Forex Medium-Term Outlook

September 29, 2023

MIZUHO

Overview of Outlook

USD/JPY continued to soar in September, renewing the year-to-date high intermittently. Some media reports raised expectations of the abolition of negative interest rates by the BOJ, but in the event, the BOJ dismissed the possibility following its Monetary Policy Meeting (MPM). Even if negative interest rates were to be abolished, it would only happen after the results of next year's spring offensive have been confirmed. It would also require a set process to be followed, including the acknowledgment of harm due to negative interest rates following the ongoing "Monetary Policy Review from a Broad Perspective." The process is expected to take at least another year. Moreover, from the perspective of this report, which has contemplated the USD/JPY outlook based mainly on JPY supply and demand, Japan's trade balance climate is more important than any minor increase in the JPY interest rate due to the abolition of negative interest rates. An improvement in the trade balance this year was premised on an improvement in JPY rates and crude oil prices compared with last year. In reality, however, both JPY weakness and crude oil prices have accelerated yoy, and the odds of imports ballooning all over again are quite high. This is compounded by the fact that exports, led by exports to China, are beginning to slow down, giving rise to the prospect of an expansion in Japan's trade deficit both due to imports and exports. Taking such circumstances into account, I have decided to push back my predicted timing for the bottoming out of the weak-JPY trend from January-March 2024 to April-June 2024. Meanwhile, predictions of 2024 being a year of rate cuts for the Fed seem likely to gather steam, but one is also reminded that, at the end of 2022, most analysts were predicting JPY appreciation in 2023 based on the assumption of Fed rate cuts. In this report, my prediction is that the Fed will begin discussing rate cuts around October-December 2024. However, that by itself is unlikely to tilt the JPY supply-demand balance away from a net sale of JPY.

EUR depreciated consistently in September as several reasons to sell EUR arose. For one, the euro area has the most conspicuously deteriorating real economy among the three key economic regions (U.S., euro area, and Japan); for another, this prompted the ECB to respond with a de facto interest rate hike suspension. However, now that the ECB has announced a de facto interest rate hike suspension, the focus will shift to whether it can, indeed, make do without raising interest rates. As the increase in crude oil prices gains momentum, does the ECB really stand a chance of containing inflation rates at around 2 percent? If, for instance, another acceleration in the core Harmonized Index of Consumer Prices (HICP) is confirmed, would there not be a renewed awareness within the ECB of the need to control inflation? The possibility of the ECB returning to its rate-hike path cannot be ruled out altogether, and the long-awaited forward guidance inserted recently could end up becoming a dead letter. Going forward, if the ECB resumes rate hikes, and the markets become aware of an increasing EUR-USD interest-rate differential given that the Fed has already decided to end its rate hikes, EUR rates could increase as investors are lured by the prospect of better interest rates. Meanwhile, Germany, though performing so poorly as to be dubbed the "sick man" of Europe, still seems guaranteed to post a trade surplus. Given that EUR rates are stably correlated with German as well as overall euro area trade balances, I do not expect to see the currency crash or fall below parity. A downward revision of the outlook, however, seems justified.

Summary Table of Forecasts

	2023 Jan -Sep (actual)	Oct-Dec	2024 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	127.22 ～ 149.71 (149.38)	148 ～ 152 (150)	150 ～ 155 (153)	147 ～ 153 (148)	145 ～ 151 (147)	141 ～ 147 (144)
EUR/USD	1.0482 ～ 1.1276 (1.0565)	1.04 ～ 1.09 (1.07)	1.05 ～ 1.10 (1.07)	1.04 ～ 1.10 (1.06)	1.05 ～ 1.11 (1.07)	1.06 ～ 1.12 (1.09)
EUR/JPY	137.45 ～ 159.76 (157.82)	156 ～ 164 (161)	159 ～ 168 (164)	155 ～ 163 (157)	155 ～ 164 (157)	156 ～ 165 (157)

(Notes) 1. Actual results released around 10 am TKY time on 29 SEP 2023. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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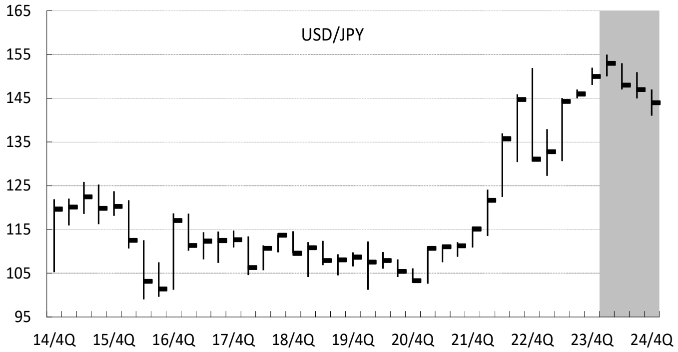
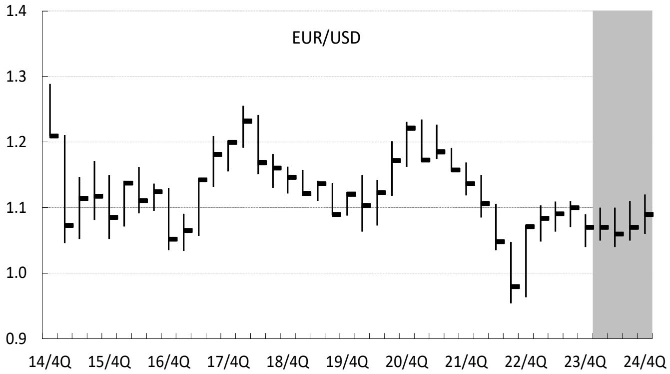
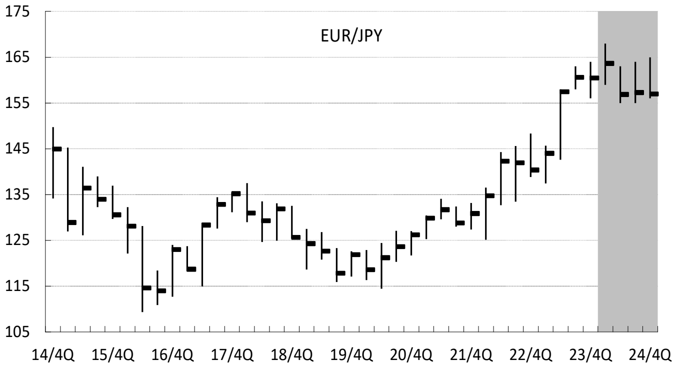
Exchange Rate Trends & Forecasts







USD/JPY Outlook – No Choice but to Sit and Wait for U.S. Economic Slowdown

Japanese, U.S., and European Monetary Policies Now and Going Forward – Trend of Negative Interest Rate Abolition

No Repeat of September 22, 2022

Japan's monetary policy remained unchanged following the September 22 BOJ MPM, and the eagerly awaited press conference by Governor Kazuo Ueda was also uneventful. In an interview published on September 9 in the Yomiuri Shimbun, Ueda said regarding the abolition of negative interest rates, "It is not impossible that sufficient information and data required to abolish negative interest rates may be gathered by the end of the year," triggering market speculation that negative rates could be abolished this year and a brief period of JPY appreciation. The monetary policy remaining unchanged was as per market predictions. As for the possibility of the Yomiuri Shimbun interview statement being reaffirmed at the press conference, opinions were split.

In the event, Ueda disavowed his previous statement about the possibility of abolishing negative rates this year with the statement, "The timing of policy revision or specific policy responses really cannot be pinpointed in advance," thereby putting an end to all the fuss. Precisely a year earlier, another BOJ MPM had been held, on September 22, 2022. After that meeting, which decided to maintain an accommodative monetary path, then BOJ Governor Haruhiko Kuroda exacerbated and accelerated the JPY depreciation trend by stating, "There will be no interest rate hikes for the next two or three years." Immediately after this, the government and Ministry of Finance implemented a currency intervention by buying JPY and selling USD, giving rise to conjectures that Kuroda's statement may have been a trap to burn off speculative JPY selling. This time, again, the continuation of monetary accommodation led many to be wary of a repeat of September 22, 2022, but JPY depreciation following the meeting was relatively mild, and a major incident was avoided.

Abolition of Negative Rates Has Become Easier to Discuss

To sum up the developments from the publication of the Yomiuri interview through Ueda's press conference, it would appear that Ueda was unhappy about speculations of an early monetary policy tightening and decided to put out the fire. However, with regard to the possibility of abolishing negative rates this year, the phrases "not impossible" and "cannot be pinpointed in advance" mean the same thing in practice. Further, it is not clear what context led Ueda to make his interview statement. It is quite possible that, from his own perspective, the governor does not view his statement at the press conference as particularly different from his statement in the interview. Having stated that policy responses and timings cannot be pinpointed in advance, Ueda went on to say, "If I were to say from my position as the governor that there is no such possibility (*of abolishing negative rates) this year, that would severely restrict discussions at every MPM going forward. My statement, therefore, was phrased in such a way as to avoid saying it." [*Portion within parentheses is my insertion.] It, therefore, seems quite likely that both the reporting of his statement and the interpretation of his comment may have been exaggerated (which happens quite frequently).

Having said that, an outcome of the recent fuss over Ueda's statement seems to be that <u>the abolition of negative interest rates in the near future has become a more realistic prospect for a larger number of market participants</u>. The most important and challenging thing when it comes to discussions surrounding policy normalization is ensuring that they do not shock the markets at the initial stage. Thanks to the recent exaggerated interpretation of the governor's statement on the part of the markets, discussing the abolition of negative rates going forward may have become less difficult.

No Choice but to Sit and Wait for U.S. Economic Slowdown

Further, though JPY depreciated only mildly following the MPM, USD/JPY remains at year-to-date high levels. Amid this chronic JPY weakness, the BOJ will continue to find itself in an extremely tight position when it comes to monetary policy operation. As I have argued in past issues of this report, <u>forecasts regarding the outcome of BOJ MPMs going forward will have to factor in some amount of pressure from the markets for the bank to respond to JPY weakness</u>. If markets assume that a continuation of the status quo will lead to JPY selling and that even measures to tighten the monetary policy will be insufficient to curb the trend, then JPY *will* continue to be sold. Speculative traders who sell JPY to urge the BOJ to tighten monetary policy may be blessed with profit opportunities if they switch to buying JPY at the right time just as the BOJ decides to actually implement monetary tightening (if the tightening is accompanied by currency intervention, the speculators could profit even more). So long as JPY remains weak, the BOJ will be faced with an onerous situation where every MPM turns into a "live meeting." In the past, under former governor Masaaki Shirakawa, the BOJ ended up depleting all its options for monetary easing in responding to persistent JPY strength; the Ueda administration faces the risk of running out of monetary tightening options.

<u>Japan at the moment is faced with a combination of negative policy interest rates, a negative trade balance (deficit), and probably a negative current account balance when viewed on the basis of cash flows, so one is compelled to admit that the current JPY weakness is a market trend that reflects the economy's fundamentals</u>. Of course, it is a different question whether the 140-150 range is a fair reflection of JPY's value, but Japan does not have the means to reverse the weak-JPY trend, so <u>the best and only solution it may have is to sit and wait for the U.S. economy to slow down</u>. However, going by the dot plot pertaining to the September FOMC meeting, the majority view seems to be no more than 2-3 rate cuts by the Fed in 2024 (details later). If one assumes that there are three rate cuts, the options for timing are forecast to be June, September, and December, as per the Staff Economic Projections (SEP), if non-contiguous; or toward the end of the year, in September, November, and December, if contiguous. Based on the dot plot projections, rate cut discussions could begin in June 2024 at the earliest. My projection for the start timing of rate cut discussions is even later – sometime during the October-December quarter of 2024. At any rate, it falls during the second half of the current forecasting period, and the BOJ would have to bide its time while skillfully dodging the JPY depreciation pressure.

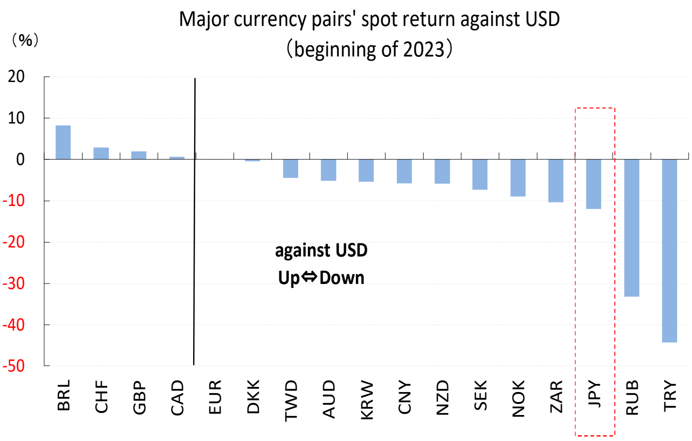
No Option but to Recognize Harm Due to Negative Rates

In the end, when can we expect to see negative rates abolished? The basic scenario may be as has always been expected – i.e., a decision could be made after seeing the results of the April 2024 spring offensive. However, right since the time of the Kuroda administration, the assumption has been that a wage rate hike commensurate with a 2% inflation target involves a 3% increase in basic salary. This year's spring offensive, while achieving an increase in wages higher than anything seen in the past 30 years, was still just over +2%. Spring offensive negotiations targeting large enterprises begin in February, with results including for small and medium-sized firms being finalized by the end of March. In other words, the consumer price index (CPI) taken into account for reference would pertain to January or February 2024. In this context, it must be noted that the core CPI for January 2023 was +4.2%, and the core CPI for January 2024 seems very likely to be roughly half that. As of the current time, therefore, it is difficult to incorporate the possibility of a 3% increase in basic salary following the 2024 spring offensive into one's main forecast scenario. If so, <u>it seems unrealistic to predict the abolition of negative rates half a year from now, given that the condition for such an abolition is the sustainable and stable realization of a 2% inflation target accompanied by an increase in wages.</u>

What could the BOJ do in this case? <u>If it proves difficult to realize the positive condition for the abolition of negative rates, i.e., an increase in wages, the only other option is to declare that a negative interest rate policy is harmful</u>. One can imagine an argument to the effect that a negative interest rate becomes a reversal rate and holds back real economic growth, and that Japan's negative interest rate is, in fact, weighing down on real economic growth via JPY depreciation and other factors. However, even if such a verdict were to be handed down, it would probably be after the results of the 2024 spring offensive have come out. Moreover, the second workshop on the ongoing Monetary Policy Review from a Broad Perspective, which was begun in July this year, is scheduled to be held in May 2024. A comprehensive discussion of all the cases analyzed until that point is expected to be held at the workshop. <u>If negative interest rates are to be abolished based on the recognition of their harmful effects, a good time for it might be around July 2024, when the Outlook Report taking into account the results of the Monetary Policy Review from a Broad Perspective is released.</u>

Misgivings Regarding JPY Seeping Through Forex Market Transactions

Looking at the rate of change against USD for major currencies, as of September 28, the only currencies that have fallen more dramatically against USD than JPY (-12%) are the Argentine Peso (ARS; -97%), Turkish Lira (TRY;-44%), and Russian Ruble (RUB; -35%). G7 currencies apart from JPY have either strengthened against USD (GBP, CAD, EUR), or remained level; and CHF, which has a similar standing, has also appreciated against USD. Considering that JPY is a G7 currency, the scale of its sale has been quite extraordinary, making it difficult to explain solely on the basis of the U.S.-Japan interest rate differential. Of course, it would not be fair to compare Japan to Argentina, with policy interest rates in excess of 100% as a measure to curb inflation, or Turkey, which continues to experience close to +60% yoy inflation rates.



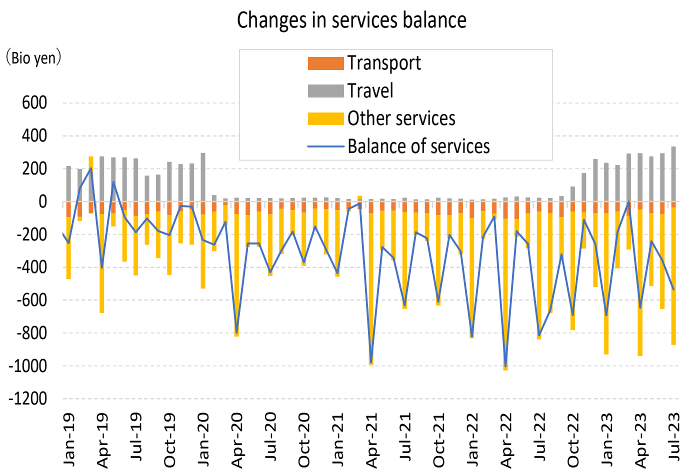
(Source) macrobond (Note) Up to 22SEP2022

In Japan, the flow of funds is still held up by the trinity of government, BOJ, and private banks, and (leaving aside whether this is a good or bad thing) this makes it difficult for interest rates to shoot up as in Argentina or Turkey. However, in contrast to the bond markets, the forex markets always go by instinct. From the perspective of foreign investors who do not really understand Japan's circumstances, the fact that the Japanese monetary authorities are persisting with negative interest rates despite facing an inflationary situation similar to the U.S. is sufficient reason to sell JPY. Moreover, if the BOJ doggedly maintains its accommodative monetary policy regardless of the level of JPY selling in the markets, there is no reason for such investors to lose in a big way by selling JPY. Japan's CPI aggregate for August, which was released the same day that the BOJ MPM was held, posted +3.2% yoy growth. While this is 0.1pp lower than the previous month's growth, it indicates the continuation of similar inflation levels as the U.S. The abolition of negative interest rates, therefore, is likely to be determined not in response to the good news of strong rise in wages following the spring offensive, but in response to the bad news of persistent JPY weakness.

JPY Supply and Demand Climate – Supply and Demand Remains Tilted Toward Net JPY Selling

Travel Surplus Finally Resembles That in 2019

Japan's July Balance of Payments, which was released by the Ministry of Finance on September 8, was reported widely as having posted the largest ever current account surplus for July, at +JPY 2.7717 trillion. The reasons for this expansion in the surplus included (1) the largest ever single-month travel surplus, (2) two consecutive months of trade surplus, and (3) the primary income surplus continuing to remain quite strong. Reason (3) above is a given in all discussions surrounding Japan's current account surplus, but the recent JPY depreciation appears to have further boosted the primary income surplus. With regard to (2), a respite in the JPY depreciation and high resource price trends resulted in an improvement in Japan's trade balance starting early this year, but this trend of an improvement in the trade balance boosting the current account surplus will not be easy to maintain from August onward due to various factors, including accelerated depreciation of JPY, stronger increase in crude oil prices, and a clear slowdown of the Chinese economy (details later).



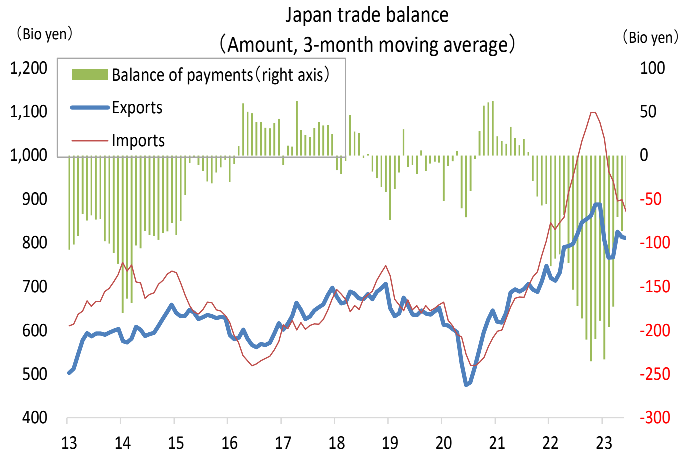
(Source) Bank of Japan

Reason (1), meanwhile, is worthy of special note. The travel surplus for July was +JPY 336.8 billion, which is the largest ever for a single month and the first time it has been over +JPY 300 billion. While this is merely the result for a single month, it is worth paying attention to as a symbolic milestone, in the sense that the numbers were higher than 2019, which was a peak year for tourism demand from foreign visitors to Japan. However, as I have argued in previous issues of this report, it must also be noted that, against the backdrop of the historical weakness of JPY, the amount spent by foreign tourists in Japan gets bulked up in JPY terms – this is similar to export firms posting higher sales in JPY terms despite their sales volume remaining the same. More accurately, in this case, the number of foreign visitors to Japan in July this year was under 80% of the number in July 2019, so the situation amounts to sales having increased despite the sales volume decreasing. Further, in addition to the JPY value of receipts from inbound tourism being bulked up due to JPY weakness, another reason for the travel surplus expansion is the fact that the number of Japanese people traveling overseas has not increased, which means that payments made by them abroad have not increased. In fact, in contrast to inbound tourism figures, the number of Japanese people traveling abroad in July 2023 (890K) was roughly half that in July 2019. This may be partly due to the fact that July was barely two months after the downgrading of COVID-19 to a Class 5 disease, but there is also a sense that overseas travel has become a luxury for Japanese people in view of the historical JPY weakness. At any rate, the record high travel surplus is significantly owing to JPY weakness.

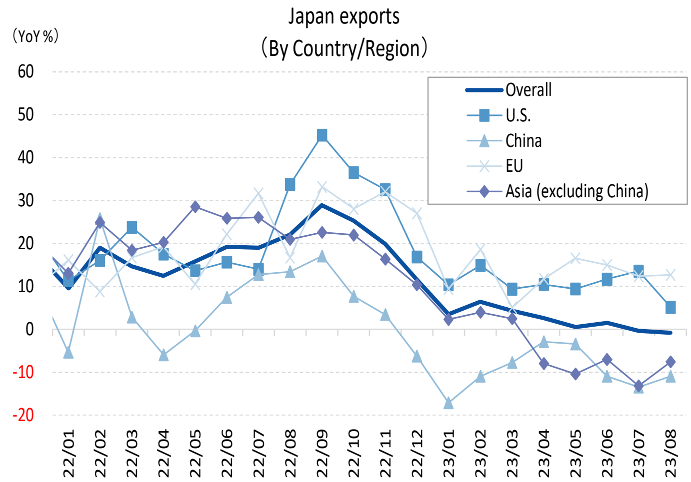
Further, as in other months, the July current account surplus is also largely based on a primary income surplus, which does not guarantee the generation of JPY-buying cash flows (CF) – a point I have explained several times, including in last month's issue of this report. As per my calculation, the CF-based current account balance for July is roughly JPY 600 billion smaller than the approx. JPY 1.4 trillion for June. This trend is not in conflict with the continuing JPY weakness in the forex markets. On the flip side of the consistent improvement in the headline current account balance, there is no significant change in the basic fact that more people want to sell JPY than those who want to buy it.

Unforeseen Crude Oil Price Increase & Negative Export Growth Continue

Going forward, the key statistic to watch out for will be the trade balance. Japan's August trade balance, released on September 20, posted a -JPY 930.4 billion deficit. Since July, two unforeseen developments have arisen in connection with Japan's trade balance. One is the slowing down of the Chinese economy, while the other is an increase in crude oil prices. The trend clearly strengthened from July through August. Looking at the seasonally adjusted figures for the August trade balance, while exports fell by -1.7% mom, imports fell by -2.1% mom, resulting in a contraction of the trade deficit, but this was due to the delayed impact of JPY appreciation and decline in resources prices seen since November 2022. However, JPY depreciation resumed and crude oil prices began to increase again starting March and late June 2023, respectively. It seems likely, therefore, that signs of trade deficit expansion will appear again before the end of the year as import prices increase. As for the other unforeseen development, namely the slowing of exports, exports to China have been posting negative yoy growth for nine months in a row, while Japan's global exports have also been posting negative yoy growth for two months in a row.



(Source) macrobond

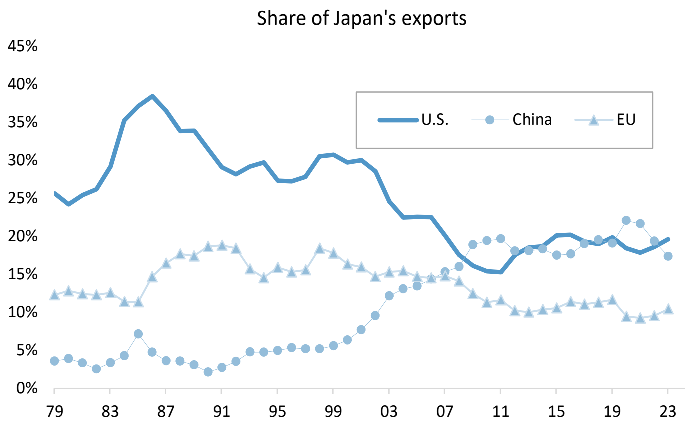


(Source) macrobond

However, as the figure to the right shows, exports to Asian regions other than China also posted negative yoy growth for the fifth month in a row, at -7.6% yoy, for August. Looking at figures by country, exports to Taiwan were down by -14.3% yoy, to South Korea by -10.8% yoy, to Singapore by -24.6% yoy, to Thailand by -4.5% yoy, to Malaysia by -17.4% yoy, and to the Philippines by -19.0% yoy, showing double-digit negative growth for most countries in Aisa. It seems clear that the continued monetary policy tightening by central banks in advanced countries are having ripple effects on Asian economies, weighing them down via a deterioration in their external demand climates. The sluggish growth in Japanese exports is not just owing to China.

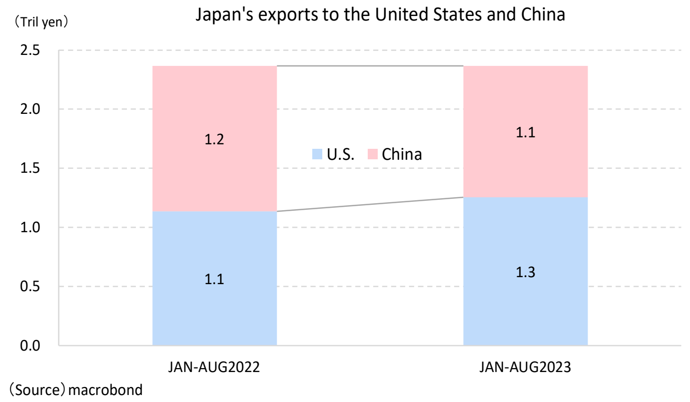
Whatever the Reason, Slowdown in Exports to China is a Factor of JPY Depreciation

Exports to China, which are drawing particular attention, are slowing down owing to a Chinese economic slowdown in the short term, but owing to the "decoupling" from China by Western powers in the medium/long term. In the recent past, political factors weighed down Japanese exports to China in August, with the Japanese government's tighter regulation of advanced semiconductor manufacturing equipment exports to China going into effect at the end of July, and China imposing stricter control on imports of Japanese marine products. Meanwhile, from the medium/long-term perspective, it could be said that the decline in exports to China is a part of the process of structural transformation and should be assessed positively. As the figure shows, Japan's exports to the U.S. and China have switched places when viewed in terms of cumulative exports for the January-August 2023 period, with exports to the U.S. amounting to roughly 20% and those to China amounting to roughly 17%. Given the present situation, this trend is likely to continue. Further, considering that exports to China were smaller than those to the EU until 2006, a return to "EU > China" is symbolic of a rewinding of time. These developments are undoubtedly a result



(Source) macrobond (Note) Year 2023: as of total from JAN to AUG of the increasing risk aversion of Western powers, and are certainly a positive development when viewed from the medium/long term.

However, regardless of the background, the fact remains that China is the destination of close to 20% of Japan's global exports, and there is no alternative country/region that Japan could look to for its exports. This means that sluggish exports to China will directly result in a deterioration in Japan's trade balance and become a contributor to JPY depreciation in the forex markets. If we compare this year's performance with last year for the January-August period, it does seem that exports to the U.S. have increased by exactly the same extent that exports to China have decreased (see figure), but the question is whether this is a sustainable trend. Intuitively speaking, it does not seem likely that the U.S. can absorb the entire amount of demand freed up from China, so trade volumes not just for Japan, but for the world as a whole, may suffer.



In this report, I have always held that, while the U.S.-Japan interest rate gap is also important, the basic fact of JPY supply and demand being tilted toward a net sale of JPY must be taken firmly into account when it comes to understanding the JPY depreciation trend. I, therefore, view the recent change in trade balance trends as an important factor that will impact my medium/long-term forex outlook. Japan's cumulative trade balance for the January-August 2023 period has been -JPY 7.9 trillion, which is an improvement over the previous year's -JPY 12.2 trillion for the same period. However, 2022 was an exceptional year, with high resource prices, JPY weakness, and supply constraints all coming together simultaneously. If we exclude 2022, the largest ever trade deficit posted by Japan until then was -JPY 12.8 trillion in 2014, and this figure seems in sight for the current year as well. Incidentally, USD/JPY posted a roughly +12% increase in 2014, which is exactly the same level of increase (roughly +12%) so far this year at the time of writing this report (September 27). In addition to the U.S.-Japan interest rate differential, I will continue to view the trade deficit as one of the important factors contributing to the persistent weakness of JPY against USD.

JPY Rates Now and Going Forward – Experiencing Asia's Weakest Currency

Huge Domestic-International Price Gap

In early September, I went on a business trip to Singapore. The last time I visited Singapore before that was about five years ago. As is my habit, I compared prices between Singapore and Japan, and found that the gap has become quite significant. Starbucks prices are frequently used for comparisons, and I found, for instance, that the Iced Caffe Americano cost roughly SGD 5.8 for the tall size. At the time of writing this report, the SGD/JPY exchange rate is roughly 108, which gives JPY 626 for SGD 5.8. Given that the Iced Caffe Americano (tall) costs JPY 445 in Japan, the price in Singapore is roughly 1.6 times higher. Again, a bottle of water (Evian, 500 ml) cost roughly SGD 3.2 at Changi Airport, which amounts to roughly JPY 346 at the time of writing this report. I could not find the same product at Japanese convenience stores, but looking online, I found the suggested retail price to be JPY 170 (just over JPY 180 including taxes). It appeared that the price would be JPY 142 (inclusive of taxes) if purchased at a retail store or in bulk. In other words, the price of the same product was roughly 2.4 times higher in Singapore. Of course, there are likely to be stores that sell the product cheaper in Singapore, and bulk purchases would also be possible, not to mention that the price I saw at the airport may have been on the higher side. Having said all that, it is difficult to imagine a bottle of water being sold for JPY 300 at an airport in Japan (even JPY 200+ is unlikely).

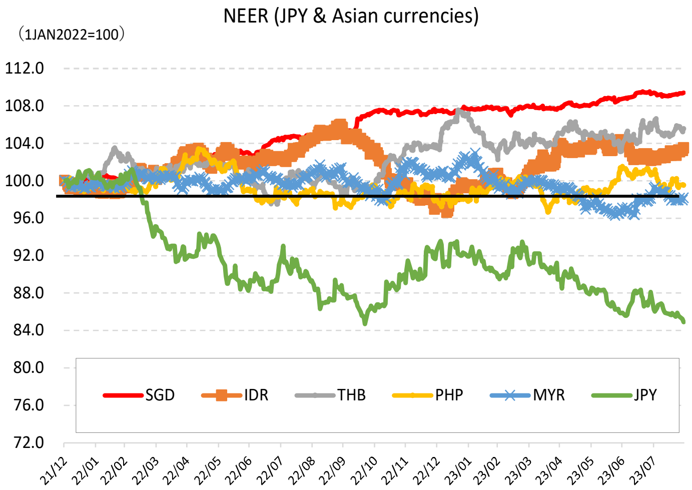
It is easy to imagine that these steep differences in prices, as reflected even in the prices of everyday products such as coffee and water, might be hurting the pockets of tourists, business visitors, expatriates, and others from Japan. This will inevitably make it difficult for people to travel abroad from Japan, and payments in the travel balance (i.e., the import of services) are also likely to dwindle going forward. One predicts that the demand for domestic travel will increase as an alternative to overseas travel, resulting in tighter domestic travel market conditions, and such a phenomenon may, in fact, already be taking place.

Signs of Travel Balance at Domestic Airports

Tourists to Japan from abroad, meanwhile, are likely to have the reverse experience. As a result, Japan's receipts in the travel balance (i.e., service exports) are likely to increase going forward, and this is indeed true, as seen above. I witnessed a situation that symbolized this recently – the snaking line at Security Check prior to departing for overseas from Japan. An airport worker told me that there was a wait of 30-40 minutes on average, and 20 minutes at least, at the Haneda Airport Security Check area for those who were not already registered for authentication by facial recognition. Incidentally, the crowding at check-in counters at the airport was also terrible. Most of the passengers gathered at these counters were foreign tourists to Japan, with a fewer number of Japanese passengers visible. Such scenes at the Security Check also seem to symbolize the prospect of an expansion in the travel surplus going forward. Other issues, such as the lack of priority Security Check lines (in other words, both economy and business class passengers use the same gate), given Haneda Airport's relatively small size to begin with, were also pointed out as a reason for the crowding, and one assumes the problem will only get worse going forward, as the airport finds itself hard-put to handle the ever increasing demand for inbound tourism going forward.

The Reality of Asia's Weakest Currency

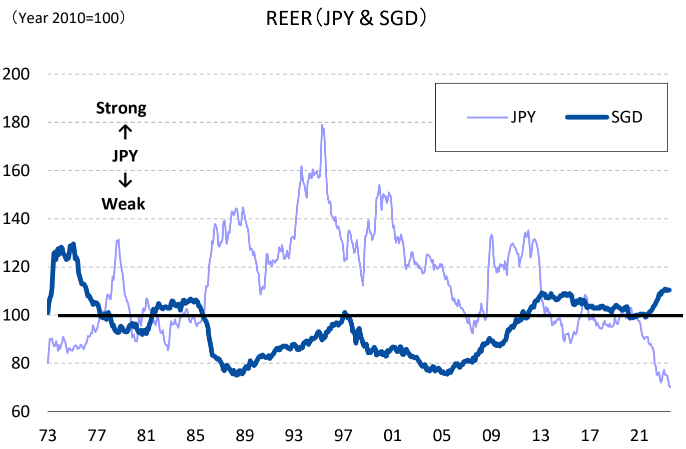
Returning to the difference in prices between Japan and Singapore, one of the big factors is definitely the nominal depreciation of JPY in recent years. If nominal effective exchange rates (NEER) at the start of 2022 are taken to be 100, JPY's NEER has fallen by roughly -15.4% as of the end of September, while SGD's NEER has increased by roughly +9.5%. This means, in terms of index levels, JPY's NEER is 30% lower than that of SGD. In addition to this significant different due to the forex factor, one must also take into account the difference in wage levels, so the aforementioned difference in prices seems par for the course.



(Source) macrobond

Of course, given that Singapore also functions as a financial center, one could say that it is in a good position to experience steep increases in both prices and wages among Asian nations, but the margin of JPY's decline is remarkable even compared with other South East Asian currencies (see figure). I frequently emphasize regarding the current phase of JPY weakness that it is not simply owing to USD strength, and my point becomes quite clear when one looks at the trend of Asian currencies. If one were to assume that the real reason for JPY weakness is an across-the-board strengthening of USD, there ought to be other currencies that have also weakened as much as JPY, but that does not seem to be the case. My position since last year has been that the current JPY depreciation is clearly also owing to structural factors such as Japan's expanding trade deficit, a primary income surplus that is not repatriated to Japan, and an expanding service deficit led by Digital, Consulting and R&D service categories. As I have discussed this point several times in past issues, I will refrain from doing so again this time.

Another point I have repeatedly discussed in past issues of this report is the fact that <u>the nominal JPY depreciation is merely a secondary factor causing the domestic-international price gap</u>. Continuing with the examples of the Starbucks ice coffee (tall size), for the price in Japan to be the same as that in Singapore, the SGD/JPY exchange rate would have to be 67 (390÷5.8). This is closer to the level that existed in 2011-12, when USD/JPY was stable at the 70 level. Of course, those who consider this to be a fair value for JPY would be in the minority. Even simply looking at the trade balance, no one could have concluded in 2011-12 that Japan was a "trade deficit country" (it was the transition period when Japan's trade balance was only just beginning to change). Ultimately, <u>in addition to JPY's nominal depreciation trend, a difference in price-setting trends among Japanese and overseas firms rooted in domestic-international wage gaps must be viewed as a big reason for the expanding price gaps between Japan and Singapore, or other countries</u>. There is already a big gap at the juncture where companies determine list prices. Real effective exchange rates (REER) are forex rates that take price differentials into account, and looking at the rate of change between early 2000 and August 2023, JPY's REER has declined by -54%, while SGD's REER has increased by +31%. Given this extent of difference in REER, which is an indicator of a currency's purchasing power, it is natural that list prices in both countries would be extremely different even for the same goods and services. In the past 1-2 years, in particular, the two countries have been moving in exact opposite directions (see figure).



(Source) BIS

The Risk of Attributing Price Differences Solely to JPY Depreciation

When discussing the price differences between Japan and other countries, an intuitive takeaway tends to be that it is a side effect of JPY depreciation. However, while it is important to take note of nominal forex rate trends, it is equally important to consider whether Japan can establish a sustained trend of wage increases through negotiations, which can then be reflected in the price-setting behavior of firms – something that happens as a matter of course in other countries. Considering the chronic labor shortage Japan experiences, it is unthinkable for nominal wages not to increase. I, therefore, feel that the seeds of "increase in nominal wages → price rises" are slowly but steadily beginning to be sowed in present-day Japan. If prices increase, the REER (i.e., purchasing power) of JPY will also begin to rise, in contrast to its consistent decline so far as seen above. Going by the structure of JPY supply and demand, which this report regularly discusses, it does not seem likely that JPY's REER can be lifted out of its slump via nominal JPY appreciation. This is all the more reason to bet on the path involving an increase in domestic wages and prices. At any rate, the situation appears to be changing compared with the pre-COVID era, when complacence reigned supreme as Japan appeared to be in a state of perpetual deflation.

U.S. Monetary Policy Now and Going Forward – Are Rate Cuts a Given in 2024?

Was Not Increasing Rates the Right Decision?

As expected by the markets, the target range for the federal funds (FF) rate was maintained at 5.25%~5.50% following the September 19-20 FOMC meeting. This is the first time in two months, since the June meeting, that the rate has been kept unchanged. While there is no rush to conclude that this signifies the end of rate hikes, it can be said that the current phase of rate hikes appears to be entering a lull. In the revised SEP, real GDP forecasts were +2.1%→+1.5%→+1.8% for the years 2023, 2024, and 2025, respectively, which amounted to a +1.1pp upward revision for 2023, +0.4pp upward revision for 2023, and no change for 2025 compared with the previous (June) forecasts. It is rarely that growth rate forecasts jump so dramatically in the space of three months. Despite this, the growth rate in the longer run remains unchanged at +1.8%, which seems to suggest considerably tight conditions (demand>supply) when it comes to the gap between supply & demand in the U.S. economy. In this context, a reporter at the press conference asked about the contradiction between the marked increase in projected growth rates and the postponement of rate hikes, to which Fed Chair Jerome Powell replied that there was no contradiction, given that the inflation rate projections remained mostly unchanged. Specifically, inflation rate (i.e., personal consumption expenditure deflator; PCE deflator) projections for 2023-25 were +3.3%→+2.5%→+2.2%, which amounted to a +0.1 pp upward revision for 2023 and 2025, and no change for 2024, while the projections for core PCE deflator were +3.7%→+2.6%→+2.3%, which amounted to a -0.2pp downward revision for 2023, +0.1pp upward revision for 2025, and no change for 2024.

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

	2023	2024	2025	2026	Long-term
Real GDP Growth rate (as of JUN)	2.1 (1.0)	1.5 (1.1)	1.8 (1.8)	1.8	1.8 (1.8)
Unemployment rate (as of JUN)	3.8 (4.1)	4.1 (4.5)	4.1 (4.5)	4.0	4.0 (4.0)
PCE inflation rate (as of JUN)	3.3 (3.2)	2.5 (2.5)	2.2 (2.1)	2.0	2.0 (2.0)
Core PCE inflation rate (as of JUN)	3.7 (3.9)	2.6 (2.6)	2.3 (2.2)	2.0	

(Source) FRB

There is something to be said for keeping the target range for the FF rate unchanged in the absence of inflation acceleration combined with a decline in the core PCE deflator in the short term. Even so, one can understand the reasoning behind the question by the reporter who asked why there was no rate hike despite such a strong increase in growth rate projections. My view is that the reporter made the stronger point.

When Are Discussions of Interest Rate Cuts Likely to Start?

Regarding FOMC members' FF interest rate projections (dot plot median forecast figures, see chart) for the end of 2023, it is important to note that most members (12 out of 19) are anticipating one more interest rate hike (by 25bp) in 2023 and, given this, it would seem inappropriate to suggest that the rise of the median forecast figure for the end of 2024 (from 4.6% to 5.1%) is indicative of increased hawkishness. It is clear from a glance at the actual dot chart that most of the 2024 year-end level forecast dots are in the 4.6%-to-5.1% range, suggesting expectations of two or three interest rate cuts, and this does not seem to deviate much from market expectations. A comparison of the September dot plot with the June dot plot mainly indicates that the timing of interest rate cuts is now likely to be somewhat more delayed than previously, and even that delay is not a certainty.

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

FOMC Date	2023	2024	2025	2026	Longer run
Mar-22	2.625%	2.625%	n.a.	n.a.	2.250%
Jun-22	3.750%	3.375%	n.a.	n.a.	2.500%
Sep-22	4.625%	3.875%	2.875%	n.a.	2.500%
Dec-22	5.125%	4.125%	3.125%	n.a.	2.500%
Mar-23	5.125%	4.250%	3.125%	n.a.	2.500%
Jun-23	5.625%	4.625%	3.375%	n.a.	2.500%
Sep-23	5.625%	5.125%	3.875%	2.875%	2.500%

(Source) FRB

Even if it is correct to anticipate three interest rate cuts in 2024 as suggested by the September dot chart, if intermittent rate cuts are expected, it remains questionable whether would be better to anticipate cuts in June, September, and December, or cuts at the year's last three meetings, in September, November, and December. In any case, there is now a perception that the cuts will be implemented from June at the earliest. Since there are probably not many people who were convinced that continuous interest rate cuts would be initiated during the first half of 2024, one gets a strong impression that the increased 2024 year-end level forecast is more in line with market expectations. Seeking to be realistic about political considerations, I believe there is not a high likelihood that interest rate cuts will be discussed and initiated just before the presidential election – it seems reasonable to assume that the status quo will be maintained for a while before discussions about the cuts begin in the last quarter of 2024.

Danger of Taking Interest Rate Cuts for Granted

Regarding the forex market, it should be noted that the JPY depreciation trend is unlikely to reverse until the Fed discontinues its interest rate hikes and makes it clear that its next step will be to begin cutting interest rates. I have long argued that the recent JPY depreciation trend is fundamentally attributable to the JPY supply-demand environment. I have also acknowledged the stable relationship between the Japan-U.S. interest rate differential and USD/JPY, but my view is that most discussions of JPY depreciation are too narrowly focused on the interest rate differential situation. Although the headline CPI and PCE deflators have peaked out, it will likely take a considerable amount of time before the levels of those deflators justify interest rate cuts. The above forecast of interest rate cuts in the latter half of 2024 cannot be said to be a very precise one, and this reflects the fact that, judging from the content of Chairman Powell's September 20 press conference, it appears that the Fed itself does not have a good understanding of the reasons for the US economy's persistent strength. Various points were made at the press conference, including that excess savings still remain (≈ there is room for the savings rate to decline), that the neutral interest rate appropriate for the U.S. economy may have risen, and that household and corporate balance sheets are generally healthy. Asked about whether interest rates were already at a sufficiently restrictive level or not, Chairman Powell touched on various hypotheses, but concluded that – "I would say you know sufficiently restrictive only when you see it. It's not something you can arrive at with confidence in a model or in various estimates, you know." Given that view from inside the Fed, there is no basis for outside observers to confidently anticipate an interest rate cut in the foreseeable future.

We should recall how, during the period from the end of 2022 through early 2023, anticipation of U.S. interest rate cuts caused forecasts of JPY appreciation trends to become dominant. Since then, based on the assumption that 2023 will be the year of U.S. interest rate cuts, expectations of an incipient JPY appreciation trend have become dominant in the forex market. In a situation where even the Fed is unable to explain the reason for the U.S. economy's strength, however, it should be recognized that it is dangerous to assume that U.S. interest rates will definitely be cut during 2024. From the forex market perspective, it appears that U.S. interest rates will remain high and the impact of excessive JPY selling on the JPY supply-demand environment will continue at least until some time in the first half of 2024. Based on this outlook, while this article had previously anticipated the JPY depreciation trend's peaking out during the first quarter of 2024, the latest projection is for that peaking out to take place during the second quarter of 2024.

Risks to My Main Scenario – Continued Concerns Regarding Shifts from JPY to Other Currencies

Nascent Savings-to-Investment Transition

In September, the BOJ released its flow of funds statistics for the April-June period. There are frequent news media reports about how Kishida administration and various government entities are encouraging a shift from household savings to household investments in line with the "asset management nation" concept. The flow of funds statistics offer a means of measuring the actual progress of that shift, so it is likely they will be attracting increasing attention going forward. The table below shows changes in household financial assets over the six-month period from December 31, 2022 to June 30, 2023.

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

	Amount (trillion yen)	(%)
Total assets	2,114.9	100.0
Foreign currency	74.1	3.5
Foreign currency deposit	6.6	0.3
Foreign securities investment	26.0	1.2
Investment trust	41.5	2.0
JPY-denominated	2,040.8	96.5
Cash and deposits (excluding foreign currency deposits)	1,110.8	52.5
Government bond, etc.	27.5	1.3
Stocks and investments	267.7	12.7
Investment trusts (excluding the foreign currency portion)	64.4	3.0
Insurance and pension reserves	537.9	25.4
Deposit, etc.	32.4	1.5

Financial asset composition of the Japanese household sector (end of DEC 2022)

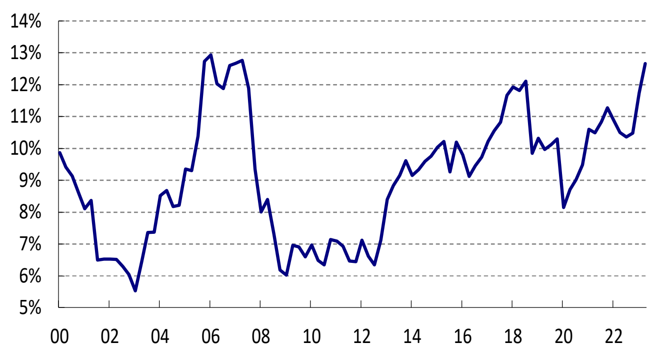
	Amount (trillion yen)	(%)
Total assets	2,037.5	100.0
Foreign currency	64.4	3.2
Foreign currency deposit	6.4	0.3
Foreign securities investment	22.7	1.1
Investment trust	35.2	1.7
JPY-denominated	1,973.1	96.8
Cash and deposits (excluding foreign currency deposits)	1,109.9	54.5
Government bond, etc.	25.6	1.3
Stocks and investments	213.5	10.5
Investment trusts (excluding the foreign currency portion)	56.6	2.8
Insurance and pension reserves	532.8	26.1
Deposit, etc.	34.8	1.7

Changes from the end of DEC 2022 to the end of JUN 2023

	Amount (trillion yen)	(%)
Total assets	77.4	
Foreign currency	9.7	0.3
Foreign currency deposit	0.2	▲ 0.0
Foreign securities investment	3.3	0.1
Investment trust	6.2	0.2
JPY-denominated	67.7	▲ 0.3
Cash and deposits (excluding foreign currency deposits)	1.0	▲ 1.9
Government bond, etc.	1.9	0.0
Stocks and investments	54.2	2.2
Investment trusts (excluding the foreign currency portion)	7.8	0.3
Insurance and pension reserves	5.1	▲ 0.7
Deposit, etc.	▲ 2.4	▲ 0.2

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

Ratio of equity and investment in household financial assets



(Source) Bank of Japan

Japanese household financial assets amounted to approximately JPY2,115 trillion, of which JPY-denominated assets accounted for roughly 97% (JPY2,041 trillion), and cash and deposits accounted for about 53% (JPY1,111 trillion) of those JPY-denominated assets. These figures suggest that that Japan's household sector has largely maintained its traditional conservative asset management style. Despite the overall conservativeness of the asset management style, however, there are some signs of change. For example, reflecting an uptrend in stock prices since early spring, the share of household financial assets in the form of stocks and investments rose to 12.7%. This level is close to the all-time high (12.9%) reached in the first quarter of 2006, which was said to be a financial bubble period, and it will be interesting to see whether it will reach a new record level in the near future (see graph). Furthermore, according to my estimates, the share of household financial assets in the form of foreign currency assets also increased slightly (by 0.3 percentage point), from 3.2% to 3.5%. However, the roughly JPY10 trillion increase in foreign currency assets cannot be considered negligible in view of the current JPY supply-demand situation. By the way, the share of household financial assets held in foreign currency assets was only 0.9% in the first quarter of 2000, so that share has roughly quadrupled over the past 20 years. (In value terms, the foreign currency asset holdings have grown by about JPY61 trillion during that period.) It is important to recognize that the savings-to-investment transition is progressing slowly by surely in the form of a shift from JPY assets to foreign currency assets.

Significance of Media Reports on Higher Foreign Currency Deposit Interest Rates

It was widely reported in the news media during September that one of Japan's major banks will raise the rate of interest it pays on USD time deposits from 0.01% to 5.3%. Internet banks in Japan have already been offering USD term deposit interest rates in the 5-6% range for quite some time, and USD term deposits with rates close to 10% are also available depending on the conditions, so many people familiar with such financial products may consider the situation to be a trivial case that is only considered newsworthy because the initial interest rate was unusually low. Given that the trends in Japan's flow of funds statistics are largely driven by elderly people with low-levels of internet literacy, however, it is highly significant that the interest rate hike by a major bank that is likely to address that elderly demographic was widely reported. Relatively young Japanese may already be actively buying foreign currencies with their smartphones, but it will still be a long time before their investment behavior is clearly reflected in the country's flow of funds statistics. It is changes in the behavior of the relatively old Japanese who used to pay fees to purchase foreign currency at bank counters that will be more likely to have an impact on the flow of funds statistics and, ultimately, on movements in JPY exchange rates. As I have repeatedly noted in previous editions of this article, Japanese people are temperamentally unlikely to be greatly affected by theoretical arguments about the virtues of internationally diversified investments. It is when such traditional media as newspapers, magazines, and television promote a general perception that "everyone is doing internationally diversified investments" that Japanese people will be spurred to action with respect to the international diversification of their investments.

Since the transition to a floating exchange rate system, the negative aspects of JPY depreciation have never until now been spotlighted for protracted time periods, but the risks of doing nothing to diversify away from purely JPY-denominated asset portfolios are becoming increasingly apparent to all Japanese at this point. The reality faced by Japanese today is that a combination of JPY depreciation and rising resource prices is propelling a significant general rise in prices of gasoline and other daily necessities, and an increasing share of those who have abandoned hope that nominal wages will rise enough to offset the rise in prices are now seeking to cover the shortfall through improved asset management methods. Although the rate of change in the contract-currency-basis import price index has slowed, the level has become elevated to a fairly high level in a short period of time, and the impact of persistently rising import prices is gradually permeating Japanese people's daily lives. Japan's government and ruling party have been persistently preaching about the need for better household asset management methods recently, and it appears clear that, as nominal wage increases have reached their limits, the government and ruling party are hoping that Japanese people will to some extent take the initiative in better managing their assets for their own benefit.

"Household JPY Selling" Remains Biggest JPY-Related Risk Factor

Although there are various complexities to consider, it is certainly true that risks associated with JPY depreciation can to some extent be hedged by purchasing foreign currencies. The purchase of foreign currencies makes sense both as a positive means of maximizing returns on assets and as a defensive means of avoiding JPY-related risks, but it is only when Japanese people feel a real sense of crisis about the vulnerability of their own assets that they will abandon their traditional focus on simple "saving" and proactively shift to somewhat more complicated "investment" approaches. When Japan's elderly population (which has a huge amount of financial assets) wakes up and decides to proactively defend the value of their assets, they may choose to greatly change the disposition of about JPY1,100 trillion in cash and deposits. If they were to shift 5% of their assets into foreign currency-denominated assets, the amount shifted would amount to about JPY55 trillion, and if 10% of their assets were shifted, the amount would be about JPY110 trillion. Given that Japan's annual current account surpluses amount to just over JPY10 trillion (of which most is probably not repatriated into JPY), the magnitude of such potential fund shifts should be understood to be extremely large, and it is quite possible that they may cause JPY to plummet. There was as yet no such "JPY selling by Japanese" in 2022, when USD/JPY rose to almost JPY152. This is not to suggest that USD/JPY may rise to JPY160 or JPY170 in the near future, but if one acknowledges the huge magnitude that Japanese household sector JPY selling could eventually attain, one should recognize that there is ample potential for JPY to reach such levels over the longer term. As I have repeatedly argued, "household JPY selling" is the biggest risk factor facing the Japanese economy, and if such selling materializes on a large scale, the domestic inflation situation would be likely to become incomparably more severe than it is now. Once that scenario takes shape, it will be extremely difficult to moderate it by means of currency and financial policies.

EUR Outlook – Can Stagflation Really be Avoided?

EUR Area Monetary Policies Now and Going Forward – Interpreting the De Facto Interest Hike Suspension

ECB Takes Pride in Resolutely Fighting Inflation

The September 14 ECB Governing Council meeting decided to raise the three key ECB interest rates – the first time in history that the rates have been hiked at 10 consecutive Governing Council meetings. This meeting raised the deposit facility interest rate to 4.00% (the highest level ever recorded), the major refinancing operation (MRO) interest rate to 4.50%, and the marginal lending facility interest rate to 4.75%. As discussed below, the interest rate hike was accompanied by a "de facto declaration of an interest rate hike suspension", although the question of whether the ECB will actually be able to refrain from additional rate hikes going forward is an important one. Given the euro area's economic and financial situations, I had believed there was a high likelihood that the September Governing Council meeting would announce the pausing of interest rate hikes. It had appeared more-correct for the ECB to further raise interest rates, but it seemed likely that the ECB would postpone such rate hikes given the increasingly dovish tone of the July Governing Council meeting's statement and the downward revision of inflation rates in the revised staff forecasts released in September. Although the comprehensive basis euro area consumer price index (HICP) forecast was revised upward for 2023 and 2024, the core basis HICP forecast remained unchanged for 2023 and was revised downward for 2024 and 2025. The staff forecasts of real GDP growth rates have been lowered for the entire 2023-2025 period (see chart). These revised forecasts seemed to provide a rationale for pausing interest rate hikes.

ECB staff outlook（SEP 2023） (%)

	2023	2024	2025
HICP	**5.6**	**3.2**	**2.1**
（Previous : JUN 2023）	5.4	3	2.2
Core HICP	**5.1**	**2.9**	**2.2**
（Previous ： JUN 2023）	5.1	3	2.3
Real GDP	0.7	1	1.5
（Previous ： JUN 2023）	0.9	1.5	1.6

(Source) ECB (Notes) EURUSD rate is assumed to be 1.09 Year 2023-2025
Core excludes energy and food

Nevertheless, it seems that the Governing Council chose to implement an additional interest rate hike this time because the comprehensive-basis HICP forecast has been increased and the trend of increase in crude oil prices is seen as an additional upside risk factor that may place upward pressure on inflation rates going forward. In fact, the Governing Council meeting's statement points out that– "Upside risks to inflation include potential renewed upward pressures on the costs of energy and food." Although it belied my expectations, the Governing Council meeting's decision to hike rates can considered a demonstration of how much the ECB is taking pride in resolutely fighting against inflation. As discussed below, however, <u>now that the ECB has suggested that it has suspended interest rate hikes, the focus of attention may now shift to what policies the ECB can adopt to obviate the need for additional interest rate hikes</u>.

De Facto Declaration of Terminal Rate Attainment

My forecast had been that the Governing Council would forgo a rate hike in September and compensate for that by suspending the reinvestment of principal payments from maturing securities purchased under the Pandemic Emergency Purchase Program (PEPP; plans currently call for such reinvestment to be continued "until at least the end of 2024") at an earlier date, thereby achieving a balance of hawkishness and dovishness. However, President Lagarde made it clear at the post-Governing Council meeting press conference that there had been no discussion about the PEPP reinvestment policy. Furthermore, when a reporter asked whether the ECB would consider outright sales of assets purchased under the Asset Purchase Programme (APP; for which reinvestment has already been suspended), President Lagarde similarly denied that there had been any discussion about – "any kind of APP outright sales". She stated that – "we regard interest rates as the key tool in the work that we are doing in order to reach our 2% medium term target" – and it appears that the September Governing Council meeting was focused on discussing that key tool. <u>On the other hand, the meeting's statement incorporated the sentence cited below with respect to the current levels of key ECB interest rates, and this sentence seems to strike a balance between the agendas of Governing Council hawks and doves. This sentence also communicates the key result of the meeting's discussions, and it should be understood to be highly important as it clearly suggests a pause to the series of interest rate hikes the ECB has implemented</u>.

- **Based on its current assessment, the Governing Council considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target.**

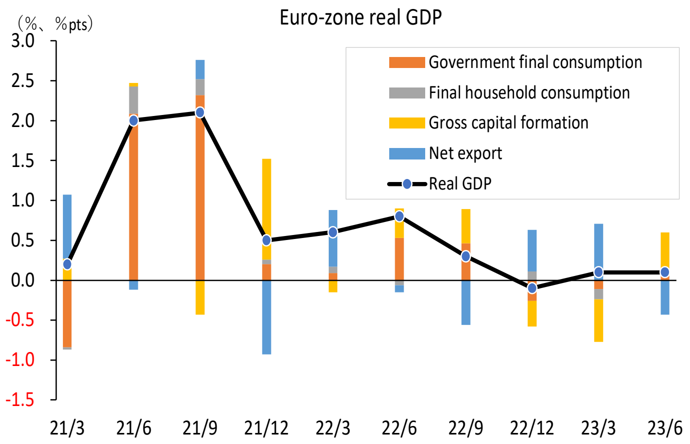
This sentence essentially states that the current key ECB interest rate levels are sufficiently high to reduce inflation if they are maintained long enough, and <u>this is tantamount to saying that the terminal rate has been reached. It can be considered a roundabout declaration of the suspension of further interest rate hikes</u>. I previously pointed out that the September Governing Council meeting would be the ECB's last chance to raise interest rates, and it seems the clear that the "last chance" element may have contributed to the ECB's decision to go ahead with the September rate hike.

There were numerous references to the above cited sentence at the press conference, and President Lagarde herself described that sentence as – "the critical one." She analyzed the sentence, saying – "both elements matter, the level sufficiently restrictive and the duration. But it's obvious that the focus is probably going to move a bit more to the duration." Although she went on to undermine the clarity of that statement, saying – "But we can't say that now we are at that peak." – because of various uncertainties, it now appears that major unforeseen circumstances (such as re-accelerating increases in natural gas prices or extremely negative trends regarding employment and wages) will be prerequisites to additional interest rate hikes.

While acknowledging the importance of keeping the key ECB interest rates at current levels "for a sufficiently long duration" and "at sufficiently restrictive levels for as long as necessary", the Governing Council meeting's statement also clearly says that future policy management will be "data dependent", and a reporter at the press conference posed the question – "My question is if the data dependency and held for long are at odds with each other, and if this can be contradictory, and if you are prepared to cut rates if growth slows further. In other words, if it is sufficiently restrictive, could that sentence imply a cut?" President Lagarde briskly disposed of that question, saying – "This [rate cut] is not even a word that we have pronounced. Yes, the data dependency applies to both the determination of the sufficiently restrictive level as well as the length of time where it has to stay at that level. So we don't see any contradiction in having the two components in the same sentence. One will drive the other, actually." She was basically saying that each Governing Council meeting will use new data to determine whether the interest rates are sufficiently high and how long those rates should be maintained. It seems possible that the key sentence cited above was merely designed to explain the ECB's current perception of current interest rate levels and that, if rate cuts come under consideration, the ECB's basic approach will be to prepare updated forward guidance.

Can the ECB Prevent Stagflation?

I am concerned that the ECB may have gone a bit too far in making a de facto announcement of a halt to interest rate hikes. In light of the euro area economy's current state and outlook, the ECB's September rate hike can probably be considered a last-ditch hike, and if prospective developments are in line with the ECB's expectations, there is a strong possibility that the September hike will be the last hike. As the euro area economy is highly dependent on external demand, slumps in such major countries as China and Russia are clearly having negative impacts, and net exports declined in the most recent April-June period (see graph). The euro area economy seems likely to face this kind of headwind for some time. In the early 2000s, Germany shouldered the costs of East-West integration and suffered through a dark period when it was often referred to as the "sick man of Europe", and some are now suggesting that Germany is regaining its sick man status[1] and that the entire euro area may be dragged downward by Germany and therefore face growing disinflationary pressures. These suggestions are fairly persuasive. The reason the ECB decided to hike interest rates in September even though conditions in the euro area's real economy are significantly worse than those in Japan and the United States is probably because it judged that there was no guarantee that euro area inflation rates will decelerate in response to an economic slowdown. That in itself appears to be a correct judgment.



（Source）Bloomberg

The ECB has so far taken issue with the price-setting behavior of companies in the euro area (making profit margins thicker than necessary) as well as with the wage increases labor unions are demanding in response to rising prices, a pattern recently referred to by President Lagarde as tit-for-tat inflation. However, the ECB appears to believe that the tit-for-tat inflation situation is gradually fading away, and President Lagarde supported that view at the post-Governing Council meeting press conference by pointing out that there were signs of a slowdowns in the paces of increase in employment and corporate profits. However, the ECB's view is basically a prediction of improvement, and the correctness of that view cannot yet be confirmed. In fact, the rates of wage increases bargained for by labor unions have been much higher than initially expected, and there is insufficient evidence to make a confident prediction that those rates will be declining going forward. Although the ECB has declared a de facto suspension of interest rate hikes, one wonders whether it will perceive a need for higher rates to curb inflation if, for example, it is confirmed that core HICP growth is once again accelerating. If such a situation arises, the ECB may well feel it must re-initiate its interest rate hikes, and that would reveal that the long-awaited suggestion that the terminal rate may have been attained was not actually a trustworthy kind of forward guidance. In light of that, it appears that the latest Governing Council statement should ideally have explicitly acknowledged the possibility that interest rates could be raised somewhat more depending on the situation – it seems that the statement was unnecessarily making it difficult to flexibly respond to potential developments in the future.

EUR selling progressively increased following the September Governing Council meeting, and that trend was generally believed to reflect the ECB's suspension of interest rate hikes. The trend may also have reflected anticipation that the latest interest rate hike would increase the euro area's economic sluggishness as well as a perception that economic sluggishness is associated with a deceleration of inflation that has made further interest rate

[1] See the article entitled "Is Germany once again the sick man of Europe?" in the August 19, 2023, edition of The Economist.

hikes unnecessary. However, the scenario the ECB is hoping to see is one in which the euro area economy enters a recession while interest rates remain at high levels, and then interest rates and inflation rates gradually subside. The biggest challenge the ECB currently faces is preventing a stagflation scenario in which the euro area economy enters a recession but euro area interest rates and inflation rates continue rising.

Euro Area Economy and EUR Now and Going Forward – Return of the "Sick Man of Europe"?

The Sick Man Returns

Bearing the cover text – "Is Germany once again the sick man of Europe?" – the August edition of the U.K.-based Economist magazine argued that, while the German economy was a stand-out success within the euro area during the 16 years Angela Merkel-led governments reigned, it is now quickly deteriorating. Various other news media have subsequently begun featuring similar reports, and since I have previously published books analyzing the euro area and Germany, I have been receiving a growing number of inquiries about Germany-related trends. Although it is impossible to comprehensively discuss Germany's political and economic challenges in a single article, I would like to provide here a brief overview of the current state of the German economy. Objectively speaking, the German economy has in fact been changing in ways that fully justify the "sick man returns" theme of recent media coverage.

Changes in image of Europe and Germany: The Economist

Date	Title	Target country
1999/6/3	The sick man of the euro	Germany
2003/12/18	Sick man walking	Germany
2004/11/17	Germany on the mend	Germany
2005/5/19	The real sick man of Europe	Italy
2007/4/12	A new sick man of Europe	EU
2007/7/25	Sick man no more	Germany
2010/3/11	Europe's engine	Germany
2013/6/13	Europe's reluctant hegemon	Germany
2023/8/17	Is Germany once again the sick man of Europe?	Germany

(Source) The Economist

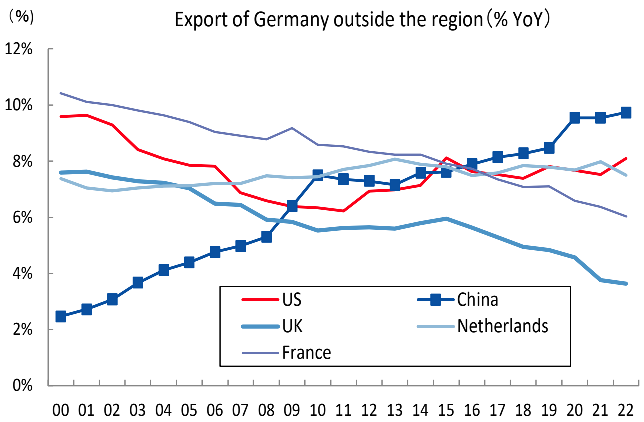
The "sick man of Europe" phrase has been used in various ways during different historical periods of the EU economy, in fact it has been used to describe not only Germany but also Italy and even the EU itself. As described in greater detail in my most-recent book ("After Merkel: What's Next?" published in 2021 by Nihon Keizai Shimbun), from the late 1990s through the early 2000s Germany struggled with the costs of unifying East and West Germany (including widening fiscal budget deficits, high inflation rates, and high interest rates), prompting The Economist magazine to mock the country with the phrase "The sick man of the euro." The sick man subsequently began recovering owing to such factors as the reduction of unit labor costs following labor market reforms implemented by Gerhard Schröder-led governments and the acceleration of German export growth following the launch of EUR, and after 2013 (when the impact of the European debt crisis had dissipated) Germany's excessive economic strength actually began to be seen as problematic. The European debt crisis from 2009 to 2013 weakened the economies of EU countries other than Germany, but it could even be said that Germany strengthened its political and economic power during that period.

Eventually, Germany's excessive economic power and self-centered behavior led to it being criticized as a demi-hegemon causing trouble for other EU countries. For example, it was frequently pointed out that high levels of dependence on China and Russia promoted by Merkel-led German governments exposed the euro area to serious risks, but these risks were not seriously addressed. After the Merkel-led government suddenly offered to accept unlimited numbers of refugees in September 2015, other EU countries through which the refugees passed on their way to Germany were severely impacted. Germany was stronger than any other EU country but not quite strong enough to actually force other EU members to accept its initiatives, and this led to the coining of such ironic terms as half-hegemony or semi-hegemony to describe Germany's status within the EU.

Largely due to the eventuation of geopolitical risks, however, Germany has once again become characterized as a sick man. Since it will be difficult for the euro area economy to vigorously recover while Germany's economic slump continues, the "sick man returns" situation will inevitably affect the ECB's monetary policy management and, ultimately, the direction of EUR exchange rate trends, so it is quite important to discuss this situation.

Chancellor Merkel Bet Too Much on China and Russia

As discussed in my book, there are multiple factors that contributed to the German economy's growing vitality under Merkel-led governments, and it goes without saying that one of those factors was economic diplomacy that ignored geopolitical risks. The German economy's strong performance largely reflected the fact that Germany placed a large emphasis on Russia as a resource source and on China as a major export destination. In particular, the share of Germany's exports going to China expanded by about 2.5 times (from about 4% to about 10%) during the 16 years of Merkel-led governments (2005 to 2021). China's share of all Germany's international trade transactions (exports + imports) roughly doubled (from about 5% to about 10%; see graph), leading up to a situation in

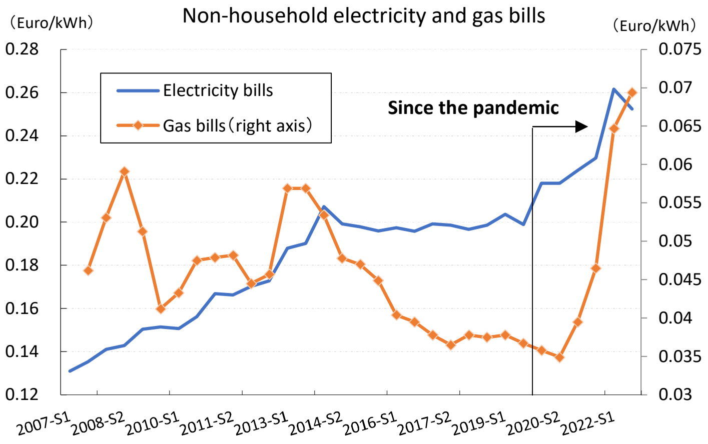


(Source) Datastream

which one in three new German luxury cars were marketed in China. This is one of the greatest achievements of Chancellor Merkel's diplomatic activities, although the style of those activities has been derided by some as being diplomacy by means of flattery. In June 2022, Germany's current chancellor, Olaf Scholz, said that Germany had done a lot of things that controvert the first thing you learn in business school, which is not to put all your eggs in one basket, and that Germany now needs to urgently decentralize its supply chains and export markets. Those statements were implicitly criticizing the Merkel-led government's moves to bet too much on China and Russia. Germany had placed too many of its "eggs", or resource sources and export markets extremely important to the real economy, into a "basket" of countries and regions characterized by high levels of geopolitical risks, and the upshot was that many of the most important eggs had been broken at the same time.

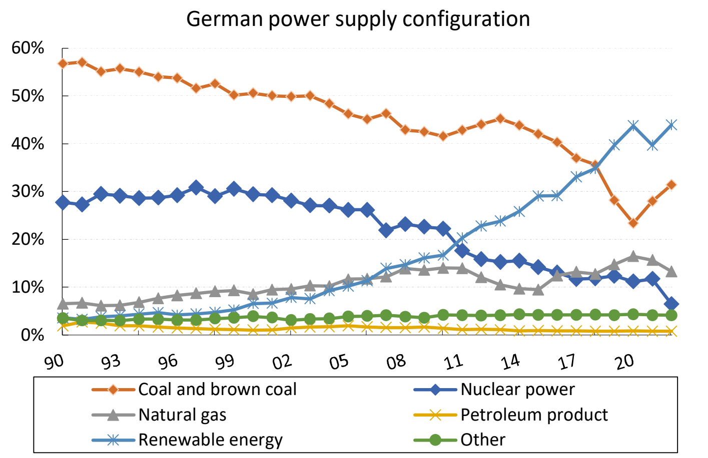
Dire Energy-Related Problems Stemming from Germany's Own Decisions

As has been widely reported for quite some time now, Germany has a dire resource procurement situation owing to its moves to distance itself from Russia. The electricity and gas bills of German households and industrial plants have ballooned since Russia's invasion of Ukraine, and the government imposed a cap on those bills starting in 2023. (Plans call for the cap to continue until April 2024.) The graph shows trends in electricity and gas costs for non-household (industrial, etc.) uses in Germany. It shows that, since the Covid-19 pandemic started, electricity costs have increased about 130% and gas bills have increased roughly 200%. Of course, depending on the specific indicators one examines, one may find cases where the rates of increase is even greater, but it is a clear fact that economic entities in Germany have been facing extremely sharp rises in utility costs recently, and households' electricity and gas bills have been rising at comparable rates. The rise in utility costs reflects not only the supply constraints caused by the pandemic and the war in Ukraine but also of Germany's "self-chosen path". On April 15 2023, Germany's last three nuclear power plants were shut down in accordance with the Merkel-led government's policy of completely phasing out nuclear power. The nuclear power phase-out that former Chancellor Merkel suddenly announced immediately after the Fukushima Daiichi nuclear disaster in March 2011 has been duly implemented since her retirement. Accordingly, during the period from 2000 to 2022, nuclear power's share of Germany's total electric power generation fell from just under 30% to just over 6% while renewable energy's share grew from just over 6% to over 46%. Following the revision of its Renewable Energy Sources Act, Germany is moving toward the goals of meeting 80% of its electric power requirements with renewable energy sources by 2030 and completely decarbonizing its electric power generation network by 2035, and progress is being made toward those targets. However, the price being paid for these ambitious programs is Germany's relapse into the state of being the sick man of Europe once again.



(Source) Eurostat (Note) All taxes and levies included

It is noteworthy that nuclear power's share of Germany's total electric power generation was just under 12% in 2021 and that this share was halved in just one year. Of course, those advocating the shutdown of nuclear power plants are able to say that the economy has continued to operate despite the share of power derived from such plants dropping to just over 6%. In any case, Germany deliberately chose to increase its dependence on renewable energy sources not always capable of providing stable electric power at a time when developments related to the war in Ukraine were increasingly jeopardizing its conventional energy supply sources, and that decision is a key factor leading to the German economy's current dire situation. Renewable energy supplies are greatly affected by a given country's climate and topography, and the decision to rely on them as a main power source during wartime was a kind of risky gamble. It turned out that the gamble did not immediately cause disastrous results because of the mildness of weather conditions during the winter of 2022-2023, but what would have happened that winter weather had not been so mild? It probably would have required rolling blackouts and similar countermeasures that would have had essentially the same drastic impact on the economy that lockdowns did during the pandemic. Despite the obvious risks, however, Germany shut down its remaining three nuclear power plants in April 2023.

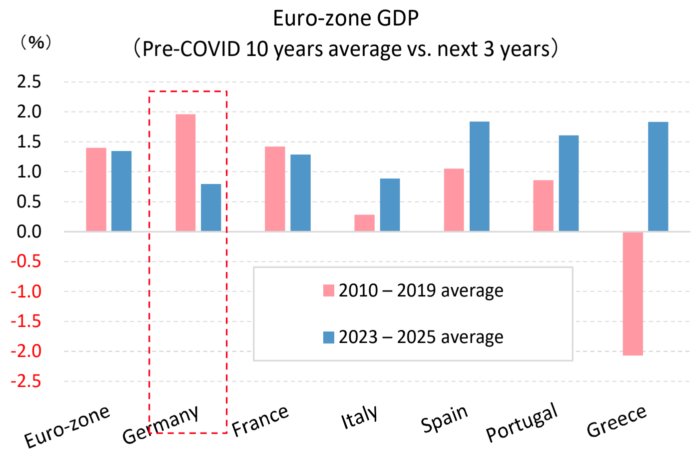


(Source) macrobond

It will be interesting to see how well Germany's real economy can perform without nuclear power plants during the upcoming 2023-2024 winter season, which may not be a mild one. If persistently high resource prices lead to a severe recession, it will be debatable whether Germany will still be positioned to take pride in successfully devising means of overcoming self-created challenges to survive the winter season. It should be acknowledged that the rapid rise in geopolitical risks related to Russia, Ukraine, and China has been a major factor forcing the German economy to rely on energy sources that are more expensive and unstable than ever before and that it would be difficult for Germany by itself to make significant progress in alleviating those risks. On the other hand, it is also important to note that, to a certain extent, Germany's reliance on energy sources that are more expensive and unstable than ever before stems from the country's own decisions.

Higher Costs and Loss of Biggest Customer Will Reduce Economic Growth Rates

The recent significant deterioration of Germany's economic performance reflects such factors as a slowdown in exports to China and the inability to procure natural gas and oil from Russia. There is room for debate about whether the current situation should be seen as the beginning of protracted period of chronic economic weakening or as a transient bout of economic weakening, but it appears at this point that expectations of chronic economic weakening will predominate for the foreseeable future. According to the IMF World Economic Outlook, Germany is the only G7 country for which recession remains the main 2023 forecast scenario, and the weakening of the German economy is also clear from a longer-term perspective. Looking at average GDP growth rates in the 10 years prior to the pandemic (2010-2019) and projected average GDP growth rates during the next three years (2023-25), for example, one finds that, among euro area countries, Germany had the highest growth rate in the former period and has the lowest projected growth rate in the latter period (see graph). It is clear that Germany's economy is weakening, but can this weakening be expected to be a short-lived transitional weakening reflecting temporary geopolitical risk factors, or should one expect it to be a persistent trend? It is unlikely that resource procurement from Russia or exports to China will return to their previous states in the near future so, for some time, Germany will have to shoulder higher resource prices and seek to promote exports to new markets other than China. In short, it seems that higher costs and the loss of its biggest customer will inevitably reduce Germany's economic growth rates.



（Source）Datastream、IMF "WEO, April 2023"

Of course, countermeasures to the energy-related challenges are already beginning to be taken, with the EU targeting Qatar as well as the United States as alternative sources of natural gas. And in May 2022, Germany signed an energy-related cooperation agreement with Qatar, aiming to expand its imports of liquefied natural gas (LNG) from that country. However, it is believed that completely halting natural gas imports from Russia will not be possible until April 2024, and the LNG from alternative sources will be considerably more expensive than the natural gas procured from Russia via pipelines. Even if Germany can procure a sufficient quantity of natural gas from alternative sources, it will only be able to obtain natural gas at significantly higher prices. While Germany is undoubtedly in a transition period, there is considerable uncertainty about how much progress the country can make toward what was considered normal prior to the transition.

This is to some extent the path that Germany has chosen for itself, and when projecting Germany's future, one has to consider whether or not the country has any intention of changing that path. It is worth noting that, just before the last three nuclear power plants were shut down in April, roughly half of those responding to German public opinion polls opined that the shutdown decision was wrong. This is a sign that the German people may well want to revise their chosen path, and this may reflect a mindset change stemming from the symptoms of the sick man of Europe's illness. Will Germany's Scholz-led government (or the next government) take action in light of this change? This article is mainly focused on the current situation that led to Germany's earning the "sick man" appellation, but I plan in subsequent articles to delve deeper into the various problems the German economy is beginning to face and consider the optimal solutions to those problems.

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