Forex Medium-Term Outlook

July 31, 2023

MIZUHO

Overview of Outlook

USD/JPY fluctuated significantly in July but left the impression of weakening overall. At one point, the currency pair dropped by almost 8 yen from its year-to-date high, but has since mostly recovered. The weakening of U.S. job data and speculation of monetary policy tightening by the BOJ were rumored by some to be behind the temporary fall in USD/JPY, but I believe it was more likely to have been due to JPY being bought back after being oversold. In order not to be distracted by such temporary position biases, one has to understand the big picture related to JPY supply and demand. Even though Japan's current account balance is on the mend compared with last year, JPY has continued to weaken. Since November 2022, the Fed's rate hike margin has shrunk from +75 bp to +25 bp, with further rate hikes even being postponed at one point; yet JPY did not strengthen. What could be the reason for this? While some may assume it is because of a persisting sense of higher U.S. interest rates going forward, my theory is that it may be because of Japan's current account balance, which is practically in deficit despite appearing to be in surplus from the accounting perspective – this is the basic understanding from which I gain my bigger perspective regarding JPY rate trends. Japan's trade balance turned positive (surplus) in June, giving rise to expectations or improved demand for JPY. While a marked improvement compared with last year is inevitable, I believe it will be difficult for Japan to sustain a reasonable trade surplus going forward. If one excludes mineral fuel imports, the rest of Japan's trade balance, which is certainly not at the mercy of temporary market conditions, is on a deteriorating trend even in USD terms. One cannot afford to look away from the structural reality that a larger number of people are seeking to sell JPY than to buy it, so even if JPY does appreciate a bit with a decline in U.S. interest rates, I see no reason to worry about the extent of that appreciation.

EUR remained strong again in July. Though a continuation of rate hikes was confirmed at the July ECB Governing Council meeting, the possibility of rate hikes continuing beyond September is rapidly shrinking. Even in June, rate hikes continuing through the end of 2023 did not seem entirely implausible, but now it appears that the ECB's policy operations are beginning to take the regional economic slowdown into consideration a bit more. So far, this report has predicted EUR strength based on the understanding that the ECB's policy stance is more hawkish relative to the Fed's, but the situation appears to be changing somewhat. Of course, there is also the practical problem of tight labor market conditions, so stubbornly high inflation rates led by service prices may be inevitable for the rest of this year. In effect, the situation in Europe is beginning to resemble stagflation, and it must be noted that, even if policy operations shift toward greater consideration for the economy, there is no guarantee of being able to solve the inflation problem. Resource prices led by natural gas prices remain a downside risk to watch out for. If they shoot up again in anticipation of a harsh winter as the year progresses, supply and demand conditions for Germany and the rest of the euro area could deteriorate rapidly all over again. If that happens, there could be significant downward pressure on EUR again, as in 2022.

Summary Table of Forecasts

	2023 Jan -Jul (actual)	Aug-Sep	Oct-Dec	2024 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	127.22 ～ 145.07 (140.87)	138 ～ 146 (141)	140 ～ 148 (142)	138 ～ 146 (140)	137 ～ 145 (138)	136 ～ 144 (137)
EUR/USD	1.0482 ～ 1.1276 (1.1024)	1.08 ～ 1.13 (1.11)	1.07 ～ 1.14 (1.12)	1.07 ～ 1.14 (1.11)	1.08 ～ 1.14 (1.09)	1.07 ～ 1.13 (1.08)
EUR/JPY	137.45 ～ 158.03 (155.30)	152 ～ 160 (157)	152 ～ 161 (159)	149 ～ 158 (155)	147 ～ 156 (150)	146 ～ 155 (148)

(Notes) 1. Actual results released around 10 am TKY time on 31 July 2023. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end level
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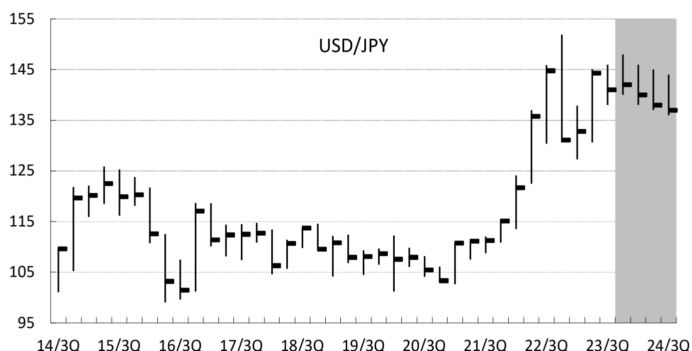
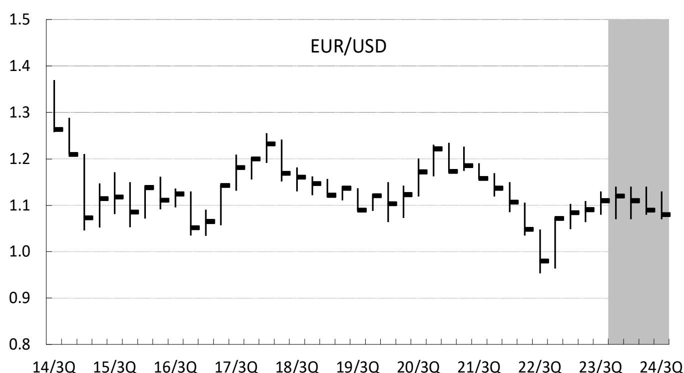
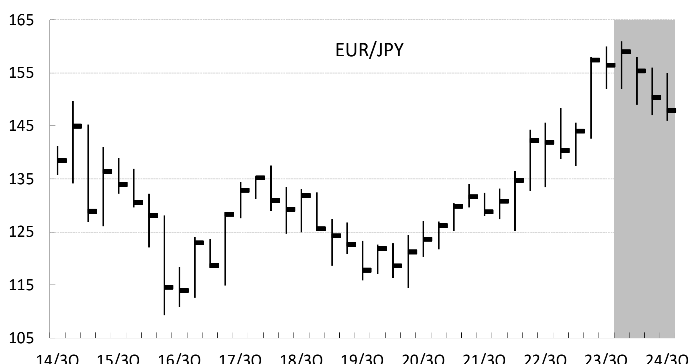
Exchange Rate Trends & Forecasts





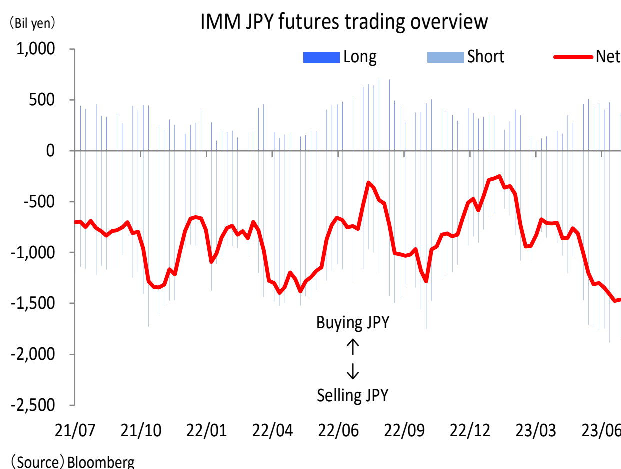


USD/JPY Outlook – "Provocation due to JPY Selling" is a Risk Going Forward

JPY Supply and Demand – CF-Based Current Account Balance is Key

JPY Appreciated Mainly Due to Being Previously Oversold

At one point in July, USD/JPY posted a sudden fall by 7 yen or so from its year-to-date high (JPY145 to USD). This was triggered by the release of the U.S. June job data on July 7, which turned out weaker than expected, as well as by the remarks of BOJ Governor Kazuo Ueda hinting at a revision of Japan's monetary easing policy, which were also reported the same day. However, the explanation that JPY was being bought back after being previously oversold can also not be overlooked. As of July 11, JPY's short position against USD had accumulated to a level last seen during the week of May 10, 2022 – this was when the Fed's rate hike margin was accelerating from +25bp to +50~75 bp and crude oil prices were also soaring. Given that both the Fed's interest rates and crude oil prices are trending in the exact reverse direction at the present time, it is natural for the pace of accumulation of the JPY short position to be seen as excessive (see figure). The appreciation of JPY as these short positions are closed is, in fact, a healthy development necessary from the perspective of USD/JPY finding its ceiling.



(Source) Bloomberg

The real question is – will USD/JPY continue to fall even after this adjustment period (of JPY being bought back after having been oversold)? To answer this question, one must go back and look at the bigger picture from the perspective of JPY supply and demand.

Cash Flows More Important than Current Account Surplus or Deficit

To understand the bigger picture, one must take a careful look at the JPY supply and demand climate. In this context, Japan's Balance of Payments for May, which was released by the Ministry of Finance on July 10, revealed a Current Account surplus of JPY 1.8624 trillion. The media greeted the news quite positively, with cheerful headlines announcing the fourth consecutive month of surplus and 2.4-fold yoy growth in the surplus margin. While it does not make much sense to express current account or trade balances (especially original series figures) in terms of rate of change (or multiples), one must acknowledge that the current account balance is on the mend.

However, every time the Balance of Payments are released, I am struck by the consistence with which news reports interpret the single datapoint of the current account being in surplus as the source of a deep sense of security. Specifically, there are those who seem to think that the current account surpluses negate last year's pessimism over "undesirable JPY weakness" or of Japan having become a "mature creditor nation." It must be pointed out that such a line of reasoning is extremely superficial. It could also be said that those who reason this way have not made an honest attempt to understand either the Balance of Payments or current forex market realities. Of course, a current account surplus offers a greater sense of security than a current account deficit, but with JPY continuing to weaken both in real and nominal terms, and real wages also on a decline in the country, it is difficult for me to comprehend the holistic sense of wellbeing some seem to derive from the fact that the current account is in surplus.

One of the reasons some analysts are wedded to the positive or negative sign next to the current account balance (surplus or deficit) could be because they do not fully understand the actual cash flows (CFs) associated with the current account balance. I have presented similar arguments in past issues of this report, but this time, I would like to dig deeper and from a different perspective.

First, let me provide a summary of the current account balance and the present market climate. It is true that Japan has posted its fourth consecutive month of current account surplus, but at the time of writing this report (July 31), JPY has weakened by -7.5% against USD and -11% against EUR so far this year. Needless to say, JPY is the weakest among G10 currencies. Further, JPY's nominal effective exchange rate (NEER) has fallen by -5.3%, while its real effective exchange rate (REER) has fallen by -7.0%. In other words, it would be no exaggeration to say that JPY has weakened across the board. Further, the current account surplus for the whole year was +JPY 11.5 trillion in 2022, but this was the year in which JPY was down by as much as -30% against USD at one point, and ended up about -15% weaker than USD at the end of the year.

Taking such circumstances into account, it seems natural to suspect that, the positive sign next to Japan's current account balance notwithstanding, there does not seem to be a commensurate demand for JPY. Moreover, though the Fed's rate hike margin has shrunk from +75bp in November 2022 to +25bp in recent months, with rate hikes even temporarily put off, JPY continued to weaken. This is bound to have been quite contrary to the expectations of most experts. I think it may be worth considering the structural change in JPY supply and demand suggested by the current account balance as one possible reason for this. Those who make a big deal of the expansion of the current account surplus as though it heralds the end of last year's critical period are focusing too much on the sign next to the current account balance and the extent of its expansion, without a thought for the reality of CFs generated by the current account balance. In other words, they are not thinking things through.

The sign next to the current account balance, which tends to make the headlines, do not hold the key to understanding the relationship between the current account balance and forex rates. What is important is to understand the actual cash flows that are generated. The reason the sign became a hot topic of discussion last year was because Japan had posted a current account deficit – a rare occurrence in its economic history. The main factor behind the historical depreciation of JPY last year was that Japan's trade and service deficits had ballooned to the extent of nullifying its enormous primary income surplus. The sign next to the current account balance was not that important in of itself. When considering the impact on forex markets, the simple approach is to focus on the trade and service balances, which generate outright JPY trading. Again, as I have explained several times in past issues of this report, within the balance of services, there are numerous paths (digital, consulting, R&D, etc.) through which foreign currency flows out of Japan.

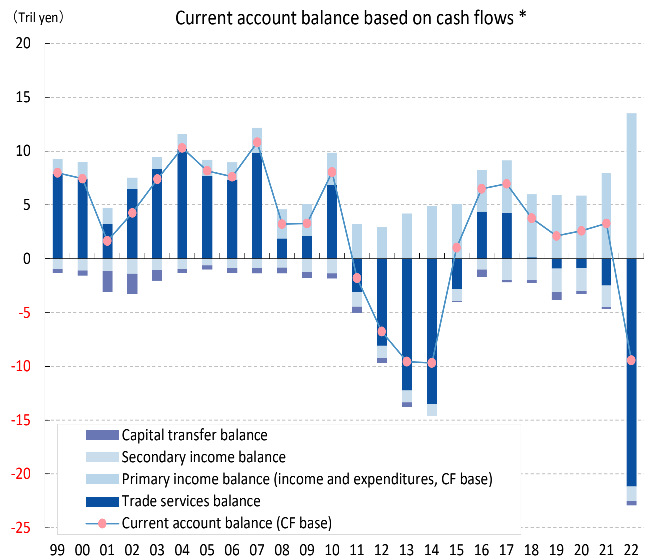
Postulate Regarding CF-Based Current Account Balance

This section presents the reality of Japan's primary income balance and, thereby, also its current account balance based on CFs. For instance, in 2022, the primary income balance based on payments received was about JPY 50 trillion. Of these, the balance pertaining to Portfolio investment income, Direct investment income, and Other investment income were, respectively, JPY 18.5 trillion, JPY 27.6 trillion, and JPY 3.7 trillion. Portfolio investment income comprises mainly dividends and interest earned on bonds, which are usually reinvested without conversion back to JPY. Roughly half of the Direct investment income (about JPY 13 trillion) is also reinvested earnings, which does not get converted back to JPY. In sum, of the JPY 50 trillion primary income balance (payments received), roughly 70%, amounting to JPY 31.5 trillion (JPY 18.5 trillion + JPY 13 trillion), is likely not to be converted back to JPY. In other words, it can be estimated that only about 30%, amounting to JPY 18.4 trillion, leads to JPY buying.

The above calculations are based only on payments received; for more accurate calculations, we must apply the same arguments also to payments made, before assessing the primary income balance as a whole. Payments made amounted to roughly JPY 14.7 trillion – JPY 8.2 trillion pertaining to Portfolio investment income, JPY 4.4 trillion pertaining to Direct investment income, and about JPY 2.0 trillion pertaining to Other investment income. Based on the same arguments as above, it can be said that Portfolio investment income (JPY 8.2 trillion) and the reinvested portion of Direct investment income (roughly JPY 1.7 trillion) are likely to remain as JPY without conversion into foreign currency, but the remaining roughly JPY 4.8 trillion worth of payments made could result in JPY selling.

In sum, the actual portion of Japan's primary income surplus for 2022 that resulted in JPY buying may have been about JPY 13.6 trillion (JPY 18.4 trillion – JPY 4.8 trillion). This should be taken as the CF-based primary income surplus, which is far removed from the publicly released figure of roughly JPY 35 trillion. I view this as a useful theory for explaining the reason why JPY depreciated dramatically in 2022 despite Japan posting a +JPY 11 trillion current account surplus. Since last year, I have believed that there is sufficient reason to give some space to this theory also, instead of explaining everything solely based on the U.S.-Japan interest-rate gap.

Additionally, taking 2022 as an example, Japan posted roughly -JPY 21 trillion in trade and services deficits, most of which contributed to JPY selling in the forex markets. Given our above calculation of the CF-based primary income surplus as being around JPY 13.6 trillion, this puts the CF-based current account balance at a deficit worth -JPY 9 trillion. It seems clear that the headline current account surplus is merely an accounting-based figure that did not all contribute to JPY buying pressure. Incidentally, in the past, the CF-based current account balance has posted a deficit similar to 2022 (over JPY 9 trillion) in 2013 and 2014, and in both these years, JPY weakened by over -10% against USD. 2013-14 was when Abenomics, symbolized by monetary easing of a “different dimension,” was drawing a lot of attention, so JPY weakening at this time was quite persuasively explained as being due to the BOJ’s monetary policies – but was that really the case? Of course, the two things may not have been entirely unrelated, and another contributing factor may have been the improvement in the external environment (the Fed’s pivot to policy normalization and the end of the European sovereign bond crisis). However, one cannot entirely overlook the fact that 2013-14 was also the time during which JPY supply and demand began to be impacted by a larger number of people wanting to sell JPY than to buy it in Japan’s external economic sector.



(Source) Bank of Japan
(Note) *With regard to the receipt and payment of primary income and expenditure, "reinvestment income" of direct investment income, "dividends" of securities investment income and expenditure, and "bond interest, etc." are deducted

Of course, the above are merely my theories, and I do not intend to present them as undisputed facts. However, I cannot support attempts to explain USD/JPY trends solely based on the U.S.-Japan interest rate gap or the failure to acknowledge the damage from JPY weakness by those who are too busy celebrating high share prices. We have been in what must be called a historical phase of JPY weakness for a year and four months now. An honest stance to adopt in analyzing this historical rate trend should involve acknowledging the possibility of a historical (probably structural) change – regardless of whether or not such a change turns out to be true.

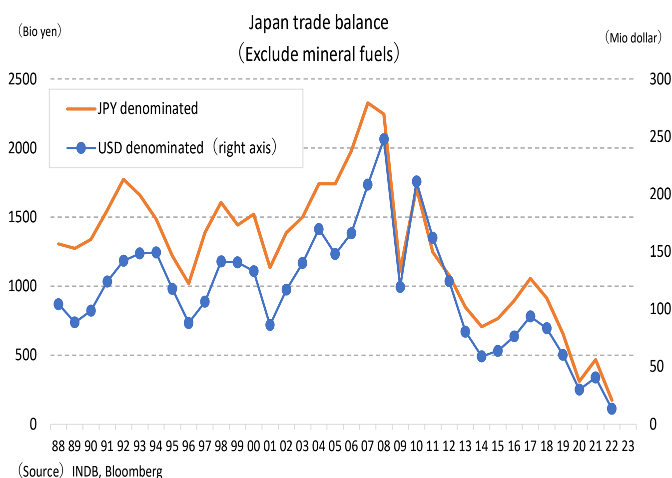
JPY 7 Trillion Trade Deficit for 1H

Also in the news in July was the fact that Japan posted its first trade surplus in 23 months for June. The increase in auto exports is pointed out as a contributing factor, but the decline in imports (-12.9% yoy) due to the fall in crude oil and other resource prices is also bound to have played a role. It was during 2H of 2022 that imports began to balloon as a result of high resource prices and JPY weakening, so the trade balance seems likely to post yoy improvements in the coming months, and there also exists a possibility of surpluses in seasonally adjusted figures going forward (seasonally adjusted figures still posted a deficit of around -JPY 550 billion for June). However, it must also be noted that Japan’s trade balance for 1H of 2023 was a deficit worth roughly -JPY 7 trillion, which is only JPY 1 trillion less than the -JPY 8 trillion deficit for 1H of 2022. Whether exports will continue to grow strongly in July and beyond depends also on the U.S. and European economies, so there is no guarantee of surpluses becoming the norm.

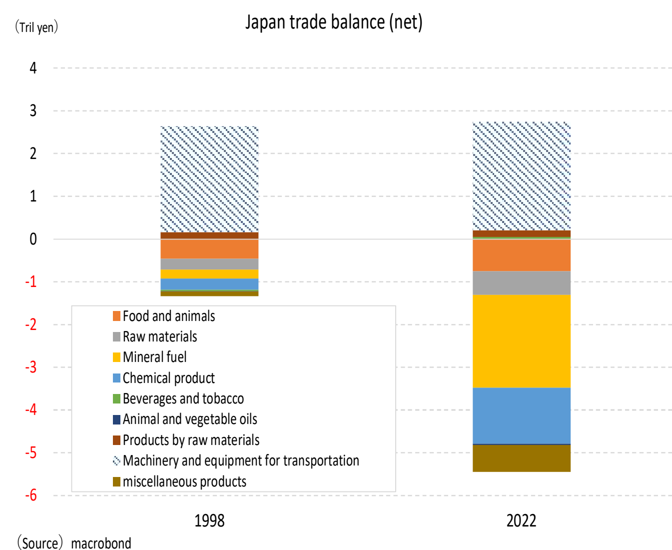
If Japan posts a trade deficit of -JPY 3 trillion for the remaining six months of this year, that will result in two consecutive years of yearly deficits exceeding -JPY 10 trillion. As of the present time, 2022 holds the record for the largest ever trade deficit posted by Japan (roughly -JPY 20 trillion), but it is followed by 2014 (roughly -JPY 12.8 trillion) and 2013 (roughly -JPY 11.5 trillion), in that order. As of the present time, the possibility of 2023 entering this league cannot be ruled out. Incidentally, plotting these figures against the rate of change in USD/JPY, we find that USD/JPY rose by +12% in 2022 and 2014, and by +18% in 2013, i.e., JPY weakened significantly in all three years. As for 2023, despite the upward pressure on JPY due to the suspension of rate hikes (and wider speculation of rate cuts) by the Fed, JPY has failed to appreciate as expected due to the collapse in its supply-demand balance, as I have repeatedly emphasized.

Structural Change in Japan's Trade Balance Obvious

Japan posted its largest ever trade deficit in 2022, but most analysts explain this away as a temporary phenomenon spurred by the historical weakening of JPY and high resource prices. This view could gain strength following the June trade surplus. As a matter of fact, it is not wrong to say that last year's massive trade deficit was a temporary phenomenon resulting from the historical JPY weakness and high resource prices, but there also remains the undeniable fact that, when one excludes mineral fuel imports, Japan's trade balance is continuing to deteriorate even when calculated in USD terms. Of course, it is also a fact that when mineral fuel imports are excluded, Japan's trade balance is no longer in the red. Not that this indicates a return to large surpluses – rather, imports and exports seem to be balancing each other out. (It does not make any real sense, however, to exclude mineral fuel imports; i.e., it would be best to acknowledge Japan's trade deficit status with honesty). Taking the above facts into account, it can be conjectured that the trade balance is deteriorating even after the exclusion of mineral fuel imports. There is no one reason for this, but if we compare the year 2022 (when Japan posted a trade deficit of around -JPY 20 trillion) with the year 1998 (when Japan posted its largest ever trade surplus at around +JPY 14 trillion), we find that, in addition to mineral fuel imports, there has been a marked growth in chemical imports. As is generally known, this category is led by pharmaceuticals. What is happening here is that, in addition to overseas pharmaceutical companies exporting to Japan, Japanese pharmaceutical companies have been expanding their overseas manufacturing, so that the pharmaceuticals they sell in overseas markets are no longer counted as exports for Japan.

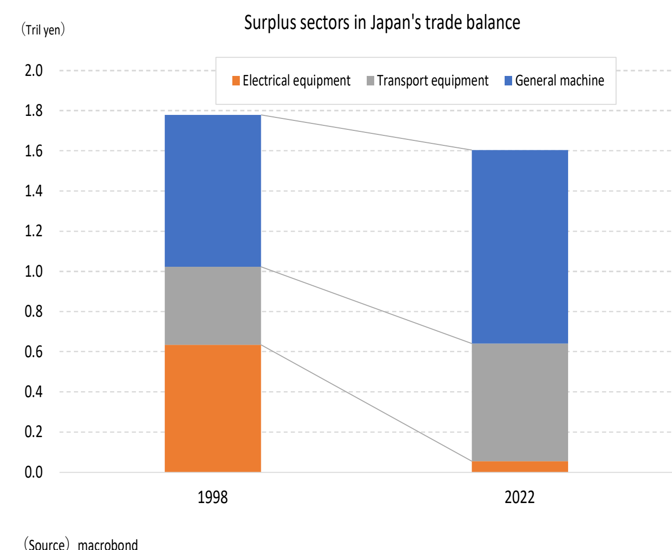


(Source) INDB, Bloomberg



(Source) macrobond

On the export side, while machinery and transportation equipment continue to be leading exports (surplus categories) for Japan, their breakdown is also worth looking at. Specifically, while semiconductor and other manufacturing equipment, motors and other general machinery, and cars and other transportation equipment continue to expand the surplus, contribution to the trade surplus from refrigerators, televisions, and other electrical appliances, where Japan once boasted a leading position, has all but vanished. Focusing on 2H (July-December) of 2022, in a development that was widely reported, electrical appliances posted a deficit for the first time since records began. This phenomenon is obvious even to the person on the street. Around the year 2000, Japanese flat-screen televisions took the world by storm, and Japanese mobile handsets also had a significant presence. Neither of these is anywhere to be seen these days. This dramatic change in circumstances surrounding consumer appliances is reflected quite accurately in trade statistics. The above developments are taking place separately from the phenomenon of higher imports due to high resource prices and JPY weakness, and are indicative of structural change.

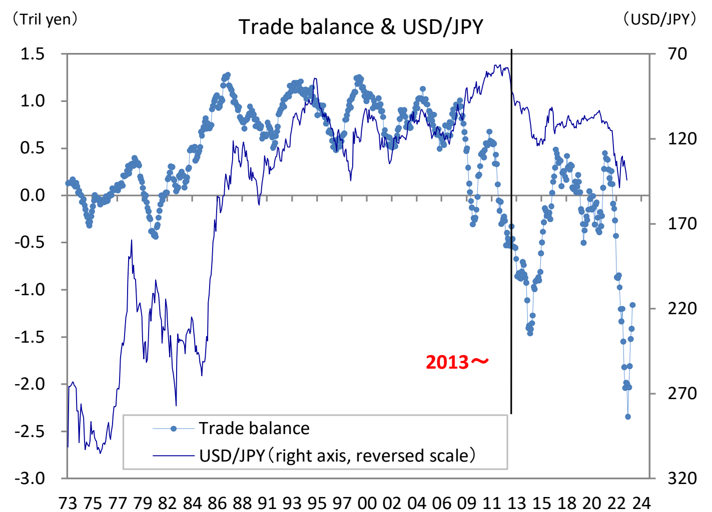


(Source) macrobond

End of the Era of Earning Foreign Currency by Selling Goods

To summarize, the bigger picture in Japan's trade statistics over the past quarter century is that, while on the one hand mineral fuel and chemical imports have expanded, on the other hand, no export categories have emerged to make up for the decline in electrical appliance exports. The result has been a loss of trade surpluses for Japan and depreciation of JPY; and Japan is now beginning to work on encouraging inward direct investment and positioning itself as an attractive R&D destination in an effort to utilize JPY weakness to its advantage.

To put a positive spin on all this, one could observe that JPY has stopped experiencing extreme appreciations ever since it lost its trade surplus trend sometime around 2012-13 (see figure). The main reason behind this is not Abenomics, which emerged around the same time, but rather Japan's evolution from a "young creditor nation" earning foreign currency by selling goods to a "mature creditor nation" earning foreign currency from an increase in the value of its past investments. However, as explained above, most of this "increase in the value of its past investments" (i.e., primary income surplus) is not repatriated to Japan. Under these circumstances, my theory is that, though Japan may be a current account surplus country in accounting terms, in actual terms, its current account balance is in the red. This is the bigger picture I base my JPY forecasts on, and I will continue to formulate my outlooks based on this understanding of a change in the trend, rather than being swayed by monthly current account or trade statistics.



(Source) Bloomberg
(Notes) Trade balance is presented two years in advance and is based on a 6 month moving average.

Japan's Monetary Policy Now and Going Forward – BOJ's Vulnerability to Provocation by JPY Selling" a Big Problem Going Forward

Deliberately Ambiguous Decision Amounting to an Abolition of YCC

At the much-anticipated July 27-28 Monetary Policy Meeting (MPM), the BOJ decided to conduct yield curve control (YCC) with greater flexibility. However, in reality, the revisions amounted to maintaining the *status quo* while expanding the allowance band to such an extent as to suggest an actual abolition of the YCC, making it all extremely difficult to comprehend. While both the yield targets for 10-year Japanese government bonds (hereafter: long-term yields) and their allowance band were kept unchanged at zero percent and ±50 bp, respectively, the Bank raised the implementation level for its unlimited, consecutive-day fixed-rate purchase operations from 0.50% to 1.00%. In practical terms, this allows for long-term yields to move in the 0.50%-1.00% corridor. If the Bank had wanted to make its policy easier to understand, it would have increased the yield target from the original zero percent to 0.50%, and maintained the allowance band at ±50bp – such a policy would have been more straightforward and had the same effect as the recent revision.

However, the BOJ is not in a position to raise the yield target, because it has long held the position that this would amount to a rate hike. Further, abolishing the unlimited, consecutive-day fixed-rate operations themselves would have clearly amounted to abolishing YCC, but here again, the Bank retained a line of defense making it difficult for anyone to accuse it of having abolished YCC. In his press conference, BOJ Governor Kazuo Ueda stated, "On whether there is a bias in the overall policy stance toward monetary policy tightening or normalization, I would say no," emphasizing that the recent policy decision was not intended as a step toward policy normalization. The decision was justified as a technical measure aimed at reducing bond price distortions and preventing financial market volatilities.

In fact, the long-term yield rose to around 0.575% for the first time in nine years, making it quite difficult to insist that this was not a monetary tightening. As for the unlimited, consecutive-day fixed-rate purchase operations, Ueda stated that, while the Bank had set a 1% ceiling for yields, it did not expect them to increase to that level, tacitly acknowledging that the Bank had set an unrealistic yield ceiling. In other words, one could say that there are no longer any practical controls on the yield (amounting to an abolition of yield curve control). What happened in the JPY interest rate markets following the meeting can only be described as "an increase in long-term yields following the abolition of YCC." In short, the Bank's true desire to tighten monetary policy seems to have combined with its stated outward stance against monetary policy tightening to result in a deliberately ambiguous policy decision.

Out of Monetary Tightening Options

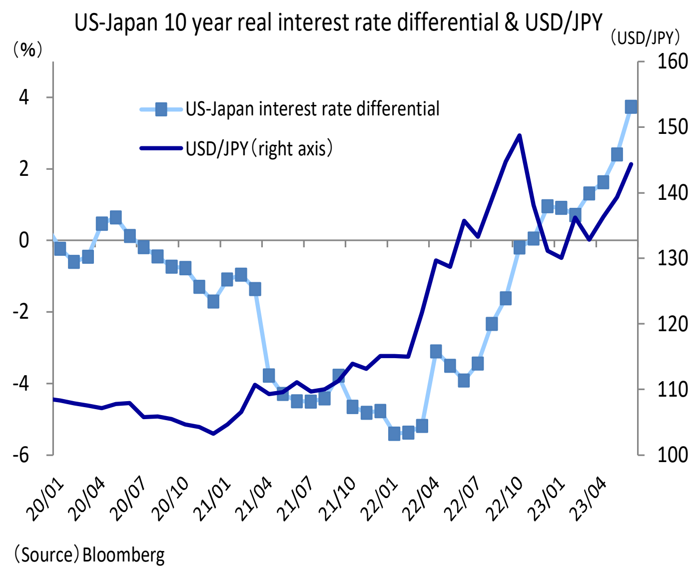
As for the current timing for this decision, Ueda explained that it was due to the upward revision of the price outlook in the Outlook for Economic Activity and Prices (Outlook Report). This is the trigger that had been expected all along to motivate a policy change. In this report, I had predicted that such a change could take place coinciding with the October Outlook Report, so my impression is that the change happened earlier than expected. The Outlook Report upwardly revised its Core CPI forecast for 2023 significantly, from +1.8% to +2.5%, but it also downwardly revised its 2024 forecast from +2.0% to +1.9%. Sooner or later, the Outlook Report (which has been ridiculed as the "Wishful Report") would have had to revise its lax Core CPI forecasts in accordance with ground realities, and it appears that the Bank decided that it was finally time to buckle up and bring its forecasts closer to reality.

This offered a natural opening for monetary policy revision. At the same time, having tightened its monetary policy to this extent, the Bank may find it difficult for the foreseeable future to implement any further tightening citing the economic or price situations as the reason. At the press conference, in response to a question on what could trigger a revision of its accommodative monetary policy going forward, Ueda responded, "Another upward revision (of the

outlook for prices), or greater confidence in the achievement of our targets or certainty in our forecasts even in the absence of any major change in stance." One assumes that such an opportunity might present itself going forward if JPY depreciates further and triggers a marked rise in general prices via an increase in import prices.

BOJ Vulnerable to Provocation from JPY Rates Going Forward

The impact of the recent policy decision on JPY rates is of obvious interest. The forex markets' response following the meeting was as expected, and as per the preview provided in a past issue of Mizuho Market Topics. YCC revision was the only practical monetary tightening card the BOJ had, and now that it has played it, there are unlikely to be any more BOJ-side JPY-appreciation factors for the time being. Rather, my prediction has been that such a move would lead to a greater stability in JPY selling trends. Despite a brief period of volatility immediately after the MPM, USD/JPY returned to the 140 level and has remained there stably since. At the press conference, a note of caution was voiced regarding the unintended decline in real interest rates – it is not impossible that this was out of consideration for the impact on forex markets. Even in real terms, there is a marked expansion in the U.S.-Japan interest rate gap, and this has established a pattern of JPY losing value against USD (see figure). One can see that the BOJ may have intended to put the brakes on this trend by increasing the nominal long-term yield.



(Source) Bloomberg

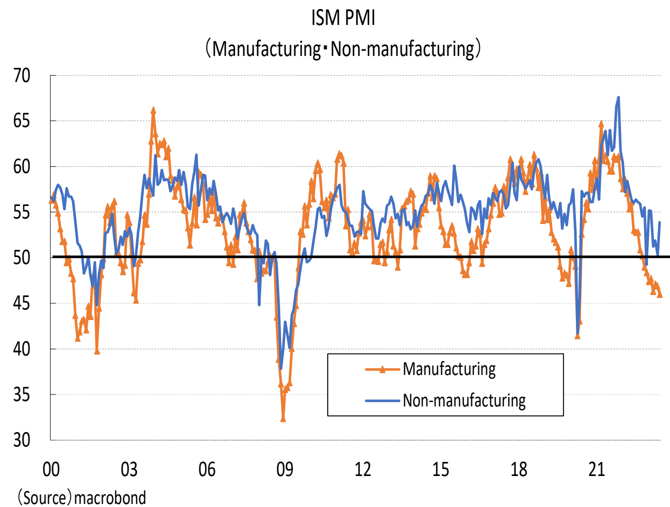
Going forward, the BOJ might be more vulnerable to JPY rate trends. While this was not necessarily the case before the recent meeting, in future, the markets might attempt to provoke the BOJ into monetary easing by selling off JPY ahead of meetings. For instance, if USD/JPY surpasses 145 and approaches the 150 level, the BOJ will be forced to make another decision. While the (previous) Kuroda-led administration stood firm even under such circumstances, rationalizing that JPY weakness was a positive for the Japanese economy as a whole, the same may be difficult for the Ueda administration, given its emphasis on the importance increasing real wages. If the Ueda administration does, in fact, respond to market provocations with monetary policy, it will find itself confronting its last remaining card, namely abolition of negative interest rates, which amounts to a genuine rate hike. This, however, would not be an easy decision for Ueda to take, given his previous statement that such a decision was a long way away. Though the BOJ seems to have skillfully implemented the practical abolition of YCC, the fact that this did not result in any significant correction of JPY weakness leaves the door open for deep insecurities over future monetary policy operation.

The recent policy revision also included an intent of containing "financial market volatilities" that were feared as potential side-effects. Going by Ueda's remarks, these included forex market volatilities, but my question is – could investors dedicated to speculative JPY selling have been expected to be persuaded merely by the practical abolition of the YCC policy, which had already become a mere façade in any case? Given the fundamentals of the Japanese economy and the associated need to sell JPY based on actual demand, JPY is probably being viewed as a currency with further scope for being sold. Having used up its YCC abolition card, the BOJ may have made itself vulnerable in the long term to attempts to provoke it into action by selling JPY.

U.S. Monetary Policies Now and Going Forward – From "Continuous Rate Hikes" to "Intermittent Rate Hikes"

Highest Interest Rate Level since the IT Bubble Collapsed

On July 26, as expected by the financial markets, the FOMC decided to raise the FF interest rate target by 25bp, to the 5.25%-5.50% range. This is the Fed's highest policy interest rate level since March 2001 – in other words, the highest level since the IT bubble's collapse (and the 9/11 terrorist attacks) required extremely resolute countermeasures. There is increasing speculation about why the high policy interest rates have not yet induced a recession, but Chairman Powell recently stated – "The staff now has a noticeable slowdown in growth starting later this year in the forecast, but given the resilience of the economy recently, they are no longer forecasting a recession." One example of the bases for that forecast is that, while ISM manufacturing index's recent weakness may seem to indicate the likelihood of a recession, the ISM non-manufacturing index's firmness is continuing to reflect the stickiness of inflation (see graph). In light of the strong wage situation confirmed by recent employment statistics, the Fed felt a need to retain the phrase – "The Committee remains highly attentive to inflation risks" – in its latest statement.



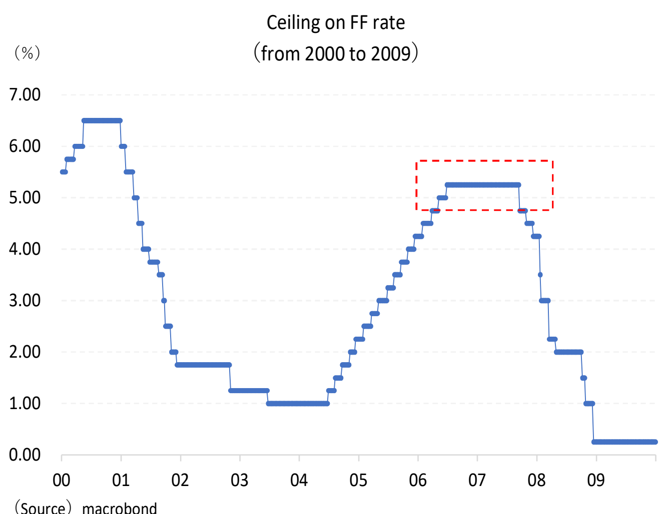
Continuous Interest Rate Hikes → Intermittent Rate Hikes → Discontinuation of Rate Hikes

It is anticipated that, as seen in June and July, the FOMC will gradually further raise the terminal rate while intermittently pausing rate hikes. <u>This is what has been for some time been characterized as a "higher for longer" policy that is likely to promote lower volatility and improved risk tolerance in financial markets and facilitate the popularity of carry trades simply reflecting interest rate differentials in the forex market</u>. Chairman Powell has now clearly indicated the nature of that policy, saying at the July 26 press conference – "So, a more gradual [rate hike] pace doesn't go immediately to every other meeting. It could be two out of three meetings, right? It could be, it just means if you're slowing down, the point really was to slow down the decision cycle as we get closer and closer to we think our destination." In accordance with this statement, the FOMC may choose to raise interest rates at every other meeting, or at two consecutive meetings, or it might even pause rate hikes at two consecutive meetings – the financial markets will not have clear clues about what might happen at any given meeting. In light of the official denial of the likelihood of a recession, however, for the time being it seems less likely that the Fed will decide to suspend rate hikes immediately and more likely that the Fed will decide to raise interest rates intermittently.

The financial markets have since last year formed asset price expectations based on expectations of a rapid "discontinuation of rate hikes → rate cuts" scenario, but <u>it seems more realistic to anticipate a more-gradual "(1) continuous rate hikes → (2) intermittent rate hikes → (3) discontinuation of rate hikes" transition. It currently appears that the Fed has moved from (1) to (2) and will wait somewhat longer before the declaration of (3)</u>. With the presidential election coming up next year, there is no evident reason for the Fed to hurry its transition to (3) any time soon. Such an expedited transition would probably not be undertaken barring a sudden trend of serious financial instability or a similarly momentous unanticipated development.

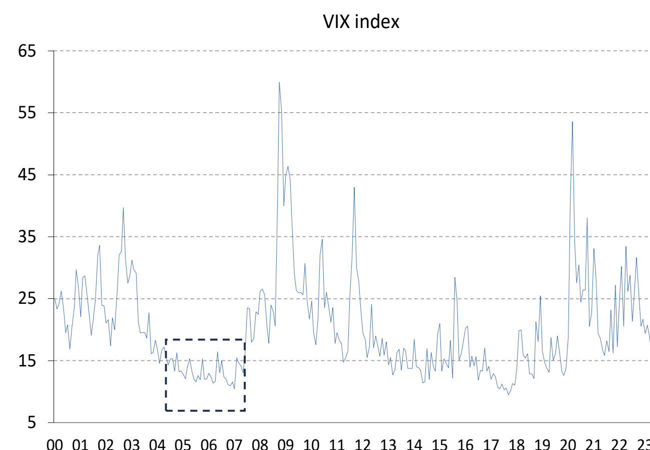
Status Quo Maintenance May Continue for More Than a Year

In any case, the possibility of a rate cut during 2023, which many market participants hoped for late last year and/or early this year, has all but disappeared. Similarly, I believe the likelihood of a shift to a JPY appreciation trend during 2023 has also become extremely low. The Fed's "next move" will be to "intermittently raise interest rates" or "maintain the status quo", and for political reasons the Fed will probably refrain from disseminating information suggesting it might adopt a lenient stance toward inflation. <u>In general, I anticipate that the fundamental Fed policy scenario from mid-2023 through mid-2024 will be a "hawkish hold", and that additional interest rate hikes may be considered depending on the Fed's perception of changing economic conditions</u>. It should be noted that in the past there have been cases in which the Fed implemented a series of interest rate hikes and then took a wait-and-see approach while maintaining the status quo for more than a year. For example, the Fed raised the federal funds rate's upper limit by 425bp (from 1.00% to 5.25%) during the two-year period from June 2004 to June 2006 and then maintained the status quo for 15



months, until September 2007 (see graph). Had it not been for the financial instability caused by the subprime shock, the status quo maintenance period could well have been further extended, and the viability of the JPY carry trade that was popular at the same time would have been protracted.

When forecasting USD/JPY, forex market players have tended to focus on the themes of Japan-overseas interest rate differentials and JPY exchange rates, which were quite volatile last year. This year, however, the fundamental scenario of Fed status quo maintenance is expected to reduce such volatility, and that is likely to create an environment suitable for JPY carry trading. As mentioned above, the ending of this fundamental scenario would require an environment in which an interest rate hike discontinuation or a shift to interest rate cuts would be clearly called for and announced, but such a situation seems unlikely barring the emergence of seriously problematic systemic financial instability. At this point, given that there is no material basis for including such instability within the main forecast scenario, this article continues to believe there is no need to formulate a JPY appreciation scenario based on changes in the Fed's monetary policies.

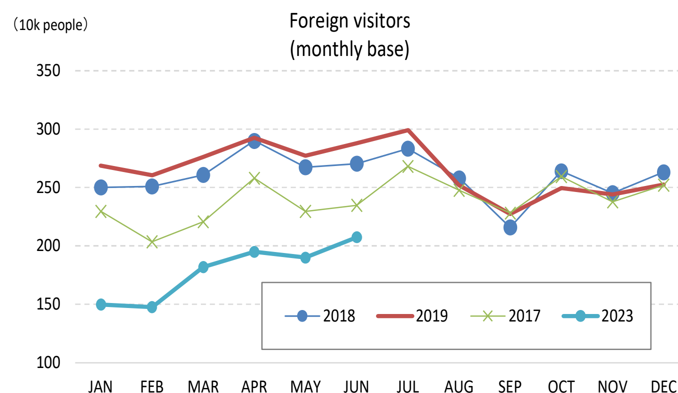


(Source) Bloomberg

Risks to My Main Scenario – Destinations of "Foreign Currency Earned through Labor"?

Inbound Tourist Numbers Nearing Normalization

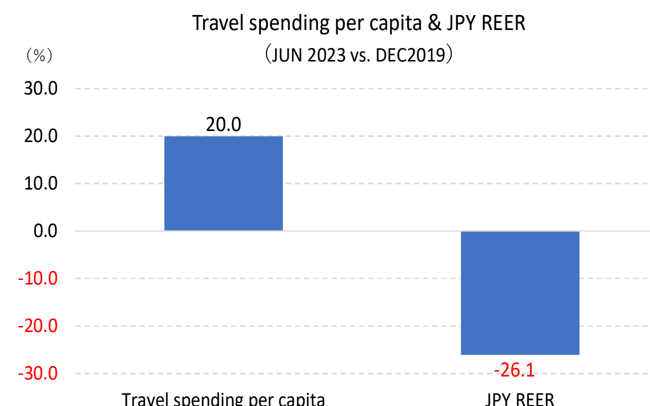
The Japan National Tourism Organization (JNTO) announced on July 19 that the number of foreign visitors to Japan (inbound tourists) in June was 2,073,300, surpassing the 2 million mark for the first time since February 2020. That is 28% below the pre-pandemic level (in July 2019), but it can be positively viewed as representing a more-than-70% recovery from the extremely low levels seen during the pandemic. During the first half of 2023 (January through June), the number of inbound tourists was 10,712,000, and that is roughly 60% of the pre-pandemic level (16,630,000 during the first half of 2019). Given that inbound tourists from China previously accounted for roughly 30% of Japan's inbound tourists but have only recovered at this point to account for just over 20% of Japan's inbound tourists, however, the overall 60% recovery represents an inbound tourism situation that has almost returned to normal. If previous levels of group tours to Japan from China (still restricted) and air flights to Japan (re-initiation of flights from some locations still delayed) are restored, the re-attainment of the pre-pandemic inbound tourism levels appears well within reach. JNTO reports that the number of scheduled international flights to Japan this summer will be only about 60% of the pre-pandemic level, and going forward it will be important for the airline industry to ensure that it has the capacity to meet the needs of the increasing numbers of people seeking to travel to Japan.



(Source) JNTO

Normalization of Inbound Tourists' Spending

Regarding the impact of inbound tourism on the Japanese economy, however, rather than the simple number of people visiting to Japan, it is more important to discuss the amount of money spent by those visitors. The results of a survey of consumption trends among foreigners visiting Japan announced on July 19 by the Japan Tourism Agency indicate that such consumption during the April-June 2023 period was JPY1,205.2 billion. As this is 95.1% of the amount for the April-June 2019 period, the normalization of Japan's inbound tourism can be considered close to completion. As discussed in previous editions of this article, <u>even if the number of foreign visitors to Japan does not return to previous levels, the overall amount of spending in Japan by inbound tourists may increase significantly if the consumption per person surpasses the pre-pandemic level</u>. The April-June 2023 period consumption per person level was approximately JPY204,000, considerably above the roughly JPY155,000 level in the April-June 2019 period

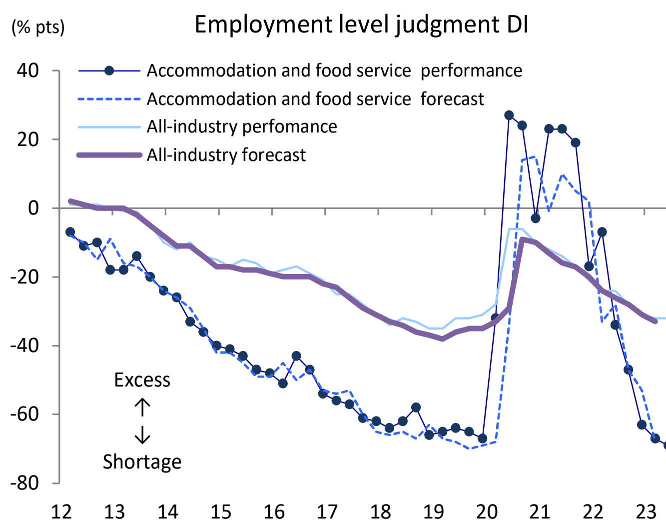


(Source) INDB & macrobond

and the roughly JPY174,000 level in the October-December 2019 period, and the entirety of this trend of increase is attributable to JPY depreciation. As the graph shows, travel expenditure per person has increased to 20% above the pre-pandemic level, and JPY's real effective exchange rate has fallen by 26% compared to the pre-pandemic level. Because nominal JPY exchange rates against other major currencies have plummeted, even when foreigner visitors spend the same foreign currency-denominated amounts as previously, their JPY-denominated consumption is tending to surge. Moreover, as prices in Japan are becoming cheaper than in other major countries, even if they spend the foreign currency-denominated amounts as previously, foreigner visitors are likely to feel greater senses of satisfaction, and many such people are therefore likely to make repeated visits to Japan.

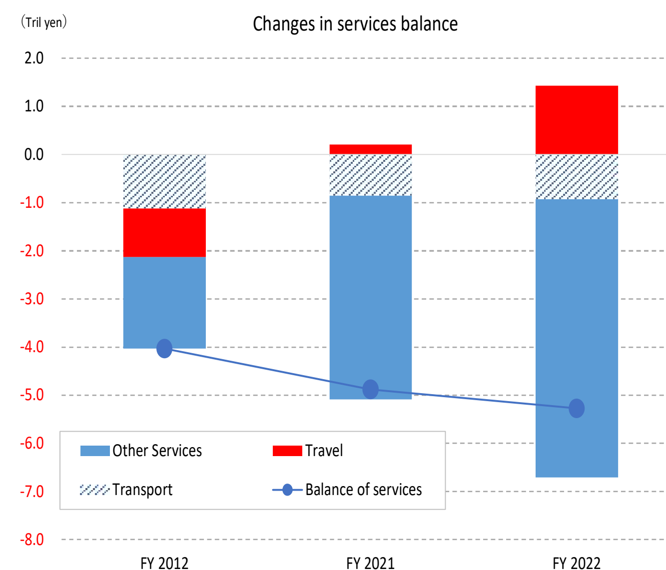
Foreign Currency from Domestic Labor-Intensive Industries Offset by Consumption of Foreign Capital-Intensive Services

One can roughly monitor the recovery of Japan's inbound tourist-related demand based on various JNTO statistics, but the actual extent of recovery will ultimately be confirmed based on the travel balance portion of Japan's balance of payments statistics. When Japan's inbound tourist-related demand peaked in 2019, the annual number of foreign visitors to Japan was 32 million, and the country's travel balance surplus was about JPY2.7 trillion. In light of this, the restoration of this JPY2.7 trillion travel surplus could be considered Japan's goal for the time being. Even at this intermediate stage of tourism restoration, however, Japanese people are expressing a significant amount of complaints about tourism-related congestion at tourist destinations, and Japanese phrases connoting "overtourism" (or "tourism pollution") have come into frequent use. In addition, the general degree of labor shortages in Japan has become increasingly severe, and the domestic accommodation and food service industry's employment situation diffusion indexes within the BOJ's Tankan survey have come to indicate unprecedented labor shortages (see graph).



(Source) Bank of Japan

What is particularly worrisome about Japan's current situation is that foreign currency earned by Japan's labor-intensive accommodation and food service industry is being used to pay for services from overseas capital-intensive industries that do not always require much labor, including digital services (such as cloud computing services, internet advertising, and video and music distribution services) and R&D services. In 2022, Japan's deficit in its "other services" balance, which encompasses payments to such sectors, reached about JPY5.8 trillion, a figure more than double Japan's 2019 travel surplus. How sustainable is a trade structure in which Japan's hard-earned foreign currency from a physical labor intensive industry that creates local frictions is used to pay for scalable, capital-intensive services from overseas (created from mental labor) that are core elements of Japanese people's day-to-day lives? Based on this services balance of payments structure (including the "travel" and "other services" sectors), Japan's balance of payments deficit in services may well increase in the future but is not likely to decrease. If the travel surplus is the only services sector in which Japan can proactively earn increasing amounts of foreign currency, there is no doubt about its importance. However, the reality Japan is facing is that even with growing travel surpluses, Japan has not been able to alleviate a services deficit structure that is causing large net outflows of foreign currency, and my view is that such changes in the JPY supply-demand structure are at the root of the persistence of the JPY depreciation trend. If Japan's other services deficit eventually grows to surpass JPY10 trillion, then the "JPY selling based on the JPY demand-supply situation" forex market theme will attract incomparably more attention than it does today, and it is liable to have a considerable impact on Japanese society and the quality of Japanese people's daily lives. Compounding the other services deficit with respect to the JPY supply-demand situation is the persistent risk of substantial growth in JPY selling by Japan's household sector, which has been discussed in several recent editions of this article. In light of all these factors, it should be recognized that the era in which USD/JPY levels were determined largely by Japan-U.S. interest rate differentials may finally be coming to an end. One must keep in mind that JPY exchange rates are now constantly exposed to large downside risks associated with the JPY supply-demand situation.



(Source) macrobond

EUR Outlook – Suddenly Strengthening Dovishness

EUR Area Monetary Policies Now and Going Forward – Rapidly Fading Hawkishness

Statement Clearly More Dovish

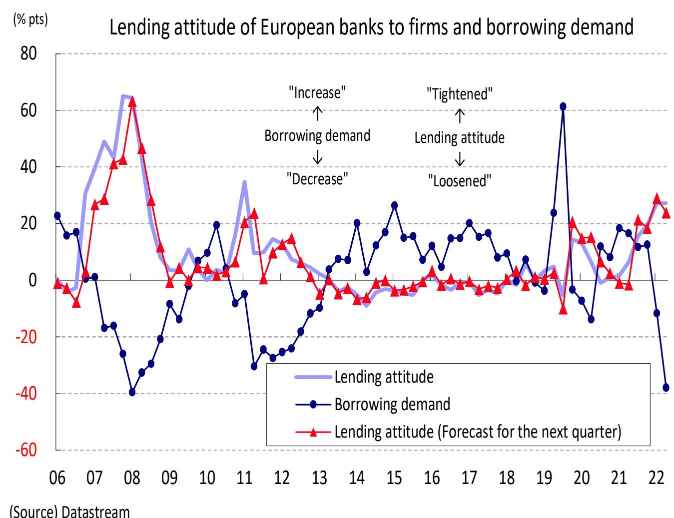
The July 27 ECB Governing Council meeting was the ninth consecutive Governing Council meeting to hike interest rates, raising the deposit facility interest rate from 3.50% to 3.75%. It is worth noting that the ECB's policy interest rate has attained its highest level in about 22 years and is now on a par with all-time high levels. In other words, the Governing Council will soon be deciding whether, after the upcoming September hike, it will approve an interest rate hike that will bring the policy interest rate to its highest level in the ECB's history. Particularly worthy of attention was a change to the text of the July Governing Council meeting's statement, which clearly increased the statement's dovishness:

- (July Meeting) Our future decisions will ensure that the key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary.
- (Previously) Our future decisions will ensure that the key ECB interest rates will be brought to levels sufficiently restrictive […] for as long as necessary.

The policy rate was previously to be brought to sufficiently restrictive levels but from July is said to be set at sufficiently restrictive levels. It seems possible this change may indicate that the ECB will soon end its phase of continuous interest rate hikes and begin a wait-and-see phase while monitoring trends in the economic and financial situations. In fact, several reporters at the post-Governing Council-meeting press conference asked about this change, and ECB President Lagarde responded to the first such query saying – "We say "our future decisions will ensure that the key ECB interest rates will be set at sufficiently restrictive levels […]". So, some of you may have noticed a slight change of a verb. And that is not just random or irrelevant." Of course, no clear commitment was given about whether there will be an interest rate hike in September, but the remark that attracted attention at previous meetings – that the ECB had "more ground to cover" (regarding interest rate hikes) – was subtly attenuated at the July meeting, with President Lagarde specifying that – "data and our assessment of data will actually tell us whether and how much ground we have to cover. […] [W]e have an open mind as to what the decisions will be in September and in subsequent meetings." As discussed below, the euro area's employment and wage situation is still tight, and it should be safe to continue raising interest rates based on that situation alone. A decisive difference between the euro area and the United States is that the euro area temporarily recorded negative growth from the start of 2023 and the deterioration of the euro area's real economy is becoming more evident. As euro area economic conditions have begun showing signs of stagflation, it has become difficult for the ECB to decide whether to focus on the economy or inflation, and it is possible that the ECB has begun placing additional emphasis on the regional economy.

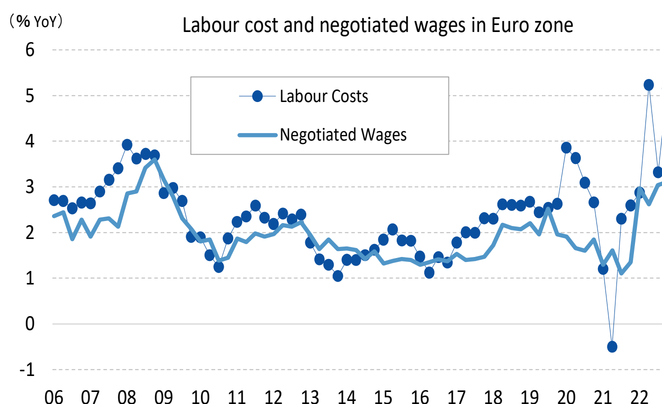
Bank Lending Survey Suggests Effective Monetary Policy Transmission

The July edition of the Bank Lending Survey (BLS) was recently released, and this survey was mentioned numerous times at the press conference. One reporter asked – "the second question for me is on your assessment of the ECB euro area bank lending survey because it had some data on demand that was, I think, never seen in the past 20 years and so whether it was discussed at the Governing Council and it had an impact also on today's decision?" The July Governing Council meeting's statement contains a section on the BLS findings just before its conclusion, suggesting that the findings have had a significant impact on the ECB's policy posture. In fact, the recent sharp decline in euro area borrowing demand has been sharper than that associated with the 2007-2008 financial crisis. The statement reports that – "Higher borrowing rates and the associated cuts in [households' and businesses'] spending plans led to a further sharp drop in credit demand[.]" – and President Lagarde explained at the press conference that this drop was the intended result of the transmission of ECB monetary policy. In other words, it is possible that the ECB's interest rate hikes have already produced the intended results to a certain extent and that the ECB is now seeking to determine whether those results are sufficient to justify discontinuing the hikes. However, when President Lagarde expressed her satisfaction with the BLS results, she went on to say – "Are we satisfied? Are we claiming victory? No, we want to go to the end of the game." – and this reflects her determination to emphasize that the situation remains fluid and unpredictable.

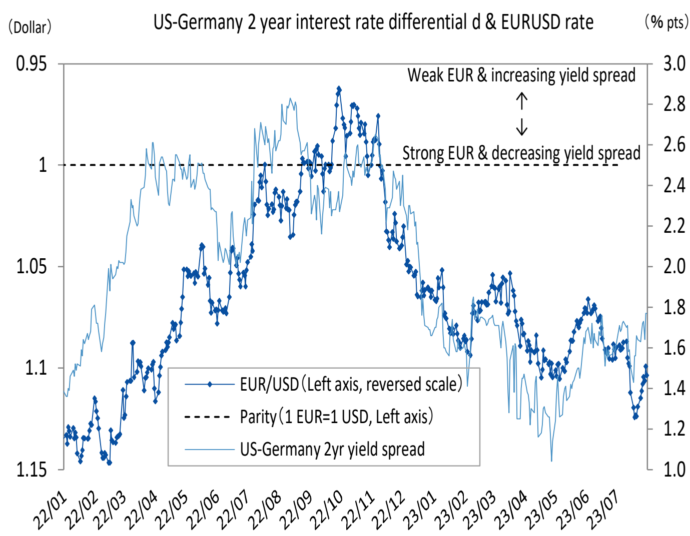


(Source) Datastream

Possibility of ECB Aligning with the Fed



But the euro area wage environment is potentially problematic, and several questions were posed at the press conference following the July Governing Council meeting about the possibility of a wage-price spiral. It is worth noting that the Account of the June Governing Council meeting expressed concern that – "until there was confirmation that wage pressures had run their full course, an upside risk to wage growth remained. Moreover, given staggered wage-setting and long-term contracts in Europe, the impact of higher wages would be spread over many years to come." In fact, euro area labor costs are rising in a manner that suggests they are paralleling the path of increases in labor unions' negotiated wages (see graph). Negotiated wage growth figures provide an image of future wage trends, and the sustained height of negotiated wage growth rates suggests that euro area labor cost growth rates will remain high for the time being. While President Lagarde denied concerns about a wage-price spiral at the press conference, the reality is that wage growth rates are not decreasing and service price growth rates remain high, and these situations are problematic with regard to the ECB's prospective shift toward greater dovishness. Although the rate of growth in the euro area consumer price index (HICP) has fallen, it remains above 5% yoy, and when people express concerns that interest rate hikes have reached the point of overkill with respect to the euro area economy, all the ECB seems able to do at this time is to repeat its cliché about "following a data-dependent approach". At the June Governing Council meeting, multiple Governing Council members expressed a preference for raising interest rates by 50bp rather than the eventually approved 25bp – "in view of the risk of high inflation becoming more persistent". Given the unlikelihood that the recognition of the risk of high inflation has completely dissipated in just six weeks, an ECB interest rate hike in September cannot yet be removed from the main forecast scenario.



In light of all these circumstances, what is the outlook regarding trends in EUR/USD? The ECB's recent policies, which have come to be considered relatively hawkish compared to those of the Fed, have narrowed the Europe-U.S. interest rate differential, which has directly promoted EUR/USD firmness. As discussed above, there are strong grounds for suspicion that the Fed is shifting away from continuous interest rate hikes and toward intermittent rate hikes and status quo maintenance, and the ECB's recent information dissemination suggests that it is shifting toward a stance similar to that of the Fed. This represents a significant change from the previous assumption that ECB would definitely hike rates again in September and that the possibility of subsequent ECB rate hikes is not low. If the ECB discontinues its interest rate hikes, then because EUR is associated with lower absolute interest rate levels, it will likely weaken. Given the still-large volume of EUR buying in IMM currency futures trading, the likelihood of an adjustment to EUR/USD has become higher for the time being.

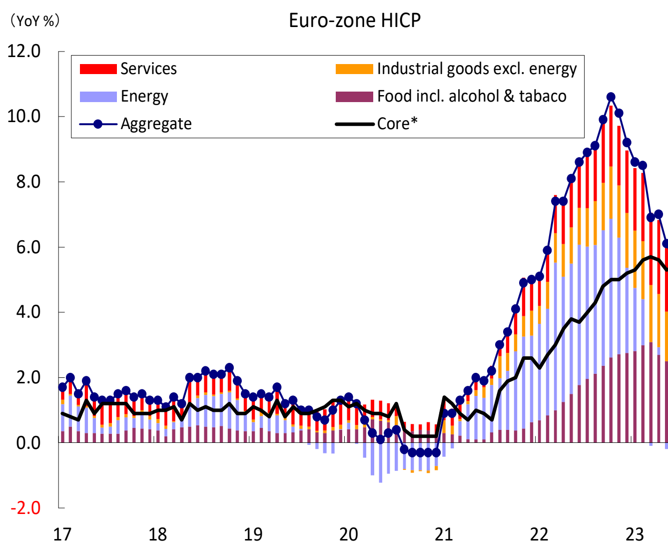
Both the ECB and the Fed will convene three more meetings this year, and I am anticipating that the Fed will hike interest rates 1-2 times and the ECB will hike interest rates 2-3 times, which could possibly cause EUR/USD to rise to roughly 1.15. If the ECB can only be expected to implement one or two rate hikes this year, however, then I have the impression that a EUR/USD rise to 1.15 will become considerably more difficult. In light of this point, this article's EUR/USD forecast range has been revised downwards, albeit slightly.

The Euro Area Economy Now and Going Forward – Tight Employment and Wage Situation Impacting Inflation Trends

Core-Basis Inflation Soon to Outpace Comprehensive-Basis Inflation

Euro area HICP figures for June were released on July 19. While the headline comprehensive-basis inflation rate is conspicuously decelerating, the underlying core-basis rate remains at a high level, and concerns over wage inflation are persisting. The comprehensive-basis inflation rate was 5.5% (all inflation rates are yoy unless otherwise specified), a significant slowdown from 6.1% in May, while core-basis inflation accelerated to 5.5%, from 5.3% in May. It seems likely that the rate of growth in core-basis HICP will outpace that in comprehensive-basis HICP next month. The drop in the comprehensive-basis inflation rate reflects an accelerating decrease in energy prices (-1.8% →

-5.6%), and this trend is likely to intensify for the time being. This is because it was just around this time last year that tensions with Russia further rose, concerns surfaced that Europe would face the worst energy crisis in its history during the 2022-2023 winter season, and natural gas prices began soaring. The euro area is now entering a period of time in which inflation rates reflect the alleviation of such concerns – growth in comprehensive-basis HICP will decelerate along with the drop in energy prices, making it difficult to perceive the actual inflation situation. Within comprehensive-basis HICP, however, inflation of food, alcoholic beverages, and tobacco products is maintaining a double-digit growth rate of 11.6%, so it seems difficult to anticipate when comprehensive-basis HICP growth will decline to 2% or less. While inflation rates have generally peaked out, the financial situations of EU citizens remain more difficult than before, and it is highly probable that the momentum of wage increases will persist through the foreseeable future, as will be discussed below.

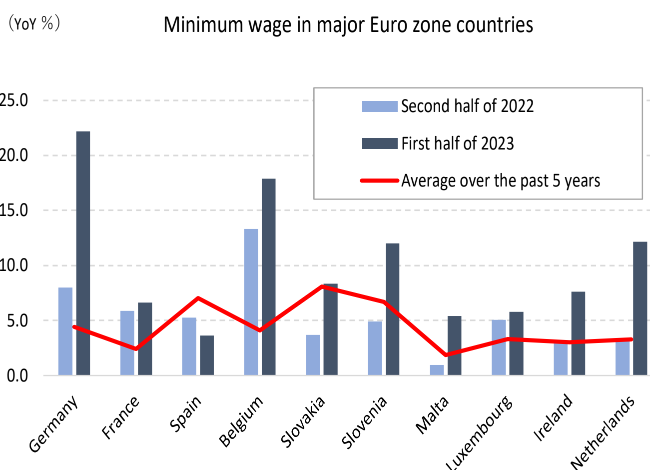


(Source) Datastream
(Note) Core excl. energy, food, alcohol & tabacco

On the other hand, the current acceleration of core-basis HICP growth reflects the temporary reduction of public transport charges in Germany last summer as a means of promoting greater traveling. Similar to Japan's nationwide travel support program, that German policy was intended to restore travel- and tourism-related demand after the end of the pandemic, and the lack of such a program this year will continue impacting euro area core-basis HICP growth through August. This can be presumed to one of the factors causing growth in euro area service prices to accelerate from 5.0% to 5.4% this June, and one wonders if the service price inflation rate will significantly decelerate in September, when the effect of the special 2022 factors is discontinued. Currently, it appears that the ECB is focusing more on the core-basis HICP growth than on comprehensive-basis HICP growth, and within the core-basis HICP growth, the ECB is giving particular attention to service prices, as service prices are closely related to the wage situation.

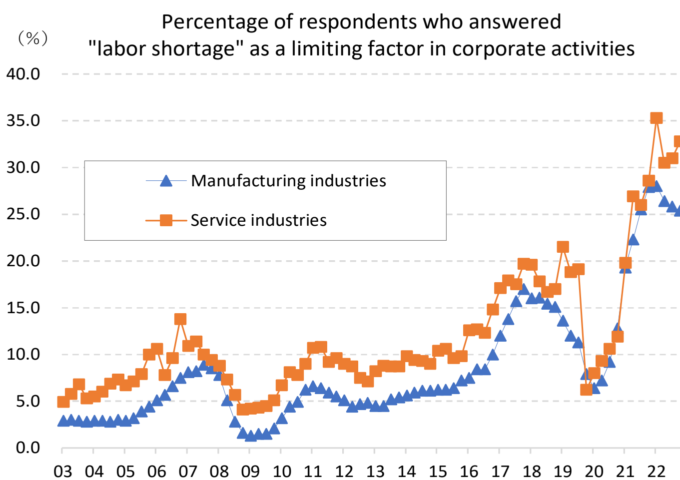
Employment and Wage Situation Clearly Tight

At the end of last month, there was a disturbing report of news related to this point. On June 26th, Germany's Minimum Wage Commission recommended a two-stage increase in the minimum wage – by 3.4% (to EUR12.41 per hour) from January 2024 and by 3.3% (to EUR12.82 per hour) from January 2025 – and the country's Minister of Labor and Social Affairs, Hubertus Heil, has announced his acceptance of these recommendations. However, even these rates of wage hikes will not be sufficient to compensate for the price increases that have occurred since last year. Minister Heil noted that there are voices calling for further wage increases, and it does not appear at all likely that the momentum for additional wage hikes will peter out soon. A leader of the German Trade Union Confederation has suggested that real wages after inflation will be decreasing unless the hourly wage is raised to at least EUR13.50. As can be seen from the graph, minimum wage growth rates are accelerating to above five-year average rates in Germany and many other euro area countries – it seems that the wage pressures and general wage growth trend the ECB has been particularly concerned about are becoming a reality.



(Source) macrobond

Moreover, many euro area companies are continuing to face labor shortages. According to the European Business Cycle Indicators (First Quarter 2023) survey of companies conducted by the European Commission, "labor shortages" are a "limiting factor for business activities" for about 25% of companies in manufacturing industries and about 33% of companies in service industries, and both these levels are the highest recorded since the survey was begun (see graph). Manufacturing industries' labor shortage



(Source) macrobond

appears to be gradually disappearing, but the labor shortage of service industries is now worsening after having been temporarily alleviated once. It appears clear that euro area companies are faced with various challenges owing to the increasingly tight employment and wage situation, and so long as the shortage of workers continues, seeking to restrain wage increases will be unrealistic. As mentioned above, however the ECB Governing Council currently seems to be more concerned about the slowdown in the real economy than with the tightening of the employment and wage situation. If the ECB were to shelve its policy of raising interest rates, then additional growth in the real economy might be expected to decelerate the rates of increase in wages and prices, and it seems likely that the ECB will eventually decide to wager on such a positive outcome.

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