Forex Medium-Term Outlook

MIZUHO

January 31, 2024

Overview of Outlook

JPY consistently fell against USD through January. There were many factors that contributed to this – the Noto earthquake on January 1 triggered JPY selling due to a sense of national crisis, household JPY selling became a theme with the introduction of the New NISA scheme, and to top it all, U.S. economic indicators put up a strong performance. A number of issues have coincided right from the beginning of the year, but the most concerning of them is the focus on household JPY selling, something I have previously expressed concern about in this report. As Minister of Finance Shunichi Suzuki has said, the amount involved is not sufficient to determine the JPY rate trend, but the fact is that the forex markets are easily influenced by what is trending, and a trend of household JPY selling does indeed exist, and with its continued promotion as national policy, it seems natural to assume that it has contributed to JPY weakness to some extent. As per my calculations at the present time, JPY 7-9 trillion worth of JPY selling can be attributed to the New NISA scheme, which is sufficient to cancel out Japan's cash-flow-based current account surplus. Taking into account the greater-than-expected attention focused on the New NISA scheme combined with JPY selling triggered by a sense of national crisis right from the beginning of the year, I have decided to raise the ceiling of my forecast range a bit. I would also like to take into account the possibility of the weak-JPY trend resuming from the October-December quarter onward if former U.S. President Donald Trump gets reelected. However, assuming that the Fed will implement several rate cuts this year, I maintain my prediction that there may be some investment opportunities to be gained from JPY appreciation during the April-June and July-September quarters.

EUR also weakened in January. The ECB is using "summer" as the key phrase to encourage the markets to factor in rate cuts during 2H of the year. To put it another way, it seems clear that the ECB does not intend to make any moves to cut rates until summer. What the markets factor in may gradually change based on wage statistics released from April onward. Considering the sluggishness of wage growth as seen from help-wanted ads, it seems very likely that growth in negotiated wages will also slow, and this may be what the ECB is hoping for. If a slowdown in wage growth and, therefore, inflation growth can be confirmed from the June staff macroeconomic projections following the announcement of negotiated wage at the end of May, the ECB could cut rates as early as July, but more likely in September. The ECB staff macroeconomic projections released early this year presented a quantitative analysis suggesting that supply constraints seen earlier may have formed the backdrop to soaring inflation rates, so policy operations going forward may be premised on the assumption that 2024 will be a year of rate cuts. EUR is likely to weaken in response to this, but given that the ECB's rate cuts could coincide with those of the Fed, no dramatic decline is expected. Ultimately, with both Europe and the U.S. likely to avoid a recession, the battle between EUR and USD may come down to which of the two central banks implements rate cuts first. If they start at the same time, my sense is that USD selling may attract closer scrutiny. EUR may not be sold off to the extent suggested by the weakness of the euro area's real economy.

Summary Table of Forecasts

	2024 Jan (actual)	Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2025 Jan-Mar
USD/JPY	140.80 ～ 148.80 (147.50)	140 ～ 149 (145)	137 ～ 147 (144)	136 ～ 145 (143)	140 ～ 149 (145)	140 ～ 150 (146)
EUR/USD	1.0796 ～ 1.1046 (1.0843)	1.06 ～ 1.11 (1.09)	1.05 ～ 1.11 (1.08)	1.05 ～ 1.11 (1.07)	1.04 ～ 1.10 (1.06)	1.05 ～ 1.11 (1.08)
EUR/JPY	155.10 ～ 161.84 (159.93)	155 ～ 163 (158)	152 ～ 162 (156)	150 ～ 160 (153)	152 ～ 162 (154)	153 ～ 163 (158)

(Notes) 1. Actual results released around 10am TKY time on 31 JAN 2024. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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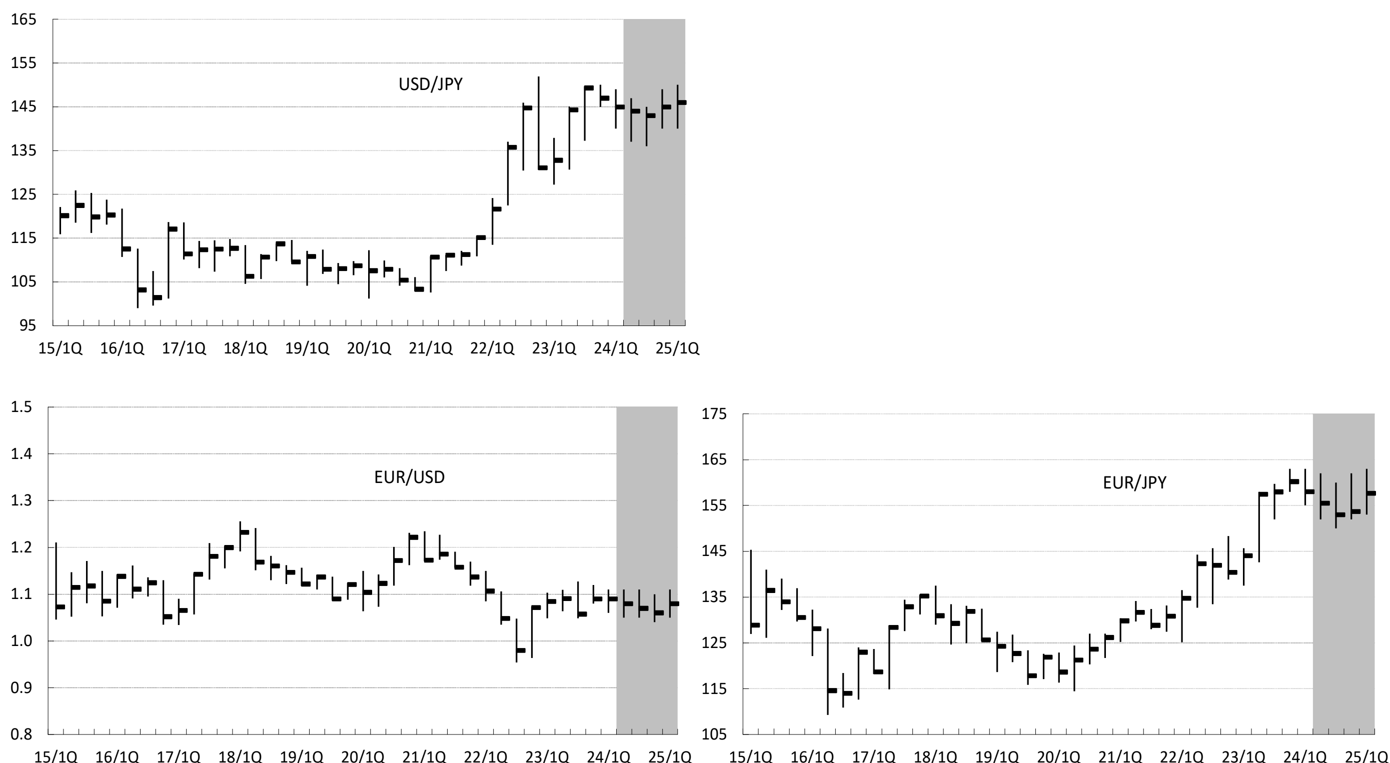
Exchange Rate Trends & Forecasts



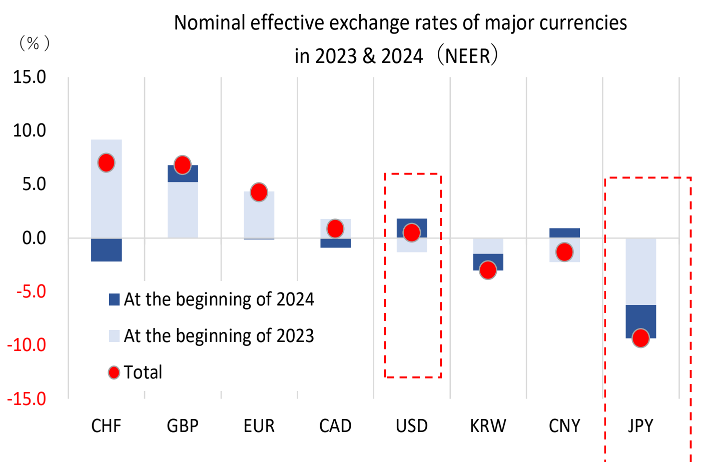
USD/JPY Outlook – Has "Household JPY Selling" Begun?

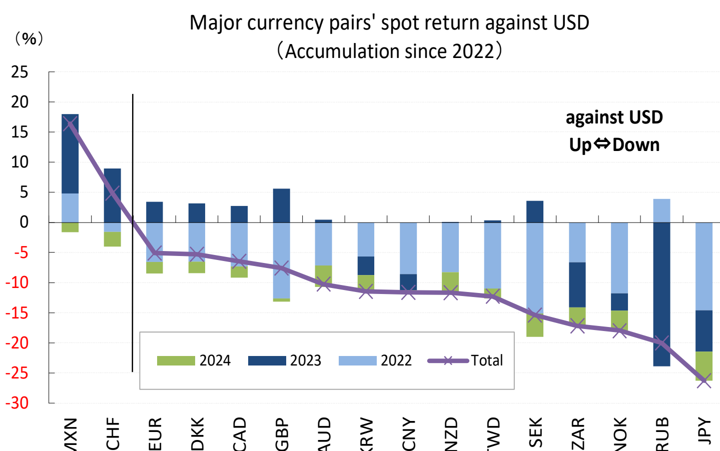
JPY Rates Now and Going Forward – Will JPY Remain the Sole Weak Currency Again in 2024?

No Change in JPY Status

At the end of the first month of 2024, let us take stock of JPY's current status based on its nominal effective exchange rate (NEER) and spot rate. In terms of NEER (see figure to the right), the strongest currency so far this year is USD at +1.8%, while JPY is the weakest at -3.1%. Incidentally, the Turkish lira (TRY) fell by -1.0%, so, going by the past one month's performance, one could say JPY's decline has been much steeper than even TRY. Given that it is still quite early in the year, let us take a broader look at the performance of various currencies incorporating their performance for all of 2023 also. The strongest currency in this case has been CHF at +7.0%, while the weakest is JPY at -9.4%. In terms of NEER, many currencies have experienced a rebound from their depreciation in 2023 over the past month, while JPY alone conspicuously continues to fall.

Next, looking at the rate of change against USD for all the key currencies (excluding TRY and Argentine peso (ARS) to avoid scale-related challenges), the strongest currency since the beginning of 2024 has been RUB, which has been more or less level against USD, while the other currencies have all fallen against USD (this is partly in reaction to the -24% depreciation of RUB against USD in 2023). As one can see also from the NEERs, the first month of 2024 has seen USD strengthen across the board, with most other





(Source) macrobond (Note) Up to 30JAN2024

currencies depreciating as a result. Especially weak among the various currencies has been JPY, which fell by -4.8% against USD. To get an even bigger picture, if we look at the cumulative rate of change of various currencies against USD from 2022, when the ongoing phase of JPY depreciation began, the strongest currency has been MXN at +16.4%, while, with the exception of TRY and ARZ, JPY is the weakest at -26.3%. The extraordinariness of JPY's fall is highlighted by its status as a G7 currency. This current status of JPY makes it easy to understand why I have consistently maintained that Japan-specific structural factors are driving JPY weakness. It is impossible to explain the current level of JPY weakness based solely on external factors (e.g., USD strengthening due to the widening U.S.-Japan interest rate gap).

Not to Rule Out Seeds of JPY Appreciation

It must be noted, however, that some part of JPY's depreciation since the beginning of 2024 can probably be explained by across-the-board USD appreciation, though not all of it, given the significant level of JPY's decline. My theory is that JPY selling triggered by a sense of national crisis following the Noto earthquake, and household JPY selling in response to the launch of the New NISA (Nippon Individual Savings Account) scheme, which makes small investments tax exempt, may be additional factors. Leaving the additional factors aside, if we agree the recent JPY depreciation may have an undercurrent of USD strength, then the Fed pivoting to rate cuts could seed the JPY appreciation trend. Of course, what extent of JPY strengthening could result from this is a different question, but I do not have the impression that JPY will continue on to the 150 level with no buying opportunities inbetween. One scenario in which this could potentially happen is if Fed Chair Jerome Powell's December remark that rate cuts were beginning to "come into view" gets shelved, and the federal funds (FF) rate is maintained at its current level, but my main forecast scenario cannot be based on the assumption of such an inconsistent policy operation. At best, I would like to keep the possibility of no rate cuts by the Fed as an upside risk to my main scenario for 2024.

One of the arguments I have made repeatedly is that JPY rate trends passed a turning point about 10 years ago, and we are now right in the middle of an era of JPY weakness. As there were phases of JPY weakness during the larger era of JPY strength subsequent to the introduction of the floating exchange rate system for JPY, there will be phases of JPY strength in this era of JPY weakness. The only factor I can think of that would trigger such phases is a switch to rate cuts by the Fed. Of course, there is also the view that the start of successive rate hikes by the BOJ could also kickstart the resumption of JPY buying amid dramatic narrowing of the U.S.-Japan interest rate differential. However, my view is that the only reason the BOJ might start successive rate hikes is if JPY depreciation became really uncontrollable. In other words, it is difficult to imagine that the BOJ would embark on the difficult task of successive rate hikes except in response to such a critical situation. From the perspective of forex rates, such a situation may arise if USD/JPY were to surpass the 150 level by a wide margin and the possibility of its hitting 160 or 170 level becomes realistic. At any rate, JPY weakened unexpectedly during January 2024, but if the current rate level continues even after the Fed begins to cut rates, JPY weakness will be reevaluated as a chronic disease plaguing Japan, and there will emerge a stronger sense of the need for measures to contain it. I will find other opportunities to discuss possible measures by Japanese authorities in such a scenario.

JPY Supply and Demand – 2024 JPY Supply-Demand Outlook

Fixed-Point Observation of New Era Deficits

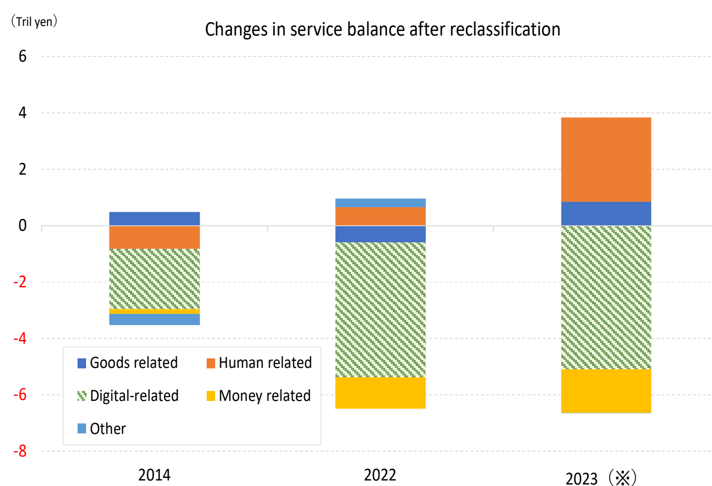
Immediately after the Noto earthquake on January 1, an analyst commented that JPY would briefly appreciate in the Tokyo markets during the New Year holiday period. However, in reality, JPY depreciated. Until recently, JPY had always been bought as a "safe-haven currency" during risk-off phases, whether following an earthquake, a tsunami, or an accident at a nuclear power station, or when missiles were shot into waters surrounding Japan. But my view is that, with the passage of time and the establishment of an economic structure conducive to the outflow of foreign currency, centered around Japan's trade balance, JPY has become an "ordinary currency" that is sold off during times of national crisis.

Since March 2022, I have emphasized in this report that the current phase of JPY weakness may be a structural phenomenon, and the series of developments in the markets appear to have proven my hypothesis to a considerable extent. In that sense, the recent earthquake could be positioned as an "unforeseen JPY-depreciation risk" within my main forecast scenario of a swing back to JPY appreciation as a brief respite from the long-term weak-JPY phase. National crises are generally associated with domestic currency weakness, but this was not the case for JPY until recently.

Further, my persistently repeated arguments since last year regarding Japan's Services deficits, symbolized by its Digital services deficits, appear to have started gaining widespread recognition. The use of the apt phrase "Digital tenant" in a January 15 article in the Nikkei Shimbun to describe Japan's current status was brilliant. Strictly speaking, the Services deficit includes Consulting, R&D, and Insurance and Pension services deficits in addition to Digital services deficits, so the problem is not necessarily limited to Digital services, but Digital services are certainly the largest category contributing to the Services deficits. At the time of writing this report, Japan's Balance of Statements for November 2023 have been released, and we will have to wait for February to see the statistics for the whole year, but I have been receiving a large number of inquiries as to the scale of

Digital and other "New Era" deficits based on the fixed-point observation method, and would like to take a look at this afresh.

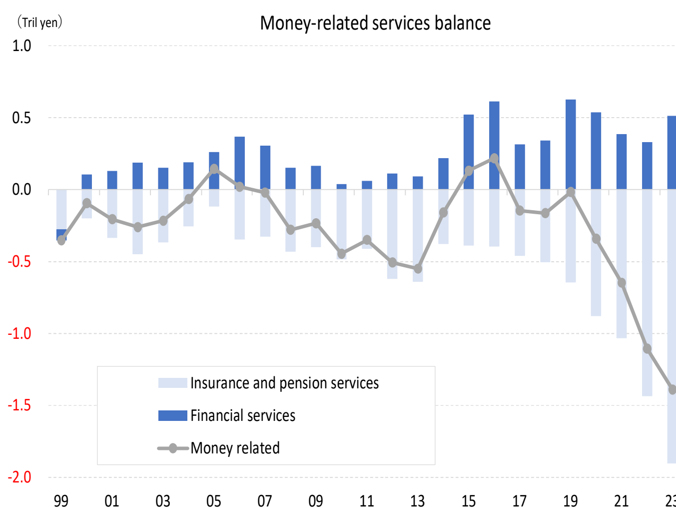
Looking at the January-November 2023 Services balance by each of the five categories (Goods, People, Digital, Money, and Other), a total deficit of -JPY 2.8194 trillion was posted. Of this, the Digital services deficit accounted for -JPY 5.0909 trillion, while the People-related balance (i.e., Travel balance) posted a surplus of +JPY 2.9766 trillion, showing a continued tussle between brain work and manual labor (incidentally, the figures above are the largest ever deficit and largest ever surplus, respectively, posted for the categories in question). So long as the People-related surplus growth continues strong, it may be able to slow down the expansion of the Services deficit. However, given the severe shortage of labor in the accommodation and catering service industries, as revealed by the BOJ Tankan and other data, this structure (of People-related surpluses offsetting the Digital-related deficits) is unlikely to continue long. By contrast, because unit prices for Digital services are unilaterally set by U.S. companies, there seems no end in sight to the trend of expanding Digital deficits. Japan finds itself very much in the position of a tenant at the mercy of the land-owner, and hard-put to increase its own income.



(Source) Compiled by the author based on the BOJ Review "Globalization of Service Transactions from the Perspective of Balance of Payments Statistics"
(Note) 2023=Total for January through November

Money-Related Balance Orchestrating an Ambush

Digital- and People-related balances determine the overall trend of Services balance, but as the figure above shows, the Money-related balance is also contributing to an expansion of the deficit. In numerical terms, the Money-related deficit was -JPY 1.5510 trillion, which is also the largest ever for this category. As I have discussed in past issues of this report, this is due to the rapid expansion of the Insurance/Pension services deficit. This is because domestic financial institutions have sold a large number of investment-worthy insurance products, but finding themselves unable to fully undertake the risk pertaining to these products, are increasingly purchasing reinsurance premiums from overseas insurance companies. As the figure shows, there has been a significant one-sided expansion of this deficit since 2020, making this a category that may become difficult to overlook going forward. Even at the present time, it is possible to see the Money-related deficit as cancelling out roughly half of the People-related surplus earned through inbound tourism, which makes it one of the big categories of the New Era deficit. Despite Digital- and People-related service balances drawing all the attention, the Money-related balance may be orchestrating an ambush.



(Source) BOJ Review "Globalization of Service Transactions from the Perspective of Balance of Payments Statistics" (Note) 2023= Total for January through November

2024 JPY Supply and Demand Outlook

The future is not easy to predict at this time, but with the caveat that this is an extremely rough projection, one possible scenario is roughly -JPY 6 trillion for Digital, +JPY 3.5 trillion for People, -JPY 1.7 trillion for Money, +JPY 900 billion for Goods categories, and a more-or-less neutral performance for the Other category, giving an overall Services deficit worth -JPY 3 trillion or so. The Trade balance is also difficult to predict, but the 10-year average Trade balance for the years 2010 through 2019 (pre-COVID) was -JPY 2.5 trillion a year. If this is taken as a reference, we get a combined Trade and Services balance worth over -JPY 5.5 trillion. The Primary Income balance is expected to continue earning large surpluses to the tune of +JPY 30 trillion, but only 25-30% of these results in actual JPY buying as per my calculations. If true, we could say that roughly +JPY 10 trillion of the Primary Income balance accompanies JPY buying.

Subtracting the Trade and Services deficit from this leaves us with a total of +JPY 4.5 trillion or so. However, there is also a surprisingly large Secondary Income deficit worth about -JPY 4 trillion, resulting in a more-or-less neutral Current Account balance or a small surplus based on cash flows (CF). Given that the CF-based Current Account balances for 2022 and 2023 were deficits, one could say a slight improvement can be expected for 2024. However, if household JPY selling spurred by the New NISA scheme has an estimated impact of JPY 7-9

trillion worth of JPY selling (details below), one could say that there may be no change in the overall status of net JPY selling after all. The real state of affairs including actual figures can be confirmed through weekly releases of the International Transactions in Securities, but it seems quite possible that the JPY weakness trend is continuing unabated due to household JPY selling (which I had so far put in the category of unforeseen JPY depreciation risk factors) weighing down JPY rates. I will discuss household JPY selling in detail in the next section, given that it has become a hot topic for discussion since early this year.

Household Sector Investment Behavior – A Mild Capital Flight

A Mild Capital Flight

I have argued for a long time that household JPY selling was the biggest potential risk to JPY rates and, therefore, to the Japanese economy. Even when Prime Minister Fumio Kishida launched the “Invest in Kishida” program in the City of London in May 2022 and the “Asset-Management Nation” theory gained widespread attention, I expressed my concern that the Household sector cannot be assumed to remain meek forever. As one can see, this point has become the focus of attention since the beginning of the year.

As per some media reports, the launch of New NISA triggered an outflow of over JPY 100 billion in one day into foreign equity funds managed by major Japanese securities companies, and there are increasing speculations that this may be behind the recent JPY weakening. In fact, as U.S. interest rates also strengthened a bit early in the year, it is somewhat unclear whether the recent weakening of JPY was due to the widening of the U.S.-Japan interest-rate differential or household JPY selling. However, adding up the figures, it seems likely to be a development based on the latter. When the short-term sale of the domestic currency by the household sector causes the prices of domestic government bonds or domestic-currency-denominated assets to crash, this is called a “capital flight,” but as of the moment, there are no indications of something quite as dramatic. However, “mild capital flight” could become an appropriate phrase going forward.

Household JPY Selling will Probably Amount to JPY 7-9 Trillion/Year

In the December 23 Nikkei Shimbun ran an article titled “New NISA Installment Bookings at Five Online Securities Companies Indicate Investments to the Tune of JPY 200 Billion/Month.” As per the article, the big five online securities companies, which together manage 60% of all old NISA accounts, reported that advance bookings based on customers’ monthly investment settings indicated investments would add up to at least JPY 200 billion a month. More specifically, the article mentioned an advance booking amount of JPY 230 billion as of December 20. Additionally, the article listed the top three (by amount) investment funds (as of December 20) for which applications had been put in under the New NISA scheme. All three were global equity funds, primarily comprising U.S. equities, with the total purchase booking for the three funds adding up to JPY 149.9 billion a month. According to the article, even the top Japanese equity funds were ranked at around the 20th, strongly indicating that most of the JPY 230 billion advance bookings are aimed at foreign-currency-denominated (especially USD-denominated) assets.

One can get a sufficiently concrete picture of household JPY selling from the figures provided in media reports. Monthly JPY sales to the tune of JPY 230 billion mean an annual sale of roughly JPY 2.8 trillion. If the big five securities companies account for 60% of NISA accounts, the total sale of JPY per year is estimated to be JPY 4.7 trillion (2.8 ÷ 0.6). However, the articles are specifically focusing on the Installment investment quota of New NISA, which has a JPY 1.2 million ceiling. There also exists a Growth investment quota, which has a JPY 2.4 million ceiling, that can be clubbed with Installment investment. No data is available regarding Growth investment bookings, but if we take them to be the same as Installment investment bookings, that would be an additional JPY 4.7 trillion, and even half of that would amount to JPY 2.4 trillion. The figure could also be twice that of Installment investment bookings, i.e., JPY 9.4 trillion, given the 2x ceiling for Growth investment.

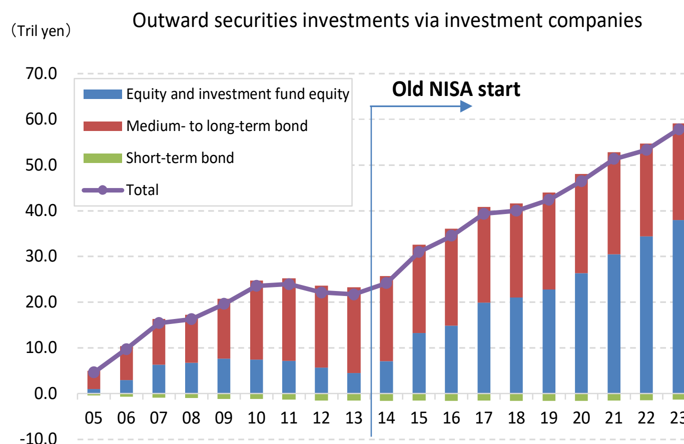
However, things are unlikely to be that simple. Just because the tax-exempt quota under New NISA has doubled, the Household sector’s investment capabilities have not necessarily strengthened. It is a rare household that can afford to invest JPY 3.6 million a year, i.e., JPY 300,000 a month to use up the combined quota of installment investment and growth investment, and perhaps most households will not even be able to use up the full installment investment quota. This is quite clear from the usage status of the old NISA scheme. According to the Financial Service Agency’s “NISA Account Usage Status Survey (as of the end of September 2023),” there were 20,347,312 NISA accounts (both ordinary and installment-saving type) as of the end of September 2023, and their total purchase amounts added up to JPY 34.02814597 trillion. This works out to JPY 1.67 million per account. If this has been the performance of the old NISA scheme, which was launched in 2014 and had an annual tax-exempt quota of JPY 1.2 million, leave alone JPY 3.6 million a year in investments, even half of that seems too much to manage. The JPY 230 billion figure quoted in the Nikkei article mentioned earlier, when divided among the existing 20.34 million or so old NISA accounts, comes to roughly JPY 10,000 per account. If so, one can conjecture that, as per last year, the Household sector is able to make installment investments worth JPY 10,000 a month (as opposed to the JPY 100,000 tax-exempt quota).

Of course, such discussions are only based on conjectures. Let us take one potential scenario of JPY sales resulting from investment in the Growth investment account ranging from the same as or half that of the Installment investment account (i.e., from JPY 2.4-4.7 trillion). Adding this to the JPY sales resulting from investment into the Installment investment amount, which is assumed to be JPY 4.7 trillion, we get roughly JPY 7-9 trillion a year of JPY sales accompanying the launch of the New NISA scheme. It is important to take these figures with a very large grain of salt as they are based on estimates of estimates, but going by the government repeatedly calling on households to

manage their assets, and the resultant popularity of New NISA among the people, perhaps it is not such a daring estimate after all.

Trends So Far and Going Forward

One thing seems certain, namely that the demand for asset management will increase going forward. According to the aforementioned FSA survey, account holders in their 30s (17.5%), 40s (18.9%), and 50s (18.3%) form the core zone of old NISA account holders, with the share declining among the 60s and older age groups. To look at this another way, future generations of seniors who will replace the current generations can be expected to be different both in terms of investment appetite and investment literacy. Further, the original core zone of account holders in their 30s to 50s will gradually be replaced by a new core zone that has grown up not taking JPY strength for granted. The new generations are likely to be more motivated toward asset management not as investment but as self-preservation. At any rate, it does not seem likely that the demand for investments will shrink going forward. If the aforementioned Installment investments increase from JPY 10,000 to JPY 15,000, annual JPY sales would add up to JPY 7.1 trillion, and if they increase to JPY 20,000, annual JPY sales would rise to JPY 9.4 trillion or so (*Not taking the Growth investment quota into account, and based on a simple calculation of JPY 4.7 trillion x 1.5 = JPY 7.1 trillion, assuming an increase from JPY 10,000 to JPY 15,000 per month). Such amounts are not negligible taking into account the current structure of JPY supply and demand, which I will discuss in greater detail in the second part of this report.



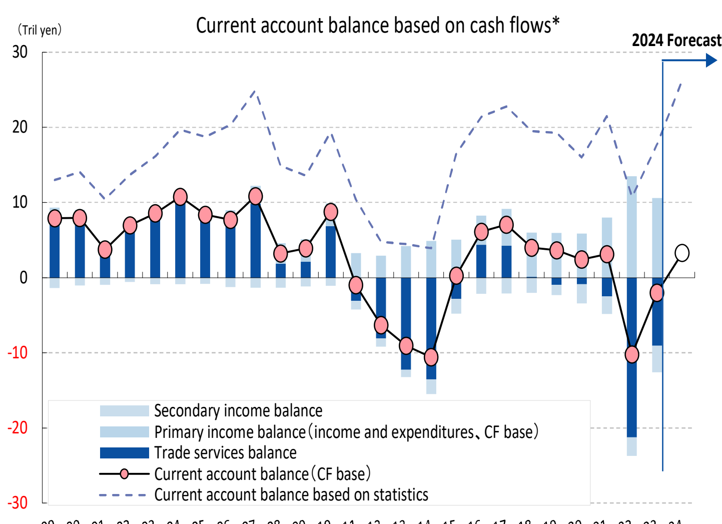
(Source)INDB (Note) Accumulation starting in 2005

If we assume that the level of demand for asset management is going to increase in the future, we need to understand what the current level of demand is. A rough image can be obtained from the Outward Securities Investment trend by investor category. The amount of outward securities investment made via investment companies serves as more specific reference data. As the figure shows, old NISA was launched in January 2014, and outward securities investments via investment companies have posted uninterrupted yoy increases since then. On average outward securities investments have grown by +JPY 3.6 trillion a year in the ten years from 2014 through 2023. If we limit ourselves to the 6 years before COVID (2014 through 2019), the average annual growth is not that different, at +JPY 3.4 trillion. Incidentally, last year, investments grew by +JPY 4.5 trillion for the entire year. This year, with the launch of New NISA, it will be interesting to see how much higher than +JPY 4.5 trillion the annual investment growth adds up to. If we taking the +JPY 4.5 trillion figure as a reference, my previous calculation of JPY 7-9 trillion doubles to 1.5 or 2.0 times. Of course, JPY selling may not reach that level right away. However, if we take into account the new inflow of funds due to the expansion of the tax-exempt quota as well as the excavation of hitherto latent investor categories, my assumptions do not seem all that unrealistic either.

Asset-Management Nation vs. Tourism Nation

What impact will the aforementioned JPY 7-9 trillion worth of JPY selling have on the current JPY supply and demand? I would like to make a comparison using the current level of Current Account balance and household financial assets to make it easy to understand.

Japan's Travel surplus from January through November 2023, for instance, was roughly +JPY 3 trillion. Incidentally, this is an extremely large number, the largest ever Travel surplus posted by Japan for a calendar year. If we were to be so bold as to compare the two things as national policies, we could say that JPY selling accompanying the Asset-Management Nation policy outstrips JPY buying accompanying the Tourism Nation policy. If we go beyond the Travel balance and make a comparison against the Current Account balance as a whole, Japan's Current Account surplus for the January through November 2023 period was around +JPY 17.7 trillion, which is an extremely large surplus. However, this is merely a statistical surplus. As I have repeatedly explained in previous issues of this report, only 25-30% of the Primary Income surplus, which forms the bulk of the Current Account surplus, leads to JPY buying as per my calculations. Interests earned on U.S. Treasury securities, dividends earned from U.S. shares, profits retained at overseas subsidiaries, and other categories of income get reinvested as is, without ever being converted to JPY, but are still posted as surpluses in



(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

statistical data. My calculation of CF-based Current Account balance, which takes the above into account, comes out to a deficit of -JPY 2 trillion. I will refrain from discussing the relationship between the CF-based Current Account balance and JPY rates here, as I have discussed it many times before. Even if the CF-based Current Account balance for 2024 improves to post a small surplus as Japan's Travel surplus expands and its Trade and Services deficits shrink, that small surplus is likely to be wiped out by the JPY 7-9 trillion worth of household JPY selling, resulting in a possible continuation of a net JPY selling structure. This is precisely what I have been worried about all along.

What Does JPY 7-9 Trillion Mean for the Structure of Household Financial Assets?

Even from the perspective of household financial assets, the JPY 7-9 trillion or so amount is not small. According to the BOJ's Flow of Funds Accounts, household foreign-currency-denominated assets added up to about JPY 74 trillion as of the end of September 2023, comprising roughly +3.5% of all household financial assets (roughly JPY 2121 trillion). This is a historically large level, but not yet worthy of special mention. Assuming that roughly JPY 7-9 trillion, or JPY 8 trillion on average, of JPY-denominated assets are shifted to foreign-currency denominated assets, the household sector's foreign-currency-denominated assets will be JPY 82 trillion at the end of 2024, adding +0.4pp to the ratio of foreign-currency-denominated assets within total financial assets, to give roughly +3.9%. If we assume an annual increase in the ratio of foreign-currency-denominated assets by +0.4pp, the ratio will significantly surpass 4% a year later, renewing the all-time high. Of course, it is not that simple a calculation in reality, because the numerator (i.e., total household financial assets) will also expand. As explained earlier, there has already been a trend of JPY 3-4 trillion a year worth of outward securities investments via investment companies, and this has not resulted in the ratio of foreign-currency-denominated assets increasing significantly. There is no one reason for this, but a frequently pointed-out potential factor, for instance, is the increase in the aged population resulting in a higher ratio of those who prefer to keep their money in cash and deposits. Indeed, the level of cash and deposits has been renewing all-time highs every term.

However, it is likely that the upcoming senior generation, i.e., those who are now in their 40s and 50s, will have a greater appetite for investment. It is quite possible that the allocation of financial resources to foreign-currency assets and domestic equities will increase to the extent that deposits decrease. At any rate, if there is indeed JPY 7-9 trillion worth of outward securities investment via investment companies, this would be an unprecedented scale of such investments, and it would not be surprising to see the ratio of foreign-currency-denominated assets grow strongly.

So Long as Capital Flight is Mild, JPY Could Still Appreciate

As explained above, household JPY selling has become a big theme in the markets. But there is a tendency in the forex markets for themes that seem likely to dominate the financial markets that year to receive excessive attention in January. New NISA was launched starting January 1, and several factors – the fact that a large number of installment payments through automated credit-card draw-downs tend to come in all at once during the beginning of each month, and the chatter in the markets – may have resulted in the weak-JPY risk from household JPY selling, which was previously viewed as a weak-JPY risk factor only by some market participants, becoming exaggerated.

As mentioned above, the latent power of household JPY selling is certainly to be feared. However, it is a long-term risk factor. For instance, the foreign-currency-denominated investment fund purchase amount reported by the Nikkei report, namely JPY 230 billion a month, is not big enough to determine the trends even in the forex market, leave alone in the stock market. As I discussed in last month's edition of this report, my image is that foreign currency assets could increase gradually over the longer term, like snow cover in the mountains. I wrote about my impression that, during this process, the JPY weakness trend may prove to be exceptionally tenacious, with phases of JPY strength becoming hard to come by, and before one realizes it, there may come a time when the main battling range for USD/JPY has shifted from 100-120 to 125-145 .

My assumption has not been that household JPY selling by itself would cause JPY to depreciate by 4-5 yen against USD within the space of a month and subsequently lead to a currency crisis or other major development. As explained in the earlier half of this report, it may simply cause a mild capital flight. Again, given the mild pace of capital flight, one should also anticipate some level of JPY appreciation if the Fed begins rate cuts, and this is a part of my main forecast scenario.

The Risk of Mild Becoming Strong

Of course, there is no guarantee that the capital flight will remain mild forever. For example, even assuming that the Household sector is currently making investments worth JPY 10,000 or so toward the Installment savings account (which has a ceiling of JPY 100,000 a month), whether such behavior will change going forward is up to the households themselves. As mentioned above, the JPY 230 billion/month figure works out to about JPY 10,000 per month per account. If the amount per account per month were to increase to JPY 15,000 or JPY 20,000, the monthly total for all accounts would increase to JPY 345 billion or JPY 460 billion. While still a discussion based on vague conjectures, one feels that the shift from "mild" to "strong" capital flight is a far yet near phenomenon. Depending on the volume involved, there may come a time when JPY fails to appreciate or even continues to depreciate despite the Fed implementing rate cuts, U.S. interest rates declining, or the U.S.-Japan interest-rate gap shrinking.

Japan is a country where people are spurred into action by those around them doing the same thing. Going forward, a considerable number of investors may enter the fray in tune with the popular mood. As prices, especially of imported products, continue to rise, there may arise a class of investors who manage their assets more in self-preservation than for investment purposes, and their decision would be quite rational. As investments made via the New NISA scheme are essentially likely to be "pickled in salt," i.e., unlikely to be reconverted into JPY in the near term, they may contribute to restricting the direction of JPY rate trends over the medium- to long-term, in the same way that foreign direct investments by Japanese companies made it difficult for JPY to appreciate. In that sense, JPY rates are truly in

a transition period, and this is the reason I have been describing the ongoing phase of JPY weakness since March 2022 as a structural one.
I have been saying that 2024 will be the year that confirms that the transaction range for USD/JPY has clearly shifted, i.e., a year that confirms the USD/JPY paradigm shift. My rationale for doing so is based on the possibility of USD/JPY remaining in the 130 range even after the FF rates have been lowered. However, if the household JPY selling transitions from mild to strong, there is a possibility that USD/JPY will remain in the 150 range even after the FF rates have been lowered. Such a possibility is still outside the scope of my assumptions for my main forecast scenario for 2024. However, given my understanding of and emphasis on the fact that the change in JPY's supply-demand structure will encourage significant JPY depreciation, it could even be said that we seem to be fast-forwarding into the future.

BOJ Monetary Policies Now and Going Forward – JPY Depreciation Risks Factored In but Still Redoubtable

Increasing Likelihood of Negative Interest Rate Discontinuation at April Meeting
The BOJ's January monetary policy meeting attracted considerable attention but decided to maintain the status quo. Most financial market participants had been expecting status quo maintenance at the January meeting – in light of BOJ Governor Kazuo Ueda's press conference following the December meeting and the Noto Peninsula earthquake on January 1 – so the meeting had an extremely limited impact on various asset prices. The tone of the post-meeting press conference (discussed below) was interpreted as being hawkish, causing a transient bout of JPY appreciation, but JPY exchange rates quickly returned to their previous levels. Figures in the January edition of the BOJ's Outlook Report (issued in January, April, July, and October; see chart) were revised downward to reflect consumer price index (CPI) trends. The core CPI (all items excluding fresh food) trend has been attracting much attention, and the January Outlook Report's median core CPI forecast for FY2024 was +2.4%, down from +2.8% in last October's Outlook Report. Although core CPI has been growing at rates above 2% for two consecutive years, the BOJ decided to maintain the status quo because of its view that a virtuous cycle of wage and price increases has not yet been realized. Although the January Outlook Report revised the core CPI forecast for fiscal 2025 upward slightly to +1.8% (from +1.7% last October), the BOJ does have a logical basis for arguing that its inflation rate target has not been achieved because the rate is expected to fall below +2% during the forecast period.

Major outlook by BOJ policy board members （YoY %）

	Real GDP	Core CPI （ex fresh food）
FY 2023	1.6～1.9 <1.8>	2.8～2.9 <2.8>
Outlook as of OCT	1.8～2.0 <2.0>	2.7～3.0 <2.8>
FY 2024	1.0～1.2 <1.2>	2.2～2.5 <2.4>
Outlook as of OCT	0.9～1.4 <1.0>	2.7～3.1 <2.8>
FY 2025	1.0～1.2 <1.0>	1.6～1.9 <1.8>
Outlook as of OCT	0.8～1.2 <1.0>	1.6～2.0 <1.7>

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

However, if the CPI growth rate exceeds +2% for two consecutive years and declines to +1.8% in the third year, it would not be surprising if the BOJ were to assert that its target had been achieved. This point is clearly reflected in the somewhat bullish statement in the Outlook Report – "The likelihood of realizing this outlook has continued to gradually rise, although there remain high uncertainties over future developments." Governor Ueda repeated this sentence at his press conference, spurring JPY buying. Given that financial markets have already factored in a discontinuation of negative interest rates in April, it seems safe to assume that the mostly likely negative interest rate discontinuation timing is April, when the next edition of the outlook report is released. Expectations of the timing being in April rather than March seem even more rational when one considers that the April timing will enable financial markets to digest the results of the spring wage negotiation offensive at large companies (negotiations at most large companies are expected to be concluded by mid-March) as well as subsequent results regarding small and medium-sized enterprises and that the April timing will preclude impacting financial institutions' results for their current fiscal years (generally ending March 31). This article has argued that timings in June or July, following the completion of the BOJ's broad-perspective monetary policy review, would be most appropriate, but if the BOJ were to wait another six months, the CPI growth rate may have clearly descended below the +2% level at that time. If the BOJ would prefer a timing that enables it to declare that a sustained rise in the inflation rate has been achieved despite the steady deceleration of CPI growth rates, then the sooner the better. Generally speaking, expectations that negative interest rates will be lifted during the April-June period are not likely to turn out to be far off the mark.

March Timing Not Precluded
Moreover, the view that even April is too late is gradually gaining momentum. When asked at the press conference what bases he would use to make decisions during the period through the March monetary policy meeting, Governor Ueda said, "There will be some data coming out on wages, the economy, and inflation. There will be another two months, so we will be able to obtain various survey information." This statement suggests that one cannot rule out the possibility of negative interest rate discontinuation in March. As for the evaluation of wage trends, the March meeting will be held after the results of the spring wage negotiation offensive at large companies are clear, and it appears possible that the BOJ will consider itself able to render a snap judgement about the overall wage trend even if it has

not yet obtained data on spring wage negotiation results with respect to small and medium-sized enterprises. Looking back at the BOJ's history, it seems that the BOJ has found it difficult to disseminate information about major policy revisions without referring to the latest Outlook Report data, so there has been a tendency for important monetary policy meetings to be those held in January, April, July, and October, and the financial markets have generally anticipated that this pattern will continue. However, Governor Ueda has already stated that – "The likelihood of realizing this outlook has continued to gradually rise" – so the BOJ may not feel a need to await the next Outlook Report so long as it can conclude that the likelihood "is further increasing" or "has further increased". It is worth noting that, in March 2006, the BOJ made its decision to discontinue quantitative easing without waiting for the April 2006 outlook report.

Additionally, there are a growing number of people arguing that a March timing is preferable from a political perspective. It has long been noted that it will be difficult to implement drastic policy normalization measures while being considerate of the Liberal Democratic Party's Abe faction, the progenitor of the extraordinary easing policy. As the Abe faction (and other factions) becomes forced to disband owing to political funding issues, however, the concept that political considerations are an obstacle to normalization is fading away. Given that there will be a series of by-elections for parliamentary seats immediately after the April meeting, some believe that conditions at that time will not be ideal for making decisions about interest rate hikes that are likely to affect public opinion. However, there is no doubt that the BOJ's monetary easing policy has contributed to JPY depreciation, which has negatively impacted voters' lives, so there may be a political incentive to discontinue the policy relatively quickly.

Ultimately, the key factor affecting the negative interest rate discontinuation timing is that the discontinuation should be implemented while the domestic and overseas environments allow it. Domestic factors promoting relatively quick normalization include the need to take action before CPI growth rates decelerate, before the political situation becomes chaotic, and before JPY weakness becomes an urgent social problem. The main overseas factor promoting relatively quick normalization is the desire to act before the United States and Europe begin lowering their interest rates. While it would not be impossible for the BOJ to discontinue negative interest rates when the CPI growth rate is below 1.5% and the Fed and ECB are on a path to lower interest rates, it would take considerable courage to do that. If the BOJ seeks to demonstrate its political neutrality, it has the option of doing so by implementing the March discontinuation scenario, which avoids overlapping the timing of national elections. Even if the negative interest rate discontinuation is not implemented in March, the BOJ's information dissemination approach at its March policy meeting will be extremely important, since the financial markets are largely anticipating an April discontinuation.

What is "Discontinuity"?

Governor Ueda stated at the press conference that – "Given the current economic, inflation, and financial outlook, it is possible to avoid policy management that would result in major discontinuities [...] Even if negative interest rates are discontinued, extremely accommodative financial conditions will continue for the time being." This may be interpreted as suggesting that, even if negative interest rates are lifted by means of a 10bp interest rate hike, one should not anticipate that continuous interest rate hikes will begin thereafter. There remains a strong tendency, particularly in overseas markets, to view negative interest rate discontinuation as the starting point of a period of rate hikes, and Governor Ueda's statement appears to be a conscious effort to restrain that tendency.

Governor Ueda also used the word "discontinuity" in his answer to a question about whether the BOJ would maintain yield curve control (YCC) even after negative interest rates are discontinued, saying – "Regarding purchases of long-term government bonds, we would like to conduct monetary policy in such a way that there is as little discontinuity as possible before and after the exit." Although he did not directly confirm whether YCC would be continued or discontinued, he clearly hinted that the discontinuation of negative interest rates does not mean that the BOJ will suddenly stop intervening in the government bond market. This point has been discussed in previous editions of this article, and the conclusion is that regardless of whether the formal YCC system is sustained or not, so long as Japan's government debt exceeds its nominal GDP, the BOJ will continue intervening (both openly and non-openly) in the Japanese government bond market for some time to come. Regardless of what happens to YCC, the gist of the governor's statement seems to be that the BOJ will continue seeking to control the yield curve in some way(s) even after negative interest rates are discontinued.

Postponing Negative Interest Rate Discontinuation in Light of JPY Depreciation Risks

Finally, I would like to point out potential risks we should be wary of, particularly the risk that terminating the negative interest rate policy might turn out to be impossible. While various people are making rational arguments for their predictions that the policy discontinuation will be in March or April, one should be aware that all these arguments are based on the premise that the wage increases at large companies resulting from the spring wage negotiation offensive and the accompanying wage increases at small and medium-sized enterprises will be large enough for the BOJ to justify terminating the negative interest rate policy. Governor Ueda has repeatedly stated that policy normalization requires that inflation promoted by the "first force" (the pass-through of import price rises since 2021 to selling prices) be supplemented by the "second force" (a virtuous cycle between wages and prices), and sufficiently large wage increases are a prerequisite for confirming that the "second force" has attained sufficient power. Essentially, Governor Ueda wants to confirm that sustained wage increases will lead to sustained increases in service prices, and the key question is whether he will be able to make such a confirmation during the next three months. It is not possible to predict trends in corporate wage setting with certainty, and it is even more difficult to predict overseas economic, financial, and political situations that might influence such wage setting.

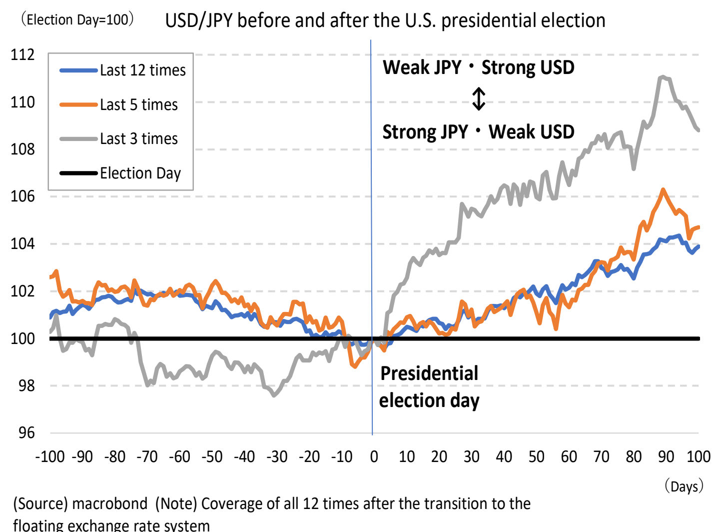
Given that, some people are of the opinion that the BOJ has passed up good opportunities to normalize its policies last December and this January. Although the likelihood is not high, a scenario in which the BOJ finds it inopportune to move ahead with policy normalization in the near future cannot be ruled out at this point. For example, the bankruptcy

of Silicon Valley Bank in the United States last March caused a sudden rise in expectations of significant interest rate cuts. If such a situation were to arise in the near future, it might become extremely difficult for the BOJ to move ahead with policy normalization. <u>However, the most frightening aspect of the current situation is that USD/JPY has remained stable at levels above JPY145 despite the general anticipation that the BOJ will soon discontinue its negative interest rate policy</u>. When one considers that JPY is continuing to be so weak even after the financial markets factor in the prospective policy termination, it should be clear that a postponement of the policy discontinuation would engender a large risk of additional JPY depreciation.

U.S. Presidential Election and USD – Election to Promote JPY Weakness and USD Strength?

Lessons from Past Experience

Currently, this article's main scenario for mid-2024 is an orthodox one anticipating that as the Fed lowers its policy interest rates U.S. interest rates will decline, promoting JPY appreciation and USD depreciation. But it is worth considering what kinds of factors could possibly reverse this moderate JPY appreciation scenario and cause JPY to start depreciating again. Such factors might include, ① the Fed returning to interest rate hikes, ② a surge of USD buying following the U.S. presidential election, and ③ additional easing by the BOJ. Given Fed Chairman Jerome Powell's clear hints about the possibility of interest rate cuts at the FOMC meeting last December, it seems that, because factor ① would require Chairman Powell to renege on his hints and undercut his creditability, factor ①does not seem to be a realistic possibility. In light of the fact that the BOJ's negative interest rate discontinuation timing has become such a hot topic, factor ③ is probably even more unlikely than factor ①. Based on expectations regarding Japanese and U.S. monetary policies, the main scenario seems justified in assuming a prospective narrowing of Japan-U.S. interest rate differentials.



(Source) macrobond (Note) Coverage of all 12 times after the transition to the floating exchange rate system

In view of historically observed forex market anomalies associated with U.S. presidential elections, however, factor ② seems like a more-realistic possibility than factors ① and ③, and factor ②does appear to be capable of becoming a factor promoting JPY depreciation. Looking at forex market trends during the 100 days before and after past U.S. presidential elections, one finds there is a tendency for USD to be weaker and JPY to be stronger before elections and for USD to be stronger and JPY to be weaker after elections. This is not limited to recent elections – the same general pattern can be seen from data regarding the 12 U.S. presidential elections since 1976, the 5 since 2004, and the 3 since 2012 (see graph). Given the change expected in the Fed's policies during the first half of 2024, the possibility of a similar pattern recurring is even more alarming.

Background of the Forex Market Anomalies

Why do such exchange rate trends occur in connection with U.S. presidential elections? It is difficult to provide a definitive rational explanation for the repeated pattern of trends (anomalies are by definition peculiar phenomena difficult to harmonize with the usual patterns), and we do not even know if such an explanation exists. However, one reasonable hypothesis is that the considerable political uncertainty generated prior to U.S. presidential elections promotes the fleeing of funds from the United States. Looking at past U.S. presidential elections, one can see that the forex market reaction (the tendency for a slight weakening of USD and strengthening of JPY prior to elections and a slight strengthening of USD and weakening of JPY following elections) is the same regardless of which political party won the election in question. This seems to strengthen the hypothesis that USD selling is simply associated with political uncertainty. In the current case, with the potential for Donald Trump's re-election, there seems to be even more speculation that people may shift funds from the United States in view of the great magnitude of the political uncertainty. If candidate Trump is re-elected president, it is safe to assume that he will promote such economic policies as protectionist trade policies and expansionary fiscal policies designed to promote growth of the domestic economy. The former policies will encourage capital inflows into the United States, while the latter policies will promote a tightening of the supply-demand gap. From the perspective of standard economic and financial analysis, this economic policy management posture appears likely to induce inflation, and that prospect might fundamentally disrupt the current consensus in favor of selling USD in response to lower U.S. interest rates. Of course, at the time this article this article was written, there remained doubts about whether the resolution of various court cases will enable Mr. Trump maintain his candidacy, so it would be premature at this point to create a full-fledged forecast scenario based on how U.S. economic policies may be managed by a prospective Trump administration. However, I still think we should keep an eye on the potential for such a scenario.

Protectionism to Continue No Matter Who Wins

Regardless of whether it is the Democratic Party or the Republican Party that wins the upcoming U.S. presidential election, however, the country's protectionist policies will remain unchanged. In fact, those policies remained unchanged even after the Trump administration was replaced by the Biden administration. The Inflation Reduction Act and the CHIPS and Science Act promoted by the Biden administration have highly protectionist characteristics. If one assumes that U.S. protectionism will continue regardless of who the next U.S. president is, it may seem logical to anticipate that the presidential election's impact on the forex market will be small, but a future Trump administration is liable to take a more-swashbuckling approach that would provoke greater media coverage. From the perspective of the forex market, it is easy to imagine protectionist policies causing flows of capital returning to the United States, and that in itself would tend to promote USD appreciation.

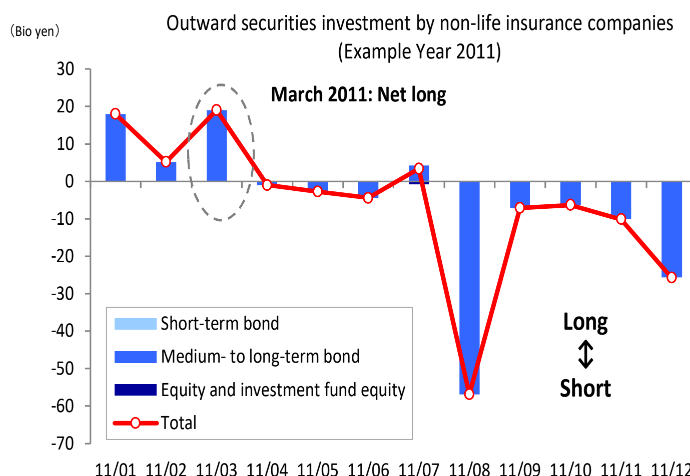
(Source) macrobond

On the other hand, a second Trump administration might possibly disseminate information promoting USD depreciation, as seen during President Trump's first administration from 2016 to 2020, and many people consider this to be cause for concern. However, USD was not actually depreciating during the period from November 2016 to October 2020 following President Trump's election to the presidency – the USD nominal effective exchange rate during that period actually rose approximately 1.8% (see graph). Since Trump faced a trend of interest rate hikes during most of his term, one could argue that he was not then positioned to weaken USD despite his strenuous efforts to do so, but a second Trump administration would be likely to operate during a period of interest rate declines, so there would certainly be a possibility that his verbal intervention might prove more successful. Yet it should also be noted that President Trump during his term in office sometimes spoke of his preference for a strong USD, so it appears that he may not actually have a fixed opinion on the desirability of USD weakness or strength. There is no point in over-analyzing the difficult-to-predict prospective policies of the next U.S. president at this time, but it certainly bears keeping in mind that there has long been a clear tendency for USD to weaken and JPY to appreciate before U.S. presidential elections and for USD to appreciate and JPY to weaken after the elections. Based on currently available information, I think it is safe to make a return to JPY depreciation from the fourth quarter of this year the main forecast scenario.

Risks to My Main Scenario – Beauty Contest Vote in Favor of "Household JPY Selling"

"Household JPY Sellers" as Beauty Contest Participants

At a press conference on January 19, Japanese Finance Minister Shunichi Suzuki responded to the argument that household JPY selling associated with the new Nippon Individual Savings Account (NISA) system is promoting JPY depreciation, saying – "It is difficult to attribute fluctuations solely to the new NISA system." Regarding household investment behavior, he said – "We are aware that from the perspective of diversification, investment is increasing not only in domestic assets but also in overseas assets [...][and forex market trends] are determined by a variety of factors, including domestic and overseas economic and financial conditions, the balance of payments, trends in monetary policy, and investor expectations and sentiment."



(Source) Ministry of Finance, Japan & INDB

These statements by Finance Minister Suzuki are correct. Based on information available at the time this article was written, I estimate that the scale of "household JPY selling" associated with the new NISA system is around JPY7-9 trillion, and this cannot be said to be a sufficiently large amount to generate a forex market trend. However, it is generally understood that the forex market is liable to attach importance to factors simply because "everyone thinks that factor is significant". The economist John Maynard Keynes famously compared the stock market to a beauty contest, and the same can be said of the forex market. In fact, in the forex market, which in some respects has a more straightforwardly impulsive nature than the stock market, the question of "whether everyone thinks so or not" is an important issue. The trend of JPY appreciation following the Great East Japan Earthquake is a classic

example of this. After the earthquake struck on March 11, 2011, there was widespread speculation that Japanese non-life insurance companies would sell foreign currency-denominated assets and convert the proceeds into JPY to prepare for the disbursal of insurance claim payments. As Japan is the country with the world's largest net external net worth, it seemed logical to anticipate that, facing an emergency, Japanese companies would sell foreign currency-denominated assets to improve their liquidity. This “risk-off JPY buying” phenomenon was cited as an explanation for JPY appreciation. The “non-life insurance company fund repatriation” theory was accepted in the forex market without much resistance, causing USD/JPY to descend sharply to the JPY76-77 level, and that excessive trend was only brought to a halt by means of a coordinated JPY selling/USD buying forex intervention program, the first time such program had been implemented in about a decade and a half. However, foreign securities investment by investor category data later released by the Ministry of Finance showed that, in March 2011, non-life insurance companies were net buyers of foreign securities – they were increasing their foreign currency-denominated assets (see graph on previous page). This is a good example of how reality can be displaced by whatever it may be that many forex market participants happen to believe.

Household JPY Selling Theory Overblown?

However, comparing the 2011 situation with the current “household JPY selling” situation is problematic. If the theory that the new NISA has triggered household JPY selling is not true and merely reflects a forex market beauty contest vote, then the JPY depreciation trend associated with that theory should be transient, since even when the impulsively simplistic forex market is involved, things that are not true will not last forever. Unlike the “non-life insurance company fund repatriation” phenomenon, however, household JPY selling actually does exist. Moreover, since there is a national policy designed to promote household JPY selling, it is likely that scale of household JPY selling will continue to increase going forward. If the Japanese government is emphasizing the need for more diverse household asset management method and it is widely believed that JPY is depreciating due to “household JPY selling”, how will ordinary Japanese people just beginning to think about how to invest their assets react? Many of them will naturally conclude that they should consider purchasing foreign currency-denominated assets to hedge risks associated with JPY depreciation. As mentioned above, I estimate that JPY sales related to the new NISA system currently amount to about JPY7-9 trillion, which is not a large amount for the forex market as a whole, but that amount is enough to cancel out Japan’s current account surplus on a cash-flow basis. In this way, the household JPY selling theory has a much better factual basis than the “non-life insurance company fund repatriation” theory of 2011. Even if household JPY selling is considered to be generating a fairly small volume of JPY selling at this point, there is a clear possibility that the volume will eventually grow large based on a self-fulfilling prophesy.

Hoping the Fed Will Bring JPY Depreciation to a Halt

Fortunately, the Fed had not yet begun cutting interest rates at the time this article was written, but if and when the federal funds rate actually begins to be lowered, there is a possibility that it will offset some of the current downward pressure on JPY. It can be said that there is no choice but to bet on such an offsetting, and it is hard to imagine that the JPY depreciation trend will remain unchanged even if the federal funds rate is lowered. Therefore, at the time this article was written, I was anticipating some movement toward JPY appreciation. However, in light of concerns that household JPY sales will gradually increase in volume, that market moving factors promoting JPY appreciation will be exhausted after the discontinuation of negative interest rates, and that the historical anomalistic pattern associated with the U.S. presidential election (which tends to facilitate USD appreciation before and after elections) will have an effect, I believe that USD/JPY will recover during the October-December period.

It would be problematic if the JPY depreciation trend cannot be reversed during the April-June and July-September periods even if the federal funds rate is lowered. There is a possibility that measures that directly affect forex flows – such as forex interventions and fund repatriation tax cuts for the corporate sector – may be considered. Although I cannot yet at this point factor such measures into the main forecast scenario, it is probably worth keeping the possibility of such measures in mind as a risk scenario. Even so, unless the Fed lowers interest rates, Japan may face “undesired currency depreciation” trends as if it were still a developing country, and this makes me keenly feel how dramatically different today’s world is from that of roughly a decade ago, when fiscal and monetary policies were desperately mobilized to roll back excessive JPY appreciation.

EUR Outlook – Policy Revisions Postponed to “Summer”

Euro Area Economic and Monetary Policies – Significant References to “Summer”

Significant References to “Summer”

The January 25 ECB Governing Council meeting decided to leave the deposit facility interest rate unchanged at 4.00%, the second consecutive Governing Council meeting to maintain the interest rate status quo. The ECB has been disseminating almost no information about prospective interest rate cuts, and when the first reporter called on at the post-Governing Council-meeting press conference asked about this, ECB President Lagarde dismissed it, saying – “the consensus around the table of the Governing Council was that it was premature to discuss rate cuts.” For some time now, there has been a feeling that the ECB is viewing “mid-2024” as a turning point. As decided at the December Governing Council meeting, the full redemption amounts of assets purchased under the Pandemic Emergency Purchase Programme (PEPP) will be reinvested until the end of June. On January 18, at the World Economic Forum in Davos, President Lagarde was asked about the possibility of a summer interest rate cut and she answered that it was “likely”. At the post-Governing Council-meeting press conference, President Lagarde was asked about that statement and said – “I typically stand by my comments” – thereby confirming that no major policy revisions are expected before the summer. Since the beginning of this year, even German Bundesbank President Joachim Nagel, one of the most hawkish ECB Governing Council members, has said that the “summer break” would be an appropriate time to consider policy revisions. If the “summer break” is assumed to be the period for considering revisions, the September Governing Council meeting may be an important one with respect to the implementation of revisions.

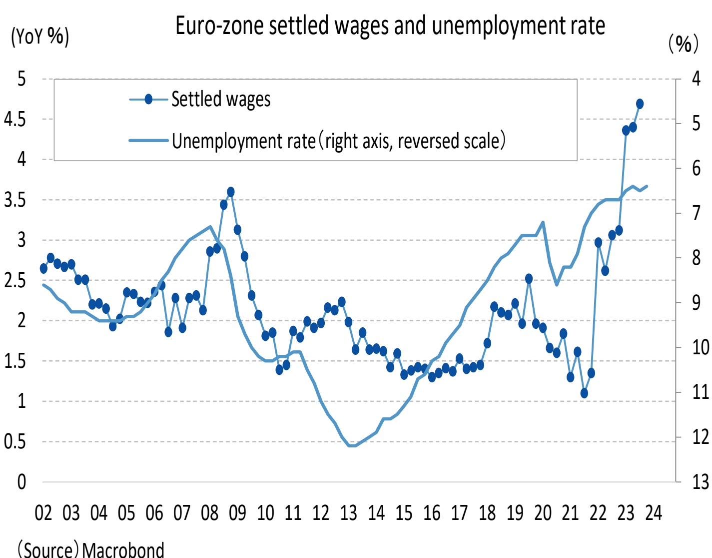
On the other hand, it is also possible that the ECB is intentionally hinting about the summer to prevent speculation about interest rate cuts at the March or April meetings. Some reporters at the press conference asked whether might be a rate cut in April, but President Lagarde replied – “I think it is totally premature to anticipate what exactly will be the growth projections at our next meeting in March. We will come to that projection when we produce our projections in March.” It now appears obvious that nothing will happen at the March Governing Council meeting, and while I am not ruling out the possibility of something happening at the April Governing Council meeting, as explained below, because the ECB will probably need to wait until the end of April to confirm relevant data, it seems reasonable to anticipate that there will be no major ECB policy changing in the March-April period.

No Comment about the Possibility the Rate Cut Might be Late

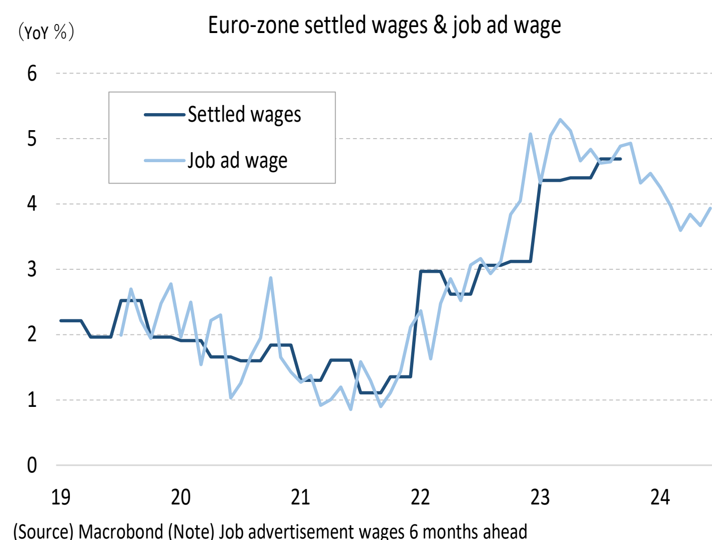
At the post-Governing Council-meeting press conference, reporters posed questions about what kind of wage indicators the ECB was focusing on, and another reporter asked – “You’re data-dependent to this data on wages that won’t be published before late spring. Don’t you think this could lead to cut too late, if not before June?” In response, President Lagarde said – “we look at a whole range of data. We’re not only focused on wages. We are clearly interested in wages because it’s a significant component of services, and services is that section in the breaking down of inflation which is still quite resistant and stayed at 4% from December to November. It’s the only item that has actually stayed at the same level.” I feel that this response did not really answer the question – “Don’t you think this could lead to [a] cut [that is] too late?” It seems that President Lagarde responded to the criticism that focusing on wages may lead to backward-looking policy management by simply arguing that the ECB is looking at a lot of things – not focusing exclusively on wages. Regarding the ECB’s evaluation of wage trends, President Lagarde said – “On wage growth, I think whether you look at past wage numbers, whether you dissect that in compensation per employee, in negotiated wages, taking on or excluding the one-off payments, we are seeing a slight decline. So it’s directionally good from our perspective.” – and this appears to be an argument that, if all goes well, the ECB will be able to confirm a significant deceleration of wage growth and inflation without making any major miscalculations.

Nothing can be Decided until the End of April

There were also many questions at the press conference about what specific employment and wage data the ECB was focusing on, and President Lagarde reiterated each time that the ECB was not focusing on or strongly emphasizing specific indicators. That said, it will inevitably be the statistics generated by Eurostat and the ECB that attract the most attention. One reporter directly asked about the significance of the timing of data availability, saying – "I understand that probably the ECB wants to see wage settlements data that have to do with the first quarter, which probably you will receive from Eurostat at the end of April. Am I wrong on this?" – to which President Lagarde replied – "I would not draw any conclusion from a date of publication." Given that she was simply being asked to confirm the timing of the release of the statistics, President Lagarde's response seemed to be a little too strong; in fact, her strong response gave the impression of highlighting the importance of the wage settlements data, which are scheduled to be released at the end of May. Looking at the latest data, one finds that as of November, the euro area unemployment rate had declined to 6.4%, the first such decline in five months, and the number of unemployed people had decreased for the first time in three months. Furthermore, the latest wage settlements growth data (for the July-September period of 2023) indicates that the wage settlements growth rate remains high (see graph, above right). In light of the deceleration of inflation and the slowdown in wages based on job advertisements, however, growth in wage settlements appears likely to slow down (see graph, below right). If these trends are confirmed in the data for the January-March period and all goes well, we will likely see an ECB interest rate cut following the June release of the latest Eurosystem staff forecast – in July at the earliest, or perhaps in September.



(Source) Macrobond



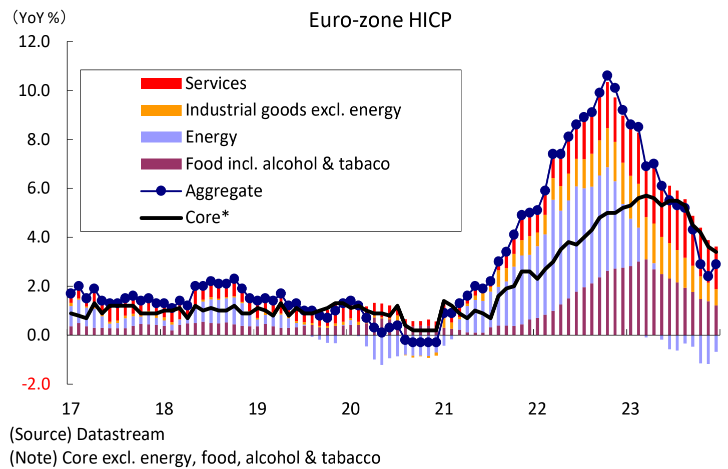
(Source) Macrobond (Note) Job advertisement wages 6 months ahead

On the other hand, given the continued tightness of the euro area job market, there is a possibility that wage settlements growth might again accelerate, and even if wage settlements growth continues to decelerate, it would not be impossible for the ECB to argue that it must continue to be cautious about lowering interest rates in view of the low level of unemployment. Thus, although the basic scenario is for the ECB to lower its policy interest rates by September, the reality is that it will not become possible to be confident about anticipating that scenario until the end of April, following the release of the latest staff forecast in March. The more I ponder this situation, the more I get the feeling that the March Governing Council meeting will be uneventful, and since it will not be possible to confirm the wage settlements data trend at the time of the April Governing Council meeting, I think it highly likely that the April meeting will be similarly uneventful.

Euro Area Economy Now and Going Forward – Has the Rise in Inflation Rates Really Ended?

Renewed Rise in Euro Area Inflation Rates

On January 25, ECB Vice-President Luis de Guindos gave a speech in Madrid in which he announced – "Economic activity in the euro area slowed slightly in the third quarter of 2023. Soft indicators point to an economic contraction in December too, confirming the possibility of a technical recession in the second half of 2023 and weak prospects for the near term." Regarding the hot topic of inflation, he said – "The rapid pace of disinflation that we observed in 2023 is likely to slow down in 2024, and to pause temporarily at the beginning of the year [...] Positive energy base effects will kick in and energy-related compensatory measures are set to expire, leading to a transitory pick-up in inflation[.]" Vice-President de Guindos's statement was supported by the euro area consumer price index (HICP) growth rate for December, which was 2.9% yoy (all inflation rates are yoy unless otherwise specified), up 0.5 percentage point from the November growth rate of 2.4%. This is the first time in eight months (since April 2023) that a month to month increase in the HICP growth rate has been seen. While declining energy prices have been playing a leading role in helping decelerate inflation, the rate of decline in energy prices dropped from 11.5% November to 6.7% in December,



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

confirming that a positive base effect related to energy is indeed starting to take effect. However, the rate of decline in prices of industrial goods other than energy continued to slow, declining from 2.9% in November to 2.5% in December, and the rate of growth in services prices, which many people are concerned about, remained flat at 4.0% during the November-December period. This is the first time in five months (since July 2023) that the uptrend in services price inflation has halted, and attention will be focused on whether the euro area employment and wage situation will continue to settle down. Decreasing rates of decline in core-basis HICP growth rates (excluding energy, food, alcoholic beverages, and tobacco) are causing rises in headline inflation rates, but it appears that this is not a matter of great concern for the ECB, which focuses on the underlying inflation rate. Most senior ECB officials, including Vice President de Guindos, seem to believe that the changes to inflation rates they had initially expected are indeed taking shape, and they do not appear to see rises in HICP growth rates as posing risks regarding their monetary policy management.

A Recent ECB Working Paper's Perspective

The ECB on January 9 published a working paper entitled “Supply chain disruption and energy supply shocks: impact on euro area output and prices” that analyzes the inflation situation within the euro area. The working paper includes an econometric analysis of the sharp rise in HICP owing to the pandemic and the Russia-Ukraine war, and states that – “In aggregate, the great supply shocks since the beginning of 2020 account for about 55% of the 2.7% increase in core HICP and about 60% of the 0.6 percentage point increase in 2-year inflation expectations.” The paper's abstract states – “The dynamics of core prices and inflation expectations are instead mostly explained by supply chain disruption shocks and to a lesser extent by adverse energy supply shocks.” Overall, the paper argues that recent ups and downs in the euro area's economic and price trends basically stem from supply shocks, so there need not be concerns about their permanence.

While the working paper cannot be assumed to be the ECB's official position, it is not significantly inconsistent with statements recently made by senior ECB officials. If it can be concluded that the current trend is merely a temporary increase in inflation caused by supply factors, then there is no need for concern about the second-round effects (or in other words, a wage-price spiral) that the ECB has traditionally worried about. As mentioned above, the question of whether the euro area is just experiencing a temporary increase in inflation caused by supply factors will not be conclusively answered until employment and wage data from the end of April can be closely examined. If the current period of relatively high inflation rates is attributed exclusively to supply shocks, however, then the hurdles on the path toward interest rate cuts will become even lower during the period from 2024, when it can be assumed that the effects of supply shocks will have largely dissipated.

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