Forex Medium-Term Outlook

November 30, 2023

MIZUHO

Overview of Outlook

USD/JPY renewed its year-to-date high early in November, but has since shown strong signs of a correction. The correction has been in response to weak results for the U.S. October CPI and a decline in U.S. interest rates following statements by senior Fed officials, which has led forex market predictions of an end to the weak-JPY trend to gain momentum. This is very similar to the “CPI shock” phenomenon seen last November, and it seems within the scope of possibility that JPY may appreciate in response to a likely start of rate cuts by the Fed from 2024 onward, a whole two years after it began raising interest rates, and the resultant shrinking of the U.S.-Japan interest rate gap. The key question, however, is – to what extent will JPY appreciate? In Japan’s history, it has never been saddled with such an enormous trade deficit at the start of a phase of U.S. rate cuts. Historically, trade surpluses have been the norm for Japan, so a decline in U.S. interest rates directly resulted in a supply-demand-linked JPY appreciation. The current market predictions of JPY appreciation are probably based on this past experience to some extent. Others, in the coming days, are bound to predict JPY appreciation based on USD/JPY’s significant higher-side divergence from the PPP-based rate, but in all honesty, one has to wonder what corrective path they envisage. Japan has been a trade deficit nation for the past ten years now, and it is possible that JPY is in a transition phase as the currency of a trade deficit nation. Based on this perspective, I maintain my forecast scenario of only a limited appreciation of JPY if at all.

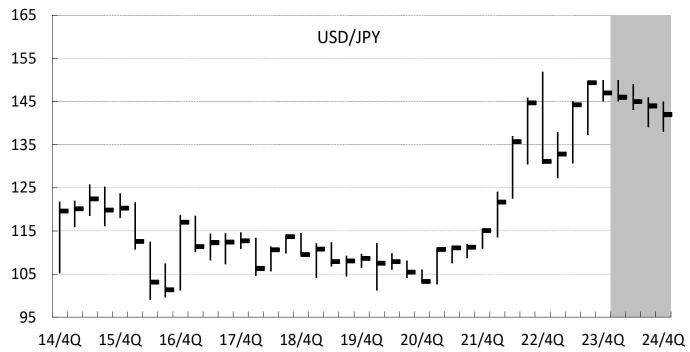
EUR underwent a rate reversal in November, soaring to post the highest rate against JPY in 15 years and attracting a great deal of attention. However, there is no guarantee that the ECB can maintain a more hawkish monetary policy stance than the Fed. Rather, the euro area’s real economy is weak enough to give rise to rumors that the ECB, which began rate hikes later than the Fed, could embark on rate cuts earlier. EUR appreciation in November was no more than a simple response to the shrinking Europe-U.S. interest rate gap as U.S. interest rates fell faster than euro area interest rates. The EUR/JPY rate surpassing 160 was also merely the result of JPY weakness, and cannot really be explained based on euro-area-related factors. As the ECB itself recognizes, successive rate hikes have definitively inhibited the regional economy, and credit conditions clearly indicate the cooling off of inflation going forward. It is quite possible that EUR will begin to lose momentum starting the second half of the current forecasting period. Upside risks include employment and wage conditions. As of the July-September quarter, there were no clear indications of a reversal in labor costs or in the wages as agreed by labor unions on which they depend. ECB Executive Board Member Philip Lane recently commented that the ECB cannot be confident that inflation has cooled off until next spring, so any dovish change in the bank’s stance is likely only in or after the April-June quarter of 2024. EUR could, therefore, begin to weaken sometime after mid-year next year.

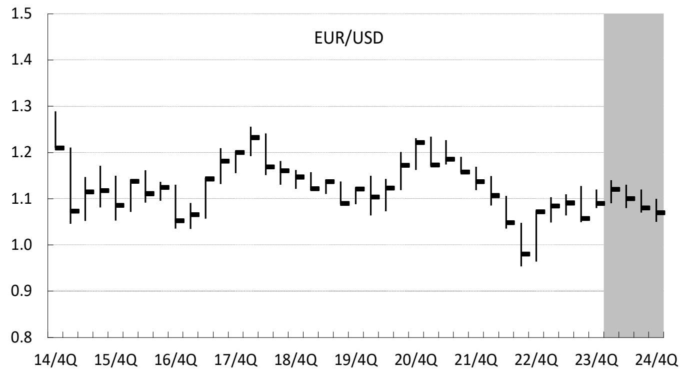
Summary Table of Forecasts

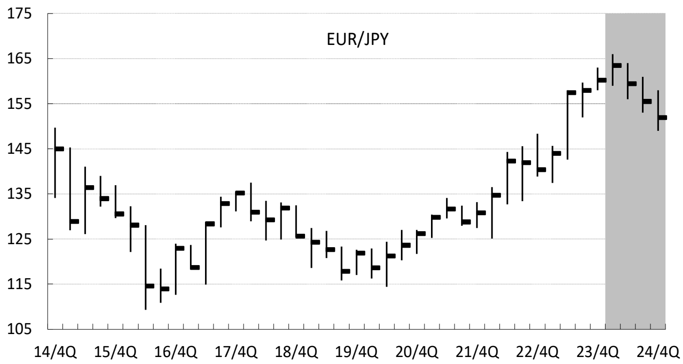
	2023 Jan～Nov（Actual）	Dec	2024 Jan～Mar	Apr～Jun	Jul～Sep	Oct～Dec
USD/JPY	127.22 ～ 151.92 (146.98)	145 ～ 150 (147)	145 ～ 150 (146)	143 ～ 149 (145)	139 ～ 146 (144)	138 ～ 145 (142)
EUR/USD	1.0448 ～ 1.1276 (1.0980)	1.08 ～ 1.12 (1.09)	1.09 ～ 1.14 (1.12)	1.08 ～ 1.13 (1.10)	1.07 ～ 1.12 (1.08)	1.05 ～ 1.10 (1.07)
EUR/JPY	137.45 ～ 164.31 (161.38)	158 ～ 163 (160)	159 ～ 166 (164)	156 ～ 164 (160)	153 ～ 161 (156)	149 ～ 158 (152)

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

Exchange Rate Trends & Forecasts







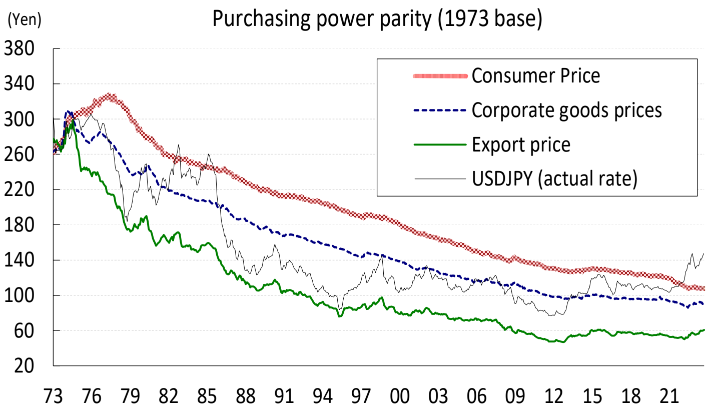
USD/JPY Outlook – Is “End of JPY Depreciation” the “Start of JPY Appreciation”?

USD/JPY Now and Going Forward – Will Market Rates Really Approach PPP?

The Possibility of Market Rates Approaching PPP

USD/JPY witnessed a continued decline in November, triggering stronger predictions of the end of the weak-JPY phase. As I have explained in previous issues of this report, the bottoming out of the current JPY depreciation trend in response to the Fed’s stance is within the scope of expectations. <u>However, the bigger question Japan needs to ask going forward is – to what extent will JPY recover as a result?</u> Interacting with investors and corporate clients on a daily basis, I get the feeling that an increasing number of people are gripped by fear that the fall could be as great as the rise has been.

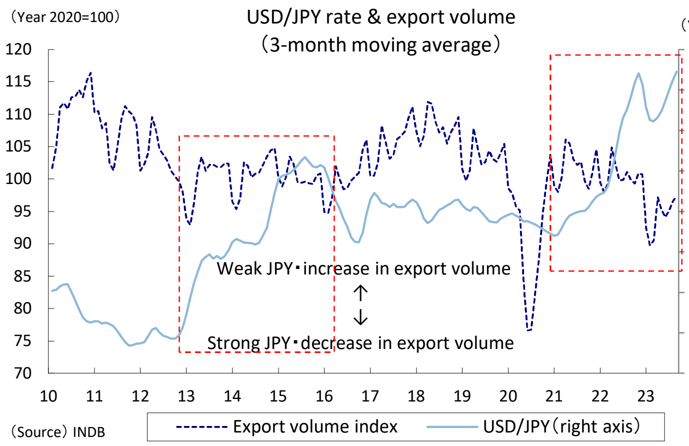
During such discussions, the purchasing power parity (PPP) often comes up. Similar to what happened at this time last year, JPY appreciation seems likely to be the dominant prediction for 2024 also, and PPP-based rates lend themselves to being brought out in support of such predictions. While this is also a topic I have discussed previously, I would like to revisit it here and share my thoughts on the relationship between JPY appreciation and the PPP given the large number of inquiries I have been receiving about this since JPY began to appreciate. As of the writing of this report, October 2023 is the latest month for which the PPP can be calculated, so I will use this to provide a recap of the relationship between the PPP and the market rate (see figure). Looking at specific figures, the USD/JPY rate is 108 in terms of the consumer price index (CPI) PPP, and 90 in terms of the producer price index (PPI) PPP. It is also 62 in terms of the export price index PPP, but as this rate has almost never been taken as a reference point, I will refrain from discussing it further. As of October, given the market rate (USD/JPY at around 150), JPY is around 40% weaker than the CPI-based PPP and around 70% weaker than the PPI-based PPP. As one can tell from a glance at the figure, PPP-based rates have never been so irrelevant as they are now, but the strong-USD phase during the first half of the 1980s may be the closest we can get to this level of discrepancy. That was during a phase of consecutive rate hikes by the Fed under former Chair Paul Volcker, with the accompanying USD appreciation lasting until the Plaza Accord was signed. The current level of USD strength against JPY is similar to (greater than) the level seen during the early 1980s, when the situation was only able to be resolved



(Source) Datastream

through international cooperation. How to interpret this is a question analysts will have to ask themselves.
There are, however, some caveats that must be considered when discussing the PPP at the present time. Over the past two years, JPY's PPP has increased relative to that of other countries thanks to more modest inflation rates in Japan relative to those elsewhere. This has resulted in a sudden increase in JPY rates as suggested by the PPP. If so, the PPP could reverse to indicate greater JPY weakness as inflation rate growth in the U.S. and Europe slows down in the coming months. In other words, the current levels of JPY undervaluation by 40-70% could be the result of temporarily exaggerated PPP-based rates. However, even before the pandemic hit (December 2019), the CPI-based PPP was JPY122, while the PPI-based PPP was JPY95, which would make JPY at current market rates undervalued by 20-60%. Ultimately, the fact remains that the market rate of JPY is excessively undervalued compared with its PPP. To look at this differently, JPY's excessive weakness relative to its (PPI-based) PPP is not a recent phenomenon, but one that has been going on for the past 10 years. This is also quite obvious from the figure.

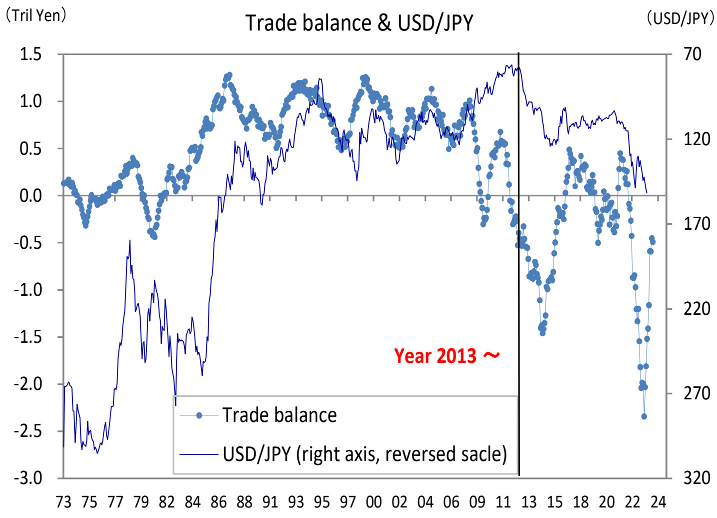
Defining "Excessive JPY Weakness"
This is where the problem begins. The orthodox view is that, given JPY's excessive weakness relative to its PPP, the currency's market rate will increase (JPY appreciation against USD) to approach its PPP. Indeed, in light of the recent strengthening of JPY, some analysts are already using the PPP to support their predictions of JPY appreciation from 2024 onward, and more are likely to do so going forward. Historically, there are no examples of key currencies remaining or being left uncorrected at market levels much lower than their PPPs, and this is why many are predicting that JPY will also undergo a correction to be more in line with its PPP.
However, Japan has often been the first to experience economic/financial problems not yet experienced elsewhere. Deflation is an example, as are the normalization of an ultra-low interest rate policy and high government debt levels as a ratio of GDP, which accompanied deflation. Japan is also facing an unprecedented outflow of foreign currency as a result of digital service and other deficits, as I have discussed in several previous issues of this report. While one *can* learn from history, there is no guarantee of being able to predict the future accurately based on history. To begin with, the definition of excessive JPY weakness is quite ambiguous. It must be remembered that export volumes have to be rising for JPY to convincingly be declared "too weak." In other words, JPY can only be considered too weak from the perspective of its PPP when this boosts export volume, expands Japan's trade surplus, and promotes real-demand-based JPY buying, thereby raising the value of JPY. It is only when this corrective path functions that one can look back and say that the starting rate of JPY had been "too weak." However, given that JPY weakness is no longer boosting Japanese exports, and the corrective path is no longer functioning, can one really use the PPP as a measure to declare JPY to be "too weak"? This is a point that must be given some consideration.



As the figure shows, export volumes have been clearly falling despite the dramatic weakening of JPY against USD since 2021. The same was true under Abenomics starting 2013. Looking at USD/JPY rate trends since Japan adopted the floating exchange rate system, the PPI-based PPP served as the ceiling for JPY market rates for a very long time. However, that also ended in 2013, and one must not overlook the fact that Japan's trade surplus began vanishing at around the same time. Ten years on from the time Japan became a trade deficit nation, could it not be that JPY is undergoing a transition as the currency of a trade-deficit nation? Of course, there are many measures by which to determine whether or not JPY is "too weak," so one must avoid making declarations lightly. However, for JPY to strengthen against USD to be more in sync with its PPP, there first needs to be an increase in exports and trade surpluses. To predict JPY appreciation "because the PPP suggests a stronger JPY" while overlooking the fact that an increase in exports and trade surpluses can no longer be expected for Japan seems altogether too superficial.

Approx. -JPY8.6-Trillion Deficit for January-October
To digress a bit from the subject of PPP, the vanishing of Japan's trade surplus and the expansion of its trade deficit are probably related to the current JPY weakness. As of writing this report, Japan's trade deficit for the first 10 months of 2023 has become available, and is at around -JPY 8.6 trillion. Even if 2023 ends without a further expansion of the trade deficit, the deficit for the entire year will still be Japan's fourth largest ever, following after the -JPY 11.5 trillion posted in 2013. This year's JPY depreciation may have come as a surprise for most people, but given JPY's supply-demand balance, one could say it was an inevitable outcome. I am often asked how the causal relationship works – "Is it JPY weakness→increase in import value→increase in trade deficit, or increase in trade deficit→JPY weakness→increase in import value?" – and I have to say that it is both. Historically, given that Japan is a resource-importing country, any increase in crude oil prices has caused Japan's trade balance to deteriorate.

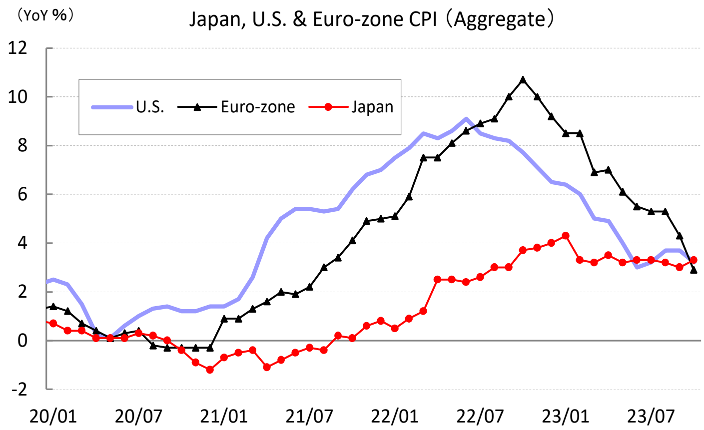
However, the discussion surrounding this has never gone so far as to conclude this to be a cause of JPY depreciation. This is because Japan has historically enjoyed a long period during which JPY weakness automatically boosted export volume, thereby limiting the extent to which the trade balance could deteriorate (in some cases, it could even be expected to improve). 2013-14 was a phase during which large trade deficits coincided with JPY depreciation, but the JPY depreciation at that time was chalked down to Abenomics ("a different dimension of monetary easing"), and few attempted to correlate it to the trade deficit. However, looking back at history, one cannot deny the possibility that the trade deficit could also have contributed to the acceleration of JPY depreciation. As the figure shows, Japan has not experienced any significant JPY strengthening in the past 10 years. A previous figure showed that it was 10 years or so ago that USD/JPY broke past the PPI-based PPP rate (which had until then functioned as a ceiling), and has not returned since. Perhaps, given that JPY weakness does not result in an increase in exports, it has become difficult for JPY to correct itself through appreciation.



(Source) Bloomberg
(Note) Trade balance is presented sic months in advance and is based on a six-month moving avverage.

An End to "the History of JPY strength" being "the History of Deflation"?

The argument in the previous section is based on JPY supply and demand, but the PPP is a measure of prices, so it is important to discuss this aspect too. The history of USD/JPY since Japan's switch to the floating exchange rate system has been a history of JPY strength, and this is theoretically consistent with the fact that Japan was the only nation in the world with a deflationary economy. This too, however, has recently been changing. As is widely known, Japan is facing an unprecedented labor shortage at this time. In a society with chronic labor shortages, it is essentially impossible for nominal wages not to rise. The government/BOJ's official view aside, the average person in the street is unlikely to still be laboring under the notion that the Japanese economy is deflationary.



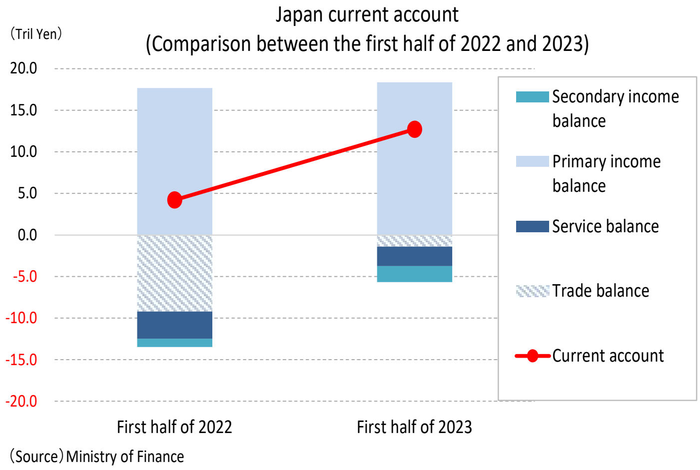
(Source) Bloomberg

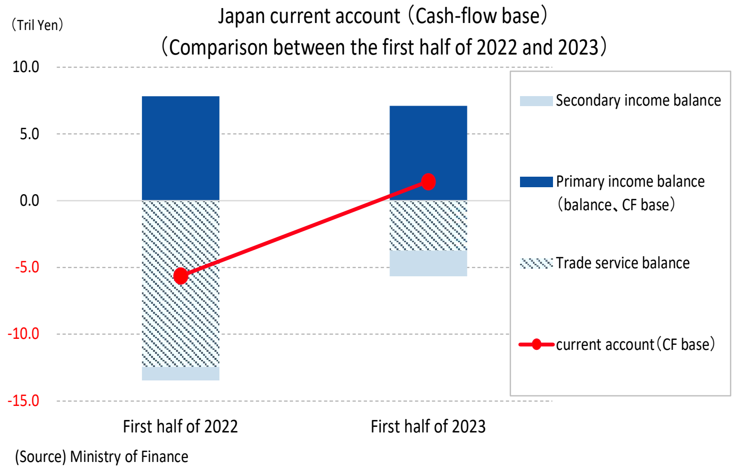
Until recently, the U.S. and Japanese economies fell into a clear-cut structure of "inflationary U.S. economy" vs. "deflationary Japanese economy," which overwhelmingly justified JPY strength in terms of PPP calculations. However, in a society where wage rises become inevitable against the backdrop of labor shortages, there is bound to be a gradual structural change. One cannot say much based on monthly datapoints, as they do not show a trend, but looking at the data for the whole of this year, at least, it seems that the price gaps between Japan vs. the U.S. or Europe have more-or-less vanished, at least based on the CPI (see figure). Assuming that this means Japan is no longer the only deflationary economy, the PPP could slowly correct itself to reflect greater JPY weakness against USD. In other words, it could be the PPP that needs correction rather than the market rate. One should discuss the relationship between JPY and its PPP based on the recognition that it is not just JPY supply and demand, but also price trends, that have changed compared with 10 years ago.

As explained at the start, as the 2024 JPY outlook draws greater attention, we are likely to hear predictions of "a return to JPY strength because the market rate has significantly deviated from the PPP" more frequently. However, this by itself is no more than a technical explanation equivalent to saying that JPY will be bought because it has been oversold. Of course, to some extent, one can agree with the claim that a currency that has been oversold is likely to be bought, and a change in the Fed's monetary policy stance is bound to offer a buy-back opportunity for JPY. Having said that, merely discussing transitory factors does not help gain an understanding of the structural changes the Japanese economy is facing, nor does it explain why JPY has remained so persistently weak.

JPY Supply and Demand Climate – Understanding the 1H Balance of Payments

Surplus Down to One-Tenth When Viewed from Cash-Flow Perspective

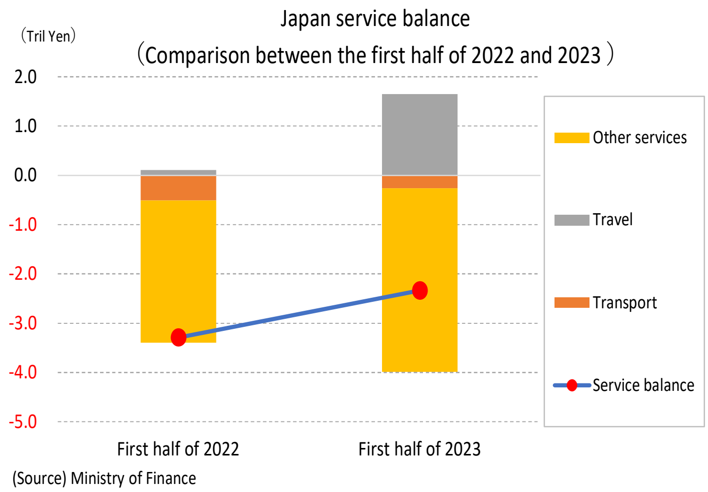




The (preliminary figures) of Japan's Balance of Payments for 1H of FY 2023 (April-September) were released by the Ministry of Finance on November 9. They revealed a current account surplus three times larger than that for the same period of the previous year, at +JPY 12.7064 trillion, the largest ever posted for 1H of a fiscal year, and made the news headlines. Three key takeaways from the FY2023 1H Balance of Payments were, (1) the shrinking of the trade deficit, (2) the expansion of a trade surplus, and (3) the expansion of the Other Services deficit; and it can be said that the impact of (1) and (2) surpassed the impact of (3) for the period in question. Looking first at (1), the trade deficit, at -JPY 1.4052 trillion, had posted significant yoy improvement (by +JPY 7.7762 trillion) from the -JPY 9.1814 trillion posted last time. (2) The travel surplus (+JPY 1.6497 trillion) had also posted an over 10x yoy growth, up by +JPY 1.5394 trillion from the +JPY 110.2 billion posted last time (although one must be cautious not to over-value this sharp yoy growth, given that the country was closed to tourists last year). Meanwhile, (3) the Other Services deficit (-JPY 3.7235 trillion) had expanded by as much as -JPY 834.8 billion from -JPY 2.8887 trillion last time.

To summarize, the current account surplus margin for 1H of 2023 was essentially equivalent to the shrinking of the trade deficit, and the main reason for this, needless to say, was the decline in crude oil prices (by -25.3% yoy to USD 83.52 per barrel). Of course, such market-related factors do play an important role, but they should not be made too much of, since they are irrelevant to structural facts. Moreover, the cash-flow (CF)-based current account balance, which I calculate and check as part of writing this report each month, came out to be roughly +JPY 1.5 trillion for 1H of FY2023. Given that it was -JPY 5.6 trillion for 1H of FY2022, there has definitely been an improvement in the JPY supply and demand climate. Having said that, the fact that the CF-based current account surplus shrank to one-tenth the statistical figure of roughly +JPY 12.7 trillion is important to take note of in formulating the medium-term outlook for JPY (see figure on previous page). Incidentally, calculating the CF-based current account balance for January-September 2023 gives us -JPY 2.2211 trillion, which is a deficit despite being a significant improvement from the -JPY 6.8125 trillion for the same period of 2022, and is consistent with the weakening of JPY starting early 2023.

Largest Ever Other Services Deficit



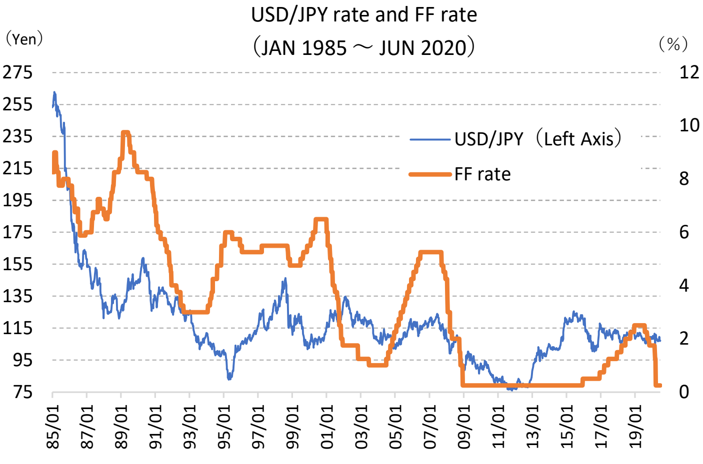
The fact that the Other Services deficit remains large is also worth taking a look at. Against the backdrop of the robust improvement in demand for inbound tourism, the travel surplus expanded, thereby shrinking the overall Services deficit (from -JPY 3.2884 trillion to -JPY 2.3347 trillion), and this tends to attract most of the attention, but Other Services, which are also a determining factor in the Services balance, have been posting extremely large deficits. As mentioned above, the current account surplus for 1H of FY2023 posted the largest ever for 1H of a fiscal year, but the same is true for the Other Services deficit (the largest ever deficit for 1H of a fiscal year). The Other Services balance (for one half of a fiscal year) has never even posted a deficit of over -JPY 3 trillion, but this time, it is approaching -JPY 4 trillion (at -JPY 3.7235 trillion). Compared with the trade balance, which can depend significantly on crude oil prices and other commodities market factors, or the travel balance, which can depend on overseas economic conditions, the Other Services balance is determined by factors such as payments made to giant platformers, and the deficit here is forecast to essentially continue expanding. It is a concerning development that could contribute to lowering Japan's current account surplus and, therefore, weakening JPY.

Of course, the travel surplus is also accumulating at an unprecedented pace, and a surplus of +JPY 1.6497 trillion is the largest ever seen for 1H of a fiscal year. However, given the extreme short supply of labor in the accommodation and restaurant service industries, as cited by the BOJ Tankan, etc., it seems that Japan is entering a phase where, even if there is an increase in demand for inbound tourism, sustaining the required level of supply may be difficult. To summarize, Japan's Services balance is facing a conundrum in that, while it is approaching the ceiling for how much forex can be earned through the travel surplus, payments toward digital and other services continue to increase, leaving greater scope for the expansion of the Other Services deficit. Even if Japan is able to earn significant forex in labor-intensive industries such as tourism, there seems no end in sight to the amount of forex paid out in capital-intensive industries such as platform services. Some think that a medium- to long-term JPY weakness is the market phenomenon required to correct this.

How U.S. Monetary Policy is Related to JPY Rate Trends – Implications for Japan Entering a Phase of U.S. Rate Cuts as a Trade Deficit Nation

The History of U.S. Rate Cuts and JPY Appreciation

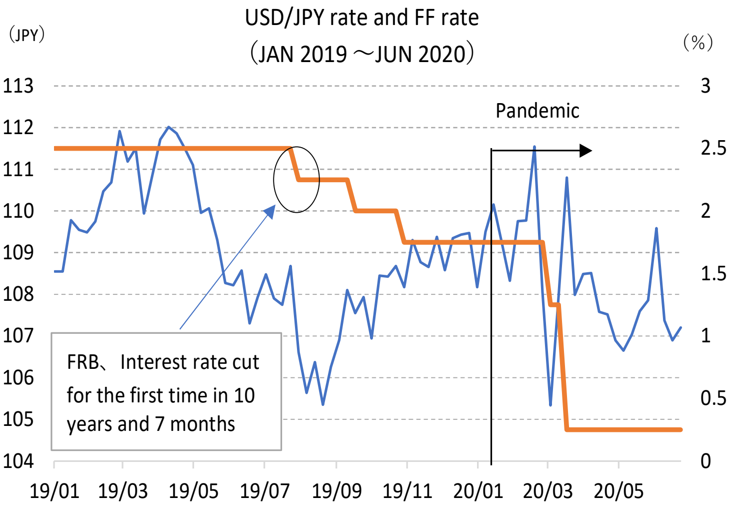
JPY appreciation predictions are likely to dominate for 2024 amid expectations of rate cuts by the Fed and the accompanying fall in U.S. interest rates. The downswing in the U.S. October CPI acted as a trigger for such expectations, which is exactly reminiscent of what happened a year ago. However, given that the current phase of U.S. rate hikes has been going on for exactly two years, market participants are increasingly convinced that the U.S. economy will soon go into a recession, triggering rate cuts by the Fed. How likely is it that this second "CPI shock" in two years will prove to be the game changer? To be sure, there is an emerging possibility that the persistently one-sided JPY depreciation trend will end as a result of it. However, as I have repeatedly argued, the real question is – to what extent will JPY appreciate assuming the Fed begins rate cuts? Predictions of JPY appreciation in response to Fed rate cuts are based on past experience, and while one cannot say that this correlation has applied every single time in the past, the tendency cannot be denied (see figure). As is generally known, Japan held sway as the world's leading trade surplus country for a very long time starting the 1985 Plaza Accord. For instance, even when the U.S.-Japan interest rate gap expanded during phases of U.S. interest rate hike, and speculative trading was biased toward JPY selling in exchange for USD, actual demand for JPY underscored by Japan's enormous trade surplus always warranted JPY buying in exchange for USD. This remained the case until around 2010. After this time, whenever the U.S. began cutting rates, there would be a rollback in speculative JPY selling, resulting in JPY buying, which combined with the existing actual demand for JPY and resulted in hysterical JPY buying owing both to real demand and speculative factors. Roughly speaking, this was the reason for the higher volatility experienced during JPY appreciation phases than during JPY depreciation phases in the forex markets.



（Source） Bloomberg

Entering a U.S. Rate-Cut Phase as a Trade Deficit Nation

In contrast to the past, Japan is essentially a trade deficit nation at the present time. Even before the pandemic, the predominant image was of a neutral trade balance at best. There no longer exists actual demand for JPY on a scale that could cause hysterical JPY appreciation. At the same time, Japan has almost never experienced entering a phase of U.S. rate cuts while being saddled with such a real-demand climate. The reason for saying "almost" is that the Fed implemented a rate cut for the first time in 10 years and 7 months at the end of July 2019, at which time Japan was already a trade deficit nation. At that time, though USD/JPY swung in the direction of JPY strength the following month (August 2019), it returned right away to JPY weakness subsequently (see figure). Of course, the pandemic followed soon thereafter, and the Fed lowered interest rates to 0% at one go, and there is no impression of JPY having strengthened against USD as a result of this. Even if we allow that there cannot be direct comparisons between times of crisis (pandemic) and ordinary times, I think the fact that JPY did not appreciate much during August-December 2019 could serve as a reference when forecasting JPY trends in 2024.



（Source） Bloomberg

Further, as the figure also indicates, Japan has posted trade deficits for the entire calendar year 11 times since 1985, and they have all been since 2011. It is thought extremely likely that this is due to reasons such as the JPY hyper-appreciation following the collapse of Lehman Brothers, the change in Japan's power generation mix following the 2011 Tohoku Earthquake disaster, and Japanese companies relocating their production bases overseas, but I will refrain from discussing them in this time's report. My theory is that JPY underwent a structural turning point around 2011 – as I have argued many times in past editions of this monthly report as well as in my book titled *Where Has the Strong Yen Gone?* (Nikkei Premier) published last September.

Japan trade deficit and FRB policy management

	Japan trade deficit (Mio Yen)	FRB	Remarks
2011	-2,565	Unchange	
2012	-6,941	Unchange	
2013	-11,468	Unchange	
2014	-12,816	Unchange	
2015	-2,792	Rate hike	FOMC raise interest rates in Dec for the first time in 9 and half years
2018	-1,225	Rate hike	
2019	-1,668	Rate cut	FOMC cut interest rates in Jul for the first time in 10 years and 7 months
2021	-1,784	Unchange	
2022	-20,330	Rate hike	

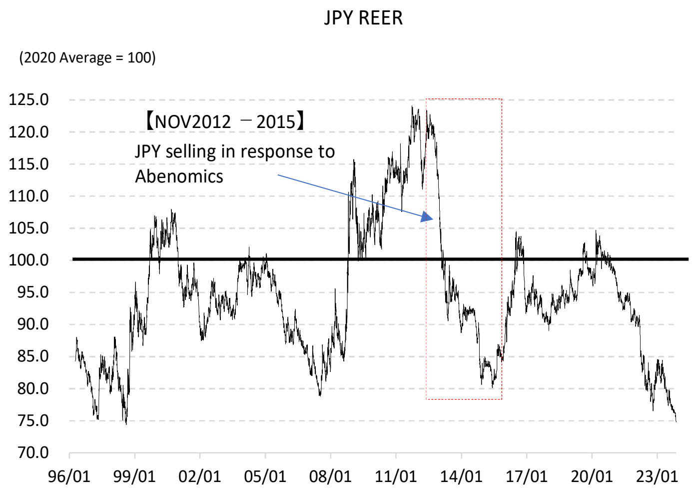
(Source) Ministry of Finance, & FRB, created by the author

Taking into account their failed predictions for 2023, my guess is that many of those who had been predicting earnest JPY appreciation a year ago are toning down their predictions this year to "not likely to appreciate that much." However, as mentioned above, JPY has consistently failed to appreciate as much as expected for the past 10 years; i.e., this is not a recent phenomenon. The past 1-2 years have highlighted the structural tendency toward JPY weakness, thanks to inflation triggered by the coinciding of the pandemic and wars, the extreme widening of domestic-international interest rate gaps, and persistently high resource prices, but I think that, going forward, modest JPY weakness will take the place of extreme JPY weakness. When formulating JPY outlooks for 2024 and going forward, I think it is important to keep in mind that JPY appreciation is not a given.

JPY Now and Going Forward – Nominal Effective Exchange Rate Approaching Record Lows

JPY's NEER Approaches Record Low Levels

In late November, USD/JPY fell to the JPY149-150 range, its lowest level in about two weeks, as a decrease in U.S. interest rates caused USD selling to become dominant. As 2024 approaches, speculation about the timing of Fed interest rate cuts will be in full swing, and it is reasonable to assume this will tend to promote USD selling and JPY buying. This article often discusses how changes in the JPY supply-demand environment have been weakening JPY, and this might lead to a misunderstanding. To clarify, my basic view is that the explanatory power of supply-demand factors has increased relatively compared to the past, but that does not mean that I think that interest rate factors have a negligible effect. The federal funds rate determines the global cost of capital, and upcoming cuts to that rate will certainly have a significant impact on forex rates.



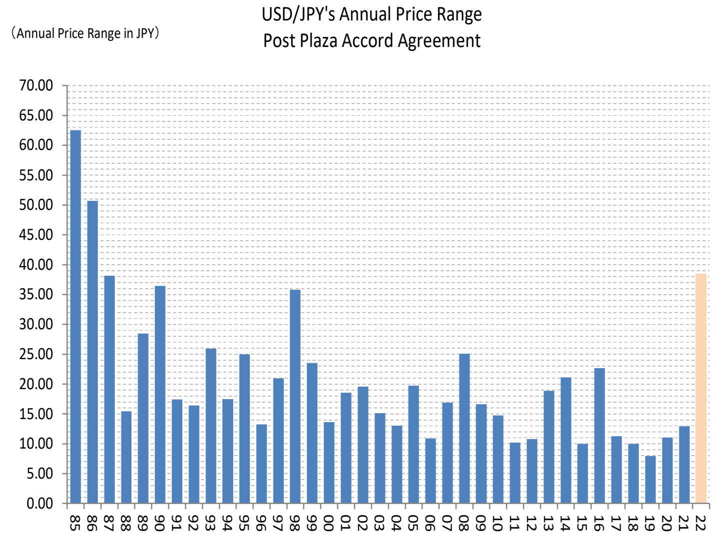
(Source) macrobond (Note) as of 20 NOV 2023

It is highly likely that JPY will rebound against USD during the forecast period, but this will not bring a sudden change to the perception of JPY's chronic weakness. Looking at daily movements in JPY's broad-based nominal effective exchange rate (hereinafter simply NEER), one finds JPY's NEER was 74.39 on November 16. (See graph; it was 75.34 as of November 20th, at the time this article was written.) This 74.39 level is the lowest level reached during the current JPY depreciation phase that began in March 2022. Looking back as far as April 11, 1996, one finds that JPY's NEER reached its lowest level (74.35) on August 11, 1998, and its November 2023 levels were quite close to that. The BOJ's website defines NEER as "an indicator of overall exchange rate fluctuations that cannot be seen by merely looking at exchange rates between two specific currencies". If one focuses not only on the degree to which JPY has depreciated against USD but also on the extent to which JPY has weakened against the full range of foreign currencies, it is apparent that 2023 has already become a year during which JPY has weakened more than during 2022.

Examining the specific figures, one finds that in JPY/USD terms, JPY's weakest level during 2023 (JPY151.92) was almost the same as that in 2022 (JPY151.94), but in NEER terms, JPY lowest level in 2023 (74.39) was significantly lower than that in 2022 (76.53). The significance of this NEER decline is a point that this column has persistently repeated – JPY depreciation is not necessarily just the flip side of USD appreciation. JPY has been depreciating against the currencies of its major trading partners, causing JPY depreciation on a NEER basis in 2023 that will exceed that in 2022. JPY's NEER dropped considerably during 2022, and there was only a weak temporary rebound from the nadir during 2023, as JPY depreciation against currencies other than USD gradually progressed. Consequently, the NEER has fallen to historic lows, and it can be said that the perception of JPY's chronic weakness was further reinforced during 2023.

Still Barely Inside the Historic Range

It is worth noting that, from the end of October 2012 (when the Democratic Party of Japan was in power and JPY reached its all-time high against USD) to the end of June 2015 (following the December 2012 inauguration of the second Liberal Democratic Party (LDP) government led by Prime Minister Shinzo Abe), JPY's NEER fell by approximately 30%. When one considers that the NEER was then in the process of being adjusted from its all-time high level (124% of the average level in 2020), however, it becomes apparent that the margin of this drop was not quite as dramatic as it may seem to be. Furthermore, starting from its nadir at the end of June 2015 to the end of June 2016, the NEER increased 24% in a one-year period. Looking back over the past decade, that was the last protracted period of JPY appreciation. Various factors contributed to JPY's sharp appreciation in the year through June 2016. The United States in December 2015 hiked interest rates for the first time in 10 years but did not undertake additional interest rate hikes in 2016 owing to the nature of domestic and foreign economic and financial conditions, so the U.S.-Japan interest rate differential did not widen as much as initially expected. (The second U.S. interest rate hike was delayed for about a year, until December 2016.) An even more impactful event in 2016 was the United Kingdom's referendum decision to leave the European Union (Brexit), which promoted "risk-off JPY buying". The Brexit referendum was completed during the morning of June 24, 2016, Japan time, and JPY sharply appreciated against USD (to USD/JPY99) on that day, which was the last time USD/JPY has fallen below the JPY100 level. Furthermore, JPY's sharp appreciation at that time was ephemeral, and additional surges of JPY buying were not subsequently seen even when uncertainties about the Brexit situation deepened.



(Source) Bloomberg

After the sharp JPY appreciation in the year through June 2016, JPY exchange rates entered a period of relative stability. For example, the USD/JPY fluctuation range fell below JPY8 in 2019, which is unusual. In fact, that was the narrowest annual USD/JPY fluctuation range ever, and many forex market players at that time were concerned about the lack of movement in JPY exchange rates. It is worth noting that, in 2018, the USD/JPY fluctuation range fell below JPY10, and some observers opined that the protracted paucity of fluctuation might become the new normal owing to an increase in high-volume/high-speed trading. As the graph shows, the USD/JPY fluctuation lull was sustained from 2017 through 2021, and looking back, it appears that period was the proverbial "calm before the storm". Since 2022 (particularly since March of that year), changes in economic conditions against the backdrop of the covid-19 pandemic and the war in Ukraine have promoted JPY selling. The abnormal economic and financial situation seen as the pandemic petered out (excess savings, release of pent-up demand, rising wages due to chronic labor shortages, etc.) was exacerbated by Russia's invasion of Ukraine on February 24, 2022, causing a sharp increase in the demand-pull and cost-push inflationary pressures faced by many countries. As a result, overseas central banks have continued to implement large interest rate hikes, widening the gaps between Japanese and overseas interest rates and thereby exerting downward pressure on JPY. It is clear that this scenario in itself was encouraging substantial JPY selling, and that encouragement was then magnified by product and commodity supply constraints along with a sharp rise in resource prices that caused the rapid expansion of Japan's trade balance deficits and considerable deterioration of the JPY supply-demand balance. Given that JPY supply-demand balance deterioration and the fact JPY is the world's only negative-interest-rate currency, a strong surge in JPY selling was inevitable. JPY's NEER has fallen approximately 17% during the period from the end of December 2021 through November 20, 2023, and the current trend suggests that the NEER may be attaining additional record low levels going forward.

Although JPY's NEER is currently at a historic low level, however, it cannot yet be said that it has clearly deviated from its ordinary range seen since 1996, which roughly has a lower limit of 75 and an upper limit of 105. Considering the situation from a broader perspective, one may conclude that the post-Lehman Shock period (2008-2012) was the only period in which JPY was abnormally strong.

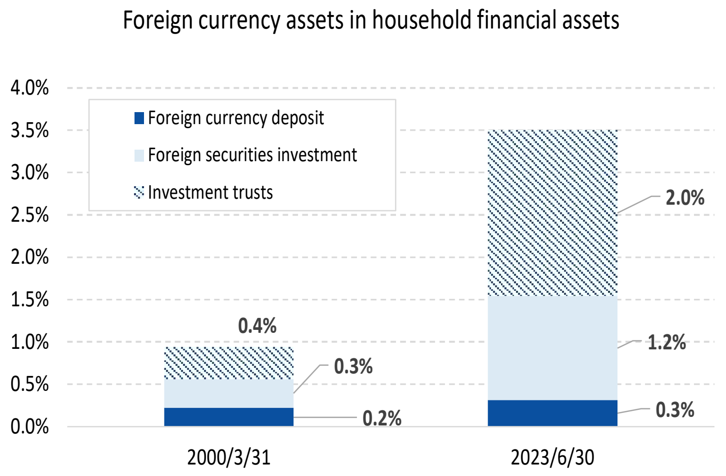
NEER Perilously Perched on a Cliff Edge?

However, the abnormal strength of JPY during approximately five years of the post-Lehman Shock period caused Japanese manufacturers to begin shifting their plants overseas, and it appears that the Great East Japan Earthquake of March 11, 2011 accelerated that trend. The fact that JPY has not experienced a period of sustained appreciation since then suggests that the associated structural transitions have been completed and that there is a good chance that JPY's NEER's lower limit will be further lowered going forward. The NEER might be on the verge of a rapid drop akin to falling off a cliff. As already discussed, the U.S. interest rate cuts anticipated from 2024 will actually be the first such cuts that Japan will face as a full-fledged trade-deficit country. As mentioned above, the five months from August to December of 2019 provide a transient but valuable clue about how JPY will behave, during normal times, when Japan is recording trade deficits and the United States lowers its interest rates. JPY at that time experienced a temporary bout of appreciation before quickly returning to its depreciation trend. Although that time period was short and provides only a limited amount of data, that data may be considered a useful basis for forecasting the results of similar scenarios going forward.

At least for the time being, it is difficult to imagine that U.S. interest rate cuts would dramatically change the trend of JPY weakness suggested by JPY's NEER. Furthermore, it is worth noting that the above discussion is based on nominal figures. Given that JPY has been showing an inferior performance relative to inflation, if the discussion were rephrased based on real figures, the JPY depreciation trend would be presented as even more severe. Moreover, the concept of an end to JPY depreciation is not synonymous with the end of the "Cheap Japan concept". Even if USD/JPY shifts from JPY150 to JPY130 or JPY125, people in Japan would probably still continue thinking that "travel abroad is expensive" and "imported goods are expensive". It probably does not need to be pointed out that, for people in Japan, the "cheap Japan concept" is a more important issue than the latest JPY forex trends.

Risks to My Main Scenario – First year of "Asset Management Nation" Concept May be First Year of "Household JPY Selling"

Foreign Currency Deposits an Easy Starting Point for "Household JPY Sellers"

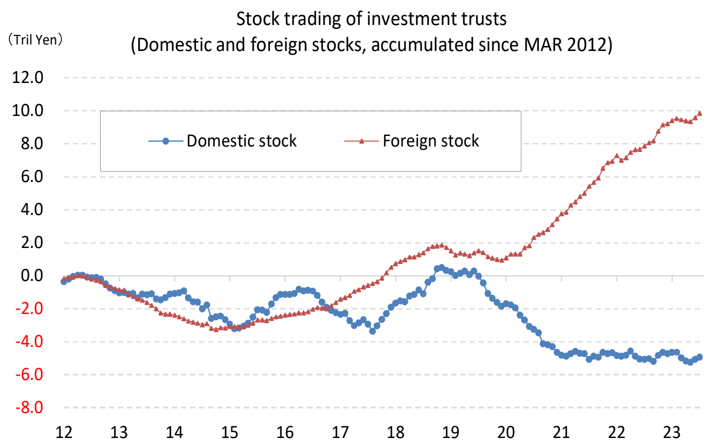


(Source) Bank of Japan, Investment Trusts portion calculated by the author

Although the JPY depreciation trend is showing signs of peaking out, JPY's nominal value will continue to be significantly reduced, and that is likely to have a considerable impact on the investment behavior of Japan's household sector. In past issues of this article, I have argued that the biggest risk factor for JPY and, ultimately, for the Japanese economy, is the prospective rise in "household JPY selling" promoted by the Japanese government's policies designed to make Japan an "Asset Management Nation". At the end of June 2023, Japanese households held approximately JPY1,100 trillion in cash and deposits (excluding foreign currency deposits), and if even 10% of that were converted to foreign currencies, it would result in JPY110 trillion of JPY selling. Such JPY selling would naturally cause additional JPY depreciation. Furthermore, since the cash and deposits held by the private banking sector are linked to the consumption of government bonds via current accounts at the BOJ, "household JPY selling" is also a risk factor for JPY interest rates. Even though such risks have been pointed out, however, I rarely pass a day without seeing a special feature in a newspaper or magazine that provides guidance on asset management in line with the government's "Asset Management Nation" policy goals.

There has also been an increase in articles about the relationship between asset management and JPY exchange rate trends, and I have been receiving a growing number of inquiries about that subject. For example, an article in the November 3 edition of Nihon Keizai Shimbun newspaper entitled "USD Time Deposits Become More Attractive with Interest Rates as High as 6% – Beware of Fees" discusses the high level of interest rates on foreign currency deposits at major domestic banks and the risks associated with such deposits. If high-interest foreign currency deposits were widely touted as they are in that article, more Japanese people might be interested. Foreign currency deposits are just "deposits" except for the associated forex risk, and I would think that they are an extremely easy option for Japanese to consider as a starting point for diversifying their assets. However, while the share of Japanese household financial assets in the form of foreign currency assets has quadrupled over the past quarter century, from 0.9% at the end of March 2000 to 3.5% at the end of June 2023, the share in foreign currency deposits has remained almost stable in the 0.2%-to-0.3% range (see graph on previous page). The possibility that the share in foreign currency deposits will rise in the future is attracting attention as the shift from saving to investing becomes more serious, but deposits seem likely to remain a minor category of foreign currency investment.

Basic Trend of Growth in Investment Trusts

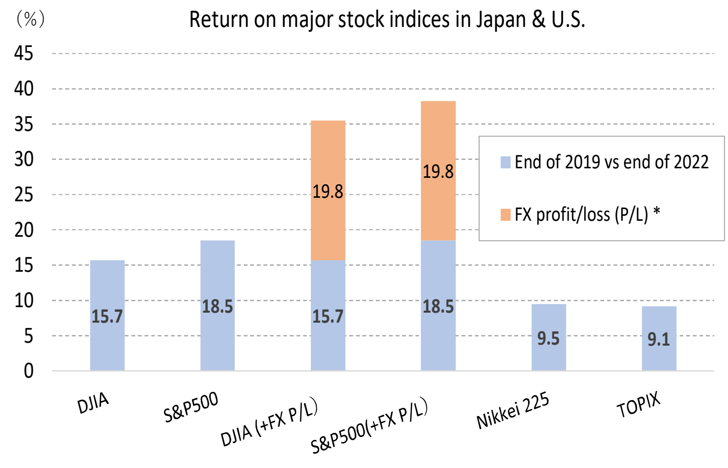


(Source) Investment Trusts Association (Note) as of SEP 2023

Investment trusts are the foreign currency asset category whose share of Japanese household financial assets has increased most significantly over the past quarter century. As the graph on the previous page shows, the share of Japanese household financial assets in foreign currency denominated investment trusts has quadrupled, rising from 0.4% to 2.0%, and, according to my estimates, the value of such investment trusts has increased eightfold, from roughly JPY5 trillion to roughly JPY42 trillion. Although the risk of price fluctuations is higher than with foreign currency deposits, it can be seen that the purchase of foreign (≈ U.S.) stocks via investment trusts has maintained strong momentum, reflecting the U.S. stock investment boom that began before the pandemic. Data from the Investment Trusts

Association of Japan shows that there has been a clear shift from domestic stocks to foreign stocks since the start of the pandemic in 2020 (see graph above), which has itself entailed a considerable amount of JPY selling, and such JPY selling has undoubtedly played a role in pushing USD/JPY up to its current levels.

Furthermore, even though U.S. stock prices declined considerably from 2022, reflecting the Fed's repeated interest rate hikes, the sharp weakening of JPY against USD caused the Japanese household sector's JPY-based investments in U.S. stocks to benefit from forex gains, so one can conjecture that the overall performance of those investments was not so bad. So, many of those household investors have had a successful investment experience that can be expected to facilitate the government's efforts to encourage a shift from saving to investing. Looking at JPY-based investments in U.S. stocks from the end of 2019 to the end of 2022, it is worth noting that the associated forex gains were actually greater than the capital gains. Although major U.S. stock indexes rose at rates in the 15%-to-18.5% range during that period, the forex gains amounted to almost 20% of the investment values (see graph on previous page). It is highly likely that the large positive effect of JPY depreciation on JPY-based investments in U.S. stocks recently will have a lasting impact on the behavior of individual Japanese investors.



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

The October edition of the "Monthly Survey <Foreign Exchange>" jointly conducted by QUICK and Nikkei Veritas included a question – "How will the asset management nation concept affect foreign exchange rates?" Although 63% of respondents believed that there would be no significant impact on JPY exchange rates, 26% said it would cause JPY to weaken, and only 4% said it would cause JPY to appreciate. Furthermore, when asked – "When investing your own assets, which financial products do you think are the most attractive for future investment?" – 44% of respondents cited domestic stocks (41%) and domestic bonds (3%), while 52% of respondents cited foreign stocks (39%) and foreign bonds (13%), reflecting a strong desire to make overseas investments. When asked – "Which region do you think is the most attractive place to invest your assets?" – the United States was cited by an overwhelming share of respondents (79%), followed by Japan (44%) and India (24%). Although the respondents may not be confident about what the asset management nation concept's prospective impact on exchange rates will be, they clearly believe that USD-denominated assets are the best choice for building up their own personal wealth. These survey results suggest that as Japanese households advance from saving to investing, they will increase their investments in Japanese stocks while concurrently undertaking an inevitable shift from JPY to foreign currencies.

Prospective JPY Selling Attributable to a "New Investor Class"

From news reports, one gets the impression that the Japanese government's "Doubling Asset-Based Incomes Plan" designed to encourage a shift of personal financial assets from savings toward investments may have already begun, but the implementation of related plans to expand the Nippon Individual Savings Account (NISA) system into the New NISA system and reform the Individual-type Defined Contribution Pension plan (iDeCO) into a New iDeCO plan allowing for new participants of higher ages will begin only in 2024. Accordingly, it is only from the end of this year that people will be positioned to monitor, discuss, and analyze the Doubling Asset-Based Incomes Plan's actual effects on "household JPY selling". It is likely that those effects will attract attention as an important forex market-related issue in the future.

While New NISA and New iDeCo are receiving attention as the first two pillars of the Doubling Asset-Based Incomes Plan, the plan's "pillar 5" is described as – "Enhancing financial and economic education to spread the importance of stable asset formation". Explaining the importance of this pillar, the plan states – "While only 7% of people acknowledge that they have received financial and economic education, more than 70% say that financial and economic education should be provided, suggesting strong public interest in such education. In addition, 40% cite "lack of knowledge about asset management" as the reason for not engaging in asset management. In order to spread the importance of stable asset formation to these groups, it is important to deliver financial and economic education." Thus, in addition to increasing potential investment amounts and allowing for new participants of higher ages in the existing two investment promotion programs, the Doubling Asset-Based Incomes Plan is clearly aiming to provide financial education in ways that help create a new class of individual investors. As the shift from saving to investment progresses going forward, JPY's recent weakness is likely to spur many people to participate in that shift. The new investor class that the government is seeking to create is a group that has not existed in Japanese society up until now, and it is largely this group that can be expected to be responsible for a prospective surge of JPY selling.

The first time the Japanese government coined the "From Savings to Investing" slogan was in the Junichiro Koizumi-led administration's "Big-Boned Policy Outline" released in June 2001. Subsequently, the government has repeatedly re-proclaimed that slogan but failed to actually promote such a saving-to-investment shift. Given the long history of JPY appreciation, however, it can be said that holding JPY in cash and deposits was previously a fairly rational asset management method in that it enabled the avoidance of risks related to forex rate fluctuations. However, previously, JPY was supported by an "iron-walled JPY supply-demand environment" created by Japan's huge trade surpluses that could be counted on to countervail JPY depreciation trends and promote JPY appreciation. Currently, one gets a strong impression that JPY is steadily being weakened by the genuine fundamental factors of chronic trade deficits and low interest rates. In light of that, it is not surprising that individual Japanese investors' belief in the sustainability of JPY depreciation is reinforcing their emerging conclusion that now is the time to move ahead with foreign-currency investments because "this time is different".

Current Account Surpluses on a Cash Flow Basis Only 1/10th the Nominal Sizes

There are still persistent voices saying that JPY will regain its strength owing to Japan's current account surpluses, and individual investors influenced by that argument may not yet think that "this time is different". In fact, the dominant tone of Japanese news reports suggests that that there will be an uptrend in Japan's current account surpluses from the start of 2023. However, it should be recognized that current account surpluses no longer provide sturdy support for JPY. I have repeatedly emphasized that current account balances should be evaluated on a cash-flow basis. As mentioned above, Japan has been maintaining current account surpluses because its large deficit in the trade and services balance is more than offset by its large surplus in the primary income balance. Interest and dividends generated from overseas securities account for slightly less than 40% of Japan's primary income receipts, and given that these are normally reinvested in foreign currencies, one can consider the primary income surplus to be a "statistical surplus" and assume that it will never generate a "practical cash-flow". Furthermore, reinvested profits earned by Japanese companies' overseas subsidiaries, which are directly reinvested locally, account for just under 30% of the primary income received. Since the profits directly reinvested locally are clearly "reinvested in foreign currencies", it can be assumed that they are not associated with "practical cash-flow." If one seeks to analyze how Japan's current account surpluses may affect JPY exchange rates, one must subtract such "non-repatriated surpluses" and evaluate the current account balances on a cash-flow basis.

I have long argued that Japan-specific factors are contributing to the current JPY depreciation trend. Otherwise, JPY would not have become so depreciated on a NEER basis. In this regard, the BOJ's prolonged negative interest rate policy is definitely one of the factors unique to Japan. But my view is that it is difficult to argue that Japan's low interest rates and the associated widening of the Japan-U.S. interest rate differential alone can explain the JPY depreciation trend that has already lasted for more than a year and a half. Seeking an alternative explanation, I have focused on the fact that, when considered on a cash-flow basis, Japan's current account balances are much weaker than they appear nominally. If you consider the situation a year ago, you may recall that almost no experts then anticipated that USD/JPY would remain at the JPY150 level even after the Fed suspended its interest rate hikes. Given that, it makes sense to consider what factors other than U.S. interest rates could be responsible for JPY's recent depreciation. As already discussed, on a cash-flow basis, Japan's current account surplus for the first half of 2023 will be about one-tenth of its nominal size. When preparing a forex forecast outlook, one must give due consideration to how little of the current account surplus is truly linked to JPY buying.

Will 2024 be the Inaugural Year of "JPY selling"?

In addition to this problem of Japanese current account surpluses being relatively small when considered on a cash-flow basis, foreign currency outflows related to such "new era deficits" as those associated with digital services and consulting and research and development activities have been increasing. While I would not say it is a main cause, it is highly likely that Japan's service balance deficit, which has been increasing in recent years, is also a contributing factor to JPY's prolonged depreciation.

Basically, I have been arguing that changes in the JPY supply-demand structure may be the true cause of JPY's prolonged depreciation. Of course, the validity of this hypothesis has not yet been proven, but it will become easier to confirm or debunk the hypothesis when the United States actually begins to cut interest rates. In that sense, the period from 2024 can be seen as an important period for clarifying the cause of JPY's prolonged depreciation. Furthermore, since Japan's conservative elderly population remains the majority demographic segment, it is possible that the prospective shift from saving to investing may only progress only slowly, if at all. However, if the United States initiates interest rate cuts and actually implements several interest rate cuts, will it then be possible for JPY to return to the USD/JPY100-120 range that was the main battleground in the past? It seems that the number of forex market participants who consider such a return likely or possible has greatly diminished, and this is a big change compared to the situation just a year ago. I think it is the younger generation of Japanese that is perceiving the unlikelihood of JPY's return to its former main battleground relatively keenly. If this is the case, I anticipate that Japan's shift from saving to investing will progress slowly but surely, yet faster than in previous years when there was no progress at all. Ideally, I would like to see a greater share of Japanese politicians adopt more-realistic yet vigilant stances regarding the prospective shift from saving to investing.

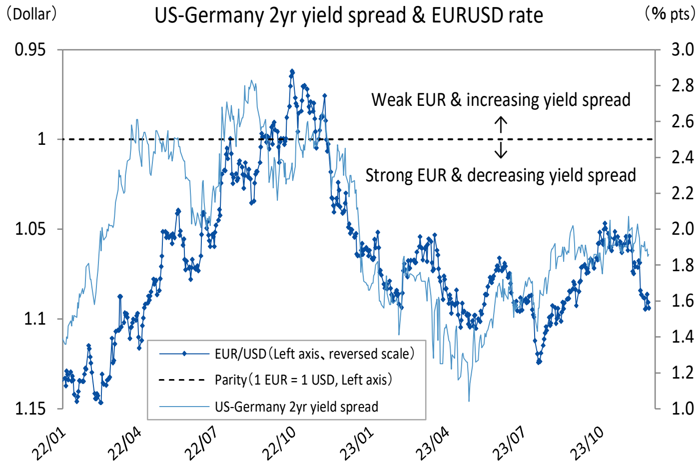
The year 2024 will the first year of Japan's full-scale efforts to become an "asset management nation". Given that it has the potential to be the first year of JPY selling by many individual investors, it also should be recognized as having the potential to be a significant turning point for Japan's financial markets and, ultimately, for the Japanese economy. We should all continue to be wary of the risk of an unexpected surge of JPY depreciation and should therefore make a point of closely monitoring Japanese household budget trends from 2024 onwards.

EUR Outlook – What Are the Reasons for EUR's Robustness?

Euro Area Economic and Monetary Policies – Interest Rate Hikes Exerting Pervasive Effects

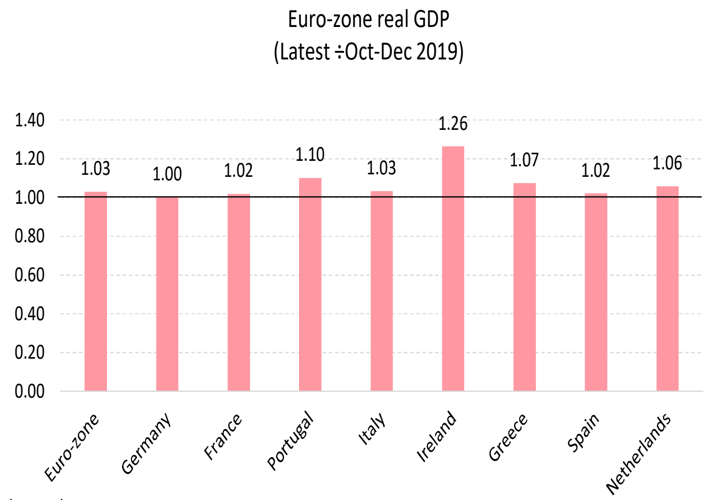
Current State of the Euro Area Economy

Now that it is clear that U.S. interest rates have peaked out, at this point, EUR is regaining its strength. However, there is no certainty that the ECB will be able to maintain monetary policies more hawkish than those of the Fed. In fact, the euro area's economic and financial vulnerabilities have been exposed to the extent that many people expect that the ECB, which started raising interest rates later than the Fed, may precede the Fed in cutting interest rates. Regarding the interest rate situation, since the rate of decline in U.S. interest rates has been greater than that in euro area interest rates, it can be said that the forex market is simply reacting straightforwardly to the narrowing of the U.S.-Europe interest rate differential (see graph). It may also be said that Fed's decision to keep U.S. interest rates so high for so long was excessive, given the U.S. economy's unusual strength, which contrasts sharply with the weakness of the euro area economy since the beginning of this year. This is largely due to the fact that the German economy, which accounts for 30% of the euro area economy, seems to be on the verge of a recession. Regarding the factors causing Germany's economic slump, please refer to the recent Mizuho Market Topic article entitled "Return of the 'Sick Man of Europe'?", which explains that Germany will not be able to regain its former economic strength if it continues to face high energy costs while remaining dedicated to its "idealistic" goal of eliminating nuclear power.



(Source) Bloomberg

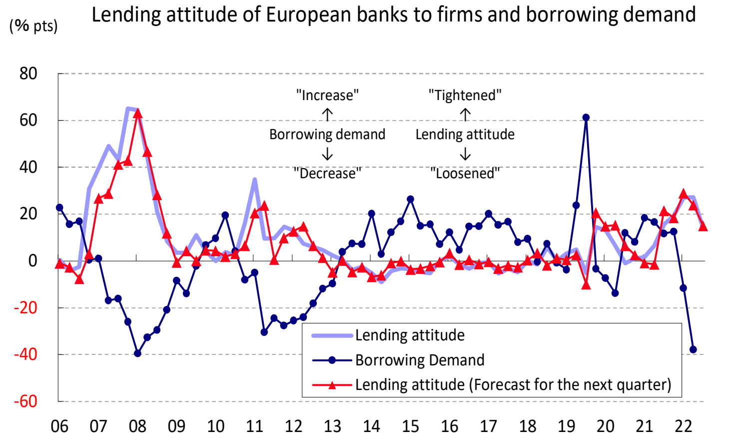
It is worth noting that Germany's real GDP has remained unchanged from its level just before the pandemic, and the real GDP increase for other euro area countries has been limited to around 3% (see graph). It is generally understood that, amidst lackluster real economic conditions, the euro area has been suffering from the highest inflation rates in its history. The euro area has been facing cost-push inflationary pressures rather than demand-pull pressures, and it is clear that its economic slump was due to the real income environment and, ultimately, to the suppression of consumption and investment. In any case, it is probably safe to conclude that EUR's current strength is a response to the downward adjustment of U.S. interest rates that had temporarily risen too high and is not a reflection of the euro area's economic and financial situation. Although EUR/JPY's rise to above JPY160 in November attracted considerable attention in Japan, it should be understood that the rise stemmed from special Japan-related factors rather than factors related to the euro area. This point will be discussed below.



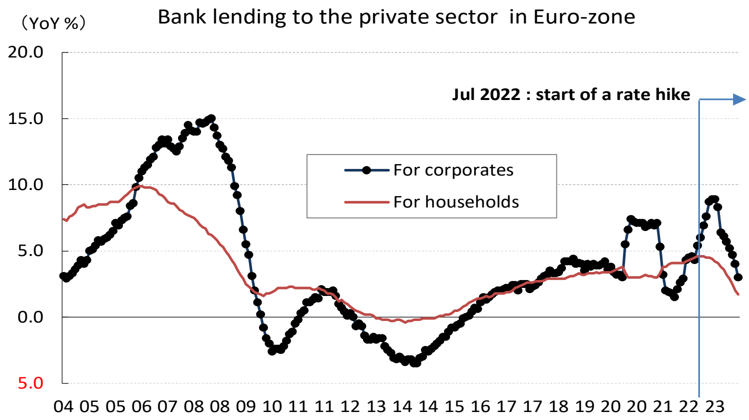
(Source) Bloomberg

Pervasive Effects of Interest Rate Hikes

It is questionable whether the remarkable narrowing of the U.S.-Europe interest rate differential seen in November will be sustainable, since the ECB itself recognizes that the effects of its repeated interest rate hikes are definitely suppressing the euro area economy. The ECB's Bank Lending Attitudes Survey shows that, although the shift toward stricter lending attitudes appears to be moderating, rising interest rates have clearly caused borrowing demand to decline sharply (see graph, above right). This decline and the fact that actual lending results are becoming consistent with these surveys indicate that lending to households and businesses has generally decelerated. It can theoretically be expected that the euro area's inflation pressures will recede after the passage of a certain amount of time. The next graph (below right) shows that the current degree of decrease in lending has previously been seen only in the aftermath of the Lehman Shock, after which the euro area became progressively "Japanized" with disinflation and low interest rates becoming the norm[2]. Considering the degree of suffering stemming from the ECB's interest rate hikes, the decision to suspend those hikes appears quite reasonable. It thus seems fairly rational to anticipate that ECB interest rate cuts are more likely than further ECB rate hikes.



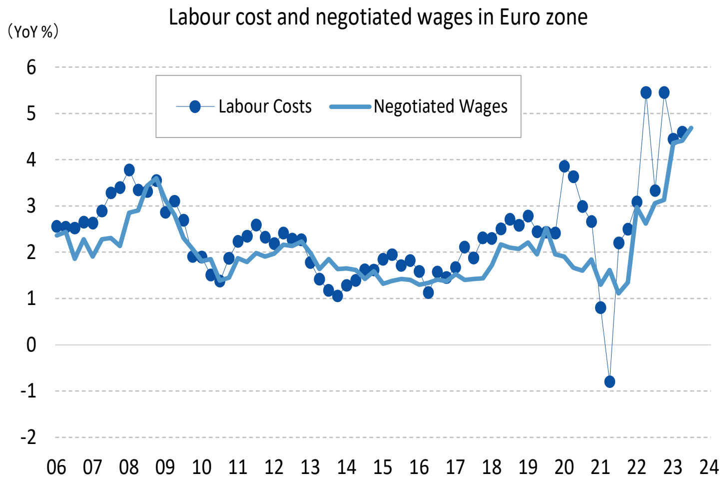
(Source) Datastream



(Source) ECB (Note) For non-financial institutions

ECB Shift to Dovishness Not Likely Until Next Spring

In view of all that, I do not think that EUR's current strong performance reflecting U.S.-Europe interest rate differentials will be sustained very long, but if the euro area faces an significant upside inflation risk factor, it is probably associated with the employment and wage situation. As can be seen from the graph on the right, as of the third quarter of this year, there were still no signs that the uptrends in wages agreed to by labor unions (negotiated wages) and in the labor costs affected by negotiated wages were peaking out. Although the euro area has finally stopped attaining new record-low unemployment rate levels, the unemployment rate remains in the 6.4-6.5% range, which can be considered close to a full employment situation. In early October, the ECB's chief economist Philip Lane said that he expected wage growth to moderate over the next few months but emphasized that the ECB will only know around Easter next year if wage growth is indeed decelerating as expected. If this statement can be considered to reflect the consensus view of the ECB Governing Council, it seems likely that the ECB will continue maintaining a wait-and-see posture through the first quarter of 2024. If the ECB shifts to more dovish policies in consideration of the real economy, such a shift will likely only be from early spring or subsequently. In light of this, it appears that the real test of EUR's strength will take place from April to June next year.

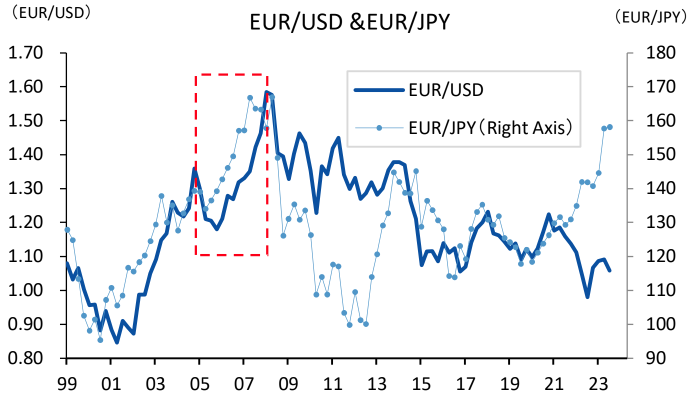


(Source) Macrobond (Note)It differs from the actual labour cost growth due to unsettled

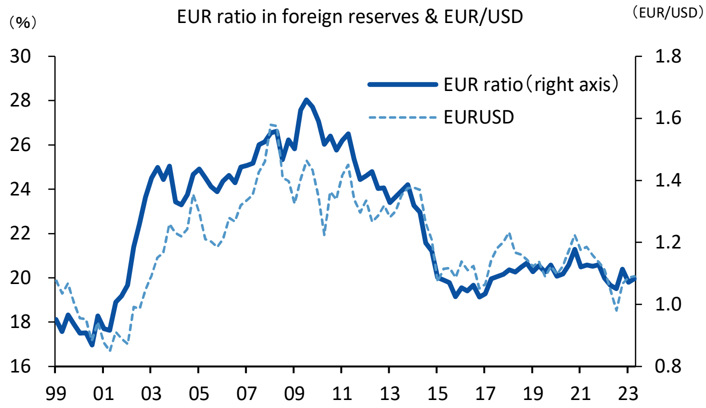
EUR Now and Going Forward – Implications of EUR/JPY Surmounting the JPY160 Level

Understanding the Greatest Appreciation of EUR Against JPY in 15 Years

While USD/JPY has been attracting considerable attention as it reaches additional year-to-date high levels, I have also been receiving a growing number of inquiries about the continued rise of EUR/JPY. At the time this article was written, EUR/JPY was remaining stable at the JPY160 level – this is the highest level seen in about 15 years, since August 2008. In view of this, many people have asked me how I evaluate the euro area's economic and financial situations. <u>My answer, in brief, is that the continued rise of EUR/JPY cannot be said to reflect the euro area's economic and financial situations</u>. The sustained trend of EUR appreciation from 2002 to 2008 took shape based on expectations that EUR would become the world's "second reserve currency" after USD, and such expectations even led to the coining of the word "europhoria" (euphoria or enthusiasm for EUR). Working at the European Commission's Directorate-General for Economic and Financial Affairs at the time when the EUR exchange rate was at its highest (2007-2008), I was involved in the writing of a paper entitled "EMU@10: Successes and Challenges after 10 Years of Economic and Monetary Union" to commemorate the 10th anniversary of EUR's launch. With EUR attaining all-time highs against USD and JPY, the paper aimed to "examine the role of EUR as a reserve currency". This story offers a hint about how high expectations for EUR were at that time, although nowadays the possibility that EUR might play a role as a major reserve currency is hardly discussed at all. What was happening in the forex market during the 2007-2008 period was an across-the-board trend of EUR appreciation – EUR continued to rise against JPY and USD, attaining new record high levels against both currencies. Currently, however, while EUR has continued rising against JPY, it has remained weak against USD (see graph, above). In that sense, it cannot be said that EUR has been appreciating across-the-board recently, and the recent trend of EUR appreciation should be recognized as being quite different from the EUR appreciation trend causing EUR/JPY to attain the JPY160 level in 2008. It is worth noting that, at that time, EUR accounted for more than 25% of the world's forex reserves, and that level reached its all-time high of 28% in the third quarter of 2009. It is clear that the EUR appreciation trend at that time was largely driven by expectations that EUR would account for growing shares of the world's forex reserves as it became the "second reserve currency", and in this respect the current situation has a quite different background, as EUR's share of the world's forex reserves is now fluctuating at levels below 20% (see graph, below).



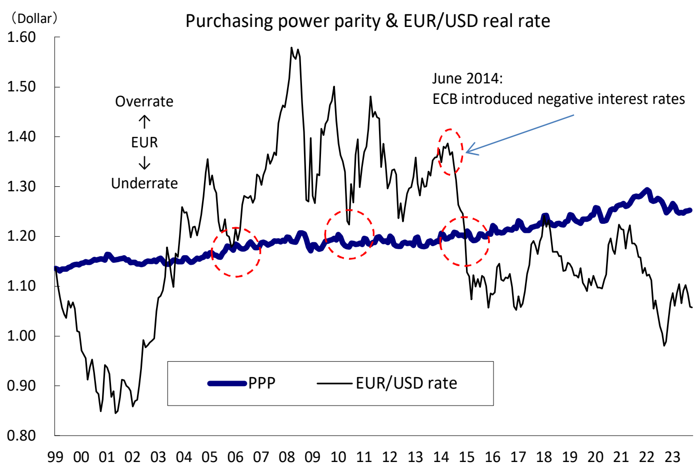
(Source) macrobond



(Source) IMF, Datastream & Bloomberg

EUR/JPY Levels Above JPY160 Simply Reflect JPY Weakness

Although EUR/JPY is currently at its highest level in about 15 years, the situation is very different from 2008, when EUR was all the rage in the forex market. Currently, JPY is weakening against EUR as JPY reaches record levels of overall weakness on a NEER basis, and the reality seems to be that JPY's depreciation against EUR just happened to reach historic levels in the context of JPY's general depreciation. Furthermore, since EUR has only been around for about 25 years, the hurdles for updating historic levels relative to EUR are lower than those for updating historic levels against USD. If the trend seen in November continues, a new all-time EUR/JPY high (JPY169.97) may be attained, but even if that happens, it will be due to record levels of JPY weakness, and the situation is clearly quite different from that during the time of europhoria.



(Source) Datastream & Bloomberg
(Note) PPP: Consumer price base (Jan 1999 base)

It is true that EUR-related policy interest rates are incomparably higher than those related to JPY, and this is itself a EUR-related factor promoting EUR buying and JPY selling. On November 10, ECB President Lagarde announced that current interest rate levels would be maintained for at least several quarters, and her elimination of the possibility of near-future interest rate cuts appears to have strengthened EUR against JPY. However, since all the world's countries have higher interest rates than JPY, this cannot be the only reason for EUR's exceptional appreciation against JPY. It is difficult to explain the current trend of JPY depreciation against EUR based on circumstances within the euro area. Furthermore, when President Lagarde ruled out the possibility of a rate cut, EUR/USD also rose, but at the time this article was written, EUR/USD was at around USD1.10, which is the highest level in about three months but the same level as it was in April 2008. EUR/USD is far from its all-time high level of USD1.599. In contrast to EUR/JPY, which is approaching historic highs, EUR/USD is showing a historic downward deviation relative to purchasing power parity (see graph). From a long-term perspective, the current situation is that EUR has continued to show noteworthy weakness against USD.

Incidentally, some observers have noted that, while there is a sense of wariness about the possibility of market intervention with respect to JPY, there is no such wariness regarding EUR, and this may be what is pushing up EUR/JPY. Although there is some truth to this argument, it does not seem to be a convincing argument as, even when EUR fell below parity with USD last year, ECB EUR buying/USD selling intervention measures did not become an issue. I get the strong impression that this argument is just a hindsight-based effort to rationalize EUR/JPY's rise. Personally, I do not see a need to attach any special significance to EUR/JPY's exceeding of JPY160, even though it is the highest level seen in 15 years. It is probably most appropriate to simply consider EUR/JPY's historic rise to be a forex market phenomenon occurring as part of JPY's general weakening against major currencies.

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