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Forex Medium-Term Outlook

March 29, 2024

Overview of Outlook

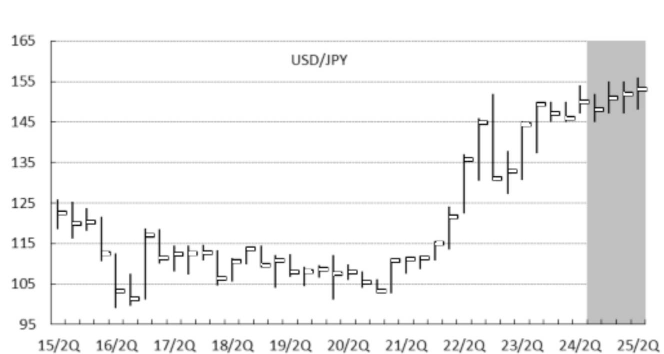
In March, USD/JPY surged to its highest in 34 years. The BOJ's exit from negative interest rates, which had been considered the only and biggest Japan-side factor that could promote JPY appreciation, ended up "selling the rumor and selling the fact." The details of the BOJ's decision to end negative interest rates were designed to emphasize consideration for the bond markets, and as a result, it did not have the expected impact on the forex markets in terms of curbing JPY depreciation. In its current state, the Japanese economy is submitting to JPY depreciation in return for reining in interest rates. As I have said many times in this report, trying to explain JPY rate trends solely based on the U.S.-Japan interest-rate differential amounts to abandoning critical thinking; the structural change in JPY supply and demand must also be considered. Japan's cash-flow-based current account balance has consistently been in deficit, and net outflow of funds through foreign securities investment via investment trusts has been growing at an unprecedented pace. Compared with a year ago, there is a clear increase in the use of the balance of payments and other structural changes in JPY supply and demand to analyze JPY rate trends, as is evident from the Ministry of Finance setting up a panel of experts to review the balance of payments. The Fed delaying rate cuts is not the reason why JPY continues to weaken. JPY continues to weaken because Japan has become unable to earn foreign currency. Of course, investors can expect buying opportunities aligning with the Fed's rate cuts, but these are not likely to be major buying opportunities. Taking into account the BOJ's failure to put its negative-rate-exit option to good use, I will consider upwardly revising my forecast range for USD/JPY.
EUR/USD remained deadlocked in March. Following the March ECB Governing Council meeting, the markets appear to have been promised a state of tranquility for the time being. Until some time ago, my main forecast scenario was that EUR rates would be driven down due to the ECB being forced to start rate cuts early in view of the significantly poorer performance of the euro area's actual economy compared with the U.S. However, it now appears that the euro area economy might be able to avoid going into a deep recession. The Fed and the ECB may, therefore, start implementing rate cuts at around the same time, which means there may be no major changes in the Europe-U.S. interest rate differential during the current forecasting period. Consequently, the EUR/USD rate trend is also predicted to remain deadlocked with no clear sense of direction. Taking a look at the regional economy, nominal wages (the factor that will determine the start of rate cuts by the ECB) are expected to remain strong. They are predicted to post as much as +4.5% growth this year. Going by past experience, the Harmonized Index of Consumer Prices (HICP) is unlikely to settle at around +2.0% against this backdrop of soaring nominal wages, which also makes it unlikely that the ECB will rush to implement rate cuts. Further, the PMI reveals strong business confidence in the service sector, so there are no signs of a marked slowdown in nominal wage growth. Under such circumstances, there are no strong market expectations that could lead to factoring in an early start to ECB rate cuts. I would like to predict that rate cuts by the ECB will begin only in 2H of the year. It must, however, be noted that the solid demand for EUR, primarily relying on the German economy, is also thanks to winter 2023 having been quite mild. This is an important factor that has been preventing an EUR crash.

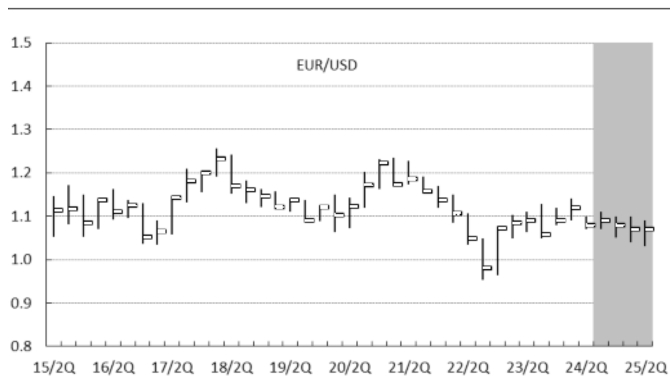
Summary Table of Forecasts

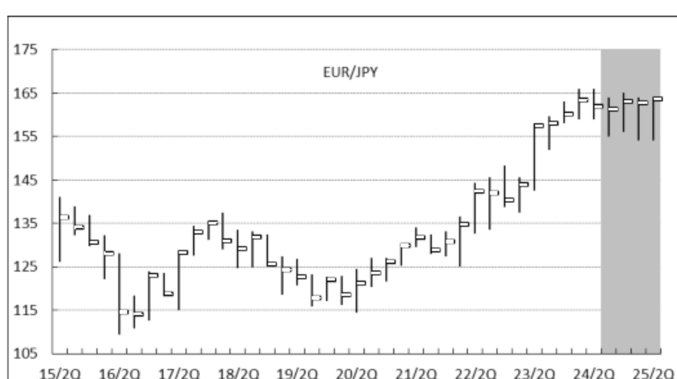
	2024 Jan-Mar (actual)	Apr-Jun	Jul-Sep	Oct-Dec	2025 Jan-Mar	Apr-Jun
USD/JPY	140.80 ～ 151.97 (151.32)	147 ～ 154 (150)	145 ～ 152 (148)	147 ～ 155 (151)	147 ～ 155 (152)	148 ～ 156 (153)
EUR/USD	1.0695 ～ 1.1046 (1.0784)	1.07 ～ 1.10 (1.08)	1.07 ～ 1.11 (1.09)	1.05 ～ 1.10 (1.08)	1.04 ～ 1.10 (1.07)	1.03 ～ 1.09 (1.07)
EUR/JPY	155.10 ～ 165.33 (163.15)	159 ～ 166 (162)	155 ～ 164 (161)	156 ～ 165 (163)	154 ～ 164 (163)	154 ～ 164 (164)

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

Exchange Rate Trends & Forecasts







USD/JPY Outlook – Year-to-Date High Triggered by BOJ's Considerateness

Japan's Monetary Policies Now and Going Forward – JPY Depreciation is the Price of BOJ's Considerateness

Markets Ended up Selling the Rumor and Selling the Fact
At its March 18-19 Monetary Policy Meeting, the BOJ decided to tighten monetary policy by (1) ending yield curve control (YCC), (2) raising the target uncollateralized overnight call rate from -0.1% to +0~0.1%, and (3) discontinuing purchases of exchange-traded funds (ETFs) and Japan real-estate investment trusts (J-REITs). This is the first rate hike implemented by the BOJ in 17 years. The Bank's decision regarding the scale of long-term Japanese government bond (JGB) purchases was also a focus of interest alongside the abolition of negative interest rates, and in this regard, the Bank decided to "continue its JGB purchases with broadly the same amount as before" (roughly JPY 6 trillion per month). As I will explain in detail later, this decision appears to have significantly diluted the hawkish tone of the recent meeting and greatly influenced the forex markets' response.
To be specific, while the recent MPM had many noteworthy points (including the return from the Kuroda administration's aberrant three-tiered interest rate system back to a single-tiered system and the lowering of the ceiling of the planned range of JGB purchases in open-market operations during the April-June period this year), overall, the markets were able to see through the BOJ's wavering between wanting and not wanting to raise interest rates.
USD/JPY, which was being closely watched, soared to post its year-to-date high immediately after the decision to raise interest rates. In my preview[1] before the MPM, I had warned that, as a result of the various leaks, the market course may be headed toward "sell the rumor, sell the fact" rather than the standard "buy the rumor, sell the fact." My concern seems to have been warranted. Whether due to malice or negligence, once the contents of its upcoming decisions were leaked to the market, the Bank became obliged to exceed prior expectations. However, those obligations were too difficult to meet given the state of Japan's real economy, with vulnerabilities in personal spending and production.

Ruined by Considerateness for Bond Market
As many market participants feel, the decisions taken at the recent MPM were considerate to the bond markets. There is no doubt that this considerateness ruined the BOJ's decision for JPY by prompting "selling the fact" in forex markets. In fact, even after the BOJ decided to raise interest rates, Japan's long-term interest rates continued to decline. In return for strengthening protection of the bond market against attacks, the BOJ weakened protection of the forex market. The Japanese economy has been reduced to a position where it must choose between putting up with one of either interest

[1] Please see March 18 Mizuho Market Topic titled "JPY Trends Suggest Likelihood of Selling the Rumor and Selling the Fact."

rate appreciation or JPY depreciation, and as of the present time, market participants should understand that JPY depreciation has been chosen in return for avoiding an increase in interest rates.

The BOJ's considerateness for the bond markets can be gauged from its long-term JGB purchase adjustment policy. The monetary policy statement notes, "The Bank will continue its JGB purchases with broadly the same amount as before. In case of a rapid rise in long-term interest rates, it will make nimble responses by, for example, increasing the amount of JGB purchases and conducting fixed-rate purchase operations of JGBs -- both of which can be done so regardless of the monthly schedule of JGB purchases -- and the Funds-Supplying Operations against Pooled Collateral." Given that the BOJ owns over half of all JGBs issued, such a policy will result in a continuation of YCC in practical terms despite its termination in form. Of course, continuing with the JPY6-trillion purchase amount could be positioned as a shock-absorbing measure until such time as the Bank begins to shrink its balance sheet (quantitative tightening, QT), as can be gauged from the fact that the ceiling of the planned purchase amount has been lowered. However, the promise to "make nimble responses by, for example, increasing the amount of JGB purchases and conducting fixed-rate purchase operations of JGBs (…) and the Funds-Supplying Operations against Pooled Collateral" makes what was supposed to be an important adjustment policy no different from the previous policy except for the exit from negative interest rates. Also, as is generally known, the "discontinuation" of risky asset (ETF and J-REIT) purchases is insignificant, given that these purchases were not being made to begin with.

This benevolent considerateness toward the bond markets inevitably nullified the expected impact on forex markets, namely that of containing JPY depreciation. Perhaps the exit from negative interest rates was considered the main issue at hand, and multiple leaks were allowed until right before the decision was made precisely in order to achieve a soft landing. However, given that Japan follows the floating exchange rate system, any effort to prevent interest rates from rising is bound to come as a set with allowing JPY depreciation to continue. As the BOJ is likely to know, Japan does not have the political or economic strength to take rising interest rates lightly, so perhaps the recent turn of events was inevitable.

Topic Shifts from Monetary Policy to Declaration of Exit from Deflation

The BOJ's monetary policy statement released after the recent meeting clearly stated, "Given the current outlook for economic activity and prices, the Bank anticipates that accommodative financial conditions will be maintained for the time being." Taken at face value, this seems to suggest that there will not be successive rate hikes, so asset price formation in the financial markets will have to be based on this forward guidance going forward (leaving aside the fact that, strictly speaking, when a neutral interest rate cannot be identified, the relationship between accommodative financial conditions and rate hikes is variable). However, even assuming that the BOJ's monetary policy operation enters a period of calm from here on, there does remain one point of concern – the government's declaration of exit from deflation.

One of the reasons the BOJ was able to make the decision to exit negative interest rates this time is the fact that the first tally of the spring wage negotiations revealed the largest wage hikes in 33 years. This, undoubtedly, made it easier to get political approval for the BOJ's decision. As is widely known, Prime Minister Fumio Kishida has been devoting himself to urging companies to raise wages and formulating tax policies to incentivize wage increases. The government/ruling party would probably like to take credit for the improvement in the employment/wage climate that has resulted in the exit from negative interest rates as being the effect of its policies, and declaring an exit from deflation is a good symbolic move to achieve this. My position is that a declaration of exit from deflation is fundamentally difficult, but if at all it happens, it may happen during 2H of the year. Many reasons can be offered for this, one of which being that the implications of an exit from negative interest rates are very different from those of exit from deflation. One of the reasons there was no major public opposition to the recent exit from negative interest rates may be because it was speculated that an exit from negative interest rates would check JPY depreciation. Declaring an exit from deflation, however, would give the impression that the government is endorsing a clear improvement in business sentiment.

The implications of deflation are different for different economic entities. For the government and BOJ, deflation probably implies stagnant consumer price index (CPI) growth. For companies and foreign investors, it may imply stagnant share prices. What about for households? There is no single correct answer to this, but I believe stagnant real wages is one implication. I think this sense of "something being not quite right with the economy," which different entities experienced in different ways, has been expressed using the term "deflation" over the past three "lost decades." Also note that, reflation, embodied by Abenomics, was declared to be the brilliant move that had the power to reverse deflation in one stroke.

Based on the above assumptions, it would seem that any move by the government to declare an exit from deflation would be timed to avoid a public outcry, i.e., to coincide with the alleviation of households' sense of stagnant real wages. In this context, real wage growth is expected to turn positive at some point this year (in summer at the earliest), when a decline in CPI coincides with rising nominal wages. Now, since 2024 is a year that could see a snap general election, it may be wise to assume that the real wage growth turning positive, the declaration of an exit from deflation, and a snap general election could all come together as a set.

2024 Still the Year that Could Confirm a Short Break in Long-Term JPY-Depreciation Trend

The various aforementioned government/BOJ actions and moves do not impact my JPY outlook. Early in 2024, I wrote a Market Topic report titled "A Short Break in the Long-Term JPY-Depreciation Trend Possible in 2024." My view in this regard has not changed.

Even if prior communications to that effect were unfortunate, the BOJ did exit negative rates, and the markets have fully factored in three rate hikes by the Fed this year. Yet, USD/JPY remains at the 150 level. I had assumed that the BOJ's exit from negative interest rates would give investors at least a brief buying opportunity (JPY appreciation against USD), but it did not. This was because its potential to serve as a JPY-boosting factor got exhausted due to multiple leaks in

advance of the event. The fact that USD/JPY remains at the 150 level despite a rate hike by the BOJ shows that trying to understand USD/JPY rate trends solely based on the U.S.-Japan interest-rate differential amounts to abandoning critical thinking.

Over the past two years, I have continued to argue in this report that JPY supply-and-demand rather than interest rates hold the key to understanding the current state and future outlook of JPY rates. In the beginning, I received absolutely no support for my theory (for instance, almost nobody but myself was talking about the digital deficit last year), but now that it has become difficult to explain JPY depreciation against USD based on the U.S.-Japan interest rate differential, analysts are gradually beginning to take an interest in the balance of payments. Of course, the Fed has not yet cut rates, so there is still a chance that JPY will appreciate to some extent when it does going forward. However, it must be strongly stated any such appreciation will be no more than a short break in the long-term JPY depreciation trend. As the BOJ failed to make good use of its one precious move that could have checked JPY depreciation (i.e., exit from negative interest rates), the prospect of USD/JPY falling below even 140 this year has become quite difficult.

Japan’s Current Economic and Financial Situation – The Nominal/Real GDP Gap and Japan’s Potential Transition to MIC Status

Understanding Disparities between Nominal GDP and Real GDP

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.

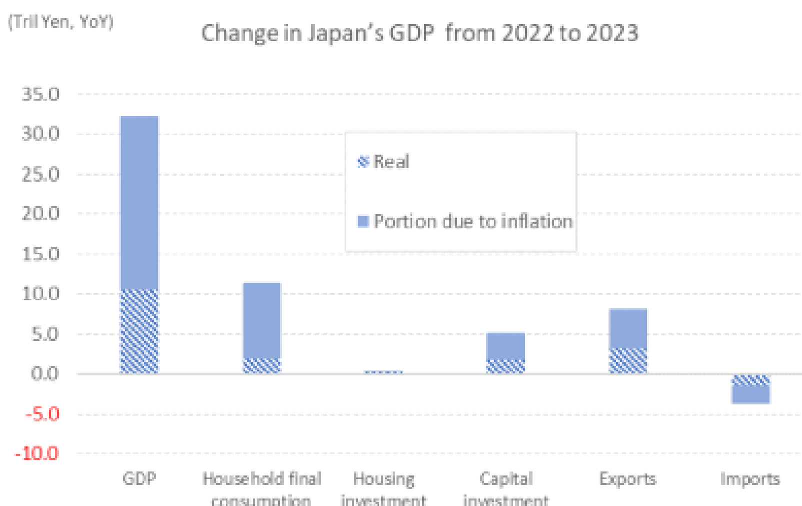
Previous editions of this article have discussed whether the Japanese economy is currently in the process of adjusting to inflation. For example, last month’s edition of this article discussed the concept that the Nikkei Stock Average Index’s attainment of a new all-time high probably was owing to the effects of inflation. While many people are celebrating the surge in Japanese stock prices that has taken place since the beginning of the year, however, there are also many who are lamenting the weakness of the country’s real economy. This seems to reflect a fundamental problem in that Japanese households generally have a low levels of stock ownership and that GDP growth attributable to inflation is not being fully passed on to households. The issue of low levels of household stock ownership is currently being addressed by the government’s efforts to transform Japan into an “asset management nation”, so for better or worse, it is expected that the stock ownership situation will be changing going forward. At this point, all we can do is wait to see what happens in that regard.

When discussing the degree to which inflation is responsible for the rise in Japanese stock prices (as well as for JPY depreciation and the rise in real estate prices), however, it becomes impossible to analyze the real economy without taking into account the disparities between nominal and actual GDP. As Japan has been suffering from deflation, it has been considered significant that usual disparity between nominal and actual GDP (the “real GDP < nominal GDP” pattern seen in economies with inflationary trends) has been reversed in the case of Japan (i.e., real GDP > nominal GDP). According to the “Nominal GDP – (Nominal GDP x Inflation rate) = Real GDP” definition, the most common situation (since most economies have some degree of inflation) is “Real GDP < Nominal GDP”, but in economies with negative inflation rates (deflation), the situation is “Real GDP > Nominal GDP”. Of course, genuine economic growth as perceived by a country’s population means that the economy is expanding in terms of real GDP, which excludes the portion of changes in GDP attributable to inflation or deflation. If my salary doubles but the prices I have to pay also double, my perception of the economy will not change, even though nominal GDP would have expanded significantly. That is why it is important to look at the disparities between nominal GDP and real GDP in inflationary economies.

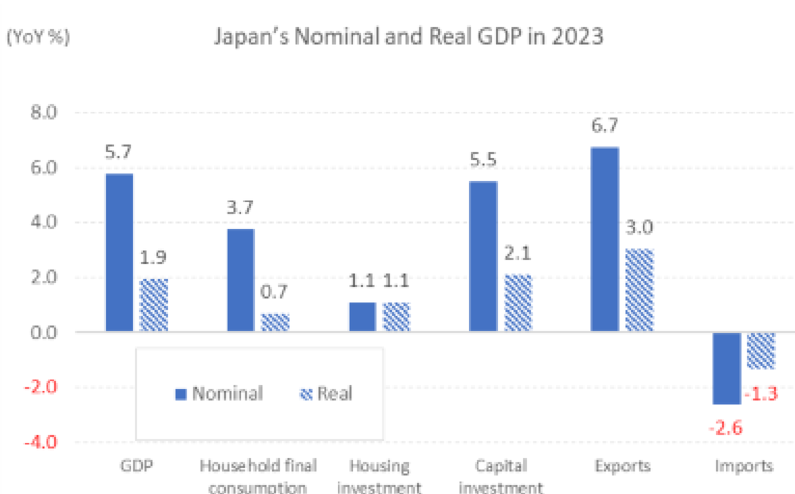
Most Nominal GDP Growth Offset by Inflation

If Japan’s economy really becomes an inflationary one going forward, it will then accord with the normally assumed “real GDP < nominal GDP” pattern. As the government has already announced, the Japanese economy is now within sight of achieving in fiscal 2024 the “GDP of JPY600 trillion” goal set by the second Abe administration. (In 2015, the Abe administration set the goal of “GDP of JPY600 trillion by fiscal 2020”.) There has been a lot of positive press coverage about this prospective achievement, but it is important to note that the JPY600 trillion target relates to nominal GDP and there has been no mention of setting a real GDP target.

It is generally understood that inflation will naturally cause an increase in nominal GDP. If candies that used to sell for JPY100 become priced at JPY120 or JPY150, nominal sales will increase even if the same quantity is sold, so the increase in prices of goods and services alone will cause a rise in nominal GDP. Thus, everyone can acknowledge that the essentially important issue is how much growth is being achieved in real GDP, excluding the effects of inflation. Attaining the "nominal GDP of JPY600 trillion" goal may superficially seem to be a significant achievement, but that achievement does not necessarily guarantee a genuine expansion or strengthening of the economy. It is worth taking a closer look at the data on the disparities between nominal GDP and real GDP.



(Source) Cabinet Office



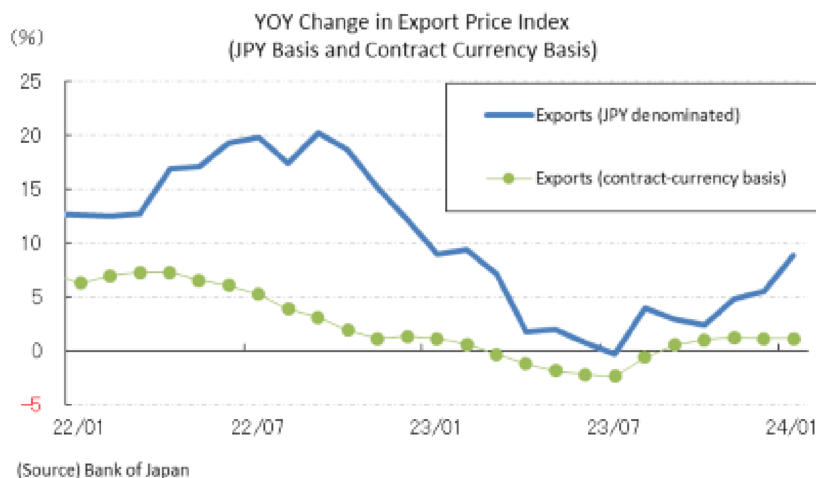
(Source) Cabinet Office

For example, Japan's nominal GDP in 2023 increased by approximately JPY31 trillion to approximately JPY591 trillion, from approximately JPY560 trillion in 2022 (see graph on right, above). However, over the same period, the country's real GDP increased by only about JPY11 trillion, from about JPY548 trillion to about JPY559 trillion. Approximately JPY20 trillion of the nominal GDP growth simply reflected inflation, and this portion cannot be considered tangible economic growth that benefits Japan's population. Thus, while Japan achieved a nominal GDP growth rate of 5.7% in 2023, the country's real GDP growth rate was only 1.9% (see graph on right, below). Taking an example more directly relevant to how Japan's population perceives the economy, household final consumption increased by approximately JPY11.4 trillion in nominal terms during 2023, but the portion of that due to inflation was approximately JPY9.4 trillion, so household final consumption in real terms only increased by approximately JPY2 trillion. The nominal rate of growth in household final consumption was 3.8%, but the real growth rate was only 0.7%, illustrating how most of the nominal increase in consumption was offset by inflation. To reiterate, when inflation occurs, nominal sales and profits will increase in the short term, and stock prices are likely to be pushed upward. However, the short-term rise in nominal sales and profits simply reflects consumers' efforts to keep up with inflation, and this situation ends up creating a scenario like the current one in Japan, where domestic demand has no upward momentum despite rises in stock prices. Since consumers cannot keep up with inflation over the longer term without increases in their real incomes, the gap between nominal GDP and real GDP can be expected to widen in the long run.

Background of Strong Export Performance

As you can see from the graphs, exports are the only GDP segment that is recording robust growth in real terms. The increase in exports was approximately JPY8.1 trillion in nominal terms but only approximately JPY3.3 trillion in real terms, and the increase due to inflation was approximately JPY4.8 trillion. Although the portion of the rise in exports attributable to inflation was quite large, the nominal/real growth ratio for exports can be seen to be considerably better than that for household final consumption and capital investment. This is evidence that exporting companies are finding it possible to shift their inflation burden by passing it on to higher overseas prices.

This shifting of the inflation burden can be confirmed from related statistics. Since July 2023, Japan's export product price index has been trending upward even in terms of contract currencies (≈ overseas markets' currencies), and this clearly indicates that domestic and foreign inflationary pressures are being shifted in the form of higher export product prices (see graph). Theoretically, JPY depreciation will cause exporting companies to lower contract currency denominated prices and thereby achieve increases in export volume. If a company was exporting a ballpoint pen for USD1 when the USD/JPY was JPY100, for example, then when JPY depreciates to USD/JPY120, it will be possible for that company to maintain its JPY-denominated sales revenue even if exports the pen at USD0.83 (0.83 x JPY120 ≈ JPY100). From the statistics, however, it appears that what Japanese export companies are currently doing is raising the price of the ballpoint pen to USD1.20 or USD1.50, and their JPY-denominated sales revenue will therefore increase considerably (for example: $1.2 x JPY120 ≈ JPY144). Moreover, since JPY has depreciated much more than in this example, the extent to which exporting companies' performance will improve due to JPY depreciation will be even greater. This inflation-related situation may be a major factor pushing Japanese stock prices upward.



(Source) Bank of Japan

Is Japan Gradually Shifting to MIC Status?

If exporting companies are able to achieve a certain amount of real basis growth in their sales and profits, a key question is whether those companies will shift a portion of the benefits of that growth to the domestic household sector by such means as nominal wage increases. It appears that such shifting has not taken place to a sufficient degree, given that household final consumption has hardly grown in real terms. While the BOJ is hoping to see the creation of a virtuous cycle of inter-related increases in both wages and prices, which it refers to as the "second force", it unfortunately cannot be said that such a virtuous cycle has yet begun emerging.

Overviewing the performance of the world's major stock indexes over the past year, one finds that such developing countries with high rates of inflation as Argentina, Nigeria, Turkey, and Egypt are among the countries that have achieved stock index growth rates higher than the rate of increase in the Nikkei Stock Average (see chart). Countries with high levels of inflation tend to see rapid depreciation of their own currencies, which tends to push up the level of stock indexes denominated in those currencies. Such situations are common in developing countries but not seen so often in such developed countries as Japan. Although it would be an exaggeration to say that Japan is actually similar to developing countries at this point, it is worth considering the possibility that the current rise in Japanese stock prices reflects a certain basis for suspicion that Japan might be gradually becoming more akin to developing countries and less akin to other developed countries. Countries mid-way along the path of transition from developing country status to developed country status are sometimes referred to as middle-income countries (MICs), but is it realistic to suspect Japan might be shifting toward MIC status? If Japan's trend of stock price increases is being promoted by a real economic situation that is being greatly impacted by inflation, and if the forex market is factoring in the possibility that Japan may be slowing moving toward MIC status, then one should recognize the possibility that the trends of stock price increases and JPY depreciation may prove to be quite lengthy. At this point, it seems difficult to find a sufficient basis for completely rejecting that hypothesis.

	Key Global Stock Price Indices (Top 10 by Rate of Increase)	Rate of Increase	Rate of Change If Local Currency Converted into USD
1st	S&P MERVAL, Argentina	326.09%	-76.5
2nd	EGX 30 INDEX	81.29%	-70.0
3rd	NGX ALL Share Index, Nigeria	78.01%	-0.8
4th	BIST 100, Istanbul	70.89%	-40.5
5th	Lusaka Stock Exchange AI	65.33%	-15.5
6th	BIST 30, Istanbul	63.66%	-40.5
7th	KSE100 Index, Karachi	59.53%	-1.3
8th	Budapest Stock Exchange BUX Index	49.23%	-2.2
9th	KASE Index, Kazakhstan Stock Exchange	46.25%	-4.7
10th	Nikkei Average	43.62%	-9.7
32th	NY Dow Jones Industrial Average	16.77%	-

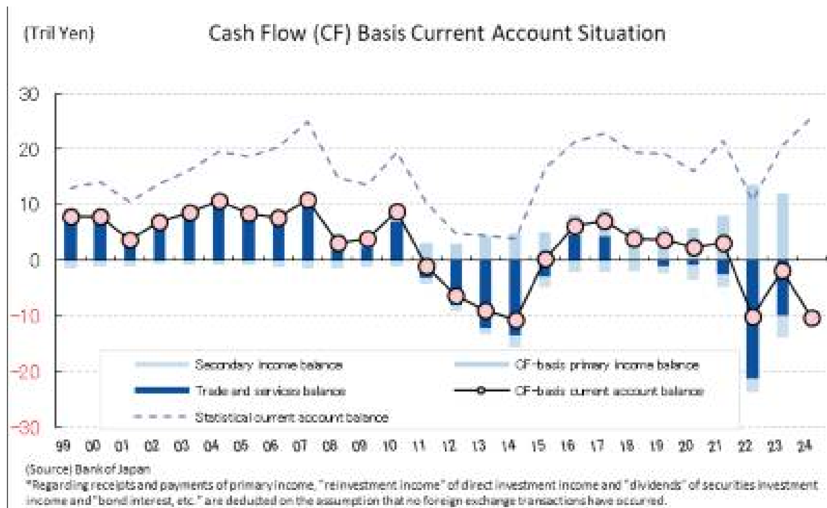
(Source) Bloomberg,
For a 12-month period from March 3, 2023 to March 4, 2024.
March 4th was the day when the Nikkei Stock Average exceeded 40,000 yen for the first time.

JPY Supply-Demand Environment – Japan Recording CF Basis Current Account Deficits from 2024

Japan's CF Basis Current Account Balance for January

The Nikkei Stock Average collapsed in mid-March, and USD/JPY briefly plummeted at that time but soon recovered to around USD/JPY147. At the time, speculators held large outstanding JPY short positions (estimated from IMM currency futures data), and there was considerable leeway for JPY buying, but JPY did not appreciate significantly even during a genuine risk-off phase (when the Nikkei Stock Average fell by more than JPY1,000 in a single day). This situation once again highlighted the importance of the argument that changes in the JPY supply-demand environment are the main factors promoting JPY depreciation.

In this regard and with respect to Japan's international balance of payments data for January (released on March 8), I have received several inquiries about changes in the cash flow (CF) basis current account balance figures I have been calculating. It would be difficult to draw momentous conclusions from data for a single month. Moreover, because of timing distortions stemming from the Chinese Lunar New Year holiday period (from January 22 to February 5 in 2023 and from February 10 to February 24 in 2024), it is best to assess the international balance of payments statistics for January and February together, but given the apparently high level of interest, I will present the figures for January. Regarding the nominal data, Japan's current account balance for January was a surplus of JPY438.2 billion, and the media generally highlighted the fact that Japan recorded a JPY2,013.6 billion current account balance deficit last January but a surplus this January. While that is strictly true, it would be better if the media were to also report that, because the timing of Japan's exports is greatly affected by the Chinese Lunar New Year factor, there are concerns that there may be a significant drop in those exports during February. However, the media are continuing to focus on the story that, despite a huge deficit in the balance of trade and services (JPY1,963.8 billion), Japan achieved a huge surplus in its primary income balance (JPY2,851.6 trillion). That story is true in one sense, but a more-in-depth analysis is required to estimate the effect of current account balance trends on the JPY supply-demand environment. I begin that analysis by estimating the primary income surplus JPY conversion rate (the percentage of the surplus that is thought to be associated with JPY purchases), and the average rate for the latest four quarters has recently been roughly in the 25-30% range. Using that JPY conversion rate to calculate the current account balance <u>on a CF basis, I find that Japan's current account balance for January was an approximately JPY1.8 trillion deficit, the first such deficit in two months (see graph).</u>



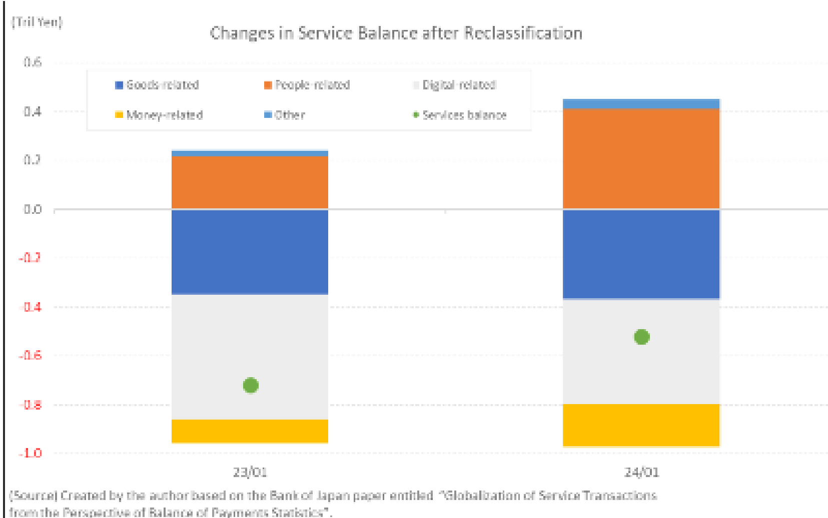
(Source) Bank of Japan
*Regarding receipts and payments of primary income, "reinvestment income" of direct investment income and "dividends" of securities investment income and "bond interest, etc." are deducted on the assumption that no foreign exchange transactions have occurred.

<u>I have long maintained that, despite Japan's statistical surpluses, the country is continuing to record actual deficits on a CF basis, and that it will be difficult to restrain JPY depreciation so long as this situation continues</u>.

Japan's Digital Deficit

In addition to queries about trends in Japan's CF-basis current account balance, many people have asked me about the size of the country's digital deficit. The digital deficit is likely to be a hot topic for some time to come, as evidenced by the increasing number of special features on this topic that have been appearing in newspapers and magazines as well as on television. Calculated by rearranging items related to Japan's service balance, <u>the country's digital deficit was JPY430.7 billion in January 2024, and this is slightly smaller than JPY512.6 billion digital deficit in January 2023. However, the average level of Japan's monthly digital deficit has recently been JPY460 billion, and there are no signs that the deficit will be significantly shrinking soon, so it would perhaps be best to just accept it as a chronic phenomenon that will be around for the foreseeable future</u>. On the other hand, Japan's human-related surplus, driven by the travel surplus, increased to JPY410 billion in January 2024, roughly double the JPY217.9 billion level of January 2023. As a result, Japan's overall services balance for January 2024 was a deficit of JPY521.1 billion, a significant improvement from the JPY717.7 billion deficit for January 2023. On the other hand, the large improvement in the human-related balance simply reflects the fact that Japan was still imposing strict immigration restrictions in the first quarter of 2023, and it will only become possible to make fair yoy comparisons from April this year.

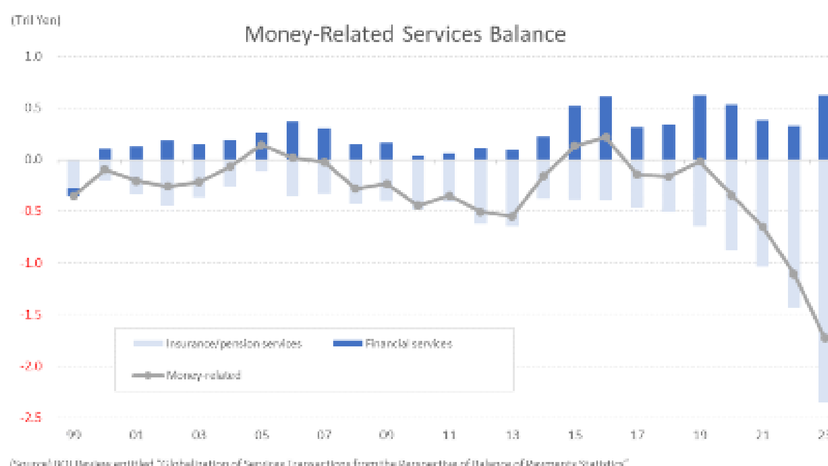
I anticipate that, going forward on a monthly average basis, Japan will be recording digital-related deficits of JPY460 billion, human-related surpluses of JPY310 billion, money-related deficits of JPY140 billion, and goods-related surpluses of JPY62 billion. The country will thereby end up recording annual overall services deficits of between JPY3.0 and JPY3.5 trillion. Changes are underway in demand related to digital services and inbound tourism, so it is necessary to a maintain a certain degree of flexibility in evaluating these items. However, considering that the average level of Japan's annual services balance deficits during the second Abe administration was only JPY1.5 trillion, it should be recognized that foreign currency leakage stemming from service transactions is a major change confronting the Japanese economy.



(Source) Created by the author based on the Bank of Japan paper entitled "Globalization of Service Transactions from the Perspective of Balance of Payments Statistics".

Focusing on "New Era Deficits" Rather Than Digital Deficits

As mentioned above, Japan is recording average monthly money-related deficits of about JPY140 billion, and this figure has been tending to increase owing to such factors as a rise in Japanese insurance companies' reinsurance payments. For the full year of 2023, the money-related deficit was approximately JPY1.7 trillion, which offset roughly half of the human-related surplus (approximately JPY3.0 trillion), so it cannot be said to be an insignificant item. In light of that, rather than focusing on the increasingly conspicuous digital-related balance deficit alone, I believe it important to analyze how JPY depreciation is being induced by what I would call Japan's "new era deficits", defined as encompassing both digital-related and money-related balance deficits. During 2024, there will likely be more periods in which the direction of USD/JPY is determined by interest rate trends, but it will ultimately be the JPY supply-demand environment that determines the USD/JPY level, so I am confident that balance of payments analysis will continue to be the key focus of analyses aimed at forecasting trends in JPY exchange rates and, by extension, in the Japanese economy.

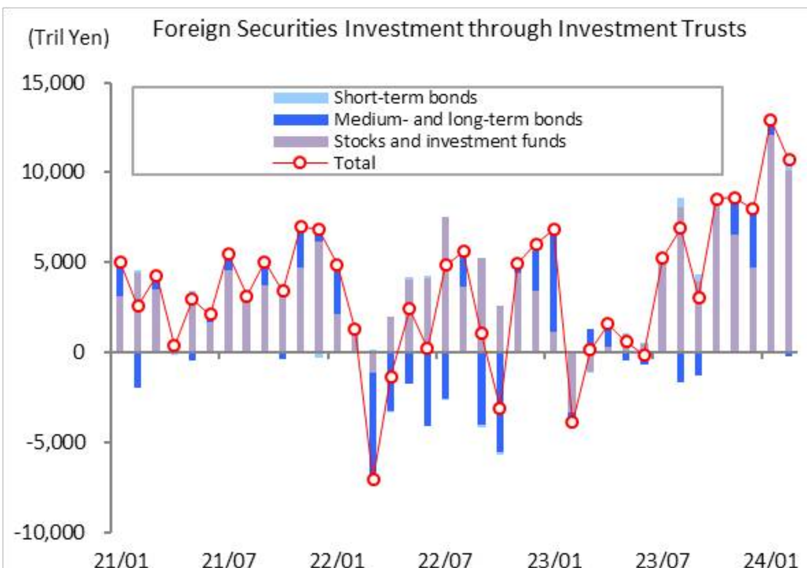


(Source) [illegible] Review entitled "Globalization of Services Transactions from the Perspective of Balance of Payments Statistics"

Household Sector Investment Behavior – Testing the Mettle of Japanese Individual Investors

Net Buying of Foreign Securities Exceeds JPY1 trillion for Two Consecutive Months

Even after the BOJ's move to discontinue negative interest rates, USD/JPY continued to rise in March, reaching a new year-to-date high. Given that JPY's excessive depreciation has not been alleviated even after negative interest rate discontinuation, which is considered to be a measure aimed at narrowing the Japan-U.S. interest rate differential, it clearly is no longer possible to explain the current situation from an interest rate perspective. In this regard, information from the "International Transactions in Securities" report (based on reports from designated major investors) released by Japan's Ministry of Finance on March 8 can help explain the link between JPY's current weakness and trends in the JPY supply-demand environment. Investment trust management companies (hereinafter simply referred to as investment trusts) are being

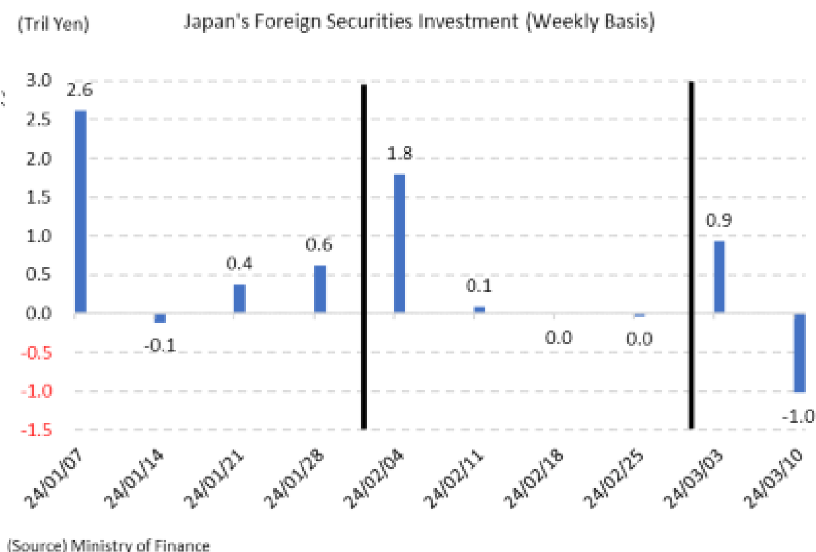


(Sources) Ministry of Finance, INDB

closely watched as a means of evaluating how much Japan's new Nippon Individual Savings Account (NISA) system will stimulate individual investment, and those investment trusts recorded considerable net foreign securities purchasing in February, amounting to JPY1,071.4 billion. Following the record high level (JPY1,293.7 billion) seen in January, such net foreign securities buying exceeded JPY1 trillion for a second consecutive month in February, and this is the first time since this statistic has been compiled that such sustained high levels of net foreign securities buying have been recorded. Examining the investment trusts' purchases by product category, one finds that the "equity and investment fund shares" category amounted to JPY1,010.6 billion, accounting for almost all of the total net buying. Japanese investment in overseas securities via investment trusts (mainly focused on U.S. stocks) continues to be strong, and there are strong grounds for suspecting that this investment is promoting JPY depreciation.

Individual Investors Precipitously Discouraged in March

It will be interesting to see whether the momentum of investment in foreign securities will be maintained from March. Due to the timing of new NISA system installment investment settings, "household JPY selling" associated with the new NISA system tends to be concentrated at the beginning of the month. This situation is clearly seen in the weekly "International Transactions in Securities" reports for January and February, which show very high net buying levels in the first week of those months (followed by sharp declines). At the time of this article was written, weekly "International Transactions in Securities" reports were available for the March 3-9 and March 10-16 periods. In the March 3-9 period (the first week of March), net foreign securities investment amounted to JPY924.6 billion, which is quite large, but there has been considerable deceleration from levels in previous months (JPY2,611.7 billion in the first week of January and JPY1,791.2 billion in the first week of February). It has been pointed out that new NISA "growth framework" investment increased in a festive manner from the start of the year (New NISA provides separate frameworks for monthly installment "tsumitate" investments of up to JPY100,000/month and for discretionary growth "seicho" investments of up to JPY2.4 million/year.) and that the true scale of "household JPY selling" should gradually become clear as this inaugural festive spirit progressively dissipates going forward. In particular, early in the second week of March (March 10-16), the Nikkei Stock Average sharply adjusted, losing half of the margin of increase it had achieved since mid-February, and this is the first shock suffered by many individual investors who started their investing by taking advantage of the new NISA system. Reflecting that, the weekly report for the second week of March recorded JPY1,020.9 billion of net selling, the largest weekly net sell-off seen since the beginning of the year. Since then, the Nikkei Stock Average has attained new all-time high levels, so it does not seem to be a major cause for concern, but it may be that novice individual investors were traumatized by the temporary slump and might gradually lose their desires to invest. If many of the novice individual investors become discouraged from investing, one major factor promoting JPY depreciation could dissipate.



(Source) Ministry of Finance

Responding to measures taken in line with goal of becoming an "asset management nation" promoted by Japan's government and ruling party, many individuals in Japan have begun adopting a strategy focused on financial markets since the beginning of 2024, so it can be said that the "asset management nation" concept has been successfully launched. Given the retreat of investors in the second week of March, however, one has to wonder whether it will be possible to maintain the current level of enthusiasm for the concept. Having long focused on "household JPY selling" situation, this is a very interesting topic for me.

I had originally expected new NISA users to make growth framework investments during such major stock price downturns as the one seen in the second week of March, but is appears that there are still not many individual investors who are able to calmly take stock of the market from a medium-to-long-term perspective. In any case, mentally dealing with sharp price fluctuations is an integral part of investment, and if Japan is truly to become an asset management nation, more individual Japanese investors will need to see market slumps as buying opportunities rather than becoming precipitously discouraged.

Ratios of Foreign Currency Assets and Foreign Securities Nearing Record Highs

The BOJ's flow of funds statistics are an important basis for the fixed-point observation of trends in the household sector, and the latest flow of funds statistics, released on March 21, clarify the situation as of the end of December 2023. At the end of 2023, the balance of household financial assets reached a record high of JPY2,141 trillion. Over 95% of those assets were JPY denominated, and cash and deposits (excluding foreign currency deposits) accounted for over 50% of those assets, reflecting the persistent strength of Japan's "home asset bias". However, there are signs of a savings-to-investment shift with respect to JPY-denominated assets, and the share of stocks and investments within JPY-denominated assets maintained its record high level of 12.9% for the second consecutive quarter. Considering the Japanese stock price upsurge during the first quarter of this year, there is a high possibility that the share of stocks and investments within JPY-denominated assets will be found to have attained a new all-time high level as of the end of

March 2024 when the next set of flow of funds statistics becomes available. Changes in the share of foreign currency assets have been attracting particular attention against the backdrop of JPY depreciation, and this share rose to 3.7%, from 3.5% in the previous quarter, although this is still below the record high level (3.9%) recorded at the end of December 2007. Looking at changes from the end of December 2022 to the end of December 2023, one finds the foreign currency asset ratio increased by 0.5 percentage point, or JPY14.3 trillion, which is a large change over a single year. Investment trusts were the main driver of that increase, accounting for 0.4 of the 0.5 percentage point rise. This suggests that Japanese households have a strong desire to invest in investment trusts focused on overseas stocks. As mentioned above, the momentum of overseas securities investment via investment trusts has been unprecedentedly strong since the beginning of the year, so it appears highly likely that the foreign currency asset ratio will be found to have reached a new record high in the next set of flow of funds statistics (offering figures as of March 31, 2024), which will be the first data covering the period following the launch of the new NISA system. Both with respect to stocks and to foreign currencies, Japan's ongoing shift "from savings to investment" can be clearly confirmed.

Financial Asset Composition of the Japanese Household Sector（End of DEC 2023）

	Amount (tril yen)	（%）
Total assets	2,141.5	100.0
Foreign currency	78.7	3.7
Foreign currency deposit	6.7	0.3
Foreign securities investment	26.7	1.2
Investment trust	45.3	2.1
JPY-denominated	2,062.8	96.3
Cash and deposits (excluding foreign currency deposits)	1,120.8	52.3
Government bond, etc.	28.3	1.3
Stocks and investments	275.8	12.9
Investment trusts (excluding the foreign currency portion)	66.1	3.1
Insurance and pension reserves	537.5	25.1
Deposit, etc.	34.3	1.6

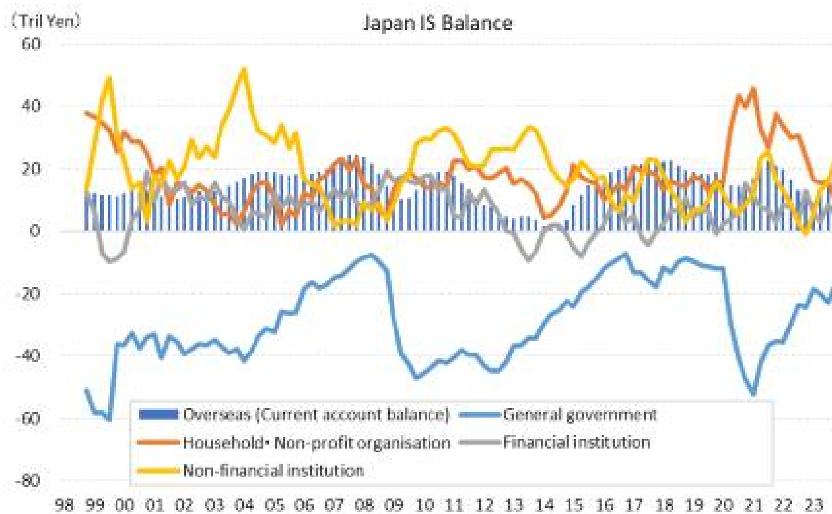
Financial Asset Composition of the Japanese Household Sector（End of DEC 2022） / **Changes from the End of DEC 2022 to the End of DEC 2023**

	Amount (tril yen)	（%）	Changes: Amount (tril yen)	Changes: （%）
Total assets	2,037.5	100.0	104.0	
Foreign currency	64.4	3.2	14.3	0.5
Foreign currency deposit	6.4	0.3	0.3	▲ 0.0
Foreign securities investment	22.7	1.1	3.9	0.1
Investment trust	35.2	1.7	10.1	0.4
JPY-denominated	1,973.1	96.8	89.7	▲ 0.5
Cash and deposits (excluding foreign currency deposits)	1,109.9	54.5	10.9	▲ 2.1
Government bond, etc.	25.6	1.3	2.7	0.1
Stocks and investments	213.5	10.5	62.3	2.4
Investment trusts (excluding the foreign currency portion)	56.6	2.8	9.6	0.3
Insurance and pension reserves	532.8	26.1	4.7	▲ 1.1
Deposit, etc.	34.8	1.7	▲ 0.5	▲ 0.1

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

Noteworthy Shrinking of Household Savings Seen in Japan's IS Balance

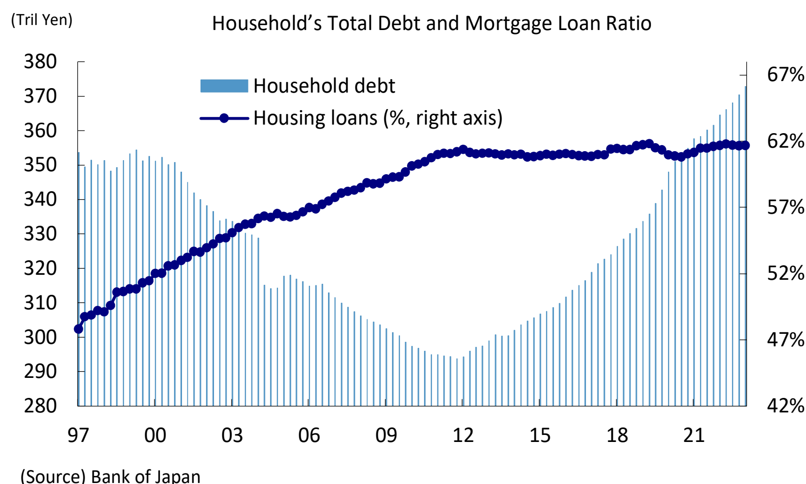
In addition to the flow of funds statistics, the statistics on Japan's savings and investment (IS) balance have also been updated. It has long been pointed out that "excess savings in the private sector", as reflected in the IS balance, are a major factor promoting deflationary trends in Japan. The IS balance explains the dynamics of resource allocation within an economy and, based on an analysis of Japan's IS balance, there is a persuasive theory that the household and corporate sectors' low proclivities to consume and invest have caused them to accumulate excess savings, which have depressed the economy's growth rate of and restrained price increases. In this regard, it is interesting that Japan's household sector's excess savings have been declining in recent years. Focusing on four-quarter average levels to moderate the considerable fluctuations in individual quarterly figures, one finds that those excess savings had fallen to approximately JPY9.3 trillion at the end of December 2023 – the lowest level in about nine years, since September 2014. Theoretically, the diminution of household sector excess savings will cause a rise in the interest rate that brings savings and investment into balance (≈ the natural interest rate), and such an interest rate rise can be expected to augment inflationary pressures. Thus, the changes seen in Japan's IS balance are economic phenomena consistent with the current trends of JPY depreciation and rising prices.



(Source) macrobond (Note) Use four-quarter average

Significance of Fact that Housing Loans Account for 60% of Household Debt

While Japan's campaign to become an "asset management nation" has naturally led to considerable attention being given to trends in household assets, it is also worthwhile monitoring trends in household liabilities. The Japanese household sector's outstanding debt as of the end of December 2023 amounted to approximately JPY373 trillion, the highest level ever recorded. Analyses of household investment trends and their impact on the forex market (particularly their promotion of JPY depreciation) tend to focus primarily on the composition of household assets, yet it is also important to note that household debt is increasing while the household sector's excess savings is shrinking. As mentioned, the household sector's outstanding debt has reached a record high level, and approximately 62% of that debt was accounted for by housing loans, which have also attained an all-time record high level. The share of household debt accounted for by housing loans been incrementally increasing since reaching 60% in 2010 and, given the recent rise in real estate prices, it appears likely that growth in housing loans will promote a continued rise in total household debt outstanding (see graph). Concerns that it will be politically difficult for the BOJ to implement consecutive interest rate hikes given that such hikes would directly augment the population's housing loan burden have already been mentioned from time to time, and it is likely that this issue will become an increasing focus of attention among BOJ watchers going forward. Although independent central banks should theoretically be insulated from political pressures, there is an undeniable possibility that political situations may have some influence on the BOJ's behavior.



(Source) Bank of Japan

As already mentioned, however, the cost of an accommodative stance toward the bond market (in the form of low interest rates) is emerging in the form of sustained pressures promoting JPY depreciation, so one ultimately has to choose what kind of cost is to be paid but cannot totally avoid incurring some kind of cost, or political discomfort. The household sector's income environment will be negatively impacted by increased debt repayment burdens associated with interest rate hikes, but it is also being negatively impacted by the general price rise associated with JPY depreciation. While home owners are likely to have a more-tightly-focused concern about the former risk, causing strong political opposition to interest rate hikes, the cost-push inflation caused by the weaker JPY via import prices will be reflected in the prices of all kinds of goods and services, saddling the entire public with a relatively broadly dispersed cost burden. This scenario has already existed for the past two years, so it is probably not difficult to understand. Looking back at Japan's history, one finds that the BOJ's inability to continuously raise interest rates has largely reflected consideration for the government sector and its large amount of outstanding debt. Going forward, however, in addition to consideration for the government sector's situation, it is likely to become increasingly common for the BOJ's behavior to be attributed to concerns about the household sector's large debt burden (≈ outstanding home loans). Given that politicians are particularly sensitive to the household sector's grievances, it seems that the situation is changing in a way that will make it even more difficult to raise interest rates than previously.

U.S. Monetary Policies Now and Going Forward – Decreasing Likelihood of a "Temporary Dip" in USD/JPY

Basically Uneventful FOMC Meeting

The March 19-20 FOMC meeting decided to maintain the status quo – the fifth consecutive meeting to maintain the status quo. The wording of the March meeting's statement remained unchanged from that of the previous meeting, and it was basically an uneventful meeting. The FOMC members' latest FF interest rate projections (dot plot median forecast figures, see chart) indicate the potential for the policy rate to decrease 75bps during 2024 (perhaps about three reductions), and this has caused some surprise among observers. While the dot chart suggesting about three rate cuts was carried over from the FOMC meeting last December, rate cut expectations have clearly waned in the three months since then, contributing to the pressure pushing USD/JPY upward. Anticipating that the Fed's shift to dovishness would recede, the financial markets had factored in two rate cuts within 2024, so it was surprising to them that the interest rate cut outlook in March remained the same as it was in December. It is noteworthy that only 2 out of 19 FOMC members predicted that there would be no interest rate cut this year, which reinforces confidence that the Fed's basic message continues to be that "interest rate cuts will start in 2024 and continue through 2025". (Although the anticipated number of interest rate cuts during 2024 has declined from four to three, the markets do not appear to consider this to be a very significant factor.)

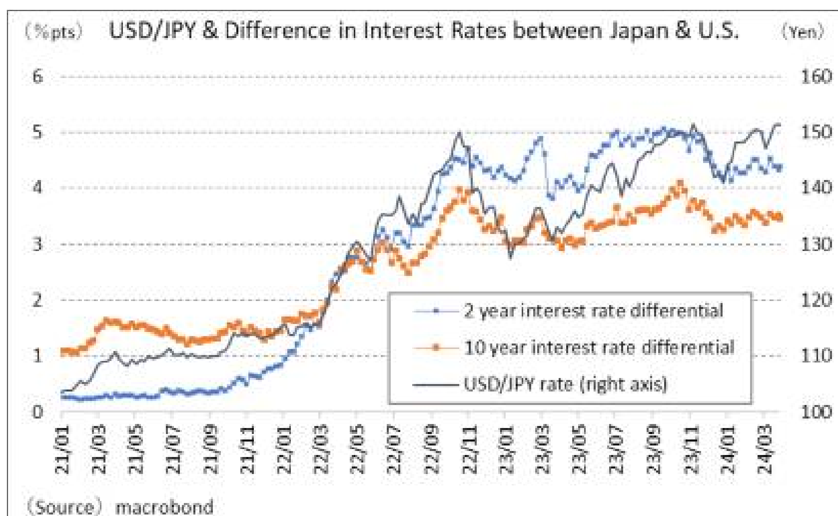
Policy Interest Rate Outlook as of Each Year End (Median Estimate)

FOMC Date	2024	2025	2026	Longer run
Sep-22	3.875%	2.875%	n.a.	2.500%
Dec-22	4.125%	3.125%	n.a.	2.500%
Mar-23	4.250%	3.125%	n.a.	2.500%
Jun-23	4.625%	3.375%	n.a.	2.500%
Sep-23	5.125%	3.875%	2.875%	2.500%
Dec-23	4.625%	3.625%	2.875%	2.500%
Mar-24	4.625%	3.875%	3.125%	2.5625%

(Source) FRB

At the post-FOMC meeting press conference, Fed Chairman Jerome Powell emphasized that the Fed plans to cut interest rates by the end of the year, saying – "[I]f the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year." The timing of the next interest rate cut has been pushed back a bit, but if all goes well, it may be best to anticipate that it will happen in June, or July at the latest. As the U.S. employment and wage environment is currently extremely stable, the possibility of a sharp turn toward interest rate cuts is unlikely to be included in the main forecast scenario. It is worth noting that, if the FOMC starts cutting interest rates at its June meeting and cuts rates once every two meetings, there will be exactly three cuts at the time of the December FOMC meeting. In light of the information currently available, there seem to be reasonable grounds for anticipating that events will generally unfold in such a manner.

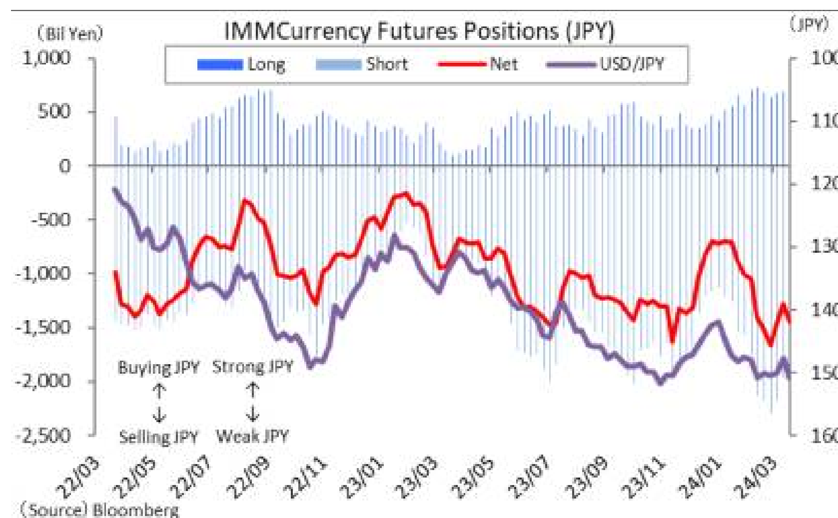
Decreasing Likelihood of a "Temporary Dip"



The latest FOMC meeting has not had a significant impact on the USD/JPY outlook. However, the timing of the start of Fed interest rate cuts has been pushed back, and this may reduce the "temporary dip" in USD/JPY that was expected to accompany those initial cuts. Previously, this article had anticipated a temporary adjustment phase of JPY strengthening against USD beginning from the April-June period. But the underlying assumption was that the Fed would start cutting interest rates from May onwards, and if initial cut is delayed to June or July there may no longer be a basis for expecting the temporary dip in USD/JPY. Originally, the theory was that there would be a temporary dip in USD/JPY during the April-June period because of the concurrent timing of the BOJ interest rate hike and Fed interest rate cut. However, media reports about leaked information suggesting the BOJ's prospective negative interest rates discontinuation policy would prioritize consideration for the bond market caused the markets to quickly factor in expectations of such a policy, and JPY ended up facing a hopeless "selling on rumors and selling on facts" situation. There may be a future period when the reduction of BOJ government bond purchases encourages JPY buying, but it seems safe to assume that there is basically no BOJ move that will effectively promote JPY appreciation in the near future. If that is true, then the only opportunities for temporary dips in USD/JPY might be at a time when speculative JPY selling is reversed in response to Fed interest rate cuts. The start of Fed interest rate cuts would undoubtedly be one such opportunity. However, the financial markets have gradually been factoring in the anticipated Fed rate cuts over a period of almost two years, and it is unclear how much of an impact the actual cuts will have on forex market price formation. If the Fed were to implement large-margin rate cut akin to those that have been implemented in response to financial crises or the recent pandemic, there would be a potential for a deeper USD/JPY adjustment, but it seems to be becoming increasingly difficult to find grounds for anticipating a "temporary dip" in USD/JPY in the absence of such a crisis situation.

Risks to My Main Scenario – Successive BOJ Interest Rate Hikes Could Spur either JPY Appreciation or JPY Depreciation

"Successive Rate Hikes" a JPY Appreciation Risk Factor



Previous editions of this article have argued that if there is a genuine JPY appreciation risk factor, that factor is likely to be associated with the risk that the BOJ's normalization process does not end with a one-shot discontinuation of negative interest rates but leads to successive interest rate hikes, focusing increasing attention on the narrowing of the Japan-U.S. interest rate differential. There is a reasonable basis for recognizing the potential for such a development, which should be considered a legitimate risk factor with respect to the current main forecast scenario. The BOJ's most recent Monetary Policy Meeting statement includes the forward guidance – "Given the current outlook for economic activity and prices, the Bank anticipates that accommodative financial conditions will be maintained for the time being." On the other hand, if the BOJ were to implement 25bp policy interest rate hikes in every

quarter from now on, it would be safe to recognize the potential of such moves to trigger unexpected JPY appreciation. Even taking into account the magnitude of speculators' JPY shorts, as reflected in IMM currency futures transactions, it is reasonable to assume that an unexpected rise in JPY interest rates will directly augment the risk of unexpected JPY appreciation (see graph).

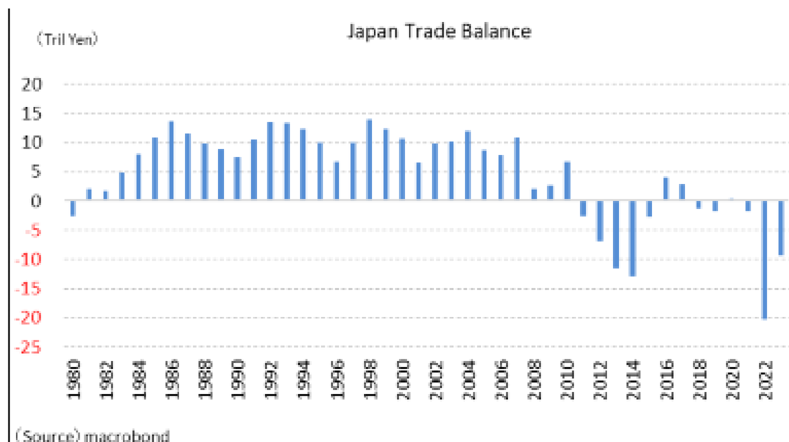
Frightening Mirror Image of Challenges Faced by the Shirakawa-Led BOJ

However, there are also some grounds for concern about an opposite scenario regarding risks of further JPY weakening. This article has long argued that if the real cause of the current JPY depreciation trend is a major change in the JPY supply-demand environment, then it is quite possible that JPY may not re-strengthen even after successive BOJ interest rate hikes. On March 26, Japan's Ministry of Finance set up a panel of private-sector experts to analyze trends in the country's balance of payments[2], reflecting the increasing recognition of the causal relationship between JPY's prolonged depreciation and changes in the JPY supply-demand environment. (I will be participating in the discussion as a panel member.) Under current circumstances, if the tentative assumption that "JPY's current weakness largely reflects the JPY supply-demand situation and cannot be effectively stopped by interest rate hikes" becomes widely believed, it is likely that each future BOJ interest rate hike may no longer be accompanied by concerted JPY selling designed to press for additional hikes.

I have long argued that the most feared potential development under the Ueda-led BOJ is the mirror image of what was most feared during the term of the Shirakawa-led BOJ. During the term of BOJ Governor Masaaki Shirakawa, no matter how many additional easing measures were implemented, the persistence of JPY buying encouraged people to press for additional easing measures, and the policy cards the BOJ could play were stripped away one by one. Currently, if the current JPY depreciation trend continues as it is, there is a risk that, regardless of how many tightening measures the Ueda-led BOJ implements, the persistence of JPY selling will generate pressures to implement additional interest rate hikes. If repeated bouts of JPY selling become seen as surely leading to additional tightening, forex market players may become habituated to utilizing time periods just before and after BOJ Monetary Policy Meetings as sure-fire profit earning opportunities. Such a possibility makes more likely the specter of a vicious cycle situation in which interest rate hikes lead to JPY weakening and JPY weakening leads to interest rate hikes. In light of this, it seems clear that the BOJ's consideration of successive interest rate hikes could be more likely to cause unexpected JPY depreciation than unexpected JPY appreciation and that that unexpected JPY depreciation may happen at time when the BOJ is in a weak position to respond. The worst-case scenario would be for every BOJ Monetary Policy Meeting to become viewed as a new opportunity to test the JPY depreciation trend's durability, and in fact, the JPY exchange rate trends following the discontinuation of negative interest rates have been giving a hint about the real potential for that worst-case scenario to take shape.

Accommodation for the Bond Market Brings Pressures on the Forex Market

The problem is that, while it is theoretically possible for Japan to countervail JPY appreciation by infinitely undertaking the selling of JPY and buying of foreign currency, the scale of the country's foreign currency selling and JPY buying to countervail JPY depreciation is limited by the amount of its foreign currency reserves. As speculators are aware of Japan's ammunition stores (foreign exchange reserves) and the power of the weapons (interest rate hikes) Japan could utilize, they may see themselves as being positioned to confidently undertake JPY selling. While this is currently only one of several risk scenarios, it is a risk factor that should be kept in mind. Since April 2023, the BOJ has imposed lending restrictions on Japanese government bonds to prevent bond market tightening caused by rising JPY interest rates (Japanese government bond selling), and this reflects the burden from forex market speculators. Ultimately, this "giving consideration to interest rates at the cost of neglecting forex rates" structure will likely become the key point to consider when analyzing the relationship between the BOJ's monetary policy management and the financial markets. As mentioned above, after negative interest rates were discontinued, the BOJ was faced with a situation in which its special consideration for the bond market had a counterproductive result in promoting JPY depreciation, yet it would be politically difficult for the BOJ to abandon its special consideration for the bond market, so the same thing is likely to happen repeatedly going forward. In light of Japan's current situation – with trade deficits, the policy interest rate at zero, and the potential growth rate at less than 1% –it is safe to say that JPY depreciation is a trend in line with the fundamentals (see graph). While it is impossible to conclude whether or not the USD/JPY150 level is a fair value for JPY, it should be noted that the "if the BOJ raises interest rates or the Fed lowers interest rates, JPY's depreciation can be



[2] For more information about the MOF's panel of private-sector experts, which has the theme "Challenges and prescriptions for the Japanese economy from the perspective of the balance of payments", please visit https://www.mof.go.jp/policy/international_policy/councils/bop/notification.html.

halted" argument was fundamentally only plausible in the era when Japan was chronically earning trade surpluses. Going forward, it will be necessary to keep in mind that countervailing the JPY depreciation trend through interest rate channels alone will be difficult.

EUR Outlook – Likelihood of ECB Policy Revisions in June and Status Quo Maintenance Prior to That

EUR Area Monetary Policies Now and Going Forward – Bases for Decisions Not Available until June

Reiterating the Importance of the June Governing Council Meeting

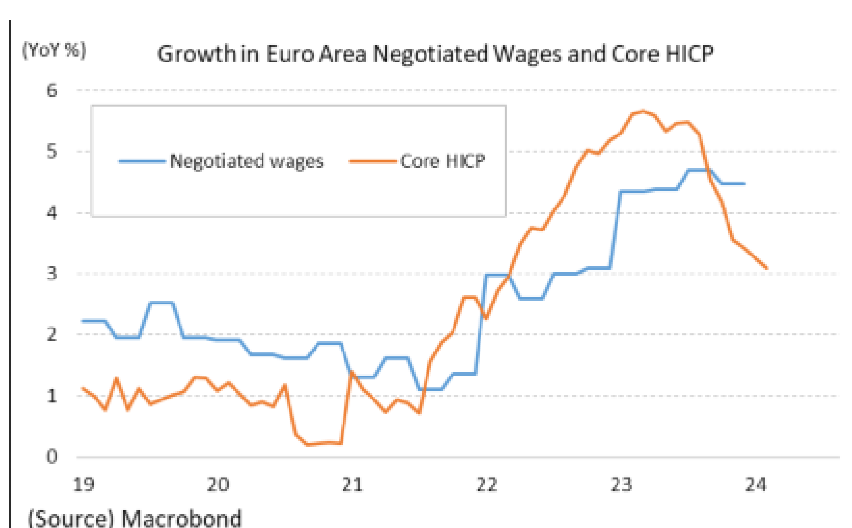
The March 7 ECB Governing Council meeting decided to keep policy rates unchanged (becoming the fourth consecutive Governing Council meeting to maintain the interest rate status quo) with the deposit facility rate left at 4.00% and the major refinancing operation rate left at 4.25%. It also emerged that interest rate cuts were not discussed at all at the meeting, and it generally can be said that information provided after the meeting was as had been expected. It was also made clear that the Governing Council will not be positioned to fully assess the controversial euro area employment and wage situation until the middle of the year, so it is almost certain that the status quo will be maintained at the March Governing Council meeting as well as the April Governing Council meeting. At the post-Governing Council-meeting press conference, ECB President Christine Lagarde emphasized that sufficient information to make decisions will not be available in April but will probably be accessible in June, saying, "We will know a little more in April, but we will know a lot more in June." Since January, the financial markets have shown signs of continuing to maintain a forecast that March and April will be uneventful but that the June Governing Council meeting is likely to be quite eventful.

President Lagarde also stated that – "What we have done is that we have just begun discussing the dialing back of our restrictive stance" – and that confirms that the ECB is preparing to undertake its policy normalization process. Based on the information provided by President Lagarde, it seems reasonable to expect that the ECB will maintain its current policy interest rates through April, and that rates are likely to be reduced in June or July, just as the markets are anticipating and factoring in. One thing the ECB has already decided is that reinvestment of the full redemption amounts of assets purchased under the Pandemic Emergency Purchase Programme (PEPP) will be discontinued at the end of June (the reinvestment amount will be gradually reduced thereafter), so it is increasingly likely that, from the second half of the year onward, ECB policy normalization will proceed with respect to both interest rates and quantitative easing. The current situation is that the ECB has indicated that there will be a period of calm uneventfulness, and EUR is likely to be fairly stable during that period.

What about Discrepancies between Inflation Trends and Wage Trends?

In sum, almost no new information emerged from the March Governing Council meeting (in accord with the ECB's expressed commitment to not even discuss its "next move" until it is able to fully assess wage-related trends) so financial market participants have not been able to identify any potential market moving factors. The last reporter called on at the press conference posed an interesting question – "Even if wages continue to increase, the declining trend in underlying inflation may continue. It's just a possibility, but in this case which would you consider more important when it comes to deciding when to cut interest rates? The declining [inflation] trend or wage growth rate?" In response, President Lagarde said – "[W]e want to be stable on three accounts: inflation outlook, underlying inflation and strength of [policy] transmission." – and she also expressed caution about the inflation trend, saying that the Eurosystem staff forecast – "indicates clearly that we are in this disinflationary process – that inflation is declining. But we also look at the underlying inflation and what feeds some of this underlying inflation, including wages in particular." The reporter was basically asking whether it might be possible for the wage growth trend to remain strong even if the inflation trend weakens, but such a situation is generally unlikely. Since inflation trends are largely determined by service prices and service prices are largely determined by wages, it is difficult to imagine a situation in which the pace of inflation declines despite strong growth in wages.

However, data on negotiated wages (wages agreed to by trade unions, which the ECB closely monitors) are not readily available in a timely manner, while it is possible to watch movements in the euro area Consumer Price Index (HICP) every month. Consequently, a situation may indeed arise in which the inflation trend shows signs of weakening despite the apparent strength of growth in those wage figures that the ECB is able to confirm. In fact, that is the case at this time (see graph). While the rate of growth in negotiated wages during the last quarter of 2023 remained high at around 4.5%, the euro area core HICP inflation rate has been gradually trending downward with the potential to fall below the 3% level in March



and April. At the time of the June Governing Council meeting, the latest available data on the rate of growth in negotiated wages (covering the first quarter of 2024) may suggest that the wage growth rate remains high at around 4%, while the core HICP growth rate for May may well fall below the 3% level. Given the limitations of the data, the ECB may simply have to accept a certain amount of "discrepancy" between wage and inflation trends, and that is why the reporter pointed out the issue of how the ECB plans to evaluate the relative importance of the available wage and inflation trend data.

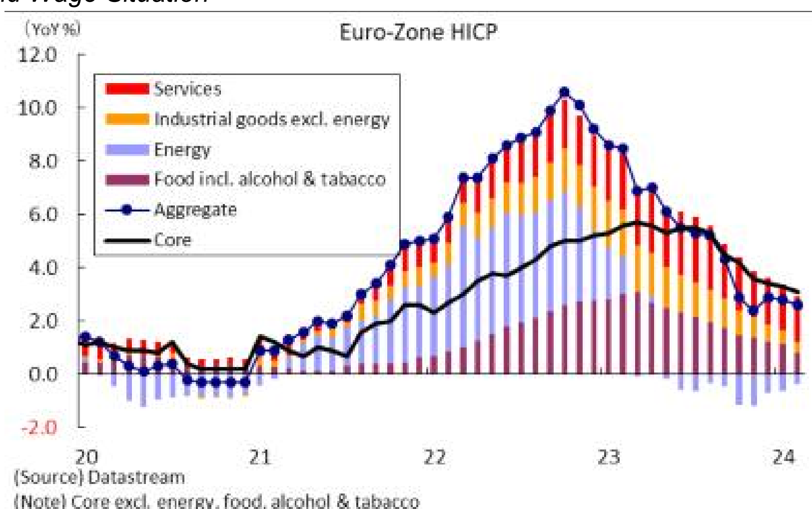
Correlation of Rate Cut Timing and Staff Forecast Timing

It appears likely that the ECB's plan is to start cutting interest rates in June based on its assessment of somewhat old data suggesting there is momentum behind the slowdown in negotiated wage growth and taking into account the latest trend in core HICP growth. As will be discussed below, however, it cannot definitively be said to be highly likely that negotiated wage growth rates (as measured by a prominent wage trend survey that analyzes job advertisements on private digital platforms or as measured by the wage tracker the ECB is currently developing) will fall below 4% within this year. President Lagarde's answer to the abovementioned question indicated that the ECB seeks to evaluate an array of indicators and not give undue emphasis to any single indicator. Given the euro area's current employment and wage situation, however, I do not at all anticipate that each Governing Council meeting from June will undertake interest rate cuts. The ECB tends to make important decisions when new staff forecasts become available so, although its interest rate cuts may start in June at the earliest, I think there is a high likelihood that the ECB will subsequently delay additional initiatives until it can consider the appropriateness of rate cuts based on staff forecast data that becomes available in September and December.

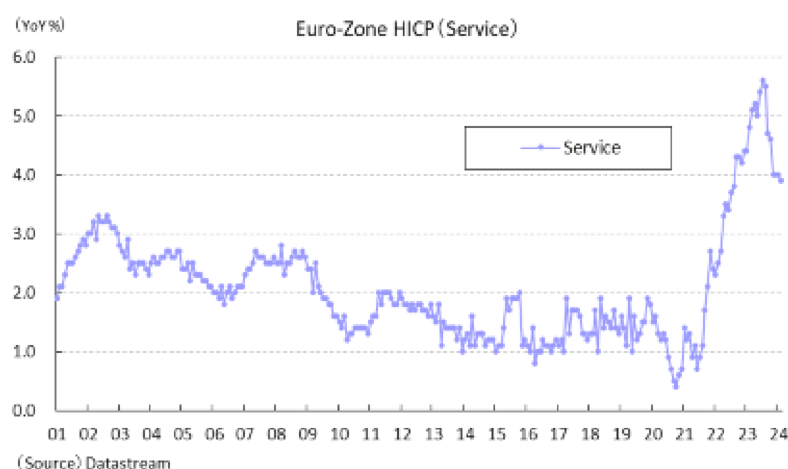
EUR Now and Going Forward – Little Need to Rush to Cut Interest Rates

Difficulty of Predicting Euro Area's Employment and Wage Situation

As mentioned above, the latest ECB Governing Council meeting decided to maintain its policy status quo in light of the difficulty of assessing the euro area's employment and wage situation. Looking at the currently available data, however, there does not appear to be any need for the ECB to rush to cut interest rates. In February, for example, the yoy growth rate in the euro area consumer price index (HICP, preliminary figures) was 2.6%, down from 2.8% in January but slightly above the level expected by the financial markets (2.5%; see graph, above right). The yoy growth rate of core HICP (excluding highly volatile prices of energy, food, alcoholic beverages, and tobacco) was 3.1% in February, down from 3.3% in January, but this February growth rate also exceeded the market forecast of 2.9%. Although it can be said to be good that overall basis HICP has grown at rates in the 2%-to-3% range for four consecutive months, the pace of HICP growth rate deceleration is clearly decreasing. Moreover, it cannot be said that the ECB is pleased with the inflation situation, as core basis HICP growth rates have remained in the 3-to-4% range. The yoy growth rate in services prices, which are greatly influenced by nominal wage trends, was only 3.9% in February, a slight decrease from January's 4.0% rate (see graph, below right). The euro area unemployment rate fell to 6.4% in February, from 6.5% in January, and the fact that the unemployment rate has returned to its lowest level ever suggests that it will be difficult to predict trends in the euro area's employment and wage situation going forward.



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



(Source) Datastream

Negotiated Wage Growth Deceleration May Not Be Sufficient

It is generally understood that, regarding the decision about when to start cutting interest rates, the ECB is giving emphasis to the trend in negotiated wages. In light of the lack of timely data on negotiated wages, the ECB is obtaining preliminary data from a prominent wage trend survey that analyzes job advertisements on private digital platforms and is also striving to develop its own wage tracker system. This article will discuss that wage tracker development project later, however, the confirmed data now available indicate that the yoy growth rate in negotiated wages for the last quarter of 2023 was 4.5%, a slight deceleration from the 4.7% growth rate for the third quarter. In a speech presented in Brussels

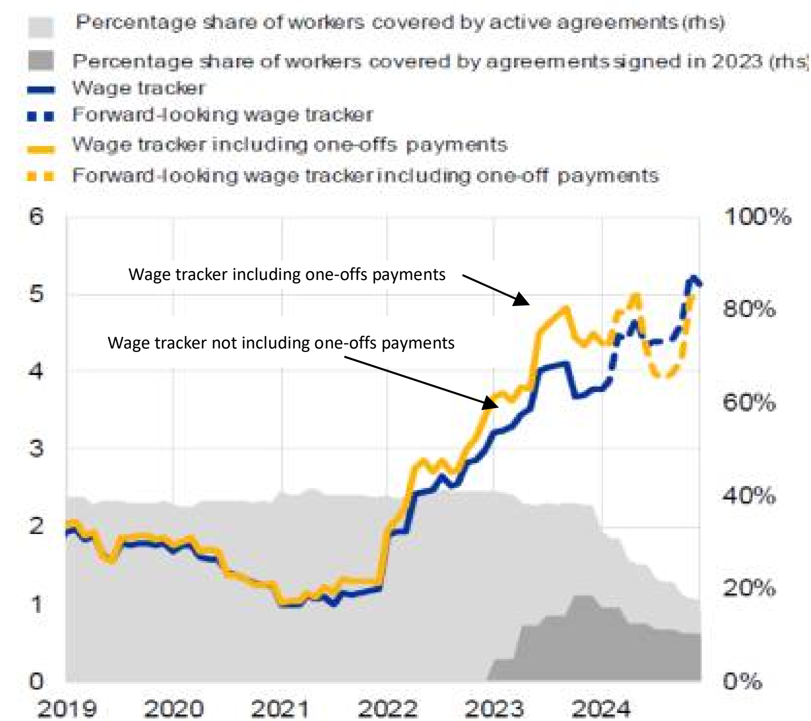
on February 15, ECB President Lagarde said that this trend was obviously encouraging and added that – "The current disinflationary process is expected to continue, but the Governing Council needs to be confident that it will lead us sustainably to our 2% target."

President Lagarde also noted that there are many economic sectors in which wage negotiations will be completed during the January-March period, that data on the results of those negotiations will be important bases for ECB decisions on the outlook, and that she is hoping that the data continue to be encouraging. It appears that the ECB does not consider 4.5% yoy growth in negotiated wages to be a sufficiently low growth rate, and it seems clear that it will not make a final decision on a mid-year interest rate cut unless it sees a further downward momentum in that rate. Based on 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), negotiated wage growth is expected to decelerate from around 4.5% to around 4.0%, but it is also possible that the growth rate will subsequently remain stable or bottom out (see graph). In light of historical data, it appears unlikely that HICP growth will stabilize around 2.0% when negotiated wage growth remains around 4.0%, so if negotiated wage growth remains stubbornly high, the ECB will not have a strong rationale for undertaking an interest rate cut. In sum, deceleration in negotiated wage growth is indeed anticipated, but that deceleration may not be sufficient.

(Source) Macrobond, *Job advertising wages are posted 6 months in advance.

Developing ECB wage tracker suggests remaining high

Wage trackers based on data from worker recruitment companies' websites relate only to the wages of newly hired workers, and it is a bit of a stretch to assume that the wages of new hires accurately reflects overall trends in the employment and wage market. (In fact, it has been pointed out that there is a discrepancy between wage tracker data and actual negotiated wage data in some euro area countries where Indeed.com's coverage is not extensive.) In light of that, the ECB has begun working with euro area countries' central banks to develop its own negotiated wage tracker, and details about this development project are explained in an occasional paper entitled "A forward-looking tracker of negotiated wages in the euro area" that the ECB released on February 8, 2024. As the new tracker is still under development, the data generated in connection with the tracker is not yet published regularly or available in chronologically ordered formats. However, the occasional paper does say that – "Looking at the euro area, the wage trackers signal aggregate negotiated wage growth of 3.7% in 2023 on average excluding one-offs, compared to 4.2% including one-offs. Based on the contracts already in force, wage growth (both excluding and including one-offs) is expected to move broadly sideways at levels around 4.5% in 2024." Currently, financial markets are generally anticipating that interest rates will be cut at the June Governing Council meeting based on the revised staff forecast available at that time, which will take into account the first quarter negotiated wage figures that will be announced by late May, but it is not clear whether the market expectations are well founded. If the still-under-development ECB wage tracker is correct, the rate of growth in negotiated wages will not fall below the 4% level by the end of 2024 (see graph). It is understandable that the ECB is responding to the economic slowdown by leaning towards lowering interest rates rather than raising them, and the wage and price situation is not serious enough to justify successive rate hikes. Although the March Governing Council meeting's statement and President Lagarde's statements at the post-meeting press conference seemed to tentatively acknowledge a deceleration in wage growth and suggest the possibility of a policy change at the June Governing Council meeting, the possibility of an interest rate cut was only hinted at, so I believe the main scenario should anticipate an interest rate cut after the summer vacation, at the



(Sources) Deutsche Bundesbank, Banco de España, the Dutch employer association (AWVN), Oesterreichisched Nationalnank, Bank of Greece, Banca d'Italia, Banque de France

September Governing Council meeting. It appears safe to expect that, following the March Governing Council meeting's status quo maintenance, the status quo will similarly be maintained at the April Governing Council meeting, as the negotiated wage data for the first quarter will not yet be available at that meeting. It is worth noting that, although the euro area PMI data released in late February showed deteriorating conditions in the manufacturing sector, positive trends in the service sector caused figures for the overall economy to improve. It is worth pondering the question of whether nominal wages can slow down significantly despite the recovery trend in service industries. The bases of market expectations for an early ECB interest rate cut are fragile, and I am anticipating that the start of rate cuts will be delayed until the second half of the year.

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