Forex Medium-Term Outlook

December 26, 2023

MIZUHO

Overview of Outlook

USD/JPY fell by a wide margin through most of December, but has steadied toward the end of the month. The Fed released unexpected information following its last FOMC for the year, not just communicating a suspension of rate hikes but even hinting at rate cuts. This compels me to consider lowering my forecast range for USD/JPY. However, I do not believe that the move will prompt a very significant JPY appreciation, given that Japan meets this round of U.S. rate cuts as a trade deficit nation. There is no doubt that USD will depreciate in response to a decline in FF rates, but the impact of this on other currencies will depend on the supply-demand climate of the currency in question, and JPY, as I have frequently argued, has been rather weak in this regard in recent years. However, it is reasonable to predict that JPY appreciation pressures both from interest-rate and supply and demand will be stronger in 2024 compared with 2022-23. With regard to supply and demand, while some improvement compared with the past two years is expected, this does not indicate a dramatic recovery in demand for JPY. My estimates suggest that Japan's cash-flows-based current account balance will recover to post a modest surplus in 2024, while remaining susceptible to an immediate backslide into deficit in the event of unforeseen situations. As for interest rates, the shrinking of the U.S.-Japan interest rate gap will probably be limited. A bottoming out of JPY rates is not synonymous with a resumption of JPY appreciation – rather, the current excessive JPY weakness may merely improve to a more reasonable level of JPY weakness. Will the main battling range for USD/JPY shift downwards? We should be able to find out during 2024.

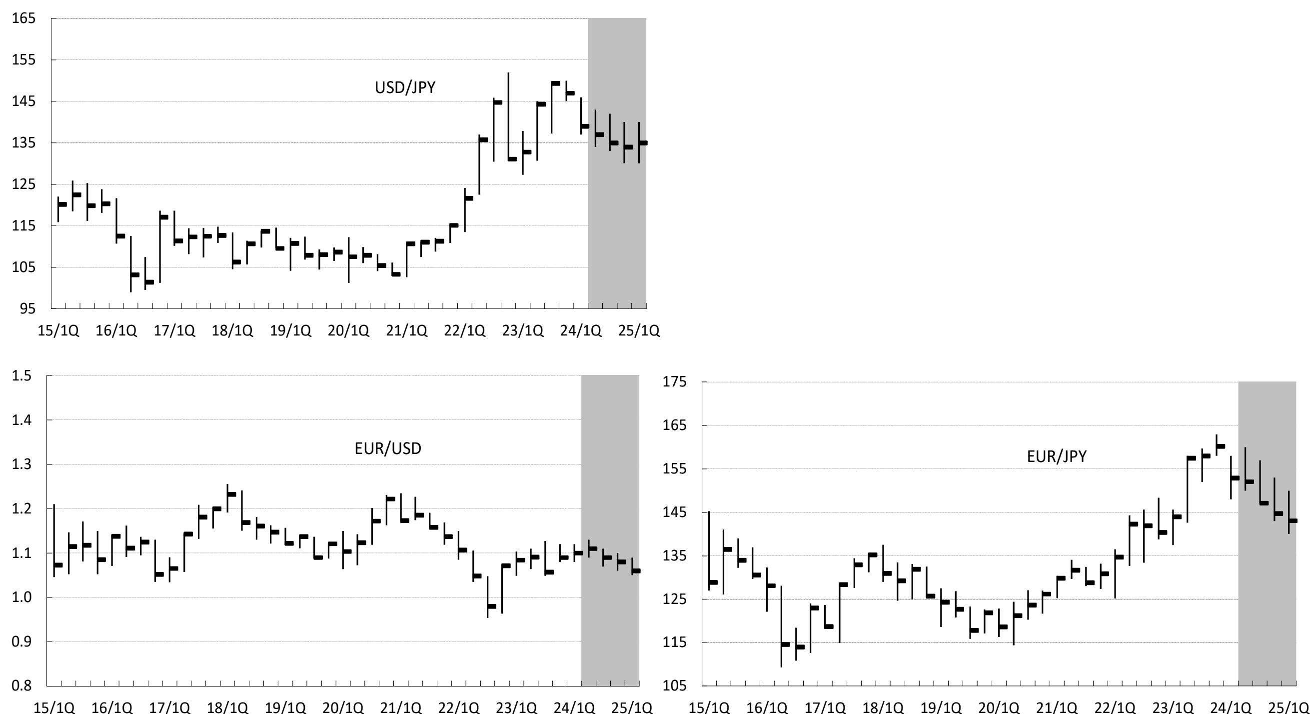
EUR continued to strengthen in December. In contrast to the Fed, which went so far as to suggest a rate cut, ECB President Christine Lagarde herself declared that the ECB would keep its interest rates unchanged for the next few quarters. This makes it easy for the markets to view the ECB as relatively more hawkish, inevitably helping to boost EUR rates from the perspective of the Europe-U.S. interest-rate gap. Inflation rates are steadily declining in the region, finally dropping to 2% in terms of headline rates, and the euro area's real economy continues to weaken. It would, therefore, not be surprising for the ECB to indicate actions similar to the Fed. However, there is also the fact that service prices have levelled, thanks to tight labor market conditions, which have been bothering the ECB. Taking all this into account, ECB Executive Board Member Philip Lane recently commented that the ECB could not be confident of a cooling off of inflation until next spring. This and the outcome of the December Governing Council meeting both suggest that 1H of 2024 may serve as a turning point for the ECB. Under such circumstances, it seems rational to assume that the ECB will maintain its current interest rates at least until mid-2024, thereby keeping EUR strong. However, I predict that the currency will begin to depreciate during 2H in response to the weakening of economic and price conditions. In fact, given that concerns surrounding the real economy are stronger in the euro area than in the U.S., it is quite possible that the ECB ends up implementing rate cuts earlier than the Fed. My impression that 1H and 2H of 2024 will see a reversal of EUR-related actions.

Summary Table of Forecasts

	2023 Jan～Dec（Actual）	2024 Jan～Mar	Apr～Jun	Jul～Sep	Oct～Dec	2025 Jan～Mar
USD/JPY	127.22 ～ 151.92 (142.27)	137 ～ 146 (139)	134 ～ 143 (137)	133 ～ 142 (135)	130 ～ 140 (134)	130 ～ 140 (135)
EUR/USD	1.0448 ～ 1.1276 (1.1019)	1.08 ～ 1.12 (1.10)	1.09 ～ 1.13 (1.11)	1.07 ～ 1.11 (1.09)	1.06 ～ 1.10 (1.08)	1.05 ～ 1.09 (1.06)
EUR/JPY	137.45 ～ 164.31 (156.77)	148 ～ 158 (153)	150 ～ 160 (152)	147 ～ 157 (147)	143 ～ 153 (145)	140 ～ 150 (143)

(Notes) 1. Actual results released around 10am TKY time on 26 DEC 2023. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts



USD/JPY Outlook – From Extreme JPY Weakness to Moderate JPY Weakness

USD/JPY Now and Going Forward – Surveying the Prospect of Rates in 2024 Based on Interest Rates and Demand

Supply-Demand Continues to Hold Key to Rate Forecasts for 2024
In past issues of this report as well as in Mizuho Market Topics for over the past year, I have presented arguments as to why I could not agree with the view that 2023 would be a year of JPY appreciation. My reasoning seems to have proved right through all of 2023. In 2024, I would like to continue analyzing the forex markets based on my stance that JPY supply and demand must be taken into consideration in addition to interest rates.
Having said that, amid all the attention focused on the timing of the Fed's policy-stance pivot, interest rates will have greater persuasive power in 2024 than in 2022 or 2023 and, therefore, cannot be ignored. In this final edition of this report for 2023, I would like to provide an overview of my rate predictions for 2024 from both key perspectives, namely interest rates and forex rates.
To get straight to the point, my argument that supply and demand conditions point to JPY weakening is likely to take a backseat for the moment. My prediction of JPY depreciation over the past two years or more was based on the distortion in JPY's supply and demand balance, but with some improvement in the supply-demand situation in sight, I predict some level of JPY appreciation going forward. The shrinking of the U.S.-Japan interest rate gap is likely to help this trend along from the interest-rate perspective. However, USD/JPY peaking is not synonymous with a strong-JPY trend reemerging. At best, one can say that JPY appreciation is inevitable, but unlikely to be acute.

Interest rates: JPY appreciation inevitable, but unlikely to be acute
Let me present the outlook from the interest rate perspective first. At the time of writing this report, the storyline adopted by most market participants is that 2024 will be a year of JPY appreciation, with the Fed cutting rates and the BOJ raising them. Almost exactly the same reading of the situation was made a year ago. Right since the end of 2022, we have seen widespread claims that the Fed would definitely cut rates in 2023. That, however, did not happen, even though rate hikes certainly ended.
However, as already reported, there was a sharp change in Fed Chair Jerome Powell's messaging following the December FOMC. Not only did he declare the end of rate cuts by stating, "We believe that our policy rate is likely at or near its peak for this tightening cycle," he even went on to suggest that rate cuts were beginning to "come into view." Most market participants had not expected the Fed to simultaneously indicate the end of rate hikes and the start of rate cuts. Given Powell's mention of rate cuts, the likelihood of a Fed rate cut in the January-March quarter has become more real, though it is more likely that rate cuts will begin in the April-June quarter. However, U.S. average hourly wages continue to grow at +4~5% yoy, which is rather high from the perspective of stably maintaining inflation of general prices at the +2% level. This led to the assumption that the Fed's essential strategy in 2024 would be to maintain its hawkish stance (hawkish hold) while continuing to wait and watch, and intermittently prepare the ground for rate cuts, but it appears to have had a sudden change of heart.

The federal funds (FF) rate serves as the world's cost of capital, so its lowering would naturally force not just forex rates but a variety of other asset prices to tumble. This will trigger a switch in trends from selling equity and bonds to buying them, and from buying to selling USD. Given that JPY (which has been unilaterally disliked by investors over the past two years) exists in a world of floating exchange rates, there is no reason to believe it will remain unaffected, so a considerable buy-back of JPY can also be expected. It is often said that forex rates are influenced by "the other party," the "other party" essentially being USD. However, the impact of USD on the rates of any given currency is based on that currency's supply-and-demand structure. In this context, Japan has had significant vulnerabilities in recent years, as I will explain in detail in later sections.

2024 May be the Year the BOJ Graduates from Negative Interest Rates

In discussing the correlation between interest rates and JPY, we must discuss the BOJ's actions in addition to those of the Fed. To get straight to the point, how can we expect the BOJ's withdrawal from negative interest rates to proceed? I expect the BOJ to raise interest rates in June or July, based on the conclusions of its "Review of Monetary Policy from a Broad Perspective" (the second workshop for which is scheduled for May), and coinciding with the release of the Outlook for Economic Activities and Prices (Outlook Report), but there is the risk that the Fed's sudden change in stance could impact the timing. Going forward, the ECB could also switch to a similar messaging following in the Fed's footsteps, and if that happens the BOJ could face an extremely difficult policy climate as the world's only central bank oriented toward policy normalization. There may emerge expectations that the BOJ ought to start policy normalization before the Fed enters its rate-cut phase, if possible, as the markets are inclined to go by such logic. BOJ Governor Kazuo Ueda appears to have anticipated the possibility of such market expectations and preemptively declared them to be "inappropriate," but this may simply be because, as governor, he cannot afford to make any statements assuming actions by other countries' central banks or forex trends. It would not be surprising if his actual thoughts were different. Moreover, rather than a series of rate hikes, the Ueda administration's goal for the time being may simply be to exit negative interest rates in one go with a +10bp rate hike, so a one-time policy operation to accomplish this before the Fed begins rate cuts is easy to imagine. Given that negative interest rates have already been reduced to a formality, it is likely that Ueda, a theoretician, sees no problem in removing them at any time. The BOJ could, therefore, use this opportunity to change track, inspired by the Fed's change of heart. Under such circumstances, the possibility of negative interest rates being abolished in the January-March quarter cannot be ruled out, even though I predict June or July as part of my main forecast scenario.

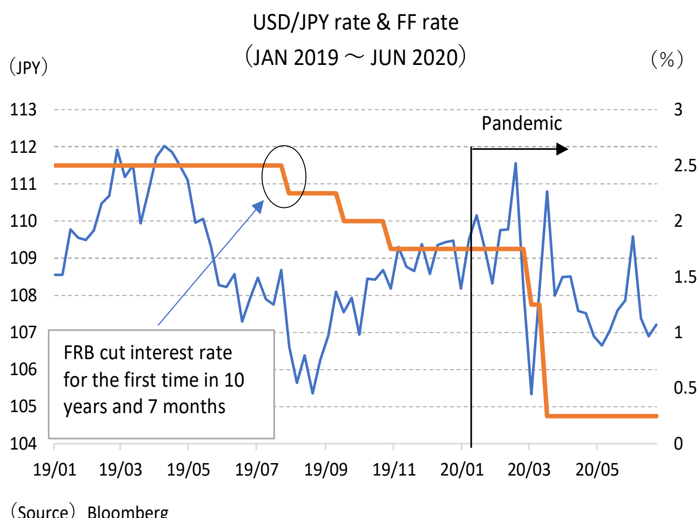
Japanese society is facing an unprecedented labor shortage. It is nearly impossible for wages not to rise during periods of labor shortage, so there is no guarantee that an economic/financial climate permissive of negative interest rates can be sustained through 2024. However, a one-shot +10bp interest rate hike to eliminate negative interest rates would exert only a temporary upward pressure on JPY, and is unlikely to be a sustained factor (rather, it could turn into a factor promoting JPY weakness, as I will explain later). While U.S. authorities may be considering rate cuts, that does not mean a return to zero interest rates. If so, we would do well to understand that, <u>from the perspective of the U.S.-Japan interest-rate gap, JPY appreciation is inevitable but unlikely to be acute</u>.

Japan's Might as it Enters Rate Cut Phase as a Trade-Deficit Nation

Based on the aforementioned arguments, <u>it can be said that the interest-rate-related storyline for 2024 favored by most market participants, namely that rate cuts by the Fed and rate hikes by the BOJ will be the key highlights, is highly probable, and forecasting JPY appreciation based on this assumption is rational</u>. However, there is also a lot of focus on the likely extent of JPY appreciation, and a detailed analysis of supply and demand is required to understand this. I will discuss the current state and future prospects of JPY supply and demand in detail on the next page, but in this section, I would like to re-introduce to my readers the fact that Japan has never before entered a phase of rate cuts by the Fed as a trade deficit nation. Most market participants are entering 2024 with the question, "Assuming the Fed begins to cut rates, to what extent will JPY appreciate?" The reason predictions of JPY appreciation begin to trend in response to rate cuts by the Fed is because of past experience of the two things going hand in hand. Based on past experience, therefore, such predictions are convincing.

As is generally known, Japan became a global trade-surplus superpower after the 1985 Plaza Accords were signed. <u>Whenever the U.S.-Japan interest-rate differential expanded during phases of rate hikes by the Fed, speculators tended to sell JPY and buy USD, resulting in a stronger JPY depreciation tendency, but there was always a strong justification for JPY buying in exchange for USD due to real demand backed by Japan's trade surplus. This is a brief explanation of the recent history of the Japanese economy</u>. When the Fed eventually switched to a phase of rate cuts, the undercurrent of JPY buying owing to real demand was augmented by speculative JPY buying amid the rollback of previous speculative JPY sales, which resulted in hysterical JPY appreciation, as JPY buying was backed both by speculative trading and real demand. This was the reason phases of JPY appreciation were more volatile than those of JPY depreciation in the Tokyo forex markets.

In contrast to this, Japan's trade balance now is essentially in deficit; even before the pandemic, the trade balance was neutral at best. Japan's real demand conditions, therefore, are no longer capable of promoting hysterical JPY appreciation. Nor does Japan have much experience entering a phase of rate cuts by the Fed saddled by these real demand conditions. The reason for saying "much" experience is that, when the Fed decided to implement rate cuts for the first time in 10 years and 7 months at its FOMC meeting at the end of July 2019, Japan was already a trade deficit nation. At that time, USD/JPY did record a dip (JPY appreciation against USD) during the month after that (August 2019), but bounded back again right away (see figure). Strictly speaking, the JPY appreciation had already begun before the rate cut was implemented, but even taking that into consideration, one can see that USD/JPY went from 112 in May 2019 to 109-110 in December, which is not that much of a JPY appreciation. This was followed by the pandemic breaking out in early 2020, when the Fed lowered its interest rates to zero percent in one go, but there does not seem to have been any marked appreciation of JPY against USD as a result of this. I think these experiences from 2019-20 may offer valuable insights when predicting what is to come in 2024.



(Source) Bloomberg

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	

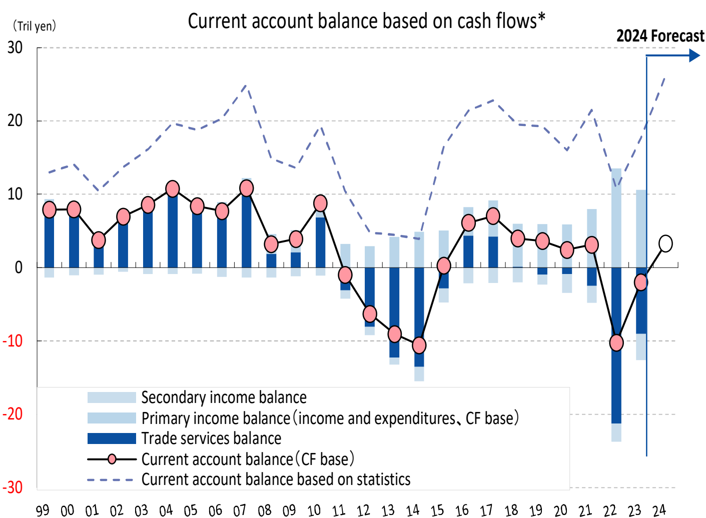
(Source) Ministry of Finance Japan & FRB, created by the author

Incidentally, Japan has posted trade deficits 11 times since 1985, and all of these instances have been recorded since 2011 (see figure). This is very likely to be because of the overseas relocation of production facilities by Japanese companies due to the ultra-strong JPY following the collapse of Lehman Brothers and the major changes to Japan's power mix in the wake of the 2011 Tohoku earthquake and nuclear disaster (of course, the change in the power mix has also directly contributed to an increase in the import value). My theory is that JPY rates underwent a structural turning point sometime around the year 2011. It is possible that forex rate trends in 2024 may leave many market participants feeling that JPY did not appreciate as much as they had expected. However, this is a trend that has been unfolding gradually over the past 10 years. We no longer hear phrases such as "buying JPY as a safe haven currency" or "buying JPY during risk-off phases." In 2022-2023, as a result of wars following close on the heels of the pandemic, resource prices remained stubbornly high, the domestic-foreign interest-rate differential widened dramatically, and inflation was ignited. My understanding is that these exacerbated conditions that were already conducive to JPY depreciation and resulted in an extraordinary situation. Taking into account this supply-demand structure of JPY, I think we may merely see a change from the current excessive JPY weakness to a more reasonable level of JPY weakness even if the Fed begins to cut rates. Ultimately, even if the expected direction of USD/JPY in 2024 points to JPY appreciation, the extent of this appreciation will be determined by supply and demand as represented by Japan's trade balance (details on the next page).

JPY Supply and Demand – Better Than the Previous Two Years, but Still Weak

Demand-Driven JPY Weakness Prediction to Take a Backseat for Now

As explained above, there seems no major disagreement among experts regarding the outlook for USD/JPY based on interest rate trends. However, a detailed analysis of JPY supply and demand is necessary to understand whether or not JPY, which has weakened dramatically in the past two years, can recover its previous value. To begin with, the widening of the U.S.-Japan interest-rate differential and the adoption of negative interest rates by the BOJ are not recent phenomena. It is, therefore, unreasonable to seek to explain JPY's decline in value by up to 30% since March 2022 entirely on the basis of interest rates. This is where it becomes important to take a look at JPY's demand structure. Japan may, statistically speaking, be among the world's largest current account surplus nations (8th largest current account surplus in the world for 2022), but taking a closer look, we find that nearly no JPY buying was generated as a result of cash-flows (CF) pertaining to the primary income surplus (a key part of Japan's current account balance). This discrepancy between a statistical surplus vs. actual deficit is extremely important to pay attention to in analyzing forex rate trends. I have frequently discussed this issue in Mizuho Market Topics and past editions of this report through 2023, and it will continue to form the core of my forecasts in 2024 and hereafter.



(Source) Bank of Japan (Notes) 2023: Sum from Jan to Oct
*With regard to the receipt and payment of primary income and expenditure, "reinvestment income" of direct investment income, "dividends" of securities investment income and expenditure, and "bond interest, etc." are deducted

Let me first provide an overview of the current status of and future prospects for the CF-based current account balance. At the time of writing this report, Japan's current account balances for January to October 2023 have been released. The headlines focus on the nine consecutive months of surplus and the expanding travel surplus. However, while the statistics show a cumulative +JPY 17.7 trillion current account surplus for the January-October 2023 period, my calculations show a current account deficit of -JPY 2 trillion based on cash flows (see figure). Incidentally, the figures for 2022 were a statistical surplus of +JPY 10.7 trillion vs. a CF-based deficit of -JPY 10.2 trillion. Which of the two things – the statistical surplus or the CF-based deficit – is likely to have determined JPY rate trends in 2022 and 2023? The answer seems obvious. Of course, given that the CF-based deficit for the same period (January-October) of 2022 was -JPY 8.9 trillion, JPY supply and demand have certainly improved against the backdrop of the country's expanding travel surplus, but a deficit is a deficit, and 2023 was a year of JPY depreciation as though to prove it. What can we predict for the CF-based current account balance in 2024? As the image above shows, <u>it seems highly likely that net-JPY selling situation of the past two years will be corrected, and the "JPY weakness from a demand perspective" argument will take a backseat in my main scenario for now</u>. However, this is limited to my main scenario, as it is important to note that the current account balance can fluctuate based on a variety of factors. Developments such as an increase in crude oil and other resource prices, a prolonged export slump, inbound tourism failing to increase as expected, or an expansion of the digital deficit could lead to greater JPY selling all over again. On the other hand, developments contrary to the above could result in greater JPY buying. Predictions related to such developments can only be made within reason.

Prospects for CF-Based Current Account Balance in 2024

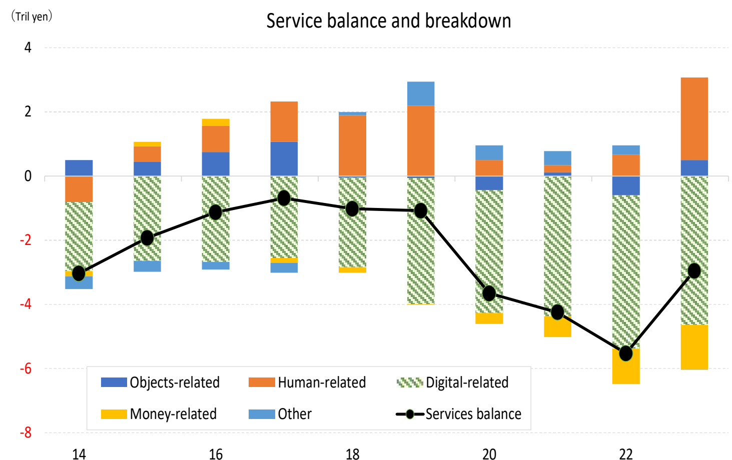
What would happen to the CF-based current account balance in 2024? For example...

	Item	Amount (Tril yen)	Remarks
①	Trade services balance	-2.5	※Average of 10 years from 2010-2019
②	Service balance	-3.4	
	Travel	3.3	※Annualized figure of average from May - Oct 2023
	Transport	-0.6	※Annualized figure from Jan - Oct 2023
	Other	-6.1	※Annualized figure from Jan - Oct 2023
③	Primary income balance	36.4	※Annualized figure from Jan - Oct 2023
④	Primary income balance (CF base)	13.5	※ 37% JPY convertion rate of average from Jan - Oct 2023
⑤	Secondary income balance	-4.3	※Annualized figure from Jan - Oct 2023
	Current account balance (CF base)	3.3	①+②+④+⑤
	Current account balance (based on statistics)	26.2	①+②+③+⑤

(Source) Bank of Japan, created by the author

I would like to paint a very rough picture first before moving on to present specific figures. Estimations as of the time of writing this report are necessarily based on cursory methods, but they will serve to paint a rough picture as of the present. The CF-based current account balance for 2024 presented in the graph above is my estimate based on Japan's current account balance for the January-October 2023 period. Within this, the trade balance has been estimated as an average of the 10 years through 2019 (since the figures for 2020 through 2023 were affected by special factors) using the chart on the previous page. The trade balance is the portion that could easily deviate from my assumed value. My estimation regarding the travel balance is based on summing up the travel balance for May (when COVID-19 was downgraded to a "class 5" disease) through October 2023, and annualizing the figure. Going forward, it seems likely that the travel surplus will remain close to the all-time high level of +JPY 3.0~3.5 trillion, and could even grow further. However, given that the labor shortage in domestic accommodation and food service industries remains at its worst ever, even if there is higher demand for inbound tourism, the supply may be close to its limit, so one must be prepared for the possibility that the travel surplus will hit a ceiling at some point in the not-distant future. Moving on, my estimates for the transportation balance, other services balance, and the primary income balance are based on an annualization of figures for the January-October 2023 period. However, the transportation balance aside, <u>it is difficult to predict how large the other services deficit (which I like to call the "new age deficit"), led by payments toward digital services, will be. The deficit here could well be larger than the above simplistic assumptions</u>. For instance, the headlines pertaining to the period from January-October 2023 focus heavily on the travel surplus renewing all-time highs, but the fact is that the other services deficit also posted its largest ever deficit at -JPY 5.0584 trillion, surpassing the deficit for the same period of the previous year (-JPY 4.5478 trillion). Incidentally, the deficit for the same period was -JPY 3.3096 trillion in 2021, and -JPY 3.0901 trillion in 2020, clearly revealing a rising trend. <u>Given the nature of this category, it seems unlikely that the trend will be broken in 2024.</u>

Until recently, the trade balance and the primary income balance were the first categories to come to mind when considering Japan's current account balance. However, it is becoming increasingly important to think in terms of the extent to which the travel surplus can cancel out the other services deficit when thinking about the current account balance. In other words, to what extent can foreign currency earned through manual labor in the tourism industry pay for payments toward brain work in the digital services industry (see figure)? This seems likely to draw greater attention as a new challenge facing the Japanese economy from 2024 onward. Digging deeper into changes in fund-flow patterns in the services balance will make this discussion too long, so I will leave it at this for now.



(Source) Bank of Japan review "Globalization of services transactions in terms of balance of payments statistics"
(Note) Data for 2023: January to October 2023 total

Trade Balance and JPY Conversion Percentage Difficult to Read

To return to my estimates of the CF-based current account balance in 2024, another issue is to figure out the percentage of primary income surplus that is likely to be converted to JPY (i.e., lead to JPY buying). Here again, my calculations are based on estimating the percentages for January to October 2023 and averaging them, which gave me 37%. However, if I take an average of figures from the past 10 years, it comes out to 27%, which leaves the possibility that I am overestimating the percentage of the primary income surplus that is converted to JPY. Incidentally, the CF-based current account surplus comes out to a surplus of roughly +JPY 3.3 trillion when calculated assuming a 37% JPY conversion percentage, while using a 27% JPY conversion percentage gives a deficit of -JPY 400 billion. My aforementioned estimate of the services balance (-JPY 3~4 trillion) seems unlikely to miss by a wide margin, but the JPY conversion percentage, the trade balance, and the primary income balance are somewhat unclear as of the current time, and they may inevitably contribute to some extent of inaccuracy in my supply-demand forecasts.

Given that the rise in resource prices appears to have peaked, the decline in exports to China appears to have bottomed out, and USD/JPY also appears to have peaked, it is difficult to imagine Japan posting trade deficits as large as those in 2022 or 2023 in 2024. If so, the CF-based current account balance is unlikely to post a greater deficit than the -JPY 10 trillion in 2022. Trade deficits in 2024 are likely to be smaller than even in 2023. Under such circumstances, I predict at this time that the CF-based current account balance in 2024 seems very likely to be better than in 2022 or 2023, while also acknowledging the possibility of a neutral result with no clear sense of direction. As a result, the supply-and-demand factor could become less persuasive in explaining JPY rate trends, in contrast to the rising persuasiveness of the interest-rate factor. And as explained above, the latter indicates JPY appreciation.

2024 May Prove to be a Year of Clear Change in Battling Range for USD/JPY

In the sections above, I presented an overview of my forecast for USD/JPY from two key perspectives – interest rates and supply & demand. My main conclusion is that it would be reasonable to forecast an increase in JPY-appreciation pressures from both interest rate and supply & demand perspectives compared with 2022~23. However, it must be noted that, in terms of interest rates, the shrinking of the U.S.-Japan interest-rate differential will ultimately be limited; and when it comes to supply & demand, while some improvement is certain compared with the past two years, there is no reason to expect a dramatic recovery in demand for JPY. Taking all this into account, it seems reasonable to recognize that, while JPY appreciation is inevitable, it is unlikely to be acute, and that we may only see an improvement from excessive JPY weakness to moderate JPY weakness. My forecast range for USD/JPY is 130-145 or so, and while it certainly points to JPY appreciation in terms of direction, the extent of appreciation makes it difficult to view this as the start of a strong-JPY trend, given that the starting point of the current phase of JPY depreciation was 113 or so.

Has the main battling range for USD/JPY transitioned from 100-120 to 120-140 or 125-145? We should be able to find out in 2024.

U.S. Monetary Policy Now and Going Forward – A Sudden Change in the Tide

The Tide has Changed Completely

The last FOMC meeting for 2023 proved to be a big surprise. At his press conference following the meeting, not only did Powell declare the end of rate cuts by stating, "We believe that our policy rate is likely at or near its peak for this tightening cycle," he even went on to suggest that rate cuts were beginning to "come into view." It was completely unexpected that the Fed would simultaneously indicate the end of rate hikes and the start of rate cuts. Powell had until recently maintained that the Fed would "make decisions about (…) how long policy will remain restrictive based on the totality of the incoming data." Does this mean sufficient data became available in the six weeks between the November and December FOMC meetings to go beyond hinting at the end of rate hikes to also hint at rate cuts coming up? As the market response shows, not many market participants appear to have thought so. Of course, rate cuts beginning to "come into view" does not guarantee that they will be implemented in the near future, but given Powell's mention of them, the likelihood of a Fed rate cut in the January-March quarter has become more real.

I had been expecting that, even if rate cuts discussions were held beforehand, the rate cuts themselves would take place in 2H of 2024, either during the July-September quarter or the October-December quarter, but following Powell's remarks, I have revised my predicted schedule to include discussions during the January-March quarter and actual implementation in the April-June quarter. Of course, since Powell himself has indicated that rate cuts are beginning to "come into view," there is certainly the possibility that both discussions and actual implementation of rate cuts will take place in the January-March quarter. The dot plot (FOMC members' projections of policy interest rates) has also changed to project an FF rate of 4.50~4.75% at the end of 2024, with three rate cuts being factored in (see figure). If we assume a -25bp rate cut at successive FOMC meetings, rate cuts would have to start in September 2024 to meet the above projection, but September seems too far away going by Powell's remarks. As the dot plot's projections changed to include three rate cuts in 2024, the markets' projections changed to factor in six rate cuts. While that seems like too much to expect, <u>it has admittedly also become exceedingly difficult to maintain the assumption that there will be no rate cuts until 2H of the year</u>. Until recently, whenever share prices increased in response to the dot plot swinging in the dovish direction, Powell cautioned against it. Market participants strongly expected to see the same at the recent FOMC meeting too, but no such note of caution was observed at the press conference. It seems clear that the December FOMC meeting was a turning point of sorts for U.S. interest rates.

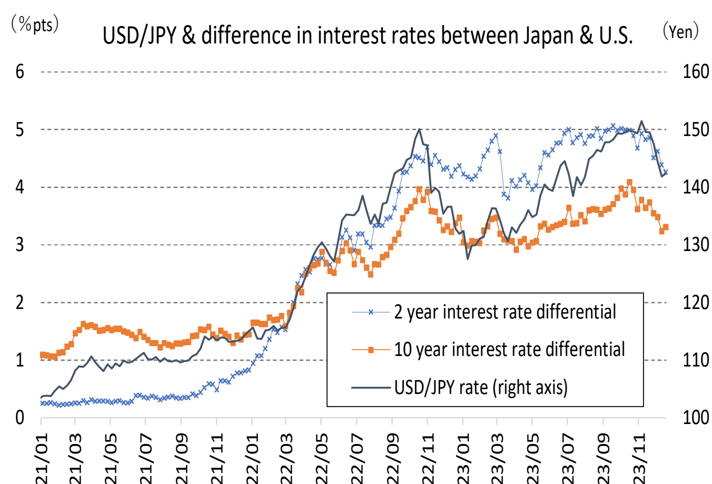
Policy interest rate outlook as of each year end (median estimate)

FOMC Date	2023	2024	2025	2026	Longer run
Jun-22	3.750%	3.375%	n.a.	n.a.	2.500%
Sep-22	4.625%	3.875%	2.875%	n.a.	2.500%
Dec-22	5.125%	4.125%	3.125%	n.a.	2.500%
Mar-23	5.125%	4.250%	3.125%	n.a.	2.500%
Jun-23	5.625%	4.625%	3.375%	n.a.	2.500%
Sep-23	5.625%	5.125%	3.875%	2.875%	2.500%
Dec-23	5.375%	4.625%	3.625%	2.875%	2.500%

(Source) FRB

Heightening JPY-Appreciation Risk – USD/JPY Could Fall to 130-135 Yen in 1H of 2024

Naturally, the JPY appreciation risk has suddenly increased following the recent FOMC meeting, necessitating a revision of my forecasts. Due to rate cuts being brought forward, the possibility has emerged of USD/JPY tumbling to the 130-135 range during 1H of 2024. However, even if some JPY appreciation against USD is inevitable with the narrowing of the U.S.-Japan interest-rate gap, <u>the fact that Japan is entering this phase of U.S. rate cuts as a trade deficit nation means that there is very little possibility of panic-inducing levels of JPY appreciation</u>. Rate-cuts by the U.S. authorities will not lower Japan's trade or services deficits, which makes it theoretically illogical to expect as much upward pressure on JPY from U.S. rate cuts as was common during the Japanese trade surplus era. However<u>, though U.S. rate cuts will have no impact on Japan's trade/services deficits, they may impact the BOJ's monetary policies</u>. This point is discussed in detail on the next page.



(Source) macrobond

BOJ Monetary Policies Now and Going Forward – Prospective Discontinuation of Negative Interest Rates Driving JPY Appreciation?

Only Question Remaining is When to Do It

The BOJ's last monetary policy meeting (MPM) in 2023 attracted much attention for its potential to make changes but decided to maintain the status quo. While appearing before the House of Councilors' Committee on Financial Affairs on December 7, BOJ Governor Kazuo Ueda said that monetary policy management would "become even more challenging from the year-end and heading into next year", and that was widely considered to hint at the possibility of preparations for discontinuing the BOJ's negative interest rate policy. When asked about his posture regarding measures to be taken going forward, however, he said that he simply planned to brace himself and further focus his energies. Judging from the governor's press conference held after the December MPM, it seems safe to say that the potential for a move away from negative interest rates in January is almost out of the picture. However, a speech given by BOJ Deputy Governor Ryozo Himino on December 6 included a large section on "What Would Happen If an Exit from the Large-Scale Monetary Easing Starts in the Future?". After the speech, Deputy Governor Himino told reporters regarding the timing for phasing out negative interest rates that – "We'll look at various factors, but there's never a moment when you see a green light flash for all of them. There's also never a moment where the lights all turn red. In reality, you have to make a call at some point amid a mixed batch of signals." – and <u>this suggests a possibility that the BOJ may take steps to end negative interest rates even if some doubts remain about the economic and financial situation</u>. Anticipating BOJ moves during 2024, it does appear that discontinuing the negative interest rate policy will be the default course and that the only issue remaining to be decided is when to do it.

Forex Market Perspective on the Significance of Negative Interest Rate Discontinuation

So, how can one anticipate the timing of the discontinuation of negative interest rates? Based on the outcome of the 2024 spring wage negotiation offensive and the conclusions of the BOJ's broad-perspective monetary policy review (the second round of "workshop" discussions is scheduled to be held in May), I am assuming that, at the earliest, the timing could be in June, or perhaps when the BOJ's quarterly Outlook Report is released in July. (The Outlook Report is issued in January, April, July, and October.) This assumption is appearing increasingly realistic in light of recent BOJ hints that the timing will not be soon. If the timing will be after January (as Governor Ueda's press conference comments appear to indicate), it would be difficult to set the timing to correspond to the end of Japan's fiscal year (March 31), as it is expected that practical preparations for changes will require somewhat more time. Therefore, the earliest possible timing would be when the Outlook Report is published in April. The financial markets have generally anticipated that the earliest possible timing would be in April, after evaluation of the spring wage negotiation offensive, but I believe that, given the time and effort invested in the broad-perspective monetary policy review, the BOJ will seek to cite the results of that review when discontinuing the negative interest rate policy. Moreover, June and July timings are not considered particularly difficult in light of the political calendar. (There is expected to be a snap general election before the September 2024 Liberal Democratic Party leadership election.) The preclusion of a December timing has clarified the likely timeframe of the prospective negative interest rate policy discontinuation.

The biggest question remaining is whether international financial conditions allow the BOJ to wait until next summer. The Fed suddenly changed its monetary policy stance at the December FOMC meeting and, although there are no signs of this happening so far, there is a possibility that the ECB will follow the Fed's example and shift to a similar type of information dissemination. In that case, the BOJ would be the only one of the world's main three central banks still aspiring toward policy normalization, making its policy environment extremely difficult. Governor Ueda has declared that the financial markets reasoning that the BOJ should normalize its situation before that happens is "inappropriate", but he is not in a position to know the exact nature of prospective changes in other countries' central bank policies or in forex rate trends. It would not be surprising if Governor Ueda's true feelings about this are somewhat different from his expressed view. After all, the BOJ's goal is not to launch a series of interest rate hikes but simply to end negative interest rates via a single move to raise the rates 10 basis points. Given how simple that goal is, one might think that the BOJ could do it at any time from the start of 2024. Although the likelihood of a move to hike interest rates at the January MPM appears to have greatly diminished and such a move would not at all be the BOJ's most-desired approach, there does remain a possibility that a move to hike interest rates could be undertaken at the January MPM and could be factored into forex rates based on advance reporting.

End of Negative Interest Rates Could Actually Promote JPY Weakening

If it is considered virtually impossible for the BOJ to launch a continued series of interest rate hikes then, when negative interest rates are discontinued, it could be interpreted to suggest that the BOJ will at that point have no more remaining approaches for strengthening JPY. If you think that the BOJ (regardless of its official stance) is actually intent on restraining the JPY depreciation trend, and you anticipate that the BOJ will be unable to undertake a second or third interest rate hike to move forward with policy normalization, then it will be clear that the discontinuation of negative interest rates could actually promote subsequent JPY weakening, so it seems likely that the BOJ would want to make its negative interest rate discontinuation move at a time when it is judged that that the JPY depreciation trend has already been nipped in the bud. Although USD/JPY has peaked out, it is still in the JPY140-145 range, and if JPY were to significantly depreciate going forward, the markets may soon begin anticipating USD/JPY's resurgence to the JPY150 level. At this point, there remains a basis for concern about what may happen if the BOJ appears to have played all of its available policy cards.

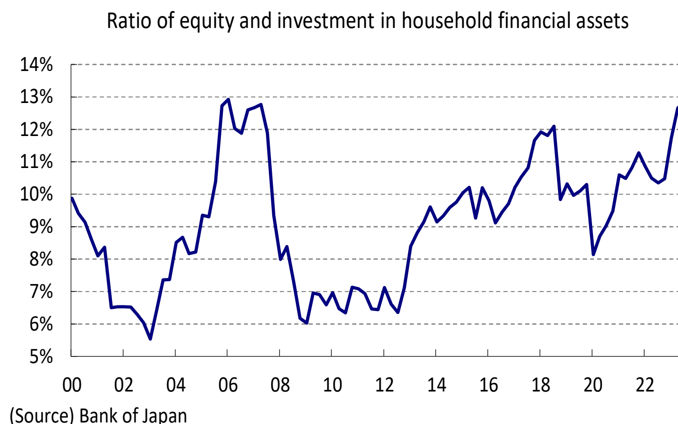
While it seems that there has long been a general feeling in Japan that the BOJ should refrain from discontinuing its negative interest rate policy based on consideration for public opinion and political factors, it now appears that there is no need to continue worrying about those factors. The concept that negative interest rates are promoting JPY depreciation has already permeated the general public, and the number of Japanese averse to JPY depreciation is clearly increasing, as reflected in the increasingly common use of such phrases as "undesirable price increases" and "undesirable JPY depreciation" to explain why people perceive their quality of life is deteriorating. If discontinuing negative interest rates is considered necessary to curb JPY depreciation, there will be no reason for public opinion to oppose it. However, in the unlikely event that JPY depreciation trend is not curbed even after the ending of negative interest rates, the BOJ and the government will have to face the extremely negative combination of continued JPY depreciation amid rising interest rates. In particular, the end of negative interest rates is likely to boost variable mortgage interest rates, which can be expected to arouse considerable anxiety among much of the population. Public opinion will greatly disfavor a situation in which the population shoulders higher mortgage and other interest burdens while the JPY depreciation trend remains unchecked.

Of course, forex rates are not something that can be so easily controlled using the BOJ's policy management tools, but the general public is not sufficiently sophisticated to understand that. From the perspective of Japan's government and ruling party, the possibility that monetary policy adjustments could trigger a strong public backlash is something to be avoided at all costs, and as a Bloomberg article reported prior the December MPM, it was quite unlikely that the BOJ would feel any motivation to expedite its ending of negative interest rates during December. While there are no major impediments to projections of negative interest rate policy termination during 2024, it should be kept in mind that such a policy termination is likely to mark the end of the BOJ's policy normalization efforts for the time being and that there is thus a risk that the JPY depreciation trend will resume due to a perception that the BOJ has exhausted its policy cards.

Risks to My Main Scenario – Japan's Foreign Direct Investment History Illustrates Household JPY Selling's Potential Effects

Stocks and Investments Account for a Record High Share of Household Assets

Both upside and downside JPY exchange rate risks are increasing, but given the magnitude of its potential impact, the Japanese household sector's prospective proclivity to sell JPY is a particularly important risk factor. I have updated my evaluation of that situation based on flow of funds statistics (preliminary figures) as of the end of September, which the BOJ released on December 20. At the end of September 2023, Japanese households' financial assets reached a new record high level of JPY2,115 trillion. Although the majority of those assets was still in the form of cash and deposits (52.2%, excluding foreign currency deposits), it noteworthy that the share in the form of stocks and investments had risen to 12.9%, the highest ratio ever recorded (see graph).



The last time this ratio was so high was at the end of March 2006, when the world was in the midst of a financial bubble (later known as the subprime and Lehman shocks). Japan was in the JPY depreciation bubble era, and its current account balance and trade balance were both increasing. Recently, the Nikkei Stock Average has been showing a fairly large increase (rising around 18%, from JPY28,000 at the end of March to JPY33,000 at the end of September), and it is safe to assume that the increase in the share of household assets in the form of stocks and investments largely reflects the price effect stemming from the rise in stock prices. The rise in the share of household assets in the form of investment trusts (excluding the foreign currency portion) can similarly be considered to be a reflection of price effects. Whether or not the share of household assets in the form of stocks and investments will be pushed up by a quantity effect associated with actual transactions will depend on the effectiveness of Japanese government policies designed to make Japan an "Asset Management Nation", which will be implemented from 2024, but recent movements in the size of that share indicate that there is indeed an incipient shift from savings to investment, albeit a very gradual one.

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

	Amount (tril yen)	(%)
Total assets	2,121.2	100.0
Foreign currency	74.3	3.5
Foreign currency deposit	6.7	0.3
Foreign securities investment	25.9	1.2
Investment trust	41.7	2.0
JPY-denominated	2,047.0	96.5
Cash and deposits (excluding foreign currency deposits)	1,106.3	52.2
Government bond, etc.	28.0	1.3
Stocks and investments	272.9	12.9
Investment trusts (excluding the foreign currency portion)	65.2	3.1
Insurance and pension reserves	539.1	25.4
Deposit, etc.	35.6	1.7

Financial asset composition of the Japanese household sector (end of MAR 2000)

	Amount (tril yen)	(%)
Total assets	1,401.1	100.0
Foreign currency	13.2	0.9
Foreign currency deposit	3.1	0.2
Foreign securities investment	4.7	0.3
Investment trust	5.3	0.4
JPY-denominated	1,387.9	99.1
Cash and deposits (excluding foreign currency deposits)	741.6	52.9
Government bond, etc.	50.6	3.6
Stocks and investments	138.3	9.9
Investment trusts (excluding the foreign currency portion)	52.2	3.7
Insurance and pension reserves	369.9	26.4
Deposit, etc.	35.3	2.5

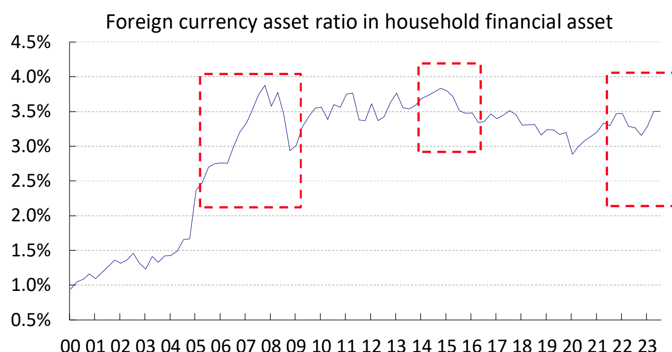
Changes from the end of MAR 2000 to the end of SEP 2023

	Amount (tril yen)	(%)
Total assets	720.1	
Foreign currency	61.1	2.6
Foreign currency deposit	3.6	0.1
Foreign securities investment	21.2	0.9
Investment trust	36.4	1.6
JPY-denominated	659.0	▲ 2.6
Cash and deposits (excluding foreign currency deposits)	364.7	▲ 0.8
Government bond, etc.	▲ 22.6	▲ 2.3
Stocks and investments	134.5	3.0
Investment trusts (excluding the foreign currency portion)	12.9	▲ 0.7
Insurance and pension reserves	169.2	▲ 1.0
Deposit, etc.	0.3	▲ 0.8

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

Share of Household Assets in the Form of Foreign Currency Assets Rose About 400% Over 25 Years

This article has repeatedly discussed the a possibility that the Japanese household sector's shift from JPY-denominated cash deposits to other assets will gain momentum in response to Japan's various measures related to the idea of becoming an asset management nation. Since relatively financially conservative elderly households account for the bulk of household assets measured by flow of funds statistics, it can be difficult to detect significant changes in the asset structure of younger households just by looking at quarterly flow of funds statistics. However, the share of household assets in the form of foreign currency assets (mainly investment trusts) has increased to about 3.5%, from about 0.9% a quarter century ago (at the end of the first quarter of 2000). A

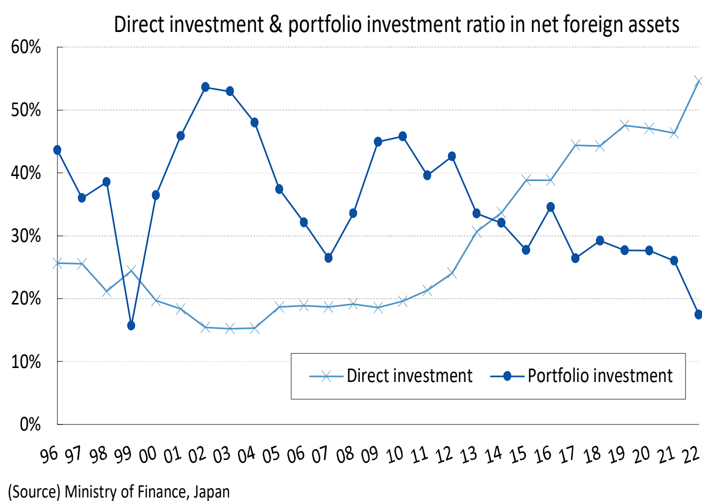


(Source) Bank of Japan, calculated by the author.
(Note) Dotted line indicates weak JPY

change of about 400% in terms of share and 600% in terms of amount cannot be considered small. Of the 2.6 percentage point increase to the share, investment trusts accounted for 1.6 percentage points, foreign securities investment (such as investment in individual U.S. stocks) accounted for 0.9 percentage point, and foreign currency deposits accounted for 0.1 percentage point. The various asset management nation measures that will be launched from 2024 will largely focus on facilitating access to investment trusts, so it is reasonable to anticipate an increase in the share of household assets in the form of investment trusts going forward. As repeatedly noted in this article, Japanese households are clearly showing a growing tendency to choose foreign currency-denominated investment trusts rather than JPY-denominated investment trusts, and there are strong grounds for suspecting that this is contributing to JPY depreciation. Although this trend may not be large enough to cause much fuss at this point, there is a possibility that it will gradually become large enough in the future.

Japan's Foreign Direct Investment History Illustrates Household JPY Selling's Potential Effects

While many Japanese media headlines are predicting that the launch of such asset management nation systems as the new Nippon Individual Savings Account (NISA) system will trigger an avalanche of foreign currency investment and cause JPY to continue depreciating, I believe that the amount of Japanese-held foreign currency-denominated assets will increase only gradually, as snow accumulates over the winter season. My reasoning is easy to understand if one looks back at the history of Japan's foreign direct investments, which began to increase on a flow basis from around 2010. The recent acquisition of an American steel company by Japan's largest steel company has been cited as a factor contributing to JPY depreciation, but JPY has already shown a trend of strengthening since reports about the acquisition. There is no way to know what kind of forex transactions will be associated with individual direct investments, and even if such forex transactions occur, it is possible that the progress of associated business operations will progressively diminish the impact of the initial forex transactions. Ultimately, it is difficult to detect a direct relationship between flow-based foreign direct investment levels and JPY exchange rate movements. However, as a result of the steady accumulation of flow-based foreign direct investment that began around 2010, the stock-based foreign direct investment balance has come to have a significant effect on the forex market. Japan has the world's highest level of external net assets and, as of the end of 2022, direct investment accounted for more than half of those external net assets, while securities investment (which previously accounted for half) accounted for less than 20%. Almost half of Japan's primary income surplus (which supports the current account surplus) comes from direct investment income, and the fact that reinvested income (a component of direct investment income) does not flow back into JPY is one reason that JPY is liable to depreciate despite Japan's current account surpluses. The accumulation of individual foreign direct investments created a situation that facilitates structural JPY depreciation, but flow-based foreign direct investment transactions did not suddenly move the forex market.



(Source) Ministry of Finance, Japan

I anticipate similar developments will stem from the Japanese household sector's prospective shift to foreign currency investment. Given that the majority of Japanese households' financial assets are held by conservative elderly households, an overnight surge in households' foreign currency investments capable of strongly impacting the forex market is highly unlikely (although if it were to happen, Japan might face a situation akin to the European debt crisis). However, just as the gradual rise in the direct investment ratio eventually impacted Japan's external net asset balance, even in the absence of a major short-term change, it is quite conceivable that a gradual increase in the foreign currency asset ratio may proceed over a certain time period, and suddenly people will notice that the ratio has attained levels of 10%, 15%, and then 20%. The share of Japanese households' foreign currency assets has quadrupled during the past quarter century dominated by JPY appreciation trends so, if it is generally believed that countries recording trade deficits will find it difficult to strengthen their currencies, it would not be surprising to see considerable acceleration of growth in Japanese households' foreign currency investment. JPY selling and foreign currency purchases that occur in connection with such asset management nation systems as the new NISA are likely to be outright transactions that do not quickly flow back into JPY, so even if they are not a significant factor promoting JPY depreciation, they may become a structural forex market factor impeding JPY appreciation. Household JPY selling remains the biggest risk factor capable of promoting JPY depreciation, and it is important to note that this risk factor is associated not only with short-term capital movements but also with the progressive transformation of the household sector's asset portfolio over the long term.

EUR Outlook – Has the Inflation Surge Really Been Subdued

Euro Area Economic and Monetary Policies – Increasing Importance of Labor Costs

Hawkish ECB Abstains from Discussion of Rate Cuts
The December 14 ECB Governing Council meeting (the last meeting in 2023) decided to leave policy interest rates unchanged, the second consecutive Governing Council meeting to maintain the interest rate status quo. However, unlike the Fed, the ECB has not at all been hinting about prospective interest rate cuts, and the latest Governing Council meeting generally had a strongly hawkish tone, confirming that reinvestment of full redemption amounts of Pandemic Emergency Purchase Program (PEPP) assets would end in the first half of 2024. The December Governing Council meeting had the natural result of promoting a broad trend of EUR appreciation. As expected, many of the questions posed by reporters at the post-Governing Council meeting press conference focused on whether or not the ECB was considering the timing of prospective interest rate cuts in a manner similar to that of the Fed. The first question asked was – “The first [question] is on the market expectations about the future rate trajectory, especially after the Fed yesterday was quite explicit about the potential of three rate cuts during the course of next year. So what is the ECB’s thinking?” In response, ECB President Lagarde said – “We are data dependent. We are not time dependent.” – and emphasized that policy decisions will be made based on the latest data regarding three previously explained key criteria (inflation outlook, underlying inflation trend, and monetary policy transmission strength) and that the timing will not be set in advance.
While it could be judged that the ECB’s inflation control efforts are clearly progressing based on these three criteria, President Lagarde pointed out the latest Eurosystem staff forecast’s inflation projections are conditioned on the interest rate path that was embedded in market data before the November 23 cut-off date, so the accuracy of those projections is somewhat discounted. Given that along with continued uncertainties regarding the employment and wage situation, she said – “we should absolutely not lower our guard.” – meaning that monetary policies should be maintained that are somewhat more hawkish than one might think appropriate in light of the projections alone. The second reporter posed a more-straightforward question about whether there had been any discussions about interest rate reductions, and President Lagarde responded quite unambiguously that – “We did not discuss rate cuts at all. No discussion, no debate on this issue.”

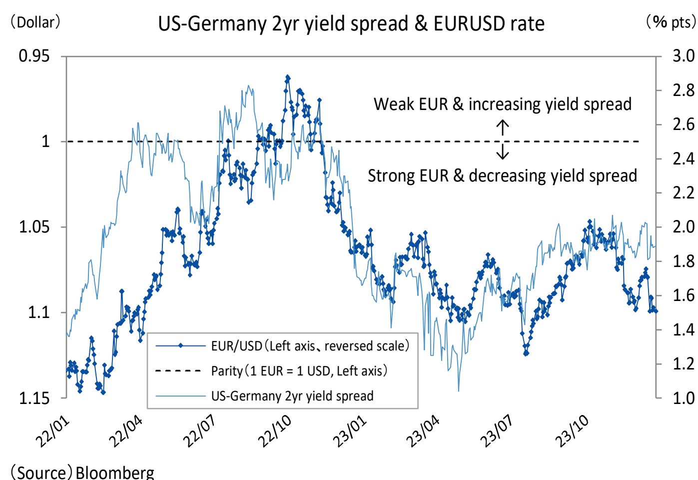
President Lagarde Compares Interest Rate Movements to Solids, Liquids, and Gases
As previously reported, President Lagarde announced at a media event in November that she did not anticipate any change to the ECB policy interest rates during the next few quarters, which attracted considerable attention in financial markets. A reporter at the press conference asked whether she still held that view, and President Lagarde responded by complaining that many reporters (and market participants) were considering only two options – rate hikes or rate cuts, which she compared to solids and gases, respectively – and she went on to compare the current maintenance of high interest rates to liquids, saying – “It's like solid, liquid and gas: you don't go from solid to gas without going through the liquid phase. This [reduction of interest rates] was just not discussed.” In President Lagarde’s analogy, the ongoing transition from solids (rate hikes) to gases (rate cuts) takes time, and the intermediate stage of liquids (interest rate maintenance) cannot be skipped. This is obvious, and at the December FOMC meeting mentioned above, the market was shaken by information that appeared analogous to a single leap from a solid state to a gas state. There are indeed excellent reasons for making status quo maintenance the ECB’s “next step” policy prior to raising interest rates, and it does seem very reasonable and appropriate for the ECB to maintain the current situation for a certain amount of time. Essentially, President Lagarde was simply saying that the ECB is now in the process of assessing the effects of the repeated interest rate hikes and that the ECB needs to confirm data for the first half of 2024 before making a final decision about advancing toward new policies.

No Relationship between Balance Sheet Policy and Interest Rate Policy
On November 10, President Lagarde told the Financial Times Global Boardroom conference that no change should be expected to ECB policy interest rates in "the next couple of quarters", and if that is interpreted as meaning the status quo will be maintained for at least two quarters, one gets the impression that there will be no interest rate cuts during the first half of 2024. As mentioned above, the ECB plans to discontinue its reinvestment of 100% of PEPP assets on their maturity from the end of the first half of 2024. The reason important monetary policy changes are to be made at the end of the first half of 2024 is because relevant data (particularly employment and wages data) will be available at that time. However, one reporter at the press conference asked about the sequence (temporal order) of policy decisions, saying – “Is the PEPP a prerequisite - or the earlier stop of reinvestments or fading out of reinvestments - is that a prerequisite for having rate cuts [...]?” After it discontinues its reinvestment of 100% of PEPP assets on their maturity from the end of June 2024, the ECB will shift to reinvestment of 50% of PEPP maturing assets from July through December and it is projected that ECB balance sheet will shrink by EUR7.5 billion per month during that period. The timing of that move has aroused speculation that the ECB may intend to start lowering interest rates from July. However, President Lagarde stated at the press conference that there is no relationship between quantitative tightening (QT) and interest rate changes – they are determined “on a standalone basis”. She said – “[I]t's totally unrelated to “If they do that with PEPP, then maybe they're planning this on rates”. No, rates are the primary

tool and we're going to use that independently of what happens on the PEPP side, which as I said is on the back burner." While the financial market players will continue speculating about a possible relationships between balance sheet policy and interest rate policy, the ECB is firmly maintaining that they are unrelated.

Particular Importance of Monitoring Euro Area Labor Costs in 2024

While the Fed has clearly become more dovish, the ECB has remained resolutely hawkish, thereby promoting a steady trend of EUR appreciation. Since the ECB started hiking interest rates later than the Fed, it is not surprising that the ECB is lagging behind when it comes to rate cuts, but the difference between the two central banks' stances has led to a clear narrowing of the Europe-U.S. interest rate differential and a corresponding increase in EUR/USD during December. Taking information provided by the Fed and the ECB at face value, it appears that this general situation may continue for the next three to six months, encouraging EUR/USD eventually become firm at levels above USD1.10. As has been the case with the Fed, however, we should anticipate that the information provided by the ECB may suddenly change at some point. For example, President Lagarde's three-states-of-matter metaphor suggests that there will no such sudden changes in the ECB's monetary policy for some time, but <u>if there is a sudden change in euro area economic and/or financial conditions (such as the emergence of a financial crisis or additional geopolitical risks), there is a possibility that the current liquid state (neutral policy stance) could very quickly advance to the gaseous state (dovishness)</u>. In light of the statements made at the press conference following the December Governing Council meeting, it seems possible that the ECB may change its policy stance as soon as it receives some positive data related to employment and wages. <u>In this regard, the negotiated wage and labor cost statistics released once a quarter will be quite important, and GDP deflator and unit labor cost figures are also likely to have considerable influence on the ECB's prospective decisions</u>. President Lagarde has emphasized that the ECB will assess the euro area wage situation "in multiple ways". In particular, the negotiated wage statistics are quite difficult to accurately interpret (which is one reason the interest rate hikes have lasted so long), and the ECB will always be fearing that statements about the euro area economy being "stronger than expected" could directly spur general expectations and discussions about interest rate reductions. Going forward during 2024, besides monitoring such financial indicators as interest rates and exchange rates, it will be important for ECB watchers to undertake careful analyses of labor costs throughout the euro area economy.

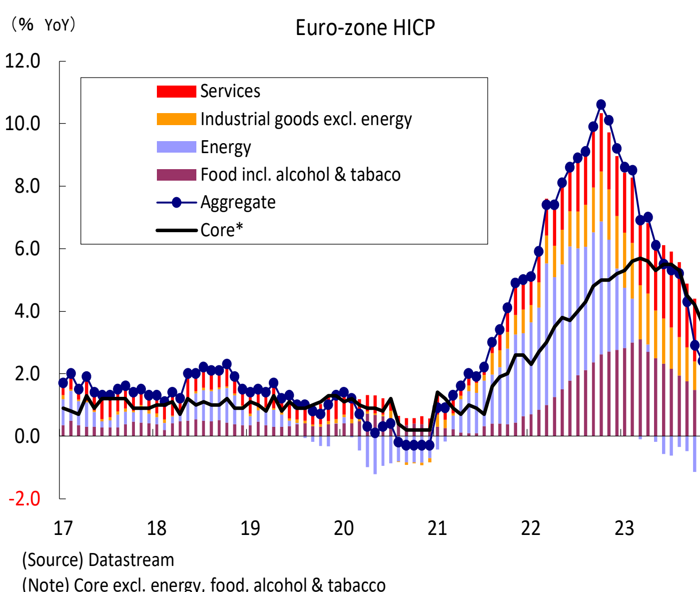


(Source) Bloomberg

Euro Area Economy Now and Going Forward – Has the Inflation Surge Really Ended?

Service Prices are Inflation's "Last Bastion"

The latest euro area consumer price index figure (HICP, for November) was up 2.4% from the same month last year. HICP growth thus decelerated for the seventh consecutive month and fell to the slowest rate in 2 years and 4 months (since July 2021; all inflation rates are yoy unless otherwise specified). Growth in the core index (excluding food, alcohol, and tobacco) fell below the 4% level, to 3.6%, so there appears to be no doubt that the euro area's inflation surge has stalled (see graph). In light of these inflation-related developments, as explained above, the December 14 Governing Council meeting (the last meeting of the year) decided to postpone additional interest rate hikes, the second consecutive Governing Council meeting to postpone rate hikes. <u>Financial markets are starting to factor in an interest rate cut around April 2024, but it is too early to judge whether the markets are being prescient in this regard. The ECB has been close monitoring trends in service prices, which strongly reflect the employment and wage situation, and those service prices have continued to rise at a high rate (4%)</u>. Before the ECB will undertake a reduction of interest rates, it will have to confirm a clear trend of deceleration in the quarterly statistics on labor costs and negotiated wages. In this regard, ECB Executive Board member and chief economist Philip Lane has expressed the view that it will not possible to make any decisions regarding future trends in employment and wages until after the Easter holidays (the end of March 2024). However, it will be quite difficult for the ECB to seriously consider interest rate cuts until its sees a clear correction to

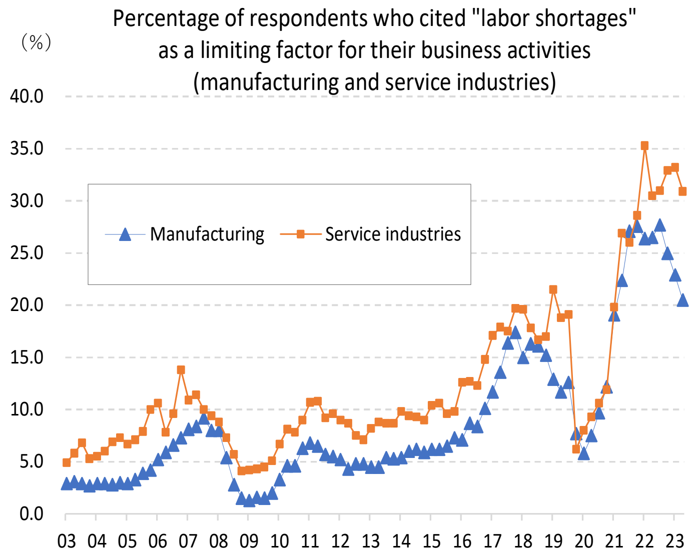


(Source) Datastream
(Note) Core excl. energy, food, alcohol & tabacco

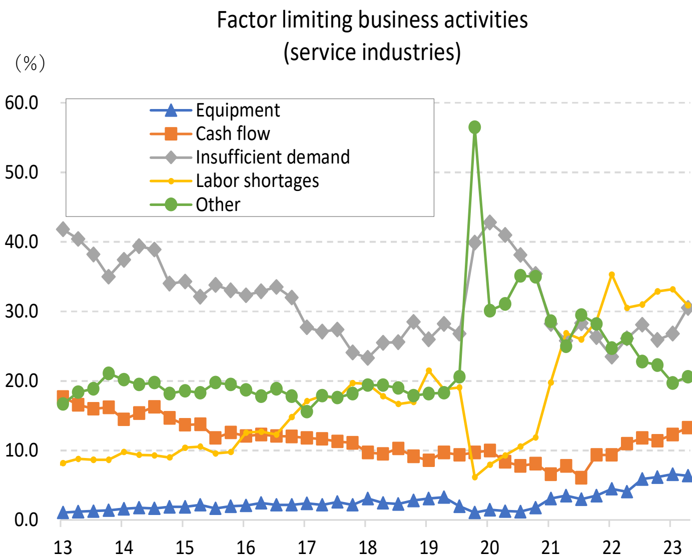
the persistently strong growth in service prices, which are akin to inflation's last bastion or stronghold, and it seems too early to assume that this will happen by April.

Service Industry Companies Still Facing Labor Shortages

In fact, looking at the results of a European Commission corporate survey released in October, it can be seen that the percentage of respondents who cited "labour shortages" as a factor limiting business activities has peaked out in manufacturing industries but remains high in the service industries (see graph, above right). It seems clear that service prices are not falling as much as expected owing to the fact that service industry companies are still facing labor shortages. Looking deeper into the survey's results related to service industries, one finds that, while the percentage of respondents who cited "labour shortages" as a factor limiting business activities is still the highest, the percentage of respondents who cited "insufficient demand" has been decreasing (see graph, below right). This general trends among manufacturing industries are similar, and it should be noted that if businesses continue to face insufficient demand, their need for labor will inevitably decrease, and that can be expected to cause the uptrend in wages to decelerate. You could say that the euro area economy is now approaching a crossroads. Furthermore, the effect of the ECB's interest rate hikes appears to be steadily permeating the economy, as the percentage of respondents citing cash flow or financial constraints has been increasing. Will it be possible to completely halt the wage/price spiral that seems to have begun? The ECB appears to be on the brink of making a decision regarding that question, yet Chief Economist Lane's recognition that the ECB is not yet in a position to make a decision is probably justified. The Euro area's October unemployment figures were released at the same time as the November HICP data, and they indicate that unemployment rate is stubbornly remaining at 6.5%, the lowest level recorded since the calculation of that statistic began. Although it seems almost certain that the ECB will continue suspending interest rate hikes for some time to come, one must keep in mind that the interest rate hike suspension issue is separate from the issue of when the ECB will initiate interest rate cuts.



(Source) macrobond



(Source) macrobond

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