Forex Medium-Term Outlook

October 31, 2023

MIZUHO

Overview of Outlook

USD/JPY finally surpassed the 150 level in October, thereby renewing its year-to-date high. The main factor behind this was the continued increase in U.S. interest rates backed by the remarkable underlying strength of the U.S. economy. As a sudden slowing down of the U.S. economy seems unlikely in the foreseeable future, this pattern of strong economic growth resulting in higher and higher U.S. interest rates seems likely to continue for the time being. While such a situation is essentially conducive to JPY depreciation, it could also be viewed as a risk factor for JPY appreciation given the potential for systemic risks arising from an increase in U.S. interest rates, similar to the scenario that unfolded earlier this year, in March. This is the one blind spot in my JPY-depreciation forecast scenario. On the other hand, this also means that JPY appreciation cannot be foreseen except under such extreme circumstances, which gives a good indication of how deep-seated the current phase of JPY depreciation is. Moving on to JPY supply and demand, which this report considers quite important, Japan’s total trade balance for the January-September period of 2023 amounted to a deficit of -JPY 7.9 trillion, which has already surpassed the -JPY 6.9 trillion trade deficit recorded for all of 2012 (Japan’s fourth largest annual trade deficit ever). With three months to go, this year’s trade deficit could approach the -JPY 11.5 trillion posted in 2013. Japan’s trade deficit has surpassed -JPY 10 trillion only three times in its history – in 2013, 2014, and 2022. In each of these years, JPY had depreciated by over 10% against USD. Going by this historical fact, I feel that this year’s JPY depreciation was in the natural course of things. It seems likely that the supply-demand climate, in addition to interest rate trends, will continue contributing to JPY depreciation for some time to come.

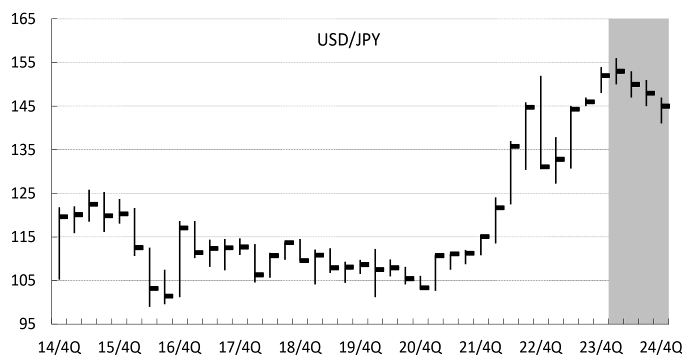
EUR renewed its year-to-date low during the early part of the month, but recovered subsequently. The ECB, having weighed the consequences of economic slowdown against those of soaring inflation, appears to have decided on policy operation prioritizing the former, and its rate hikes appears to have entered a period of suspension starting the October Governing Council meeting. In this report, going by the ECB’s more stubbornly hawkish stance relative to the Fed, I had assumed that EUR would retain its strength amid the shrinking of the Europe-U.S. interest rate gap. However, the ECB’s recent stance reversal compels me to consider downwardly revising my outlook for the currency. I have also stated in the past that the biggest risk to EUR is an increase in natural gas prices, and this risk has become more realistic since early October. In addition to the sudden eruption of a crisis in the Middle East, there was also the incident of damage to a natural gas pipeline and the suspension of its operation in Northern Europe, causing natural gas prices to increase slightly. The EU does have sufficient natural gas reserves at the present time, so an energy crisis similar to last year is unlikely as of the moment. However, if deteriorating market sentiment pushes up natural gas prices and keeps it persistently high, the regional trade balance, led by Germany, is likely to deteriorate, and this itself would justify the weakening of EUR. In other words, EUR may be weighed down both by interest rate and supply-and-demand factors.

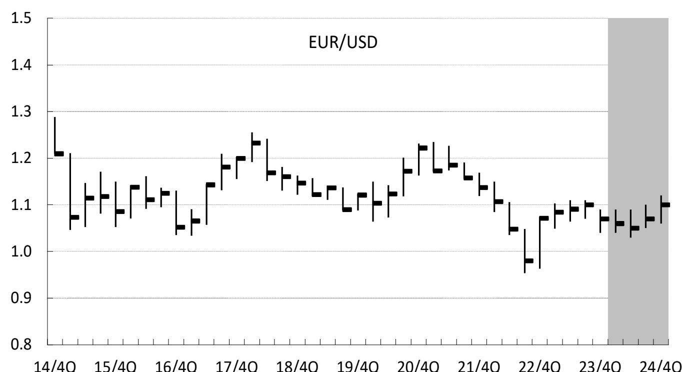
Summary Table of Forecasts

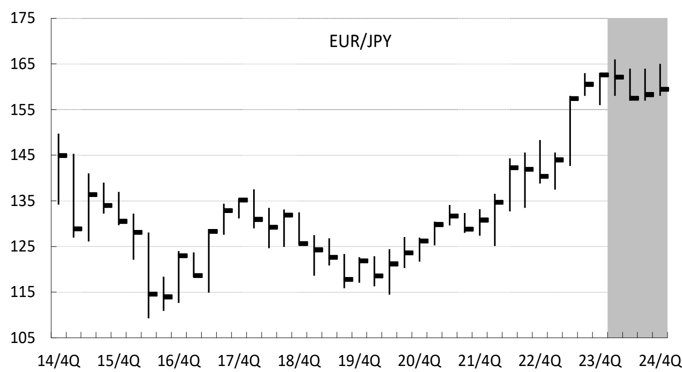
	2023 Jan～Oct（Actual）	Nov～Dec	2024 Jan～Mar	Apr～Jun	Jul～Sep	Oct～Dec
USD/JPY	127.22 ～ 150.78 (149.41)	148 ～ 154 (152)	150 ～ 156 (153)	147 ～ 153 (150)	145 ～ 151 (148)	141 ～ 147 (145)
EUR/USD	1.0448 ～ 1.1276 (1.0612)	1.04 ～ 1.09 (1.07)	1.04 ～ 1.09 (1.06)	1.03 ～ 1.09 (1.05)	1.05 ～ 1.10 (1.07)	1.06 ～ 1.12 (1.10)
EUR/JPY	137.45 ～ 159.90 (158.55)	156 ～ 163 (163)	158 ～ 166 (162)	157 ～ 164 (158)	157 ～ 164 (158)	158 ～ 165 (160)

(Notes) 1. Actual results released around 10 am TKY time on 31 October 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





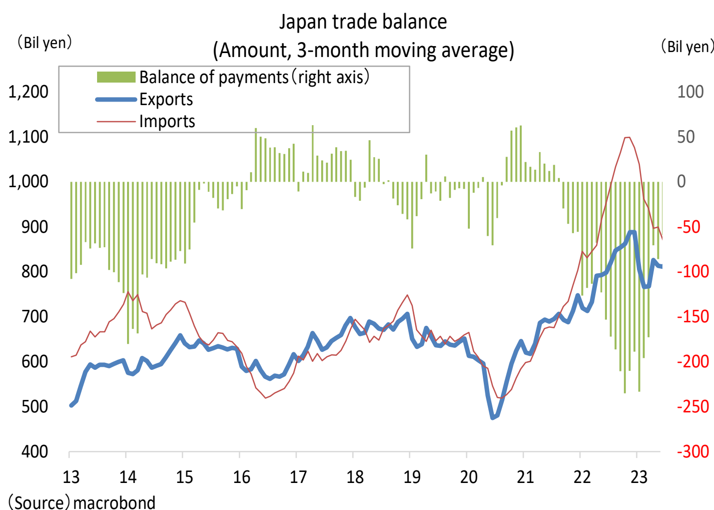


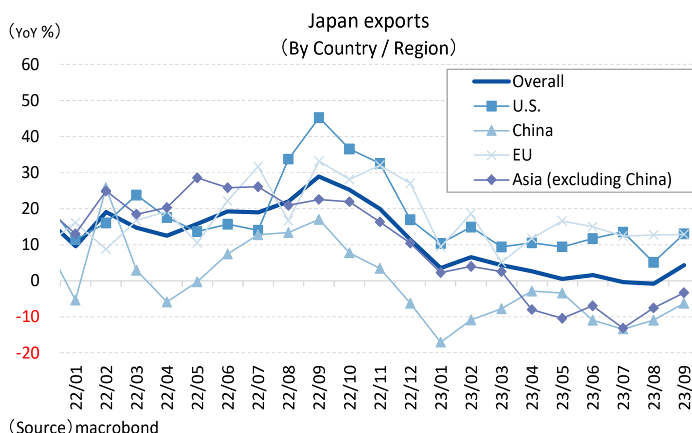
USD/JPY Outlook – Factors Causing the Return to the 150-Yen Rate

JPY Basic Supply and Demand – JPY Weakness in 2023 Only Natural

Trade Balance Improvement Trend Unlikely to Continue

On October 19, the Ministry of Finance released Japan's trade balance for September 2023, which had posted a surplus for the first time in three months, at +JPY 62.4 billion. With the release of the September trade statistics, we have the numbers for 1H of FY2023 (April-September), which add up to a cumulative deficit of -JPY 2.7183 trillion. Most of the news headlines were focusing on the improvement in trade balance compared with the same period of 2022, when the deficit had ballooned as a result of JPY depreciation and strong resource prices, but it must be remembered that the cumulative trade deficit so far for the calendar year 2023 (from January-September) is -JPY 7.9 trillion, which is a historically large figure (details below). Further, the JPY depreciation and high resource price trend, which had temporarily plateaued, have resumed since August and are expected to boost export prices once again with a 3- to 6-month delay. Trade results for September as a single month were favorable, with global exports posting the first positive growth in three months, at +4.3% yoy, but exports to China continued to post negative yoy growth for the 10th month in a row, at -6.2% yoy.





With no sign of improvement in Japan's exports to China, which constitute just under 20% of its global exports, one must assume that continued export improvement will be difficult. In September, global exports were boosted by the sharp rise in auto exports to the U.S. (by +34% yoy), but it is difficult to tell if this is a sustainable trend. Considering that the impact of successive rate hikes is likely to surface

going forward, it seems unreasonable to formulate a forecast scenario betting on a U.S. domestic demand recovery. I do not believe that the recent improvement in Japan's trade balance is sustainable.

JPY Weakness in 2023 Only Natural

The chart to the right lists the five largest trade deficit years in Japan's history since switching to the floating exchange-rate system. For reference, the chart also provides the rate of change in JPY's value relative to USD during the years in question (yoy rate of change at the end of each year). This is merely for reference, because there may not be a straightforward correlation between the trade deficit and JPY rate trends in any given year owing to leads and lags; still, the figures in the chart do not seem particularly surprising. Historically, Japan's trade deficit has surpassed the -JPY 10-trillion mark in only three years so far – 2013, 2014, and 2022. In each of these years, JPY had depreciated by 10% or more against USD (2013 was the first year following the ultra-strong JPY trend and the implementation of reflationary policies, which partially contributed to JPY depreciation). The three years in question also saw a coincidence of JPY depreciation and resource price appreciation. Crude oil prices remained over USD 100 per barrel through all of 2013 and up to mid-2014. This was right after the launch of the Kuroda BOJ administration under Abenomics, when "monetary easing of a different dimension" had a conspicuous impact on the markets (from mid-2014 onward, the Fed starting its tapering process coincided with a plummeting of crude oil prices after OPEC postponed production cuts). The memory of soaring crude oil prices and JPY depreciation in 2022, of course, is still fresh. In a resource-poor country like Japan, it is very natural for the coinciding of JPY depreciation with high resource prices to result in a vicious cycle of greater trade deficits and further JPY depreciation, and this is obvious in the aforementioned three years. When companies had their production bases in Japan, and JPY depreciation was able to boost export volume, this led to an improvement in the trade balance, so the vicious cycle was not taken very seriously, but the trade-balance-improvement process can no longer be expected.

Japan trade deficit (past No. 1 to No. 5) and USD/JPY

Year	Trade deficit (Tri yen)	Percentage change in JPY ag USD (YoY)	JPY depreciation rate ranking
2022	-20.0	-13.9	6th
2014	-12.8	-13.7	7th
2013	-11.5	-21.4	2nd
2012	-6.9	-12.8	9th
2015	-2.8	-0.4	22th
2023（Up to September）	-7.9	-3.3	

(Source) Ministry of Finance, Japan & Bloomberg (Note) Data since 1973

The cumulative trade deficit for 2023 so far (January-September), at -JPY 7.9 trillion, has already surpassed the -JPY 6.9-trillion trade deficit recorded for all of 2012 (Japan's fourth largest annual trade deficit ever). With three months to go, this year's trade deficit is expected to approach the -JPY 11.5 trillion posted in 2013. Going by this historical fact, and in light of the JPY supply-demand balance, I feel that this year's JPY depreciation was only natural. Amid persistently high inflation rates in the U.S. and Europe and the resultant increase in their interest rates, the domestic-foreign interest-rate differential is also, naturally, bound to have contributed to JPY depreciation, but the change in the JPY supply-demand climate can also not be overlooked.

Large Trade Deficits Could Become the New Normal

Further, looking back at the period since mid-2014, there were times when – against the backdrop of events such as a reversal of high oil prices, the "China shock" (2015), Brexit, and the U.S. election of President Donald Trump (2016) – fears overshadowed the Fed's rate-hike path, and the trend of JPY weakness against USD naturally entered a reversal process. What about this time round? This time, there is a strong view that crude oil prices will remain persistently high owing to supply constraints as the decarbonization trend takes hold. Rather, not just limited to crude oil, the global economy may be entering a phase when it is forced to remove Russia and China from its calculations, which is bound to make the world a more inefficient and expensive place than before. It is quite possible that Japan will have to resign itself to essentially high prices not just of mineral fuel, but also of other imports, including goods. Turning to exports, the decline in exports to China seems likely to become more permanent, reflecting the de-risking trend. With challenges to face both in imports and exports, Japan's trade balance may find it difficult to improve significantly in the foreseeable future.

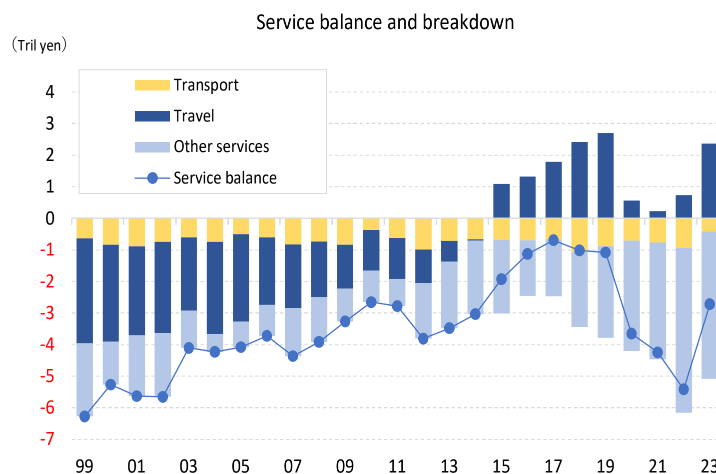
Of course, one cannot rule out the possibility of a marked JPY appreciation following the Fed's pivot to rate cuts and a resultant shrinking of import value. The question, however, is – can a JPY appreciation trend really return? As I repeatedly argue in this report, Japan has now entered a phase of posting annual Services deficit worth -JPY 5-6 trillion, and the deficit is only predicted to increase going forward. Even when it comes to Japan's highly treasured primary income surplus, my calculations suggest that no more than a third of it gets repatriated to Japan (please see past issues of this report for details). On top of all this, Japan has a negative-interest-rate monetary policy. With the two great fundamentals – interest rates and supply & demand – both affirming JPY weakness, one wonders to what extent JPY can appreciate solely on the strength of the Fed pivoting to rate cuts. Japan has never before experienced a phase of U.S. rate cuts coinciding with such an enormous trade and services deficit, so one must be prepared for the possibility of JPY failing to appreciate as much as expected. Of course, JPY is expected to appreciate to some extent alongside Fed rate cuts – perhaps to the 135-140 level. There is, however no guarantee that it will return to the vicinity of the 110 level, which is where it was before its current depreciation phase began.

The combination of high crude oil prices and weak JPY, which causes Japan's trade deficit to expand, may no longer be a transitory phenomenon, but a new normal that must be taken into account when trying to understand the present state and future outlook of the domestic and external economy. This is an important issue to focus on as something that may raise the USD/JPY rate level up a notch.

Japanese Economy Now and Going Forward – Services Balance Reflects Structural Changes in the Economy

Services Balance – A New Composition

In this report, I propose calling the Services-led, and especially Other-services-led, expansion of Japan's trade deficit the "new era deficit," and I have been discussing it as a possible indirect cause of persistent JPY weakness. Please see past issues of this report for more details in this regard. Looking at Japan's August Balance of Payments, released by the Finance Ministry on October 10, the Other services deficit was -JPY 522.9 billion, making the total deficit for January-August 2023 -JPY 4.6710 trillion, which is a yoy increase in deficit by over JPY 1 trillion (-JPY 3.5670 trillion for the same period last year). On the other hand, the Travel balance, which has been drawing attention amid increasing demand for inbound tourism, posted the highest ever surplus recorded for the month of August, at +JPY 258.2 billion, bringing the total surplus for January-August 2023 to +JPY 2.3656 trillion and posting an over 13-fold yoy growth (compared with +JPY 174.42 billion for the same period last year). Thanks to this expansion of the Travel surplus, the overall Services deficit remained modest, but the expanding trend of the Other services deficit is still quite conspicuous (see figure). I believe that the key to understanding the structure of JPY rates going forward will involve a detailed analysis of the trends not just of the Trade or Primary Income balance within Japan's Balance of Payments, but also of the Services balance.



(Source) Bank of Japan (Note) The data for 2023 is through August.

In this context, the BOJ Review "Globalization of Service Transactions as Seen from the Balance of Payments," which was published on August 10, 2023, discusses recent structural changes focusing on the Services balance, opening an extremely interesting avenue of thought. Most Services-related transactions are thought to accompany an outright forex buying/selling, and the items discussed here seem likely to be contributing directly to a structural change and, therefore, to the protraction of JPY weakness. In past issues of this report, I have suggested that Digital, Consulting, and R&D are three evocative keywords in connection with the expansion of the Other services deficit in recent years, but the BOJ Review analyzes the change in the Services balance overall using a more detailed classification that clearly highlights the structural changes in recent years.

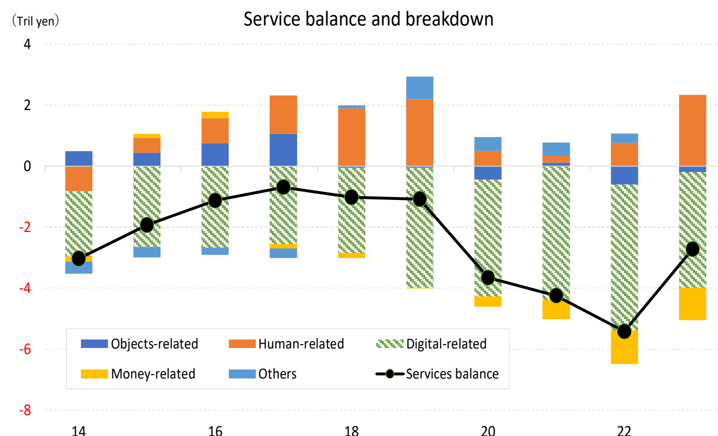
Specifically, the BOJ Review classifies and recombines the Services balance into the following five categories:

(1) Balance pertaining to the movement or production of goods (Goods-related balance)
(2) Balance pertaining to the movement or local consumption activities of people (People-related balance)
(3) Balance pertaining to digital activities (Digital-related balance)
(4) Balance pertaining to finance and insurance (Money-related balance)
(5) Other balances (Other)

For instance, payments and receipts pertaining to inbound tourism, which tend to draw attention as part of the Services balance (in other words, the Travel balance), would fall under category (2) above, while payments and receipts pertaining to U.S.-based IT giants' platform services and online advertising transactions would fall under category (3). For statistical purposes, the payments to foreign consulting firms, which have been expanding their business operations and increasing their sales in Japan in recent years, would also be filed under category (3) (as "professional and managerial consulting services" include online advertising and consulting-related payments). Further, category (4) is the combined balance of insurance/pension services and financial services, and this category has also been witnessing an expansion in deficits in recent years. This category (money-related balance) tends to get buried if included as part of the Other services balance, but as I will explain in detail below, it forms one of the pillars of the "new era deficit" when seen separately as its own category.

What Does the Digital Deficit Ultimately Amount to?

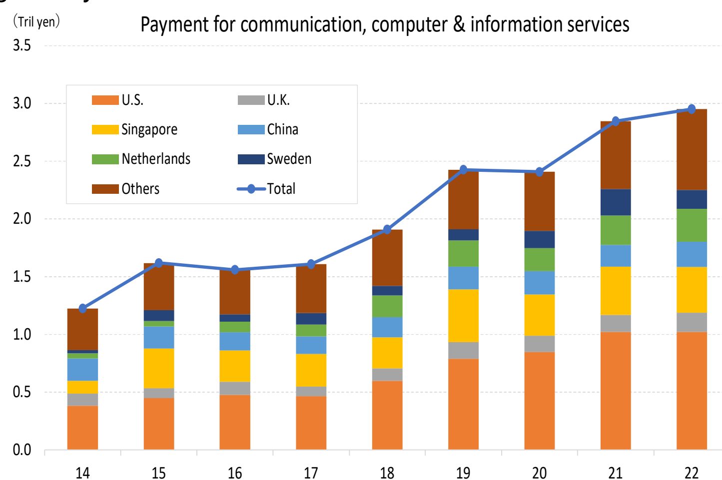
Over the course of discussing the new era deficit, I have received inquiries as to the actual volume of digital-related deficits. In response to this, I reclassified the Services balance based on the aforementioned BOJ categorization and made some calculations to visualize the trend so far (up to August 2023; see figure to the right). In 2022, the Services balance posted its largest deficit in roughly 20 years since 2002, at -JPY 5.4202 trillion, and -JPY 4.7814 trillion of this was owing to the digital deficit. If we go by the BOJ's categorization, it would not be wrong to say that <u>the digital deficit accounted for most of the Services deficit</u>. However, thanks to statistical limitations, payments to foreign consulting companies, which have recently been on the rise as mentioned above, and payments pertaining to the sponsorship of international sporting events, etc., are also included in the Digital balance, so there is some scope for debate as to whether it could really be said that digital deficits account for most of the Services deficit. Of course, assuming that this is, indeed, the case is not cause for major discomfort.



(Source) Bank of Japan review "Globalization of services transactions in terms of balance of payments statistics"
(Note) Data for 2023 is as of January through August

Incidentally, the digital deficit for 2014 (the earliest year for which records exist) was -JPY 2.1483 trillion, indicating that the figure has more than doubled in the span of eight years. During the same period, the people-related balance, led by the Travel balance, turned from a deficit of -JPY 816.6 billion to a surplus of +JPY 769.6 billion, and it seems likely to stabilize at over +JPY 2 trillion or so going forward, but even this is only expected to offset at most half of the digital deficit. Looking at the figures for January-August this year, having confirmed the recent-most data, the Services deficit is at -JPY 2.7198 trillion, with all of the +JPY 2.3329 trillion people-related surplus driven by the sharp recovery of inbound tourism having been wiped out by the -JPY 3.7984 trillion digital deficit. The money-related balance also contributes to expanding the Services deficit by consistently posting a deficit in excess of -JPY 1 trillion, chiefly owing to overseas reinsurance premium payments. In other words, the Services balance is structurally prone to large deficits despite the accumulation of people-related surpluses led by inbound tourism demand.

U.S. Obviously the Destination of a Large Portion of Digital Payments



(Source) Bank of Japan review "Globalization of services transactions in terms of balance of payments statistics"
(Note) Data for 2023 is as of January through August

While not all the details regarding the destination of payments related to digital services are available, the big picture can certainly be painted. In this section, I would like to limit the data to payments toward communication, computer, and information services, which includes payments for platform services to U.S.-based IT giants, and take a look at the volume of payments made by country/region. From the figure on the previous page, it is clear that, of the roughly JPY 3 trillion in payments made during 2022, roughly one-third (about JPY 1 trillion) went to the U.S., followed by Singapore (around JPY 400 billion), the Netherlands (around JPY 290 billion), and China (roughly JPY 200 billion). Unsurprisingly, payments to the U.S. are head-and-shoulders above the rest, and have more than doubled in the five years since 2017 (roughly JPY 460 billion). It seems unlikely that there will be any major change in this trend of expanding deficits going forward. Incidentally, as I discuss in detail below, payments pertaining to the money-related balance are also mostly destined for the U.S., followed by Central and South America, which offer attractive tax breaks. I believe this increase in Services-related payments to the U.S. will increasingly draw attention as the backdrop to the current strong USD/JPY trend.

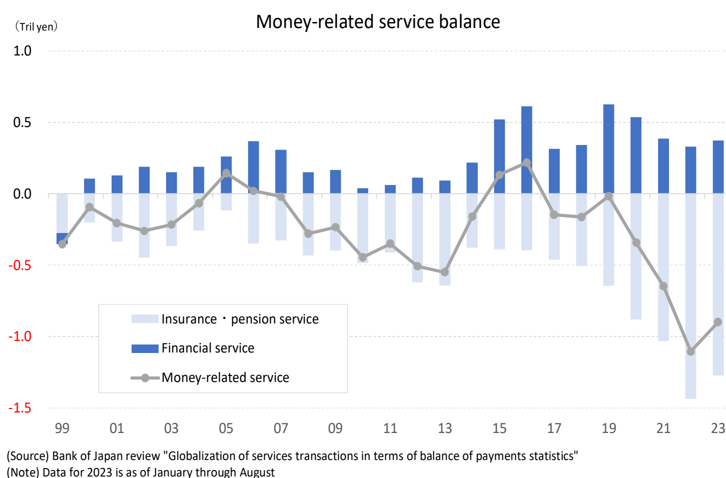
What are Money-Related Deficits?

To summarize the discussion so far, if we classify the Services balance into five categories, namely goods-related, people-related, digital-related, money-related, and other, the main changes in the past eight years since 2014 (for which records are available) include (1) an expansion in the people-related surplus, (2) an expansion in the digital-related deficit, and (3) an expansion in the money-related deficit. (1) and (2) have already been discussed above, but exactly what kinds of service transactions does (3) reflect? The money-related deficit has expanded almost 10-fold from -JPY 159.9 billion in 2014 to -1.1053 trillion in 2022, and it is expanding at an even higher pace this year, having already posted a deficit of -JPY 1.0657 trillion for the January-August 2023 period. About half of the people-related (travel) surplus of +JPY 2.3329 trillion earned during January-August 2023 has been wiped out by the money-related deficit, which makes it a category that is difficult to ignore. The following section takes a brief look at the realities pertaining to the money-related balance.

Expansion in Payments toward Insurance/Pension Services

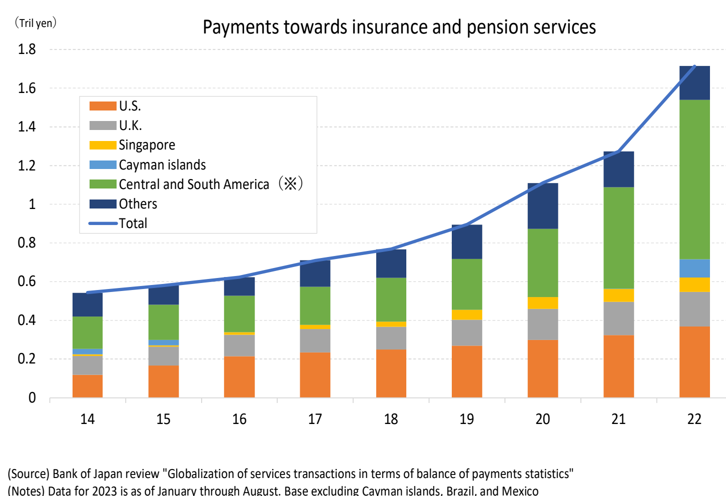
The money-related balance has been structured as the combination of insurance/pension services and financial services. It comprises, for instance, insurance premiums paid toward reinsurance and cargo insurance, and as the figure shows, its trend is essentially dictated by the expanding deficits pertaining to the former. This is thought to be especially impacted by the increase in payments toward reinsurance premiums. Reinsurance is defined as insurance that an insurance company purchases from domestic or foreign reinsurance underwriters, especially with regard to its own high-value insurance contracts, with the aim of risk diversification. In this context, the BOJ has explained the background to the increase in payments toward insurance/pension services: “with an increase in domestic investment-grade insurance products, the number of reinsurance contracts that Japanese insurance companies enter into with overseas reinsurance underwriters to suppress market risks is also increasing.” While not clearly defined, it is

thought that "investment-grade insurance products" include forex-denominated insurance products, where premium payments are made and insurance claims and surrender fees are received in foreign currency, and variable insurance or variable individual annuity insurance products, where a portion of the premium paid is invested in stocks, investment trusts, etc. Coincidentally, it was reported at the end of September that the Financial Services Agency views the sales structure of forex-denominated insurance products as problematic and looks to strengthening its oversight. It is interesting to note that insurance products that are so widespread as to be difficult to overlook from an administrative point of view are also exerting a not insignificant impact on the structure of the Services balance. Another possible interpretation is that this is part of an increasing move to promote investment rather than savings as part of Japan's asset-management-based nation-building initiative, and given that insurance-product-based investments are already quite popular in Japan, the result is an impact on the structure of the Services balance.



(Source) Bank of Japan review "Globalization of services transactions in terms of balance of payments statistics"
(Note) Data for 2023 is as of January through August

Looking at payments toward insurance/pension services by country/region, as expected, the U.S. and the UK are recipients of a large proportion of such payments, but interestingly (see figure), payments to Central and South America have shown marked growth since 2020 due to a well-developed reinsurance market thanks to attractive tax breaks. Of course, a unidimensional understanding of such insurance/pension service payments would not paint an accurate picture. As is generally known, there is a growing trend of Japanese insurance companies acquiring foreign insurance companies. This may partly be the reason for the increase in payments toward insurance/pension services from Japan to overseas locations, and if the payments are made to the overseas affiliates of Japanese companies, it must be noted that a significant portion of such payments can also be expected to be repatriated back to Japan in the form of primary income surplus (dividends, distributed branch profits, reinvested profits, etc.). In this context, the BOJ Review also notes that "it can be pointed out that (Japanese insurance companies) contribute not just to the Services balance but also to the expansion of the primary income surplus." Of course, it is a different question whether something posted as a "primary income surplus" will really get repatriated to Japan. As I have repeatedly argued in past reports, most of the primary income surplus cannot be expected to be repatriated (as per my estimates, only one-third or so of the overall primary income surplus may directly contribute to JPY buying).



(Source) Bank of Japan review "Globalization of services transactions in terms of balance of payments statistics"
(Notes) Data for 2023 is as of January through August. Base excluding Cayman islands, Brazil, and Mexico

Not Just Goods, Services also Enroute to Globalization

To summarize the above discussion, despite an expansion of the people-related surplus driven by demand for inbound tourism, Japan's Services balance overall is weighed down by the quite rapid pace at which its digital- and money-related deficits are simultaneously expanding, resulting thereby in a dampening of the Current Account balance overall. To take a look at the figures, the combined digital- and money-related deficits in the 2022 Services balance was -JPY 6 trillion, which accounts for most of the Services balance (of -JPY 5.4 trillion).

According to the BOJ Review, the globalization of service-related transactions is clearly contributing to an increased outflow of foreign currency from Japan, and this is a new factor contributing to JPY weakness. At the present time, the Services balance is smaller than the Trade balance, and this makes it lower in priority. However, considering the nature of the Services balance, it seems clear that it holds greater scope for an expansion of deficits. While this may be obvious, if Japan consistently posts a Services deficit worth -JPY 5-6 trillion, it will have to post a Trade surplus of the same or higher magnitude for the country to maintain a Trade & Services surplus. However, to see a stable Japanese Trade surplus of +JPY 5 trillion or more, one has to go back in time to 2010 or before, when Japanese companies' overseas relocation of their production bases was not yet seen as a problem (the process of relocation is likely already to have been completed by then, just that it was not yet being seen as a problem).

Assuming that the Trade balance fails to return to pre-2010 surpluses while the Services deficit continues to expand, Japan's Current Account surplus is feared to eventually be eroded to equilibrium and eventually fall into a deficit in the long term. Pointing out structural factors behind the JPY depreciation that started last spring met with stubborn denials from many quarters, but the BOJ Review points out a structural change via the globalization of service transactions – a structural change that implies JPY selling rather than buying. While one gets the impression that the structural change affecting Japan's Trade balance (Japanese companies' overseas relocation of their production bases) has

already gained widespread recognition, the current reality is that such a globalization is not limited to goods but has also spread to services. My understanding is that forex analysts must also accept and incorporate this new perspective into their analyses.

BOJ Monetary Policies Now and Going Forward – YCC to be Abolished in Name and Reality in 2024

Repeated "Prior Report → Minor Revision"

At its Monetary Policy Meeting of October 31, the BOJ decided to re-revise its long- & short-term interest rate operation (yield-curve control or YCC) policy. While the revision was undoubtedly in the direction of monetary tightening, it was also extremely close to maintaining the status quo. Following the announcement, there was a sudden spate of JPY selling in the forex markets, which had been expecting a greater monetary tightening based on a prior Nikkei Shimbun report. The Bank's policy related to its fixed-rate operations to purchase 10-year JGBs at close to 1% was revised, and the 1% rate, which had previously served as a practical ceiling, will now be considered a "reference," indicating that a rate exceeding 1% will be accepted. The fact that the Bank has abandoned the 1% line in the sand it had drawn for itself can only be interpreted as an acceptance of higher interest rates, so the recent decision could correctly be viewed as a rate hike in practice despite retaining a situation as close to the status quo as possible. As I will explain later, one must take special note of the fact that JPY was sold off significantly despite this. Under the administration of BOJ Governor Kazuo Ueda, the markets seem to be making a habit of factoring in a revision of accommodative monetary policies based on prior reports, and a pattern of "prior report → minor revision" seems to be repeating. If kept up, the already hollowed YCC will remain only in name as a truly useless artefact. A major point of debate is the timing at which YCC will be abolished in name as well as reality, and in this connection, the April 2024 MPM, when the results of the 2024 Spring Offensive become more or less clear, will be a milestone event of utmost importance for the financial markets. Based on such monetary policy assumptions, April-June 2024 may become an important milestone from the perspective of forex outlooks too (of course, a major precondition is for the end of Fed rate hikes to become certain and rate cut speculations to have strengthened by mid-2024 in line with majority predictions)

A Setup that Adds Fuel to the Fire

In the Outlook for Economic Activity and Prices (Outlook Report) released alongside the MPM, the outlook for the yoy growth rate of the consumer price index (Core CPI excluding fresh foods) was upgraded only slightly, to +1.7%, for FY 2025, but quite considerably, to +2.8%, for both FY 2023 and FY 2024 (see figure). This soaring CPI growth is clearly exceeding the BOJ's assumptions. One gets the feeling that the protracted JPY weakness is inherently provocative for the BOJ, which cannot abandon its monetary easing despite inflationary conditions. While unable to rise to market expectations, the BOJ did make a decision in the direction of monetary tightening, and the fact that JPY selling accelerated in spite of this gives the impression that the BOJ has fallen behind at least from the perspective of protecting the currency. Of course, the BOJ's official stance is that its revision of monetary accommodation is not intended to rein in JPY depreciation, but in reality, it is unlikely that the Bank was happy with the forex market reaction (JPY depreciation). As I have argued in past issues of this report, the BOJ will probably continue to be urged into using its monetary tightening options by the forex markets through JPY selling aimed at signaling the insufficiency of the BOJ's tightening efforts, and this pattern is likely to continue until the results of the 2024 Spring Offensive become somewhat clear. This setup – with the BOJ's moves to tighten monetary policy resulting in further JPY selling as though to add fuel to the fire – is likely to continue going forward and is cause for concern.

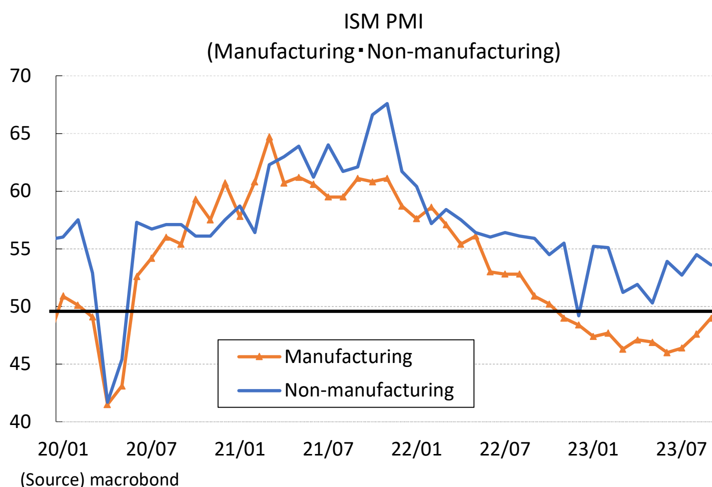
Major outlook by BOJ policy board members (YoY%)

	Real GDP	Core CPI (ex fresh food)
FY2023	1.8～2.0 <2.0>	2.7～3.0 <2.8>
Outlook as of JUL	1.2～1.5 <1.3>	2.4～2.7 <2.5>
FY2024	0.9～1.4 <1.0>	2.7～3.1 <2.8>
Outlook as of JUL	1.0～1.3 <1.2>	1.8～2.2 <1.9>
FY2025	0.8～1.2 <1.0>	1.6～2.0 <1.7>
Outlook as of JUL	1.0～1.2 <1.0>	1.6～2.0 <1.6>

（Source）Bank of Japan
（Note）＜＞ indicates the median estimate by policy board members

U.S. Monetary Policies Now and Going Forward – Sharp Rise in U.S. Interest Rates Could Trigger JPY Appreciation

"Concerns" about the U.S. Economy's Bottoming Out



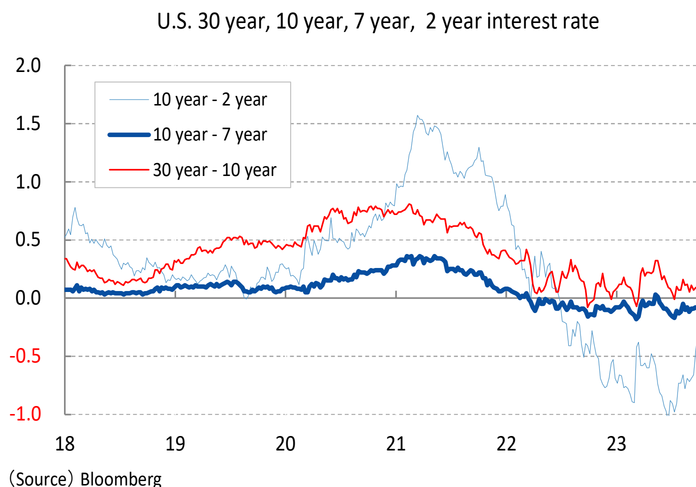
The continued rise of U.S. interest rates attracted considerable attention in financial markets during October and, on October 20, the 10-year interest rate surpassed 5% for the first time since July 2007. The fact that the U.S. economy has retained its strength despite repeated interest rate hikes can be considered to be good in general, but it has complex implications with respect to monetary policies. The Fed is emphasizing measures to curb inflation, and the possibility that the U.S. economy may bottom out is worrisome to the Fed insofar as it might countervail those inflation curbing efforts. Although it is unusual to be concerned about the prospect of an economic bottoming out, it is easy to understand the basis for such concern given that persistently high inflation rates present a great risk to the U.S. economy and, by extension, to the global economy. Looking at the ISM indices, for example, one finds that the index levels for both manufacturing and non-manufacturing industries can be considered steady, although the manufacturing industry index is showing clear signs of bottoming out (see graph). The ISM comprehensive index for manufacturing industries fell to 46.0 in June this year (its lowest level in about three years, since May 2020, a time when business sentiment was particularly pessimistic owing to the emergence of the covid-19 pandemic), but in the subsequent three months it has increased by 3 points. The manufacturing industry index remains below 50 (the dividing line between expectations of economic expansion and contraction), but the recent trend in that index clearly suggests that business sentiment has passed its worst period and is showing a trend of sustained improvement.

On the other hand, the ISM comprehensive index for nonmanufacturing industries has been attracting considerable attention because of its sensitivity to the impact of employment and wage trends, and that index declined in September (from 54.5 to 53.6), suggesting that the pace of economic expansion is slowing. Moreover, the new orders index within the ISM nonmanufacturing industries index dropped considerably in September (falling six points from the August level), and this is just one of numerous indicators that are hinting at the possibility of prospective decline in consumption of services. The Fed is probably hoping that such trends will be reflected in employment statistics and that wages will continue to grow at moderate rates; however, such signs of economic deceleration are currently evident only in soft data and are not seen in hard data. Within the ISM nonmanufacturing industries index, the business activity index (designed to indicate the current level of economic activities) rose 1.5 point mom in September to 58.8, its highest level in three months. It appears that it will not be possible until a certain amount of time has passed to confirm a weakening in such lagging indicators as employment and wage indicators. Within both the manufacturing and nonmanufacturing industry indices, the employment index is above 50, suggesting that the trend of economic expansion will continue for the time being.

Looking at GDP as a representative example of hard data, third quarter U.S. GDP figures were announced on October 26, and that data shows that real GDP growth was 4.9% qoq, the highest level in about 2 years. This appears to confirm that the actual situation is far removed from the "decline in consumption and investment appetite due to repeated interest rate hikes accompanied by an overall economic recession" scenario that has been feared since the beginning of the year. Growth in personal consumption, which supports 60% of the U.S. economy, considerably accelerated in the third quarter to 4.0% yoy, from 0.8% yoy in the second quarter, and such rapid growth makes it difficult to imagine that the U.S. economy's dynamism will dissipate any time soon.

Rising U.S. Interest Rates as a JPY Appreciation Risk Factor

Current U.S. economic and financial trends along with the height of U.S. interest rates are fundamental factors promoting JPY depreciation and, accordingly, USD/JPY fluctuated around the JPY150 level during October. However, I also believe the recent rises in interest rate levels in Europe and the United States – particularly the rise in interest rate levels in the United States during October – are also dangerous situations with the potential to promote JPY appreciation. They remind me of what happened this past March. It was at that time that financial instability triggered by failure of Silicon Valley Bank temporarily evoked memories of the Lehman Shock, causing a sharp drop in U.S. interest rates along with a period of JPY appreciation. At that time, there was a sudden increase in the number of people with extreme expectations that the trend of successive interest rate hikes would quickly turn into a trend of interest rate cuts. In the wake of the Silicon Valley Bank collapse, regional banks in the United States were seen to be failing one after another, and major financial institutions in Europe were also forced to restructure. In the end, the period of flux ended without causing major systemic instability, but it bears noting that the accelerating bank run stemmed from the rise in interest rates and the associated growth in banks' unrealized losses on long-term government bonds and mortgage-backed securities (MBS). Given that subsequent rises in U.S. interest rates were even more unexpected and that there are concerns that the high interest rate levels may be prolonged, it seems that one should be preparing to deal with a prospective scenario of "USD selling triggered by financial system instability".



(Source) Bloomberg

Naturally, such financial system instability cannot be part of the main forecast scenario, but it is still worrisome to note how the uptrend in U.S. long-term interest rates strengthened during October in a way that seems to be anticipating an end to the inverted yield curve situation (see graph). In view of that, it would not be surprising if a growing number of financial market participants were to be reminded of what happened this past March. The U.S. banking sector is suffering from a considerable amount of unrealized losses on its bond holdings, and those losses are a basis for anticipating that banks may become increasingly reluctant to extend additional loans, thereby causing a general deterioration of the credit environment. Furthermore, although this is not currently a concern, so long as interest rates continue rising and pushing up the entire yield curve, there is a possibility of a rapid cooling down of the private sector's appetite for capital investments, housing investments, and other consumption and investment activities.

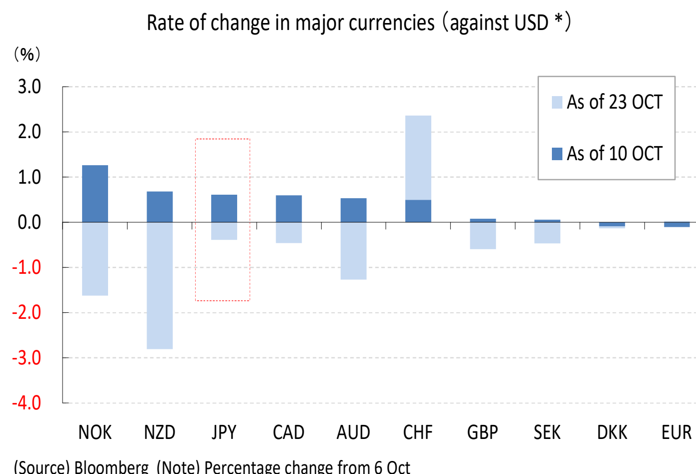
Looking Back Nostalgically at the "Great Moderation" Period

Fed Chairman Jerome Powell is currently excluding the possibility of a recession from his main forecast scenario, saying he does not anticipate a recession. From an economist's point of view, there are fundamental doubts about how the large margin of increase in interest rates seen recently will not lead to a recession. As mentioned above, U.S. long-term interest rates are currently at their highest level since August 2007, and at that time the "Great Moderation" phrase was being bandied about along with the "This Time Is Different" phrase – a famous phrase designed to make light of the financial markets' predilection for repeating the same mistakes over and over while expecting the results to differ from historical experiences. The monetary policy approach of dismissing the possibility of a recession while repeatedly raising interest rates to a quite high level raises the possibility that history is repeating itself yet again – that this time is not really different. On the other hand, the reality at this point is that U.S. economic indicators are still favorable and that interest rate levels have naturally had to be hiked to high levels in an attempt to restrain inflation rates amid those favorable economic indicators. Consequently, JPY depreciation can be expected to continue. I have been steadfastly forecasting the current JPY depreciation scenario since last year, but I still think that that unexpectedly high U.S. interest rates are pushing USD/JPY (now fairly stable in the vicinity of JPY150) upward to greater than expected degree and that we are now entering a situation in which it would not be very surprising if JPY were to appreciate somewhat owing to its having been oversold.

Of the various queries I receive, questions about when JPY depreciation trend will finally stop are among the most frequently posed, and the gist of the answer to those questions is – we have no choice but to sit back and wait for the United States' economic and financial situations to worsen before we can start anticipating the end of the JPY depreciation trend. In this regard, renewed financial system instability stemming from the sharp rise in U.S. interest rates is a scenario that could rapidly cool down the U.S. economic and financial situations, and such a scenario is one that would perhaps bring the quickest possible end to the current JPY depreciation trend. On the other hand, in light of the JPY depreciation trend's deep roots, the reality is that the trend is likely to persist unless such an extreme development eventuates.

Risks to My Main Scenario – Middle East Risks Prolong JPY Depreciation and "Risk-Off JPY Buying" Fades

Disempowerment of "Risk-Off JPY Buying"



(Source) Bloomberg (Note) Percentage change from 6 Oct

On October 7, a major geopolitical risk factor eventuated in the form of a ground attack on Israel by the Islamist Hamas organization, which governs the Palestinian Gaza autonomous region. That event and associated responses are generating considerable risks for the global economy, which had already been struggling to control inflationary trends that remain volatile despite repeated interest rate hikes. Many people are wondering how the risks might impact JPY exchange rates and other aspects of the forex market, so I will here present a brief summary of the current and prospective situations. Following the attack, as one might intuitively expect, oil prices rose sharply in the international commodity market and there was considerable buying of Norwegian krone (NOK) in light of Norway's oil-producing capabilities. The attack took place on

October 7 (Saturday), so the immediate forex market reaction can be measured based on changes in currency values against USD during the period from October 6 (Friday) to the morning of October 10 (Monday; see graph). It is noteworthy that NOK rose against USD by approximately 1.3% during that period. In the past, this kind of destabilizing geopolitical event regularly triggered considerable "risk-off JPY buying" in the forex market; however, this time (although JPY did initially appreciate by around 0.6%) such "risk-off JPY buying" has not been as strong as before. As the graph shows, as of the morning of October 10, the margin of JPY appreciation was comparable to that for such currencies as CAD, AUD, and CHF. In this regard, one might note that CHF (traditionally considered to be a "safe currency" akin to JPY) also did not appreciate very much against USD during the initial reaction period through October 10. However, CHF has appreciated significantly against USD since the beginning of the year so, with a slight continuation of its rise during the initial reaction period, it can be seen to have maintained its status as the "strongest of the G10 currencies". In contrast, given that JPY depreciated against USD by 12% since the beginning of the year, it cannot be denied that its rebound during the initial reaction period was weak. Looking at rates of change as of October 23 (Monday), about two weeks after the Hamas attack, one finds that JPY had depreciated 0.4% while CHF had reinforced its position as the strongest currency by appreciating 1.9%. Although JPY and CHF previously shared a similar "safe currency" status, they are now at different levels.

Given that the scale of speculative JPY selling just before the attack was extremely large, the small scale of "risk-off JPY buying" is particularly noteworthy. Looking at speculative positions based on IMM currency futures trading figures as of October 3, before the emergence of Middle East risks, one finds that JPY short positions against USD amounted to USD9.56 billion, reflecting the current period of JPY depreciation that began in March 2022 and close to record high levels. (The peak level of JPY short positions against USD was USD11.15 billion in the week ended April 12, 2022.) Despite the coincidence of huge geopolitical risks and accumulated speculative JPY selling, JPY's value against USD rose by only 0.6%. As discussed below, it is quite possible that the margin of JPY appreciation was limited owing to the large amount of real demand-associated JPY selling, such as that related to Japan's trade deficits. While "risk-off JPY buying" was once powerful enough to elicit Japanese society's aversion and fear, it has clearly lost much of its power.

Clear Implications for JPY Depreciation Trend

It is probably best to leave the analysis and forecasting of complex events in the Middle East to specialists, but the implications of those events with respect to JPY exchange rate outlook are relatively easy to understand – they basically seem to be factors promoting JPY depreciation. The main premise is the Middle East events will boost oil prices, and the focus of analysis is on how rising oil prices will affect exchange rates. While Israel and the Gaza Strip do not have strong presences as oil-producers, financial markets have become extremely concerned that the Gaza-related events might lead to a war involving the major Middle Eastern oil-producing countries and are proceeding with price formation processes based on that risk scenario. There is clearly a non-zero possibility that recent developments might cause a larger-scale war, and if such a war were to break out, it could directly impede oil shipments or spur major Middle Eastern oil-producing countries to impose an oil embargo, as they did after previous wars in the Middle East. It very difficult to assess the likelihood of such developments, but it is worth keeping in mind that the uptrend in crude oil prices had been a hot topic even before the Gaza-related events. It seems evident that the Gaza-related events have the potential to promote further increases in already high crude oil prices but not to promote the lowering of those prices. For example, it is quickly becoming clear that the likelihood of Saudi Arabia easing its voluntary reduction of crude oil production has diminished. Based on this understanding, it is worth making an effort to consider the prospective impact of higher oil prices on the economies of Japan and other countries.

Looking overseas, if the Gaza-related events have precluded the possibility of a decline in oil prices, then the European and U.S. central banks that have yet to overcome inflationary trends in their regions despite repeated interest rate hikes will have to deal with an additional inflation risk factor. Regarding USD/JPY, it seems clear that the further prolongation of interest rate hikes in Europe and the United States will promote JPY selling and USD buying based on differences between levels of Japanese and foreign interest rates. Volatility may temporarily increase, and it may become difficult to confidently undertake carry trades, but looking at the past, one finds that it is rare for Middle East risks to have a long-term impact on financial markets. Of course, some specialists may argue that "this time is different", but the main forecast scenario is that as time passes, the global focus of attention will progressively return to the topic of inflation trends in Europe and the United States. Regarding JPY, the only question is whether the trend of depreciation will remain unchanged, or whether it will become even stronger.

Looking at Japan, however, it is clear that continued high levels of crude oil prices will naturally promote a re-expansion of the country's trade deficits by pushing up the value of imports. Mineral fuels account for a quarter of Japan's imports. A 1% increase in crude oil prices pushes mineral fuel prices up by about 7%, thereby increasing the total value of Japan's imports by about 2%. Given that crude oil prices have already risen more than 30% since this year's bottom (in March) and that JPY has been depreciating in the meantime, Japanese imports should be increasing with a certain amount of time lag. I have been arguing that a reversal of the JPY depreciation trend will require the JPY supply-demand environment (largely determined by Japan's trade balance) to improve in 2023 (compared to 2022) and further improve in 2024. At this point, an objective observer would have to say that the likelihood of reversing the JPY depreciation trend was shaky from the start and that the Gaza-related events have made it even more shaky. In light of currently available information, I believe that the Gaza-related events will promote the protraction of the JPY depreciation trend based on both the interest rate differential and JPY supply-demand mechanisms.

Too Many Risks to Itemize
There are too many risk factors to list individually. At the time this article was written, there was conflicting information about the degree of Iranian support for the Hamas attack, but if that support leads to a tightening of U.S. sanctions against Iran, some observers expect that it will have a considerable impact on oil prices and other things. There are also grounds for concern that if the United States provides a large amount of military aid to Israel, the amount of its military aid to Ukraine may diminish and thereby cause Russia to quickly gain the advantage in the war in Ukraine. This reflects a wider-spread trend of increase in geopolitical risks, particularly in and nearby Europe. It is possible that such potential developments and risks will cause natural gas prices to continue to rise, severely impacting the euro area. If such impact eventuates, EUR depreciation may promote USD appreciation in a way that might eventually cause additional JPY depreciation. There are countless risk scenarios associated with difficult-to-predict geopolitical risks, and it is necessary to make some tentative conclusions about those risks when formulating the main forecast scenario.
Currently, regarding Middle East-related risks, it is difficult to find any factors that might promote JPY appreciation, and it is similarly difficult to identify any factors that might alter the ongoing JPY depreciation trend. On the other hand, it does seem that persistently high oil prices are increasing the risk that the JPY depreciation trend may become more protracted than previously anticipated.

EUR Outlook – ECB's Sudden Shift toward Dovishness

EUR Area Monetary Policies Now and Going Forward – Why Can't the ECB Accelerate QT?

ECB Shifts to a Wait-and-See Mode
The ECB Governing Council meeting held on October 26th decided to postpone hiking interest rates, the first time the Governing Council has paused the series of interest rate hikes it began in July 2022 and implemented at 11 subsequent meetings. Since July, the Governing Council appears to have been shifting the focus of its monetary policies from inflation toward economic conditions, and this October meeting can be said to have clearly confirmed that shift. The deposit facility interest rate has reached its highest level seen since the ECB's establishment (4.00%), and seems that the ECB is currently waiting to observe and assess the effects of the previous interest rate hikes. Changes to Governing Council meeting statement texts appear to confirm this shift to a wait-and-see mode. It is worth noting the following difference between the September and October statements:

- September: 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…
- October: Based on our current assessment, we consider that the key ECB interest rates are at levels that, maintained for a sufficiently long duration…

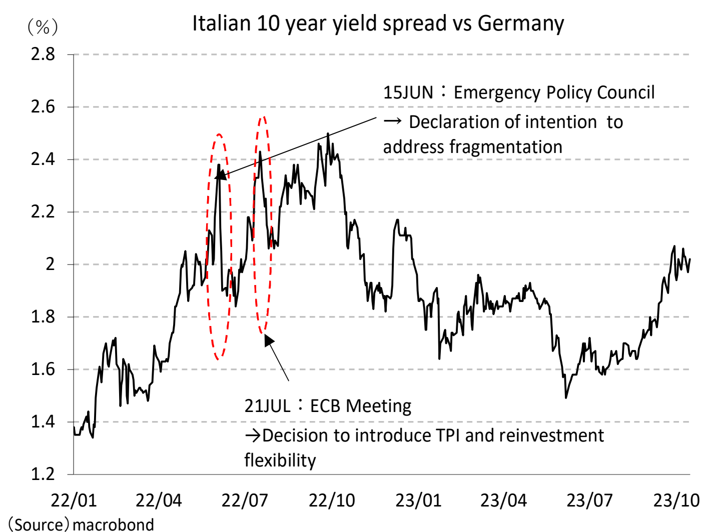
The September statement used the present perfect tense to suggest the attainment of a neutral interest rate level, and this attracted a great deal of attention. On the other hand, the October statement uses the present tense to express the nuance that interest rates were perceived to already be at a neutral level that should bring inflation under control over time. It appears that the biggest issue at this point is evaluating how the economic and financial situations change during the period the policy interest rate level is kept stable. At the post-Governing Council-meeting press conference, a reporter posed the question – "You said that you are seeing strong transmission of your past rate increases to financing conditions. Can you say how much of the impact has yet to hit the real economy and then inflation?" In response, ECB President Lagarde commented regarding the impact that – "We know that there is still more to come." – and then cited the staff forecast's assessment that the impact – "will continue to unfold throughout the end of 2023 and first quarter of 2024." In other words, the ECB is assuming that previous rate hikes will have the effect of slowing down the real economy through the first quarter of 2024 – it is anticipating a situation in which monetary tightening effects are exerted without additional interest rate hikes.
However, there are innumerable uncertainties associated with the staff forecast, and such situations as an upswing in energy prices in response to Middle East-related risks or an unexpected protraction of labor market tightness could make developments diverge from the ECB's expectations. The EBC's assessment of whether additional interest rate hikes are needed may change from time to time depending on how such situations are evaluated, and that is why the ECB has come to frequently characterize its policy stance as being "data dependent". In fact, the crude oil price assumptions in the revised staff forecast released in September ($82.7 per barrel in 2023 and $81.8 per barrel in 2024) have already proved to be far from accurate at this time. President Lagarde cited the "data dependent" phrase five times during the press conference to acknowledge the uncertainty of future developments, and she further emphasized that point by saying – "And I just want to mention that the fact that we are holding doesn't mean to say that we will never hike again." There is a clear possibility that rising energy prices will force the ECB to resume its interest rate hikes, and it currently appears that Middle East-related risk factors may determine whether the ECB will have to take that step. However, such a possibility is best considered a risk scenario, and the basic forecast assumption is that, beginning from the October meeting, the ECB has entered a period in which it will be monitoring the effects of its previous interest rate hikes.

Why No Move to Accelerate QT?

Until just before the October Governing Council meeting, it was rumored that the ECB might accelerate the suspension of the reinvestment of Pandemic Emergency Purchase Program (PEPP) assets and raise banks' minimum reserve requirements (MRR). Currently, PEPP reinvestments are slated to continue until the end of 2024, and the MRR is set at 1%, and many observers were expecting that the October Governing Council meeting might bring forward the reinvestment suspension timing and raise the MRR level as means of counter-balancing perceptions (owing to the halt to interest rate hikes) that the ECB had excessively shifted toward dovishness. The first reporter to pose a question at the press conference asked – "did you discuss or at least begin talking about ending PEPP reinvestment earlier or raising banks' reserve requirements?", but President Lagarde replied that – "Neither of these two questions, neither the PEPP, nor the remuneration of required reserves have been discussed at this meeting." – and refrained from making any further comment.

However, on October 11, Latvia's central bank governor Mārtiņš Kazāks made a statement to the effect that there is no need to wait until the end of 2024 before suspending of PEPP reinvestment, and on October 25, just before the Governing Council meeting, Estonia's central bank governor Madis Müller made a similar statement. Given that both are Governing Council members, it seems a bit strange to say that there was no discussion at all of the PEPP reinvestment suspension timing issue. The Fed began quantitative tightening (QT) quite some time ago, and the ECB has begun QT with respect to its regular asset purchase program (the Asset Purchase Programme (APP)) but not for the PEPP. Given the huge balance of PEPP assets (approximately EUR1.7 trillion), it seems a bit peculiar that such a large amount of supplemental liquidity has been kept available in the euro area despite the ECB's forceful measures to tame the region's persistently rampant inflation. Although this is speculation, it seems likely that awareness of the PEPP reinvestment issue is beginning to spread within the ECB, even though it was not on the October Governing Council meeting's official agenda. It is believed that the ECB's monetary policy management agenda is to a certain extent determined by the six-member Executive Board, which discusses various issues prior to deliberation and voting by the Governing Council, and it may be that prior to the October Governing Council meeting the Executive Board was tightly focused on the momentous decision to suspend interest rate hikes.

If this is not the case, and discussions of the PEPP reinvestment issue have been intentionally avoided, it may be out of consideration for the tenuous situations of Italy and certain other euro area countries that are facing soaring government bond yields. If that is the case, the suspension of PEPP reinvestment issue may not be on the agenda of the next Governing Council meeting in December nor on the agenda of numerous subsequent Governing Council meetings. At the October press conference, the trend of growing yields on the government bonds of certain euro area countries (often referred to as "fragmentation of the regional market") was often highlighted. One reporter posed the question – "Have you at all discussed the spread widening and especially the case of Italy? Italian spreads are now above 200 basis points. And I was wondering if this is a level the ECB is comfortable with or if it's considered to be a level of significant widening?" Italian government bond yields have been on the rise since this summer, although they have not reached the peak level of last year, when the government was forced to hold an extraordinary meeting and come up with various countermeasures (see graph). Given that both natural gas prices and inflation rates are much calmer than last year, this sudden rise is likely to be seen as a problem.



When asked about this situation, President Lagarde said – "we also have to make sure that there is proper transmission of our monetary policy throughout the whole euro area and to all countries in the euro area. And we have all the adequate tools in order to make sure that that happens." The phrase "all the adequate tools" probably refers to the PEPP reinvestment flexibility policy and the Transmission Protection Mechanism (TPI) introduced last July, particularly the PEPP reinvestment flexibility policy, which is currently being progressively more utilized. In particular, the PEPP reinvestment flexibility policy is being used in an irregular manner to utilize redemption proceeds from German and French government bonds for reinvestment in Italian and Spanish government bonds. If the effect of interest rate hikes persists through the first quarter of 2024, as the ECB staff forecast foresees, the challenges faced by Italy and other fragile euro area countries will only increase from now on, and the need for flexible PEPP reinvestment measures to alleviate those challenges will increase accordingly. It is quite easy to understand why the ECB is averse to accelerating the suspension of reinvestments and thereby reducing its leeway for implementing flexible PEPP reinvestment measures.

Governing Council Meeting Account to Hint at Internal Rifts?

Latvia's central bank governor Kazāks and others have argued that the rise in Italian government bond yields is ultimately a result of Italy's expanding budget deficits and should not be a factor preventing discussions about whether to retain the PEPP reinvestment flexibility policy. Judging from such statements, there seem to be Governing Council members who believe that reinvestment should be continued based on consideration for Italy and other Governing

Council members who believe reinvestment should be ended as soon as possible as a means of curbing inflation. Such a division within the Governing Council has not yet become apparent, however, and only those within the Governing Council can know what the actual situation is. Another reporter at the press conference asked regarding PEPP reinvestments – “What's your view on the various calls we've heard from members of your Governing Council to say that the end of those reinvestments could be brought forward? Do you think that would be a risky move?” Since the beginning of this year, whenever attention has been focused on the possibility of suspending the reinvestment of PEPP assets, President Lagarde has repeatedly dismissed the issue as not having been discussed, but there is now a growing perception that this dismissal may no longer be completely true. When the Account of the October Governing Council meeting is released in the future, one of the key points that will be focused on is whether or not the Account shows signs of a rift among the Governing Council members regarding the need to implement QT through the suspension of reinvestments.

EUR Now and Going Forward – Reemergence of Natural Gas-Related Risks

EUR’s Continued Weakening

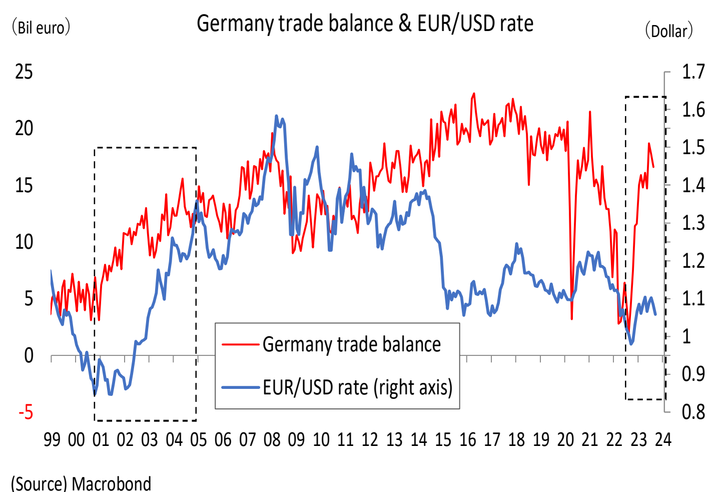
Since the start of October, EUR depreciation risk factors that this article has been concerned about for some time have begun starting to appear somewhat more likely to eventuate. EUR/USD peaked at around USD1.12 in mid-July and has since then gradually declined. In early October there were times when EUR/USD fell below USD1.05, setting new year-to-date lows. There are several possible reasons for this, but the most frequently cited one is that, since the summer, the euro area economy has been significantly weaker than the economies of the United States and Japan. According to the latest edition of the IMF’s World Economic Outlook (WEO; released in October), of all the advanced economies and emerging market and developing economies, the German economy is the only one that is projected to fall into recession (-0.5% real GDP growth) during 2023. Reflecting that, the euro area economy’s growth is expected to fall below 1%, to 0.7% (see chart). Such indices of German economic conditions as the ZEW Indicator of Economic Sentiment and Ifo Business Climate Index continue to be uniformly weak, and there are no signs that economic activities in Germany will become more dynamic in the near future. The European economy’s weakness is conspicuous when compared to the economies of the United States and Japan, both of which are expected to record growth rates above 2%. The problem is that, despite the slowdown in the real economy, euro area inflation rates have not slowed as much as expected, and while the ECB has been seeking to implement policies that give a balanced degree of emphasis to countervailing economic deceleration and high inflation rates, it is now beginning to place more emphasis on countervailing economic deceleration. It appears that the ECB Governing Council members generally have come to share the assumption that inflation rates will naturally decline as economic activities decelerate. This shift in attitudes began evidencing itself at the July Governing Council meeting and, as mentioned above, the ECB finally discontinued its policy of hiking interest rates in October, and has now adopted a stance of monitoring the effects of previous interest rate hikes over time.

IMF World Economic Outlook (Calendar year base, %)			Outlook		Comparison with July 2023 outlook	
		2022	2023	2024	2023	2024
World		**3.5**	**3.0**	**2.9**	**▲ 0.0**	**▲ 0.1**
Developed Countries		**2.6**	**1.5**	**1.4**	**0.0**	**0.0**
	U.S.	2.1	2.1	1.5	0.3	0.5
	Eurozone	3.3	0.7	1.2	▲ 0.2	▲ 0.3
	Germany	1.8	▲ 0.5	0.9	▲ 0.2	▲ 0.4
	France	2.5	1.0	1.3	0.2	0.0
	Italy	3.7	0.7	0.7	▲ 0.4	▲ 0.2
	Spain	5.8	2.5	1.7	▲ 0.0	▲ 0.3
	Japan	1.0	2.0	1.0	0.6	0.0
	U.K.	4.1	0.5	0.6	0.1	▲ 0.4
	Canada	3.4	1.3	1.6	▲ 0.4	0.2
	Other developed countries	2.6	1.8	2.2	▲ 0.2	▲ 0.1
Emerging countries		**4.1**	**4.0**	**4.0**	**▲ 0.0**	**▲ 0.1**
	Asian emerging countries	4.5	5.2	4.8	▲ 0.1	▲ 0.2
	China	3.0	5.0	4.2	▲ 0.2	▲ 0.3
	India	7.2	6.3	6.3	0.2	▲ 0.0
	ASEAN5	5.5	4.2	4.5	▲ 0.4	▲ 0.0
	European emerging Countries	0.8	2.4	2.2	0.6	▲ 0.0
	Russia	▲ 2.1	2.2	1.1	0.7	▲ 0.2
	Latin America & Caribbean	4.1	2.3	2.3	0.4	0.1
	Brazil	2.9	3.1	1.5	1.0	0.3
	Mexico	3.9	3.2	2.1	0.6	0.6
	Middle East・Central Asia	5.6	2.0	3.4	▲ 0.5	0.2
	Saudi Arabia	8.7	0.8	4.0	▲ 1.1	1.2
	Sub-Saharan Africa	4.0	3.3	4.0	▲ 0.2	▲ 0.1
	Nigeria	3.3	2.9	3.1	▲ 0.3	0.1
	South Africa	1.9	0.9	1.8	0.6	0.1
Global trade value (goods and services)		**5.1**	**0.9**	**3.5**	**▲ 1.1**	**▲ 0.2**
Consumer Price	**World**	**8.7**	**6.9**	**5.8**	0.1	0.6
	Developed Countries	7.3	4.6	3.0	▲ 0.1	0.2
	Emerging Countries	9.8	8.5	7.8	0.2	1.0

(Notes)
India: Data and outlook are presented on a fiscal year basis
ASEAN-5: Indonesia, Malaysia, Philippines, Thailand, Vietnam
Trade value: The simple average of growth rate of exports and imports value (goods and services)
IMF, Mizuho Bank

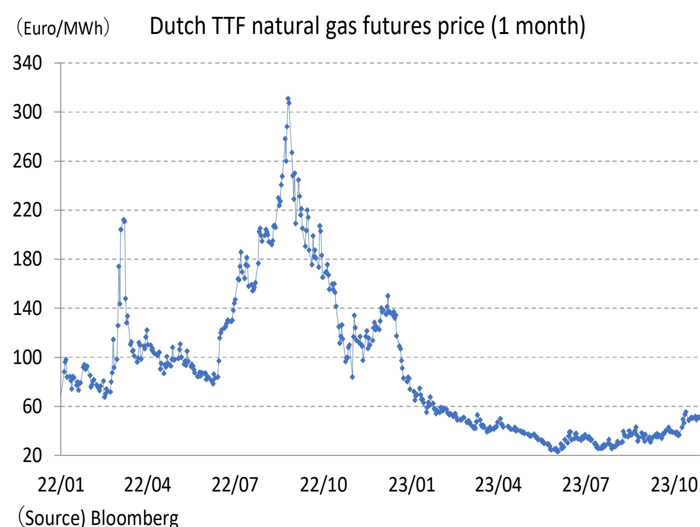
In any case, the EUR depreciation trend over the past three months appears to reflect the deterioration of the euro area economy as well as the ECB’s shift toward dovishness in response to that economic deterioration. Until now, this article has assumed that the narrowing of the Europe-U.S. interest rate differential would help keep EUR/USD firm during the forecast period, as the ECB appeared likely to sustain a more-hawkish stance than the Fed. It is becoming difficult to continue making bullish forecasts of EUR strength, however, now that the ECB has shifted its policy management focus to give more emphasis to countervailing economic deceleration than to countervailing high inflation rates. It is unclear whether the ECB will be successful in its strategy of giving greater attention to economic vitality while hoping that inflation rates will eventually decline. Even after the September and October Governing Council meetings, the ECB remains uncertain whether labor market tightness and the upward momentum of wages has diminished, and there remains a considerable risk that it may feel a need to begin hiking interest rates again. ECB President Lagarde is clearly concerned about a scenario in which Middle East risk factors lead to a resurgence in energy prices.

Renewed Risk of Natural Gas Price Rises



(Source) Macrobond

Moreover, EUR's weakening since the summer cannot be attributed solely to the deterioration of the euro area economy and lack of Europe-U.S. interest rate differential narrowing. Part of the reason I have been predicting EUR strength relates to EUR supply-demand trends, as Germany's strong export performance has long enabled the euro area to record the world's largest current account and trade balance surpluses. After falling below parity with USD during the period from 2000 to 2002, EUR appreciated against USD owing to such factors as shrinkage and reversal of the U.S.-Europe interest rate gap (which had previously been expanding) as well as the growing trade surpluses recorded by Germany (previously been referred to as "the sick man of Europe"), which enabled striking improvements in the euro area's current account balances and in the EUR supply-demand situation. EUR's fall below parity with USD last year superficially appeared to have reflected general fears that the deterioration of relations with Russia would impair energy supplies and depress the euro area economy overall, but it seems more accurate to attribute the fall below parity to the impact of surging natural gas prices on Germany, whose world-leading trade surplus was greatly diminished over the span of just a few months, and the consequential large deterioration of the EUR supply-demand situation. In fact, EUR/USD bottomed out when natural gas prices plummeted, and that corresponded to the timing of Germany's restoration of its large trade surplus (see graph).



(Source) Bloomberg

I have therefore argued that the biggest threat to my main forecast scenario of EUR strength would be a rise in natural gas prices. It is generally understood that the Hamas-Israel conflict has caused a renewed trend of increase in natural gas prices within Europe due to concerns that natural gas supplies from Middle Eastern countries may be disrupted (see graph on previous page). Additionally, on October 10, there was an incident in which the Baltic Connector submarine natural gas pipeline connecting Finland and Estonia was damaged, leading to the suspension of its operation. (The details are still under investigation but initial reports indicate the damage "was caused by external activity", and some reports speculate that the damage resulted from deliberate efforts to destroy the pipeline.) On October 13, Dutch TTF Natural Gas Futures next-month delivery prices (the benchmark price for natural gas trading in Europe) exceeded EUR55, the highest level seen in about eight months, since this past February. At the time this article was written (the end of October), the price level was remaining stable at around EUR50. The EU has been desperately arranging for natural gas shipments from all over the world to make up for the loss of supplies from Russia and cannot afford to face further supply constraints, so the possibility that Middle East-related risk factors may restrain supplies and boost energy prices is a major concern.

Of course, after last year's turmoil, the EU has taken pains to ensure that its natural gas reserves are almost at full capacity, so it would not be appropriate at this point to anticipate that Europe will face another energy crisis this winter. However, deteriorating market sentiment is pushing up natural gas prices, and so long as these prices remain high, the euro area's trade balance (largely attributable to Germany) can be expected to deteriorate, which in itself justifies projections of EUR weakening. Furthermore, as continued high natural gas prices will directly promote inflation, growing concerns about a euro area stagflation trend will become even stronger. If the markets factor in a stagflation scenario, a EUR selling trend is likely to become chronic regardless of whether the ECB raises interest rates or not. Given the current situation, I believe that the downside risks to EUR are suddenly increasing and that, consequentially, downward revisions to EUR exchange rate forecast values must be considered.

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