Forex Medium-Term Outlook

May 1, 2024

Overview of Outlook

USD/JPY continued to rise in April, posting its highest in 34 years. The Bank of Japan (BOJ) had been expected to respond to JPY weakness, but it avoided battling forex rates and persisted with the status quo. I view this as a respectable stance, but the markets responded with stronger JPY selling. In light of JPY's depreciation since the start of the year, more analysts are admitting that the situation cannot be explained by interest-rate differences, but having belabored this very point in this column for over two years, I cannot help feeling that they are a bit late to the party. As I have been persistently saying, the root cause of JPY depreciation is a change in the supply and demand structure. This change involves a cash flow (CF)-based current account deficit, symbolized by expanding digital deficits, and JPY selling by households as a result of the new NISA scheme. A recent change in forex reporting circles is that those who were used to mindlessly attributing USD/JPY rate trends to the widening U.S.-Japan interest-rate differential seem to have finally woken up. Of course, the recent JPY selling has a strong speculative tone to it, and one can expect the currency to appreciate considerably when there is a profit-making opportunity, such as when the Fed cuts interest rates. However, the Fed cutting interest rates will not improve Japan's current account balance. For example, even if we look at just the digital deficit, Japan's deficit is relatively large by international standards. While acknowledging that reversing JPY depreciation has become difficult because of supply and demand factors that cannot be improved overnight, there is a need for earnest policy discussions to improve supply and demand. Of course, the government and BOJ's stop-gap measures will continue to attract attention meanwhile, but that is not all that important.

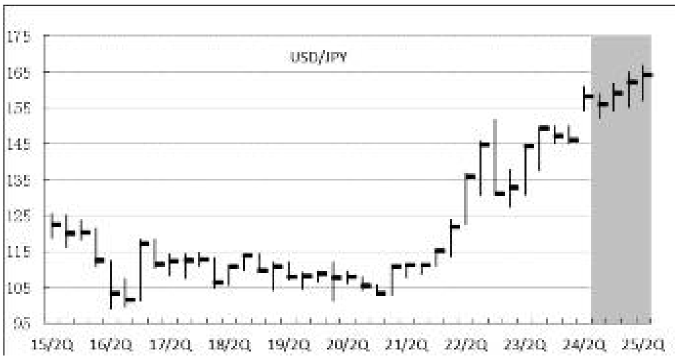
EUR weakened in April. It was thought that ECB and Fed policy operations were in sync, but the two central banks now appear to be moving away from each other, as the ECB seems likely to shift toward lower interest rates starting June, while any rate cuts by the Fed appear doubtful this year. Tight labor market and wage conditions in the region seem unlikely to improve any time soon, so there is not much reason to rush into rate cuts, but there is also very little reason to hesitate about lowering interest rates when the growth rate is fluctuating between zero and negative. ECB President Christine Lagarde appears to be leaning toward an early rate cut, having declared, "we're not going to wait until everything goes back to 2%." If this turns out to be the case, a significant decrease in EUR/USD can be expected from June onward as the Europe-U.S. interest-rate differential widens. While USD strength was viewed with concern at the G20 and G7 meetings in April, the concern was not sufficient to warrant calls for strong concerted international action. However, things could change if EUR depreciates significantly going forward, thereby pushing up inflation in the region via import prices. The extent to which USD strength hurts the euro area will be a key factor when predicting what decision is taken on concerted international action, which will have a major impact on forex markets as a whole.

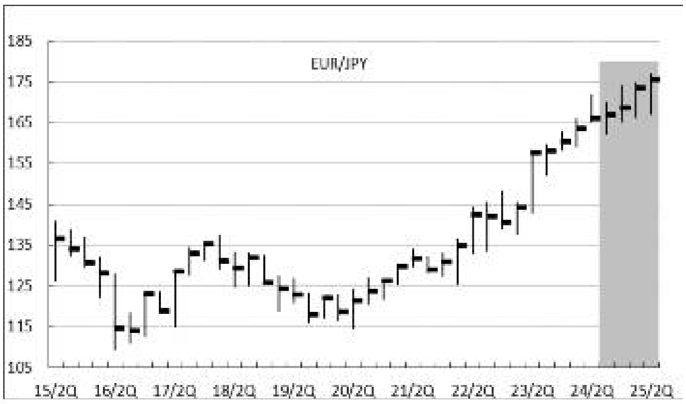
Summary Table of Forecasts

	2024 Jan-Apr (actual)	May-Jun	Jul-Sep	Oct-Dec	2025 Jan-Mar	Apr-Jun
USD/JPY	140.80 ～ 160.24 (157.74)	154 ～ 161 (158)	152 ～ 159 (156)	154 ～ 162 (159)	155 ～ 165 (162)	157 ～ 167 (164)
EUR/USD	1.0601 ～ 1.1046 (1.0662)	1.04 ～ 1.09 (1.05)	1.03 ～ 1.09 (1.07)	1.02 ～ 1.08 (1.06)	1.03 ～ 1.09 (1.07)	1.03 ～ 1.09 (1.07)
EUR/JPY	155.10 ～ 171.60 (168.20)	165 ～ 172 (166)	162 ～ 170 (167)	165 ～ 174 (169)	166 ～ 175 (173)	167 ～ 177 (175)

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

Exchange Rate Trends & Forecasts





USD/JPY Outlook – Glimpses of Worst-Case Scenario As JPY Plunges to 34-Year Low

BOJ Monetary Policy Now and Going Forward – Bank Avoids Battle with Forex Rates

Basic Stance – Don't Engage With Forex Markets

The BOJ decided to keep the monetary policy unchanged following its April 26 Monetary Policy Meeting (MPM). Contrary to prior expectations, no decision was made to reduce the scale of Japanese government bond (JBG) purchases, and the monetary policy statement also returned to its previous plain language. In the forex markets, which had been expecting monetary tightening to counter JPY depreciation, JPY selling sped up, pushing USD/JPY to 160 at the beginning of the week. Subsequently, USD/JPY has fluctuated wildly, including a sudden drop to the 154 level at one point, but the status and/or amount of forex intervention will not be known until the May 31 release of the Foreign Exchange Intervention Operations by the Ministry of Finance (MOF). Judging by the factors behind the subsequent decrease in the BOJ's current account balance ("fiscal and other factors") and the discrepancy between the decrease amount and advance forecasts made by money market dealers, it seems likely that a JPY buying intervention worth around JPY 5 trillion or so was carried out. While the effect of the intervention appears to be fading away at the time of writing this report, there is no need to be shocked by the amount, as Japan's forex reserves have been increasing.

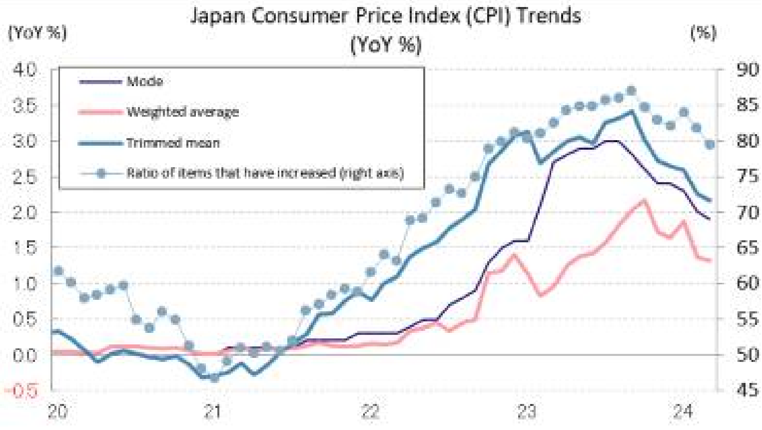
Many point to the recent BOJ MPM as the event that triggered the acceleration of JPY depreciation. To be sure, forex market trends before and after the meeting clearly indicated speculative JPY selling to prompt the BOJ to implement tightening measures to counter JPY depreciation, and subsequently, things unfolded as I had feared in this report. While I have other criticisms, <u>I do support the BOJ's decision to maintain the status quo. Giving in to pressure from speculators and tightening monetary policy would simply have set a precedent for pressuring the Bank into tightening monetary policy simply by selling JPY</u>. A situation of this kind offers great profit-taking opportunities for speculative JPY sellers, and they would have engineered a repeat performance at the June meeting. This is almost certain to have happened, going by the BOJ's painful past experience with the opposite pattern during the Masaaki Shirakawa administration.

Of course, if the current situation continues, the BOJ could face a similar JPY selling trend as it approaches its June meeting. In fact, USD/JPY has since surged to 160. However, there may be special circumstances this time, with speculative JPY selling adding to sparse liquidity during the long break, making the rates especially volatile. Large forex fluctuations during Golden Week have been seen before. The MOF has repeatedly communicated that situations in which forex fluctuations are excessive and speculative in nature could be treated as targets for forex intervention (it is not yet known whether this was the case this time). At any rate, the Japanese economy could not survive interest rates being raised at every MPM, so it is a better idea to avoid it whenever possible and hold out until the rescue boat arrives (in plain language, until the Fed cuts rates). <u>Some might object to this excessive reliance on an external factor, but the true nature of the floating exchange rate system is, in fact, that it is at the mercy of the U.S. currency and monetary policies. However, there is no particular shame in being at the mercy of external factors, nor is this situation unique to Japan</u>. One hopes the BOJ will act wisely to avoid wasting its options on unnecessary battles while buying time. Central banks must avoid engaging with the forex markets as a matter of course, but they must make an even greater effort to do so in a defensive currency battle with limited live ammunition.

Reason for Maintaining the Status Quo

The markets are not paying attention amid all the noise of JPY depreciation, but I think there were valid reasons for maintaining the status quo. BOJ Governor Kazuo Ueda said regarding JPY depreciation (excluding temporary fluctuation factors) that, “If there is an impact on the underlying inflation rate (excluding temporary fluctuations) that cannot be ignored, it will be considered or possibly used as a basis for making decisions in terms of monetary policy.” At the same press conference, he had also noted that JPY depreciation had not had a major impact on the underlying inflation rate so far and explained that this was the reason for maintaining the status quo (many say this comment is what accelerated JPY selling). Since the “underlying inflation rate” has not been clearly defined, market participants are at a loss what indicators to use to determine whether it has been impacted. However, perhaps the “Measures of Underlying Inflation,” published once a month by the BOJ, could be used to determine underlying inflation rates. To be sure, the charts show a dip in the momentum of inflation growth in light of the various underlying indicators published by the Bank, so postponing rate hikes could be viewed as reasonable.

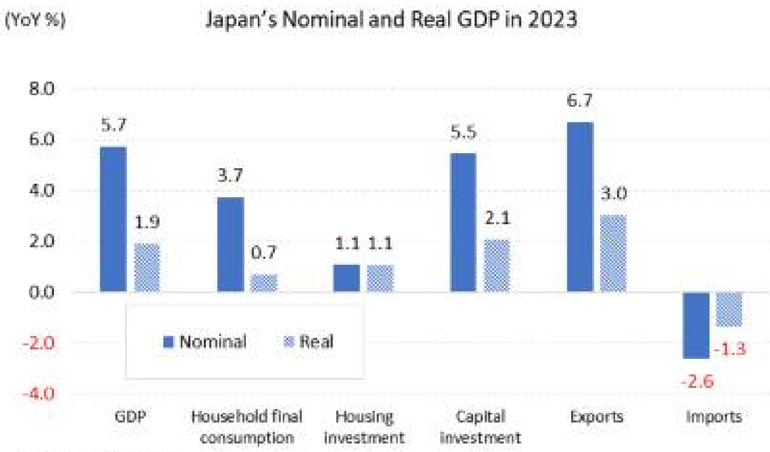
However, there also exist a wide variety of other indicators, including market-based and survey-based inflation expectations. For instance, if we were to conduct an Opinion Survey on the General Public's Views and Behavior right now, concerns regarding an undesirable increase in prices due to JPY weakness would stand out. From the standpoint of predicting the Bank’s next move, for example, the trimmed mean of the consumer price index (CPI) is clearly on the rise, and one is not sure what to make of statements to the effect that market-based inflation expectations are not keeping up. However, I do believe the BOJ had a valid reason to maintain the status quo this time. As I have explained before, it is not appropriate for the Bank to slavishly succumb to forex market pressures and decide monetary policy simply based on JPY depreciating.



(Source) Bank of Japan

A Convenient Way to Explain Upcoming Rate Hikes

However, depending on the pace of JPY selling going forward, there may be a limit to how long the status quo can be maintained, and one wonders what tools the BOJ would use to tackle such a situation. Using JPY weakness as the direct reason might be difficult. Perhaps it would be easier to explain using the two forces – “first force” and “second force” – that the BOJ has repeatedly referred to since the inauguration of the Ueda administration. As is generally known, the “first force” is the pass-through to domestic prices of the significant rise in import prices reflecting shocks such as JPY depreciation or high resource prices. The "second force" comes into play when this increase in prices triggers a virtuous cycle by pushing up wages. As per the BOJ’s diagnosis, things are presently stuck at the “first force” stage and have not moved on to the “second force” stage (hence the need for maintaining the status quo).



(Source) Cabinet Office

However, the “first force” is extremely strong at the present time due to JPY weakness and high crude oil prices. As a result, household real incomes have deteriorated, which is manifesting in the disparity between nominal and real growth rates, as confirmed by the October-December 2023 GDP growth rates (see figure). Nominal growth rate > real growth rate ordinarily indicates normal economic conditions, not deflation, but if the discrepancy becomes too large, it will result in stagflation. Stagflation is a situation in which the “first force” is cancelling out the “second force.” An interim stage in the process leading to stagflation involves weak real personal consumption, during which it is difficult to raise interest rates. The Japanese economy is probably in this stage right now.

Going forward, the BOJ can afford to bide its time while maintaining the status quo if inflation subsides and we reach a state of “ordinary stagnation” where both real and nominal growth are low. However, if JPY depreciation and resource price appreciation do not subside, and stagflation becomes a reality, the Bank will be forced into implement a rate hike against its wishes. If, at that time, the BOJ did not wish to use the word “stagflation,” it might find it convenient to explain the rate hike as a decision intended to narrow the U.S.-Japan interest rate differential to counter the slump in real personal consumption caused by JPY depreciation. However, regardless how the BOJ explains it, such a monetary policy decision would be based on and in response to forex rate trends, which essentially makes it a currency policy.

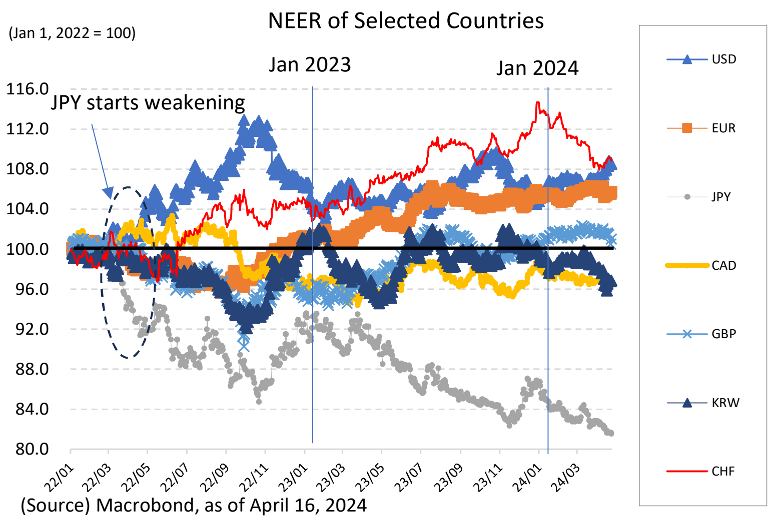
Current Level of JPY Rates – Statement a Smart Move, but Time Not Yet Ripe

Japan-Korea-U.S. Joint Statement a Smart Move

The G20 Finance Ministers and Central Bank Governors' Meeting was held in Washington on April 17, coinciding with the G7 Finance Ministers and Central Bank Governors' Meeting. The G7 joint statement said, “We (…) reaffirm our May 2017 exchange rate commitments.” The May 2017 statement had said, “We reiterate that excess volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability.” While not a new idea, getting it included in the communiqué was a win for countries struggling under currency depreciation, including Japan. However, what drew greater attention than the G7 joint statement was the first Japan-Korea-U.S. Trilateral Finance Ministers’ Meeting held on the same day. A joint press statement was issued following the meeting, which said, “We will also continue to consult closely on foreign exchange market developments in line with our existing G20 commitments, while acknowledging serious concerns of Japan and the Republic of Korea about the recent sharp depreciation of the Japanese yen and the Korean won.” Bringing together neighboring countries suffering from currency depreciation and issuing a joint statement together with the U.S. was a novel approach, and USD/JPY temporarily fell amid concerns about intervention. <u>I think it was a smart move to find and involve allies and jointly disseminate information without waiting for a multilateral consensus</u>.

Time Note Yet Ripe for Concerted International Action

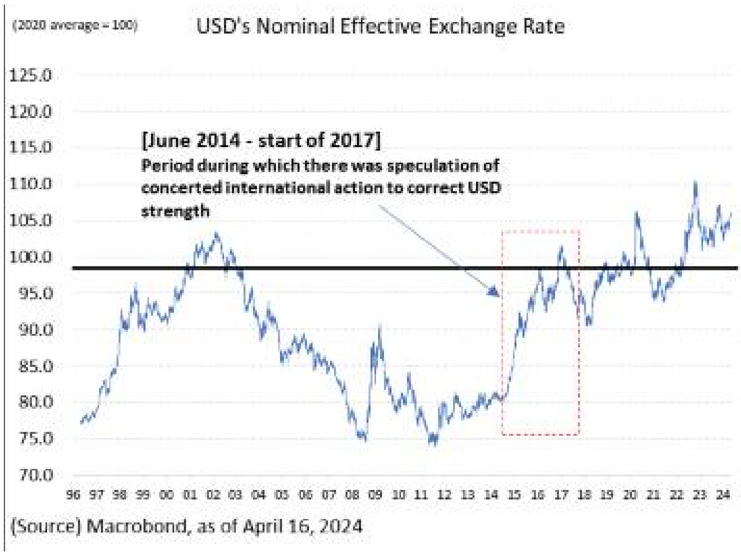
Under the floating exchange rate system, trend directions are inevitably determined by U.S. currency and monetary policies. <u>Currently, the biggest challenge facing the U.S. economy is inflation control, and since a strong USD is better than a weak one for that purpose, it is difficult for a Plaza Accord-like approach of correcting USD strength through international cooperation to take place</u>. In addition to the domestic situation within the U.S., conditions outside the U.S. also do not seem sufficiently ripe for concerted international action to take place. For example, this time, JPY and KRW have emerged as the two East Asian currencies to depreciate the most, but while KRW has experienced some depreciation this year, its depreciation over the past few years has not been as intense or sustained as that of JPY (see figure). EUR, meanwhile, is on track to hit a new year-to-date low against USD, but its nominal effective exchange rate (NEER) is level compared with the beginning of the year. It can, therefore, not be said that the time is ripe for major countries to come together and take concerted international action to correct USD strength.



(Source) Macrobond, as of April 16, 2024

USD Not Yet as Strong as in 2017

This is not the first time that the G7 or G20 platforms have been used to express consideration in the face of excessive currency rate fluctuations in member countries. Such expressions of consideration have been seen in the past as well, and whenever that happened, expectations would intermittently build for concerted international action in the form of a sequel to the Plaza Accord, but in the end, no such concerted action took place. Most recently, expectations of a Plaza-Accord-type concerted action arose around the time of the Shanghai G20, in February 2016, in the midst of a much stronger and more persistent phase of USD strength (which had begun in June 2014) than the current phase. An episode that symbolizes that phase of USD appreciation was a speech by then member of the Federal Reserve Board of Governors Lael Brainard on September 12, 2016, in which she said, “The nearly 20 percent appreciation of the dollar from June 2014 to January of this year could be having an effect on U.S. economic activity roughly equivalent to a 200 basis point (equivalent to eight 25-bp rate hikes) increase in the federal funds rate.” Given the level of awareness regarding USD strength within the U.S. at that time, speculation about a Plaza-Accord-type agreement at the Shanghai G20 meeting in February 2016, and later, speculation about the dubious “Shanghai Accord” strengthened, resulting in some USD depreciation (see figure). Further, <u>the situation was very different in the U.S. in those days, with inflation not being a problem and there emerging a desire for a weaker USD under</u>



(Source) Macrobond, as of April 16, 2024 (then) U.S. President Donald Trump. In other words, there were reasons for U.S. currency policy, i.e., politics, to lean toward USD depreciation. When compared with the USD-appreciation phase that began in June 2014, therefore, the recent phase of USD strength is not persistent enough to even be considered a "phase." To begin with, one must remember that USD was actually weak last year.

Trump's Approach to Forex Rates

Trump's verbal attacks against USD strength have already begun. His social media post on April 23, which stated, "The Dollar has just hit a 34 year high against the Yen, a total disaster for the United States" was widely reported. Having declared his position, "It sounds good to stupid people, but it is a disaster for our manufacturers and others. They are actually unable to compete and will be forced to either lose lots of business, or build plants, or whatever, in the "smart" Countries," Trump went on to criticize President Biden for allowing USD to strengthen against JPY. Since I have received many inquiries regarding the true meaning of Trump's remarks, I would like to present my impressions here.

Market participants familiar with the previous Trump administration (2017-2020) are unlikely to be surprised by such words and actions from Trump. Trump is firmly convinced that JPY weakness is the flip side of USD strength, and that the U.S. manufacturing industry is being badly let down by this situation. It seems very unlikely that he will ever change his views, especially given his political strategy. Whether or not he wins in the upcoming election, he is likely to continue making similar statements in the future. However, the fact is that the US trade deficit with Japan has not widened in response to JPY's 34-year low against USD. Although it has been on the rise over the past three years, the deficit (roughly USD 70 billion) is roughly the same as during Trump's term (see figure on previous page).

Moreover, as I have repeatedly discussed in past editions of this report, setting aside USD appreciation against JPY this year, the USD/JPY rate trends over the past two years that have led to JPY falling to a 34-year low against USD is owing to Japan-specific factors rather than being the flip side of USD strength. In fact, in terms of effective exchange rates, USD's effective exchange rate was on the decline for most of 2023, and its ongoing appreciation has not been sustained long enough to be called a "phase." Moreover, Japan's export volume has not increased as a result of JPY depreciation, and this is precisely why the currency is finding it difficult to regain strength via an expansion of its trade surplus, making for a structural problem. Theoretically, it is not at all surprising that a major trade deficit nation like Japan (which posted its largest ever trade deficit in 2022, and fourth largest trade deficit in 2023) would experience domestic currency depreciation. It is, however, altogether too futile to point a finger at Japan for unfair trade practices vis-à-vis the U.S. citing JPY weakness as the reason.

Japanese Companies Already Making Large Contributions

Looking back, Trump relentlessly continued to attack countries that had a trade surplus with the U.S. starting right after he was elected in November 2016 and right until the end of term in January 2020. The biggest target of his attacks was, of course, China, which is responsible for half of U.S. trade deficits overall, but other countries such as Mexico, Japan, and Germany, which enjoy close diplomatic ties with the U.S. were not spared criticism either. For instance, Trump repeatedly called for Japanese automakers to increase local production in the U.S. in an effort to improve the trade balance between the two countries. However, Japanese companies are already making a large contribution, and Trump's demands for more local production are based on a spectacular misunderstanding. The chart ranks G7 countries, China, and South Korea by the number of workers employed and amount of compensation paid by their companies in 2021 in the U.S. Whether going by the number of jobs or by wages paid, the contribution from Japanese companies was extremely large. This warrants gratitude, not criticism. However, it is important to know that even such straightforward ideas are difficult to get through to the Trump administration.

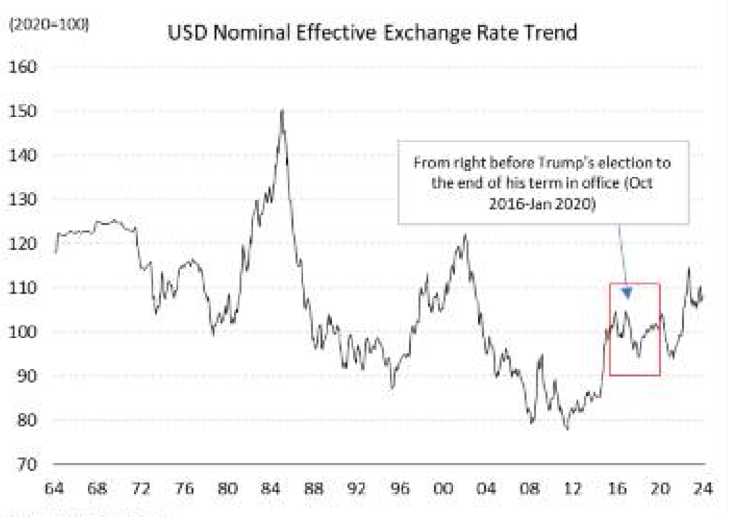
Share of Various Countries in Terms of No. of Workers Employed and Amount of Compensation by Their Companies in the US (2021)

	No. of workers	Compensation
UK	15.4%	13.3%
Japan	12.6%	12.4%
Germany	11.6%	11.5%
Canada	10.9%	10.6%
France	9.3%	8.1%
China	1.5%	1.2%
Italy	1.3%	1.0%
S.Korea	1.1%	1.3%

(Source) U.S. Department of Commerce

Ultimately, Trump is Not Thinking About Currency or Monetary Policy

Market participants who don't have a memory of the previous Trump administration may have major concerns about forex market trends post Trump's reelection. However, I am not too worried. Even as Trump is obsessing about getting USD to weaken, he will suddenly turn around and say, "Ultimately, I want to see a strong dollar." It is, therefore, quite doubtful whether he has any definitive views regarding forex rates.[1] There were reports that Trump once called his national security advisor late at night to ask if a strong or weak USD was best for the U.S. economy.[2] During the Trump administration, then Treasury Secretary Steven Mnuchin's statements also varied back and forth, perhaps reflecting Trump's uncertain views regarding forex rates. The administration's uncertain views on forex rates were reflected in the USD rate trend during Trump's term in office, with the rate of change in USD's NEER between Trump's election and the end of his term being quite flat (-0.01%). The flamboyance of his words and actions notwithstanding, USD lacked a clear sense of direction during his term (see figure on previous page).



(Source) Macrobond

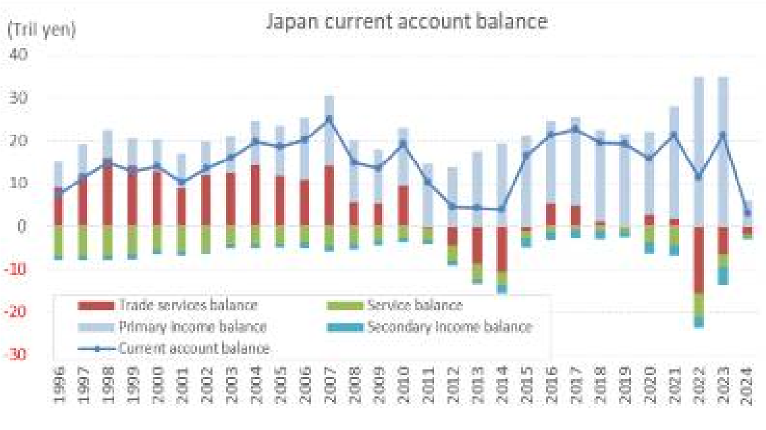
My understanding, based on his previous administration, is that Trump's statements in favor of USD weakness are not intended to disseminate information taking economic or financial conditions into consideration; rather, they are political remarks aimed at appealing to his voter base in the industrial belt in the Northeastern U.S. (the Rust Belt). In short, it is quite possible that Trump has not given any thought to currency or monetary policy.

JPY Supply-Demand Environment – CF-Based Current Account Balance Unable to Overcome Deficits

January-February current account balance is unchanged from the previous year

In mid-April, shocking news emerged of an attack by Iran on Israel. This has sharply increased the risk that the Israel-Hamas conflict, which erupted in October 2023, could spread to all of the Middle East. From a financial market perspective, one is compelled to think of a possible turn of events in which crude oil prices rise to cause a resurgence in global inflationary pressures, resulting in the Fed putting off interest rate cuts, thereby leaving JPY to continue depreciating. This is a major factor that could impact the Tokyo forex markets as a risk event potentially increasing pressure on JPY both in terms of interest rates and supply & demand.

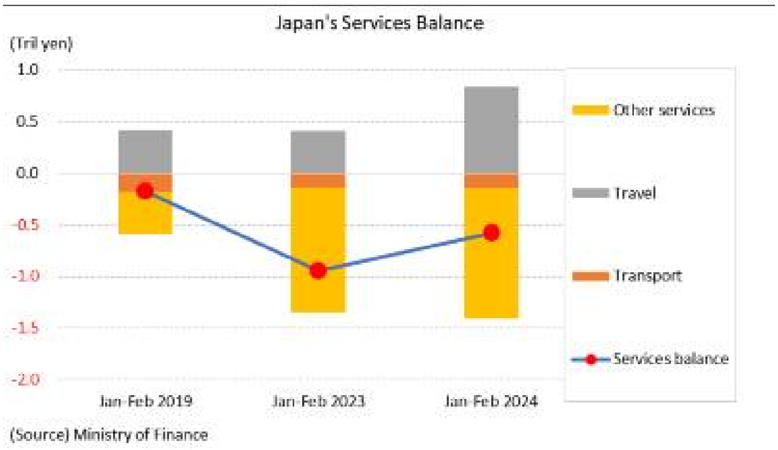
If we assume persistently high crude oil prices, downward pressure on JPY from the supply and demand side will become an increasingly important issue. I would, therefore, like to review the current situation in this section. In this context, Japan's February balance of payments, released on April 8, posted a surplus of +JPY 2.6442 trillion, the first surplus over +JPY 2 trillion in three months. The improvement is driven by a reduction in the trade deficit, centering on automobile exports, and a record surplus in the travel balance, and many in the media are reporting this positively. However, as I have explained previously, the January and February balance of payments usually fluctuate significantly due to factors including the Chinese New Year, so they must be evaluated in combination. Japan's total current account balance for January and February was a surplus of +JPY 3.1012 trillion. This is neither particularly large nor small. If the surplus accumulates at this pace, it will amount to just under +JPY 20 trillion for the entire year. This is about the same as last year. Since last fall, the travel surplus has been posting single-month record highs almost every month, but the other services deficit has also continued to hit record highs at the same pace. As a result, no significant progress has been made in shrinking the services deficit.



(Source) Ministry of Finance. The 2024 data are Jan-Feb totals.

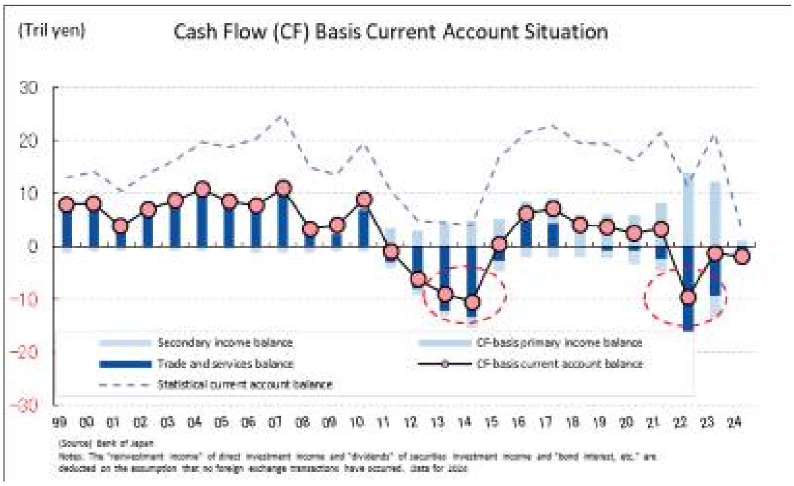
1 Please see Bloomberg article titled "Trump Now Says Strong Dollar Is Good, Yet Markets Beg to Differ," dated April 18. 2020.

2 Please see Nikkei article titled "Trump's Early Morning Phone Call Asking if a Strong or Weak Dollar was Better for the U.S. Economy" dated February 19, 2017.



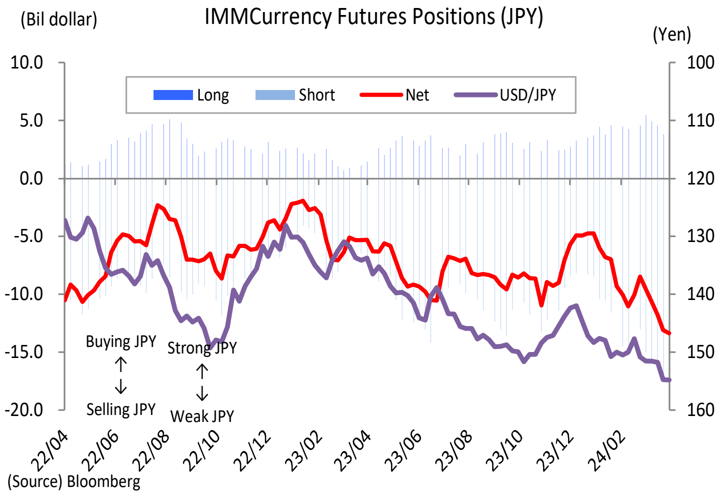
Taking a closer look at the numbers, the services balance for the same period last year (January-February 2023) was -JPY 941.8 billion, while the total for January-February this year was -JPY 576.7 billion, which is certainly an improvement. This is solely the result of the travel surplus approximately doubling yoy, to +JPY 833.1 billion. However, since border control measures in response to the pandemic were in place during January-March last year, the current performance should be seen as close to its potential. On the other hand, the other services deficit, which this report has been focusing on as a “new era deficit,” posted -JPY 1.2657 trillion, a slight increase compared with the same period last year (-JPY 1.2120 trillion), and has also been renewing the all-time-record on a monthly basis. This situation, wherein foreign currency earned through the travel surplus (i.e., tourism, i.e., physical labor) is canceled out by the other services deficit (i.e., payments made toward digital, consulting, R&D, and other services, i.e., brain work),” is now the new norm when it comes to Japan's external balance of payments. However, as has been discussed in the past, <u>assuming that Japan's population will continue to decline at an increasing pace going forward, it must be said that its ability to earn foreign currency through physical labor will dwindle</u>. Overtourism is already being seen as a problem in Japan's internationally renowned tourist cities, with some areas beginning to consider measures such as building regulations and the introduction of accommodation taxes. The travel surplus cannot be counted on to sustainably contribute to improving the service balance overall. By contrast, there is room for the other services deficit to expand going forward.

CF-Based Current Account Balance Unable to Overcome Deficits



Moreover, <u>the CF-based current account balance, which is a focus of this report, is still in the red at approximately -JPY 2 trillion in total for January and February</u>. In other words, the CF-based current account balance does not change all that much just based on a strong showing in terms of travel surplus. Any significant improvement in the CF-based current account balance going forward will require (1) a sharply decline in imports in the trade balance, and (2) a sharp reduction in reinvested earnings, and bond interest and dividends in the primary income balance. There are no reasonable grounds for expecting (2), and at present, there are concerns that the opposite will happen regarding (1). As of the end of last year, I said in this report that, assuming resource prices stabilize, the CF-based current account balance for the entire year could turn positive (post a surplus) if the trade deficit remains within the average level for the 10 years immediately preceding the pandemic (-JPY 2.5 trillion, average for the years 2010 through 2019). However, <u>amid rising resource prices, it seems likely that the deficit will continue this year.</u>

Even if JPY Appreciates by 5%...

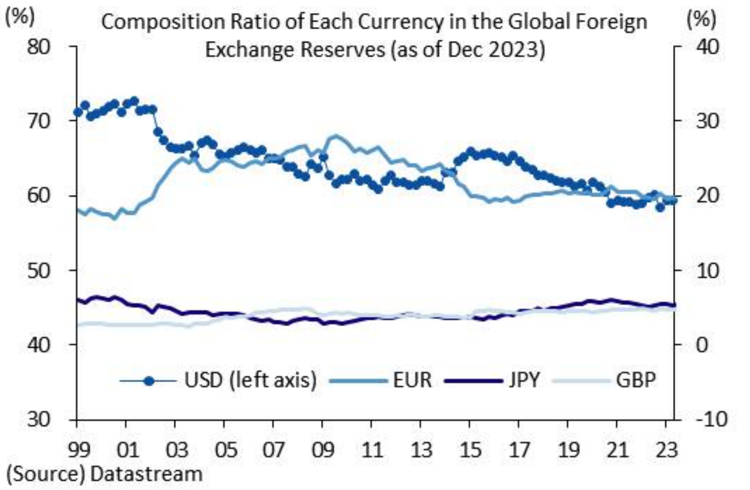


As I will discuss in detail later, one year's worth of JPY sales have already taken place in the space of three months through foreign securities investments via investment trusts. The recent JPY depreciation is due to persistently high U.S.-Japan interest-rate differentials as well as the aforementioned changes in the supply and demand environment. As speculators' JPY-selling positions, which are at the highest levels in the current weak JPY phase, are resolved, it will be interesting to see to what extent JPY can recover its value (see figure). However, the U.S.-Japan 2-year interest rate differential is 4.5 pp, while the 10-year interest rate differential is about 3.5 pp. Even assuming a forced correction (strengthening) of JPY against USD by about 5pp worth (to be generous) of interest-rate differentials, we would still only get around 145 to the dollar from the starting point of 153. If such a correction were, in fact, to take place, we may see a re-emergence of the argument that USD/JPY rate trends are determined by the U.S.-Japan interest-rate differential. This, however, is a shallow argument, as I have pointed out many times.

The question here is – could the 140 level for USD/JPY be characterized as “JPY strength?” This pertains to what I have been emphasizing in this report over the past two years – the fact that the USD/JPY rate level has been shifting upward due to structural changes in Japan’s balance of payments. In this context, it must be noted that whether JPY strengthens from the 150 level to the 140 level or the 130 level, given that the current phase of JPY depreciation started at the 110 level, my argument that interest-rate differentials alone are insufficient to explain current levels of JPY weakness remains unshakable. There has been too much focus on interest-rate differentials when analyzing USD/JPY rate trends conventionally. However, <u>over the past two years, I think there has been greater recognition of the need to look at forex rates from a more varied perspective, including based on changes in the supply and demand environment. With crude oil prices on the rise, it will become more important to keep an eye on the supply and demand situation.</u>

Could Fall in USD Composition Ratio Become a Political Issue?

On March 29, the IMF released data on the Currency Composition of Foreign Exchange Reserves (COFER). I periodically survey this data in this report, as it is important in predicting forex market trends over the medium to long term. Global foreign exchange reserves at the end of December 2023 had increased for the first time in two quarters, by USD 486.8 billion qoq, to post USD 12.3325 trillion. Looking at the October-December quarter of 2023, the 10-year U.S. interest rate fell by about 70bps from 4.6% to 3.9% between the beginning and end of the quarter, and USD’s NEER fell by about 3%. There is speculation that USD’s composition ratio in global foreign exchange reserves may have fallen by the same extent, partly due to the price effect.

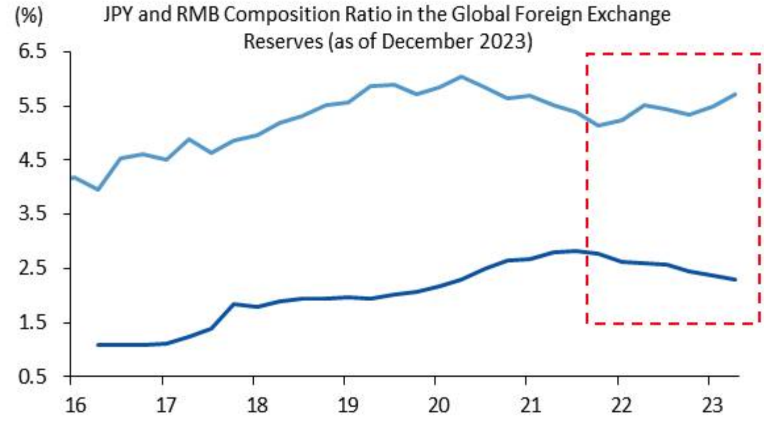


In fact, the drop in USD’s composition ratio is quite noticeable in the recently released COFER data – USD reserves declined by 0.74 pp qoq to 58.41%, breaking the previous all-time low (58.52%) recorded at the end of December 2022. Since the end of June 2021, the USD ratio has been under 60% on a four-quarter-average basis (see figure). Considering that the USD ratio consistently remained close to 80% in the early 2000s, it is clear that a new trend has taken root in the world of foreign currency reserve management a quarter of a century on. Incidentally, the cumulative change since the end of June 2022 is -0.56 pp, indicating a possible de-dollarization trend in foreign currency reserve management in response to protracted sanctions by the West in the wake of Russia's invasion of Ukraine. However, despite the USD ratio remaining consistently below 60%, there is no indication of USD weakening or U.S. interest rates rising to problematic levels. Consequently, U.S. currency authorities (in short, the political establishment) do not view it as a problem. However, if at some point in the future, there emerge concerns of surprisingly persistent high U.S. interest rates, it is possible that the move away from USD will emerge as a theme in the world of forex reserve management. Attempting to tame the surprisingly persistent high U.S. interest rates by brute force could result in unreasonable rate cuts, soaring asset prices, and the creation of a bubble. Even simply as a mental exercise, <u>it may be worth starting to think about the economic and financial impact of a possible move away from USD</u>, if that becomes the new normal as the division of power between China and Russia on the one hand, and the Western camp on the other, becomes clearer and longer-lasting.

Decline in RMB Ratio Behind Increase in JPY Ratio?

EUR is the main currency that has benefitted from the decline in USD's composition ratio – its composition ration at the end of December 2023 had increased by +0.39 pp qoq to post 19.98%. This is not surprising, given that EUR appreciated by almost 4% against USD during October-December 2023. However, the currency that saw the highest growth in share after EUR is JPY, which increased by +0.20 pp to 5.70%. Since JPY appreciated by 5% against USD during this time (JPY appreciated significantly only during the last quarter of 2023), it is logical that the JPY composition ratio would also increase owing to the price effect.

However, as the figure shows, the increase in JPY's composition ratio did not begin during this quarter, but has been going on as a trend since the end of June 2022. This more-or-less coincides with the start of the ongoing JPY-depreciation phase. Given that the COFER data is essentially discussed in USD terms, one would expect the JPY ratio to decline in light of the recent JPY depreciation, so it is interesting that it is actually rising. Could this be due to a reserve player wanting to take advantage of JPY weakness? It is difficult to tell. However, at the present time, I would like to attempt to decipher the JPY ratio movements based on RMB ratio movements. The fact is that the RMB ratio has been declining ever since the JPY ratio began to rise. At the end of the quarter in question, the RMB ratio was 2.29%, down 0.09 pp from the previous quarter and marking the seventh consecutive quarterly decline in ratio. Looking at the margin of change in composition ratio from the end of June 2022 to the end of December 2023, JPY rose by +0.55 pp, while RMB fell by -0.48 pp. While this is purely speculation, one wonders whether there is demand for JPY as an alternative to RMB.

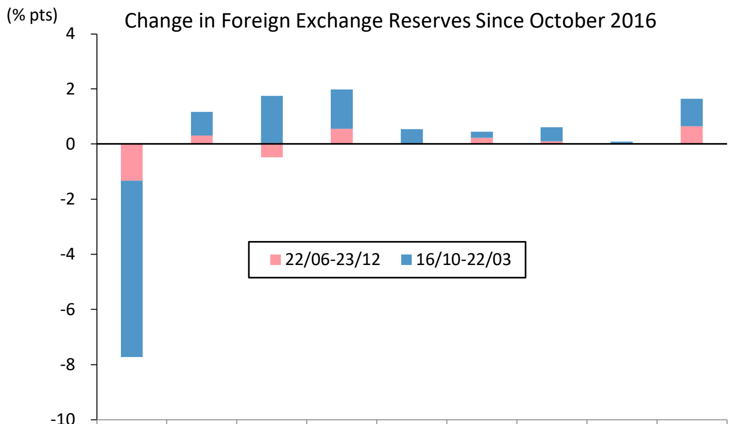


(Source) IMF, Datastream

Developments Following RMB's Adoption as Part of SDR Basket

Incidentally, it was on October 1, 2016, that RMB was adopted as part of the IMF's special drawing rights (SDR) basket of currencies and RMB data began to be published as part of COFER. I will not go into the details here, but there are criteria based on which currencies are chosen to be part of the SDR basket, and RMB's adoption attracted a lot of attention at the time, as it indicated an improvement in the currency's status and, by extension, that of China.

The composition ratio of USD from that time through the end of March 2022 declined by -6.39 pp, while that of the other currencies in the basket, led by RMB, rose. The currencies that saw the largest increases were RMB (+1.75 pp), JPY (+1.42 pp), and EUR (+0.85 pp), in that order. The particularly large increase in RMB margin is unsurprising, since the currency was adopted as part of the SDR basket in response to China's request. However, since the end of June 2022, after the Russia-Ukraine war began, the composition ratios of both USD (-1.33 pp) and RMB (-0.48 pp) have declined, while those of JPY, EUR, AUD, and CAD have continued to increase, with JPY seeing especially large growth (+0.55 pp). JPY is especially conspicuous in terms of cumulative growth (+1.98 pp) between October 2016 and December 2023 (see figure).



	USD	EUR	CNY	JPY	GBP	AUD	CAD	CHF	Other
16/10-22/03	-6.39	0.85	1.75	1.42	0.54	0.21	0.52	0.09	1.00
22/06-23/12	-1.33	0.31	-0.48	0.55	-0.01	0.23	0.10	-0.02	0.64

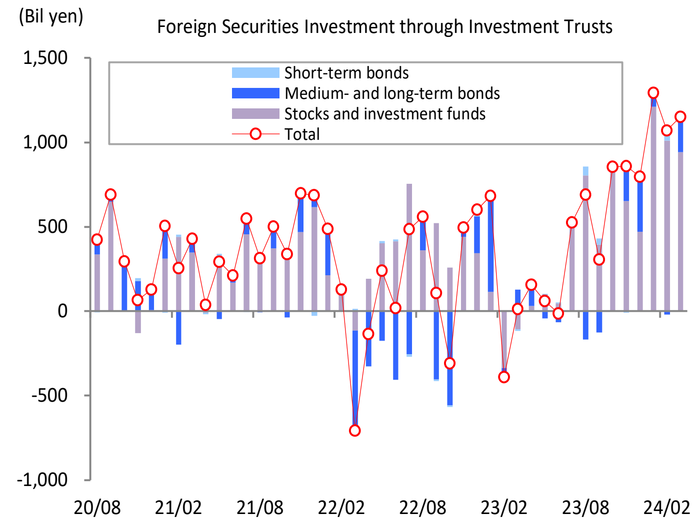
(Source) IMF, Datastream

Could it be that Western nations that had held RMB turned to other currencies in the wake of Russia's invasion of Ukraine, but their first choice had been JPY rather than USD or EUR? If so, that would be interesting. Or could it be that non-Western nations chose JPY over USD or EUR, which are at risk of immediate freezing, while there seems some scope for improvement in relations between Japan and Russia (this reason is not altogether convincing, however, given that the assets of the Russian central bank held at the BOJ have been frozen). While the reason is not clear, the statistically confirmed fact is that the preference for JPY is strengthening in the world of foreign exchange reserves, with its huge money flows. Even as the idea that JPY's protracted depreciation is due to changes in its supply and demand structure gains more widespread attention, this has come as a welcome miscalculation for Japan and is quite reassuring.

Household Sector Investment Behavior –Scale of “Household JPY Selling” Already Quite Large

Annualized Value of Net Overseas Securities Purchases Rises to Roughly JPY14 Trillion

During April, USD/JPY repeatedly rose to high levels not seen since 34 years ago. There are many factors related to this situation, but as this article has discussed numerous times, it has become undeniable that the steady accumulation of JPY selling by Japanese households is supporting the increasing weakness of JPY against USD. While the general level of interest in “JPY selling by households” appears to have peaked early this year following the launch of Japan’s new Nippon Individual Savings Account (NISA) system, the “JPY selling by households” situation merits continued monitoring, as it constitutes a new kind of JPY-selling pressure in the forex market. Data on Japan’s overseas securities investment by investor category for March (released on April 12) indicates that investment trust management companies (hereinafter referred to as investment trusts) increased their net purchases by JPY1,151.5 billion, and the rate of growth in such net purchases was higher than that in February. This net purchases amount is the second largest ever recorded since the current statistical system was created. It is worth noting that the largest amount was in this past January, while the fourth largest was in this past February. These figures make it easy to understand that net purchases of foreign securities are continuing to grow at a historically high pace.

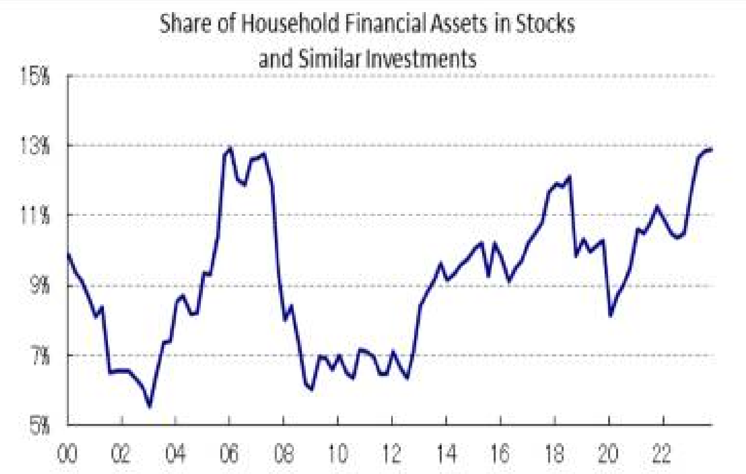


(Sources) Ministry of Finance, INDB

As a result, the total amount of net overseas securities purchases for the first quarter of this year amounted to JPY3,516.6 billion, which is of course the highest quarterly level ever recorded. Looking at full-year statistics, one finds that the past 10-year average (2014-2023) annual level was JPY3,611.1 billion, and the past 5-year average annual level prior to the COVID pandemic (2014-19) was JPY3,445.7 billion. <u>In other words, the JPY3.5 trillion recorded for the first quarter of this year is roughly equivalent to annual net purchase amounts in recent years. Of course, exchange rates fluctuate due to various factors, and the net overseas securities purchases situation is not the only major factor affecting JPY exchange rates at this time, but the fact that net overseas securities purchases have recently in a single quarter accounted for as much JPY sales as they previously caused in full years strongly suggests that it may be a major factor causing JPY’s depreciation against USD since the beginning of the year</u>. If foreign securities investment via investment trusts continues at this pace, net purchases will amount to around JPY14 trillion per year, and it can be said that there are strong grounds for anticipating that this year’s net purchases will at least be above the JPY10 trillion level. Looking at the total amount of net purchases for the January-March period (JPY3,516.6 billion) by product, one finds that stocks and investment fund interests accounted for JPY3,163.3 billion and that most of this investment was in overseas stocks.

Final Destination of the “Asset Management Nation” Strategy

In light of events during the first quarter of 2024, Japan can be said to have begun making smooth progress towards its recently announced goal of becoming an asset management nation. However, the final destination of the asset management nation strategy is not yet well understood. Japan’s household sector has become enthusiastic about investing in overseas stocks following the launch of the new NISA system largely because people are “purchasing overseas stocks to make use of the new NISA’s tax exemptions”, and this could be more-critically considered to be “using taxes to buy overseas stocks”. Given that Japan’s government is making considerable progress toward its new goal of transforming Japan into an asset management nation, Japanese citizens should be given an opportunity to get a good understanding of the eventual outcome of this transformation process.



(Source) Bank of Japan

For example, one possible outcome could be something akin to the situation in the United States, where stocks account for more than 30% of household financial assets and rising stock prices stimulate consumption and investment appetite through the wealth effect. It should be kept in mind that Japanese people are inclined to sharply shift to new behavior patterns when they perceive that “everyone is doing it”. If many Japanese become pessimistic about the future of the Japanese economy and JPY and turn to overseas investment (led by all-country or global index funds), the share of Japanese household financial assets in stocks and similar investments is likely to eventually reach the U.S. level.

(At the end of December 2023, that share was already at the record high level of 12.9% (see graph).) Even if the share of Japanese household financial assets in stocks does rise to levels comparable to U.S. levels, the stocks held by Japanese households will basically be in overseas companies, largely U.S.-based companies. Furthermore, the increase in Japanese households' holdings of foreign stocks will be promoting the weakening of JPY.
JPY and the Japanese economy have long been greatly influenced by the Fed's monetary policies (≈ U.S. interest rates), and it appears that, going forward, Japan will accept JPY depreciation as normal, while <u>the consumption and investment proclivities of Japanese households will become increasingly sensitive to trends in U.S. stock prices, which are sensitive to U.S. interest rate trends. The current situation suggests that such a scenario is quite likely.</u>

Japanese Consumption Now Dependent on U.S. Stock Prices?
If Japan's economy were to transition to such a structure, the Fed's monetary policies would become even more of a concern to the Japanese people. When the Fed is raising interest rates, for example, there are often good grounds for anticipating that U.S. stock prices will fall owing to the rise in U.S. interest rates and that JPY will weaken and USD will appreciate due to the widening of the Japan-U.S. interest rate differential. (Although a real-life scenario could be analyzed in more detail, this is meant to be a very simple example, and this extreme simplicity was also purposely retained in the example of the Fed interest rate cutting scenario, which will be discussed below.) In this case, Japan's household sector could suffer the double whammy of "an adverse wealth effect due to a decline in U.S. stocks" and "cost-push inflation due to the weakening of JPY".
Conversely, when the Fed is cutting interest rates, it is typically more likely that U.S. stock prices will rise due to lower U.S. interest rates and JPY will appreciate against USD due to the narrowing of the Japan-U.S. interest rate differential. In this case, the Japanese household sector can be expected to experience a "wealth effect due to the rise in U.S. stock prices" along with a "reduction in cost-push inflation due to the strengthening of JPY". This can be said to be a positive development for Japan, although one should not be too quick to conclude that all aspects of such a situation would be good for Japan. Japan has come to regularly record trade deficits, and although Fed interest rate cuts can generally be expected to promote JPY appreciation, there is a possibility that the margin of such appreciation will be limited.
Given that, although the Japanese household sector can be expected to enjoy a wealth effect associated with a rise in U.S. stock prices when the Fed lowers interest rates, there will still be some cost-push inflation due to the weakening of JPY, which may reduce the wealth effect. Although the Japanese household sector's levels of U.S. stock ownership is still low, that seems to be akin to the situation that Japan is currently facing.
Of course, these are just mental exercises and greatly simplify complex realities, but it is worth undertaking a step-by-step analysis of what will happen if a high share of Japanese household financial assets end up invested in U.S. stocks. Regardless of the Fed's policy adjustments, U.S. stock prices will inevitably go through periods of upswings and downswings. Currently, the ramifications of the new NISA system are only being seriously studied with respect to the weakening of JPY, and the system's potential contribution to the rise in U.S. stock prices is not well understood. Thus, whatever the Fed's monetary policy management measures may be, and even if the JPY depreciation promoted by the Japanese household sector's tendency to purchase U.S. stocks remains, a situation in which U.S. stock prices decline regardless of the actions of the Japanese household sector is quite possible. In such a scenario, the Japanese economy may be greatly challenged by the coexistence of "cost-push inflation due to the JPY weakness" and an "adverse wealth effect due to the decline in U.S. stock prices."
Some may note that this has always been the case to a certain extent, but <u>changes in Japanese households' investments may make Japan's real economy more dependent than ever on U.S. economic conditions and the Fed monetary policies designed to address those conditions</u>.

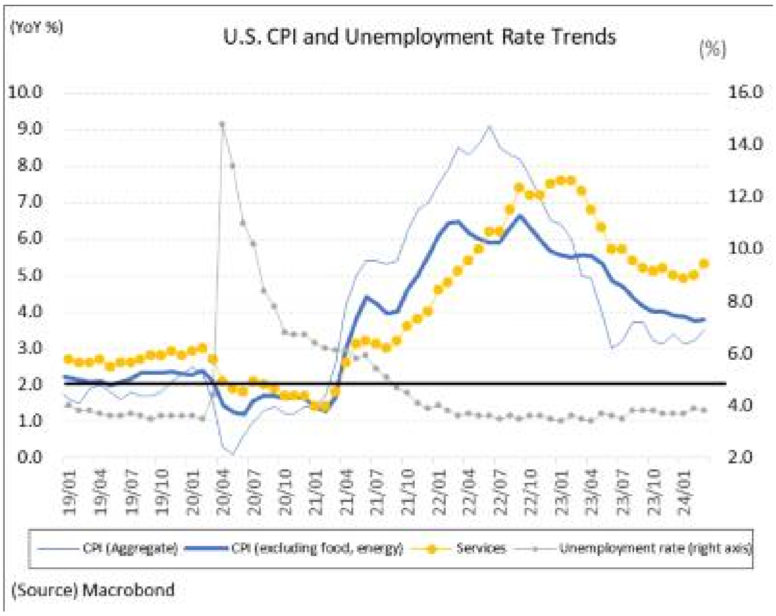
"Unfortunate Anxiety" and a New Analysis Theme
Japan has just embarked on its path toward becoming an asset management nation, and relevant statistics are not yet fully available, so there is a strong possibility that the above discussion is overly pessimistic. On the other hand, I am sure that I am not the only one feeling anxiety about the situation in which the NISA tax exemptions are promoting a sustained rise in the purchase of overseas assets rather than domestic ones. Utilizing relevant statistics that will become available in the future, I plan to continue undertaking research and analyses to elucidate the prospective characteristics of Japan as it progresses toward becoming an asset management nation. Historically, JPY cash and deposits have comprised an overwhelming share of the Japanese household sector's financial assets, so there was previously no need to consider the possibility that Japanese households' consumption and investment behavior would be affected by fluctuations in domestic and foreign financial markets. In the future, however, when Japanese households begin holding large amounts of domestic and foreign risk assets (typically U.S. stocks, etc.), those households will be significantly affected by the policy decisions of the Fed and other overseas central banks and the associated asset price fluctuations. It is inevitable that such developments will have an impact on the Japanese household sector's consumption and investment behavior. We are entering an era in which Japanese consumption behavior can be expected to be increasingly linked to trends in domestic and foreign financial markets. This is an interesting analytical topic for economists to address, and I am looking forward to seeing what kinds of results will be generated from related research.

U.S. Monetary Policies Now and Going Forward – Transient Spots on a "Bumpy Path" or a "Gateway to Inflation Resurgence"

Transient Spots on a "Bumpy Path" or a "Gateway to Inflation Resurgence"
During April, strong U.S. inflation indicators were once again in the spotlight. Statistics released on April 10 indicate that the U.S. CPI growth rate was accelerating more than expected – from 3.2% yoy in February to 3.5% yoy in March – and

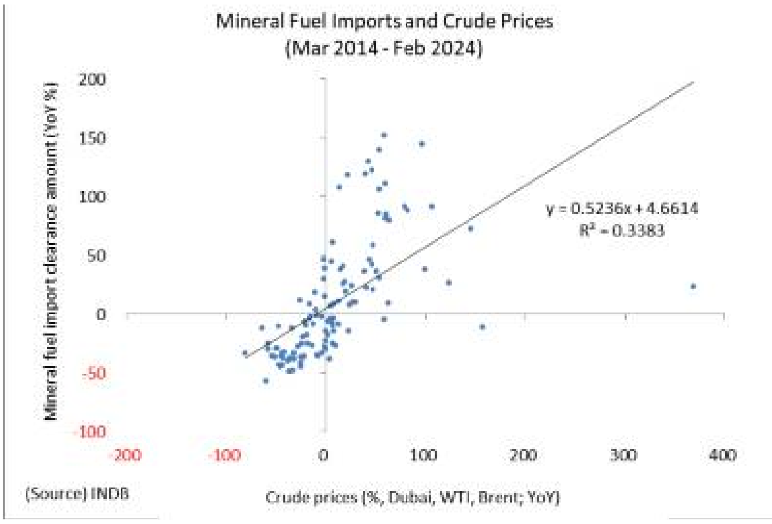
this helped push USD/JPY upward to new record high levels. Statistics released on April 25 indicate that the U.S. personal consumption expenditure (PCE) deflator for the first quarter of 2024 rose 3.4% yoy, accelerating from the 1.8% yoy growth rate in the fourth quarter of 2023, which had attracted considerable attention as it seemed to indicate that inflation was decelerating. (Core-basis PCE deflator growth for the first quarter of 2024 also accelerated, to 3.7% yoy.) Going forward, it will be important to figure out whether these signs of accelerating inflation are temporary fluctuations or reflections of a persistent trend. Fed Chairman Jerome Powell has long been characterizing the path to bringing inflation under control as "a bumpy path". Even if one considers the recent inflation upticks to be temporary, they are clearly additional bumps on the "bumpy path" that may prove to be harbingers of additional bumps. The effects of high crude oil prices are beginning to become visible in some areas, and the recent CPI acceleration largely reflects increases in gasoline and electricity prices. If the recent rise in crude oil prices is not a temporary phenomenon, then the CPI acceleration may also not be a temporary phenomenon. I think it would be prudent to be prepared for the possibility that, rather than being transient bumps, the recent inflation upticks may be a "gateway to resurging inflation" that will gain momentum going forward.

Automobile Insurance Price Surge Just a Spot on the "Bumpy Path"



There is currently no available evidence that would completely rule out the possibility that this is the beginning of an inflation resurgence. There are, however, some statistics that that make the March CPI movement appear to be simply a spot on a "bumpy path." For example, on a core basis excluding food and energy, the CPI growth rate for March was roughly stable at 3.8% yoy, but looking at the details, one notices that the rate of growth in service prices accelerated from 5.0% yoy in the previous month to 5.3% yoy (see graph). That service price increase acceleration (+0.3 percentage points) is the largest such acceleration seen in 15 months (since December 2022). Items driving the service price increase acceleration included rent (+5.7% yoy), medical services (+2.1% yoy), and transportation services (+10.7% yoy). As has become usual, rent also made a significant a large contribution the service price increase acceleration, and the contribution of imputed rents was 1.5% percentage points. When focusing on mom changes, however, the inflation of transportation service prices is particularly conspicuous. This reflects the considerable rise in automobile insurance prices (+22.2% yoy). Automobile insurance contributed 0.564 percentage point to the CPI growth rate, making it the second largest contributor, following imputed rent. However, it does not appear likely that the rise in car insurance prices will be sustainable. Automobile insurance premiums are designed to rise with some lag to take into account such factors as vehicle price changes and the occurrence of natural disasters. It would be reasonable to conclude that the rise in automobile insurance premiums reflects the emerging effects of automobile production stagnation during the COVID pandemic and the associated rise in used car prices. In light of that situation, there remains a high likelihood that Chairman Powell will characterize the current CPI growth rate rise as merely a spot on the "bumpy path".

Relationship between Crude Oil Prices and Japan's Trade Deficit



There are several ways in which crude oil price rises affect USD/JPY. USD/JPY is affected by the U.S.-Japan interest rate gap situation, and crude oil price rises elevate U.S. inflation rates and delay Fed interest rate cuts, and USD/JPY is also affected by the JPY supply-demand situation, and crude oil price rises elevate the cost of Japan's imports and widen the country's trade deficit. In light of this, it is worth being wary of the possibility that crude oil price rises may strengthen downward pressures on JPY. Since mid-April, crude oil prices have been hovering around $80-to-$85 per barrel, about 10% higher than the roughly $78 level seen last April. This is sure to worsen the JPY supply-demand environment. Based on the relationship between crude oil prices and mineral fuel prices over the past 10 years (see graph on previous page), it can be estimated that a 1% increase in crude oil prices will elevate mineral fuel prices by about 5%. Mineral fuels account for approximately a quarter of Japan's imports, so a 1% increase in crude oil prices would increase the country's imports by approximately 1.3%, and a 10% increase would increase those imports by approximately 13%. The value of Japanese imports a year ago (April 2023) was approximately JPY8.7 trillion, and approximately 13% of this amount is roughly JPY1.1 trillion. If the JPY1 trillion monthly increase continues for one year, the value of Japan's annual imports will grow by more than JPY10 trillion. While these calculations are very rough, it is clear that, as Japan has not been able to significantly increase its export volume despite the weakness of JPY, rising oil prices will cause a significant deterioration in the country's balance of payments. As Japan recorded its largest ever trade deficit in 2022, there is no need for much explanation about how problematic further trade deficit growth may be.

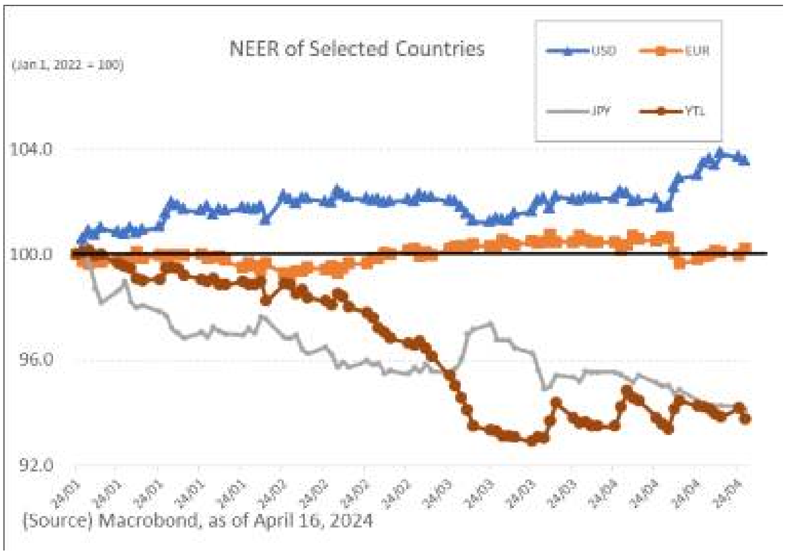
2022 Redux?

I believe the USD/JPY outlook hinges on two major factors – the U.S.-Japan interest rate gap and the JPY supply-demand situation. During 2024, I expect that downward pressure on JPY stemming from the interest rate gap will finally subside but that the leeway for JPY appreciation will be greatly limited due to the JPY supply-demand situation. This is essentially the same argument that was presented in this article last year. Observers taking the statements of the December 2023 and January 2024 FOMC meetings at face value have been almost unanimous in assuming that U.S. interest rates will decrease soon, and although the U.S. interest rate decline may be delayed, it remains a basic assumption of this article's main forecast scenario. It is still too early to consider modifying that assumption.

If the recent uptrend in crude oil prices persists, however, the story will be different, as the rise in U.S. inflation indicators released in April suggests a possibility of additional postponements of U.S. interest rate reductions that may necessitate adjustments to this article's main forecast scenario. We are currently on the brink of anticipating a situation similar to that in 2022, as rising oil prices could potentially subject JPY to downward pressures stemming from both interest rate and supply-demand factors. At the start of 2024, prior to the recent acceleration of crude oil prices, such potential situations as "a re-widening of Japan's trade deficit" and "developments in the United States preventing the Fed from lowering interest rates" were assumed to be risk factors not very likely to eventuate. This situation is now in flux, however, and, for the time being, we will continue monitoring the forex market while considering how much those risk factors may affect the main forecast scenario. If a scenario emerges in which the Middle East situation becomes increasingly tense and continued oil price rises strengthen inflationary pressures, it may become necessary to recognize that the leeway for additional elevation of USD/JPY has expanded. This point will be discussed in detail in the "Risks to My Main Scenario" section of this article below.

Risks to My Main Scenario – JPY Depreciation Risks Related to Japanese Government Debt and Renewed Fed Rate Hikes

Emerging Risk Factor Related to Japanese Government Debt



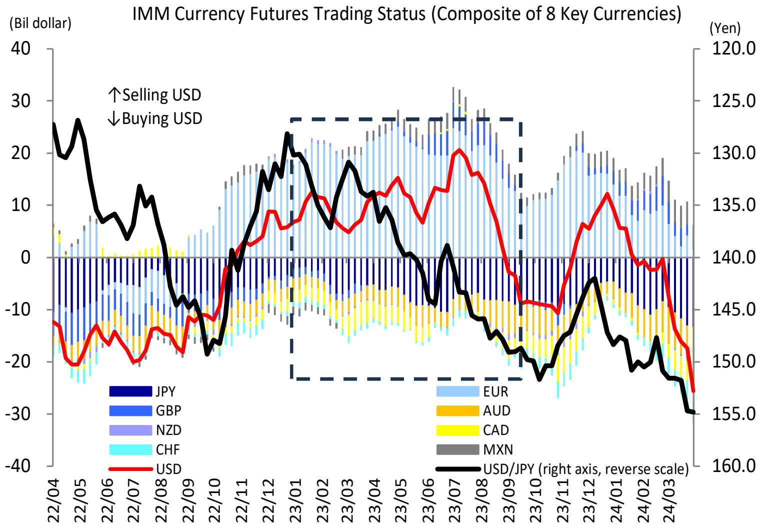
Since April, Japan has been facing an issue that more than 10 years ago would have been unimaginable – the question of whether the BOJ may be forced to raise interest rates to defend the value of JPY. Until recently, such a situation was considered to be an aspect of an ostensibly very unlikely extreme-JPY-depreciation risk factor scenario. Given that this scenario has been partially realized, however, the next potential developments requiring vigilant attention relate to Japan's fiscal financial situation. The principal factors weakening JPY at this point include the persistently low level of Japanese interest rates and changes in Japan's balance of payments structure, and it appears that the fact that Japan has the world's worst government debt situation has not yet become a main forex market theme. If speculators' focus shifts toward that government debt situation, however, an additional rise in the proactivity of JPY selling is likely to ensue. Regardless of the details of changes in Japan's balance of payments structure, some observers are already starting to argue that the BOJ's determination to maintain low interest rates largely stems from its desire to lighten the burden of interest payments on government debt. As I will discuss on another occasion, the Japanese government's net outstanding debt level has been on a gradual decline over the past three years. Leaving aside the issue of whether the government is intending to do so or not, there appears to be a possibility that the Japanese government's fiscal reconstruction is already moving forward owing to policy stances that appear to allow for considerable JPY depreciation and do not seriously strive to countervail the acceleration of domestic inflation rates. Although there appears to be only a low likelihood of substantial JPY selling stemming from concerns about the Japanese government's fiscal situation, it is a potential development that should be kept in mind given that JPY has depreciated more than TRY (the Turkish lira) since the start of 2024.

Large Risk Associated with the Fed's Potential Resumption of Interest Rate Hikes

There are also overseas situations that are significant risk factors with the potential to promote additional JPY depreciation. At the time this article was written, it was unclear how the Middle East situation will develop but impossible to completely preclude the possibility that the situation could develop into a serious conflict involving the United States, Israel, and Iran. It would be best to leave the detailed appraisal of that situation to experts on Middle East politics, but it is worth considering how forex market participants will respond if rising Middle East-related risks lead to the normalization of high crude oil prices. There is currently great concern about the potential for a “(1) sharp rise in crude oil prices → (2) delay in U.S. interest rate cuts → (3) major collapse in U.S. stock prices” scenario. Given that JPY depreciation could potentially be caused by Japan-U.S. interest rate gap widening and Japanese trade deficit growth, that potential scenario could become an additional factor promoting unexpected margins of JPY depreciation. Moreover, the worst-case situation would be for the scenario’s second “(2) delay in U.S. interest rate cuts” stage to become extended to include a resumption of Fed rate hikes. Although it cannot be said that it is very likely that the Fed would resume rate hikes, it may be necessary to assume such a development to support a forecast of USD/JPY settling in a range above the JPY160 level. It should be noted that the rise in crude oil prices is increasing uncertainty in the lives of ordinary Americans and threatens to present President Biden’s re-election campaign with additional challenges. This may not be an important factor, however, as the news media are now generally reporting that that President Biden’s chances of re-election are already quite weak, and a Trump re-election has become the financial markets’ main forecast scenario.

Recent JPY Depreciation Partially Reflecting USD’s Strength

Looking at the current JPY depreciation trend, one gets the impression that there is no way to stop it. At least with respect to forex rate movements since the beginning of the year, however, it should be recognized that USD’s strength has been a major factor and that it is not just JPY that has been depreciating against USD. In other words, JPY’s recent depreciation has not entirely resulted from a “Sell Japan” mood (although that may largely be the case, of course) – to a certain extent, it has simply reflected USD’s strength. Looking at the composite positions of eight major currencies in IMM currency futures trading (against USD), one finds that USD long positions are approaching their highest level in the past two years (see graph). So USD is being bought across the board, while JPY is positioned as just one of the many currencies being sold. On the other hand, if we look back to 2023, for example, JPY continued to depreciate even when USD selling against various currencies was accumulating (the dotted rectangle within the graph). It appears that, at that time, JPY depreciation was primarily a result of a “Sell Japan” mood rather than being the flip side of USD’s strength. In light of the current futures trading positions situation, it appears that (unlike in 2023) a certain degree of correction to JPY’s recent depreciation can be expected when USD’s strength diminishes.



(Source) Bloomberg

In any case, it is increasingly apparent that there is almost no way to moderate JPY’s recent depreciation trend at this time and that the most important factor going forward will be the timing of USD weakening, which can be expected to roughly correspond to the timing of Fed interest rate reductions. In light of this, when considering how to countervail JPY depreciation trends in the future, for example, it may be possible to explore the possibility of government policies that promote the repatriation of profits that the Japanese corporate sector retains overseas, and there is a possibility that such policies may be included in the “Big-Boned Policy Outline” the government will announce this June. Given that rising labor costs are emerging as a new trend in the Japanese economy, it would appear that the corporate sector’s domestic financing needs are greater than ever. I plan to discuss this issue in greater detail on another occasion.

EUR Outlook – Growing Potential for EUR Weakening

EUR Area Monetary Policies Now and Going Forward – ECB on Track to Approve Interest Rate Cuts in June

Increasing Signs of June ECB Rate Cuts

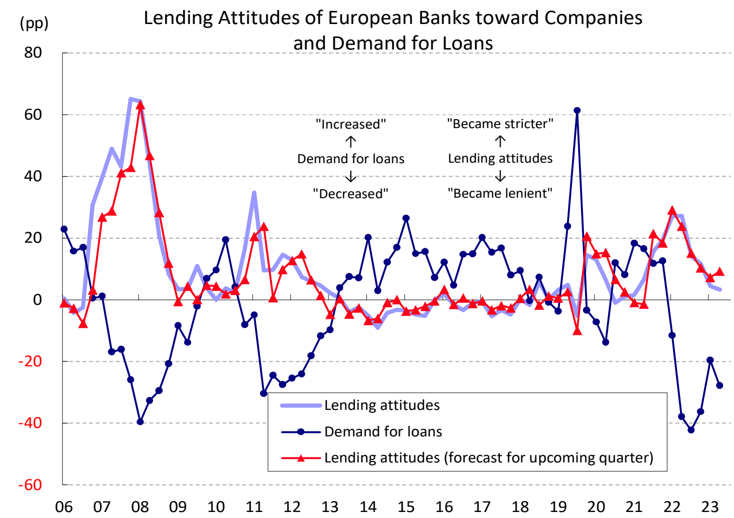
The April 11 ECB Governing Council meeting decided to keep policy rates unchanged (becoming the fifth consecutive Governing Council meeting to maintain the interest rate status quo), with the major refinancing operation rate left at 4.5% and the deposit facility rate left at 4.0%. Since the January Governing Council meeting this year, the ECB's forward guidance has indicated that there will be no major policy adjustments until the end of May, when trends in inflation and wage growth can be fully evaluated. Accordingly, the lack of policy adjustments in March and April was generally anticipated, and the financial markets did not show any particular reaction to the April meeting's results. It seems to me that the following sentence inserted in the April Governing Council meeting's statement strengthens the overall dovish image of the meeting:

- **If the Governing Council's updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission were to further increase its confidence that inflation is converging to the target in a sustained manner, it would be appropriate to reduce the current level of monetary policy restriction.**

Since last year, the ECB has been explaining that it will be making policy decisions based primarily on (1) the inflation outlook, (2) the underlying inflation situation, and (3) the strength of policy transmission. While the above text simply reaffirms this, <u>the fact that it was inserted into the meeting's statement as a pre-condition for interest rate cuts can be considered a step forward</u>. Since growth rates in the overall- and core-basis euro area consumer price index (HICP) have been steadily decelerating, it seems likely that the June staff forecast will confirm that sufficient stability has been achieved with respect to (1) the inflation outlook and (2) the underlying inflation situation. It is noteworthy that, at the most recent post-Governing Council-meeting press conference, ECB President Lagarde revealed that "a few members" felt confident enough to cut interest rates based on the limited data available in April. Those few members went along with the majority opinion that the Governing Council should wait to make sure the current trends are confirmed by the data made available in June, but <u>the fact that the ECB made a point of revealing the views of those few members reinforces the impression that the ECB is confident it will be positioned to undertake interest rate cuts in June</u>.

No Problems with Monetary Policy Transmission Channel

It appears that ECB has also confirmed progress with respect to the (3) the strength of policy transmission situation. Regarding demand for loans (used as a reference to determine the degree of penetration of the effect of interest rate hikes), the latest edition of the ECB's Bank Lending Attitudes Survey indicates that the net percentage of banks reporting a qoq decrease in demand had decreased for four consecutive quarters through the last quarter of 2023 (indicating recovering demand for loans) but increased during the first quarter of 2024 (indicating a decline in demand for loans). On the other hand, banks had been decreasing the net tightening of their credit standards for loans for four consecutive quarters through the last quarter of 2023 (indicating lending attitudes were easing) but increased the net tightening of their credit standards during the first quarter of 2024 (indicating stricter lending attitudes).



(Source) Datastream

<u>In summary, the tightening effect of successive interest rate hikes and the recovery from those effects through the last quarter of 2023 was confirmed, but the effects of interest rate hikes was causing the credit environment to weaken again during the first quarter of 2024</u>. This situation suggests that it would be reasonable to lower interest rates with the goals of stimulating the economy and enabling the avoidance of an economic hard landing. <u>In any case, it appears that the monetary policy transmission channels are functioning as the ECB would like them to function, so it is assumed that the ECB will not consider the (3) the strength of policy transmission situation to be an impediment regarding its prospective interest rate cuts</u>.

Growing Potential for a Substantial Drop in EUR/USD

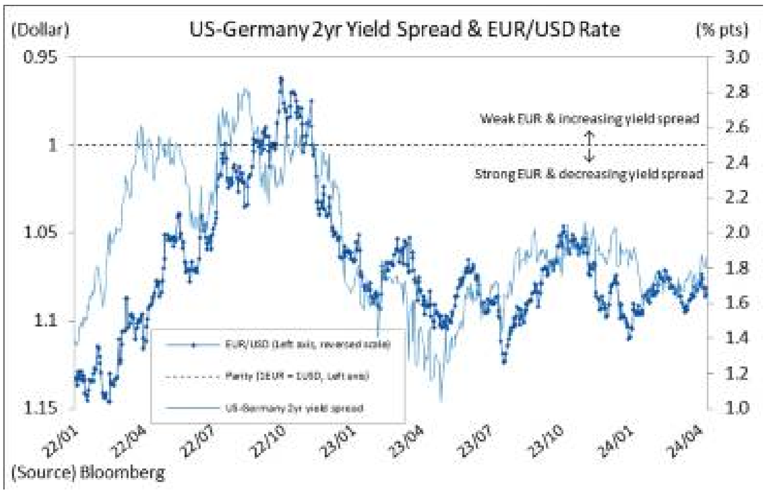
As mentioned above, the status quo maintenance of the March and April ECB Governing Council meetings was in line with expectations. However, there are also rising expectations that the ECB will do something in June to compensate for its recent passivity, and there are some signs that the ECB is preparing to make some policy adjustments in June. <u>Unless the rate of growth in HICP and euro area negotiated wages is very strong in May, the financial markets will inevitably assume that there will be an ECB interest rate reduction</u>. On the other hand, there is speculation that the Fed will find it difficult to cut interest rates by the end of the year, let alone June, so it is predicted that the ECB, which started raising interest rates later than the Fed, will end up lowering rates sooner than the Fed. President Lagarde acknowledged that the trajectory of inflation is different in Europe and the United States, stating at the press conference following the April Governing Council meeting that – "the nature of inflation in the euro area [is] different from the nature of inflation in the United States." – and pointing out differences in responses to fiscal policy and different characteristics related to consumption and investment.

EUR/USD has been expected to remain fairly stable owing to the stability of the U.S.-European interest rate differential, but if the ECB does proceed with interest rate cuts in June, EUR/USD could show its first substantial drop in some time. The potential for this drop is not being fully factored in by the forex market, but regarding CPI growth rates, the contrast between accelerating Fed countermeasures and decelerating ECB countermeasures is becoming increasingly clear. It remains to be seen whether the disparity between the monetary policies of the Fed and the ECB will emerge as a major market-moving theme in the future, but I think it is worth keeping a close eye on this potential development. One reporter at the April press conference noted that services inflation remains "very sticky" and posed the question – "Would you say that the ECB could theoretically still go ahead with a cut in June if services inflation sticks at around 4%?" This can be considered one of the most important issues from the perspective of ECB watchers. In response, President Lagarde said – "[W]e're not going to wait until everything goes back to 2% to make the decisions that will be necessary in order to make sure that inflation returns to 2% sustainably, at target, in a timely manner. It's inevitable that some items will be slightly higher." While the ECB Governing Council should be aware that euro area negotiated wages are likely to continue growing at rates around 4.5% yoy based on the movements of various wage trackers, it is probably best to assess the likelihood of the June interest rate cut scenario in light of such statements by President Lagarde. Based on consideration of the monetary policies of the Fed, the ECB, and the BOJ, the three major currencies' relative strength relationship is likely to become "USD > EUR > JPY" during the latter half of this year.

EUR Now and Going Forward – Sharp EUR Depreciation Could Spur Concerted International Action

What Will Happen When the ECB Cuts Interest Rates?

At the beginning of this month's article, I argued that the time is not yet ripe for international cooperation to alleviate USD's excessive strength. So, when can we expect the time to be ripe? The extent of the prospective EUR weakening mentioned above is likely to be an important issue in this regard. It is not unlikely that the ECB's monetary policies and prospective EUR exchange rate trends will play a key role in determining the future course of international monetary policy cooperation. In a future risk scenario in which USD becomes even stronger and support for international cooperation to alleviate USD's strength grows, such cooperation will inevitably involve the euro area. As mentioned above, barring the emergence of unforeseen problems, the ECB will almost certainly start cutting interest rates this June. In that case, it is highly likely that EUR depreciation against USD will accelerate, but will the ECB and euro area countries' central banks tacitly approve of such a trend? While conditions in the euro area's employment and wage markets are still very tight, the euro area probably does not want its currency to depreciate. As this article has argued for some time, EUR/USD tends to react as sensitively to U.S.-Europe interest rate differentials as USD/JPY reacts to U.S.-Japan interest rate differentials, if not more so (see graph).



If the EUR/USD were to fall below 1.05 or if EUR were to fall below parity with USD, the ECB would likely deem it necessary to come up with policies for restraining EUR depreciation (as well as inflation stemming from EUR depreciation). As the euro area continues to cycle between zero growth and negative growth, the ECB is probably not pleased to be in a situation in which forex considerations make interest rate cuts difficult even when the euro area might benefit from such cuts. If the excessive strength of USD has a strong negative impact on the euro area's economic and financial situation, many euro area countries may begin expressing complaints about that USD strength. This is a scenario that may clarify the extent of the EU and euro area's ability to make its claims heard as one voice on the international stage, since EU decision making processes will require the focusing of political power through majority votes. I believe that the extent to which USD strength hurts the euro area will be a key factor when predicting what decision is taken on concerted international action, which will have a major impact on forex markets as a whole, including JPY forex trends.

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