Forex Medium-Term Outlook

August 31, 2023

MIZUHO

Overview of Outlook

USD/JPY continued to soar in August, intermittently renewing the year-to-date high. There was a time when the Obon holiday period in Japan was dreaded as the “summer of JPY appreciation,” but last year and this year, it has been quite the reverse, i.e., the “summer of JPY depreciation.” A supply-demand balance deterioration, as symbolized by Japan’s trade deficit, appears to have manifested at a time of low liquidity, i.e., during the Obon holiday period. The phenomenon itself is similar to that during the strong-JPY phase, but because the balance of JPY supply and demand has reversed, the “summer of JPY appreciation” has become the “summer of JPY depreciation.” Japan’s current account surplus for 1H of 2023 is an improvement over 1H of 2022, but as per my calculations based on cash flow (CF), the current account balance is a deficit of -JPY 3 trillion. Given the normalization of a JPY depreciation trend despite current account surpluses, it would be wise to focus less on statistical figures and take an honest look at the actual flow of money, i.e., the outflow of foreign currency in terms of cash flows. There are no major changes in the interest rate climate. Even at the much-anticipated Jackson Hole Economic Symposium, the BOJ’s tone of communication set it apart from the Fed and the ECB, which staunchly maintain their hawkish stances as interested parties in the face of inflation. During the current forecasting period, the domestic-foreign interest rate differential seems likely to remain quite stable, leaving one no choice but to predict that JPY could find itself in the situation of a preferred funding currency. Further, with no signs of tight labor market conditions letting up, the Fed and ECB seem very likely to maintain their hawkish stances even into the new year. Taking all this into account, I have decided to push back my predicted timing for the peaking of the weak-JPY phase by a quarter.

EUR weakened in August, but not because of the emergence of any new factors. The fact is that the euro area is beginning to show more conspicuous signs of an economic slowdown than the U.S. or Japan, and this is creating a climate favorable to the weakening of EUR against USD via changes in the EUR-USD interest rate differential. Led by Germany, the only G7 member for which a recession is forecast, the euro area’s economy is weakening, and this itself should be a major reason to end rate hikes. Indeed, the ECB could skip a rate hike at its September Governing Council meeting. Taking this into account, I have downwardly revised the overall level of my forecast for EUR. However, there may be a need to think of the outlook for EUR as a separate issue than the euro area’s real economic situation. This is because a weaker real economy will shrink the value of fuel and other imports, which could contribute to improving the EUR supply-demand balance. In this report, I place greater importance on the stable relationship between EUR and the German (and, therefore, the euro area) trade balance, and do not view every deterioration in the region’s economic performance as cause for selling EUR. Further, the ECB is in no position to take the region’s high inflation rates lightly, so there does remain scope for a rate hike within the year. Despite downwardly revising my forecast level for EUR, I still do not consider a EUR crash likely either from the supply-demand or interest rate points of view.

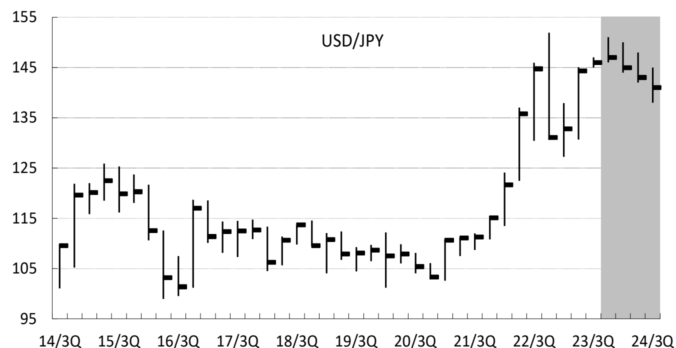
Summary Table of Forecasts

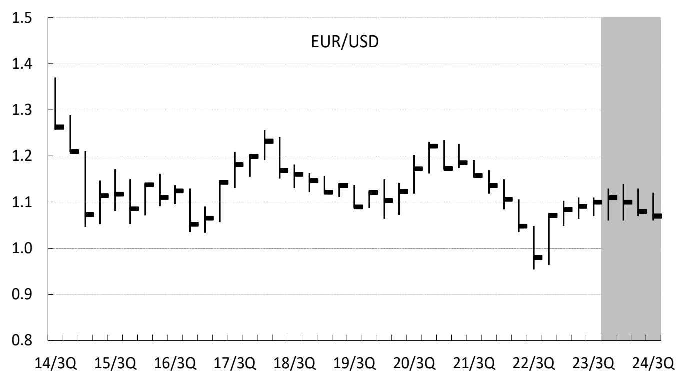
	2023 Jan -Aug (actual)	Sep	Oct-Dec	2024 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	127.22 ～ 147.37 (146.07)	145 ～ 147 (146)	146 ～ 151 (147)	144 ～ 150 (145)	142 ～ 148 (143)	138 ～ 145 (141)
EUR/USD	1.0482 ～ 1.1276 (1.0932)	1.07 ～ 1.11 (1.10)	1.06 ～ 1.13 (1.11)	1.06 ～ 1.14 (1.10)	1.07 ～ 1.13 (1.08)	1.06 ～ 1.12 (1.07)
EUR/JPY	137.45 ～ 159.76 (159.68)	158 ～ 163 (161)	156 ～ 165 (163)	155 ～ 164 (160)	152 ～ 161 (154)	148 ～ 158 (151)

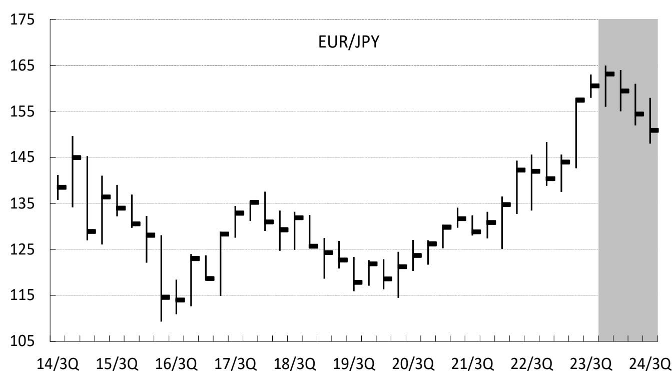
(Notes) 1. Actual results released around 10 am TKY time on 31 August 2023. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts



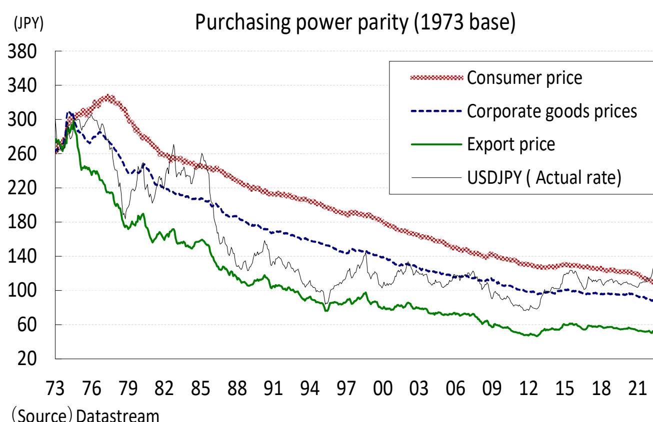




USD/JPY Outlook – Context of “Summer of JPY Depreciation”

JPY Rates Now and Going Forward – Why the PPP has Become Irrelevant

PPP No Longer Very Relevant



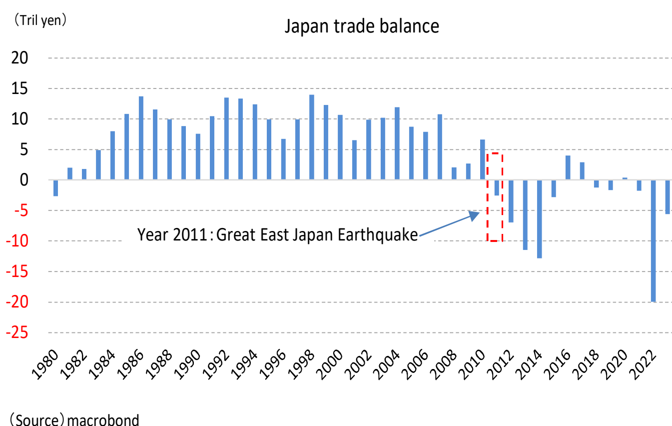
(Source) Datastream

Over the past year and a half of JPY weakness against USD, there has been too much of a discrepancy between market-based USD/JPY and USD/JPY as indicated by purchasing power parity (PPP), and I still get inquiries from clients who refuse to believe that excessive JPY weakness in light of the PPP could go on for too long. There are two points I would like to emphasize in response to such doubts. First, that this upside discrepancy between USD/JPY and the PPP-based rate did not begin recently; and second, that present USD/JPY rates can be seen as “too weak” in light of the PPP only when the weakness triggers an increase in export volumes. The two points above are worth understanding as a set, but let me begin by summarizing the current rate level. As of June, the corporate-price-based PPP, which has long been taken as the ceiling for market rates, is 92 yen to the dollar. The market rate (141 yen to the dollar as of June) is over 50% higher than this, i.e., JPY is over 50% weaker against USD than the corporate-price-based PPP indicates. In other words, the PPP-based rate is too low to be an effective indicator. Next, let us take a look at the consumer-price-based PPP. Historically, USD/JPY never has touched the consumer-price-based PPP level except during the period of extraordinary JPY weakness against USD right before the Plaza Accord was signed, but at the present time, the market-based rate of JPY is over 30% weaker than that indicated by the consumer-price-based PPP (108 yen to the dollar). In other words, the current level of JPY weakness cannot even be explained based on the weaker-side indicator that was almost never touched in the past. There is also the export-price-based PPP, which was never used even in the past, and does not need to be taken into account now, but I would like to mention that it currently indicates a rate of 60 yen to the dollar.

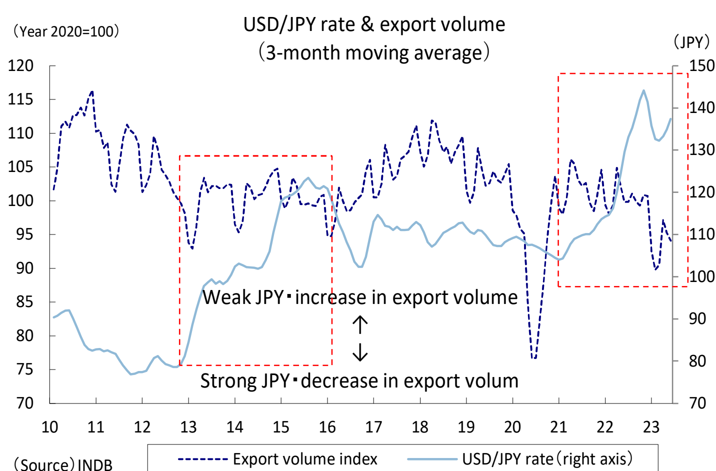
While the PPP-based rates were never a precise indicator of USD/JPY, they have never before been as discrepant as they are now. During phases of JPY strength, they were frequently discussed as the level to which USD/JPY would eventually return, but that argument is no longer being made now. I think the reality is that the PPP-based rates have become too irrelevant for people to bring up anymore.

Conditions Under Which JPY Can be Called "Excessively" Weak

Let us take a look at the first point above that I want to emphasize, namely that the upside discrepancy between USD/JPY and the rate indicated by PPP did not begin recently. As the figure shows, USD/JPY began to show a clear upside discrepancy compared with the corporate-price-based PPP in 2013, and has never once fallen below that level since. Therefore, when comparing market-based vs. PPP-based rates, one must take note that it is not a year or two ago that this major shift began, but rather 10 years ago. The question then is, what happened 10 years ago? This is another point I have brought up time and again in past editions of this report – Japan began to lose its trade surplus in 2011, resulting in the subsequent establishment of a trade deficit trend, with deficits gradually expanding. This brings us to the second point I want to emphasize, namely that present USD/JPY rates can be seen as "too weak" in light of the PPP only when the weakness triggers an increase in export volumes. For the evaluation that "JPY is too weak in light of the PPP" to hold, there must be a mechanism whereby the excessively weak JPY triggers an increase in export volumes, resulting in an accumulation of trade surpluses, which manifests as JPY buying due to actual demand, and ultimately pushes up the value of JPY. It is only as a result of the above mechanism working that the starting JPY rate can be considered to have been "too weak" in hind sight. Unfortunately, JPY weakness no longer results in an increase in export volumes for Japan. Despite the level of JPY depreciation against USD seen since 2021, Japan's export volumes have tangibly declined. The same was true during Abenomics starting 2013 (see figure). The improvement in JPY supply-demand balance through JPY depreciation is a thing of the past.



(Source) macrobond



(Source) INDB

Given the many criteria by which one can measure the extent of JPY weakness, it is difficult to make a declaration one way or the other. What is clear, however, is that export volume and trade surplus increases are essential for the current JPY weakness against USD to be corrected in the direction indicated by the PPP, and one must understand that this can no longer be hoped for. On the other hand, Japan's recent consumer price index (CPI) growth is stronger than that of the U.S., and if this situation were to become chronic, the PPP itself would be revised to indicate JPY weakness rather than JPY strength as in the past. One cannot predict such a development with any certitude at the present time, but it is impossible for nominal wages not to increase in a society with chronic labor shortages, and I believe a deflationary economic climate is no longer appropriate for the situation Japan finds itself in.

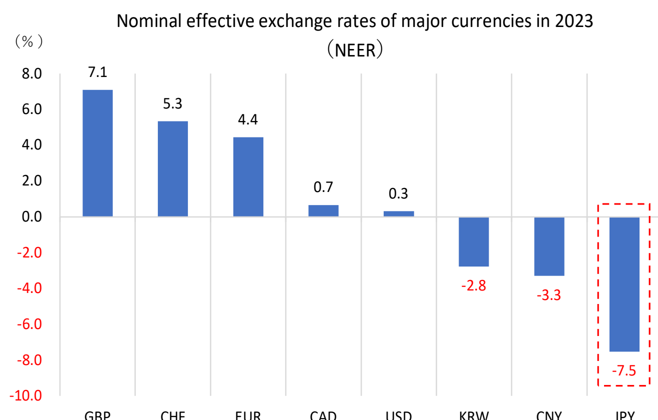
In other words, there is already a change in the erstwhile structure of an inflationary U.S. economy vs. deflationary Japanese economy, which facilitated the justification of overwhelming JPY strength in PPP calculations. Going forward, we may see a gradual revision of PPP in the direction of a weaker JPY and stronger USD. This perspective of revising the PPP rather than the market rates has not received much focus so far. Both the supply-demand structure and the associated price climate must be forecast in the medium- to long-term based on the recognition that the Japanese economy is in the process of undergoing a major transition.

Context of "Summer of JPY Depreciation"

In August, USD/JPY returned to the 145 level just as Japanese market participants left for the Obon holiday period, and the currency pair has since been intermittently renewing year-to-date highs. There was a time when the Obon holiday period in Japan was dreaded as the "summer of JPY appreciation," but last year and this year, it has been quite the reverse, i.e., the "summer of JPY depreciation." It is not entirely clear why the Obon holiday period in the past saw a peaking of JPY strength. One popular explanation was that a large number of market participants simultaneously taking a break resulted in lower liquidity in the forex markets, and the remaining actual-demand-based Leave Orders were concluded in a mechanical manner, resulting in a cluster of transactions that made it easy for JPY rates to jump up. Leaving aside the question of whether this interpretation is correct, it would apply to the current situation too. The only decisive difference is that while actual demand in the past was driven by export firms looking to buy JPY, actual demand at the present time is driven by import firms looking to sell JPY. Perhaps the Obon holiday period, when most Japanese market participants go on holiday, is the main time of the year when the actual state of JPY supply and demand becomes obvious.

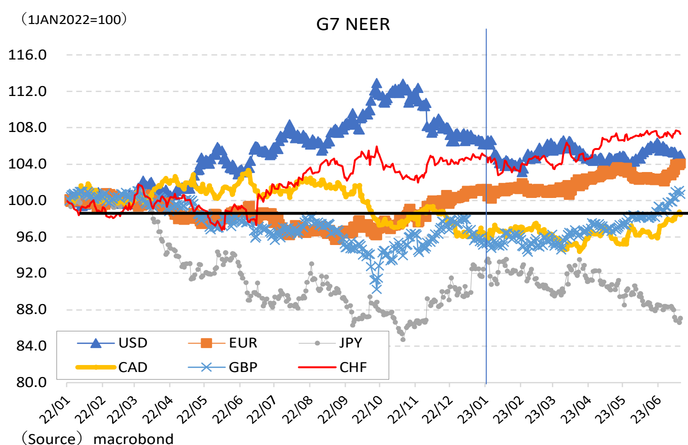
JPY Weakness is Flip Side of European Currency Strength

At the time of writing this report, JPY continues to be the only weak one among the world's major currencies. As I have been pointing out for quite some time in this report, the argument that the current phase of JPY weakness is the flip side of USD strength and that JPY will regain its strength when the Fed pivots on its monetary policy is one that betrays a shallow understanding of the forex markets. In fact, such arguments have not proved correct this year.



(Source) macrobond (Note) Status by 21 August 2023

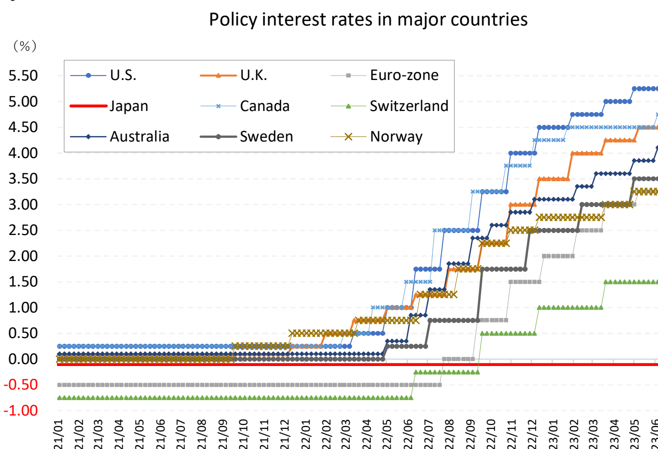
The idea that JPY weakness is the flip side of USD strength is based primarily on a prejudiced impression. This becomes quite clear just by comparing the nominal effective exchange rate (NEER) trends of the world's major currencies since the beginning of the year (see figure). As of August 21, JPY is the only currency that has weakened this year (by -7.5%), but then, USD has remained more or less flat at +0.7%. It certainly cannot be said that JPY depreciation is owing to USD appreciation. Meanwhile, European currencies such as GBP, CHF, and EUR have been growing strongly, in the +4.0-7.0% range. No USD appreciation trend has been seen in the forex markets in 2023; rather the trend of European currency strength has been more obvious.



Further, in terms of level, though JPY's NEER has fallen to the level seen in October 2022, i.e., roughly152 yen to the dollar, it is obvious from the figure that USD's NEER is not as high now as it was then. Specifically, USD's NEER on October 21, 2022, when USD/JPY approached 152, was 110.29, but it had weakened by about -5.6% and fallen to 104.15 as of August 21 this year. Meanwhile, JPY's NEER has strengthened by +0.9% during the same period. While a conspicuously large number of analysts continue to argue as though JPY rates are determined by USD rates, the facts suggest otherwise. If one had to explain this year's JPY rate trends based on other currency rate trends, it may be more appropriate to say that JPY weakness is the flip side of European currency strength. Of course, going by the figure, it does appear that JPY weakness was the flip side of USD strength throughout 2022. But here again, one must remember that USD's NEER was flat (or down by -0.01% to be precise) in March 2022, which is when JPY began to weaken against USD. At the very least, it can be said that USD strength did not trigger the current phase of JPY depreciation. If so, perhaps there is a Japan-specific factor that triggered the current phase of JPY depreciation, and perhaps it relates to major changes in the JPY supply-demand climate symbolized by the current account and trade balances – this has been my position in this report for some time now.

Can JPY Muster Actual Demand as a Safe-Haven Currency?

Of course, whether JPY weakness is the flip side of USD strength or European currency strength, the one thing common to both these scenarios is that foreign interest rates are increasing relative to Japanese interest rates. In other words, the argument that the JPY depreciation trend is supported by the domestic-foreign interest rate differential gains important (see figure). Going forward, many overseas central banks, led by the Fed and the ECB, will end rate hikes and enter a phase of hawkish maintenance of the status quo. As monetary policy moves become more predictable, volatility is likely to fall. If that happens, speculative JPY selling could build up against the backdrop of JPY carry trading. At the same time, JPY will inevitably strengthen when overseas central banks pivot to rate cuts. However, "demand as a safe-haven



(Source) macrobond

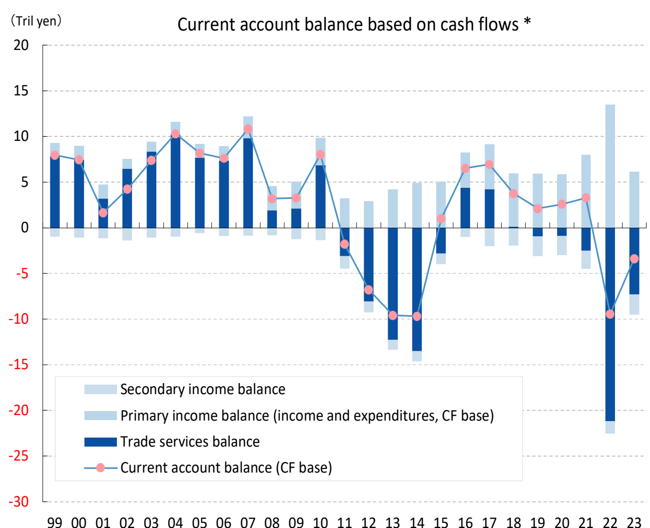
currency," which was one of the factors boosting JPY rates until recently, has now become the preserve of CHF. During the recent crisis of the Russian invasion of Ukraine, far from being bought, JPY ended up being sold off. Another pattern that was previously quite common – JPY appreciation whenever U.S. shares were sold off – has not worked all that predictably in recent years. Going forward, even if a U.S. economic slowdown becomes obvious, the Fed's pivot to rate cuts becomes imminent, and dark clouds begin to hover over the global economy as a whole, to what extent can JPY buying be expected? Perhaps one can expect JPY to appreciate in response to such events, but

there is no way to be sure of the extent to which it would appreciate.
Demand as a safe-haven currency can only be expected against the backdrop of a current account balance that includes a considerable amount of outright buying of the domestic currency (i.e., a trade & services balance) – something that currencies such as CHF and EUR have. Japan, on the other hand, has fallen into a state of merely statistical current account surpluses heavily reliant on a primary income surplus (details later), so it is doubtful whether the country is capable of re-creating periods of strong JPY appreciation that it once experienced. If significant rate hikes are difficult, and there seems little hope for an improvement in the supply-demand climate, whatever JPY appreciation takes place in the markets is likely to have very limited scope. The idea that "JPY is bound to recover strength at some point" is a vestige from the era of trade surpluses. The need of the hour is to change one's perspective and formulate forecasts based on multiple tentative theories.

JPY Basic Supply and Demand – CF-Based Current Account Balance Posts Deficit for 1H of 2023

Reinvestigating Japan's Current Account Balance for 1H of 2023 Based on CF
I would like to point out once again that the sustained fall of JPY in August remains related to the JPY supply-demand situation (namely that more people want to sell than to buy JPY). In the previous edition of this report, I argued that the current account balance ought to be seen in terms of cash flows (CF). In this connection, I would like to take stock of Japan's current account balance for 1H (January through June) of 2023, which became available in August. Japan posted a current account surplus of +JPY 8.0132 trillion for 1H of 2023, which was a yoy increase (compared with +JPY 7.2103 trillion for 1H of 2022). This was thanks to the trade and services deficit shrinking from -JPY 8.2152 trillion to -JPY 7.3007 trillion, and the primary income surplus expanding from +JPY 16.6349 trillion to +JPY 17.5286 trillion, among other factors. However, as usual, such current account balance results are in conflict with JPY rate trends. In 2022 too, Japan posted a +JPY 11.5 trillion current account surplus, but JPY fell by over 30% against USD at its peak. If JPY-buying pressure had been as strong as that indicated by the current account surplus, this level of JPY weakness would not have become established as a trend. The reason why JPY continues to depreciate despite the current account posting surpluses is probably because, statistical figures aside, the actual flow of funds (i.e., the CF) suggests an outflow of foreign currency from the country. I believe it is important to take an honest look at the possibility that the surplus cannot be taken at face value to indicate JPY buying.
Let me provide a brief overview. Analyzing the current account balance in terms of CF involves examining the details of the primary account surplus, which is the main source of the current account surplus. Specifically, this report computes the current account balance by subtracting the dividends and interest earned on bonds portions of Portfolio investment income, and the reinvested earnings portion of Direct investment income from the primary income surplus. The dividends and interest earned on bonds portions of Portfolio investment income are usually reinvested for compound interest purposes. Again, the reinvested earnings portion of Direct investment income is also reinvested as foreign currency, as the name suggests. The above portions are certain not to return to JPY. If we apply this thinking to the figures for 1H of 2023, the CF-based primary income balance excluding the above dividends, interests earned on bonds, and reinvested earnings, amount to +JPY 6.1431 trillion, which is roughly one-third of the officially released statistical figure. Incidentally, the CF-based primary income balance for 1H of 2022 was +JPY 6.2295, indicating that the actual JPY-buying pressure from the primary income balance has declined somewhat, contrary to what the statistical expansion of the surplus indicates.

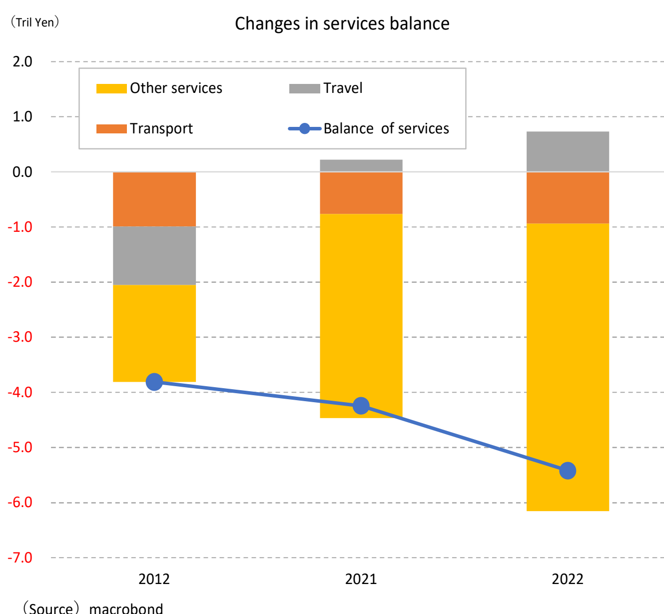
CF-Based Current Account Balance may be a Deficit
Totaling the above CF-based primary income balance, the trade and services balance, and the secondary income balance, we get an image of the CF-based current account balance. To cut to the chase, the CF-based current account balance for 1H of 2023 may be a deficit of roughly -JPY 3.4 trillion (see figure). This is a slightly greater deficit than the roughly -JPY 3.2 trillion posted for 1H of 2022. Since the beginning of the year, there seems to be an unspoken assumption that the JPY supply-demand climate is better in 2023 than it was in 2022, but one has to wonder if this assumption is correct. Of course, going solely by the domestic and international monetary policy climate in 1H of 2023 – the BOJ practically ending its yield curve control (YCC) policy, the Fed tapering/ending rate hikes, and the emergence of rate-cut speculations – one would have thought that the situation was conducive to JPY appreciation. However, the JPY depreciation trend has showed no signs of ending. While there may be more than one reason for this, my postulate, based on the CF-based current account balance, is that there continue to be more people wanting to sell rather than buy JPY. Incidentally, the CF-based current account balance for all of 2022 was a deficit worth roughly -JPY 10 trillion. A similar level of current account deficit was posted for 2013 and 2014, and JPY depreciated by -10% or more against USD during those years. I, therefore, believe, that the two things may be related, rather than it just being a coincidence.



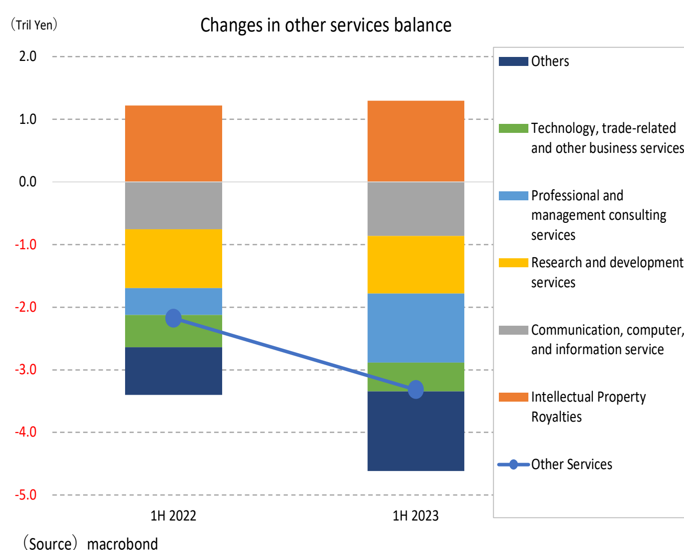
(Source) Bank of Japan
(Note) *With regard to the receipt and payment of primary income and expenditure, "reinvestment income" of direct investment income, "dividends" of securities investment income and expenditure, and "bond interest, etc." are deducted

Services Balance Involves New-Age Deficits

Further, even going simply by 1H figures, the Services deficit is clearly on the rise. As I have explained several times in past editions of this report, Digital, Consulting, and R&D are the three main categories that draw attention when discussing the expansion of the Services deficit in recent years. If we take 1H of 2023 as an example, the Services balance overall posted a deficit of -JPY 2.1220 trillion, which was a slight improvement over the -JPY 2.5647 trillion posted for 1H of 2022. Looking at the breakdown, the Transport balance was -JPY 418.5 billion, the Travel balance was +JPY 1.6161 trillion, and the Other services balance was -JPY 3.3196 trillion. The overall improvement in the Services balance can be attributed to the over 10-fold increase in the Travel balance, which was merely +JPY 128.1 billion for 1H of 2022. However, the Other services deficit had expanded by more than JPY 1 trillion for 1H of 2023, compared with the -JPY 2.1776 trillion for 1H of 2022. Despite earning a significant amount of foreign currency through its Travel surplus, Japan is losing most of it through its Other services deficit. <u>One could say that the foreign currency earned through the labor-intensive tourism industry is being used to pay for services consumed in capital-intensive industries where software competitiveness is prioritized (details later)</u>. Incidentally, the Services deficit for 2022 had ballooned to -JPY 5.4 trillion (the scale is reminiscent of Japan's Trade deficit some years ago). Most of the above deficit can be attributed to the Other services balance (about -JPY 5.2 trillion). There are many factors behind this expansion of the Other services deficit – for instance, from 1H of 2022 to 1H of 2023, the deficit for "professional and management consulting services" had expanded more than 2.5 fold from -JPY 427.6 billion to -JPY 1.1042 trillion. While this category could be classified under Digital services due to the inclusion of payments toward online advertising services, etc., it also reflects the repatriation of a fixed percentage of their earnings in Japan to their home-country HQs by foreign consulting firms, which have recently been expanding their businesses in Japan. Apart from this, the deficit for "telecommunications, computer, and information services" (which covers cloud service usage fees, etc.) also expanded from -JPY 758.2 billion to -JPY 864.0 billion, while the deficit for "research and development services" remained flat at around -JPY 920.0 billion. Unlike trade and primary income balances, which are easily affected by resource prices, forex rates, and external demand trends overall, the Other services deficit in recent years has essentially been expanding. <u>It is a problem, going by nature of this category of deficits, that one cannot expect it to shrink easily. Such new-age deficits are likely to gain more importance going forward</u>.



(Source) macrobond

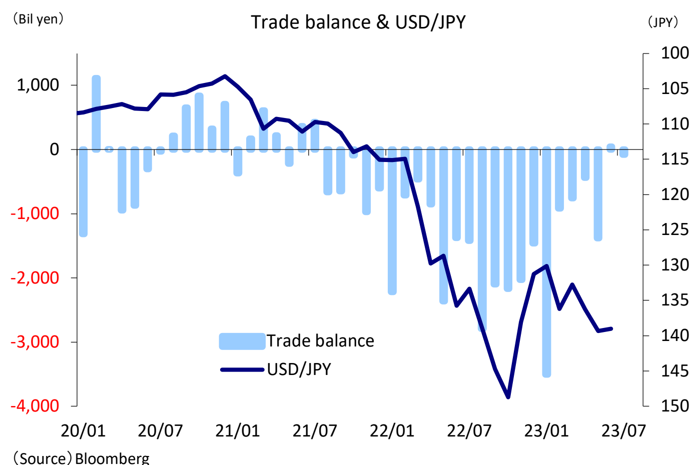


(Source) macrobond

Contrary to the majority of forecasts, I think it is important, when attempting to understand why the recent JPY depreciation trend persists, to first gain a firm understanding of the recent state of and changes to the JPY supply and demand structure. Having taken such structural changes into account, I think the main battling ground for USD/JPY may have shifted upward from the 100-120 range of the past, to the 120-140 range or, perhaps, even the 125-145 range. <u>During the current forecasting period, the validity of my reasoning will be put to the test when the Fed enters a phase of rate cuts</u>.

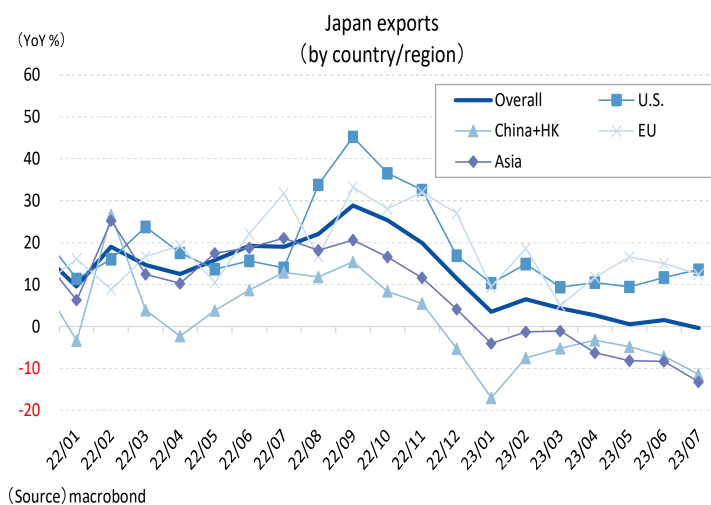
USD/JPY Will Reflect Improvement in Supply-Demand Climate only in 2024

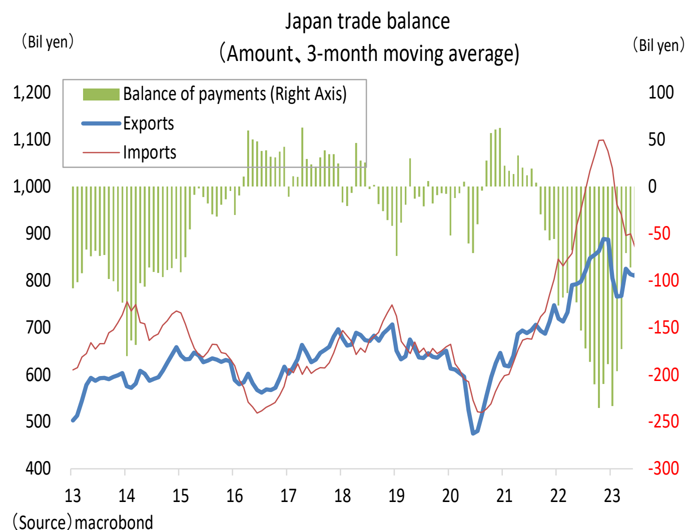
Further, I would like to take a look at the recent state of trade balances, which are key to understanding the JPY supply-demand climate. Japan's trade balance for July, released by the Ministry of Finance in August, was -JPY 78.7 billion, the first deficit in two months. This return to deficits was a reversal from the June figure, which was widely celebrated as the first surplus in 23 months. I think it is important to take note of the basic fact that Japan is no longer able to earn trade surpluses as a trend, and that there is no point exaggeratedly celebrating single-month surpluses. However, it is also a fact that the trend of JPY selling based on actual demand is peaking out. In terms of the total for January through July, the deficit for 2023 (-JPY 7.0 trillion) is an improvement over the deficit for 2022 (-JPY 9.4 trillion) (see figure). The improvement is likely to become more pronounced as the year progresses. While USD/JPY's return to the 152 level in August is disappointing, going by the basic JPY supply-demand climate, there seems no need to make too much of it. Even if the trade deficits posted during 1H of the year continue to promote JPY weakness for some time during 2H due to a time lag, it seems quite likely that the JPY-selling pressure will weaken by and by. In this report, therefore, I have begun to consider the prospect of JPY weakness peaking out after the start of the new year. However, as explained above, it is not altogether clear whether the Fed will really pivot to a more dovish stance as assumed. While there is a good possibility that the JPY depreciation trend will peak out with an improvement in supply and demand, the timing could well be spring 2024 or later.



Exports Determined by China

As of the present time, the main focus of attention when it comes to Japan's trade statistics should be the country's lackluster export growth. Japan's global exports recently posted -0.3% yoy, the first negative yoy growth in the 29 months since February 2021. As is generally known, this is partly due to the Chinese economic downturn. As the headlines have already been reporting, Japanese exports to China declined for the eighth month in a row to post -13.4% yoy. Against the backdrop of a protracted deterioration in China's real estate market, the country's economic slowdown is quite obvious, with some even beginning to call it a "Japanification" of the Chinese economy. As of July, Japan's exports to China, which account for abut 17.6% of its total exports, are quite significant and second only to its exports to the U.S., which account for roughly 20.5% (incidentally, exports to the EU account for roughly 10.9%). A Chinese economic slowdown, therefore, is in a position to directly impact Japan's overall global exports. Even if falling resource prices lower Japan's import value, ultimately there is no improvement in Japan's trade balance due to the decline in exports amid a Chinese economic slowdown. This situation with regard to Japan's trade balance is also a major reason the JPY depreciation trend has not changed much since the beginning of the year. As investments in China continue to be withdrawn in the name of de-risking and de-coupling, the Japanese economy must begin to face a new problem, namely the inability to improve its trade balance due to the decline in its exports to China. Of course, once the global process of de-coupling from China is completed, its impact is also likely to weaken, but while it is still ongoing, the world economy has no choice but to endure some splash-back. In the case of Japan, the decline in exports, the protraction of the JPY depreciation trend, and the resultant impact on the real economy may have to start being analyzed.

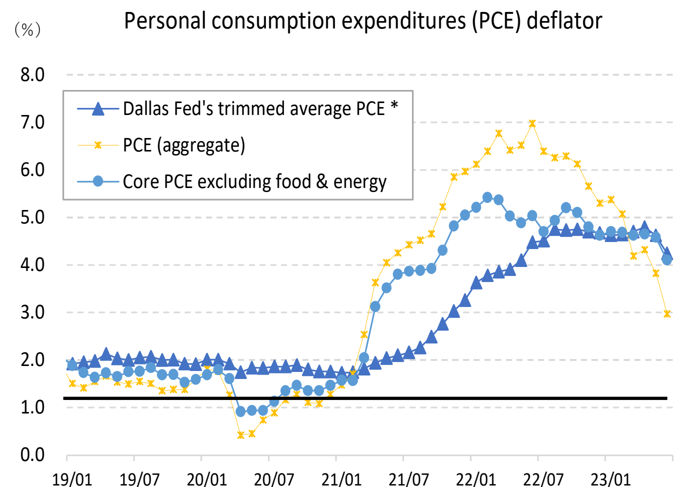




Japanese, U.S., and European Monetary Policies Now and Going Forward – Difference in Proactive Interest in Tackling Inflation

"At the Very Least, No Rate Cuts" is a Key Fact

Fed Chair Jerome Powell's speech at the Jackson Hole Economic Symposium was by-and-large as expected by the markets. Regarding inflation, Powell said, "it remains too high. We are prepared to raise rates further if appropriate." As the markets had not really expected a dovish tone of communication to begin with, the remarks did no more than re-affirm the Fed's original stance that interest rates could be raised again, depending on the data. Headline inflation rates in the U.S. at the current time are stably approaching the 2% target, but basic inflation indicators continue to grow at twice that rate (see figure). If one assumes that this is happening against the backdrop of soaring wages, the situation is not conducive to suggesting an end to rate hikes. Politically speaking, too, the government probably cannot afford to abandon its inflation-fighting stance until it gains some sense of the outcome of the Presidential election next fall. Further, taking into account the recent resurgence of crude oil prices, one may have to expect to see the headline inflation rate bottom out.



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

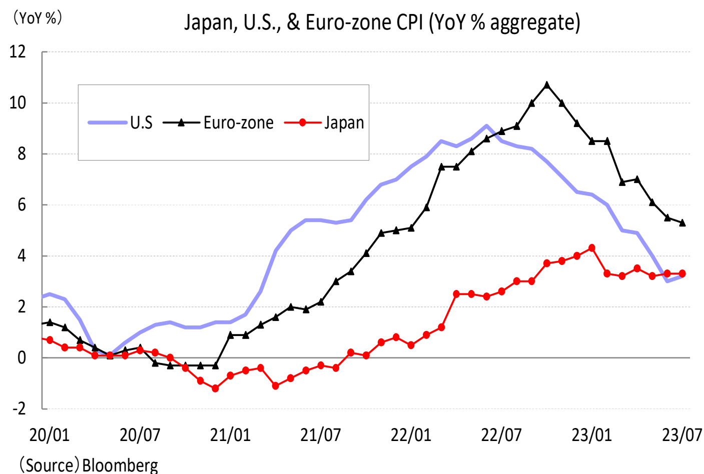
Under such circumstances, and taking the inflation rate into account, the Fed's fundamental monetary policy stance during 1H of 2024 may be to maintain the status quo or implement a rate hike if necessary. The financial markets are prepared to factor in a rate cut during 1H, but a scenario that has already been postponed for the past six months no longer seems very persuasive. As for USD/JPY, the implication that, at the very least, there will be no rate cuts for almost another year going forward is sufficient to boost carry trading. My basic prediction has been a bottoming of the JPY depreciation trend once we enter 2024, but I am beginning to think that I should revise my prediction to incorporate the continuation of JPY depreciation at least through the January-March quarter, or even through the April-June quarter.

Similar Confirmation of ECB Hawkishness

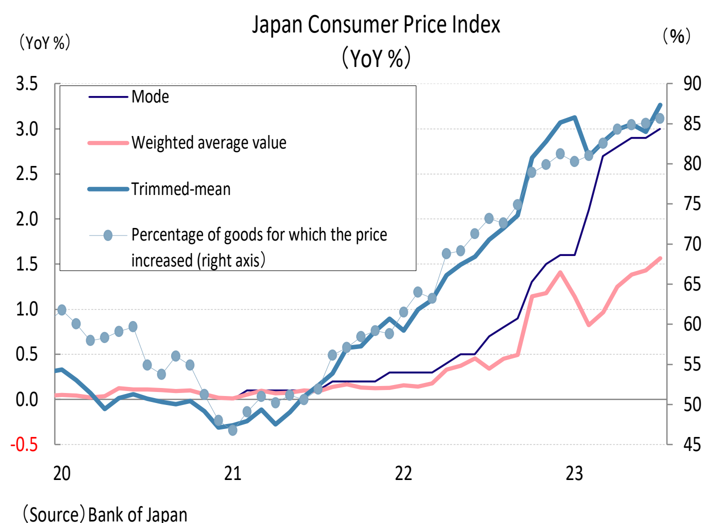
ECB President Christine Lagarde, who spoke after Chairman Powell, also mentioned the post-pandemic structural changes the global economy is facing, and she said that, although it remains to be seen whether these changes will be permanent, the changes will be more persistent than initially expected. President Lagarde cited three main structural changes – labor market transformation due to such factors as increased use of AI; an energy transition triggering profound changes in global energy markets; and growth in geopolitical divides, global economic fragmentation, and protectionism. There are no signs that any of these structural change trends will end anytime soon, and it is probably particularly important to recognize that the rise in geopolitical risks is liable to be prolonged. Rising geopolitical risks, along with heightened protectionism and supply constraints, are creating conditions that promote higher inflation rates. I personally feel that it has become necessary to construct a global economic and financial system management scenario based on recognition of the likelihood that the world economy will need to operate for a prolonged period without the full participation of China and Russia. In brief, current trends may well make economic activities throughout the world more time- and money-consuming than before, and this could lead to major changes in the assumptions used for monetary policy management and asset price forecasting.

In light of these structural changes, President Lagarde concluded her speech by stating that the ECB should – "[set] interest rates at sufficiently restrictive levels for as long as necessary to achieve a timely return of inflation to our 2% medium-term target." – and she emphasized her point using the same language used in the ECB's Governing Council meeting statements. Although the ECB has not issued official comments on whether or not interest rates will be further hiked at the September Governing Council meeting, comments made by individual senior ECB officials have generally been hawkish. For example, German Bundesbank President and ECB Governing Council member Joachim Nagel also attended the Jackson Hole symposium, where he was quoted as saying – "We shouldn't forget inflation is still around 5%. So this is much too high. Our target is 2%. So there's some way to go." – and Latvia's central bank governor and ECB Governing Council member Mārtiņš Kazāks was quoted as saying on the same day that – "We can always cut [interest rates]. If, however, we stopped too early, then of course later on it may require much larger interventions." I currently am expecting the September Governing Council meeting to approve an additional 25bp interest rate hike.

Most Central Banks Proactively Addressing Inflation-Related Challenges



(Source) Bloomberg



(Source) Bank of Japan

The day after these Western central bank leader's statements, on August 26, BOJ Governor Kazuo Ueda participated in a Jackson Hole symposium panel discussion event entitled "Globalization at an Inflection Point". At this event, Governor Ueda pointed out ongoing structural changes seen in trade and direct investment in Asia, highlighting with diagrams a progressive shift away from China with respect to Japanese companies' exports and foreign direct investments. He also noted a trend of increase in those companies' direct investments in the United States and other Asian countries as well as within Japan. When already theoretically optimized supply chains are disrupted by such structural changes or other factors, it is likely to have the effect of increasing inflationary pressures. However, the portion of Governor Ueda's panel discussion presentation that attracted particular attention in financial markets as it relates to the BOJ's "next move" in policy management was – "We think that underlying inflation is still below our target of 2%. This is why we are sticking with our current monetary easing framework." – and these sentences appear to confirm the BOJ's intention of maintaining its dovishness. The contrast between the policies of Western central banks and the BOJ has become increasingly clear, and this appears to have inspired forex market players with a greater sense that JPY selling is a safe bet.

The Jackson Hole symposium's overall theme was "Structural Shifts in the Global Economy", and the speeches presented at the event by the leaders of the Fed, the ECB, and the BOJ all acknowledged the existence of structural shifts in the global economy along with potential inflation risks. However, I got the impression that while Chairman Powell and President Lagarde were speaking as people with direct experience in dealing with serious inflation-related challenges, Governor Ueda seemed to be discussing those challenges as a "global trend" that has little to do with Japan. This seems to reflect a continued inability to draw definite conclusions about Japan's current inflationary trend. But it is worth noting that Japan's CPI growth rate has recently surpassed that of the United States on an overall basis and is becoming increasingly close to that of the euro area (see graph). Governor Ueda's assertion that "underlying inflation is still below our target" was probably based on the fact that the BOJ outlook report's forecast of growth rates in core CPI (all items excluding fresh food) for the fiscal 2024-2025 period is below 2%. (The forecast is for CPI growth of 1.9% in FY2024 and 1.6% in FY2025.)

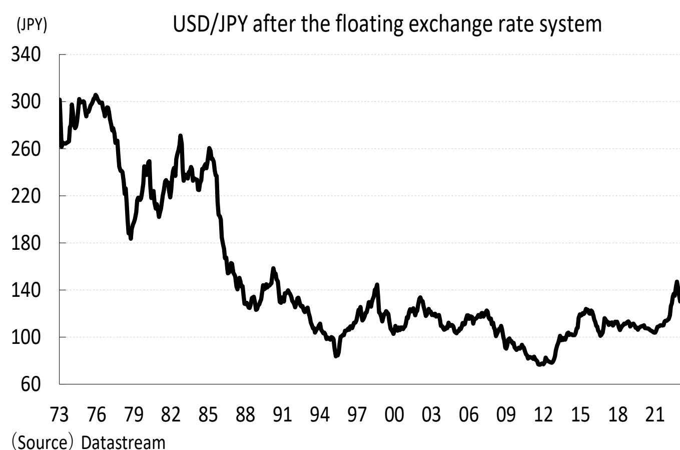
On the other hand, many of the "indices for capturing the underlying inflation rate" separately announced by the BOJ are clearly on an upward trend (see graph). What kind of speculation is the BOJ's stance toward Japan's current inflation situation likely to inspire among overseas forex market players not very familiar with Japan's economic and financial situation? The simplest assumption is that a "decline in JPY purchasing power due to inflation" concept may become a market moving theme that promotes JPY selling. Currently, when accelerating inflation is confirmed in other countries, the forex market has a standard "interest rate hikes → relevant currency buying" reaction that is implicitly based on the premise that inflation will not become uncontrollable because the central bank will respond quickly by raising interest rates. In the case of Japan, however, since the BOJ cannot be expected to react quickly by raising interest rates, it is easy for the forex markets to anticipate a "high inflation → lack of response → relevant currency depreciation" scenario. The BOJ's dovish information dissemination is likely to be considered a factor justifying JPY selling based on speculation that the Japan-overseas interest rate gap will widen, but on a more-fundamental level, JPY selling may also be justified based on speculation that the BOJ's ability to control inflation is questionable.

The statements made by the central bank leaders at the Jackson Hole Economic Policy Symposium were all somewhat similar, and I felt that the non-Japanese leaders were emphasizing that they were keenly recognizing their respective inflation-related challenges and resolutely dealing with them. However, BOJ Governor Ueda was exceptional in his lack of a sense of urgency. Although I would not go so far as to assert that this is the fundamental cause of JPY's current trend of increasing weakness, it is certainly a factor related to that weakness.

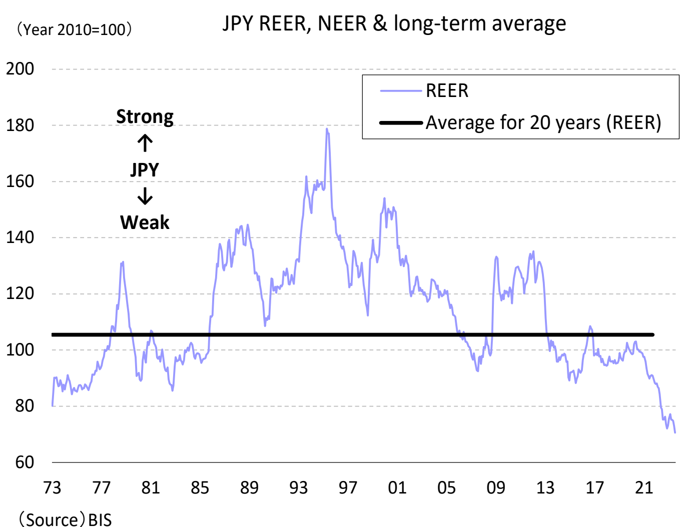
Risks to My Main Scenario – "Non-Invested-Cash Risks"

Japanese Households Face "Non-Invested-Cash Risks"

There is an increasing number of news media reports about the Kishida administration's "asset management nation" concept, which aims to expand Japanese households' income from financial assets by improving household asset management methods. As Japan's NISA system's tax-exempt investment limits are to be significantly expanded from 2024, many households are likely to begin deciding to take more responsibility for proactively managing their assets. On August 19, the Nihon Keizai Shimbun posted an article entitled "Cash and Deposits to Decrease 20% in 10 Years? Growing Inflation-Related Risks", which highlights the risks faced by Japanese households that hold the bulk of their assets in JPY cash and deposits. On August 21, the Nikkei Shimbun featured a similar article entitled "Opportunity Losses Amounting to JPY2,000 Trillion: Asset Management Nation Concept Promotes 'Asset-Growth Culture'". Institutional investors are conscious of the risks associated with needlessly holding cash and often seek to minimize the share of their assets in the form of cash, but Japan's household sector still has a strong sense that having a lot of cash gives one peace of mind. As discussed below, however, Japanese households taking the putatively "safe" path of keeping the bulk of their assets in JPY cash and deposits have recently seen a significant drop in the value of their assets in terms of USD, and this seems likely to promote greater recognition among those households of the potential impact of "non-invested-cash risks". As is well known, the "history of USD/JPY" has basically been a "history of JPY appreciation" (see graph on previous page). Therefore, if one considers exchange rate fluctuations alone, holding JPY in cash and deposits may appear to have been a wise asset management method. As the history of JPY appreciation was also a history of deflationary trends in Japan, the theory that holding JPY in cash and deposits seemed to be quite valid.



(Source) Datastream



(Source) BIS

In 2022, however, JPY depreciated by as much as 30% against USD and by as much as 18% against EUR. For the full year, JPY was down 12% against USD and 7.5% against EUR. Looking at the past three full calendar years (from the end of 2019 to the end of 2022), one finds that JPY depreciated 17% against USD and 13% against EUR. The marked rise in Japanese prices of goods and services related to daily life since the beginning of this year clearly reflects this trend of JPY depreciation. This situation presents Japanese households with an additional opportunity to realize the significance of "non-invested-cash risks".

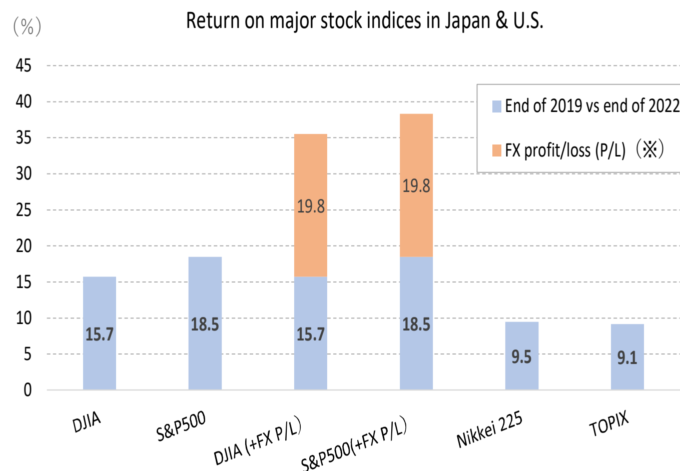
As this article has discussed many times in the past, JPY has become considerably less likely to appreciate against USD since around 2012, which happens to be the roughly the time when Japan stopped regularly recording annual trade surpluses. It was around 10 years ago that JPY exchange rate trends began undergoing a structural change, and in recent years, my hypothesis is that a combination of such "new era deficits" as those associated with digital services and consulting and research and development activities have further promoted JPY depreciation. Note that the above-mentioned JPY exchange rate trends are in nominal terms – on a real basis that takes price differences into account, JPY has been depreciating even more. JPY's real effective exchange rate (REER), which takes into account the difference between prices of domestic and foreign goods, fell 14% in 2022. The REER has continued to decline since then, and its level as of July 2023 (70.24, with 100 representing the 2020 average) was the lowest recorded in half a century (since August 1971).

"Stock Price Deterioration" + "Currency Depreciation"

When considering the management of Japanese household assets, it is important to keep in mind that the deterioration of Japanese assets is not limited to the currency category. Within its headline, the above-mentioned Nikkei Shimbun article cited the exaggerated figure of JPY2,000 trillion in opportunity losses. Leaving aside the issue of the optimal method of estimating opportunity losses, it is clear from a brief review of movements in U.S. stock prices and USD/JPY that those holding JPY in cash and deposits were exposed to a considerable "non-invested-cash risk" and those investing in Japanese stocks were unable to achieve the returns they would have realized had they invested in U.S. stocks. During the past three years (2019-2022), Japan's Nikkei Stock Average Index and TOPIX rose about 9%, while the U.S. Dow Jones Industrial Average and S&P 500 Index grew at about double that rate (15% to 18%). Moreover, if Japanese had invested in such major U.S. stock indices without hedging the associated forex

risk, they would also have realized forex gains due to JPY's depreciation against USD (see graph). In fact, the forex gains would have exceeded the stock price gains, as the rate of change in USD/JPY has been greater than that in stock prices over the past three years. The year 2022 was exceptional in that the major U.S. stock indices were in a correction phase while many investors would opine that investments in Japanese stocks were boosted by foreign exchange gains.

The inferiority of Japanese stock price performance compared to U.S. stock price performance is a reality that has existed for many years, but it was not considered particularly problematic, probably because there is little impact on most people's daily lives when their country's stock price trends are significantly inferior to those in other countries. However, forex trends do directly impact ordinary people's daily lives. When a country's currency depreciates against a foreign currency, people cannot claim that it doesn't matter because they themselves don't travel abroad, as the depreciation will, via import prices, have an impact on domestic prices. Mild bouts of JPY depreciation have been absorbed by Japan's corporate sector and did not cause significant pain to the country's household sector, but the large degree of JPY depreciation seen in a short time period since 2022 will inevitably force the corporate sector to pass the higher prices they pay on to consumers. Now that the higher prices stemming from JPY depreciation are being passed on in this way, the household sector is positioned to easily perceive the risk of not owning asset classes other than JPY cash and deposits (foreign currency-denominated assets).



(Source) Bloomberg (Note) FX P/L shows the % change in USD against JPY from the end of 2019 to the end of 2022.

Any Point in Awaiting a U.S. Interest Rate Cut?

Every time the BOJ updates its quarterly flow of funds statistics, this article has used the latest figures to argue that "household JPY selling" is the biggest risk facing the Japanese economy. As of March 31 this year, JPY cash and deposits amounted to JPY1,100 trillion, accounting for 54% of total household financial assets (JPY2,043 trillion). Following successive interest rate hikes in the United States, even one-year USD time deposits can earn interest rates of 4-5% (rates and other conditions differ from bank to bank), but Japanese households' largest asset class is still the one with no significant interest rate – JPY cash and deposits. Now that the purchasing power of JPY has fallen by as much as 30% against that of USD during the past 18 months, it would not be surprising to find that even the most conservative Japanese households have begun considering shifting from JPY to foreign currencies. There is no sign of an end to the frequent hikes of consumer goods and services prices that are constantly reminding Japanese about JPY's weakness. Many professional economists and other experts are anticipating that the next big change in the global economy may relate to the U.S. economy entering a recession, causing a decline in U.S. interest rates, and are suggesting that one should wait until then to draw conclusions about longer-term forex trends. However, the key question is whether, if the U.S. economy enters a recession and U.S. interest rates are cut as a result, JPY will really realize significant appreciation against USD. Of course there is likely to be some JPY appreciation against USD at that time, but in light of the increasing foreign currency outflows from Japan stemming from the balance of trade in goods as well as the balance of payments for services, is there any chance of USD/JPY returning to its former JPY100-120 range? I have been arguing for some time that a return to the previous range is unlikely. Although this article is anticipating that discussions about and expectations regarding U.S. interest rate cuts will emerge over the next year, I still believe it is unlikely that such developments would depress USD/JPY to below the JPY130 level. If JPY's depreciation is protracted for a long time, an increasing number of Japanese are likely to abandon their optimistic perspective on JPY and begin shifting to foreign currency investments. Depending on the scale and pace of that shifting, the trend could well develop into a major risk factor promoting JPY weakness.

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."

Key Issue Not Nominal Exchange Rates but Prices of Goods and Services

For the sake of argument, let us assume that forex history is greatly rewound and USD/JPY returns to the JPY100-120 range. Even such a case would represent a major change relating to the nominal forex rate-based world, while the real forex rate-based world would be a different story. In January of this year, for example, USD/JPY fell to the JPY127 level, which was the lowest level since the beginning of 2023 and represented a 16% drop from levels

around JPY152 last November. JPY had appreciated 16% at that time in nominal terms. However, during the same period (October 2022 to January 2023), JPY's REER recovered by only 7.1%. Even if JPY recovers in the nominal world, Japan's inferior price environment in the real world will not be easily corrected. For example, a 500ml bottle of mineral water currently costs $2-3 in New York (please point feel free to point out any misunderstanding I may have about this statistic), while the same bottle costs only around JPY100 in Japan. While this mineral water example may be an extreme case, it is still noteworthy that even if sharp JPY appreciation brings USD/JPY down to JPY100, the price of mineral water in the United States will still be two to three times higher than it is in Japan.

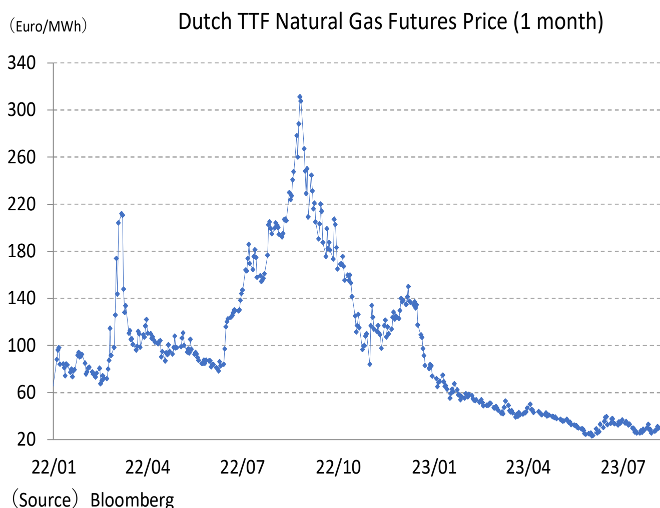
In other words, the real issue is not the nominal exchange rate level, but the difference in the prices of goods and services. That difference in prices reflects U.S.-Japan wage disparities that would be difficult to shrink. It is natural that the prices of goods and services provided in and from countries with wage levels higher than Japanese levels will be more expensive, and when Japan imports goods from overseas, it ends up being forced to pay for the wage disparities. This is the true reason why JPY is at its weakest level in half a century on a real (≈ REER) basis. Given the unlikelihood that Japanese wage levels will significantly rise anytime soon, it is only natural for more Japanese households to consider hedging at least the portion of their nominal exchange rate-based losses through foreign currency investments. The greater the growth in awareness of "non-invested-cash risks", the greater the likelihood that the shift toward foreign currency investments will become an major trend. It bears keeping in mind that Japanese tend to adopt standards of behavior based on "what everyone else is doing" rather than on rational analyses, so there may be a tipping point at which there is a sharp surge in the trend. Although we have not yet been able to measure the trend's scale in the BOJ's flow of funds statistics, we are starting to see media articles and other phenomena that indicate the trend is growing. Once again, it is important to note that, depending on the scale and pace of the household financial assets shift, the shift could directly create the risk of an unprecedented degree of JPY depreciation.

EUR Outlook – Euro Area Economic Slump to Promote EUR Selling?

EUR Area Monetary Policies Now and Going Forward – Is Reinvestment Flexibility Sustainable?

ECB Progressively Restructures Its Government Bond Holdings

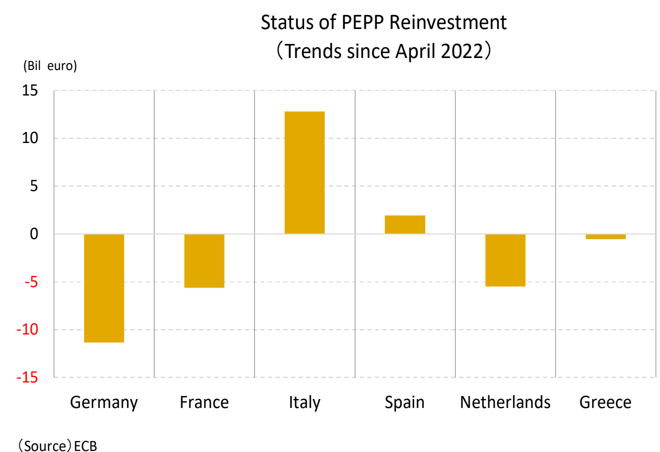
During August EUR trended weaker. There were also some interesting news items. On August 9, it was reported that the price of natural gas traded in Europe soared 40% in one day, reflecting growing concerns about supply constraints due to strikes at some LNG facilities in Australia. So far, such developments have served as reminders that Europe may face another energy crisis this winter but have not triggered significant EUR selling. Most importantly, it should be noted that recent natural gas price levels are not at all comparable to those reached during the sharp rise in such prices seen last year (see graph). If natural gas prices continue to rise, however, they may emerge as a major theme in the forex market affecting EUR. The euro area's real economy is clearly falling behind those of Japan and the United States, and if Europe is once again hit by a surge of inflation rates owing to energy prices, the ECB's current difficulty in deciding whether to emphasize supporting the economy or restraining inflation will become even more serious.



（Source） Bloomberg

As increasing attention becomes focused on the ECB's monetary policy management, issues related to the ECB's holding ratios with respect to individual countries' government bonds (which I have been highlighting for some time) are inevitably becoming a point of contention. In this regard, figures on ECB purchases of individual countries' government bonds under the Pandemic Emergency Purchase Programme (PEPP) as of the end of July were announced in August, and it is worth overviewing the current situation based on those figures. As is generally understood, the reinvestment of assets purchased through the ECB's regular asset purchase program (the Asset Purchase Programme (APP)) was suspended in May, while the reinvestment of assets purchased under the PEPP is continuing. Moreover, rather than just reinvesting funds from redeemed assets in similar assets, the ECB has adopted an irregular approach of allocating proceeds from the redemption of German and French government bonds to purchases of Italian and Spanish government bonds. This irregular approach, which the ECB calls "applying flexibility to reinvestments", is essentially a debt relief scheme for euro area countries seen as particularly vulnerable to rising interest rates.

New asset purchases through the PEPP were suspended at the end of March 2022, and the policy of applying flexibility to reinvestments of funds from the redemption of assets purchased under the PEPP was approved at the June 2022 extraordinary Governing Council meeting. So a full year has passed since the decision was made to make reinvestment more flexible, and the results can be clearly seen in the graph on the right. The net result of purchases and sales of government bonds through the PEPP during the period from April 2022 through July 2023 was to decrease PEPP holdings of German and French bonds EUR11.4 billion and EUR5.6 billion, respectively, and increase PEPP holdings of Italian and Spanish bonds EUR13 billion and EUR2 billion, respectively. <u>Over the past year the ECB has essentially been swapping German and French bonds for Italian and Spanish bonds</u>. At least from the point of view of people in Germany and France, it seems that the associated funds have been handed over to Italy and Spain free of charge.

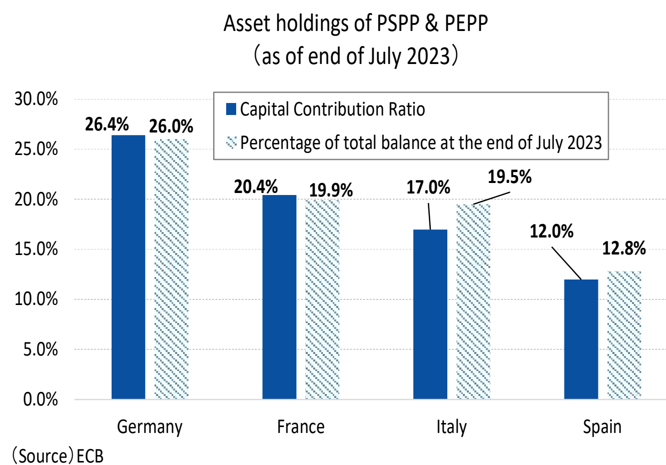


(Source) ECB

Italy Catches Up with France in Terms of ECB Government Bond Holdings

As a result of the PEPP reinvestment flexibility, the ECB's overall holding ratios for individual countries' government bonds will shift in a similar way. The ECB's government bond holdings include bonds purchased through the PEPP as well as those purchased through the public sector purchase programme (PSPP) within the APP. The graph on the right shows individual countries' government bonds purchased through both PEPP and PSPP as shares of the ECB's overall government bond holdings as well as the percentage of capital that each country has contributed to the ECB (the capital key).

In principle, the ECB seeks to make the share of purchases of individual countries' assets correspond to the capital key but, as of July 31, ECB holdings of German and French government bonds were 0.4 percentage point and 0.5 percentage point, respectively, below the capital key ratios, while holdings of Italian and Spanish government bonds were 2.5 percentage points and 0.8 percentage point, respectively, above the capital key ratios. As a result, the share of the ECB's total government bond holdings accounted for by French bonds (19.9%) and Italian bonds (19.5%) were almost equal. The ECB holding ratio gap between the countries is even smaller if one focuses only on assets purchased under the PEPP (France 19.7% and Italy 19.5%).



(Source) ECB

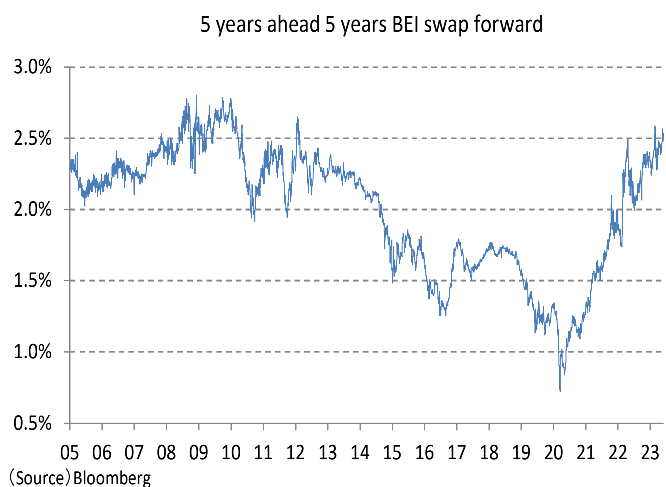
The flexible reinvestment policy is essentially providing debt relief to vulnerable countries, and the longer it continues, the more deviation it will cause from the capital key ratios, which is bound to cause frictions within the Governing Council. It is probably only a matter of time before the ECB's holdings of Italian bonds actually exceed its holdings of French bonds. It is fundamentally important for the ECB to implement policies designed to be optimal for the euro area's overall economic and financial situation and, ideally, no special significance should be attached to the precise levels of ECB government bond holding ratios, but it is also true that France appears to be displeased with the recent trend, and Germany appears to have grounds for being equally displeased. Curbing the progressive deviation of ECB government bond holding ratios from capital key ratios will require the discontinuation of the flexible reinvestment policy.

Given that the purpose of making reinvestments flexible is to protect fragile countries from the impact of interest rate hikes, and considering the fact that the deterioration of the euro area's real economy is increasingly evident, efforts to reduce distortions associated with flexible reinvestments may promote reevaluation of the ECB's interest rate hike policy itself. If the recent natural gas price upsurge is rolled back, the euro area consumer price index (HICP) continues gradually decelerating, and the euro area economy slowdown persists, the ECB may finally consider itself to be positioned to halt its interest rate hikes. In light of the current situation, it appears that the likelihood of such a scenario may be increasing. However, one still wonders if the situation can actually be resolved in such a straightforward manner. Just as last year, it can be said that natural gas price movements are likely to be a key basis for forecasting prospective ECB policies along with major trends in the euro area economy.

Euro Area Economy and EUR Now and Going Forward – Phillips Curve Evolution and Economic Weakening

Potential Acceleration in Euro Area Inflation

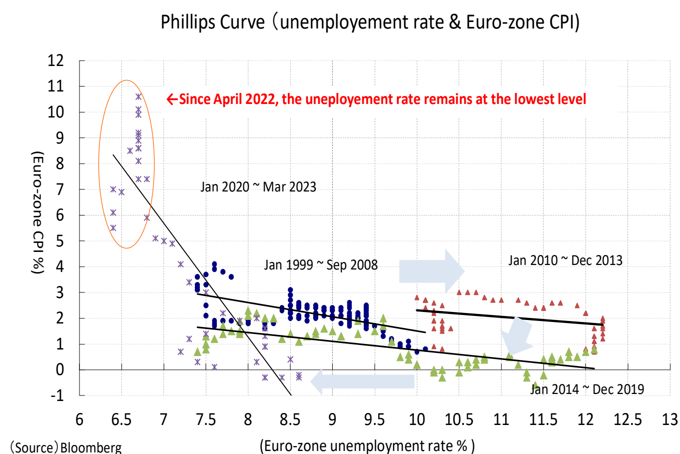
The monthly report of Germany's Bundesbank released on August 12 includes the sentence – "the impression took hold that inflation rates will nonetheless persist for longer above the rates targeted by central banks." – and that sentence applies to the euro area as a whole. The report goes on to note that labor markets continued to be tight and wage growth continued to be strong, and that the ECB's 2% inflation target was not being referenced in the wage determination process. It points out that this wage growth is – "a key reason the inflation rate is likely to stay above 2% for longer." – and that – "It also appeared that no further relief [regarding inflationary pressures] was forthcoming from commodity markets[.]" Overall, the Bundesbank report reconfirms that inflation rates remain high in Germany as well as the rest of the euro area. As this monthly article has reported, the euro area's headline HICP growth rate is indeed clearly declining, but the growth rate of core HICP remains high and has shown almost no decline. As pointed out by the Bundesbank, the persistent strength of labor markets and lack of deceleration in wage growth are key factors keeping the core HICP inflation rate high. Furthermore, the five-year in five years inflation swap break-even inflation rate (5-year BEI, see graph) that the ECB has traditionally emphasized shows no signs of descending and in fact appears likely to continue rising (see graph). Even this index alone suggests that the ECB's fight against inflation is still in its early stages. Looking at these situations, I do not get a sense that the ECB will shift to more-dovish policies in the near future.



(Source) Bloomberg

Possibility that Phillips Curve Shapes Indicate Structural Changes

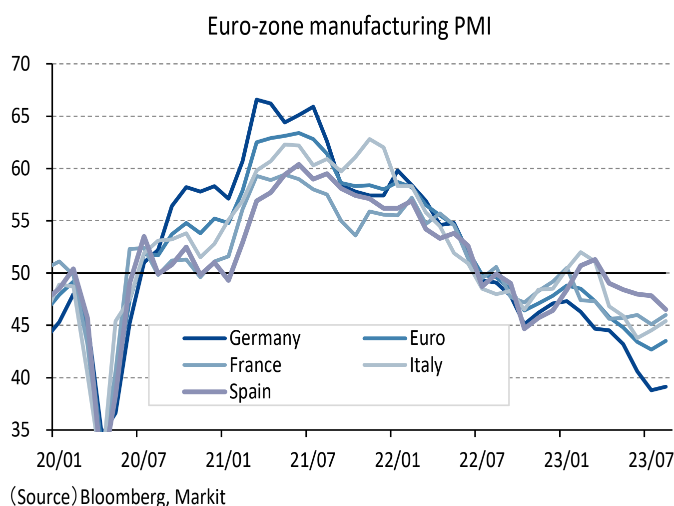
Unemployment rates in the euro area remain at record low levels. The latest euro area (20 countries-basis) unemployment rate figure available, for June, was 6.4%, which is the lowest on record, and the rate has been sustained at roughly this level since April. In fact, record low unemployment rate levels have been sustained since April and there is no sign of an end to this trend. Under these circumstances, although there has been a noticeable decline in headline HICP growth rates reflecting effect of falling energy prices, the deceleration of core-basis HICP growth rates has halted recently and those rates remain high. The Bundesbank has stated in its latest monthly report that – "high wage settlements are expected in the coming months". Given that wages will continue to rise for the time being, it can be expected that the euro area's Phillips curve will become closer to vertical (see graph) and may retain that shape for some time to come.



The graph on the right shows how the euro area Phillips curve's shape has changed during various historical periods since the launch of EUR, and it is noteworthy that the shape for the past three-year period (encompassing the pandemic period) is quite different than the shape for the previous ten-year period. It will not be possible for quite some time to confidently answer the question of whether the current shape should be considered a transient one stemming from extraordinary pandemic-related conditions (and liable to return to normal) or should be viewed as representing a genuine structural change. The ECB is seeking to lower inflation expectations and thereby promote greater economic stability, and from its perspective, the current employment and wage situation will undoubtedly make discontinuing the policy of progressively hiking interest rates more difficult.

PMI Deterioration Perhaps Welcome from ECB's Perspective

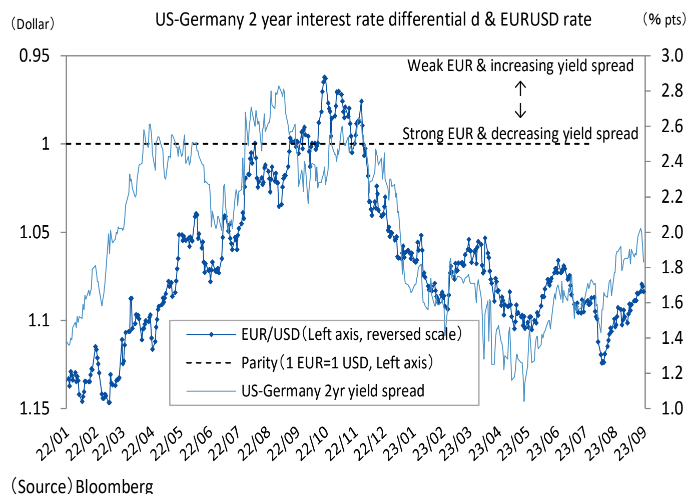
Amid the continued tightness of labor markets and robustness of wage growth, business sentiment is definitely weakening, and this was generally reflected in the euro area Purchasing Managers' Index (PMI; composite-basis, preliminary) figures for August. In particular, the headline service industry PMI fell from 50.9 to 48.3, not only falling below median market expectations (50.5), but also descending below 50 (the dividing line between perceptions of economic expansion and contraction) for the first time this year. This result inspired intermittent EUR selling. On the other hand, given that the increasing tightness of employment and wage markets has been presenting perhaps the largest challenge to the ECB's policy management, the deterioration of service industry business conditions could also be viewed as a positive factor. If the service sector PMI were to suggest continued strong service industry growth, the ECB's uncertainty about whether it should emphasize its response to economic deceleration or its response to the acceleration of inflation would be further exacerbated.



In contrast to the conspicuous downturns in the composite and service industry PMIs, manufacturing PMIs are showing signs of bottoming out (see graph). This might seem to be cause for concern with respect to the curbing of inflation, but there appears to be little basis for such concern given that the manufacturing PMIs of all the major euro area countries remain below 50. The weakness of business confidence in all euro area industries seems liable to increase the likelihood that the ECB will reconsider its policy of raising interest rates. Moreover, as the graph shows, the manufacturing PMI in Germany is particularly low, and Germany's huge presence within the euro area makes it quite possible that the dismal state of German business confidence will have a negative impact on business confidence through the entire euro area by the end of the year. The forecasts within the latest edition of the IMF World Economic Outlook (released on July 12, 2012) anticipate that Germany's will be the only G7 economy to fall into a recession, and it now appears increasingly likely that that those forecasts will turn out to be correct.

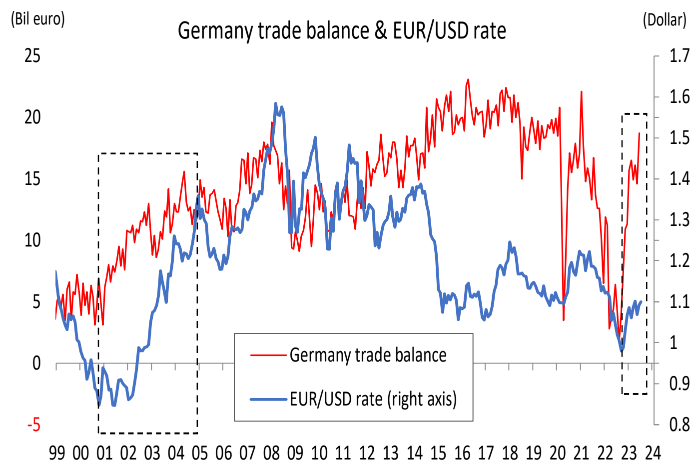
Euro Area Economic Deceleration Likely to Promote EUR Selling?

However, one should to a certain extent separate one's evaluations of the unfavorable euro area economic outlook and the outlook for EUR. It is true that EUR is liable to weaken when the ECB's interest rate hikes are discontinued. A significant slump in the euro area's real economy will be a major justification for suspending the interest rate hikes, and there is an undeniable possibility that the September ECB Governing Council meeting may decide to at least pause the hikes. The background factors leading to this article's downward revision of its EUR exchange rate outlook include the slump in the euro area's real economy, particularly as that slump may affect interest rates. The ECB and the Fed are in a similar situation insofar as they are implementing interest rate hikes while closely monitoring economic conditions so they can adjust their interest rate policies if economic conditions make such adjustment necessary. However, while a U.S. recession anticipated by many financial market players has not yet eventuated, Germany has already realized a technical recession (by recording negative growth in the fourth quarter of 2022 and first quarter of 2023, although it recorded roughly zero growth in the second quarter of 2023). The clear contrast between economic conditions in the United States and those in the euro area (centered on Germany) suggest that prospective trends in U.S.-Europe interest rate differentials may well make EUR/USD more prone to weakening going forward (see graph).



(Source) Bloomberg

However, it should not be overlooked that the slump in the euro area's real economy may help improve the EUR supply-demand environment. Intuitively, it seem reasonable to anticipate that economic sluggishness accompanied by weak domestic demand will alleviate concerns about a prospective rise in natural gas prices, which presented the euro area with major challenges last year. Natural gas prices have currently fallen nearly 90% from their peak levels in 2022, and this situation is helping improve the performance of the international economic sectors of Germany and other euro area countries. This article has repeatedly argued that EUR's fall below parity with USD last year was a direct result of Germany's worsening trade balance. Germany recorded a trade deficit for May 2022 on a preliminary basis (although it was corrected to a slight surplus on a confirmed basis), and EUR's fall below parity began soon after that. Since the beginning of 2023, however, Germany has increased its trade surpluses back to recent peak levels, and one gets the strong impression that EUR/USD has responded to this trend (see graph). Furthermore, the ongoing downtrend in Germany's domestic demand is likely to lead to declines in imports of items other than fuel, and that will theoretically contribute to further improvement in the country's trade balance. This article is basically assuming that EUR will recover, largely based on anticipation of the effects of improvement in the EUR supply-demand environment.



(Source) macrobond

Daisuke Karakama
Chief Market Economist
Derivatives & Forex Department
Mizuho Bank, Ltd.
Tel: +81-3-3242-7065
daisuke.karakama@mizuho-bk.co.jp

These materials and the content of any related presentation are confidential and proprietary and may not be passed on to any third party and are provided for informational purposes only. Assumptions have been made in the preparation of these materials and any such presentation and Mizuho Bank, Ltd. ("**Mizuho**") does not guarantee completeness or accuracy of, and no reliance should be placed on, the contents of these materials or such presentation. Nothing in these materials or any related presentation constitutes an offer to buy or sell or trade and the terms of any transaction which may be finally agreed will be contained in the legal documentation for any such transaction, with such transaction being priced at market rates at the relevant time (the rates herein or in any related presentation being purely illustrative). (As a general rule you will not have a right to terminate early any transaction entered into – if you wish to do so, losses may be incurred by you.) These materials and any related presentation should not be considered an assertion by Mizuho of suitability for you of any transaction, scheme or product herein or therein. Mizuho has no duty to advise you on such suitability, nor to update these materials or contents of any related presentation. You must determine in your own judgment the potential risks involved in the transactions outlined herein or in any related presentation (taking professional financial, legal and tax and other advice) and whether or not you will enter into any transaction that may arise from these materials or related presentation. Nothing herein or in any related presentation should be construed as providing any projection, prediction or guarantee of performance or any financial, legal, tax, accounting or other advice. Mizuho shall have no liability for any losses you may incur as a result of relying on the information herein or in any related presentation. "MHBK provides this information for free. Please request for cancellation of subscription if you do not want to receive free-of-charge information from MHBK."