Forex Medium-Term Outlook

June 30, 2023

Overview of Outlook

In June, USD/JPY continued to climb. With half of 2023 behind us, it appears that USD/JPY is progressing by and large as predicted in this report. As I have emphasized repeatedly, it is no longer possible to predict the level or direction of JPY based solely on U.S. interest rate trends. Of course, one of the reasons for JPY's depreciation may be that the Fed has continued its rate hike path longer than expected, but the fact is that USD has remained unshakably strong against JPY despite the Fed's rate hike margin declining from +75bp last November to no rate hike at the recent meeting. Why does USD/JPY remain stable despite U.S. interest rates weakening? At the risk of sounding repetitive, this is because of the continued draining of foreign currency out of Japan – a fact that cannot be perceived from a superficial glance at Japan's Balance of Payments figures. Another point I have been emphasizing in this report since last year is that, compared with 2022, a causal relationship between the domestic-foreign interest-rate differential and JPY weakness may become more apparent in 2023, as carry trading becomes easier. In fact, the current situation is quite reminiscent of the "weak-yen bubble" during 2005-07, but at that time, though speculative trading exerted downward pressure on JPY, actual demand exerted upward pressure, with the result that the trend switched from JPY depreciation to JPY appreciation when the Fed pivoted to a dovish policy stance. At the current time, however, both speculative trading and actual demand are exerting downward pressure on JPY, so my theory is that JPY will not appreciate much just based on the Fed's pivot to a more dovish policy stance. Of course, the Fed is expected to switch to a dovish stance sometime during the current forecasting period, and JPY is expected to appreciate at that time, but I believe this will just be a brief buying opportunity punctuating a larger JPY-depreciation trend. Moreover, in the event that the Fed's rate hikes continue beyond September, one must consider the upside risk of USD/JPY returning to the 150 level.

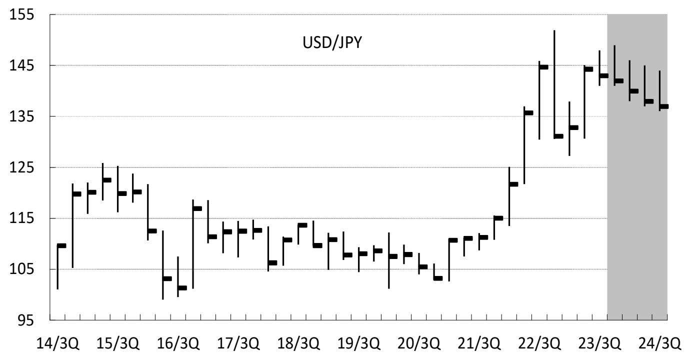
Meanwhile, EUR recovered its strength in June. Strict adherence to the rate-hike path was reaffirmed at the June ECB Governing Council meeting, so there are indications that rate hikes could continue until September, not just July. The ECB has already been implementing rate hikes for almost a year longer than initially expected, and there are no signs of an early end to the situation going by the tight labor and wage market conditions. At the time of writing this report, EUR is stronger than USD, which is stronger than JPY, directly reflecting the policy stances of the respective central banks – with the ECB continuing its rate hikes, the Fed taking a break from rate hikes, and the BOJ continuing monetary accommodation. If, as many in the market expect, the Fed ends rate hikes in July and the ECB ends them in September, the gap between the policy interest rates of the two central banks could be reflected as is in EUR/USD rates for some time thereafter. Moreover, in contrast to the collapsing demand for JPY, EUR is backed by the world's largest Current Account (and Trade) surplus. Even though the ECB is expected to pivot to a more dovish stance going forward, that by itself is unlikely to cause EUR to crash. Natural gas prices are the main risk factor for EUR, and depending on climactic conditions next winter (i.e., if faced with a harsh winter), the EUR supply-demand balance could change dramatically, making this a potential downside risk that could cause EUR to crash.

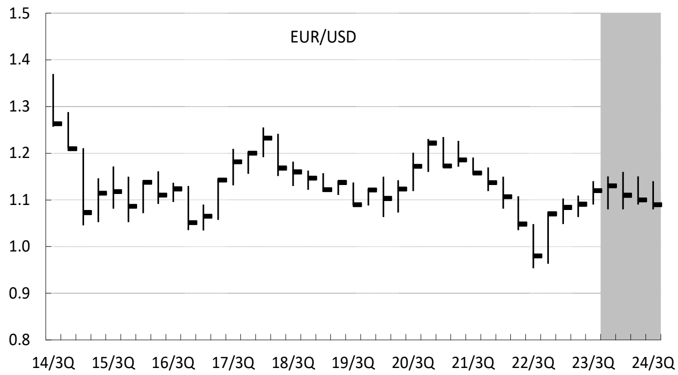
Summary Table of Forecasts

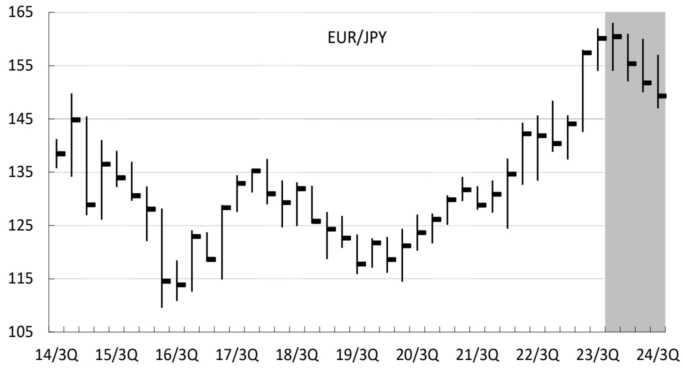
	2023			2024		
	Jan-Jun (actual)	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	127.22 ～ 145.07 (144.88)	141 ～ 148 (143)	141 ～ 149 (142)	138 ～ 146 (140)	137 ～ 145 (138)	136 ～ 144 (137)
EUR/USD	1.0482 ～ 1.1096 (1.0872)	1.09 ～ 1.14 (1.12)	1.08 ～ 1.15 (1.13)	1.08 ～ 1.16 (1.11)	1.09 ～ 1.15 (1.10)	1.08 ～ 1.14 (1.09)
EUR/USD	137.45 ～ 158.00 (157.53)	154 ～ 162 (160)	154 ～ 163 (160)	152 ～ 161 (155)	150 ～ 160 (152)	147 ～ 157 (149)

(Notes) 1.Actual results released around 10am TKY time on 30 Jun 2023. 2.Source by Bloomberg 3. forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





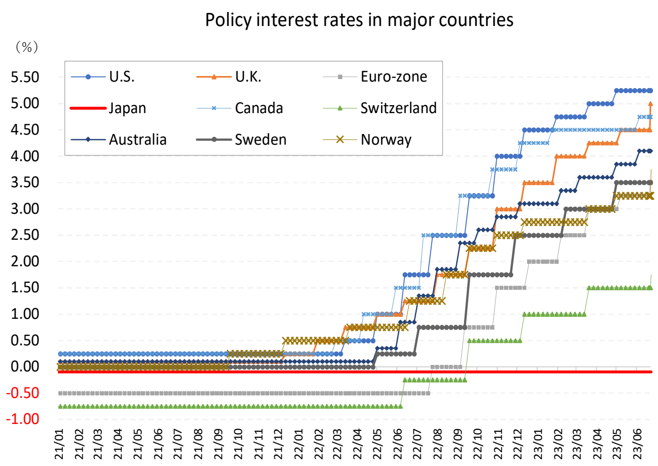


USD/JPY Outlook – Downward Pressure on JPY From Both Speculative Trading & Actual Demand

JPY Rates Now and Going Forward – Similarities & Differences Compared With "Weak-Yen Bubble" Period

Cannot Rule Out USD/JPY's Return to 150 Level

JPY has been appreciating against USD more rapidly than predicted by this report. The accelerated depreciation of JPY in June may have been more due to the impact of interest rate and price trends than due to the change in JPY's supply-demand climate, which this report has traditionally emphasized. On June 22, both the Bank of England (BOE) and Norges Bank (the central bank of Norway) took the markets by surprise when they raised interest rates by +50bp each, as opposed to market predictions of +25bp. From Japan's perspective, the downward pressure on JPY had only just eased up following an improvement in the supply-demand climate after the trade deficit began to shrink, but the reemergence of overseas inflation concerns ended up combining with the foreign-domestic interest rate gap to exert renewed downward pressure on JPY.



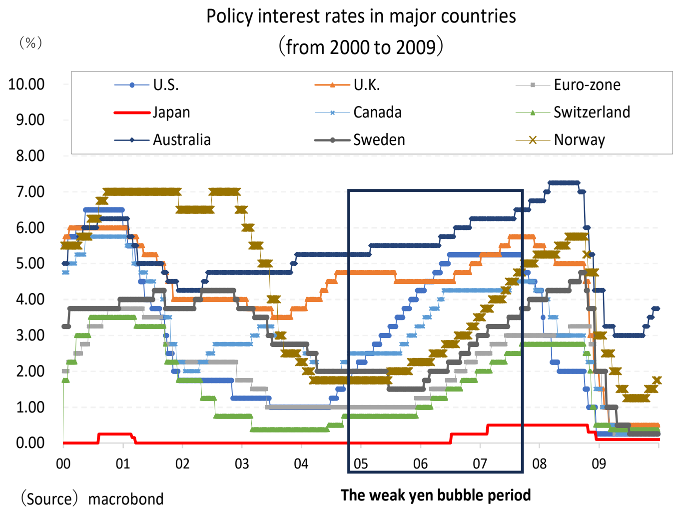
(Source) macrobond

Right from the start, I have stressed in this report that the foreign-domestic interest-rate gap could become a true causal factor of JPY depreciation in 2023 if carry trading conditions emerge. In recent days, things seem to be moving in that very direction. At the beginning of 2023, the main market prediction was that there would be no rate hikes in 2H of 2023, and in the case of the Fed, a pivot to rate cuts was being assumed. This assumption was behind most market predictions of JPY appreciation. As of the present time, however, it has to be said that such predictions seem to have missed the mark altogether. At the time of writing this report, both the Fed and the ECB appear certain to implement rate hikes in July, so the assumption of no rate hikes in 2H of 2023 is already collapsing.

In this context, it must be said that this report did not expect the Fed to consider a rate hike in July either, but it completely disagreed with other forecasters when it came to the possibility of the Fed pivoting to rate cuts during 2H of the year. Further, it has consistently maintained that JPY appreciation is impossible in the present supply-demand climate. This report has considered JPY supply-demand more important than interest rates in forecasting the outlook for JPY, and so far, this has paid off in terms of its forecasts being on point. Of course, the possibility of the Fed continuing to implement rate hikes through September is an unforeseen downside risk for JPY even from this report point of view, and it gives rise to the prospect of USD/JPY returning to the 150 level.

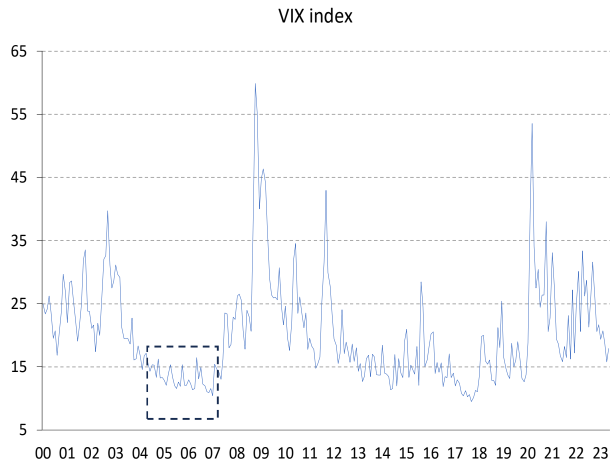
Situation Reminiscent of the Weak-Yen Bubble Period

As per my predictions since last year, the situation does appear to be increasingly reminiscent of the 2005-07 weak-yen bubble period. The figure to the right illustrates the policy interest rates of key countries at that time. As at the present time, it can be seen that all key countries apart from Japan were conducting consecutive rate hikes, while JPY conspicuously remained the only zero-interest-rate currency in the world. The phrase "carry trading" began to be used frequently starting around that time. Carry trading involves selling a currency that offers low interest rates to buy and hold a currency that offers higher interest rates, i.e., trading conducted with the intention of collecting the interest rate differential (literally, "carry").



The lower-interest-rate currency in carry trading is called the funding currency, and there are two conditions that must be met for a currency to be chosen as a funding currency. For one, the currency should be expected to continue maintaining a low interest rate (to ensure a sufficient interest-rate differential for the foreseeable future); and for another, the currency in question must have liquidity. Currencies of current account deficit or trade deficit countries are even more desirable as funding currencies in terms of their supply-demand structure. JPY in those days was backed by an abundant trade surplus, but the fact that it was a key currency offering a wide domestic-foreign interest-rate differential that was expected to remain stable made it a good funding currency (details later). Having procured a funding currency, traders need simply to wait for financial market volatility to subside before selling the funding currency in exchange for a currency offering a higher rate of interest and making a successful carry trade. Since 2000, 2005-07 (portion within dotted square in the figure) has been the longest period of low volatility in the markets. This made it very conducive for carry trading to flourish, as a sufficient interest rate differential combined with low volatility and a sense of stability are great incentives for carry trading.

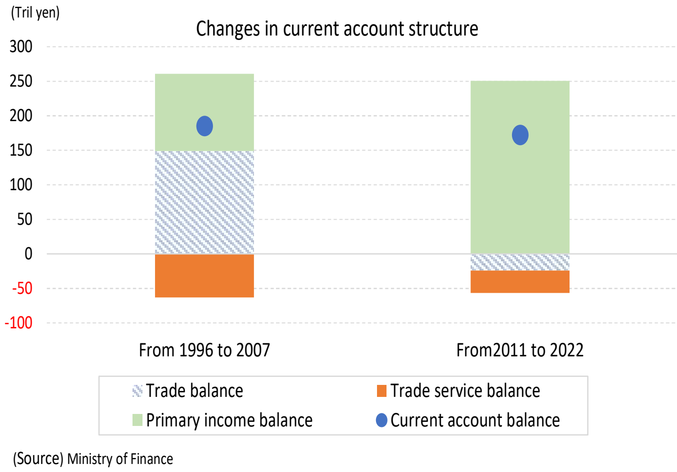
JPY depreciation during 2005-07 led to an increase in Japanese exports of flat-screen television and other consumer electronics, resulting in enormous trade surpluses. This chain of events (JPY depreciation → export volume increase → trade surplus expansion) is what led to 2005-07 being dubbed the "weak yen bubble" period, in sharp contrast to the current phase of "undesirable JPY depreciation." Incidentally, it has recently been pointed out that the phrase "undesirable JPY depreciation" is no longer being used, and that this indicates a lack of integrity. I would like to argue that it is only the media that is no longer using the phrase for its own reasons. A glance at the real economy shows that real incomes are continuing to fall significantly, making JPY weakness a difficult burden on the shoulders of the Japanese household sector. It will remain to be seen whether the profits being reaped by the corporate sector will continue to spill over to the household sector. In this context, it must be acknowledged that nominal wages have seen some increase this year, but it may be too soon to tell how sustainable the trend will be. Going forward, the "undesirable JPY weakness" issue seems certain to be brought up again if USD/JPY surpasses the 145-yen mark. One of the main reasons for silence in this regard at the current time is the difficulty of complaining about JPY weakness when share prices are increasing, especially if resource prices also happen to be stably low and the damage from JPY weakness is difficult to visualize.



(Source) bloomberg

No Longer the Same Currency as During the "Weak-Yen Bubble"

There are two differences between 2005-07 and the present. One is the pace of rate hikes, and the other is the supply-demand climate. In the case of the former, the Fed, for example, implemented a cumulative rate hike of +300 bps within the space of 30 months from January 2005 through July 2007. This time round, the Fed has implemented a +500bp rate hike within the space of 15 months from March 2022 to June 2023. This rapid pace of rate hikes, rarely seen in history, has been intended to counter the sharp rise in inflation, and the battle has not yet been won. Even as central banks in the rest of the world persist with unprecedented hawkish policies, the BOJ insists on holding on to its accommodative money policy stance. In terms of a stably sufficient interest rate differential, therefore, the present time is outperforming 2005-07. Of course, as the figure on the next page shows, market volatility is higher this time round, but given that traders can expect greater profits from interest-rate differentials than in 2005-07, it seems rational to assume that they can tolerate some level of volatility.



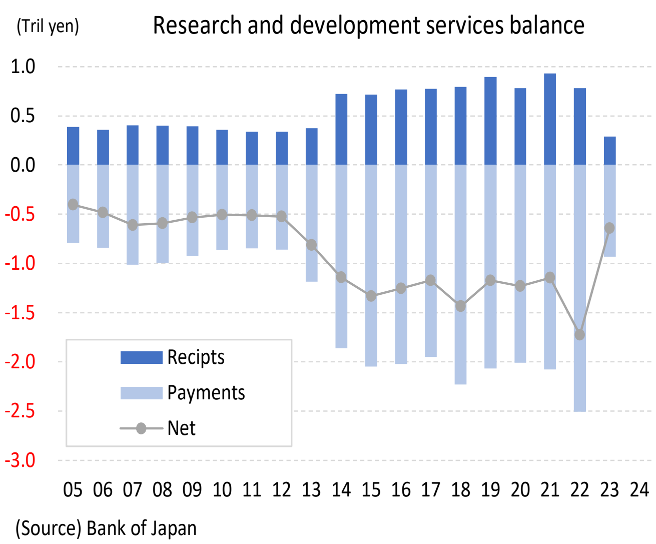
(Source) Ministry of Finance

The main difference between the 2005-07 weak-yen bubble period and the present, however, is the JPY supply-demand climate. I mentioned earlier that a currency that offers liquidity and is expected to stably maintain low interest rates (thereby offering a sufficient interest rate differential) are two conditions for it to be chosen as a funding currency. In its present state, JPY offers the further assurance of being a currency with collapsing demand (i.e., supply & demand indicate net sale). Let us take a look at some concrete figures. Japan's Trade balance (Balance of Payments) was roughly +JPY 11.8 trillion for 2005, +JPY 11.1 trillion for 2006, and +JPY 14.2 trillion for 2007, averaging a surplus of over JPY 10 trillion for the three years. Of course, this magnitude of trade surplus was not just limited to the 2005-07 period. In the 12 years from 1996 (the year until which it is possible to retrospectively calculate the Balance of Payments based on BPM6) through 2007 (the year of the subprime mortgage crisis) Japan's trade surplus fell below +JPY 10 trillion only twice (once in 1996 and again in 2001), while the cumulative trade surplus earned during this period amounted to roughly +JPY 149 trillion (see figure). As a result, Japan posted its largest ever Current Account surplus until then in 2007, at +JPY 24.9 trillion. By contrast, the cumulative Trade balance for the 12 years from 2011 through 2022 has been a deficit of -JPY 24.2 trillion. In terms of its supply-demand balance, therefore, JPY is no longer even the same currency.
During 2005-07, despite overwhelming actual demand for JPY, stably low levels of market volatility combined with the fact that Japan was the only major country with a zero-percent interest rate while all others were raising interest rates to facilitate brisk carry trading. However, carry trading is strongly speculative in nature. With the emergence of the subprime mortgage crisis and the collapse of Lehman Brothers, risk tolerance evaporated from the markets, and investors were forced to roll back their cumulative carry trading positions all at once. What remained was JPY buying due to actual demand, which ushered in a phase of extremely strong JPY for a few years thereafter. In other words, in 2005-07, though speculative trading exerted downward pressure on JPY, actual demand was exerting upward pressure.

Downward Pressure from Speculative Trading & Upward Pressure from Actual Demand → Downward Pressure from Both Speculative Trading & Actual Demand
Cut to the present, and both speculative trading and actual demand are exerting downward pressure on JPY. In 2007-08, the upward pressure on JPY from actual demand took over when the Fed switched to a more dovish monetary policy stance, but that is not the case this time around. Naturally, then, JPY appreciation cannot be expected simply due to the Fed reducing the pace of its rate hikes or keeping its policy rates unchanged at high levels. One reason JPY could appreciate in the present scenario may be because it has been excessively sold off. Other possible reasons for a trend reversal could be the emergence of financial fears similar to those in March, increasing the possibility of a Fed pivot, or the BOJ implementing currency interventions. In other words, barring an autonomous recovery or unforeseen developments, there seems no hope for a switch to JPY appreciation at the current time.

JPY Basic Supply-Demand – Japan Ridiculed as Having a "Brain Freeze"

R&D Services Deficit is the Root Cause

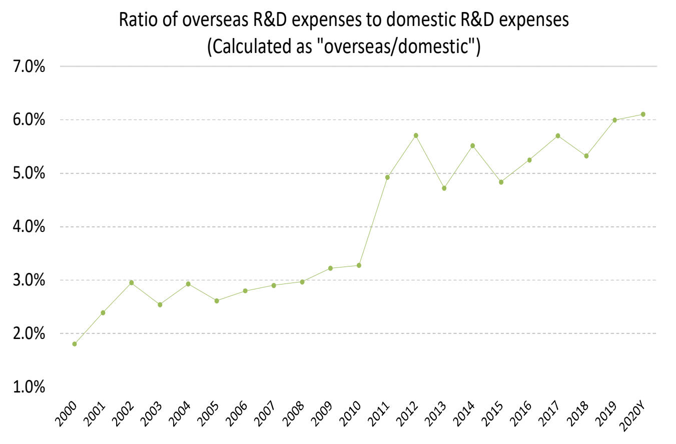


(Source) Bank of Japan

I have repeatedly argued in this report that Japan's external economic sector, especially the expanding Services deficit in Japan's Balance of Payments, is a new source of foreign currency drain out of Japan. Of the three categories comprising the Services balance (Travel, Transport, and Other Services), the new development pertains specifically to "Other Services," which posted a deficit of roughly -JPY 5.2 trillion (of the total -JPY 5.4 trillion Services deficit) in 2022.
Let us take stock of the Other Services deficit briefly. It comprises a deficit of roughly -JPY 1.6 trillion for "telecommunications, computer, and information services" (which covers cloud service usage fees, etc.), roughly -JPY 1.7 trillion for "professional and management consulting services," (which covers payments toward online advertising and funds repatriated to their home country HQs by foreign consulting firms), and roughly -JPY 1.7 trillion for "research and development services" (which covers the sale of industrial property rights, such as patent rights, utility model rights,

design rights, and trademark rights). Let us call these three categories "Digital," "Consulting," and "R&D" for the time being.

The gist of my arguments regarding these categories is as previously presented – namely, that the reason for the increase in Digital-related deficits may be because of Japan's decline in the R&D category. Statistically, R&D services are defined as "services that are associated with research and development such as basic research, applied research, and the development of new products. Also included are outright sales of the industrial property rights obtained as an outcome of research and development (such as represented in patents, utility model rights, and design rights)." My conjecture is that the R&D balance comprises largely of the sale of industrial property rights. As the figure to the right (top) shows, while receipts have increased from roughly JPY 400 billion until 2014 to JPY 800 billion or so since, payments have more than doubled from roughly JPY 900 billion until 2014 to roughly JPY 2 trillion since, causing the R&D Services deficit to expand. Perhaps there is not one but several reasons for this, including Japanese companies shifting their R&D bases from Japan to overseas locations, or even Japanese companies simply outsourcing their R&D services to overseas players (such as companies and universities). The Ministry of Economy, Trade and Industry's Survey of Overseas Business Activities also confirms a tendency among Japanese companies to spend money on R&D activities outside Japan (see figure, bottom).



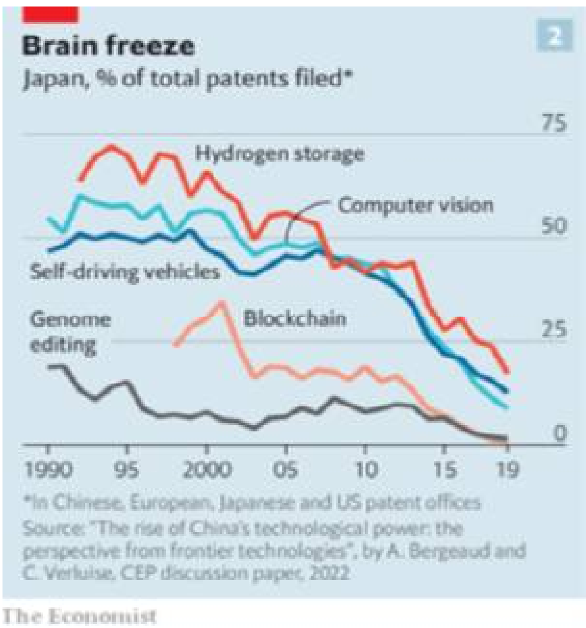
(Source) Adapted and prepared by Daisuke Karakama based on "Science and Technology Indicators 2022" of the Institute of Science, Technology and Academic Policy, the Ministry of Education, Culture, Sports, Science and Technology and "Basic Survey of Overseas Business Activities" of the Ministry of Economy, Trade and Industry.

Japan Described as Having a "Brain Freeze"

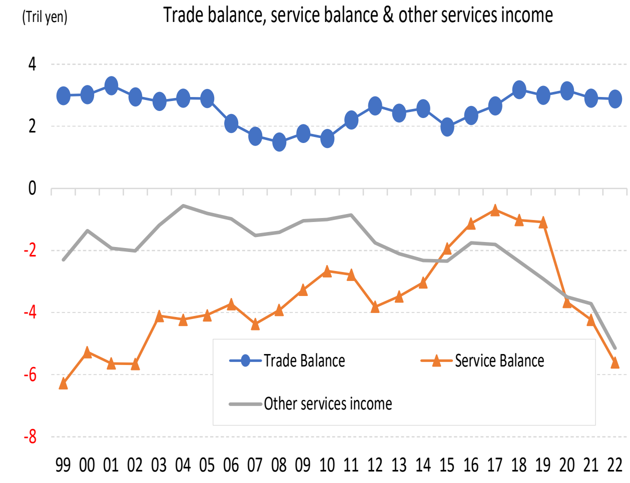
In connection with the increasing outflow of foreign currency in the area of R&D services, *The Economist* ran an article titled "It's not just a fiscal fiasco: greying economies also innovate less" in May 2023. The article laments that aging economies not just have heavier fiscal burdens, they also find it increasingly difficult to generate innovative technologies. It is not an article about Japan *per se*, but about the world as a whole. It surmises that, with populations on the decline around the world, the lack of innovative new technologies could result in lower productivity and lower growth rates for the world economy as a whole. However, the 10-page special feature does also specifically mention Japan. At the start of the article, Japan is mentioned alongside Italy as a country that will find it difficult to maintain its population, with birth rates less than the replacement level of 2.1%. The article also went on to quote Japanese Prime Minister Fumio Kishida as warning that the "country was on the brink of being unable to maintain social functions" in his policy speech at the plenary session of the House of Representatives on January 23, 2023

The crux of the article that innovation declines as birth rates decline (and the population ages), with the rest of the article going on to state that this is a phenomenon already taking place in some parts of the world, and one that will likely take place on a worldwide scale going forward, while also citing various prior studies on the topic. What is shocking for Japan is to be featured as one of the countries where such a phenomenon is already taking place. The article introduces the psychological concepts of "fluid intelligence" and "crystallized intelligence." Younger people are thought to have fluid intelligence, which allows them to use their imagination to come up with new ideas for solving problems, while older people are thought to have crystallized intelligence, which is knowledge about how things work that is accumulated over the course of time. While both types of intelligence play important roles in economic activity, fluid intelligence is more important when it comes to innovation, so the more aged an economy becomes, the weaker its ability to innovate. The article even introduces a study on the relationship between age and innovation, which discovered that the late thirties and early forties were the peak patenting ages for researchers, after which patenting rates declined gently through the rest of their forties and fifties. In economic production function terms, innovation improves the total factors in productivity (TFP), leading to higher economic growth rates even when labor and capital inputs remain the same. This suggests that societies with declining birth rates and aging populations could benefit the most from innovation, but the aging of society and decline in birth rates are also the root causes of stagnation when it comes to innovation, so there seems to be no way out for Japan.

The figure to the right has been taken from the aforementioned article in *The Economist*. It shows Japan's dramatic decline in areas where it once played a leading role. The title, "Brain freeze," seems to suggest a cessation of brain functions or something similar to a brain drain, but the phrase has also widely been translated into Japanese to suggest "a cessation of thinking functions." It is a phrase frequently used in connection with the Japanese economy/society in recent years. The article itself cites a study by the Centre for Economic Performance (CEP), London School of Economics, to point out that Japan



now makes almost no contribution to genome editing and blockchain technologies, and plays second fiddle to the U.S. and China even in technologies where it once led, such as hydrogen storage, self-driving vehicles, and computer vision (an AI field that deals with training computers to analyze and understand images). An even more frightening fact presented by the article was that young people in societies with declining birth rates and aging populations are less likely to start businesses compared with those living in other societies.



(Source) Bank of Japan

Taking all this into account, Prime Minister Kishida's policy of promoting the startup industry, while not a bad policy, may be difficult to see through, given Japan's demographics. Of course, the prime minister has combined it with another policy package to reverse the decline in birth rates, but the article in *The Economist* points out in this context that governments are powerless to reverse declining birth rates, citing the example of Singapore. Singapore has a birth rate of 1.0 despite the handsome "baby bonus" (USD 8,300 for the first child, USD 13,000 for the second) it offers its citizens to have children.

Expansion in Service Deficit Caused by "Brain Freeze"

To return to the subject of Japan's Services deficit, the aforementioned state of affairs ridiculed as a "brain freeze" is consistent with the expansion of Japan's R&D services deficit. Intuitively speaking, the decline in Japan's R&D Services balance may not be altogether unrelated to its Digital services deficit, and may even be related to its Consulting services deficit for all one knows. At any rate, there is a strong impression that Japan's Other Services deficit, which surpassed -JPY 5 trillion in 2022, is the result of the country's deteriorating competitiveness when it comes to digital technologies. And if one assumes that this has a deep-seated structural background in the form of declining birth rates and an aging society, then perhaps the Japanese economy has little choice but to be resigned to a foreign currency drain for some time to come. Perhaps the stubborn trend of JPY weakness is also, like with various other problems, attributable to Japan's demographic situation.

Current State and Future Prospects of the Japanese Economy – Could Japan Receive Inward Direct Investment?

Japanese Government Serious About Promoting Inward Direct Investment

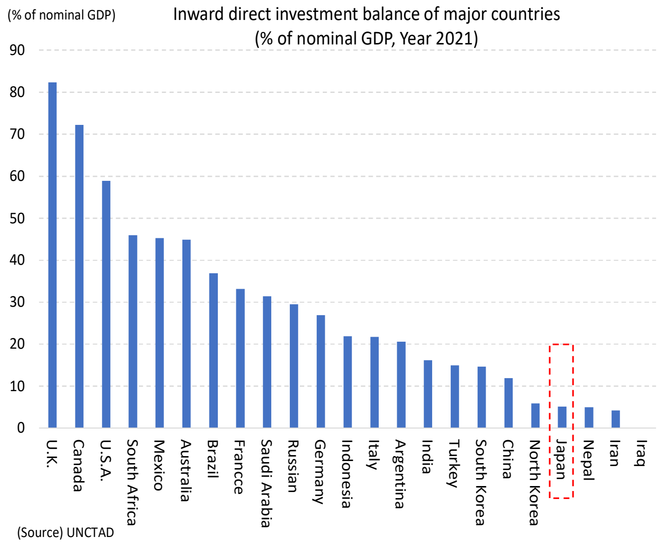
On June 16, the Japanese government's cabinet approved the "Basic Policy on Economic and Fiscal Management and Reform 2023 (Big-Boned Policy Outline)," which constitutes the basic guidelines for the formulation of the upcoming fiscal year's budget and other important measures. As I will explain later, the "Asset Management Nation" theory and the accompanying liberation of household assets incorporated in the Big-Boned Policy Outline could have major implications for the financial markets, and especially for JPY, but in this section, I would like to focus on a different issue – the fact that a target level and deadline were established for the direct investment balance:

- It is important to actively attract people, goods, money, and ideas from overseas to expand nationwide investment, enhance innovation power, and promote the further economic growth of our country. We will promote investment in strategic fields such as semiconductors […] toward early achievement of our JPY 100 trillion by 2030 inward foreign direct investment target, and contribute to the sustained growth of Japan's economy as well as the revitalization of regional economic growth.

As you may know, there have been some unexpected developments in terms of inward FDI in Japan even before the above policy was announced. For instance, Kishida's meeting with top executives from seven major foreign chip makers and research institutions at his official residence was widely reported in the media on May 18. Specifically, Kishida had met with the heads of Taiwan Semiconductor Manufacturing Company (TSMC), a company frequently mentioned in Japanese news as the world's largest semiconductor manufacturer, South Korea's Samsung Electronics, U.S. semiconductor giant Micron Technology, U.S.-based International Business Machines Corporation (IBM), Intel Corporation, Applied Materials, Inc., and Belgian research institute IMEC. Following the meeting, a policy of promoting investment in Japan was announced with the statement, "The government is committed to further expanding inward direct investment and supporting the semiconductor industry." As a matter of fact, the employment and wage situations in Kikuyohmachi, Kumamoto Prefecture are reported to have changed dramatically since TSCM was invited to establish a chip manufacturing plant there, indicating a guaranteed economic impact from inward direct investment. Let me take the opportunity of the Big-Boned Policy Outline announcement to introduce the climate surrounding inward direct investment and its prospects in Japan.

Inward Direct Investment is a Strategic Area in the Cheap Japan Era

Right now, Japan has exceptionally low levels of inward direct investment compared with the rest of the world, so it is a natural for an administrator to view it as an upside risk factor. According to data from the United Nations Conference on Trade and Development (UNCTAD), Japan's direct investment balance (as a percentage of nominal GDP) was 5.2% at the end of 2021, putting it at a pathetic 198th out of 201 countries for which data was available. Nepal, Iran, and Iraq were the only three countries that ranked below Japan, with even North Korea placing one rank higher (at 5.9%). Japan's extreme insularity when it comes to inward direct investment is equally clear when one considers that the OECD average direct investment balance is 56%. Of course, there is no need to judge countries on this list literally based on their rank, given that the highest-ranking countries/regions – Luxemburg, the British Virgin Islands, and the Cayman Islands (British overseas territory) – are outliers on account of being tax havens. However, data exists to show that the average foreign direct investment balance is 325 even for developing countries. Investment levels in Japan, therefore, are conspicuously low by international standards, and Japan continues to invite ridicule for its capital seclusion.

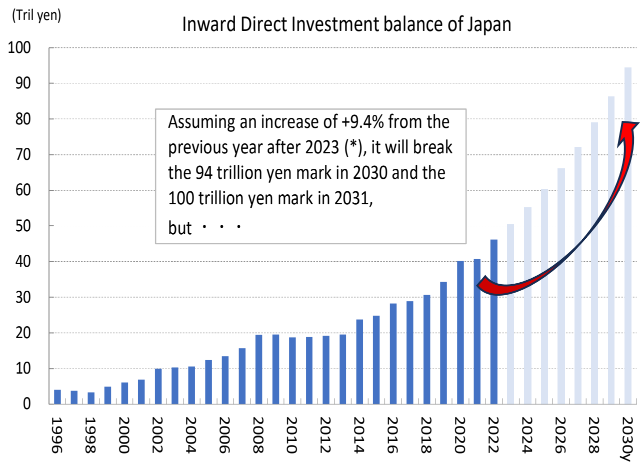


(Source) UNCTAD

If the return of Japanese manufacturing to Japan cannot be expected, encouraging new investment in Japan from foreign companies could be an extremely important policy measure in the "cheap Japan" era. As measures to promote inbound tourism encourage foreign people to visit Japan, measures to promote inward direct investment encourage foreign companies to participate in the Japanese economy. Both are worthy strategic areas for focus that could function as the two wheels of the Japanese economy in the "cheap Japan" era.

Targets Met in the Past

Taking the aforementioned situation into account, is the numerical target of JPY 100 trillion by 2030 feasible? Inward direct investment grew by an average of +9.4% yoy between 2013 and 2022. Assuming the same rate of growth, the inward direct investment balance would be roughly JPY 94 trillion by the target year 2030, and JPY 100 trillion by 2031 (see figure). Therefore, it is by no means unfeasible to achieve JPY 100 trillion by 2030, but it is also not too easy. As a challenge, it seems to have just the right level of difficulty. Incidentally, given that Japan's inward direct investment balance is quite low by international standards, various administrations have historically set themselves medium-term targets for increasing its level.



(Source) Ministry of Finance,Japan
(Note) *Average growth in inward direct investment balance from 2013 to 2022

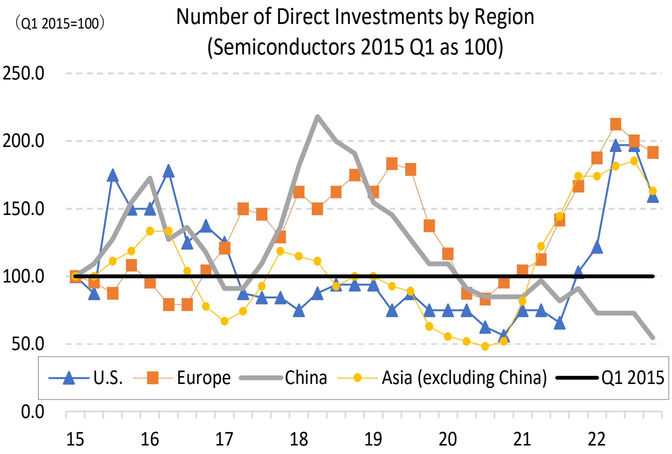
For instance, 20 years ago, in January 2003, then Junichiro Koizumi administration also set a government target of a five-fold increase in the inward direct investment balance compared with end-of-2001 levels within five years. As part of this program, in May 2003, JETRO set up its Invest Japan Business Support Center under the banner of "Invest Japan." The center was designed to be a one-stop shop for all kinds of information related to investing in Japan and to simplify some of the complexities of the process for foreign companies. In April 2004, I joined JETRO as a fresh graduate and still vividly remember my official business card containing the words "Invest Japan." The Koizumi administration met its target both in terms of the balance of investments and as a percentage of GDP (JPY 6.9 trillion → JPY 13.4 trillion, and 1.3% → 2.5%, respectively).

More recently, in 2013, the second Shinzo Abe administration set itself the target of doubling the inward direct investment balance to JPY 35 trillion by 2020 under its "Japan Revitalization Strategy." Again, the program aimed to provide comprehensive support with cooperation from JETRO. This target was also met, and Japan's inward direct investment balance was roughly JPY 40 trillion in 2020. Though starting from a low base, government targets related to inward direct investment have consistently been met, unlike fiscal reconstruction targets, which are treated more carelessly. Inevitably, there are expectations of success this time round too. Incidentally, in June 2021, the Yoshihide Suga administration announced through the Council for Promotion of Foreign Direct Investment in Japan that it would aim for an inward direct investment balance of JPY 80 trillion by 2030, i.e., double that in 2020. The recent Big-Boned Policy Outline appears to have upwardly revised that target.

Why is Japan's Inward Direct Investment So Low?

Why is Japan's inward direct investment so low? There are several theories, but no conclusive factors have been discovered yet. A frequently pointed out abstract factor, for instance, is the insular nature of Japan as a nation – something that was on full display during the pandemic. There may also be a less abstract factor – namely that the "dry" employment practices of foreign companies may be difficult to accept in the Japanese market, steeped as it is in more "wet" practices such as lifetime employment and seniority-based wages. This further relates to the concrete issue of Japan's rigid employment laws, especially those related to termination. The rigidity of Japan's employment laws could be hindering industry reorganization efforts by encouraging the entry of foreign companies. Apart from this, the language barrier (the inability to use English) may be a more basic factor hindering the entry of foreign companies. However, one has to wonder which of these factors contributes to Japan's inward direct investment being lower than that of North Korea. Do any of these factors sufficiently explain why Japan is so little preferred as a destination for foreign direct investment? There are no conclusive answers to this question. At any rate, the data suggests that Japan has been almost completely avoided, so the country needs to work on removing all the obstacles it can think of, and this intention of the government seems to be seeping through its "Big-Boned Policy Outline."

How to Increase Inward Direct Investment?



(Source) IMF, WEO2023 spring

How does the government intend to increase the inward direct investment? There seems no choice but to sequentially remove all the obstacles pointed out above and work on building a mechanism for motivating investors, but objectively speaking, the policy appears to have significant potential to help Japan recover. As part of a plan to increase the inward direct investment, the Big-Boned Policy Outline expresses an intent to "promote investment in semiconductor manufacturing and other strategic fields, formulate strategies to turn Japan into Asia's largest hub for the emergence of startups, set up the Japan System for Special Highly Skilled Professionals (J-Skip) and Future Creation Individual Visa (J-Find), work toward perfecting the Technical Intern Training and Specified Skilled Worker programs, and establish other systems to attract highly skilled professionals from overseas; and further to strengthen the functions of the International Financial Center, promote investment stimulus, and globally disseminate information toward the early achievement of an Action Plan for Attracting People and Funds from Overseas." Frankly speaking, it is difficult based simply on this stanza to predict how likely which of these plans is to succeed.

<u>One thing that can be said, however, is that the cost of investing in Japan for investors from other developed countries is relatively attractive at the present time, given that JPY's real-effective exchange rate (REER) is at the weakest it has ever been in 50 years</u>. In recent years, the importance of measures to promote inbound tourism (i.e., to attract foreign "people") as a means of utilizing "cheap Japan" to the country's advantage has attracted widespread attention, but the importance of measures to promote inward direct investment (i.e., to attract foreign "companies") does not appear to be widely recognized. <u>Objectively speaking, Japan does also have several advantages it can market, such as geopolitical stability, economic scale as the world's third largest economy, a safe country, and high levels of education</u>. In particular, as pointed out in this year's IMF World Economic Outlook (WEO) and Global Financial Stability Report (GFSR), there seems to be an increasing restructuring of direct investment. Political and foreign policy "distances" are increasingly dictating how much direct investment a recipient country receives, with "closer" countries receiving more. In this context, Japan may have an advantageous position as a key member of the Western Bloc that is also currently inexpensive. I have discussed this point in detail in a past issue of Market Topics. As a matter of fact, there is a new global trend to shift direct investment away from China due to geopolitical risks (see figure). Such contemporary trends could also serve to help Japan attract its share of inward direct investment.

More Options for Utilizing JPY Weakness Are Needed

As I have repeatedly stated in this report, <u>I believe that with the change in the structure JPY supply and demand, JPY depreciation phases are likely to be longer than JPY appreciation phases going forward. If so, Japan ought to find more options for utilizing JPY weakness to its advantage</u>. In recent years, service export (accepting foreign tourists) has been widely discussed, and there is no doubt that this is one of the options available to Japan. However, it will be challenging to keep a JPY 500 trillion economy afloat with just the help of the tourism industry (at the peak of inbound tourism in 2019, Japan's Travel surplus was a mere +JPY 2.7 trillion or so). On the other hand, I see significant potential when it comes to inward direct investment, a field in which Japan is lagging behind the likes of North Korea. If successful, this could even become the launch pad from which the Japanese economy can utilize JPY weakness to increase its export volume once again (of course, whether this is the right growth model for a new era is a different question). At any rate, if one assumes that the severe JPY depreciation of 2022 marks the end of a long history of JPY strength, <u>the key to success going forward will be to encourage foreign direct investment using JPY weakness as the lure</u>. It would not be an exaggeration, therefore, to say that increasing the inward direct investment balance is the most important point incorporated into this year's Big-Boned Policy Outline.

U.S. Monetary Policy Now and Going Forward – A "Hawkish Hold" Phase

Fed Transitions to "Hawkish Hold" Phase

Policy interest rate outlook as of each year end (median estimate)

FOMC Date	2023	2024	2025	Longer run
Dec-21	1.625%	2.125%	n.a.	2.500%
Mar-22	2.625%	2.625%	n.a.	2.250%
Jun-22	3.750%	3.375%	n.a.	2.500%
Sep-22	4.625%	3.875%	2.875%	2.500%
Dec-22	5.125%	4.125%	3.125%	2.500%
Mar-23	5.125%	4.250%	3.125%	2.500%
Jun-23	5.625%	4.625%	3.375%	2.500%

（Source）FRB

The Fed decided to keep the target range for the federal funds (FF) rate unchanged at 5.00-5.25% at its June 13-14 FOMC meeting. This is the first time in 11 meetings, since the start of rate hikes in March 2022, that there has been no change in the FF rate. The dot plot (FOMC members' FF rate projections), however, suggests an FF rate of 5.6% at the end of 2023, indicating the possibility of two more rate hikes within the year. In other words, the recent lack of a rate hike should be viewed as a suspension rather than termination of rate hikes. However, both 10-year and 2-year market interest rates fell following the meeting, giving the strong impression that the markets expect this to be the end of rate hikes with no resumption in the coming months. It would appear that the discrepancy between how the Fed and the markets view the situation remains uncorrected.

To take a closer look at the dot plot, the median of FF rate projections for the end of each year from 2023 through 2025 are 5.6%→4.6%→3.4%, which constitutes an upward revision of +0.5pp, +0.3pp, and +0.3pp, respectively, compared with the previous dot plot's projections (March). Further, none of the members forecast a lower FF rate than the current level for the end of 2023, which reconfirms my view that the markets are jumping the gun in expecting rate cuts to begin this year (see figure). Fed Chair Jerome Powell has said that the FF rate level is more important than the pace of rate hikes now that the rate is approaching its peak. One could say that the Fed has entered a phase of exploring the tightening effects of maintaining the FF rate at over 5%, and that the main forecast scenario for 2H of the year may be a "hawkish hold" – exactly what this report has been predicting since last year.

Forecasts of Rate Cuts Within the Year and of JPY Appreciation are Both in Trouble

FRB economic outlook (multiple forecast, %) as of JUN 2023

	2023	2024	2025	Long-term
Real GDP Growth rate as of MAR	1.0 (0.4)	1.1 (1.2)	1.8 (1.9)	1.8 (1.8)
Unemployment rate as of MAR	4.1 (4.5)	4.5 (4.6)	4.5 (4.6)	4.0 (4.0)
PCE inflation rate as of MAR	3.2 (3.3)	2.5 (2.5)	2.1 (2.1)	2.0 (2.0)
Core PCE inflation rate as of MAR	3.9 (3.6)	2.6 (2.6)	2.2 (2.1)	

（Source）FRB

In terms of the USD/JPY outlook, predictions of JPY appreciation based on an assumption of rate cuts within the year have become even more unlikely to come true. Even ignoring the question of whether two more rate hikes within the year are possible, the likelihood of a rate cut within the year (something many market participants have stubbornly been hoping for since last year) is vanishing by the minute. The projections for the core Personal Consumption Expenditure (PCE) deflator in the revised Summary of Economic Projections (SEP) are +3.9%→+2.6%→+2.2%, respectively, for 2023, 2024, and 2025, with the projection for the end of 2023 having been upwardly revised by as much as +0.3 pp compared with the previous time (March), and the projection for 2025 also upwardly revised by +0.1 pp (see figure). Several reporters asked about these upward revisions at the press conference, to which Powell responded that it would take some time for the slowdown in wage growth to ease the inflationary pressures. If inflation trend projections are upwardly revised mid-way through the year due to tight labor and wage market conditions, it has to be said that the possibility of a rate cut within the year has become close to nil. It follows, then, that JPY appreciation forecasts based on rate cut assumptions are equally in peril. Going forward, the only scenario in which rate cut expectations may arise again seems to be the re-emergence of financial fears similar to those in March, but it would be inappropriate to formulate asset price outlooks based on the main forecast scenario of a financial crisis emerging. Any rate cuts implemented in 2023 would be in response to a crisis situation, not part of the JPY appreciation scenario originally predicted by the markets.

Further, even if rate cuts are implemented, it seems unlikely that USD/JPY would fall to the 120 or even 110 level expected in some quarters. USD/JPY remains at the 140 level even following the suspension of a 11-month long phase of rate hikes. After all, the suspension did not come as a surprise, given most market participants' prediction at the start of the year that the Fed's rate hikes could end as early as March or by May at the latest. The point I have been emphasizing from the beginning, however, is that JPY is unlikely to appreciate much against USD even after the end of rate hikes, given that the present JPY weakness is owing to structural changes Japan is facing, such as the expansion of its trade deficit, the shrinking of JPY reconversion demand amid greater direct investment, and the emergence of new channels for foreign currency drain, such as Digital-related deficits.

When the current phase of JPY depreciation began in March 2022, pointing out structural factors for JPY weakness was frequently criticized as being too extreme a position to take, but the objective fact is that it has become more difficult JPY to appreciate. Most market participants are unlikely to have expected that USD/JPY would remain at the 140 level even following the suspension of rate hikes. What, if not structural changes, could be the reason for this? My basic position remains that it is less and less feasible to discuss the level or direction of USD/JPY based on U.S. interest rate predictions alone.

Risks to My Main Scenario – Risk of Super-Weak JPY Scenario Due to Restructuring of Japanese Households' Financial Assets

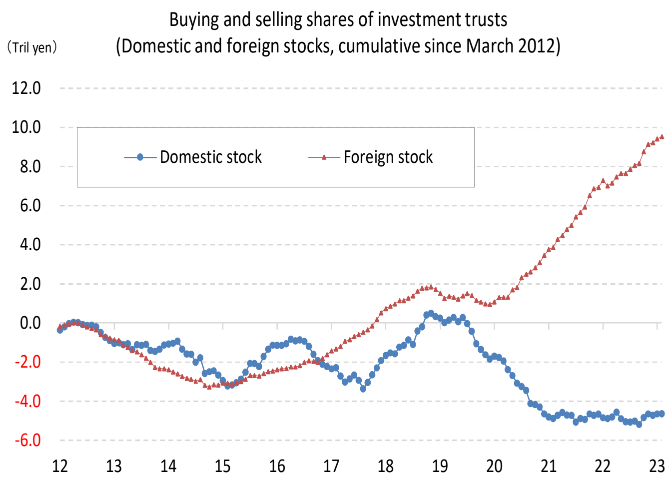
Embryonic Stirrings of a "Household JPY Selling" Trend

Trends in USD/JPY have continued to develop as this article has anticipated, with USD/JPY attaining its year-to-date high in June. Although experts have differing views about the chief causes of the current trend of JPY depreciation, this article has consistently maintained the position that one must not ignore the impact of changes in the fundamental JPY supply-demand environment on JPY exchange rates. When analyzing the JPY supply-demand environment, it is natural to begin by considering trends in Japan's balance of payments statistics, and past editions of this article have in fact repeatedly discussed such trends. On the other hand, it seems that the significance of trends related to Japanese households' financial assets has increased in recent years. Since Japanese households' financial assets amount to roughly JPY2,000 trillion, even a small change in the disposition of those assets could have a big impact. As shown in the chart, Japanese households' financial assets are currently invested extremely conservatively, with about 97% being in JPY-denominated forms and 55% being in cash and deposits. There remains considerable leeway for a shift toward greater risk taking, and if such risk taking involves foreign currencies, the potential impact on JPY exchange rates should not be overlooked.

Financial asset composition of the Japanese household sector（end of MAR 2023）

	Amount (tril yen)	（%）
Total assets	2,042.8	100.0
Foreign currency	66.9	3.3
Foreign currency deposit	6.4	0.3
Foreign securities investment	24.2	1.2
Investment trust	36.3	1.8
JPY-denominated	1,976.0	96.7
Cash and deposits (excluding foreign currency deposits)	1,100.2	53.9
Government bond, etc.	26.6	1.3
Stocks and investments	225.7	11.0
Investment trusts (excluding the foreign currency portion)	59.2	2.9
Insurance and pension reserves	534.3	26.2
Deposit, etc.	29.9	1.5

(Source) Bank of Japan "Flow of Funds Accounts."



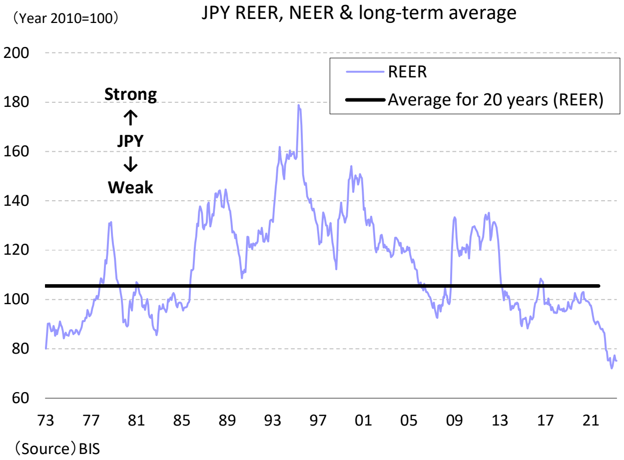
(Source) Investment Trust Association (Note) as of APR 2023

Japanese news media have intermittently been expressing concern about the potential for changes in the disposition of Japanese households' financial assets. For example, 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", which highlighted the fact that relatively young Japanese are particularly intent on increasing their holdings of foreign currency assets. For some time, this article and Mizuho Market Topic articles have been arguing that such "household JPY selling" could eventually constitute the biggest risk factor with respect to JPY exchange rates and, by extension, with respect to the Japanese economy. Looking at the results of the opinion survey summarized in the Nihon Keizai Shimbun article, one finds that survey respondents made various comments expressing their expectations that overseas economic and corporate growth rates were likely to exceed such growth rates in Japan. One respondent said – "overseas companies can be expected to realize higher levels of returns than Japanese companies" – for example, and another respondent said – "One can't expect very much growth from Japanese companies, so holding Japanese stocks over long periods is risky". Among Japanese individuals planning to make investments, the desire to invest overseas rather than domestically is common. <u>The associated shift of asset investments from Japan to overseas is not new, but it has become a particularly noteworthy trend during the past few years</u>. Looking at trends in equity investments via Japanese investment trusts, for example, one may note that purchases of foreign stocks have been gradually increasing since 2015. Investors' interest in domestic stocks was relatively weak during the period from 2015 through 2019, but <u>since 2019, there has been a dramatic shift away from domestic stocks and toward foreign stocks (see graph on previous page)</u>. It is not possible from the available statistics to determine the share of such foreign stock investments that are undertaken in conjunction with currency hedging measures, but it appears that JPY selling associated with investment in foreign stocks (mostly US stocks) may well have made a significant contribution to the recent JPY depreciation trend.

Recognition of JPY's Chronic Weakness to Transform Japanese Household Savings Methods?

As mentioned above, however, more than half of Japanese households' financial assets are still in the form of JPY-denominated cash and deposits. While Japanese households have somewhat increased their investment in foreign stocks, we are not yet approaching a situation in which such "JPY selling by Japanese" is on a scale capable of fundamentally changing the structure of JPY fund flows. However, it is important to take into account the special nature of Japanese societal psychology, as Japanese are prone to making decisions based on what the majority of other Japanese are doing rather than based on rational analyses. This pattern can be seen in how the majority of

Japanese continue to wear face masks even after the government discontinued its masking recommendations – Japanese individuals continue to mask simply because the majority of Japanese are continuing to mask. The Nihon Keizai Shimbun article mentioned above points out that, if the number of Japanese increasing their foreign currency-denominated assets continues to grow, they will eventually come to constitute the majority – and that will be a tipping point at which one can expect a considerable acceleration of the shift toward foreign currency-denominated assets. Moreover, it is no longer necessary to pay high fees to purchase foreign currency over-the-counter, and one can easily purchase foreign-currency-denominated assets using one's smartphone. Once the shift of Japanese household assets toward foreign currency-denominated assets becomes sufficiently common, there will be a potential for that shift to become akin to a stampede at any time. In fact, as reflected in JPY's real effective exchange rate (REER), which continues to be at its lowest levels in half a century, Japanese households' purchasing power with respect to foreign products has greatly weakened (see graph). In light of this, it can be considered quite rational for Japanese households to increase their foreign currency investments. JPY's weak purchasing power is pushing up the Japanese prices of goods imported from overseas, causing a situation in which imported products' price hikes are being reported on a daily basis in Japan.



In contrast, foreign tourists (inbound tourists) coming to Japan from overseas are continuing to show strong appetites for consumption and investment in Japan owing their "strong foreign currencies", which is the flip side of the "weak JPY". Many Japanese people have probably had conversations about such topics as, "Who will stay at such an expensive hotel?", or "Who will eat such expensive sushi?" Such conversations are based on feelings of resignation regarding the "weak JPY and strong foreign currency" situation, and many Japanese people are just having to accept the fact that "there are not many things that can be bought with JPY anymore". It would be nice if nominal wages in Japan were to rise in light of this situation, but I am not very optimistic about the likelihood of that. Japanese real wages decreased 3.0% yoy in April (the latest available statistics at the time this article was written), marking the 13th consecutive month of negative growth. Japanese people's financial situation is clearly deteriorating.

If the deterioration of JPY's purchasing power persists, all rational people with an understanding of basic economics will become more willing to hold their assets in "strong foreign currencies" rather than in the "weak JPY". As Japanese people become exposed on a daily basis to information about JPY's weakness (≈ the increasing relative strength of foreign currencies), it is only natural that more and more of them will grow dissatisfied with the weakness of their own country's currency. From December 2019 to now, JPY has weakened by nearly 30% against USD (with USD/JPY moving roughly from JPY110 to JPY140). While most Japanese have been holding their assets in JPY-denominated cash and deposits, which was previously thought to be the safest asset holding form, it is now clear that holding assets this way has led to considerable losses in buying power. If the trend of sharp JPY weakening had turned out to be a temporary trend limited to 2022, the dangerousness of holding JPY-denominated assets might not be so obvious, but seems quite clear that the JPY weakening trend will continue during 2023. So it is inevitable that an increasing number of Japanese will be seeking to shift their savings from JPY-denominated assets into foreign currency-denominated assets.

Shift from Asset Management to Asset Protection

In a broad sense, the prospective restructuring of Japanese households' assets may seem to be a shift from savings to investment, but I think it will turn out to be slightly different from that. The concept of shifting from savings to investments ordinarily suggests an increasingly aggressive fund management stance designed to increase an asset portfolio's value by investing in assets generally considered to be riskier than bank accounts. However, the shift from the "weak JPY" to "strong foreign currencies" stemming from the above-mentioned acknowledgement of JPY's chronic weakness is actually associated with an increasingly defensive fund management stance mainly designed to prevent the deterioration of an asset portfolio's value. Since Japan's period of rapid economic growth, Japanese people have never been troubled by JPY depreciation, although they have sometimes suffered from JPY appreciation. That is why there is a basis for serious concerns about what may happen going forward, as the unprecedented restructuring of Japanese households' assets may lead to difficult-to-anticipate trends.

At the end of December 2022, Japanese households held about JPY1,110 trillion in JPY-denominated cash and deposits. The shifting of only 10% of this to "strong foreign currencies" would entail roughly JPY110 trillion of JPY selling. The shifting of only 5% of this would entail roughly JPY55 trillion of JPY selling. Given that Japan's current account surplus in 2022 was about JPY11 trillion, one can anticipate that households' shift to foreign currencies would be capable of offsetting Japan's annual current account surplus for about 5 to 10 years. As previous editions of this article and Mizuho Market Topics have discussed in detail, Japan's current account surplus has been largely supported by the country's primary income balance surplus in recent years, so the amount of actual JPY buying associated with the current account surpluses may not be as large as one might expect. Given such a JPY supply-demand environment in Japan, there are grounds for concern that the triggering of a "Japanese selling JPY" trend may lead to a considerable amount of JPY depreciation. When one recognizes that JPY's sharp decline against USD last year (with USD/JPY moving from around JPY113 to around JPY152) occurred without the triggering of a "Japanese selling JPY" trend, it is quite apparent that there remains a real risk of considerably more JPY depreciation going forward.

Government Aiming to "Release" Household Financial Assets

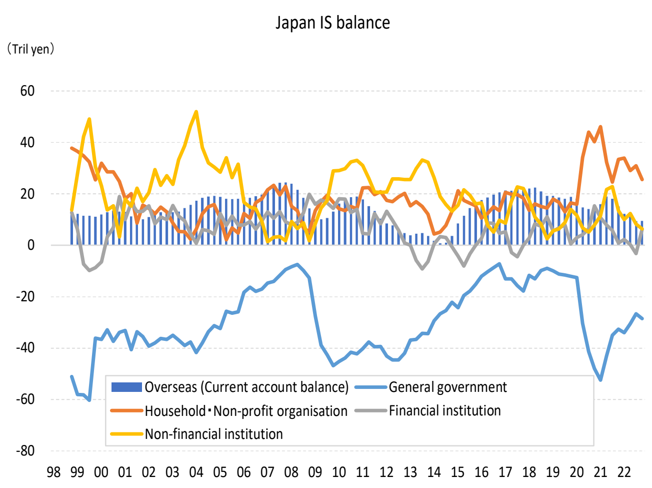
On June 16 this year, the Japanese government's cabinet approved the "Basic Policy on Economic and Fiscal Management and Reform (Big-Boned Policy Outline)" for 2023. While the media headlines about this focus primarily on the goal of returning to normal after the expansion of fiscal stimulus measures associated with the covid-19 pandemic, the financial markets' attention was caught by the following section:

- Realizing an "asset management nation" that will release JPY2,000 trillion of household financial assets and contribute to sustainable growth: To this end, it is important to expand household income from financial assets as well as wage income. [...] In conjunction with the increase in household income resulting from these measures, through such efforts as those to build a sustainable social security system, fundamentally strengthen measures to combat the declining birthrate and support child raising, and revitalize high-quality public education, we will restore an ample middle class, prevent social fragmentation due to the widening and entrenchment of inequalities, and promote the realization of a sustainable economy and society.

From the perspective of the financial market, it is very important to understand the ramifications of "realizing an "asset management nation" that will release JPY2,000 trillion of household financial assets and contribute to sustainable growth". In my opinion, there are two main types of concerns about the "release of household financial assets". First, concerns about exchange rates, and second, concerns about interest rates. Regarding exchange rates, as noted above, given that "household JPY selling" poses an extremely large potential risk to the Japanese economy, it should be recognized that blithely undertaking the "asset management nation" project without sufficient analysis and projections of the consequences could be quite dangerous. JPY depreciation in 2022 was of such magnitude that it engendered significant societal problems, but it should be recognized that that degree of depreciation occurred even without a large-scale shift of Japanese household financial assets to foreign currency-denominated assets. If policy makers loudly call for a "shift from savings to investment," there is a considerable risk that significantly greater JPY depreciation will be promoted. It is worth reiterating the general truism that, rather than economic rationality, the primary factor motivating Japanese people's economic behavior is a sense of doing something that everyone else is doing, so there are tipping points at which dramatic changes in societal behavior can be anticipated.

Impact on JPY Interest Rates and Fund Flows Structure

After exchange rate concerns, the second most serious concerns are related to the potential impact on JPY interest rates. There is a possibility that the release of household financial assets may impact the structure of fund flows that has benefitted the Japanese economy for many years by enabling the stable market absorption of government bonds. Japanese households and companies have been holding the bulk of their financial assets in the form of JPY-denominated cash and deposits largely because the Japanese economy's expected growth rates have been so low. Local currency-denominated cash and deposits (theoretically) have lower risk levels than other financial assets – they can be considered an optimal asset class during periods of slow economic growth, so the fund management approach of Japanese households and companies can be considered rational. Before it implements "asset management nation" policies that might undermine the rationality of long-standing private-sector practices, it would seem that the government should give greater recognition to the dangers such policies may pose with respect to exchange rates and interest rates.



(Source) macrobond (Note) Use four-quarter average

To understand how the release of household financial assets is likely to impact JPY interest rates, it is first necessary to get a good understanding of Japan's flow of funds structure. The cash and deposits of households and businesses are saved in the banking sector. If those funds were to stay in the banking sector and not be put to use, they could literally be considered "dead money", but the savings of the private sector (households and businesses) have actually been borrowed by the government sector and used for consumption and investment activities. Focusing on the banking sector, one finds that the cash and deposits received by the sector have been largely invested in government bonds. Such investments in government bonds cause the fund circulation structure to become balanced. Strictly speaking, there remains an excess of savings within Japan, but the Japanese overseas sector's shortage of savings (≈ current account surplus) has been bringing the entire economy's savings and investment into balance (see graph). Thus, the "private sector (household and corporate) savings surplus" is stemming from Japan's economic stagnation, and the private sector's proclivity to keep its savings in JPY-denominated cash and deposits is simply an additional result of that economic stagnation.

Looking at the latest big-boned policy outline, it appears that there is a misunderstanding about this point. Specifically, the policy outline asserts that the release of household financial assets will "contribute to sustainable growth", and this suggests a view that sustainable growth has been undermined because household financial assets have not been released. In other words, it appears that the drafters of the policy outline consider excessive savings to be a factor causing the slowness of economic growth rates. When low economic growth rates are anticipated, however, there is no reason for households to actively invest in stocks or for companies to proactively undertake capital investments. Rather than asserting that “excessive savings are the cause of low growth rates”, it would seem more accurate to say that “excessive savings are the result of low growth rates”.

Similarly, because Japan’s banking sector (particularly private-sector banks) holds large volumes of government bonds, Japanese banks are often criticized for simply investing funds in government bonds rather than “fulfilling their original role of extending loans to private sector entities”, but this is another example of confusing cause and effect. The essential role of banks is not to lend, but to “balance excesses and deficiencies of funds within the economy”. More specifically, the role expected of the banking sector is to mediate the flow of funds from entities with surplus funds to entities in need of additional funds. The reason the Japanese banking sector has not increased its lending is that, because of slow economic growth rates, it has been mediating the flow of funds from households and companies (entities with surplus funds) to the government (an entity with insufficient funds) by means of investments in government bonds. The banks have performed their essential role of “balancing excesses and deficiencies of funds” in a manner that was adjusted in response to the sluggishness of economic conditions. Although there has been a progressive shift of government bond holdings from private-sector banks to the BOJ since the period when Haruhiko Kuroda was BOJ governor, the fact remains that the banking sector has been playing its essential role by purchasing large quantities of government bonds.

When considering Japan’s failure to make progress in “shifting from savings to investment”, one must begin by recognizing that it is conditions in the Japanese economy that have been preventing such a shift. The concentration of Japanese households’ financial assets in JPY-denominated cash and deposits as well as the low and stable yields on Japanese government bonds enabled by those abundant JPY-denominated cash and deposits are results that reflect the Japanese economy’s level of dynamic strength. It appears that, to transform Japan into an “asset management nation”, the latest big-boned policy outline is seeking to forcibly alter this fundamental cause-effect relationship by means of political policies, although it is questionable whether such an approach will prove feasible.

If the Japanese Don’t Have Savings, Who Will Buy Government Bonds?

Leaving aside the issue of whether the current Japanese government bond marketing structure (centered on the private banking sector, the government sector, and the BOJ) is good or bad, it should be recognized as being a solid structure that has kept JPY interest rates stable and low. Aiming to transform Japan into an “asset management nation” by releasing households’ assets and promoting a shift from savings to investment, the latest big-boned policy outline appears to be something that will destabilize that government bond marketing structure. If the government is able to realize a progressive shift from savings to investment, will the government be able to continue marketing its bonds without encountering problems? While cash and deposits are often described as “sleeping assets”, they are constructively utilized by the banking sector to purchase government bonds. If those sleeping assets wake up and are invested in, for example, foreign currency-denominated assets, won’t it become necessary to find other economic entities to buy government bonds in place of the Japanese banking sector? It may possible to market Japanese government bonds overseas, but one cannot realistically expect overseas purchasers to accept the kind of low yields that are accepted by domestic investors. Just as JPY depreciation is causing Japanese people’s lifestyles to deteriorate, a rise in JPY interest rates will directly impact the quality of Japanese people’s lives, so these concerns cannot be said to be insignificant.

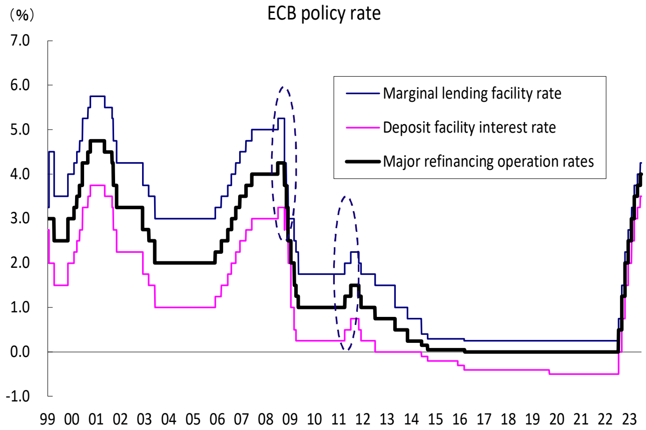
Of course, it is undeniable that the composition of Japan’s household financial assets may be excessively conservative from an international perspective, so there is some legitimacy in the argument that Japan should be transformed into an “asset management nation”. However, it appears that there has not been much discussion or debate about the large impact such a transformation may have on things directly related to people’s lives, such as forex rates and interest rates. An institutional framework for an creating “asset management nation” has already been put in place. However, although measures may be taken to considerably expand the iDeCO (Individual-type Defined Contribution Pension plan) and NISA (tax exemption system for small investments via individual savings accounts) systems, it perhaps would have been better if such systems were revised to differentiate between benefits associated with JPY-denominated assets and those associated with foreign currency-denominated assets. One wonders whether such revisions will be considered in the future if there is an increasingly active discussion about the significant impact forex rates and interest rates may have on fluctuations in household financial assets.

In any case, while it is true that the conservatism and lack of financial literacy peculiar to Japanese people are important background factors causing Japanese households’ relatively low level of asset management activities, I think that it is equally important to consider the impact of the severe economic conditions those households have been experiencing. Ideally, the government should promote a shift from savings to investment based on a good understanding of the reasons for and merits of Japan’s existing fund circulation structure.

EUR Outlook – ECB Driving Across-the-Board EUR Appreciation

EUR Area Monetary Policies Now and Going Forward – "We're not at Destination"

Interest Hikes Implemented at Record-Fast Pace Despite Technical Recession



(Source) Bloomberg

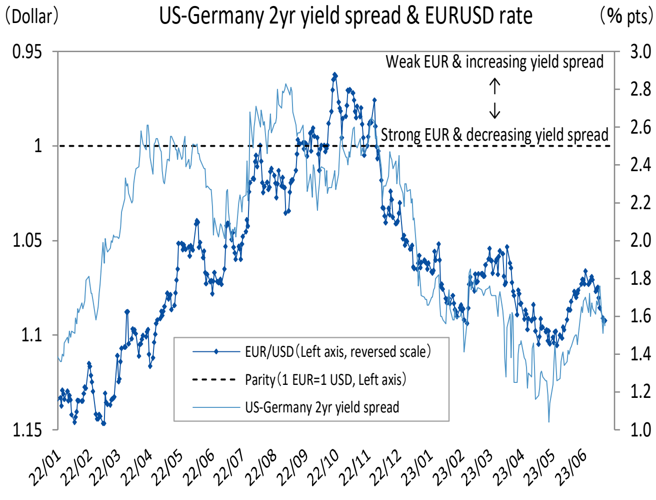
The June 15 ECB Governing Council meeting decided to hike the deposit facility interest rate and other major policy interest rates by 25bp, making the June meeting the eighth consecutive Governing Council meeting to raise interest rates (see graph). Since these rate hikes were initiated in July 2022, the aggregate margin of the hikes has reached 400bp. The hikes have been implemented at the fastest pace in the history of the ECB, and the period of rate hikes is still ongoing. The euro area's real GDP declined 0.1% qoq in both the fourth quarter of 2022 and the first quarter of this year, marking the start of a slight technical recession, and rates of growth in euro area's consumer price index (HICP) have clearly peaked out, but the fact that the ECB has maintained its resolve to continue the progressive interest rate hikes suggests that the ECB does not anticipate that such interest rate hikes will cause serious economic problems. At the post-Governing Council meeting press conference, ECB President Christine Lagarde responded to the first reporter's question by stating – "[I]t is very likely the case that we will continue to increase rates in July, which probably doesn't come as a big surprise to you." – so there appears to be a solid basis for anticipating another 25bp interest rate hike in July. Within that same response, President Lagarde also noted – "Are we done? Have we finished the journey? No, we're not at destination." – and the nuance of this response is causing increasing doubts that the interest rate hike journey will end in July. Accordingly, at the time this article was written, the financial markets had factored in an additional interest rate hike in September, so the focus of ECB watchers is likely to shift to the question of whether the interest rate hike journey might end after just two more hikes this year.

Particularly attention has been drawn by the upward revisions to prospective core inflation rates within the newly revised ECB staff macroeconomic projections. These projections anticipate that core inflation rates in 2023, 2024, and 2025 will be "5.1% → 3.0% → 2.3%". Compared to the previous projections, these figures have been revised upward by 0.5% percentage point, 0.5% percentage point, and 0.1% percentage point, respectively. Given the significant uptick in the most-easily-predictable inflation trend, it would be difficult for the ECB to back down from its determination to proceed with additional interest rate hikes. The Governing Council meeting's statement mentions that the euro area's core HICP inflation rates are showing a broad-based trend of decline – reflecting decreases in energy, food, and service prices – but it also notes that the inflation rates are remaining above the 5% level and that "Indicators of underlying price pressures remain strong".

Growing Suspicions about the Existence of a Wage-Price Spiral

Several reporters at the press conference posed questions related to the upward revision of core HICP projections. In this regard, President Lagarde made it clear that the Governing Council meeting devoted considerable time to analyzing the labor market and found that, while energy and food sectors were previously the main inflation drivers, wages have now become a main inflation driver. She overviewed these changes in the inflation-inducing factors, saying – "To oversimplify: energy played a significant role, then food kicked in, and energy is now fading, has moved now in May and is in slightly negative territory. But labour, and wages in particular, is playing a significant role as a driver of inflation." Reporters have been speculating about the existence of a wage-price spiral at each of the past several post-Governing Council meeting press conferences and, given President Lagarde's recognition that nominal wage increases are a major inflation driver, there appears to be less and less leeway for denying the existence of such a wage-price spiral. At the June press conference, one reporter asked for an explanation of this, saying – "You said that wages are having a huge impact on inflation on one side, and on the other side you say that there is no wage price spiral. So, it's not really clear to understand." In response, President Lagarde argued that, although the ECB's analysis shows that rising unit labor costs (ULC) are boosting inflation rates, ULC is somewhat different from wages agreed to by labor unions (negotiated wages), and she seemed to argue that, given the current trend in negotiated wages, the situation cannot yet be considered a genuine wage-price spiral. There is no question that central banks should do their utmost to prevent wage-price spirals characterized by repeated rounds of "tit-for-tat" corporate selling price hikes and workers' demands for higher wages in response to inflation, but the ECB is continuing to argue that the situation has not become a full-fledged wage-price spiral. The meeting's statement notes that negotiated wages are rising at rates above 4% but emphasizes that these rates are "partly reflecting one-off payments" arranged in light of previous inflation, so they might not be sustained. It is difficult at this time to confirm whether the ECB's theory in this regard is correct or not.

ECB Rate Hikes Protracted Much Longer than Expected Last September

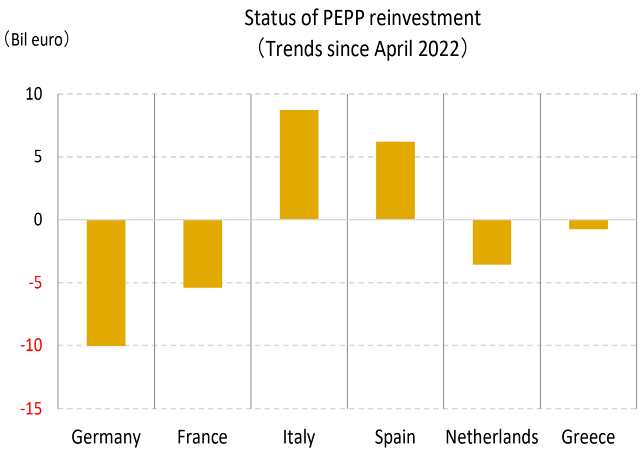


(Source) Bloomberg

As discussed below, EUR has begun appreciating since May, and this may be attributable to the hawkishness of the ECB's stance in comparison to the Fed's stance, since the relationship between the U.S.-Germany interest rate differential and EUR/USD is much more stable than the relationship between the U.S.-Japan interest rate differential and USD/JPY (see graph). In fact, however, the ECB's policy rate trajectory has become considerably higher than the ECB itself initially expected it to be. This is clear given President Lagarde's statements at the September 8, 2022 Governing Council meeting, at which she was asked to estimate the prospective number of policy rate hikes and responded that – "It's probably more than two, including this one, but it's probably also going to be less than five." Assuming that the number of prospective hikes at that time was 4 ("less than 5") and that the starting point was September 2022, the interest rate hikes would have been expected to end after the hikes of October 2022, December 2022, January 2023, and February 2023. Of course, the interest rate hikes did not actually end in February 2023. The subsequent three hikes (in March, May, and June) are all in excess of maximum number of hikes anticipated last September, and they are quite significant hikes that have added an aggregate 100bps to the ECB's policy rates. On top of that, it appears that the ECB's default course calls for an additional hike in July, and quite a few people are anticipating another interest rate hike in September. In short, while the ECB initially (in September 2022) expected to be hiking interest rates for a period of five months, it now seems likely that the period will be extended to nearly a full year, and this appears to reflect the ECB's acknowledgment that it has as yet completely failed to sufficiently restrain inflation.

Of course, the FRB has also fallen into a similar situation, and I think these situations clearly illustrate that central banks do not have perfect predictive powers and are not positioned to effectively control inflation by means of monetary policies alone.

Reducing PEPP Reinvestment to Compensate for Halting Interest Rate Hikes

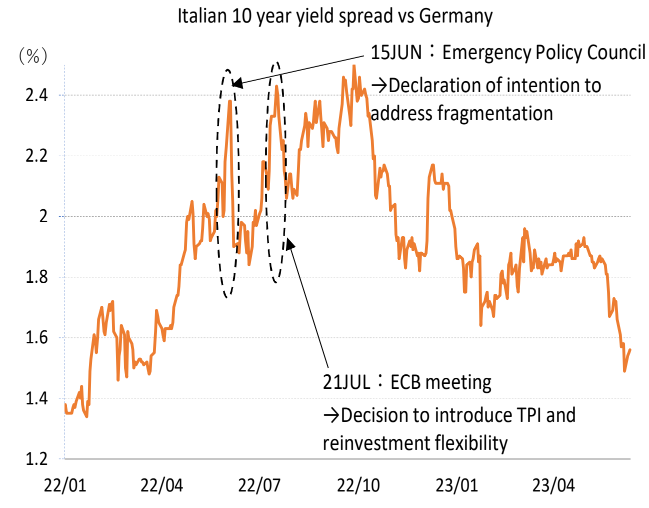


(Source) ECB

Since the full effects of interest rate hikes appear only after a certain time lag, it appears highly likely that the ECB will consider itself positioned to emulate the Fed's "hawkish hold" move after its September rate hike. As there is no guarantee that the HICP trend will be stable by then, however, the ECB may at that point see a need to present a hawkish stance with respect to policies other than interest rate policies. It seems likely that the ECB will focus on the treatment of assets purchased through the Pandemic Emergency Purchase Programme (PEPP). Such purchases were discontinued at the end of March 2022, but the current policy is "to reinvest the principal payments from maturing securities purchased under the PEPP until at least the end of 2024", and it is questionable whether this approach is sustainable. The May Governing Council meeting decided to discontinue in July the reinvestment of assets purchased under a regular ECB program – the asset purchase programme (APP) – and this means that the ECB's balance sheet will begin shrinking from this summer. However, as of the end of May, the value of assets purchased through PEPP (currently slated to be reinvested even after July) amounted to EUR1.67 trillion, and this figure corresponds to more than 20% of the ECB's balance sheet (approximately EUR7.7 trillion). If the ECB is really planning to undertake quantitative tightening, the value of PEPP assets is too large to ignore. When asked at the post-Governing Council meeting press conference in May about the impact of the suspension of APP reinvestment, President Lagarde herself said – "It does not have a massive impact" – suggesting that the effect of currently approved quantitative tightening measures will not be very significant. The pace of HICP inflation is expected to remain quite high for some time after the ECB suspends its interest rate hikes, and it seems likely that the ECB at that point may consider diminishing or even halting its PEPP reinvestments as a non-interest-rate-hike means of tightening its policy stance.

There is an additional reason why the ECB may seek to avoid the excessive protraction of its PEPP reinvestments. Exactly one year ago – on June 15, 2022 – the ECB held an extraordinary Governing Council meeting that announced plans to undertake PEPP reinvestments in a flexible manner with the goal of curbing the rapid rise of yields on government bonds of Italy and other southern European countries. This measure has called for using the proceeds from the redemption of government bonds of Germany and other northern countries to purchase southern European countries' government bonds, and there are concerns that the protraction of this process will cause the share of southern European countries' government bonds within the ECB's government bond portfolio to become increasingly excessive. From the adjacent graph, which shows the PEPP reinvestment situation from last year to the present, one can clearly see how proceeds from sales of German and French bonds have been used to purchase Italian and Spanish bonds. As a result, as of the end of May, Italian government bonds had already come to account for 18.7% of the ECB's bond holdings, which is significantly above the 17% ratio for Italian bonds specified by the capital key and is approaching the 20.7% share of the ECB's holdings of French bonds (for which the capital key ratio is 20.4%). While conformance with the capital key is important in principle, however, the ECB's primary mission is to stabilize euro area's economic and financial situation. The terms of the PEEP explicitly allow for some flexibility with respect to the capital key, and it appears that when such flexibility is required to enable the ECB to carry out its primary mission amid serious challenges, capital key deviation will be considered a relatively minor issue and therefore permitted.

On the other hand, it would probably be difficult for the ECB Governing Council to explicitly acknowledge and discuss this ranking of priorities, given the associated inter-country political frictions that are likely to arise. Sharp rises in Italian government bond yields midway through 2022 were the main reason the PEPP reinvestment policy was made more-flexible, as there were concerns that such yield surges might progressively promote financial fragmentation within the euro area, but as the chart on the right shows, those Italian government bond yields have already become normalized. That normalization may in part be resulting from the flexible reinvestment policy, but when the market environment becomes more stable in the absence of the kind of significant prospective interest rate hikes seen last year, the need for flexibility should diminish. If the ECB avoids discussions of an abrupt discontinuation of PEPP reinvestments and simply seeks to progressively diminish PEPP reinvestments by relatively small increments, it would appear that it will be able to orchestrate consensus agreements without much internal strife. In any case, the issue of how the ECB can project a hawkish stance in areas other than policy interest rates is likely to be a key focus of ECB watchers during the latter half of this year.

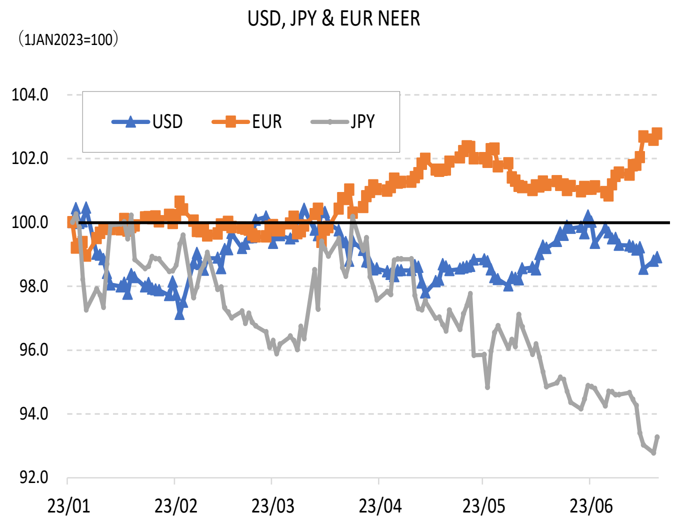


(Source) macrobond

EUR Now and Going Forward – EUR Exchange Rates Reflecting Policy Disparities

Relative Strength of Major Currencies Reflecting Central Bank Stances

As mentioned in a previous section of this article, the ECB's hawkish stance has strengthened EUR's upward momentum. As expected, the first question posed at the press conference following the June Governing Council meeting inquired about whether the ECB might consider following the Fed's lead in suspending interest rate hikes. The reporter asked – "I don't mean that you need to emulate the Fed; clearly, the ECB has its own policy. But [...] [t]here needs to be an evaluation of the effects of policy tightening. So, do you see a reason for the ECB to contemplate a similar pause?" As noted above, President Lagarde responded to the question by predicting another 25bp hike in July and by saying "we're not at [the] destination" of the rate hike journey. Essentially, she emphasized that the ECB's policy decisions are "data dependent", the ECB will make its decisions based on the ECB's data, and the data suggests that more monetary tightening is required. Within the period of global interest rate hikes that began last spring, the size of the FRB-ECB policy gap has probably reached its largest size at this time. As the forex market has a strong proclivity to focus on such easy-to-understand themes as the FRB-ECB policy gap, it is almost inevitable that this theme will continue causing across-the-board EUR appreciation. Of course, the forex market should also be considering the timing of the start of rate hikes – as the Fed began its hikes in March 2022 while the ECB started its hikes several months later, in July 2022. Given that, it would not necessarily be appropriate to conclude that the ECB's hikes have proved to be more sustainable than the Fed's. On the other hand, since the euro area employment and wage situation has not been confirmed to be as problematic as that situation is in the United States, it is possible that the forex market will continue perceiving the ECB's ability to continue hiking interest rates through the summer and perhaps during the autumn as an easy-to-understand market-moving factor promoting EUR appreciation. This article has been presenting this outlook since last year, and there is no need at this time to modify the outlook.



(Source) macrobond

As the graph on the right shows, recent trends indicate that the three major currencies' relative strength relationships are currently "EUR > USD > JPY", and this directly reflects the relevant central banks' stances – with the ECB sustaining its interest rate hikes, the Fed halting its rate hikes, and the BOJ continuing to implement monetary easing policies. In 2022, the argument that the widening gap between Japan's domestic interest rates and overseas interest rates would promote JPY depreciation was prominent and convincing. In previous editions of this article, I have argued that, if the gap between Japan's domestic interest rates and foreign interest rates actually does promote a greater amount of JPY selling, JPY's volatility will diminish, and JPY carry trading will become easier in 2023. I anticipate that the three major currencies' current relative strength relationships, which are promoting across-the-board JPY depreciation, are highly likely to remain unchanged until the fourth quarter of this year, when both the FRB and the ECB are likely to make clear shifts toward dovishness. I expect we will finally see a marked diminishment in Japan-overseas interest rate differentials relative to JPY during the fourth quarter, at which time it seems likely that the JPY depreciation trend will begin to be corrected to a certain extent. So long as the JPY supply-demand environment is fundamentally inclined toward over-selling of JPY, however, I see no need to adjust my long-standing view that it will be extremely difficult for JPY to re-attain appreciation levels seen in the past. Regarding EUR, so long as the euro area sustains its world-leading levels of current account (trade) surpluses, I do not anticipate that the ECB's prospective shift to dovishness alone will be sufficient to bring about a trend of sharp EUR depreciation.

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