy between USD/JPY market rates and PPP-based rates be allowed to continue going forward? Not necessarily. So far, it has invariably been assumed that the market rate would converge with the more characteristic PPP, and historically, this has usually been the case. As prices in Japan remained more or less unchanged compared with other countries, the PPP-based rate has usually indicated the need for JPY appreciation, and given Japan's massive trade surpluses over many years, this convergence inevitably happened with JPY appreciation.

However, as explained above, with JPY's REER at its weakest in half a century, the Japanese economy has recently been importing inflation from abroad. This is easy to understand in the case of commodity imports led by resources, but also includes the soaring of domestic prices as Japan opens its doors to accept more foreign visitors (inbound tourism). If things continue in the same direction, the possibility of inflation in Japan in line with that elsewhere in the world cannot be ruled out. If that happens, the PPP-based rates may no longer indicate the need for JPY appreciation. In other words, the PPP-based JPY rates could weaken and approach or converge with the market rates. I believe that USD/JPY trends are beginning to head toward the latter scenario. The PPP-based rates, which remained mainly in the 100-120 range until recently seems to have shifted upward to the 120-140 range. I would like to formulate my medium- to long-term USD/JPY outlook taking this into consideration.

## The Japanese Economy Now and Going Forward – Merits and Demerits of Inbound Tourism

*Considering Inbound Tourism's Up- and Down-Sides*



(Source) Bank of Japan

In May, Japan's Ministry of Finance announced that the country recorded a JPY2,278.1 billion current account balance surplus in March, the second consecutive month of surpluses above the JPY2 trillion mark. Due to a large deficit recorded in January, the January-March period current account surplus was restrained to JPY2,543.0 billion, but if the current trend continues, it is possible that the full-year 2023 surplus will exceed the full-year 2022 surplus (JPY11,546.6 billion). Japan did not make full use of its current account surplus generating capabilities in 2022 – the balance of trade and services was restrained by such special factors as supply constraints (particularly related to semiconductors) and the low level of foreign tourists visiting Japan (inbound tourists) due to the COVID-related national isolation policy – and the main forecast scenario anticipates that the current account balance will improve yoy in the absence of such special factors. As already discussed, however, the primary income surplus cannot be expected to promote JPY buying. Thus, if the trade and services balance continues to be in the red, the JPY supply-demand balance will continue promoting net JPY selling even if the overall current account balance is in the black. It is impossible not to suspect that this is the reason why JPY does not appreciate even when US interest rates decline.

For the time being, trends in Japan's travel balance will tend to be highly noteworthy with respect to discussions of trends in Japan's current account balance as well as in the Japanese economy as a whole. For the January-March quarter, the country's travel surplus was JPY740.8 billion – the biggest quarterly surplus seen since the April-June 2019 quarter, 15 quarters ago. The travel balance surplus in the January-March 2022 was only JPY43.3 billion, and while that figure is exceptionally low owing to Japan's strict COVID-related travel restrictions, it still helps illustrate how dramatically the travel surplus situation has changed in a single year. From a glance at the graph it is evident that the number of Japan's inbound foreign tourists has been rising extremely rapidly, and it is finally becoming possible to anticipate that it will re-attain pre-pandemic levels in the near future. As the April-July period is Japan's peak inbound tourism period, figures from April onwards are likely to show even more-marked improvement. Amid this trend, increasing attention will be focused on how inbound tourism should be leveraged as a tailwind force benefitting the Japanese economy overall.

But like most things, inbound tourism has both up- and down-sides. Leaving aside the question of whether the net effect of inbound tourism is positive or negative, however, it must be recognized that promoting positive travel balances is one of only a few ways Japan can effectively boost its foreign currency earnings, and it is quite clear that the country should be seeking to maximize the potential economic tailwind it can derive from inbound tourism. Since the travel balance and other elements of the service balance involve outright foreign exchange transactions (outright purchases and outright sales), expanding Japan's travel balance surplus can be expected to countervail the current trend of excessive JPY depreciation, so inbound tourism can be expected to generate significant positive effects on the Japanese economy above and beyond the benefits obtained by businesses serving foreign visitors as they move about the country. In view of the fact that the Japanese population is shrinking, it highly rational to strategically emphasize measures to expand business involving foreign visitors who are not shrinking in number and may actually considerably increase in number. The potential benefits of such measures are apparent in the responses to consumption trend surveys of foreign visitors to Japan and in the growth recorded in the travel balance within balance of payments statistics. On the other hand, there are also people whose perception of the negative aspects of inbound tourism is gradually increasing, and that situation is discussed below.

*Inbound Tourism Boosting Both Demand and Prices*

The above paragraphs mostly discussed the positive aspects of inbound tourism, but what are the negative aspects? Many Japanese have already begun giving increasing attention to the trend of increase in prices of various goods and services. As the scale of consumption and investment demand associated with inbound tourism grows, it is only natural that companies will set prices based on consideration of inbound tourists. The process of setting separate prices for Japanese and foreign customers one by one would be difficult for diverse reasons, so the likelihood of such separate-price schemes is almost zero. But if the total amount of goods and services supplied within Japan remains the same while overall demand increases in step with the increase in inbound tourism, it is natural that prices will tend to rise.

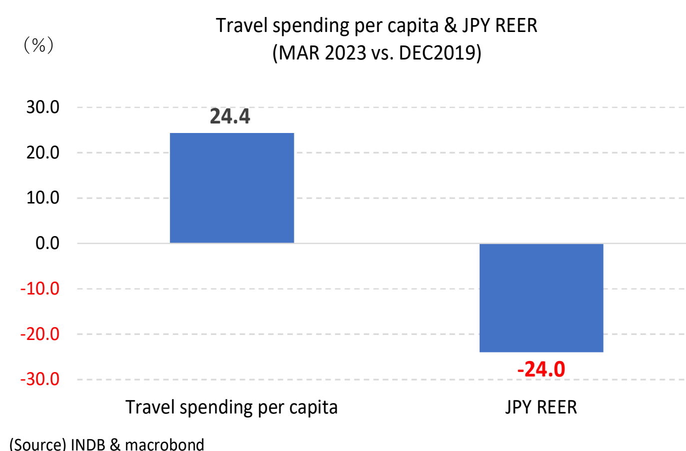
For example, Japanese touring Japan during this year's Golden Week holiday period will undoubtedly have noticed a dramatic increase in the number of foreign tourists in various places. Some of those Japanese will have faced situations in which they passed up goods and services because the price was too high, and some will have faced difficulties reaching their destinations because of the large number of foreign travelers. I personally travelled from Tokyo to Nagoya on business right after Golden Week and had a similar experience. When returning to Tokyo around 16:30, I tried to get a seat on a Nozomi train (the fastest of the bullet trains), but found that the non-reserved seats, the

reserved seats, and the first-class (green car) seats were all full. While demand for those seats is relatively high on weekdays evenings, I had never experienced a case in which even the green cars were fully occupied. I strongly suspected that this unusually high demand was not attributable to business travelers alone, and in fact I saw that there were many foreign tourists boarding the train. That was a situation I had never seen before, and this kind of situation is also causing a steep rise in hotel prices at business trip destinations, making it necessary to for travelers with relatively tight budgets to seek hotels increasingly distant from city centers.

As the number of additional consumers (inbound tourists) is increasing both in volume (the number of visitors to Japan) and in their spending-capabilities (the visitors' JPY-denominated budgets), it will inevitably become difficult for many Japanese people to maintain the consumption behaviors they have become accustomed to. The way Japanese people perceive the bargain of tolerating such consumption behavior changes in exchange for Japan's acquisition of foreign currency will be a matter of societal concern. So long as Japanese businesses do not discriminate positively or negatively with respect to foreigners in their operations, the pressure on Japanese consumers will continue, and it would be fundamentally difficult to alleviate that pressure. Moreover, one lesson we have learned during the pandemic period is that seeking to increase earnings from international travel-related businesses will ultimately make a country more-vulnerable to trends in external demand. In the past, when the Japanese economy grew primarily by exporting goods, it was generally acknowledged that too much dependence on external demand is dangerous. It was then suggested that Japan should shift to an economy driven primarily by domestic demand, but increasing reliance on inbound tourism is not in line with that suggestion.

*Tourism Growth Reflects Inexpensiveness of Japanese Goods and Services*

It would be useful at this point to reconfirm the reasons for growth in Japan's inbound tourism. While it is true that Japan has many unique cultural and other characteristics that make it an attractive tourist destination, one should not ignore the fact that Japan has become relatively inexpensive owing to forex trends. As already discussed, JPY has undergone its first major depreciation on a REER basis in half a century, and this suggests that, from the perspective of major trading partners, Japanese goods and services are being offered at bargain prices not seen for many decades. Looking back on the first five months of 2023, it appears that USD/JPY has been simply been fluctuating up and down within a roughly JPY10 range on a nominal basis, but the JPY REER actually declined steadily for the first three months (January through March) of that period.

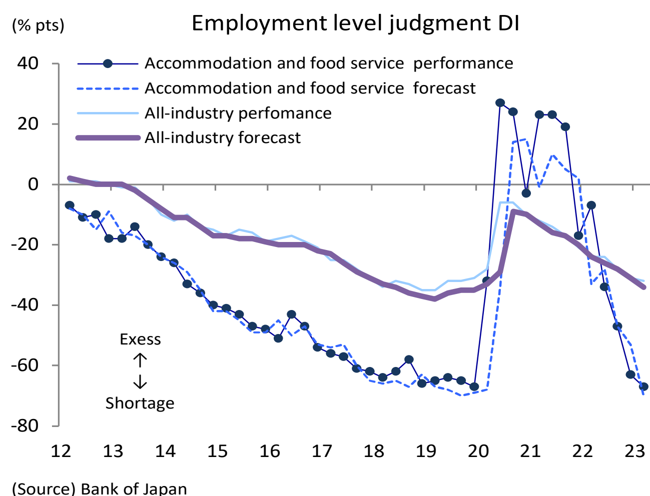


(Source) INDB & macrobond

Inbound tourists may be thinking they are consuming Japanese goods and services with the same foreign currency budgets as before the pandemic, but from the perspective of Japanese people thinking in JPY-denominated terms, those tourists' budgets have increased considerably. Inbound tourists' per capital travel expenditures have surged to 24% above the levels of such expenditures seen just before the pandemic, and this margin of growth almost perfectly corresponds to the rate of decline in the JPY REER over the same interval (see graph). Rather than reflecting growth in the volume, prices, or added value of Japanese goods and services consumed, it appears that most of the increase in per capita spending simply reflects the higher value of that spending when measured on a nominal JPY basis.

*Tourism-Related Supply Constraints May Become Serious*

Of course, none of the above discussion changes the fact that inbound tourists' spending makes a valuable contribution to the Japanese economy. The growing inexpensiveness of Japanese prices and the increasing expensiveness of overseas prices are two sides of the same coin, so when Japanese people purchase overseas goods and services they are beginning to perceive that those goods and services are relatively expensive. As this perception grows, Japanese are likely to progressively shift the focus of their travel-related activities to domestic rather than overseas destinations, causing the supply-demand relationship in the domestic accommodation and food service industry to become increasingly tight. Reflecting this trend, those industries' employment situation diffusion indexes within the BOJ's Tankan survey have come to indicate unprecedented labor shortages (see graph). Because of the difficulty of hiring sufficient staff, some restaurants have already discontinued the serving of lunches or have begun limiting their lunch services to take-out formats. Part of this problem reflects the restrictions and generally severe operating environments endured by accommodation and food service businesses during the past three years of Japan's unique quarantine policies, during which such businesses were viewed as being potential



(Source) Bank of Japan

venues for the spread of contagion, and it has been pointed out that numerous cross-industry organized labor movements that emerged during that period are now contributing to structural labor shortages. Furthermore, it appears likely that the greatest JPY depreciation seen in half a century will encourage a shift of foreign workers from Japan to other countries. It is generally understood that the Japan's accommodation and food service industry has become particularly dependent on foreign workers. While the expansion of inbound tourist-related demand is continuing to be considered a mostly positive phenomenon, the problems stemming from associated supply constraints seem likely to become increasingly prominent in the future. If demand levels for certain goods and services chronically exceed supply levels and autonomous supply-demand adjustments do not progress, there is a possibility that the government might consider creating some sorts of strategic regulations to alleviate associated problems.

*Japanese More-Aware of JPY-Denominated Asset Vulnerability?*
In line with Abenomics policies and despite temporary setbacks related to the pandemic, the number of Japan's inbound tourists surged greatly over the past decade, and it is now on track to re-attain its recent peak levels (despite the continued blockage of the flow of inbound tourists from China). While the upsides of inbound tourism have been the focus of attention so far, however, it is expected that domestic price rises and labor shortages will eventually cause equal or greater attention to be given to the downsides of such tourism. No matter how positively or negatively Japanese society perceives inbound tourism, however, Japan will simply have to strive to make the most of the associated benefits and minimize the associated challenges. It can probably be expected that there will be prolonged discussions about how the government should allocate funds and institute laws and regulations toward that end and about how such initiatives might bring about changes in Japanese society.
From a forex market perspective, it will be worth closely monitoring such developments as a trend of increase in Japanese individuals' investment in foreign currency-denominated assets as Japanese become more-keenly aware of the ramifications of JPY's weakness. Just a month ago, on May 1, the Nihon Keizai Shimbun posted an article entitled "Foreign Currency Asset Holdings Up 40%: Young Investors Favoring U.S. Stocks Over Japanese Stocks." I plan to discuss this issue separately in light of such trends as those in Japan's fund circulation structure, but it is worth briefly reiterating here that, as foreigners marvel at Japan's new-found inexpensiveness, they are increasing their consumption and investment activities in Japan, and that is in turn causing a trend of increase in ordinary Japanese individuals' cost of daily life. In light of this, it would not be at all surprising to see more and more Japanese people becoming increasingly aware of the vulnerability of their JPY-denominated assets. There appear to be indications that this growing awareness is particularly widespread among relatively young generations of Japanese who generally tend to be more sensitive to changes in Japan's global positioning.

**U.S. Monetary Policy Now and Going Forward – U.S. Interest Rate Decline Could Offer Buying Opportunity**

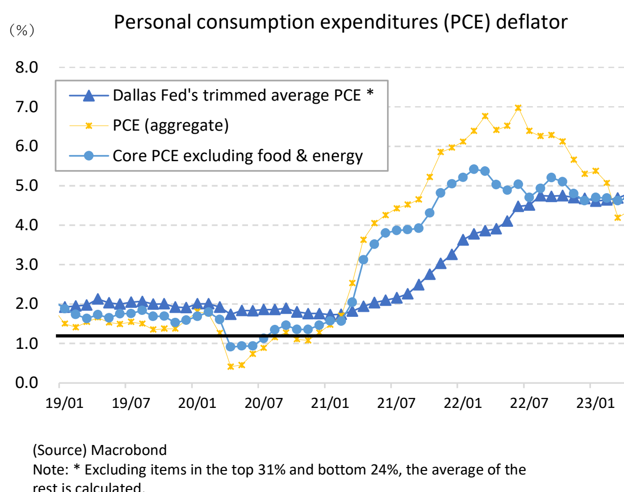
*JPY Appreciation Amid U.S. Interest Rate Decline Could Offer Buying Opportunity*
The Fed decided on a +25bp rate hike at its May 2-3 FOMC meeting, but with the collapse of several regional U.S. banks in addition to the cumulative impact of rate hikes so far, there is an increasing sense of tighter credit conditions in the market, so the FOMC statement included a hint of an end to rate hikes. Specifically, the language "some additional policy firming may be appropriate" was deleted, and "In determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation" was added, hinting at a likely end to rate hikes. Given the reference to "cumulative" impact, it seems certain that the end of rate hikes is near.
The markets have even begun to factor in the possibility of rate cuts going forward, with USD/JPY temporarily plummeting to 134 right after the meeting. This development – where USD/JPY, despite being at a year-to-date high level, was forced to plummet (as JPY appreciated against USD) amid financial insecurities – was very reminiscent of what took place between late February and early March this year. This is quite logical, as financial insecurities do promote a tightening of credit conditions and directly cause U.S. interest rates to decline and USD to depreciate without the need for rate hikes. However, as the markets begin to see that the insecurities are not going to snowball into a situation similar to the 2008 financial crisis, JPY weakens against USD again. To repeat myself, I believe that sharp appreciations of JPY associated with a decline in U.S. interest rates are simply good buying opportunities punctuating the underlying USD/JPY trend.

*End of Rate Hikes in May Would be as per Market Expectations*
The main forecast scenario of the forex markets since last year has been that the Fed would end rate hikes in either March or May this year. Based on this assumption, many market participants predicted a weak start for JPY at the beginning of 2023, followed by a gradual JPY appreciation. The figure to the right plots forecast paths for USD/JPY in 2023 by analysts of various companies as compiled for the "Comprehensive Outlook for 2023" in the December 24-31, 2022, combined issue of the *Shukan Diamond*. At least among the forecasts plotted in this figure, all except my own predict a significant weakening of JPY at the beginning of the year followed by a gradual appreciation. My prediction was that JPY would appreciate slightly in the early part of the year and gradually depreciate as the year progressed. In reality, at least as of the beginning of May, it appears that the USD/JPY trend has been more closely in line with what I had predicted (USD/JPY hit its year-to-date low at 127.22 in January). The reason most of the predictions, as shown in the figure, are so uniform in their biases is because analysts overestimate the impact of the Fed's monetary policies or, more simply, U.S. interest rates on USD/JPY.

Of course, we are still only 40% of the way into the year. Going forward, the Fed could pivot to rate cuts within the year and JPY could appreciate as per the majority prediction. This possibility cannot be ruled out so long as the Fed's reassurances regarding the stability of the financial system remain unreliable. However, it is unlikely that any of the aforementioned analysts had an inkling at the end of 2022 of the financial insecurities to come and the associated rise in possibility of rate cuts. Therefore, even if their predictions of JPY appreciation do come true going forward, that would be mere coincidence. Fed Chair Jerome Powell said in one of his press conferences that the recent financial insecurities had had a tightening impact equivalent to one rate hike. It seems unlikely that analysts as of the end of last year had anticipated this when they predicted an end to rate hikes in May this year.

*Main Forecast Scenario for the Year Remains Persistently High Policy Interest Rates*

In my case, "JPY weakness reflecting the structural change in JPY supply and demand" is the main axis around which my forecasts revolve, and my position is that U.S. interest rate trends may affect the USD/JPY level but not its trend. I, therefore, do not believe that the ongoing (or potential future) shift in the Fed's policy stance will end the weak-JPY trend to usher in a strong-JPY trend. Moreover, as of the present time, there is not much likelihood of the Fed pivoting to rate cuts, which is the key to the realization of a strong-JPY forecast. To be sure, Powell's remarks seem to indicate some sense of introspection regarding the impact of the major rate hikes conducted over the past year, but he has also dismissed the idea of rate cuts within the year as being "inappropriate" – rightly so, given that the U.S. job and wage markets remain tight. The fact is that, even though the aggregate PCE deflator appears to have peaked, the core PCE deflator is still not confirmed to be slowing down (see figure), and the possibility of a continuing wage-led inflation (the situation the authorities want to avoid the most) cannot be overruled. In fact, the core PCE deflator growth showed acceleration for April.



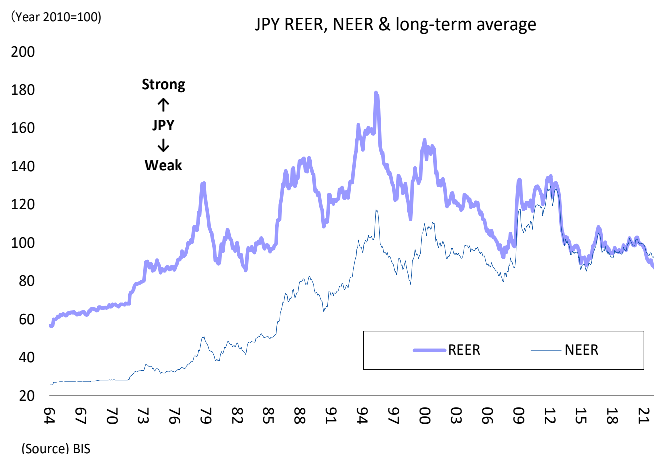
(Source) Macrobond
Note: * Excluding items in the top 31% and bottom 24%, the average of the rest is calculated.

As both this report since last year and the FOMC meeting minutes have repeatedly indicated, the Fed's most likely policy path going forward is maintaining the FF rate at its present high level. Maintaining the FF rate as is would increase the predictability of Fed policy operation and bring down market volatility. From the perspective of the forex markets, this would result in the coinciding of a sufficient interest rate differential and low volatility, which are the two necessary conditions for the success of a carry-trade strategy, i.e., selling a low-interest-rate currency in exchange for a high-interest-rate currency. When it comes to forecasting USD/JPY trends, if the Fed pivots to rate cuts within the year, USD/JPY may be traded around the 120-125 range as its mainstay during the October-December quarter. If not, then the currency pair may fall to the 125-130 range at best. At any rate, my understanding is that JPY supply and demand have changed too much to enable a return to the pre-pandemic 105-115 range.

## Risks to My Main Scenario – Will Japan's Disinflationary Period Finally End?

*Japanese Purchasing Power at Level of "Half a Century Ago"*

In May, the Nikkei 225 stock average hit a new high for the first time in 33 years, since the collapse of the bubble economy. In Japan, both rising stock prices and soaring real estate prices have attracted attention in recent years, and it is generally understood that the prices of goods and services included in the country's consumer price index (CPI) are also rising. There are many possible interpretations of these trends, but perhaps the most realistic explanation is that, in addition to becoming accepting of rising prices, Japanese people are generally lowering the levels of their expectations. The price rises are also epoch-making in the sense that they are finally marking the end of Japan's disinflationary situation. The graph shows movements in JPY's NEER and REER since 1964. A nominal effective exchange rate (NEER) represents a currency's nominal exchange rate relative to the currencies of a country's trade partners, while a real effective exchange rate (REER) takes into account changes in relative price levels in the given country and in its major trading partner countries.



(Source) BIS

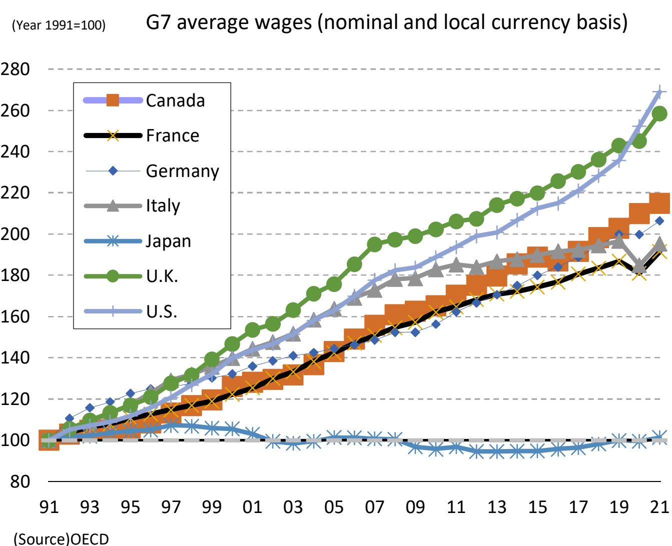
To illustrate the significance of the JPY REER, if prices (inflation rates) in Japan continue to be lower than in other countries, it will be considered to be "actual JPY depreciation" to that extent, and "REER JPY depreciation" will progress. JPY's NEER and REER have both been trending downward in recent years, but the NEER is roughly at the same level as it was around 2007, while the REER is roughly at the same level as it was around 1971 – a half a

century ago. Compared to just before the pandemic (December 2019), as of April 2023, NEER was down 16.6% while REER was down 24.6% – there was an 8 percentage point difference in the rates of decline. Looking at the rates of change since the beginning of 2023, one finds that NEER is up 0.1%, while REER is down 1.4%. The divergence between the two indices has recently become noticeable.

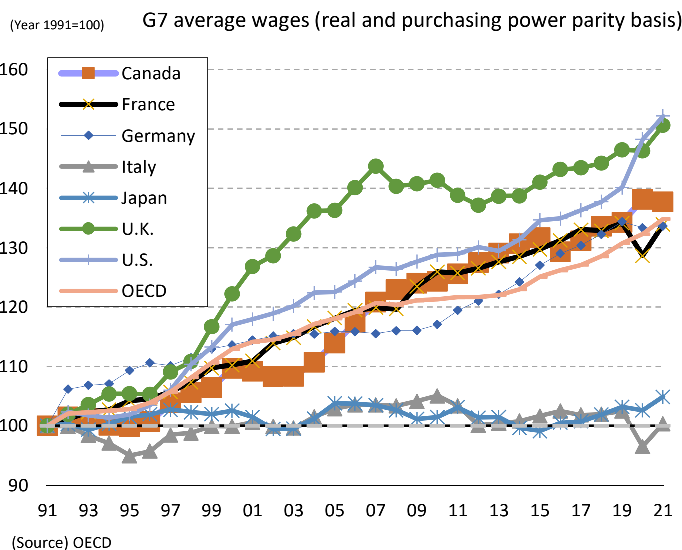
As mentioned, the difference between the JPY NEER and the JPY REER is that the latter takes into account relative price differences between Japan and other countries. The reason why the JPY REER has declined more than the JPY NEER is the that price increases are proceeding in other countries more rapidly than in Japan. It is generally understood that, overseas, nominal wages have been rising at rates in line with the general rate of price increases. In Japan, wages and prices have also begun rising at moderate rates, but the reality is that those rates are not as high as they are in other countries. Ultimately, the slump in JPY's REER means that Japan's wage environment is lagging behind those of other countries, and it also means that Japan's purchasing power is weak when it comes to purchasing goods from overseas. Outside Japan, people generally have the impression that JPY has been appreciating against USD since last October (when USD/JPY was around JPY152), but during that period, the JPY REER has basically been drifting down toward its levels of a half century ago. The historically low value of JPY's REER can be seen as evidence that the global wage and price situation is moving at a pace surpassing the pace in Japan.

*Goods and Services in Worldwide Demand Could Become Unaffordable in Japan*

REER serves as a stable international measure of purchasing power. Ultimately, countries with weak REERs are likely to have difficulty purchasing goods and services in worldwide demand. If goods and services are in demand in many countries and regions, companies set prices in line with conditions in those countries and regions. However, companies have no special reason to set low prices to suit conditions in Japan, where nominal wages have been kept low. It is more rational for them to set prices based on conditions on the majority of developed countries, particularly the United States and European countries. Since nominal wages have been steadily rising in countries other than Japan (see graph), it is natural that international prices would tend to be set at high levels from the perspective of Japan. Strictly speaking, product prices are allowed to differ slightly from country to country, but excessive discrepancies can lead to arbitrage transactions such as grey market reselling, so companies cannot ignore the ramifications of international pricing differences. For example, it appears that iPhone prices have been strategically kept low in Japan, but Apple announced last July that those prices would be raised by 10%-to-20% margins. At that time, nominal-basis JPY depreciation and USD appreciation were cited as the reason for the price hikes, but there had intermittently been arguments that Japanese iPhone prices were too high even before the sharp depreciation of JPY in 2022. The reality appears to be that the prices of top-ranked goods and services in worldwide demand have increasingly been adjusted in accordance with international standards. JPY depreciation seems to be just one of many issues behind the iPhone price hike.




Luxury cars and luxury watches are also examples of goods and services for which there is strong demand worldwide. Price hikes for such cars imported into Japan as Mercedes-Benz models were repeatedly reported last year, and the prices of Rolex watches have, depending on the model, risen as much as 100% over the past 10 years. Of course, such price hikes are happening in many countries around the world and they all impact consumers' wallets, but the degree of that impact will depend on the rate of increase in nominal wages. People in countries where nominal wages have risen 100% (or more) in roughly 30 years have a quite different perception of such price hikes compared to people in countries where nominal wages have remained almost flat for many decades. As the graph shows, wages in major countries other than Japan and Italy have risen even on an inflation-adjusted real basis, so it can be assumed that the raising of list prices for various goods and services is not that painful for many consumers in those countries. In any case, given that Japanese wages have hardly risen in either nominal or real terms, it is clear that imported goods and services in worldwide demand could easily become fairly unaffordable for many people in Japan. Prices of many popular imported products have, after initially being set, been raised at paces that Japanese people could previously not imagine. Discussions of this situation often attribute the problem



exclusively to JPY depreciation, but the exchange rate is a secondary story, and it should be understood that the situation is largely caused by Japan's relatively slow rates of increase in wages and its associated slow rates of increase in general price levels.

*Real Estate and Financial Assets also in Worldwide Demand*

So long as real estate and stocks can be traded freely, they are similar to other goods and services in worldwide demand. Regarding stock prices, given that JPY has fallen nearly 30% against USD over the past two years, along with other effects of exchange rate movements, investors may seek to buy more Japanese stocks because they have become undervalued. (Of course, one cannot yet say that all Japanese stocks are undervalued.) Taking real estate as an example, many house construction materials do not differ markedly from country to country, so those building materials themselves can be considered another kind of goods and services in worldwide demand, and their prices in Japan may therefore tend to increase. When discussing background factors contributing to the soaring of real estate prices in Japan, it is easy to focus on capital inflows from overseas investors encouraged by JPY weakness, but building material prices have recently been surging all over the world due to supply constraints associated with the global pandemic and the outbreak of wars. It is also necessary to take into consideration the fact that Japanese buildings now tend to be more expensive because JPY depreciation has had the secondary effect of boosting building materials prices in Japan. Yet another side effect of JPY depreciation is that many foreigners working at Japanese construction sites are giving up on Japan, as their foreign currency-denominated earnings are decreasing. Delays in construction projects naturally have the effect of exacerbating supply constraints, which is one of the reasons prices are rising. So one can see that it is not correct to attribute the soaring of Japanese real estate prices entirely to JPY depreciation.

The trend of increase in the prices of such assets as real estate and stocks as well as in the prices of ordinary goods and services should first be recognized to be a global trend that, when it manifests itself in Japan, is somewhat moderated by Japan's relatively low levels of wages and prices. (And, as we have repeatedly argued, those relatively low levels of wages and prices have caused the JPY REER to reach its lowest level in a half-century.) The reality is that asset prices and other prices are rising all over the world, but Japanese people are likely to be particularly sensitive to those rises. If we analyze these situations more closely, we may conclude that, as Japanese people continue coping with the general rise in prices, they will also have to generally lower the levels of their economic expectations.

*Japan Currently Importing Inflation*

The reason why the price of eating out and lodging in Japan is rising is that those are among the goods and services in demand throughout the world (and in demand among inbound tourists). The inbound tourists purchasing such goods and services in Japan are evaluating the prices of those goods and services by foreign or international standards, and so their perspective tends to be different from the perspective of local Japanese. On May 18, the Nihon Keizai Shimbun published an article entitled – "'Yokohama Nadaman' Courses for Visitors to Japan Popular Even at Double the Prices Charged for Japanese" – and the article notes that the famous Japanese restaurant chain is offering visitors courses priced at JPY65,000, which is twice the price of the most expensive (JPY30,000) course offered to Japanese people. That is a very easy-to-understand example of how a business has chosen to strategically target foreign customers rather than focusing on domestic customers whose purchasing power is unchanged from what it was a half a century ago. Explicitly setting prices for foreigners like this is a something one may often experience when traveling to developing countries, and it will be very interesting to see such pricing strategies become mainstream in Japan as well.

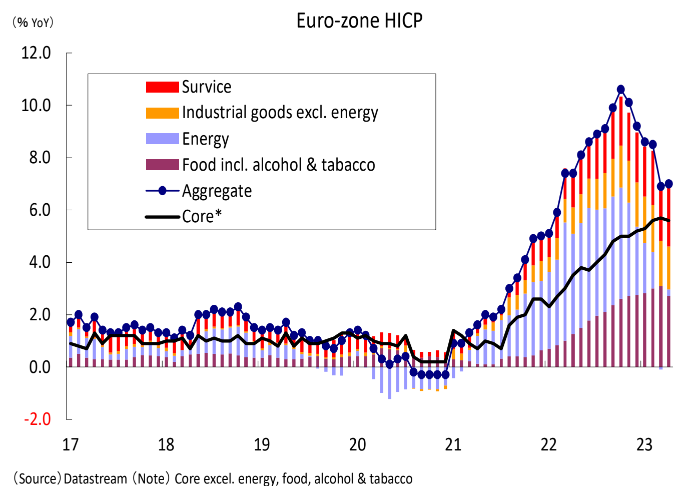
Looking at the situation philosophically, one might conclude that Japan is in the process of importing inflation by means of a currency that has significantly depreciated in real terms. It may be expected that Japan's overall employment and wage environment will be positively affected by inbound tourists' consumption activities, making it possible to initiate an "income increase → consumption increase → production increase" virtuous cycle. But such an expectation may be overly optimistic given that spending by inbound tourists amounted to only about 1% of Japan's GDP (about JPY5 trillion) at its recent peak in 2019. In the absence of the abovementioned virtuous cycle, the effect of inbound tourism will largely be restricted to boosting Japanese inflation rates but, theoretically, such higher rates of inflation will eventually cause JPY's REER to rise upward from its recent historically low levels. In light of that, it may be that the weakness of JPY and the international trend of rising prices will enable Japan to exit the chronic disinflationary situation it has suffered from for decades. For the time being, however, the trends will simply be making Japanese somewhat poorer – there are no signs that Japan's overcoming of disinflation will enable the Japanese economy to muster a dynamic turnaround. Given that developing countries tend to suffer from problems associated with inflation and currency depreciation, I find it difficult to take a bullish view on JPY's medium-to-long-term outlook. The onset of rising domestic inflation rates along with a continued JPY depreciation trend are undeniably raising the specter of momentous risk scenarios for the Japanese economy.

# EUR Outlook – ECB-Fed Policy Gap to Continue Supporting EUR

**EUR Area Monetary Policies Now and Going Forward – Meaning of "Sufficiently Restrictive Levels"**

*Some Governing Council Members Still Support 50bp Rate-Hike Margins*

The May ECB Governing Council meeting decided to raise the ECB's policy interest rates by 25bp, with the deposit facility interest rate rising from 3.00% to 3.25%. The policy interest rate levels have thus reached their highest levels since November 2008, about 14 and a half years ago. The reduction of the interest rate hike margin from 50bp to 25bp (the first such reduction in three meetings) was generally expected and, based on the Governing Council meeting's statement and ECB President Lagarde's statements at the subsequent press conference, it appears the ECB's basic policy going forward will be to continue raising interest rates by relatively small increments for a relatively long period of time. Just as with respect to the Fed, the financial markets are tending to expect interest rate cuts will be the ECB's "next move," but President Lagarde dismissed that suggestion, saying – "the inflation outlook is too high and has been so for too long" – and – "we have more ground to cover and we are not pausing – that's extremely clear."



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

At the post-Governing Council meeting press conference, President Lagarde emphasized that the Governing Council unanimously supported the continuation of interest rate hikes, noting that – "Some governors suggested that maybe 50 [basis points] was appropriate, others believed that 25 was appropriate. I didn't hear anybody suggest that zero would be appropriate, which confirms to you that this is a hiking journey that we are on and it will continue to be so." Various reasons for sustaining the policy of raising interest rates were mentioned, but those reasons essentially boil down to the fact that inflation rates are still too high. As the graph shows, a slowdown in the euro area's Harmonised Index of Consumer Prices (HICP) core basis growth rate has been confirmed, although it remains to be seen whether this slowdown will take root as a trend going forward. On its own website, the ECB offers a page entitled "Our monetary policy statement at a glance" that presents issues related to the ECB's current policy management in a question-and-answer format. The "What is going on in the economy?" section of the page includes sub-sections entitled, "Inflation has come down from its peak but is still too high" and "Rising wages and higher profits are behind high inflation", and these are simple explanations of the principle factors the ECB has considered in creating its current policies. The "Rising wages and higher profits are behind high inflation" section is tantamount to an acknowledgement that a wages-prices spiral has begun, and that suggests that the ECB does not intend to halt its interest rate hikes anytime soon.

*What Are the Sufficiently Restrictive Levels?*

The ECB's interest rate hikes have already spanned a total of 300bp, however, and the key question at this point is how much further the ECB intends to hike rates. In this regard, the Governing Council meeting's statement says – "Our future decisions will ensure that the policy rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target and will be kept at those levels for as long as necessary." At the press conference, a reporter asked – "The IMF had a view the other day, seeing the terminal rate at 3.75%. A lot of economists believe that as well. Would that be something – given the inflation outlook we have at the moment – that would be in the ballpark of "sufficiently restrictive"?" In response, President Lagarde did not give any substantive hint, saying – "I don't have a magic number of what constitutes "sufficiently restrictive"... we will know what that is when we get there and we are in the process of moving into that direction." She then quoted an aphorism by the American philosopher Ralph Waldo Emerson – "It is not the destination so much as the journey" – and emphasized that the process of attaining optimal interest rate levels (journey) is more important than the actual interest rate levels (destination), saying – "we are on a journey and we are not pausing [...] As I said, this is a journey. We have not arrived yet." The appropriate peak policy interest rate level will be determined based on the latest trends in wages and prices, and President Lagarde's argument that the peak level cannot currently be predicted is persuasive. Speaking of the 3.75% level, however, it is worth noting that that level will be reached after only two additional 25bp rate hikes and, given the current situation, it appears quite possible that 3.75% might turn out to be the terminal level.

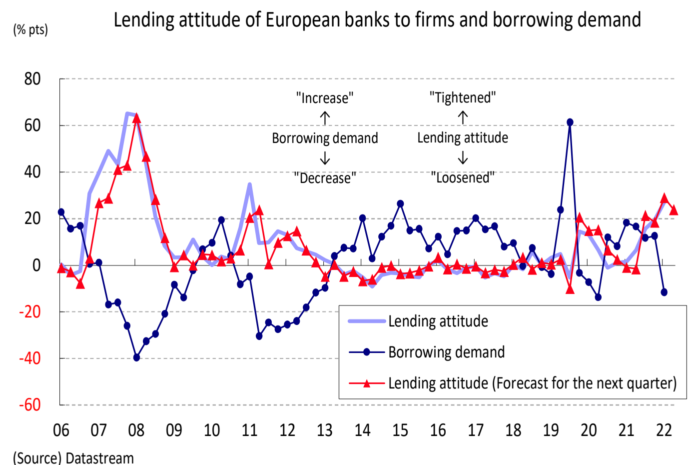
The latest Governing Council meeting made progress not only in terms of interest rates but also in terms of quantitative contraction. The February meeting decided to partially suspend the reinvestment of assets purchased under the Asset Purchase Programme (APP) from March so as to reduce the APP portfolio by EUR15 billion per month, and this measure has been duly implemented. The May Governing Council meeting added the proviso that – "the Governing Council expects to discontinue the reinvestments under the APP as of July 2023." So the full-scale shrinkage of the ECB's balance sheet is slated to finally begin midway through this summer. During the press

conference, a journalist posed a rather aggressive question about the balance sheet shrinking decision, asking – "was this decision part of a compromise deal to convince those arguing for a 50 basis point move to accept a 25 basis point move in return for accelerating the pace of shrinking your balance sheet?" – but President Lagarde denied that there was such a compromise deal. As mentioned, the decision to begin reducing the APP portfolio was made in February, and the EUR15 billion monthly reductions begun in March represent the suspension of about half of the monthly reinvestment figures, so it does not seem surprising that the Governing Council would decide to move one step further ahead in July by suspending the remaining half of monthly reinvestments. In response to another reporter's query about how much tightening the quantitative tightening is adding to the ECB's monetary policy stance, President Lagarde said – "As to the actual tightening impact that the APP run-off has, I don't want to commit a number, but it does not have a massive impact suffice to say, but we can give you separately the exact amount that has been calculated, but it's not material." This suggests that the ECB does not consider the APP winding-down to be a tightening measure and that ECB is simply ending the APP because it has become unnecessary.

After implementing interest rate hikes and halting APP reinvestments, it might appear that the ECB has already begun implementing all of its policy tightening tools, but the ECB has one more policy card to play. The ECB is currently committed to fully sustaining Pandemic Emergency Purchase Programme (PEPP) reinvestments until the end of 2024, although there might be some debate about this policy depending on the nature of inflation trends. As of May 19, the balance of PEPP assets was approximately EUR1.7 trillion, accounting for more than 20% of the ECB's approximately EUR7.7 trillion balance sheet. If at some point the ECB determines that it will not otherwise have the prospect of bringing the euro area inflation rate under control in a timely manner, it is possible that it might decide to begin suspending the reinvestment of PEPP assets ahead of schedule. Another possibility is that the ECB might consider implementing such a move as an compensatory alternative measure at the time it suspends its interest rate hikes. In that sense, it is possible that the kind of speculation about a "compromise deal" (implementing QT in lieu of interest rate hikes) that a reporter pointedly suggested at the press conference might well emerge once again.

*Lending Survey Shows Interest Rate Hikes' Effects*

Our latest bank lending survey reported a tightening of overall credit standards, which was stronger than banks had expected in the previous round and suggests that lending may weaken further. Weak lending has meant that money growth has also continued to decline



(Source) Datastream

Throughout the post-Governing Council meeting press conference, President Lagarde spent more time explaining why the ECB is continuing interest rate hikes than why the margin of rate hikes has been reduced. In response to the first reporter's question, about "the rationale behind the reduced pace in the interest rate hike of 25 basis points", President Lagarde made a clear reference to the importance of the Bank Lending Survey. The importance of this survey was noted in the Account of the March 15-16 Governing Council meeting, and the "financial and monetary conditions" section of the latest Governing Council meeting's statement includes the following: "Our latest bank lending survey reported a tightening of overall credit standards, which was stronger than banks had expected in the previous round and suggests that lending may weaken further. Weak lending has meant that money growth has also continued to decline."

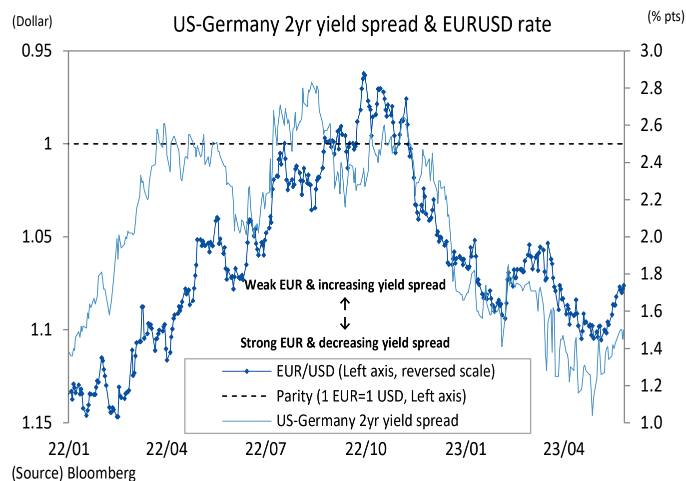
This statement basically notes that the Bank Lending Survey confirms that the interest rate hikes are having a strong impact on lending activities. According to the quantity theory of money, a tightening of the credit environment will eventually have the effect of pushing prices downward. With respect to the possibility that the euro area banking system might be exposed to systemic risks, a reporter at the press conference posed the question – "What are the indicators that you're looking at? Would you say that there is a banking crisis? What's your view of what's happening there in the banking system?" In response, President Lagarde noted that the Bank Lending Survey gives excellent data about current and upcoming credit tightening situations and said <u>the survey – "[is] also illustrative of the demand and that's an interesting point because in the Bank Lending Survey, the demand from corporates is really, really down</u>. So that's a learning we take, which indicates that our interest rate policy is beginning to have an impact, because, when asked, the corporates [...] say "it's the interest rates, it's not that we don't want to invest but the interest rates are pretty high"."

Regarding the tightening of lending attitudes, <u>it is quite noteworthy that the number of Banking Survey respondents who answered that borrowing demand had "decreased" was higher than the number who answered that borrowing demand had "increased" (see graph)</u>. This is the first time the diffusion index has indicated decreased borrowing demand since the June 2021 survey, about two years ago, but at that time economic activity was generally stagnant due to the pandemic, so it is understandable that demand for funds was weak at that time. It is more-rare to see such a weakening of demand for loans in normal times. <u>The ECB currently has more than one rationale for reducing the interest rate hike margin, but it is widely thought that the chief reason for the recent margin reduction is that the rate hikes have clearly impacted the corporate credit environment</u>. Several questions were posed at the press conference about whether the Governing Council meeting had discussed the possibility of over-tightening, and it seems easy to understand why the ECB would be concerned about the possible effects of continuing to implement 50bp interest rate hikes. All in all, it appears that the decision to reduce the margin of hikes to 25bp at this time was a reasonable one.

## EUR Now and Going Forward – Energy-Related Risks Remain

*ECB Policies' Impact on EUR*

The ECB's stance as described above represents a tailwind factor for EUR. As this column has noted since last year, there are various opinions about when the Fed will discontinue its interest rate hikes, but there is a general consensus that the ECB will sustain its hikes for some time. In the forex market, this clear contrast of policy outlooks is likely to be viewed as a major market-moving factor. At the press conference, a reporter posed the question – "Can the ECB continue hiking if the Federal Reserve stops, is that a baseline scenario you are working on?" – but President Lagarde dismissed that suggestion, saying – "we are not Fed-dependent[.]" It bears noting that, since the Fed began hiking interest rates last March and the ECB began hiking interest rates last July, the view that the ECB's hikes have been more-protracted than the Fed's is not accurate. However, so long as there are stable U.S.-Europe interest rate differentials, it is inevitable that the contrast between the policies of the Fed and the ECB is likely to determine the direction of forex trends (see graph). The softening of EUR in late May reflects the fact that an increasing number of people are beginning to expect the announcement of an additional interest rate hike at the FOMC meeting in June.

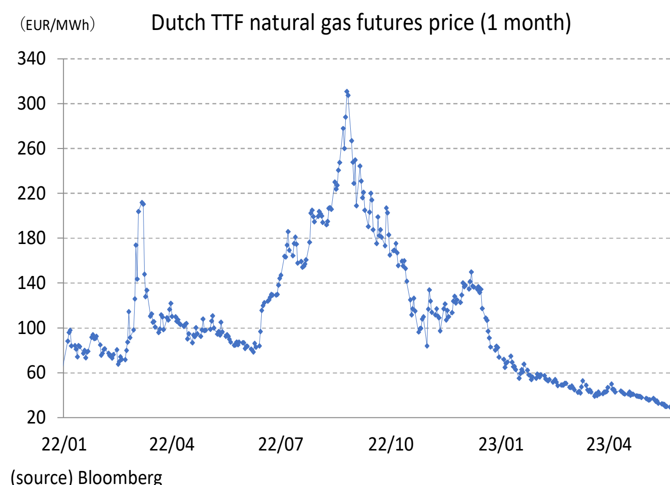


(Source) Bloomberg

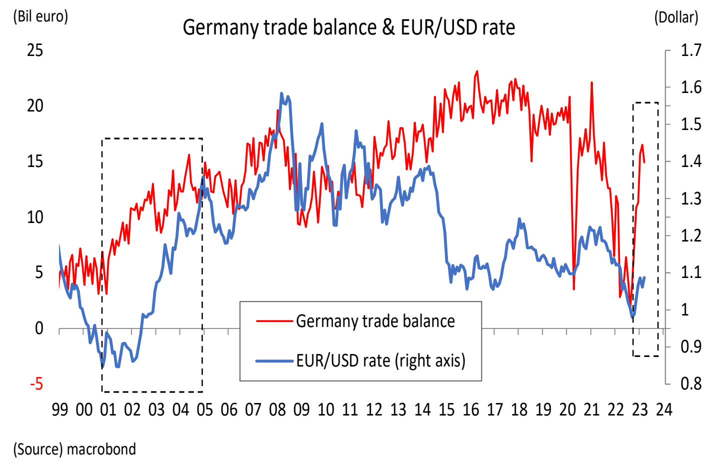
At the press conference following the May Governing Council meeting, President Lagarde declared – "We have more ground to cover and we are not pausing, that is extremely clear." – so it is "extremely clear" that the ECB will not soon halt its interest rate hikes. This kind of clear-cut information dissemination contrasts sharply with that of the Fed, which has stated that it is still evaluating the cumulative effect of its previous rate hikes. Even if one assumes that the Fed will hike interest rates once again at the June FOMC meeting, the strong likelihood that the ECB will be sustaining its interest hike policy for quite some time is expected to support EUR/USD for the time being. On the other hand, it is also noteworthy that the euro area still has no real prospect of replacing the natural gas supplies it previously obtained from Russia so, just as last year, there is an undeniable possibility that EUR selling will gain momentum beginning from the summer based on consciousness of the potential for a serious energy crisis during the winter months. This situation is discussed in greater detail below.

*Continued Risk Regarding Natural Gas Prices*

Energy price trends are another important basis for discussing the EUR outlook, and prospective natural gas price trends are cause for particular concern. As previously reported, the prices of natural gas traded in Europe have been steadily declining due to individual countries' electric power conservation efforts and the record-warm weather experienced last winter, and those prices have finally reached levels seen prior to Russia's invasion of Ukraine. Since late May, Dutch TTF Natural Gas Futures next-month delivery prices have been chronically falling below EUR30 per MWh – a drop of more than 90% from the peak levels surpassing EUR300 reached in August 2022. Given the great change in energy price-related assumptions, it is only natural that the dissipation of last summer's concerns about the possibility Europe would experience extremely severe energy situation during the 2022-2023 winter season would be followed by a period of quite positive trends. It appears that the sharp drop in energy prices has directly caused substantial improvement in the trade balance of Germany and the rest of the euro area, and that improvement has been a significant supply-demand-side factor supporting EUR buying (see graph). Of course, such factors as changes in China's gas procurement policies contributed to the previous rise in natural gas prices, so it would not be correct to consider the recent natural gas price trends to be completely attributable to Europe's warm winter weather and ongoing efforts to save electricity. But if the weather in Europe last winter had been as cold as it ordinarily is, there is significant possibility that Europe would have experienced an extremely difficult situation.



(source) Bloomberg




It is undeniable that it was only unusual weather patterns that saved Europe from a major crisis last winter and, as it would be foolish to assume that similar weather patterns will be repeated this upcoming winter, it is important to acknowledge the difficulty of predicting future trends related to Europe's energy situation. The euro area is currently seeking to compensate for the loss of natural gas supplies previously imported via pipelines from Russia by securing liquefied natural gas (LNG) supplies from around the world. However, importing LNG requires specialized terminals for the receiving and regasification of the LNG. The EU has been working speedily to create such LNG infrastructure, so it is expected that its LNG import capacity will be higher in 2023 than it was in 2022. However, given that Europe was able to continue importing natural gas from Russia through the first half of 2022, some observers expect Europe's natural gas supply-demand situation in 2023 may be worse than it was in 2022. If Europe is hit by severely cold weather during the 2023-2024 winter season while it has still not completed the expansion of its LNG infrastructure, it is highly likely that the energy supply-demand situation will become tight and energy prices will rise considerably. The EU is also proceeding with plans to create pipeline links with countries in North and West Africa to obtain relatively inexpensive supplies of natural gas, but it is unlikely that such pipelines will be operating at full capacity soon, and almost certainly not by the end of 2023.

Looking Dutch TTF natural gas prices for wintertime deliveries, one finds these are currently EUR40 per MWh for deliveries after six months and EUR50 per MWh for deliveries after nine months – these prices are somewhat higher than prices for near-term deliveries. It will not be a big problem if the rise in natural gas prices is limited to that degree, but one should keep in mind the possibility that the overall scenario may quickly and dramatically change depending on the weather. A major lesson learned during 2022 is that when unexpectedly high inflation rates dictate sharp interest rate hikes, strong concerns that the supply-demand situation will deteriorate may promote EUR selling. During the next 12 months, energy prices, and weather and geopolitical situations are likely to continue constituting downside risks for EUR.

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