Forex Medium-Term Outlook

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February 29, 2024

Overview of Outlook

USD/JPY remained stable in February. The currency pair appears to have entered a lull following what seems to be a watershed since surpassing the 150 level. The way I see it, JPY selling urged by a sense of national crisis following the Noto earthquake, JPY selling by households following the launch of New NISA, and a strong performance by U.S. economic indicators have combined to make JPY depreciate against USD more than expected. Japanese financial market news headlines in February were dominated by the fact that the Nikkei Stock Average had renewed the all-time record high for the first time in about 34 years, but this is also not unrelated to JPY weakness. JPY depreciation and the rise in stock and real-estate prices all make sense when seen as the result of inflation. JPY's real effective exchange rate (REER) is weaker than it has ever been in half a century, but thanks to inflation, the sense of undervaluation vanishes when prices are viewed in real terms. This makes one wonder whether allowing the undervaluation in nominal terms to remain uncorrected is part of the correction process. Whether or not JPY has weakened too much is determined by price levels at that time, and given that the governor of the BOJ himself acknowledges the shift from deflation to inflation, ongoing developments in Japan may not be all that strange. Assuming that the Fed will cut interest rates several times this year, I would like to believe that investors may have an opportunity to pick up on JPY appreciation during the April-June and/or July-September quarters, but another phase of JPY depreciation may begin from the October-December quarter onward as uncertainties end and protectionism reemerges following the U.S. presidential elections.

EUR remained strong in February. In the absence of outstanding factors, the easing of concerns regarding the regional economy may be contributing to EUR strength. Until recently, my main forecast scenario was that EUR would be weighed down as a result of the ECB being compelled into an early start of rate cuts despite the euro area economy significantly lagging behind that of the U.S. However, it seems likely that the region, while continuing to post very low growth, will avoid going into a deep recession. As a result, with both the ECB and the Fed on track to cut interest rates by around -25bp from around the middle of the year and not much change expected in the U.S.-Europe interest rate differential, the EUR/USD currency pair seems likely to remain deadlocked, with no real sense of direction. Further, as I have been arguing for some time, the biggest reason EUR is unlikely to crash is the existence of a solid demand for the currency. The German trade surplus, and by extension the euro area's trade surplus, has already recovered to pre-pandemic levels, and the impression is that EUR/USD has also recovered as a result. While in the case of the euro area, the trade surplus is the main pillar of current account surplus, in Japan's case, it is the primary income surplus, and it is worth understanding that this is what differentiates their two currencies. The ECB may strengthen its dovish stance starting summer this year, but I do not see this resulting in a EUR crash.

Summary Table of Forecasts

	2024 Jan-Feb (actual)	Mar	Apr-Jun	Jul-Sep	Oct-Dec	2025 Jan-Mar
USD/JPY	140.80 ～ 150.88 (150.56)	147 ～ 152 (149)	144 ～ 150 (148)	140 ～ 150 (145)	143 ～ 153 (147)	144 ～ 154 (149)
EUR/USD	1.0695 ～ 1.1046 (1.0836)	1.07 ～ 1.10 (1.08)	1.07 ～ 1.11 (1.09)	1.05 ～ 1.10 (1.08)	1.04 ～ 1.10 (1.06)	1.04 ～ 1.10 (1.06)
EUR/JPY	155.10 ～ 163.72 (163.15)	160 ～ 165 (161)	156 ～ 164 (161)	152 ～ 162 (157)	154 ～ 164 (156)	155 ～ 165 (158)

(Notes) 1. Actual results released around 10am TKY time on 29FEB 2024. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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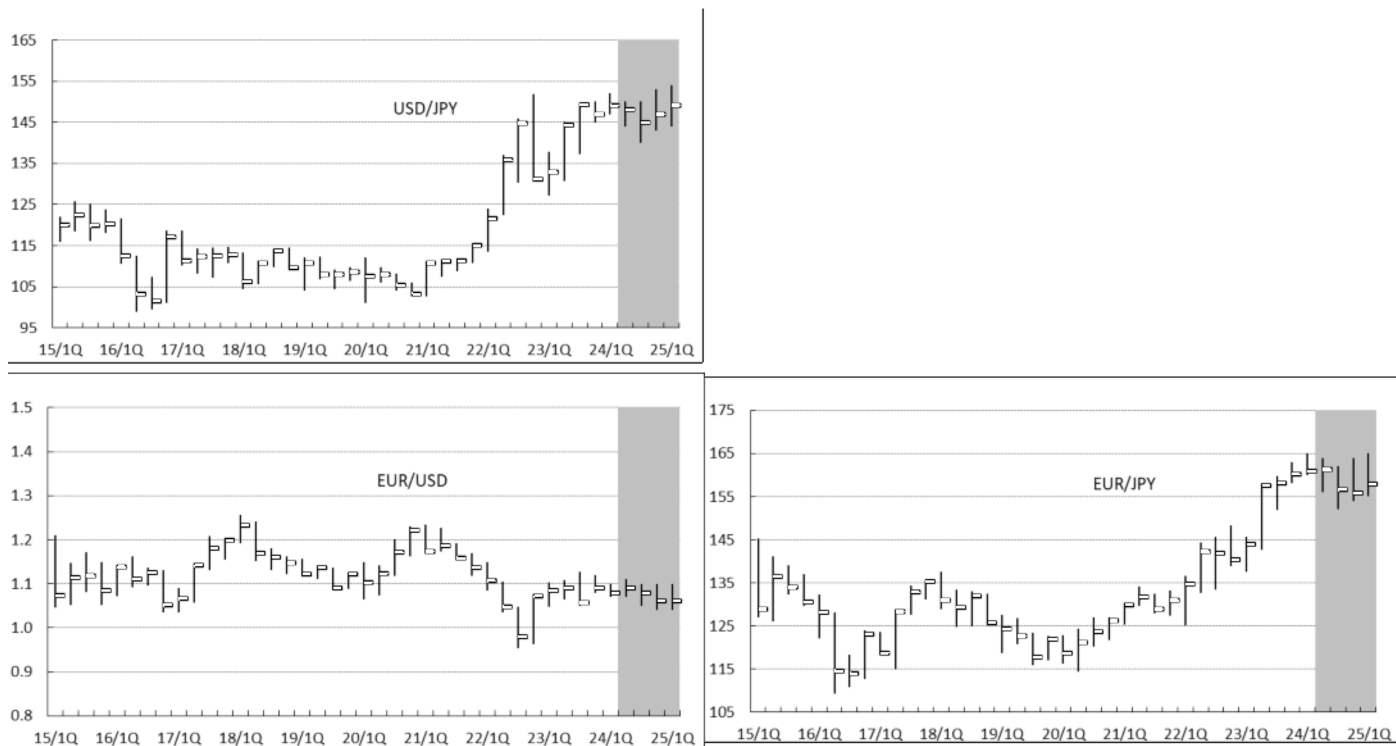
Exchange Rate Trends & Forecasts

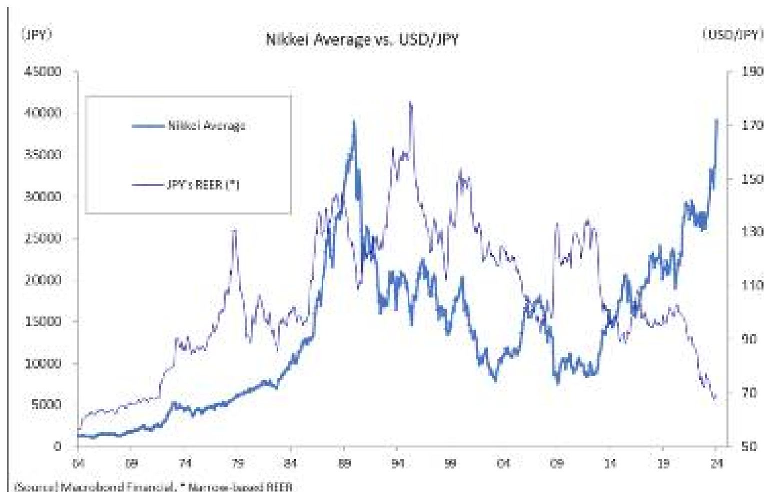


USD/JPY Outlook – Japan Faces JPY Weakness Phase While Masquerading as a Current Account Surplus Nation

Interpreting the Nikkei All-Time-Record High –JPY Weakness and Inflation Perspectives

All Thanks to Inflation

All eyes in the financial markets are on Japanese equities. On February 22 in the Tokyo Stock Exchange, the Nikkei Stock Average (Nikkei) hit JPY 39,098.68, which is JPY 836.52 higher than the previous all-time record high of JPY 38,915 posted over 34 years ago, toward the end of 1989. This has completely shifted the attention of market participants away from USD/JPY, which stubbornly remains at the 150 level, to the question of how much further the Nikkei will appreciate. However, the recent high level of share prices is merely nominal, and if one also takes into account that the composition of the Nikkei Stock Average has changed significantly in the intervening period, it seems difficult to derive statistically significant implications based on a simple comparison of the figures with 34 years ago. Of course, one does understand why the event would attract attention as a symbolic development (see figure). Since I do not specialize in the stock market, I will refrain from discussing whether the Nikkei index is undervalued or overvalued. However, when asked why the stock prices are so high, my considered response is that it is thanks to inflation. Both the weakening of the domestic currency and the appreciation of share prices, real-estate prices, and other physical assets (including foreign cars and luxury watches) are consistent with an increase in inflationary pressures – all of these are issues that are being hotly discussed in Japan right now. The same day that the Nikkei renewed the all-time record high, BOJ Governor Kazuo Ueda said regarding the 2024 price outlook in his speech to the Budget Committee of the House of Representatives, “We expect (prices) to continue to rise, just like last year and before.” He also made a point of noting that the Japanese economy is currently in a “state of inflation, not deflation.” When the economy switches from deflation to inflation, nominal prices, including of physical assets, inevitably rise. As I will explain this in detail in a later section, inflation may provide an appropriate correction path for JPY’s REER, which persists at historically low levels contrary to theoretical assumptions. Viewed this way, current levels of inflation also make considerable sense.



Argentina and Turkey Cast Shadows Again

There are also overseas examples of cases where domestic currency weakness is causing share prices to rise. As I have pointed out in past issues of this report also, over the past two years in the forex market, it has been observed that the only two currencies that have depreciated against USD even more dramatically and chronically than JPY are ARZ (Argentine peso) and TRY (Turkish lira). The figure lists the top ten major stock price indices of the world in terms of their rate of increase over the past year as of February 22, 2024, and show Argentina (S&P MERVAL Index) and Turkey (Istanbul's BIST 100 and BIST 30 indices) ranked at the top. The NY Dow Jones Industrial Average of 30 stocks, which is also expected to renew its all-time record high, was ranked 30th in terms of one-year growth rate as of February 22. Ultimately, my understanding is that the current state of the Japanese economy can be summarized by stating that the nominal JPY prices of all types of assets, including stocks, is ballooning as a result of (1) inflated overseas profits of Japanese companies due to JPY weakness, (2) an increase in inflationary pressures on the Japanese economy owing both to overseas factors (via import prices) and domestic factors (due to the unprecedented labor shortage).

Key global stock price indices (Top 10 by rate of increase)

1	S&P MERVAL, Argentina	339.70%
2	NGX All Share Index, Nigeria	86.39%
3	BIST 100, Istanbul	84.31%
4	BIST 30, Istanbul	76.87%
5	EGX 30 INDEX	74.70%
6	Lusaka Stock Exchange AI	60.93%
7	KSE 100 Index, Karachi	50.44%
8	Budapest Stock Exchange BUX Index	46.87%
9	Nikkei Average	44.25%
10	KASE Index, Kazakhstan Stock Exchange	40.21%
30	NY Dow Jones Industrial Average	18.23%

(Source) Bloomberg, Feb 22, 2023 to Feb 22, 2024

High Share Prices and Economic Downturn Not in Conflict

Under the current circumstances, many people are wondering if high share prices are not in conflict with Japan's poor GDP growth. Unfortunately, there is no conflict between poor GDP growth and continued growth in share prices. In previous reports, I have analyzed the structure of Japan's balance of payments together with its GDP performance. As my analyses show, revenues earned by Japanese companies are retained overseas rather than being repatriated to Japan. This is confirmed by Japan's primary income surplus. My calculations show that the JPY conversion rate (the percentage of the primary income surplus that results in JPY buying) changes from one year to another, but is likely to be around 25-30%. In other words, if the primary income surplus is +JPY 30 trillion, only about +JPY 10 trillion of this is returned to the Japanese economy. Please see my detailed discussion of Japan's 2023 cash-flow- (CF-) based current account balance for 2023 calculated in this manner on the next page.

Incidentally, the fact of Japanese companies' earnings tending to be retained overseas can be confirmed by more micro-level data in addition to the balance of payments. The figure shows the trend of the internal reserve balance retained in overseas locations by Japanese companies since 2003, which is the earliest year for which these reserves can be reverse calculated using the Survey of Overseas Business Activities by the Ministry of Trade, Economy and Industry (METI). As per the FY 2021 (April 2021 through March 2022) survey, the internal reserves retained abroad were the largest ever at JPY 40 trillion. Given that the ongoing JPY depreciation trend began at the end of March 2022, the impact is likely to have already been factored in in the FY 2021 survey. Needless to say, the impact of JPY weakness is likely to be reflected even more strongly in the FY 2022 and FY 2023 surveys, further inflating the value of internal reserves corporations retain in overseas locations. Leaving aside the domestic economic situation, if the above performance of Japan's corporate sector gets reflected in share prices, it is natural that share price levels will rise.

(Source) METI Survey of Overseas Business Activities

With corporate sector earnings not being repatriated to Japan, incomes in the household sector naturally fail to improve, resulting in sluggish domestic consumption and investment. It is no surprise, therefore, that Japan's GDP performance has been quite weak with the collapse of domestic demand. One of the reasons for successive reports of wage hikes, especially at large companies, is that this has finally become the only way to secure sufficient labor. In another 10 years or so, the working-age population is expected to fall short of the number of employed persons (details below). When that happens, companies will have to fight to secure workers, which will inevitably raise nominal wage levels. Wages are expected to rise starting with companies that receive government funds for investment and loans. This is likely to establish an inflationary trend in the economy, resulting in both share prices and forex rates searching for new levels.

Inflation May Correct Weakest JPY Level in 50 Years

As I will explain in detail later, the current level of JPY weakness could be viewed as an advance phenomenon that has factored in soon-to-come inflation. In theory, JPY's REER, which is stubbornly at levels lower than anything seen in the last 50 years, could be corrected if (1) JPY appreciates nominally, (2) Japan experiences inflation, or both. I have always considered (2) to be more likely. As the figure displayed previously shows, the discrepancy between the Nikkei Stock Average and JPY's REER has widened dramatically, but if one considers that the REER will be lifted up as a result of inflation, this indicates the possibility that recent high share prices may not need much correcting. For over a quarter of a century, all discussions of the Japanese economic or financial situations have been premised on a state of deflation, so it is not surprising for nominal values to change significantly when the premise changes. Inflation will eliminate the undervaluation in real terms, leaving the sense of undervaluation in nominal terms unchanged. Price levels will determine whether or not JPY weakness can be viewed as "excessive." For my part, I do not believe JPY's nominal rate will return to previous levels of JPY strength.

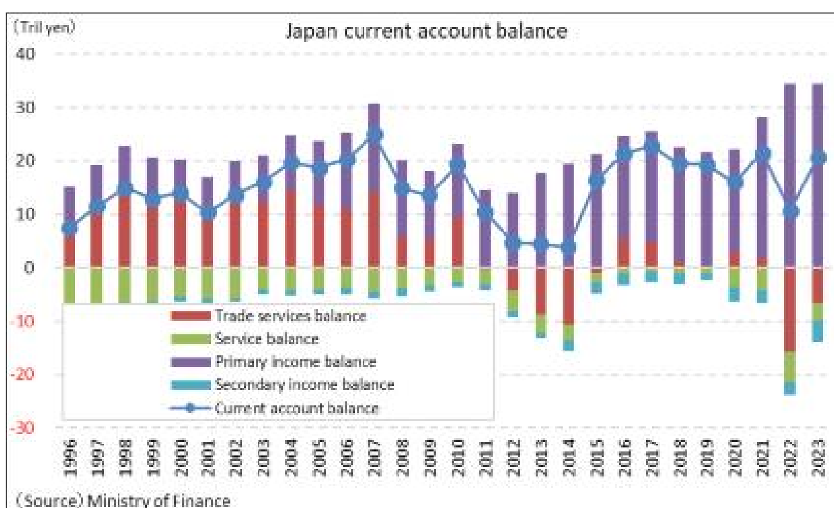
With a reversal in the nominal GDP levels of Japan and Germany in USD terms, there is a persistent view that JPY's exchange rate has deviated from its purchasing power parity (PPP) by unprecedented levels, and that, given low price levels in Japan, its real economic strength is considerably undervalued when viewed in nominal terms. This is correct in theory, but one must take a deeper look to figure out whether it is also correct in practice. It has been over 10 years since JPY's exchange rate began to deviate from its PPP on the weaker side. As an analyst, it occurs to me that the question one must ask is not whether the market rate is correct, but rather whether the PPP is correct. Assuming that Japan will switch from deflation to inflation going forward, it may be possible to see Japan's PPP as being overvalued rather than JPY's market rate as being undervalued. If JPY's market rate cannot be said to be undervalued, neither can the shrinking of its nominal GDP in USD terms. In other words, one could say that the nominal GDP in USD terms indicates a revision of figures to reflect the real scale of the Japanese economy.

In an inflationary economy, share and real-estate prices tend to rise while the currency tends to depreciate. The developments we are seeing unfold in Japan today are essentially those that are expected to take place in an inflationary economy; and the Japanese economy has switched from deflation to inflation as per the acknowledgement of the governor of the BOJ himself. My expertise is not in stock markets, but given Japan's macroeconomic climate, I think share price appreciation is inevitable. At the same time, JPY depreciation, and the increase in real-estate and luxury car/watch prices are also inevitable as the nominal value of all physical assets bloat up as the result of the economic phenomenon called inflation.

JPY Supply and Demand Climate – A Recap of 2023: Japan Masquerading as a Current Account Surplus Nation

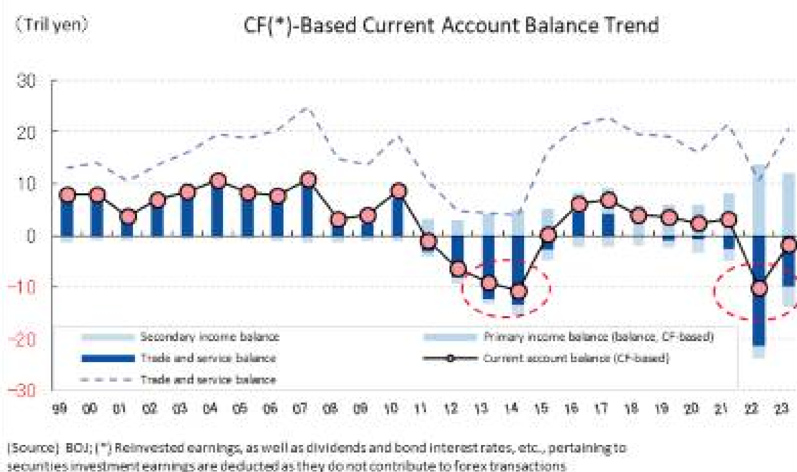
Dramatic Improvement in Statistical Terms

I would like to take stock of the current state of JPY supply and demand based on the balance of payments for 2023, which was released by the Ministry of Finance on February 8 (see figure). First of all, the headline figure for the current account balance was a surplus of +JPY 20.6295 trillion, which showed a recovery to the +JPY20-trillion level for the first time in two years. This was a +JPY9.9151-trillion increase in the surplus amount compared with the previous year. Most of this increase can be explained by the improvement in trade balance, as the trade deficit shrank by more than 50% to -JPY 9.1146 trillion. Further, the decline in the trade deficit can be explained by the considerable decline in imports (-JPY 7.6092 trillion) due to the respite in the resource-price appreciation trend. Apart from the trade balance, the services deficit also declined significantly (posting -JPY 2.3262 trillion), which also boosted the current account surplus. The decline in the services deficit is largely due to the travel surplus posting an all-time record high, at +JPY 3.4037 trillion, which is significantly higher than the previous record of +JPY 2.7023 trillion posted in 2019. The travel surplus for 2022 was +JPY 624.2 billion, so the improvement in the services balance can be explained largely by the increase in the travel surplus. The reason for such a big difference in travel surplus between 2022 and 2023 is that border controls were implemented in the face of the pandemic until COVID-19 was downgraded to a Class 5 disease in May 2023. Going forward, the +JPY3-trillion level could be taken as a given for the travel surplus. In this way, the 2023 current account surplus expansion is essentially the result of a significant shrinking of the trade and service deficits.



Second Consecutive Year of Deficit in Terms of CF

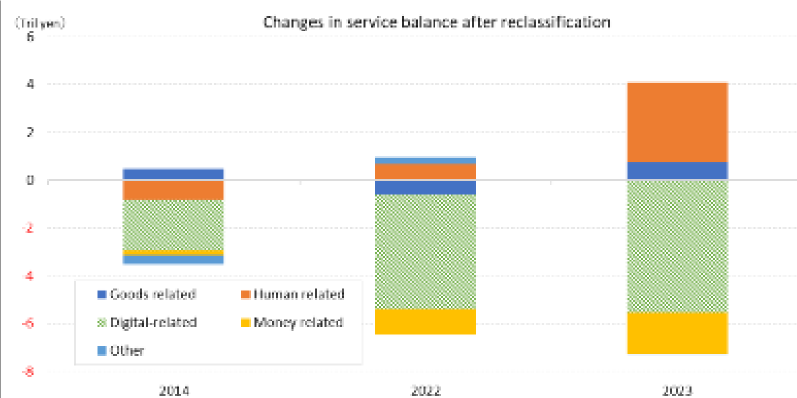
The above section summarizes Japan's current account balance based on ordinary media reports. However, when it comes to analyzing forex market trends, it is important to attempt to understand actual cash flows without being too influenced by the statistical surplus. Since starting to write about this in this report last year, I have received a great deal of feedback. To begin with a gist of my findings, my calculations show that Japan's CF-based current account balance for 2023 was roughly -JPY 1.8 trillion, the second consecutive year of deficit (see figure). Of course, given that the 2022 CF-based current account balance came out to a deficit of roughly -JPY 10 trillion, there is no doubt that JPY's supply-demand climate has improved. However, those who praise the increase in the statistical surplus without reservations as though to negate the need for any pessimism clearly appear to have missed the point. My position is to accept the fact of continued JPY depreciation during both 2022 and 2023 with an open mind and give more importance to the CF-based deficit than to the statistical surplus. Specifically speaking, the primary income surplus for 2023 renewed the all-time record high at +JPY 34.5573 trillion, but when considering the CF-based current account balance, on the receipts side, one must discount bond interest rates and dividends from securities investment earnings, as well as reinvested earnings and other direct investment transactions that do not result in earnings that are converted to JPY (of course, similar adjustments are necessary on the payments side as well). When viewed from such a perspective, the 2023 CF-based primary income surplus shrinks to a third of its statistical value, to +JPY 12 trillion or so. Of course, this figure must be taken with a grain of salt as it is merely an estimate, but it is merely escapism to assume that the nearly +JPY 35 trillion primary income surplus is manifesting as demand for JPY in the forex markets in its entirety.



(Source) BOJ; (*) Reinvested earnings, as well as dividends and bond interest rates, etc., pertaining to securities investment earnings are deducted as they do not contribute to forex transactions

Two All-Time Records: Travel Surplus vs. Digital Deficit

In addition to prioritizing CF-based figures, as above, when discussing Japan's current account balance, in recent years, with the internationalization of service transactions, I have also stressed the importance of paying attention to the outlook for the service balance. In this context, the travel surplus renewed the all-time record high as mentioned above, and this is a point the media is likely to pick up on in the coming weeks. However, the other services balance has also posted its largest ever deficit at -JPY 5.9556 trillion. The present reality of Japan's service balance is the coexistence of an all-time record high travel surplus with an all-time record large other services deficit, and I have previously expressed this as a contest between "physical work vs. brain work." This can be better visualized if we categorize the service balance into five categories, namely Goods, People, Digital, Money, and Other (see figure on previous page). Of the -JPY 3.2026 trillion service deficit posted for 2023, the People-related balance reflected by the travel balance was a surplus of +JPY 3.3501 trillion, while the Digital-related balance was a deficit of -JPY 5.5360 trillion. The service balance as a whole is determined by the balances of these two categories.



To look at the outlook for the services balance going forward, physical work seems overwhelmingly at a disadvantage. I say this because the number of people employed is already approaching the size of the working-age population in Japan, and if we look at figures by industry sector, the accommodation and food services industry, which forms the basis for travel-related earnings, is facing its worst ever labor shortage. The demand for inbound tourism could continue to increase as a result of advantageous exchange rates and cheaper prices in Japan, but there may be insufficient supply to take up the increase in demand. There may be some room for a further improvement in the travel surplus beyond the present +JPY 3.5 trillion, but not that much more improvement can be hoped for. On the other hand, the other services balance exists in a world where prices can be unilaterally raised by the suppliers, so deficits could continue to expand significantly going forward. As a result, there seems more than a slight possibility of the service balance entering a phase of expanding deficits.

New Interpretation of the Stages of Balance of Payments Theory

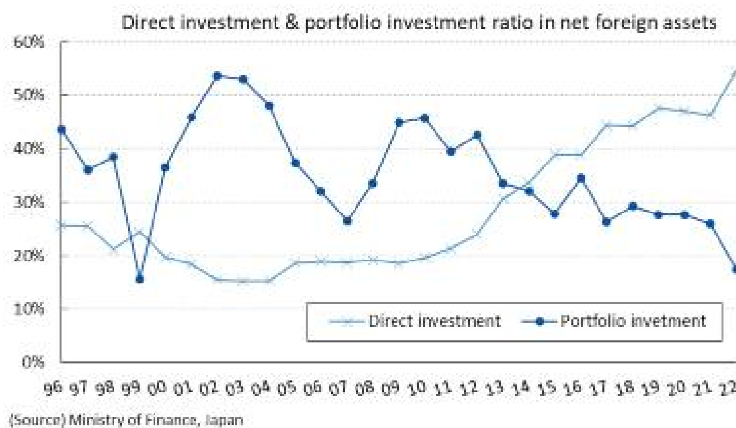
Going by the stages of balance of payments theory, Japan is currently a typical “mature creditor” nation in that it earns foreign currency not by goods trade but as an outcome of past investments. In my book Where Did the Strong-Yen Trend Go? (September 2022, published by Nikkei BP), I presented my argument why this position of Japan as a mature creditor must be taken with a grain of salt. As usual, I still sometimes hear from those who are taken in by the statistical current account surplus that my excessively pessimistic outlook regarding the balance of payments proved to be wrong, but I think this is a shallow claim based on a shallow understanding of the facts.

There are at least two points to note when applying the stages of balance of payments theory, which was proposed in the 1950s, to the present times. The first point is that the theory does not sufficiently take into account the fact that nearly 70% of the primary income balance is not converted back into the domestic currency. The other point this theory does not take into account is the thriving of international service transactions and the extremely strong supply-side (≒U.S.) price leadership resulting from it. While one is free to feel a sense of relief at the statistical surplus, one must also honestly consider why Japan is facing JPY weakness despite its current account surplus. My answer to this question is the CF-based current account balance.

Further, looking at service transactions, being charged a flat rate for platform services by U.S. IT giants has become a default feature of daily life for both the Japanese corporate and household sectors. Moreover, as mentioned above, we are powerless to resist price hikes by these IT companies. Phrases such as “digital tenants” and “digital serfs” have emerged to mock this master-servant relationship as a result. As it seems difficult to assume that the use of digital services will decline going forward, one expects that the weight of the service balance within the combined trade and service balance will only continue to increase in the coming years. Unless we assume that users will move away from platform services offered by companies such as Google, Apple, Facebook, Amazon, and Microsoft (GAFAM) in favor of domestic versions of the same, it seems very likely that the service deficit will continue to expand, led by the Digital-related deficit. The odds of such services being developed domestically seem small. If we assume that the demand for converting the primary income surplus back into JPY will continue to dwindle and that the trade and services balance will also be kept from improving by the expanding service deficit, Japan’s current status (more specifically, JPY supply and demand) as observed through the lens of CF-based current account balance is more that of an “asset liquidator” than a “mature creditor.”

“Current Account Surplus Nation” and/or a “Creditor Nation” Status is a Sham

Japan’s status as the world’s largest net external creditor, which has long served to guarantee the safety of JPY as a currency, must also be interpreted with caution. Net external assets are an accumulation of current account surpluses, so naturally, their nature has changed compared with the past. To be direct, about half of Japan’s outstanding net external assets are currently composed of direct investments (see figure). This is the result of the rapid acquisition of foreign companies by Japanese companies starting 2011 or so. Since the acquired companies are unlikely to be sold off right away, the acquisition of these companies is considered to have involved an outright sale of JPY. During the early 2000s, most of Japan’s outstanding net external assets were in the form of foreign securities, so they had greater liquidity and their re-conversion to JPY could be expected, but that is not the case now.

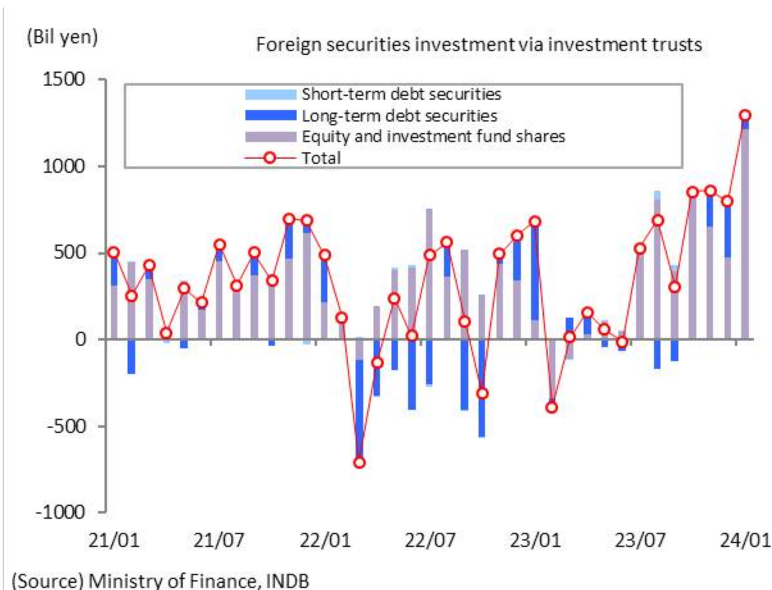


(Source) Ministry of Finance, Japan

If a majority of foreign-currency-denominated assets owned by Japanese are assets that will not be returned (not aimed at being returned) to Japan, this makes Japan’s status as a net external creditor a sham. Of course, if JPY were to go into an uncontrollable free-fall, and the country had to be rallied around to save the currency, the possibility of forcibly shifting foreign-currency-denominated assets back to Japan may be considered. A good example of a mild measure is the reduction of repatriation taxes aimed at the corporate sector, which some suggested ought to be implemented in 2022, when JPY began to weaken. However, attempting to improve currency supply and demand by going so far as to interfere with the asset formats held by the private sector is very close to being a prohibited act at least among G7 nations, and it is not a scenario that must be expected at the present time. However, how much longer can Japanese politics, economy, and society hold up under JPY depreciation resulting from the current sham of a “current account surplus nation” and/or “creditor nation”? Rather than optimistically celebrate the current account surplus level indicated by the 2023 balance of payments, I would like to pay attention to the changes taking place behind the scenes.

Investment Behavior of the Household Sector – Initial Velocity of JPY 15 Trillion/Year

January Sees Largest Ever Purchase of Trust Funds



(Source) Ministry of Finance, INDB

In last month's issue of this report, I estimated that Japanese households would make JPY 7-9 trillion a year worth of investments into foreign-currency-denominated assets through the New NISA (Nippon individual savings account) scheme. Subsequently, the actual amount of funds flowing into key investment trusts have been released and several financial institutions have released their own provisional estimates. The best way to comprehensively assess all this publicly available data would be to examine the Finance Ministry's International Transactions in Securities. In the monthly data for January 2024, which was released on February 8, looking at the figures by types of investors, foreign securities investment via investment trust management companies (hereafter "investment trusts") was JPY 1.2937 trillion, which is the largest net acquisition posted in recorded history (see figure). This is a significant jump even compared with January 2014 (JPY 190.3 billion), when old NISA was launched, and January 2018 (JPY 967.7 billion), when instalment-type NISA was launched. Looking at the breakdown, most of it (JPY 1.2104 trillion) went into equity and investment fund shares. As rumored, this reveals the enthusiasm for investment in overseas equity, centering on U.S. equity, among the Japanese. It has to be said, however, that in terms of the overall foreign securities investment for January, the net acquisition, while quite large, at JPY 3.4226 trillion, are not historical in its scale. Rather, it is conspicuous that close to half of all net acquisitions came from buying investment trust funds. This brings home the power of New NISA afresh.

The Shock of JPY 15 Trillion/Year

Growth-type NISA investments are not set up to continue at the same pace from month to month, so there is no guarantee that investments will continue at the same pace going forward. Having made that disclaimer, if we still assume a similar pace of investments to continue for the rest of the year, we are looking at an enormous scale of investments adding up to JPY 15 trillion a year. Incidentally, the amount of foreign securities investment via investment trusts was roughly JPY 4.5 trillion last year (2023), roughly JPY 3.4 trillion on average over the past 5 years (2019~2023), and roughly JPY 3.6 trillion on average for the past 10 years (2014~2023). The scale of JPY 15 trillion, therefore, is almost unimaginably large as a departure from past trends, making it difficult to incorporate into my main forecast scenario.

As already mentioned, the current account balance for 2023 was a statistical surplus of roughly +JPY 20 trillion, but a deficit of roughly -JPY 1.8 trillion in terms of cash flows as per my calculations. In other words, cash flows are already inclined toward a net sale of JPY, but JPY 15 trillion is a sum large enough to wipe out even the statistical surplus. Moreover, this amount only reflects investments made via investment trusts. Naturally, the volume of investments made by pension funds (i.e., trust accounts of trust banks), securities companies (i.e., financial instruments exchange businesses), life insurance companies, and other conventional institutional investors the forex markets focus on will be added to this. So, if one assumes that the current pace of trust fund purchases by households continues, and purchases by pensions and securities companies gets added to this, there may be months when the "instantaneous wind speed" picks up significantly. Perhaps recent developments can be interpreted as the emergence of household investors as a force to match institutional investors thanks to government policy.

A Future of Equity Swaps Between Japanese and Foreign Investors

While not as widely reported, inward securities investment from foreign investors also posted a net acquisition of JPY 5.5234 trillion, the highest since July 2022. Looking at the breakdown, equity and investment fund shares were JPY 2.8489 trillion, long-term debt securities were JPY 1.6359 trillion, and short-term debt securities were JPY 1.0395 trillion, indicating a conspicuous trend of buying Japanese assets, especially equities, by foreign investors. In combination with the clear trend of Japanese foreign investment led by the buying of overseas equities (mainly U.S.), it would appear that Japanese and foreign investors are swapping equities. In the case of Japan, given that the purchase of overseas equities was triggered by the government establishing nontaxable quotas, one could say that Japanese investors are using funds that would otherwise have been paid in taxes to invest in foreign equities. One wonders what Japan's aim is in so eagerly pushing nation-building through asset management. One possible aim is to establish an economic structure similar to that of the U.S., where equities comprise about 30% of household assets, and the wealth effect of high share prices boosts consumption and investment appetites.

The Aim of Nation Building Through Asset Management

If Japanese investment behavior continues as it is now, Japanese investors will mainly own overseas equities, especially U.S. equities, and they will be exchanging the value of their domestic currency (i.e., causing JPY weakness) in return for it. It feels as though the Japanese economic and financial conditions, which have already been at the mercy of the Fed's monetary policies, are progressing even further in that direction. Even so, if JPY were to strengthen with the Fed's pivoting toward a more dovish monetary policy stance, the worsening of Japan's terms of trade may be limited, but the question here is – will JPY indeed strengthen? We will find out this year. However, assuming that JPY does not appreciate even after the Fed switches to monetary accommodation, Japanese investors may find themselves in a situation where the wealth effect created by a rise in U.S. share prices (following monetary easing) is cancelled out by the fall in their real incomes as a result of JPY weakness. Further, taking into account that the Japanese household sector's deposits are put to use buying Japanese government bonds (JGBs) via the BOJ's current account, there is also a need to understand whether the wealth effect of higher U.S. share prices is sufficient to pay the cost of JPY depreciation and higher JPY interest rates in the medium/long term.

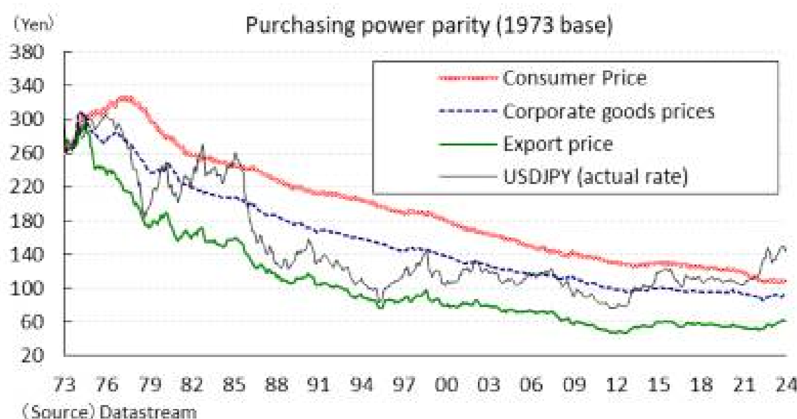
At the present time, the only impact from New NISA that can be acknowledged is JPY depreciation, with the contribution from higher U.S. share prices not expected to be too significant. If so, in addition to JPY weakness continuing, one has to take into account the possibility of a fall in U.S. share prices also. Until now, domestic/foreign financial market fluctuations have not hugely impacted the financial assets of Japanese households, which have mainly been centered on deposits. Going forward, however, household consumption/investment behavior could change as the composition of their financial assets change. Discussions of the merits and demerits of such a change will evolve gradually, but assuming that nominal wages will remain unable to keep up with inflation, it is rational to assume that that asset management is the only way to break out of this situation, and perhaps this assumption is true. In fact, I get the sense that the government and ruling party, which have been promoting nation building through asset management, are hoping that people will make up for the loss in incomes through asset management. This is not a bad thing in itself, but if most of the funds are invested in overseas assets, it may be necessary to verify/analyze potential future side-effects.

JPY and the Japanese Economy Now and Going Forward – Future Adjustments Associated with Inflation

Lack of Adjustment in JPY's PPP and REER Levels

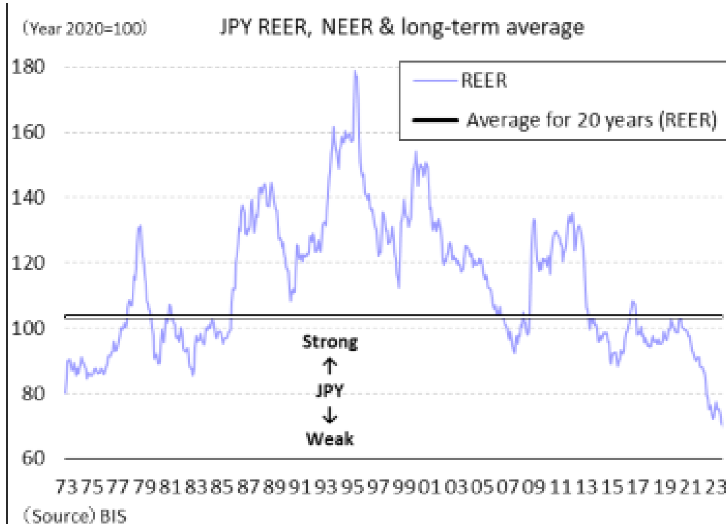
Against the backdrop of JPY's persistent weakness, I have received a growing number of inquiries related to USD/JPY's theoretical fair value levels and the USD/JPY levels that might be considered most comfortable for the Japanese economy. However, since the forex market does not actually utilize a concept of fair value, the only way I can respond to such inquiries is by discussing purchasing power parity (PPP) levels calculated based on differences among the price levels seen in various countries.

The discrepancy between actual USD/JPY levels and PPP levels has become very large since last year and, in that regard, I have argued that the actual exchange rates are correct and that the PPP levels are likely to become adjusted so as to better reflect JPY's weakness. Comparing JYP's PPP levels and actual exchange rates with respect to various currencies, one finds that the Japanese PPL level is closest to the actual forex market level in the case of USD, but the USD/JPY PPP level (calculated based on consumer price indexes) is in the JPY108-109 range, fairly distant from the market level. This may be considered to indicate that JPY has been allowed to excessively depreciate against USD by more than 30% (see graph). However, regardless of whether JPY's recent depreciation might be considered "excessive", it has to be recognized that the depreciation is a real phenomenon that is promoting Japan's exports, helping Japan build up a trade surplus, and causing greater JPY buying by companies centered on exporters. Japan has traditionally had a JPY-value adjustment mechanism by means of which JPY weakness would promote greater export volumes and the accumulation of trade surpluses, and those surpluses would promote JPY buying and JPY strengthening. That mechanism is no longer effectively functioning, so JPY's forex market values can be considered excessively weak from the perspective of PPP levels, but there is no point in overemphasizing the significance of this theoretically excessive weakness. It is wiser to focus on what can constructively be done with respect to "excessive JPY depreciation", and it seems the only thing that contemporary Japan can do at this time is to expand its exports of travel services. While exporting travel services can be an important way to earn foreign currency, it will be difficult to create a trend of JPY strengthening solely by obtaining foreign currencies from foreign tourists.



(Source) Datastream

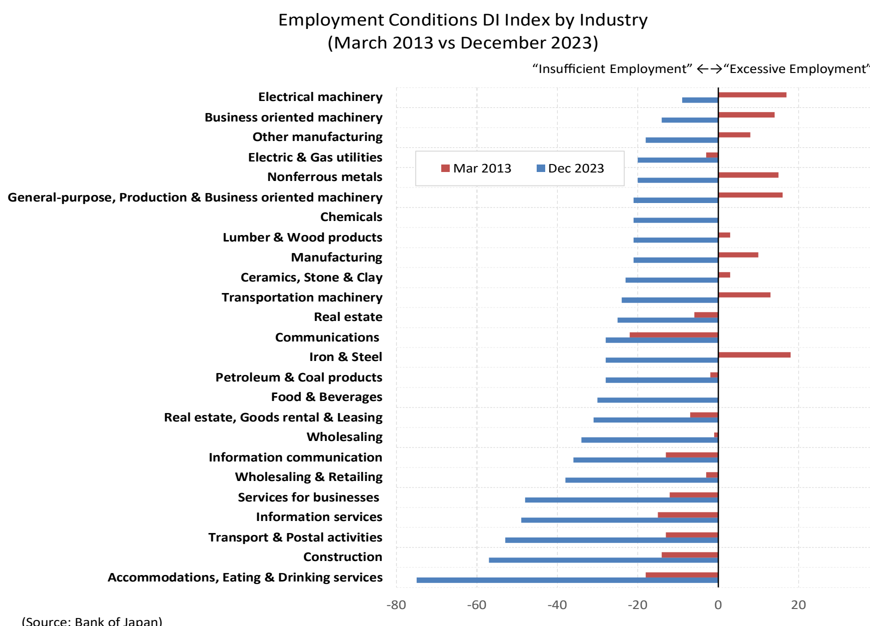
It is generally understood that Japan, compared to other countries, has been a country with relatively strong disinflationary trends and relatively low price levels. The country's relatively strong disinflationary trends have caused JPY to be stronger in PPP terms and weaker in real effective exchange rate (REER) terms. JPY's REER has recently descended to its lowest level in half a century, and the REER downtrend has not yet shown signs of ending (see graph). However, the adjustment of JPY's PPP to reflect JPY depreciation requires a situation in which Japan shifts from deflationary to inflationary trends. Moreover, JPY's REER continues to be at its lowest level in half a century, and while theoretically it can be expected to eventually move toward its long term average level, no such movement has been seen during the past three years. One wonders whether it would be unreasonable to anticipate that the decline in JPY's REER will continue.



So, what are the possible adjustment paths enabling JPY's REER to shift to an uptrend? Broadly speaking, such a shift will require either ① nominal JPY appreciation, ② relative high inflation rates in Japan, or both, but if JPY supply-demand analysis suggests that factor ① is highly unlikely, then we should give additional consideration to the possibility of factor ②. To reiterate, I do not have high expectations regarding factor ① but am concerned about the possibility of factor ②. Given the vagaries of the floating exchange rate system, one naturally cannot completely preclude factor ① (nominal JPY appreciation), but it seems reasonable to assume that any such nominal appreciation trend that might take shape is likely to end up being less sustainable and powerful than similar trends seen in the past.

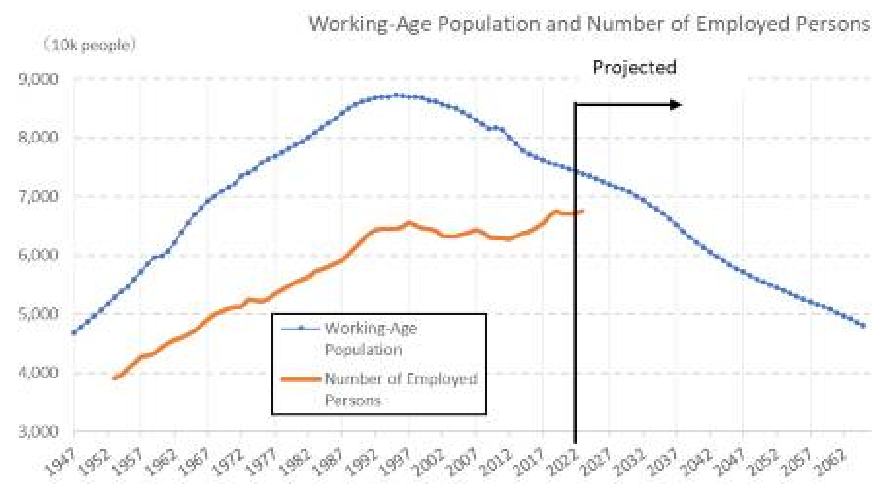
Labor Shortages, Rising Wages, and Inflation

When considering the factors that might promote inflation in Japan, the first factor that comes to mind would be labor shortages. I meet with people from various kinds of companies almost every day, and the topic of "labor shortages and wage increases" almost always comes up during our discussions. Many people are beginning to believe that the recent JPY depreciation trend is in line with the "inflation causes currency depreciation" theory. The BOJ's view is that the "second force" promoting inflation (a virtuous cycle of interactions between wages and prices) has not yet been realized, but regardless of the BOJ's view, it is a fact that both prices and wages are rising in Japan. The employment/personnel judgment DI in the BOJ's Tankan survey indicates an unusual situation in which all industries are suffering from labor shortages, while Accommodations, Eating & Drinking services are facing particularly severe labor shortages as they seek to respond to the surge in demand associated with the rapidly rising number of inbound tourists (see graph). The tightness of Japan's labor market will dictate increases in nominal wages, and it is inevitable that rising nominal wages will contribute to a general rise in prices. Contributions to inflation from the endogenous factor of labor shortages are being supplemented by contributions from such exogenous factors as mineral fuel price increases as well as the surge in inbound tourist-related demand stemming from JPY's weakness. Mineral fuel price increases are pushing up the costs of all goods and services, while inbound tourist-related demand is having a more-tightly-focused effect in pushing up prices of goods and services in strong demand from foreigners. Price increases associated with mineral fuel prices and inbound tourism are already taking place, but the prospective nominal wage hikes required to make the inflation trend sustainable will only occur if labor shortages are sustained.



(Source: Bank of Japan)

Taking a more-macroscopic perspective, <u>we should recognize that Japan's current labor shortages are minor compared to the labor shortages that will occur in the future</u>. The graph chart on the right shows that Japan's working-age population still exceeds the number of employed people, so there is leeway for additional labor supply. Based on the Cabinet Office's White Paper on Aging Society 2023 and the Ministry of Internal Affairs and Communications' predictions, however, it will be from 2035 that the working-age population will clearly descend below the number of employed people in 2023 (67.47 million people). (*I used linear interpolation to supplement figures published by the Ministry of Internal Affairs and Communications.) While there may be some adjustments to the population estimates, the general idea is that economic growth based on Japan's current amount of labor inputs will become difficult within the next 10 years. It seems inevitable that economic entities will have to compete with each other to recruit the number of workers they require to maintain their economic activities. It would be hard to imagine a scenario in which nominal wages would not rise amid such competition for workers. There are grounds for concern that rapid nominal wage increases not reflecting increased added value or improved productivity of labor will weigh heavily on Japan's corporate sector and put downward pressure on corporate profits.



Improve Productivity or Accept Immigrants

Of course, this is an extremely simplified projection scenario, and it is possible that actual future events may differ from that scenario. For example, if there are significant improvements in production per worker (labor productivity), it may be possible to avoid difficulties associated with labor shortages. In light of this, the idea that artificial intelligence (AI) may reduce employment opportunities for people may be a positive idea from the perspective of Japan. However, unless there are significant productivity improvements, the tightening of the labor supply-demand relationship will push up nominal wages, and to the extent that the wage increases exceed productivity improvements, they will become a factor that depresses corporate profits. This would usher in a stagflation situation in which rates of growth in wages and prices are high but economic growth rates are low. The only way Japan could overcome its labor shortages without improving labor productivity would be to accept large numbers of immigrants, but large-scale immigration is a kind of taboo subject in Japan, so it would be difficult to make realistic projections about it.

Returning to the subject of JPY's PPP and REER, I anticipate that inflation will promote adjustments that progressively reduce the theoretical discrepancy between JPY's recent nominal depreciation against USD and JPY's PPP as well as raise JPY's REER up from its lowest level in half a century. In light of that prospect, it is understandable that the prices of stocks, real estate, and high-end imported goods (such as cars and watches) are suddenly rising in Japan. From the prospective of advocates of Abenomics and the policy ideology known as reflationism, that prospective scenario would be a long-awaited development, although it is currently difficult to see this scenario as auguring better socio-economic conditions in the future.

U.S. Fiscal Policies Now and Going Forward – The Forex Market's "Next Target"

Movement Toward Fed Interest Rate Cuts

The January FOMC meeting received a lot of attention but decided to maintain the status quo. Although the Fed made a sudden shift towards dovishness at the December FOMC meeting, it has shifted back towards a slightly more hawkish stance in light of economic and financial developments seen during the past month. The Fed's confidence in the current situation is evident in the FOMC meeting statements' opening paragraphs. The December statement's "slowed from its strong pace" phrase was changed to "expanding at a solid pace" in January, a clear indication that the Fed has revised its appraisal of economic activity in a positive direction.

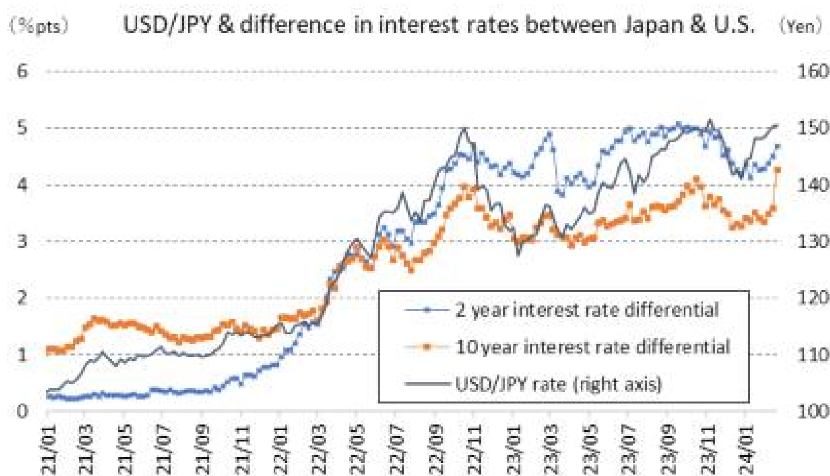
While it seems the Fed was somewhat meandering from December to January, it now seems likely that the Fed will increase the linear stability of its policies. Regarding the direction of adjustments to the federal funds rate, the January FOMC meeting's statement clearly states that the Fed will not lower interest rates "until it has gained greater confidence that inflation is moving sustainably toward 2 percent." The previously used phrase "any additional policy firming" was changed to "any adjustments", eliminating the policy-tightening bias and strengthening the assumption of interest rate cuts (target range reductions). Regardless of the specific timing of prospective interest rate reductions, the key point to take away from the statement is that the Fed is more-clearly indicating that it has interest rate cuts in mind.

Fed Interest Rate Cut Expected in May

However, the Fed has still not made a clear statement regarding the timing of prospective interest rate reductions. At the post-FOMC-meeting press conference, Fed Chairman Jerome Powell said – "I don't think it's likely that the committee will reach a level of confidence [to cut rates] by the time of the March meeting" – so the media headlines indicated that there will be no interest rate cut in March, and market expectations are following suit. On the other hand, Chairman Powell also said at the press conference that – "If we got really good inflation data soon, [...] that would tell us that, that we could go sooner [to cut interest rates] and perhaps go faster." The key point is that it is up to the Fed whether or not it can "gain a level of confidence", so it is probably best to assume that the requisite confidence could be gained at any time. In light of the U.S. employment and wage situation, there does not appear to be any need to rush to cut interest rates, and I am anticipating that the Fed will begin cutting interest rates at the May FOMC meeting after taking into consideration the economic and financial situation during the next three months.

Unusual "Fed Dovishness and BOJ Hawkishness" Scenario not Reversing JPY Depreciation Trend

In any case, although interest rate cuts are recognized to be the Fed's default course, USD/JPY has still remained around JPY150. Currently, the financial markets have largely factored in their expectation that the Fed will cut interest rates about three times this year and that the BOJ will discontinue negative interest rates by June, probably in the March-April period. The Japan-U.S. interest rate differential and USD/JPY are forex market participants' (particularly Tokyo forex market participants') most popular topic, and the central banks of Japan and the United States are clearly on the brink of interest rate adjustments likely to promote JPY appreciation against USD – adjustments that constitute a historically rare conjunction of policy direction changes – yet these developments do not seem to have significantly restrained the JPY depreciation trend. On January 31, the newly released "Summary of Opinions" from the BOJ's January 22-23 Monetary Policy Meeting indicated a strong desire for policy normalization, but USD/JPY still did not fall below JPY147. Even after the dissemination of news about the January 31 FOMC meeting, USD/JPY was merely adjusted downward to the upper half of the JPY146-147 range. Given the certainty of U.S. interest rate cuts and Japanese interest rate hikes, one can expect JPY to appreciate against USD in response to the narrowing of the Japan-U.S. interest rate differential from the April-June period through the July-September period, and it will be worth closely watching to see if USD/JPY will descend below JPY140 during the first half of 2024. JPY's current depreciation trend started in March 2022, when USD/JPY was at the JPY113-114 level, and one can't help but feel that the trend has progressed much faster and further than initially expected. I am anticipating that the lowest USD/JPY levels recorded from the April-June period through the July-September period will be the lowest seen since the beginning of the year. In view of historically observed forex market anomalies associated with U.S. presidential elections (discussed in previous editions of this article), however, it is highly likely that JPY will begin to weaken again following the upcoming U.S. presidential election.



(Source) macrobond

The "Next Target" Required for Countering JPY Depreciation

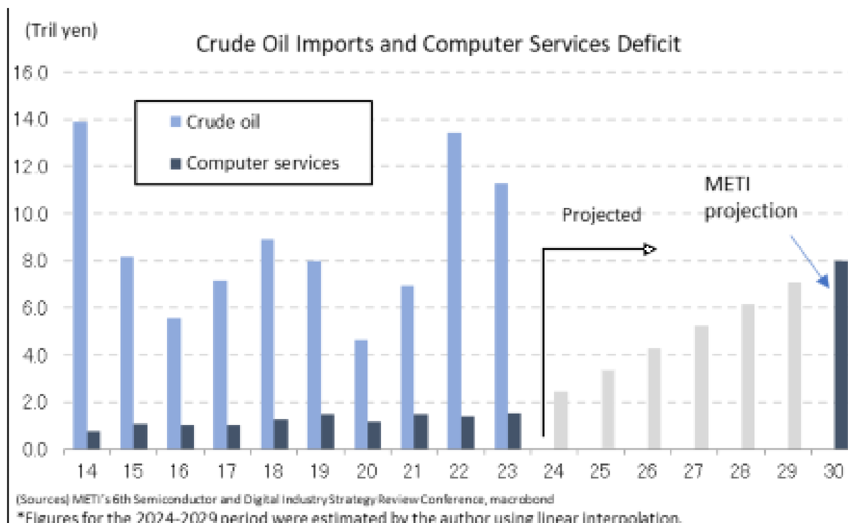
Going forward, <u>a potential development Japan should fear is that the forex market, while assuming that Fed interest rate cuts are one necessary condition for countering JPY depreciation, will begin considering the possibility of a second necessary condition in the form of continued BOJ interest rate hikes</u>. The market is not currently prepared to consider that possibility and, moreover, such a possibility could lead to the "discontinuity" (discontinuation of extremely accommodative financial conditions) that BOJ Governor Ueda is determined to prevent. In recent years, Japan has been forced to endure either a rise in JPY interest rates or JPY depreciation, and it has felt compelled to accept the latter. In light of Japan's unusual political and social allergy to interest rate hikes, I anticipate that this situation will generally continue as is. However, it is worth pondering the question of whether JPY will actually continue depreciating even after repeated interest rate cuts by the Fed.

If such a situation were to occur, it is possible that the forex market might decide that the "next target" required for countering JPY depreciation would be continued BOJ interest rate hikes. If that happens, the vicinity of USD/JPY150 may become established as the main USD/JPY battleground. Regarding JPY depreciation risks at this time, rather than the question of "whether or not the BOJ's negative interest rates will be discontinued", it can be said that the most important issue is "what happens after negative interest rates are discontinued". Even if the issue of whether negative interest rates will be discontinued or not is settled when the BOJ raises interest rates for the first time in 17 years, if that step is clearly the only one the BOJ was prepared to implement, the forex market would be likely to conclude that BOJ-related market-moving factors conducive to JPY appreciation had been completely depleted, and the market may also adopt the view that the lack of such BOJ-related market-moving factors is more important than the Fed's interest rate reductions. What could Japan do about such a situation? At this point, I would like to simply point out the potential for such a situation, which I plan to discuss in greater detail on another occasion.

Risks to My Main Scenario – Value of Digital Deficit Close to that of Crude Oil Imports

Growing Computer Services Deficit

Japan's deficit in its "other services" balance (stemming from foreign currency outflows related to such "new era deficits" as those associated with digital services and consulting and research and development activities) is beginning to receive considerable coverage from Japanese news media, which have dubbed the "other services" deficit the "digital deficit". The "digital deficit" phrase was first used in the Nikkei Shimbun in February 2023, and growth in media discussions of the relationship between Japan's service balance and JPY depreciation have gained momentum over the past year. I am receiving inquiries almost every day about the persistent JPY depreciation situation, and there has inevitably been an increase in inquiries about the "other services" deficit along with questions about the likelihood that that deficit may be alleviated at some point in the future. While I have not made my own forecasts of "digital deficit" trends, materials from the Ministry of Economy, Trade and Industry's (METI's) 6th Semiconductor and Digital Industry Strategy Review Conference held on July 20, 2022 indicate that if Japan's deficit associated with such computer services as cloud computing services continues to grow at its current pace, it will by 2030 amount to about JPY8 trillion, exceeding the value of the country's crude oil imports . Those materials indicate that the value of Japan's crude oil imports was roughly JPY6.9 trillion in 2021, but it should be noted that the figure for 2023 (the latest figure currently available) was considerably higher, at about JPY11.3 trillion (see graph on previous page).



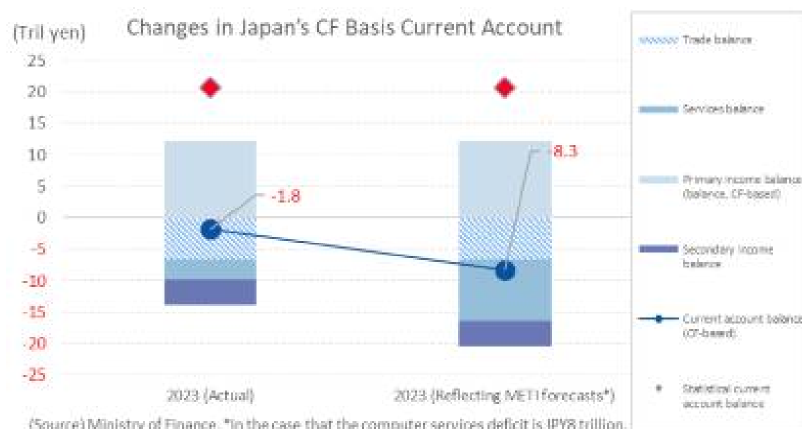
(Sources) METI's 6th Semiconductor and Digital Industry Strategy Review Conference, macrobond
*Figures for the 2024-2029 period were estimated by the author using linear interpolation.

The materials forecast the annual digital deficit's growth to JPY8 trillion in 2030 based on assumptions that the deficit's size is similar to that of Japan's domestic public cloud computing market and that the domestic public cloud computing market will expand at rates projected by private forecasters. I think it is worth briefly considering how Japan's current account balance will change if the METI forecast proves accurate.

If Forecasts are Correct, Japan's "New Era Deficit" Will Grow to Approximately JPY12 Trillion

While the METI conference focused exclusively on "computer services", I view the digital deficit as stemming from the "communications, computer, and information services" item within Japan's "other services" balance. On the other hand, the "communications, computer, and information services" deficit in 2023 was JPY1,674.5 billion, of which the "computer services" deficit accounted for JPY1,503.2 billion, so it does not seem very important to quibble about the exact scope of the basis of digital deficits. However, if Japan is expected to record a deficit of JPY8 trillion in "computer services" alone, it can be roughly forecast that the country's deficit in "communications, computer, and information services" would increase by over JPY6 trillion from the current level (approximately JPY1.7 trillion in 2023). Japan's "new era deficit" in "other services" (including "communications, computer, and information services") was approximately JPY6 trillion in 2023. If other "other services" items are unchanged and the "computer services" deficit expands in line with METI's forecast, Japan's "new era deficit" will grow to approximately JPY12 trillion in 2030.

If this "new era deficit" forecast is correct, then even if Japan's travel surplus continues to grow to record-high levels in the JPY3-4 trillion range (the actual figure for 2023 was approximately JPY3.5 trillion), those travel surpluses will not be able to offset even half of the "new era deficits". Japan's current account balance is the sum of the country's trade balance (in which deficits have been recorded in almost all months since September 2021) and the country's primary income balance (in which large statistical surpluses not directly associated with currency flows have been recorded for many years). For reference, if Japan's 2023 current account balance were to include a JPY8 trillion computer services deficit, the country's CF basis current account deficit would increase approximately 400%, from JPY1.8 trillion to JPY8.3 trillion (see graph). That current account deficit would be comparable to the JPY10.2 trillion current account deficit recorded in 2022, when JPY depreciated by more than 30% against USD. Although it is not possible to make rational predictions about the exact state of Japan's current account balance in 2030, it appears clear that if the country's already-large service balance deficit steadily widens, the JPY supply-demand environment will be dramatically changed by 2030.



(Source) Ministry of Finance. *In the case that the computer services deficit is JPY8 trillion.

JPY Selling Promoted by Procurement of Crude Oil and Computer Services

One outstanding part of the METI conference materials is their comparison of figures related to computer services and crude oil. While Japan imports crude oil from Middle Eastern countries and purchases digital-related services from U.S. companies, computer services and crude oil are similar insofar as they directly affect the daily lives of ordinary Japanese. Computer services and crude oil differ insofar as crude oil prices fluctuate due to various factors, while unit prices of digital-related services seem unlikely to decrease, although they may gradually increase going forward. Digital-related services price increases appear to be inevitable, given the trend of increase in the salaries of people working at foreign-affiliated companies providing digital-related services. To eliminate the burden on Japanese people from digital-related services price increases, Japanese people's salaries would need to rise by amounts equal to the price increases, but it is generally understood that it would be difficult to realize such salary rises. While making foreign currency payments for computer services, just as for crude oil, is essential to Japan's economy, there are concerns that computer services expenses will become onerous costs that have little to do with rational price formation processes.

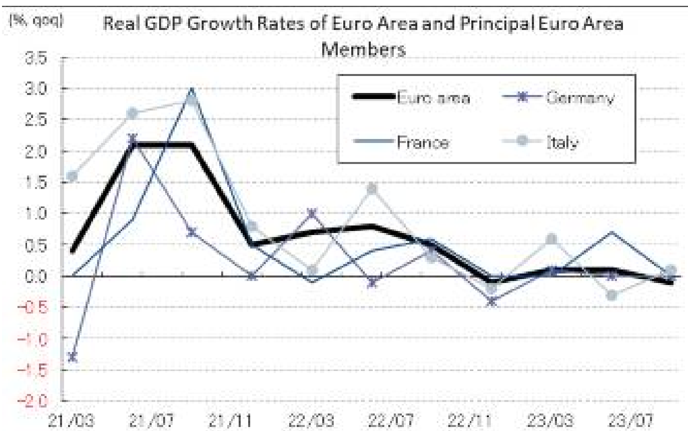
Of course, it would be difficult to improve the real economy's productivity without digital services, which can be expected to have a considerable stimulatory effect on the real economy going forward. Looking back at the Japanese economy's history, however, one may note how increases in prices of oil and other fossil fuels have repeatedly distorted the JPY supply-demand situation by promoting JPY selling, and it is thus worth being very wary of the possibility that the growth of "new era deficits" may have similar or even greater effects in promoting JPY selling. Although Japan is currently positioned as a "mature creditor country", it is important to note that the international balance of payments economic development stage theory formulated more than half a century ago did not anticipate that currency supply-demand situations would be distorted in this way. If Japan in the future shifts away from being a mature creditor country as it is pressured into becoming a country that progressively draws down its external assets, I think it is worth considering the possibility that growing "new era deficits" may be the main cause.

EUR Outlook – Importance of Wage Growth Deceleration and Summer Wage Situation Appraisal

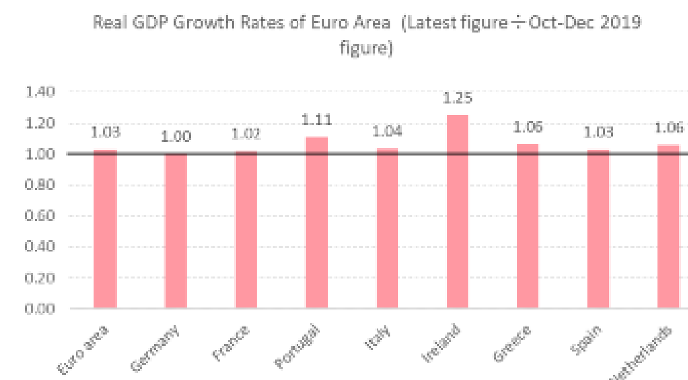
Euro Area Economic and Monetary Policies – Important Summer Wage Situation Appraisal

Euro Area Achieves a Soft Landing

Announced on January 30, the euro area's fourth quarter 2023 qoq real GDP growth rate (preliminary figure) was unchanged from the previous quarter (+0.0%) and slightly above median market expectations (-0.1%). The annualized qoq growth rate was +0.1%, a barely positive rate, so the euro area economy was able to avoid entering a technical recession (two consecutive quarters of negative growth) that was widely considered almost certain to occur. While the euro area economy did succeed in narrowly avoiding negative growth, its recording of zero growth definitely indicates a trend of economic stagnation. Furthermore, given that it is preliminary figures that are indicating zero growth, there is a possibility that future data revisions will indicate that the euro area economy actually did enter a recession.



(Source) Bloomberg

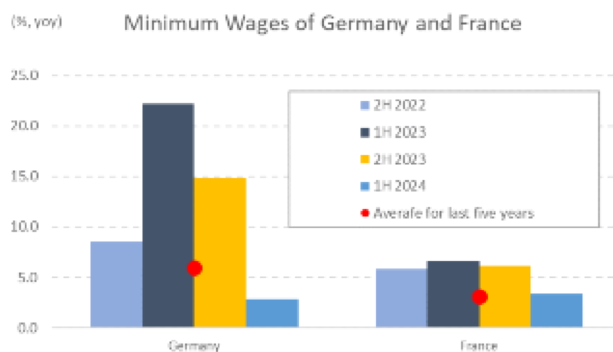


(Source) Bloomberg

The good news, however, is that the euro area economy can now be said to have succeeded in making a soft landing, avoiding the deep recession that had been feared. Looking at individual countries, Germany (whose increasing economic weakness has inspired the "sick man returns" media theme) recorded -0.3% yoy negative growth after recording zero growth for two consecutive quarters. In the last seven quarters, Germany has achieved positive growth in only two quarters (negative growth was suffered in three quarters and zero growth recorded in in two quarters). While it remains unclear whether the euro area has entered a technical recession or not, Germany appears to be on the brink of a full-fledged recession. In addition, France recorded zero economic growth for the second consecutive quarter, so the euro area's two most important economies (accounting for about 50% of the euro area's GDP) have not been growing at all recently. It is worth noting that Germany is the only euro area country that has not been able to re-attain its pre-pandemic real GDP level.

Clear Deceleration of Wage Growth

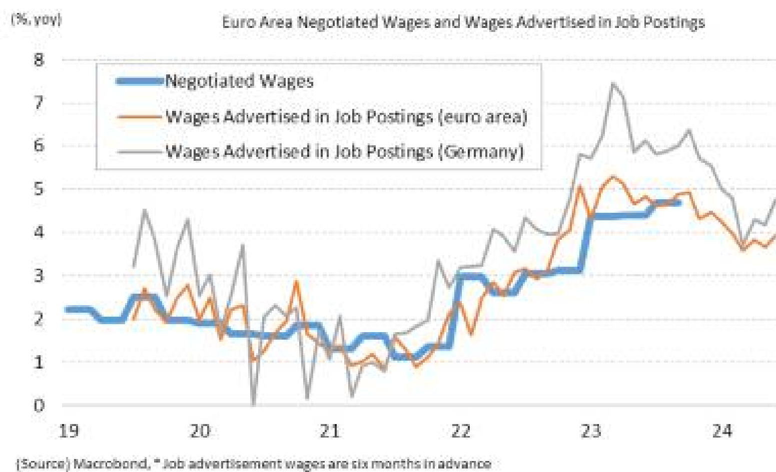
One of the ECB's policy management objectives is to determine sometime this summer whether the employment and wage indicators released through the end of May justify an interest rate cut. In this regard, reflecting the sluggish conditions in the real economy, there has been a marked deceleration in wage growth in Germany, and this deceleration is expected to have a growing impact on wage growth trends throughout the region. Minimum wage statistics published every six months by Eurostat indicate that Germany's minimum wage growth has sharply decelerated from +22.2% yoy in the first half of 2023 to +2.9% yoy in the first half of 2024. Other member states, including France, have shown a similar trend of minimum wage growth deceleration in the 2023-2024 period, but the slowdown in Germany is particularly striking.



(Source) macrobond

Important Appraisal of Euro Area Wage Situation this Summer

Aiming to obtain a more accurate and timely understanding of the wage situation, the ECB closely monitors a wage trend survey that analyzes job advertisements on private digital platforms (conducted by the Central Bank of Ireland and the U.S.-based job search site Indeed.com), and that survey indicates that Germany's wage growth deceleration trend is indeed promoting similar deceleration trends throughout the euro area, which suggests that the euro area's negotiated wage situation will become increasingly stable going forward. Given that there is a lag of about six months before the wage levels cited in job advertisements take effect, the ECB seems to be fairly justified in setting its target of determining sometime during the "summer" whether the wage situation has stabilized. At that time, the rate of growth in negotiated wages is expected to have settled in the 3%-4% range, and a soft landing situation with the rate of wage growth declining toward 2% may be in sight. If the situation progresses as most observers are expecting, with U.S. interest rates being cut at either the May or June FOMC meeting, the Europe-U.S. interest rate gap will not narrow much, and there should be no trend of sharp EUR depreciation.

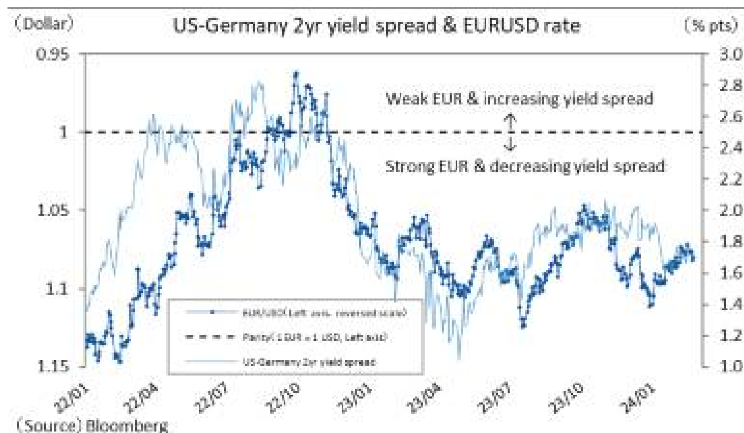


(Source) Macrobond, * Job advertisement wages are six months in advance

EUR Now and Going Forward – Downside Buttressed by Solid Supply-Demand Structure

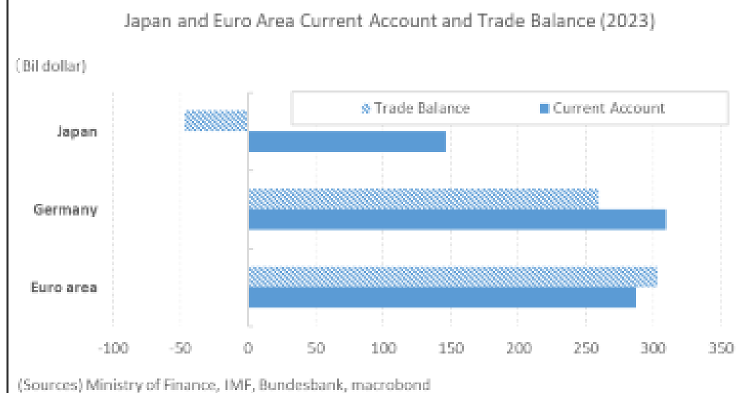
Upcoming EUR/USD Trends

The continued elevated levels of USD/JPY and new highs being recorded in Japanese stock prices have caused financial market interest to become largely focused on Japan and the United States, while new information regarding the euro area has become somewhat scarce, but it is worth taking a moment to overview the latest euro area trends. My view is that even if the ECB decides to cut interest rates in the second half of this year, a trend of sharp EUR depreciation is unlikely. I see at least two reasons for this forecast. Firstly, the Europe-U.S. interest rate gap is unlikely to change significantly. Secondly, the EUR supply-demand structure within the euro area is solid. It is generally understood that, just as USD/JPY is strongly affected by the Japan-U.S. interest rate gap, the direction of EUR/USD is likely to be determined by the Europe-U.S. interest rate gap (see graph). My assumptions are that the Fed will cut U.S. interest rates in the first half of this year (in May or June) and that the ECB will follow suit with interest rate cuts sometime around September. As both central banks are seen as being on track to cut interest rates by 25 basis points, it appears that it will be difficult to forecast EUR/USD trends based on Europe-U.S. interest rate gap trends. There were previously strong arguments that the relative weakness of the euro area's real economic conditions relative to real economic conditions in the United States would promote EUR depreciation, but the euro area's real economy is showing increasing signs that it may avoid a recession. If the euro area does indeed avoid a recession, it will be difficult to maintain an assumption that the ECB will need to cut interest rates by a larger margin than that of the Fed's interest rate cuts. Given that the ECB's policy interest rate level is lower to begin with and that (although the euro area may have avoided a recession) the euro area's real economy is likely to continue to be extremely weak going forward, however, I anticipate that the interest rate gap will determine the direction of EUR/USD, and it seems safe to assume that EUR is basically positioned to trend downward.



(Source) Bloomberg

Solid EUR Supply-Demand Environment



I have argued for some time that EUR supply-demand environment trends are the biggest reason why EUR has not sharply depreciated. In 2022, the skyrocketing of oil and natural gas prices following the start of the war between Russia and Ukraine caused considerable drops in Germany's current account and trade surpluses along with decreases in the euro area's overall current account and trade surpluses. While Germany has been recording the world's largest trade surpluses, its trade surplus almost disappeared in mid-2022, and it is no coincidence that EUR fell below parity with USD around the same time (see graph, above right). While EUR was below parity with USD during the 2000-2002 period, growth in Germany's trade surplus eventually caused a sharp rise in EUR/USD. Currently, natural gas prices have stabilized due to the mild winter weather seen in 2022 and the development of alternative procurement sources in Northern Europe, and that stabilization has enabled the resurgence of Germany's trade surplus as well as the euro area's current account surplus. One gets a strong impression that these factors are supporting an uptrend in EUR/USD. From a Japanese perspective, it is worth keeping in mind the fact that the main pillar of the euro area's current account surplus is its trade balance surplus, while the main pillar of the Japan's current account surplus is its primary income balance surplus, and this difference is reflected in trends in EUR and JPY (see graph, below right). Although Japan and Germany both have large economies and record large current account surpluses, the structure of their current account surpluses is different, particularly with respect to how those surpluses support the value of their currencies, and EUR currently has a far more solid supply-demand structure than JPY.

Speculative EUR Buying Power

Looking at speculative positions based on IMM currency futures trading figures as of February 20, one finds that speculators' long positions in EUR against USD have expanded to USD9.19 billion, although this is somewhat under one-third of the peak level seen during the past year (USD25.853 billion in May 2023). In light of that situation, it appears safe to say that there is still considerable leeway remaining for speculative EUR buying. With the ECB expected to maintain its status quo in March, April, and June, I think there may be a tendency (albeit a temporary one) for EUR to strengthen against USD, given the potential for U.S. interest rate reductions. To summarize my forecast for the coming year, I anticipate that EUR will tend to strengthen during the first half of the year and tend to weaken during the latter half of the year owing to ECB interest rate cuts, but that EUR's solid supply-demand environment will prevent EUR/USD from declining below USD1.05.

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