Forex Medium-Term Outlook

June 28, 2024

Overview of Outlook

USD/JPY continued to rise in June. An interest rate cut by the Fed, which may a lifeline to help correct JPY weakness, is fast approaching, and the BOJ has also indicated monetary policy tightening for the time being, suggesting higher JPY interest rates going forward, but there are still no signs of the weak-JPY trend reversing. Based on an analysis of the data, the JPY supply-demand climate, which was tilted toward a net selling of JPY, seems to have improved since the beginning of this year compared with 2022 and 2023, leading to a strong suspicion that speculative movements are driving JPY depreciation. However, if such speculative movements also include household JPY selling following the launch of New NISA, then speculation or not, their ability to be sustained cannot be taken lightly. Foreign securities investment via investment trusts has already exceeded last year's performance in the first five months of the year, and it seems quite difficult to insist that these movements are unrelated to JPY depreciation. At any rate, a U.S. interest rate cut is the need of the hour, but the June FOMC dot plot suggests a higher the neutral interest rate. If we accept that the neutral interest rate is higher, this means a fewer number of rate cuts will be needed in this phase of rate cuts. I do not believe that the widening of the U.S.-Japan interest-rate gap is the real cause of JPY weakness, but even if that were the case, it must be noted that we may be entering a phase in which it will be difficult to correct JPY depreciation. In the near term, the focus is on whether the BOJ will be able to implement both quantitative tightening and an interest rate hike at its July meeting. Given the current state of the Japanese economy, which is struggling under the inflation tax, this will not be as easy a policy adjustment as the market hopes.

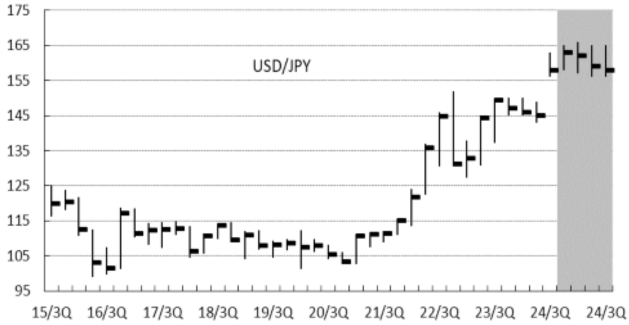
EUR also weakened against USD in June. The ECB decided to cut interest rates, but amid speculation that further rate cuts will not be easy, the direction is difficult to discern. To be sure, since April, the data has been suggesting a bottoming out of the euro area economy, so the hurdle for consecutive rate cuts not low. Taking into account revised ECB staff macroeconomic projections, etc., the expected pace of rate cuts going forward may be at most once every quarter. If so, the ECB's rate cut trajectory will not be very different from that of the FRB, which is expected to cut rates starting September, and EUR/USD may remain deadlocked in line with the Europe-U.S. interest-rate differential. However, in the near term, political developments are what are attracting greater attention in the euro area. If the French National Assembly, which abruptly announced a snap general election, is taken over by far-right forces as rumored, there are concerns of it clashing with the European Commission over fiscal discipline. As of the present time, France has the third worst government debt in the euro area after Greece and Italy. If, under these circumstances, if continues to oppose the EU's fiscal discipline, the country's sovereign debt could very well be downgraded, and there are concerns that this could lead to EUR selling. Given the upcoming political schedule, internal disputes within the euro area could trigger EUR selling this fall.

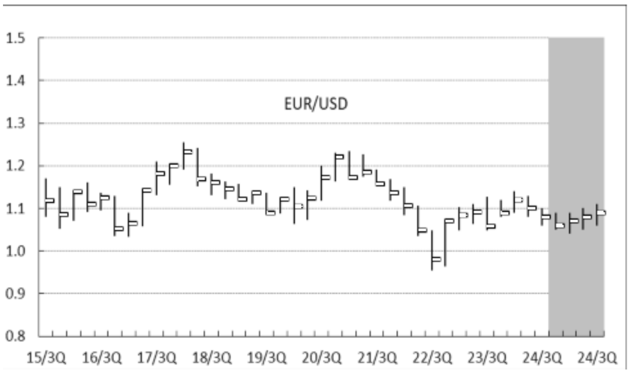
Summary Table of Forecasts

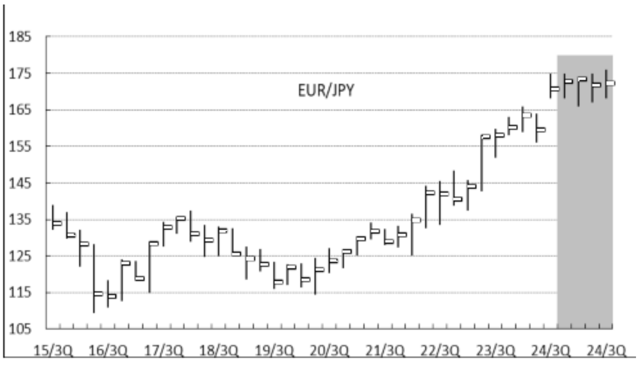
	2024 Jan-Jun (actual)	2024 Jul-Sep	Oct-Dec	2025 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	140.80 ～ 161.27 (161.12)	156 ～ 163 (158)	158 ～ 165 (163)	157 ～ 166 (162)	156 ～ 165 (159)	156 ～ 165 (158)
EUR/USD	1.0601 ～ 1.1046 (1.0697)	1.06 ～ 1.10 (1.08)	1.05 ～ 1.09 (1.06)	1.04 ～ 1.09 (1.07)	1.05 ～ 1.10 (1.08)	1.06 ～ 1.11 (1.09)
EUR/JPY	155.10 ～ 172.39 (172.35)	168 ～ 175 (171)	168 ～ 175 (173)	166 ～ 174 (173)	167 ～ 175 (172)	168 ～ 176 (172)

(Notes) 1. Actual results released around 10am TKY time on 30 JUNE 2024. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts





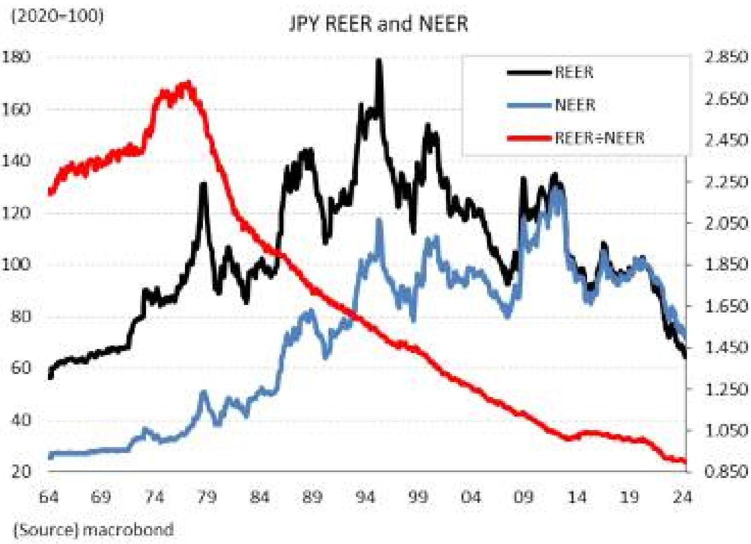


USD/JPY Outlook – No End in Sight to Across-the-Board JPY Weakness

JPY Now and Going Forward – The Importance of Evaluating Based on Effective Rates

What is “Hidden JPY Depreciation”?

JPY continued to weaken in June, hitting the 160 level against USD. The continued depreciation of JPY has led to the emergence of a new phrase – “hidden JPY depreciation.” The phrase recently appeared in a June 19 *Nikkei Shimbun* article titled “Hidden JPY Depreciation Continues, British Pound Exceeds JPY200; Interventions Unable to Work Magic.” It also appeared in articles in November 2023 and February 2024, and I sometimes hear it spoken around me, so it seems fairly well known. “Hidden JPY depreciation” sounds grand, but all it really means is that JPY’s effective exchange rate is falling. I have repeatedly said in this report, based on my analysis of JPY’s supply-demand structure, that JPY is depreciating on an effective basis and that it is dangerous to view the ongoing JPY weakness as the flip side of USD strength. Also, JPY depreciation is not hidden by any means. It is simply that the media and analysts have been overly preoccupied with USD/JPY trends while taking little interest in the trends of other currencies. Going by the monthly releases of Real Effective Exchange Rate (REER) and the Nominal Effective Exchange Rate (NEER) – in fact, the Bank for International Settlements (BIS) publishes daily NEER data, with five days’ worth of data being updated once a week – JPY has been steadily depreciating.



At the time of writing this article, REER and NEER data up to May 2024 are available. In terms of levels, the former (64.45) is the lowest since January 1967, and the latter (71.48) is the lowest since September 1990. REER after price adjustment is the lowest in half a century (or more), so it is easy to attract attention, but even before price adjustment, it is roughly the lowest in 34 years – this situation had already emerged last year. The decline of the latter (NEER) is the basis for the “hidden JPY depreciation” the newspapers are reporting. The symbolic milestone of JPY160 against USD, 170 against EUR, and 200 against GBP are merely the outcome of JPY’s continued decline, so one need not find great significance in those rates *per se*. In fact, discussions focusing on specific currency pairs are misleading from the start. However, whether real or nominal, a decline in its effective exchange rate indicates that JPY is essentially falling against the currencies of major trading partners.

To those focusing only JPY's rate against USD, perhaps the currency's decline against other currencies *seems* hidden, but this market phenomenon has been a consistent feature of the ongoing phase of JPY depreciation (it may, therefore, be more accurate to describe it as "unnoticed" rather than "hidden"). This is why I have always advocated discussing foreign currency trends based on JPY trends, rather than discussing JPY trends based on foreign currency trends. One solution to this is the discussion of structural changes in the balance of payments, which is now being heatedly debated as part of forex-related discussions.

REER, Rather Than "Hidden JPY Depreciation," Remains the Problem

Going forward, correcting the stubbornly low NEER of JPY will require interest rate cuts by the Fed and the accompanying weakening of USD across the board, which are developments that can be reasonably expected to take place. Under a floating exchange rate system, it can be expected that JPY will strengthen to some extent as USD weakens. The bigger problem is the fate of JPY's REER, which is at its lowest in half a century. This is not a problem that can be resolved as part of the trend of JPY's NEER based on USD. Although it does not have much theoretical significance, the ratio of JPY's REER to its NEER (REER ÷ NEER) as of May this year is 0.9017 (see figure on previous page). This is the lowest it has been since records began to be kept in January 1964. JPY's REER has been falling more rapidly than its NEER, which, in other words, highlights Japan's relative disinflationary situation. If this is the case, it is quite conceivable that the REER weakness will remain unchanged to some extent even if JPY strengthens on a nominal basis (i.e., in the NEER world) going forward. Even if JPY strengthens to the level of 140 to the dollar, the currency's REER may not appreciate much Japan's relative disinflation vis-à-vis the U.S. changes.
Having said that, I do believe that there is a strong possibility of JPY's REER strengthening going forward. As I have explained many times in this report, the Japanese economy's disinflation is clearly moving toward resolution, exogenously due to JPY weakness and high resource prices, and endogenously due to the labor shortage. In addition to this, demand created by inbound tourism has further raised the prices of goods and services. All this has damaged the real income environment in Japan, crowding out real consumption, as is generally understood. The theoretically expected outcome of all this is an increase in REER due to inflation in Japan, and my basic understanding is that this is currently underway.
In fact, Japan's Consumer Price Index (CPI) trends, which have been unsatisfactory over the past quarter of a century or so, are also on the mend (see figure), but it will remain to be seen whether this is a transient phenomenon or a sustainable one. Considering the various phenomena currently occurring in the Japanese economy, my position is that the REER trend must be watched based on the assumption that current price trends are likely to be sustained. At any rate, it is certainly time to develop a broader view of the market, rather than focusing too closely on the movements of specific currency pairs and making a fuss about JPY weakness.

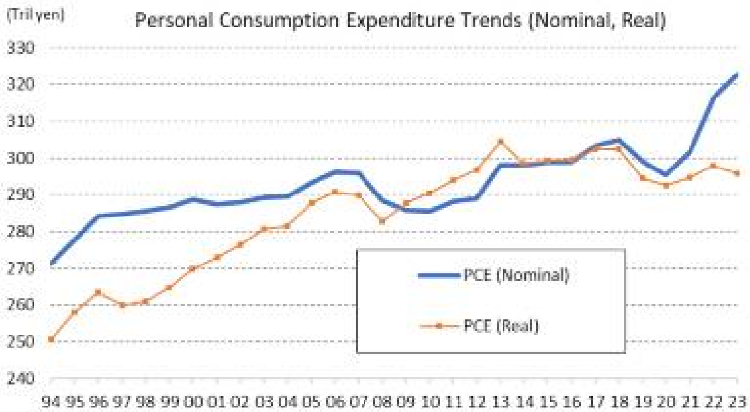
BOJ Monetary Policy Now and Going Forward – Expectations for July Have Increased

Sound Reasoning Falls on Deaf Ears in the Forex Market

At its monetary policy meeting (MPM) held on June 14, the BOJ decided to continue encouraging the uncollateralized overnight call rate, which is its policy interest rate, to remain at around 0-0.1%. Regarding the reduction in its purchases of long-term Japanese government bonds (JGBs), i.e., quantitative tightening (QT), which had attracted attention in advance reports, it was merely stated that the policy had been decided upon, while the specific amount and time frame would be finalized at the July 30-31 MPM. As there was no mention of an interest rate hike, and the QT decision had been postponed, the initial reaction of the forex markets was to sell JPY. Inevitably, expectations have increased for the July MPM, which happens to coincide with the release of the Outlook for Economic Activity and Prices report (details follow).
However, given that the BOJ does not have many cards it can actively play, buying time with a preview-style operation similar to the ECB seems wise. Of course, it is also true, as BOJ Governor Kazuo Ueda says, that a long time will be needed to bring the size of the BOJ's bond holdings and (the corresponding) excess reserves down to a "desirable level," so there may have been no intention to stall. Again, the forex markets may have found a reason to go ahead and sell JPY anyway even if something had been decided this time, so it seems a good idea to proceed bit by bit.
Although JPY weakened immediately after the release of the statement, the tone of Ueda's press conference was cautious from start to finish, probably taking into account the market's reaction to what it viewed as the Bank's acceptance of JPY weakness last time, and the damage (the extent of JPY depreciation) was able to be minimized. I think this was a commendable way to deal with a difficult situation. In contrast to the previous BOJ administration under Haruhiko Kuroda, which rejected all dialog with the market and caused friction in various places with its ruthless purchase of JGBs, the current administration is proceeding cautiously, even holding meetings with bond market participants. Taking into account JPY interest rate stability, this is not an approach to be criticized, even if not praised.
However, such sound reasoning falls on deaf ears when it comes to the forex markets, which act on impulse. Despite Ueda's statement that there is not much cost to delaying the policy decision by a month or two in the short term, it seems

inevitable that JPY selling will have to be endured at least until after the July MPM. This is the “cost” of postponing the decision. One wonders whether the BOJ will see JPY being endured at the 155-160 range, which was the range at which the previous currency intervention was implemented, and eventually decide that this seems to be an “endurable” rate.

Next Hurdle: Raising Interest Rates and “Sizeable” Rotational Bond Purchase Reductions
As I have feared for some time in this report, the BOJ’s MPMs have turned into all-out JPY-selling events. There are only two options regarding what might happen after any given meeting – if the BOJ maintains the status quo, the markets sell JPY in disappointment; if it tightens monetary policy, the markets sell JPY to urge further tightening. This is an exact repeat of the “JPY appreciation → additional easing” loop that former BOJ Governor Masaaki Shirakawa was trapped in during the global financial crisis and the European sovereign debt crisis. No matter how many rate hikes are implemented, it will be difficult for the BOJ’s policy interest rates to approach FF rates, so JPY selling spurred on by the large U.S.-Japan interest rate gap may be unstoppable. In the sense that no matter what the BOJ does, JPY will continue to be sold, the current JPY selling trend seems to be the fate of the Japanese economy.
Meanwhile, the fact that the postponement of a decision at the June MPM has raised expectations for the July MPM is a near-term problem that cannot be ignored. Deputy Governor Shinichi Uchida’s “This is different” speech raised expectations of an interest rate hike along with the release of the Outlook Report at the July MPM. Taking all this into account, the BOJ is now in a situation where it will have to both implement a rate hike and decide on rotational bond purchase reductions of a “sizeable amount” at its July MPM to prevent disappointment-led JPY selling. Will it be able to overcome this hurdle? This is the last and biggest issue of interest before Europe and the U.S. enter the summer break.
Note that “sizeable amount” is Ueda’s phrase, but the monthly purchase amount under the current policy guideline is about JPY 6 trillion, and the actual purchase amount in May was down to JPY 4.5 trillion or so. From the markets’ perspective, therefore, a “sizeable” reduction from here could be to the tune of JPY 3-4 trillion. It will be interesting to see what information is put out following the meeting with bond market participants. It will also be interesting to hear the reasoning behind interest rate hikes in light of an increasing sense of stagflation in the Japanese economy. For instance, the data for personal consumption alone clearly highlights the gap between real and nominal figures (see figure). Though the markets take them for granted, the economic situation is not all that conducive to rate hikes.



(Source) macrobond

Strategic Perspective to Correcting JPY Weakness: Awareness of Coordinating With the Fed
The only way for the BOJ to escape the vicious cycle it is currently in is to arrange a quasi policy-coordination with the Fed. In other words, to create an awareness that the BOJ will act in step with the Fed. Though it peaked out with the BOJ’s JPY-buying currency intervention from late April through early May, the market’s speculative JPY short positions are still trending at the highest levels seen during the current phase. Traders, it would be fair to say, are always looking for ways to make a profit. It would be a bonanza for them if contrasting policy decisions are made by the BOJ and the Fed. Fortunately, the likelihood of a Fed rate cut is finally in sight, with some saying it could happen as early as September. If the Fed at its July FOMC meeting offers a preview of rate cuts to come in September, and the BOJ comes through with a rate hike as well as a decision to cut JGB purchases by a sizeable amount, the combination could well contribute to a rollback of speculative positions. Leaving aside the question of whether or not this can be called “monetary policy” (it is clearly “currency policy”), the current situation is certainly strategically conducive to a policy coordination with the Fed in order to curtail JPY depreciation.

U.S. Monetary Policy Now and Going Forward – Possibility of Rate Cuts Finally Coming Into Sight

Rate Cuts to Begin as Early as September, or by December at the Latest
The Fed kept its monetary policy unchanged following the June 11-12 FOMC meeting. The dot plot (see figure), which shows the median of Policy Board members’ projections for the federal funds (FF) rate, indicated a downward revision from three rate hikes this year to one. This had already been factored in due to strong job data for May (released on June 7), but the dot plot should be assessed also taking into account the May CPI, which was released immediately before the meeting. While the median projection indicated a single rate cut (7 members), the most common projection indicated two rate cuts (8 members), while four members predicted no rate cuts. Going just by the dot plot, it would appear that many members had a hawkish outlook, but had the members had sufficient time to interpret the

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

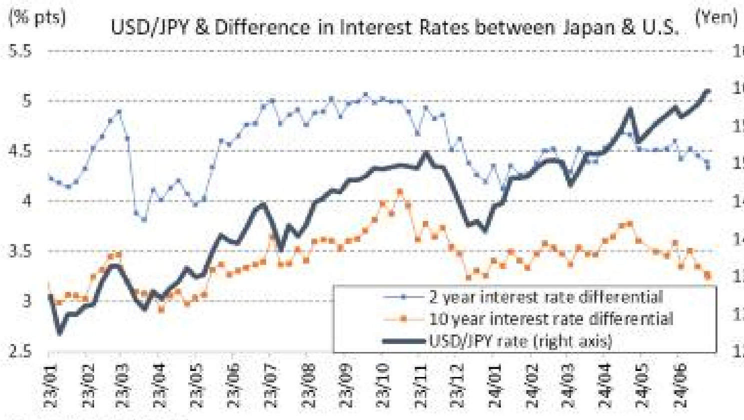
FOMC Date	2024	2025	2026	Longer run
Dec-22	4.125%	3.125%	n.a.	2.500%
Mar-23	4.250%	3.125%	n.a.	2.500%
Jun-23	4.625%	3.375%	n.a.	2.500%
Sep-23	5.125%	3.875%	2.875%	2.500%
Dec-23	4.625%	3.625%	2.875%	2.500%
Mar-24	4.625%	3.875%	3.125%	2.5625%
Jun-24	5.125%	4.125%	3.125%	2.7500%

(Source) FRB

May CPI data, which had been released immediately before the meeting and revealed the lowest growth in around two years, the median projection of the dot plot may have indicated two rate cuts.
Of course, the revision from three to two rate cuts could still be perceived as somewhat hawkish, but the number of rate cuts expected this year should be viewed more broadly as once or twice rather than just once. In fact, Fed Chair Jerome Powell acknowledged that the forecasts of one vs. two rate cuts were “close calls,” and that both seemed “plausible” to him. Further, the projection for the total number of rate cuts expected by the end of 2026 remains unchanged at nine times, so it cannot be said that members’ stances regarding the FF rate have changed in any fundamental way since the March meeting. In fact, the staff economic projections (SEP) remain mostly unchanged since March. It must be understood that the FOMC’s basic stance does not have either a hawkish or dovish bias, but rather remains committed to responding suitably to economic indicators while ensuring discretion. Under such circumstances, if I had to make a prediction, it would be that there could be a rate cut as early as September, or at least by December.

Increase in Neutral Interest Rate and Its Impact on Forex Outlook

In addition to the FF rate projections, another point of interest this time was the upward revision of the neutral interest rate from 2.6% to 2.8%. When viewed together with the U.S. economic situation with continued sticky inflation, it becomes clear that the U.S. economy’s potential growth rate is rising, and one suspects that the appropriate policy interest rate applicable in this situation is also being revised upward. In the context of the current phase of intended rate cuts, this leads to the speculation that a fewer number of rate cuts overall may be required to bring the policy interest rate to the appropriate level. To go further, given the greater-than-expected underlying strength (potential growth rate) of the U.S. economy, the situation could even be interpreted as justifying no change in the current policy interest rate.



(Source) macrobond

From the perspective of USD/JPY, one could interpret this as suggesting that it has become fundamentally difficult to correct JPY selling vs. USD buying driven by the U.S.-Japan interest-rate gap. JPY depreciation against USD since the start of this year is difficult to ascribe to the U.S.-Japan interest-rate differential (see figure), but perhaps the markets have factored in a future of no rate cuts (or limited rate cuts) by the Fed.
Looking at the current US economy, one could definitely suspect an increase in the neutral interest rate. Although the most recent CPI data is on the weak side, basic economic indicators seem to suggest that tight labor market conditions are contributing to persistently high general prices. It feels like a different era compared with immediately after the December 2023 FOMC meeting, when the markets were eager to factor in six rate cuts in 2024. In this report at that time, I thought six rate cuts were excessive but three seemed more likely (the sharp turn of the December FOMC was quite striking).
However, half a year has already gone by without much change in the tightness of labor market conditions. Of course, the road to inflation rates settling down has always been considered to be “bumpy,” so if the Fed is steadily moving toward a rate cut, then perhaps things are progressing as expected in the long term. However, given how long it is taking the Fed to cut interest rates, suspicions have arisen that the neutral interest rate may actually be higher than it appears. If so, it will be interesting to see whether the number of rate cuts required in this phase can remain at the currently assumed nine times. I do not believe that the widening of the U.S.-Japan interest-rate gap is the real cause of JPY weakness, but even if that were the case, it must be noted that we may be entering a phase in which it will be difficult to correct JPY depreciation.

U.S. Currency Policy Now and Going Forward – The Limits of Rigidity

Semiannual Report and Japan’s Re-Addition to Monitoring List

On June 20, the U.S. Department of the Treasury released the latest issue of its Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States (hereafter “Semiannual Report”). This led to wide speculation that Japan’s addition to the Monitoring List for the first time in a year may have caused JPY to depreciate further. However, the more one looks at the actual state of things, the less reasonable this interpretation seems. As news of Japan’s addition to the list emerged, the forex markets reflexively assumed that this would make it difficult for Japan to implement any further JPY-buying/USD selling intervention, but a senior Treasury Department official noted the same day that the report was released that Japan was “transparent in its foreign exchange operations” and that “the greater concern in the Treasury report is on interventions to buy dollars and thus weaken other currencies,” indicating that the U.S. did not view Japan’s currency interventions as problematic. In fact, the report did not include any language critical of Japan’s JPY-buying/USD-selling currency intervention during April-May this year. The Semiannual Report is intended to prevent policies by other countries that put the US at a competitive disadvantage through unfair currency depreciation. A country suffering from a weak currency cannot and is unlikely to be subject to sanctions (it is true that Japan has a large trade surplus with the US (details follow), but Japanese companies make a significant contribution to the US economy).
The biggest reason for Japan’s re-addition to the Monitoring List this time is because Japan’s current account surplus for 2023 met one the three criteria for a country’s addition to the Monitoring List. To recap, the report sets out three criteria,

of which two must be met for a country to be placed on the Monitoring List, and if all three are met, the country is declared a "currency manipulator." The three criteria are as follows (the survey covers the top 20 countries/regions in terms of total imports and exports of goods and services to the US; see table below):

(1) Scale of bilateral trade surplus with the U.S. – a bilateral goods and services surplus of at least USD 15 billion per year
(2) Size of current account surplus – current account surpluses of at least 3% of GDP; or a gap between the current and long-term current account balances of at least 1% of GDP
(3) Scale of currency interventions – sustained, unilateral currency interventions; specifically, interventions in at least 8 months out of the past 12, with the total amount of interventions being at least 2% of GDP

The reason Japan has been added to the Monitoring List this time is because it met criteria (1) and (2). Looking back at the period from April 2016, when the Monitoring List was first introduced, to June 2022, Japan has generally met criteria (1) and (2). Last year was an exception, as it temporarily did not meet criterion (1) due to its current account balance in 2022 being affected by the sharp expansion in trade deficit against the backdrop of the pandemic and wars. Apart from Japan, the other countries on the Monitoring List are the same as before – China, Taiwan, Germany, Malaysia, Singapore, and Vietnam. This seems to reflect how vulnerable Japan's current account balance is to external shocks. Incidentally, the Semiannual Report mentioned statistical inaccuracies for the first time in touching upon the divergence in China's goods trade balance reported in China's customs data and the trade balance reported in China's balance of payments data.

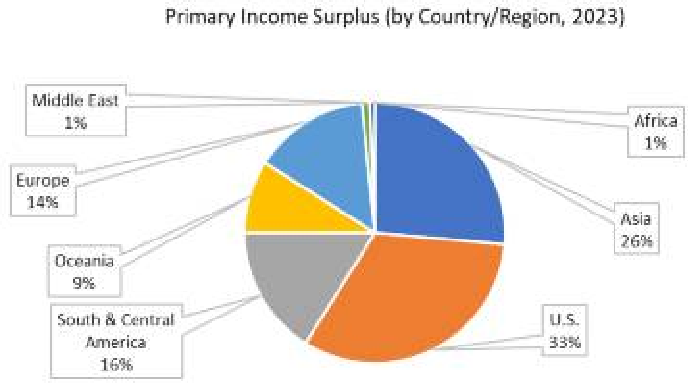
Status Pertaining to Three Monitoring List Criteria (Countries Added to List are Highlighted; data as of June 2024)

	FX Intervention (buying USD, selling own currency)	Current Account			
	% of GDP	% of GDP	3 Year Change in Balance (% pts)	Balance (USD Bil)	Trade surplus with the U.S. (USD Bil)
Canada	0.0%	-0.6%	1.4%	-13	40
Mexico	0.4%	-0.3%	-2.7%	-6	153
China	0.5-▲0.1%	1.4%	-0.3%	253	254
Germany	0.0%	6.1%	-0.4%	273	86
United Kingdom	0.0%	-3.3%	-0.4%	-110	-16
Japan	0.0%	3.6%	0.6%	151	62
Korea	-0.6%	2.1%	-2.5%	35	41
Ireland	0.0%	9.9%	16.0%	54	5
India	0.2%	-0.9%	-2.2%	-32	50
Netherlands	0.0%	10.1%	5.0%	113	-57
Switzerland	-16.7%	7.7%	7.3%	68	0
France	0.0%	-0.8%	0.8%	-23	16
Taiwan	-0.4%	13.9%	-0.6%	105	48
Singapore	7.1%	19.8%	3.2%	99	-28
Vietnam	1.5%	5.8%	1.5%	25	103
Italy	0.0%	0.5%	-3.4%	12	46
Brazil	0.6%	-1.4%	0.5%	-31	-23
Australia	-0.1%	1.2%	-1.0%	21	-32
Thailand	-0.6%	1.4%	-2.8%	7	40
Belgium	0.0%	-1.0%	-2.4%	-6	-16
Malaysia	-2.3%	1.3%	-2.9%	5	25
Euro Area	0.0%	1.6%	0.0%	254	107

(Source) U.S. Treasury Department; Note: Trade surplus with the U.S., current account balance, and amount of currency intervention pertain to calendar year 2023 (four quarters from Jan through Dec 2023)

Unreasonable to Accuse Japan Over Current Account Surplus

With the recovery of its current account surplus, Japan is once again on the Monitoring List, but as I have argued persistently in this column, it is extremely misleading to focus too much on Japan's statistical surplus. Almost all of Japan's current account surplus is owing to its primary income surplus, and a large portion of this remains overseas in foreign currency, which is why I suspect that Japan may even be in a current account deficit on a cash-flow (CF) basis at the present time. This issue, which I raised awareness about last spring, is now being examined in various forums, and although it can be debated what the actual level of cash flow is, few dispute that it is dangerous to take the statistical surplus at face value. Moreover, in terms of countries/regions, the U.S. is the largest source of Japan's primary income surplus, which amounts to about +JPY 35 trillion. For example, in 2023, Japan's primary income surplus from the U.S. was 33%, which is significantly larger than its second-largest source, which is Asia as a whole (26%) (see figure). As the primary income surplus is a "return on past investments," the above can be viewed as evidence of the scale of Japan's investments in the U.S.



(Source) Ministry of Finance

Under these circumstances, the U.S., especially, should be grateful for Japan's current account surplus rather than criticizing it. It has to be said that in the case of Japan, criterion (1) for being put on the Monitoring List is somewhat flawed. Of course, there could be various views regarding Japan's trade surplus with the U.S., but given that the automobile industry, which earns a large portion of this surplus, is also a major investor in the U.S., the simplistic view that "it is unfair because Japan has a large trade surplus with the U.S." cannot be taken. Both in terms of the number employees hired by foreign companies in the U.S. and in terms of employee compensation, Japan is second in terms of the size of its contribution (figure). Japan makes an enormous contribution to both employment and wages in the U.S.

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

Remarks Related to Currency Intervention

Incidentally, the concluding portion of the Semiannual Report's section on Japan notes, "Treasury's expectation is that in large, freely traded exchange markets, intervention should be reserved only for very exceptional circumstances with appropriate prior consultations," which can be interpreted as a warning against currency intervention. This is consistent with the remarks of U.S. Treasury Secretary Janet Yellen at the G7 summit in May this year, who said, "We believe intervention should be rare. When it occurs it should be communicated in advance." Yellen also noted that currency interventions did not necessarily work unless they were accompanied by more fundamental policy changes. At the time, her remarks were interpreted as a warning to Japan, and this led to some JPY depreciation. To be sure, Japan's currency interventions, since they do not amount to unjustified attempts to induce a weaker domestic currency, may not be viewed as a problem as far as the Semiannual Report goes, but based on the principle that interventions should be refrained from in order to enable the forex markets to be traded freely, it is possible that market participants are intolerant of intervention from either direction, and perhaps this is indeed what happened this time.

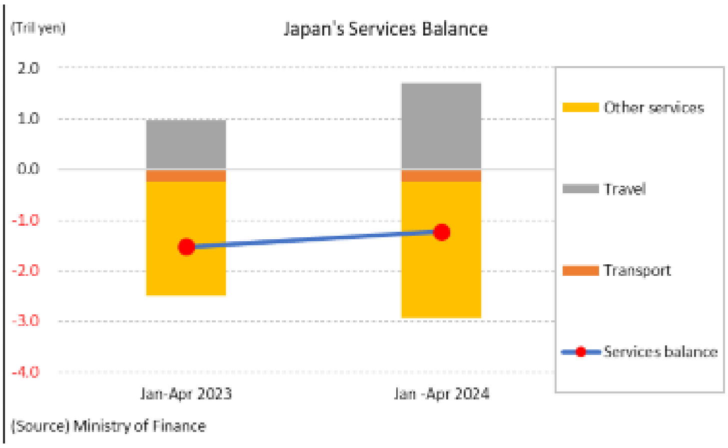
Trump Risk, Etc.

Future risks include the possibility not just of further such remarks by Yellen, but also developments associated with the election of Trump. As it seems highly unlikely that Trump would correctly understand the background to Japan's inclusion on the Monitoring List as explained above, there is some concern that he could make critical remarks against Japan based on his misunderstanding. In the first place, Trump's understanding of forex markets is questionable, so he could well issue warnings against Japan's currency interventions based on his lack of understanding. On the other hand, the fact that Japan's trade surplus with the U.S. is quite large could lead Trump to criticize Japan over the trade surplus in strong words, thereby triggering JPY appreciation. One can easily imagine, for instance, that Trump might urge the BOJ to raise interest rates, and it is well known that unreasonable rate hikes can trigger speculative JPY selling – this is a development that cannot be ruled out. While there is no reason to be concerned about the latest edition of the Semiannual Report itself, one should remain cautious of the potential for it to be misinterpreted in conjunction with statements by U.S. government officials and thereby influence trading.

JPY Supply-Demand Environment – Some Improvement, But ...

"Other Services" Deficit Surpasses JPY1 Trillion

Japan's April international balance of payments statistics show that the country achieved a reasonably sized current account surplus of JPY2,050.5 billion. As usual, this was supported by a very large primary income surplus (JPY, 832.8 billion). However, the trade and services balance was a deficit of JPY1,383.0 billion, the second largest such deficit since the beginning of the year (after the January deficit), and the services balance was a deficit of JPY721.5 billion, the largest such deficit since the beginning of the year. Looking at the services balance for the January-April period, one finds that the travel balance was a surplus 1.8 times larger than that in the same period last year (+JPY974.9 billion → +JPY1,706.4 billion), and the already huge other services balance deficit further expanded (-JPY2,259.6 billion → -JPY2,696.9 billion), so the overall services balance deficit decreased only slightly (-JPY1,532.4 billion → -JPY1,230.7 billion). A closer look at the services balance for April alone shows that the travel balance was +JPY446.7 billion (the largest travel balance surplus ever), the transport balance was a deficit of -JPY54.1 billion, and the other services balance was a deficit of -JPY1,114.1 billion (the largest other services deficit ever). Attracting particular attention is the other services balance deficit (which previous editions of this article have characterized as encompassing "new era deficits"), and this is the first time that the other services deficit has surpassed JPY1 trillion in a single month. Until now, the largest monthly other services deficit was in April 2021 (JPY923.1 billion), followed by that of April 2022 (JPY904.3 billion). Considering the timing of those record high levels, there are grounds for suspecting the April figures are affected by seasonality factors.

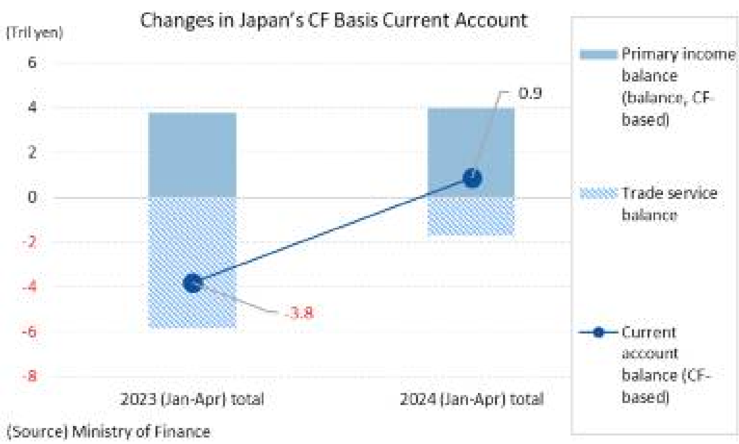


Looking more closely at April, the other services balance components with the greatest deficit increases were charges for the use of intellectual property (up JPY110.1 billion mom), communications, computer, and information services (up JPY107.5 billion mom), and research and development services (up JPY187.5 billion mom). Within the charges for the use of intellectual property item, receipts of charges for industrial property rights have fallen sharply, suggesting that royalty income from Japanese companies' overseas production operations may be being restrained by scandals affecting major automakers. Growth in the communications, computer, and information services deficit and the research and development services deficit appears to simply stem from increases in Japan's payments for those services. These "new era deficits" are showing a growing tendency to expand, and while it is difficult to precisely assess the factors causing the expansion, it appears likely that growth in "new era deficits" reflects Japan's recent slowness in the internationalization of high-tech services.

Cash-Flow-Basis JPY Supply-Demand Situation Improving

However, the situation has clearly improved since 2022 and 2023, when the JPY supply-demand structure promoted considerable JPY selling. I have calculated that Japan's cash-flow-basis current account balance for this year's January-April period was a surplus of approximately JPY0.9 trillion, a clear improvement from the approximately JPY3.8 trillion deficit for the same period last year. As the graph shows, the cash-flow-basis primary income surplus was approximately JPY4 trillion, almost unchanged from last year, but the cash-flow-basis current account balance has improved significantly due to rapid trade deficit shrinkage amid the general trend of resource price stabilization.

Some balance of payments figures have not been finalized, including the reinvested earnings figure, so the current image is still tentative, but it is becoming increasingly difficult to say that the JPY supply-demand environment is promoting JPY selling on the scale seen in 2022 and 2023.

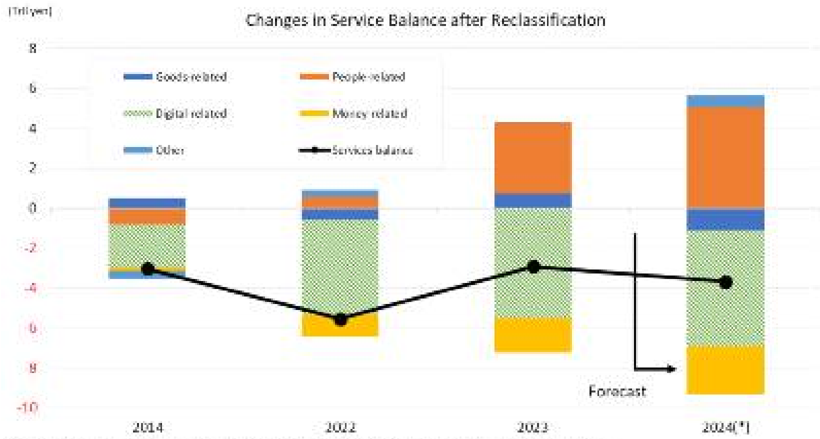


Despite this improved JPY supply-demand environment, however, JPY has been depreciating against USD since the beginning of the year, with USD/JPY temporarily exceeding the JPY160 level. So what factors are driving this trend? I believe that the three main factors currently promoting JPY depreciation are (1) the accumulation of speculative JPY short positions, (2) the delayed effects of trends in 2023, and (3) the unshakable firmness of real economic conditions in the United States. Regarding factor (2), Japan's trade deficits in the 2022-2023 period amounted to JPY30 trillion, and it is believed that a considerable portion of associated JPY flows has been delayed to 2024. Moreover, since the only factor promoting JPY buying recently has been the BOJ's slight interest rate hike, it is not very difficult to understand the basis for the JPY depreciation trend's continuation. Of course, the JPY supply-demand structure deduced from international balance of payments figures is not a sufficient basis for fully explaining JPY forex trends, which at present

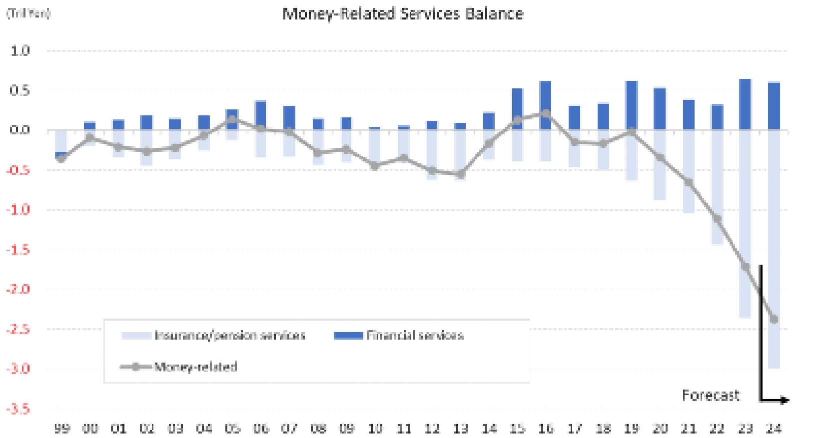
appear to be more-strongly affected by monetary policies and associated interest rate trends. Although it is difficult to say that "the JPY supply-demand structure is promoting JPY selling", however, the proposition that "the JPY supply-demand structure is promoting JPY buying" is clearly not true. Although the JPY supply-demand structure's effect of promoting JPY selling is weaker than it was in the 2022-2023 period, it is important to note that the JPY supply-demand structure has recently been in an "equilibrium" state and has no significant effect in promoting JPY buying.
With an eye to formulating near-term forex rate forecasts, however, one cannot help but suspect that if the current JPY depreciation trend is being largely driven by speculative flows and lingering effects of Japanese trade deficits recorded through last year, the trend may not persist for very long. The confluence of factors promoting JPY depreciation seen in the 2022-2023 period is slowly but surely changing, and the key question at this point is how much JPY will strengthen when the Fed cuts interest rates. My basic understanding in this regard is that one cannot expect JPY to appreciate as much as it has in the past given that the JPY supply-demand structure is at best "balanced".

Countervailing Effects of "Travel" and "Digital and Finance" Items

While the above sections of this article have overviewed the cash-flow-basis current account balance, I would like to more-deeply analyze the current services balance situation while focusing on trends in five qualitative categories of current account items (goods, people, digital, money, and others) that this article regularly monitors. Japan's total services balance deficit in the January-April period amounted to JPY1,224.4 billion. This reflected a large people-related surplus of JPY1,682.7 billion (mainly driven by travel), which was more than offset by a large digital-related deficit of JPY1,940.1 billion and a money-related deficit of JPY792.8 billion, so Japan's pattern of earning money from tourism services to pay for digital and financial services has continued. If current trends for each category continue through the end of this year, the 2024 services balance deficit will become slightly bigger than it was in 2023. Although it has a lower profile than the people- and digital-related categories, the money-related services deficit is growing at a quite rapid pace, largely driven by reinsurance payments being sent overseas – it was JPY469.1 billion in the January-April period last year and JPY792.8 billion in the same period this year, an increase of approximately 70%. The people-related surplus has also increased by about 70% (from JPY982.6 billion to JPY1,682.7 billion), but this is only natural given that Japan maintained strict border control measures until April 29 last year. If the money-related deficit continues to expand at its current pace, it may consolidate its position as the second most important threat, after the digital-related deficit.



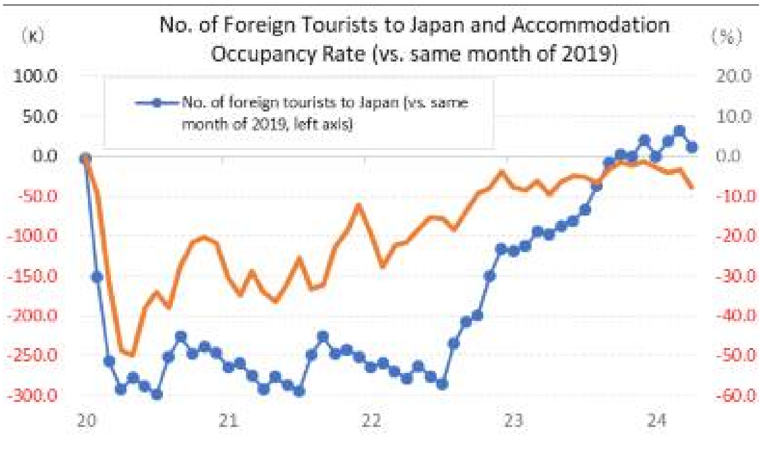
(Source) Created by the author based on the Bank of Japan paper entitled "Globalization of Service Transactions from the Perspective of Balance of Payments Statistics". Figures for 2024 are annualized.



(Source) BOJ Review entitled "Globalization of Services Transactions from the Perspective of Balance of Payments Statistics"
Figures for 2024 are annualized.

If current figures are annualized, the people-related surplus would rise to approximately JPY5 trillion, while the digital-related and money-related deficits would grow to approximately JPY6 trillion, and JPY2.4 trillion, respectively. Based on estimates that the goods-related deficit would amount to about JPY1.1 trillion and the others-related surplus would be roughly JPY590.0 billion, the 2024 services balance would be a deficit of approximately JPY3.7 trillion. Of course, the core items of the services balance are affected by seasonal factors, so annualizing figures for the January-April period will not produce accurate figures, but it is important to note that the pressures from services balance-related foreign currency outflows are by no means limited to outflows associated with the digital-related deficit.

Disturbing Inbound Tourism Statistics



(Source) macrobond, *Both vs. same month of 2019)

Given the current state of Japan's services balance and the fact that that the travel balance is a rare channel for the Japanese economy to acquire foreign currency, it will be very important to sustain growth in the travel balance. Based on the above estimates, it appears that the digital-related and money-related deficits could amount to more than JPY8 trillion in 2024. As Japan recorded its fourth-largest trade deficit (about JPY9.4 trillion) in 2023, the country needs to make every possible effort to partially offset its trade and digital-related and money-related services deficits with surpluses in the people-related category of its services balance. Daily media reports about the rapid growth in numbers of inbound tourists and in those tourists' spending seem to suggest that there is still a lot of room for inbound tourism growth that could improve Japan's balance of payments and generate diverse other benefits. Looking at the latest related statistics, however, one finds there may not be a strong basis for anticipating continued inbound tourism growth. The "Foreign Visitor Statistics" released by the Japan National Tourism Organization (JNTO) indicate the number of foreign visitors to Japan was 3,042,900 in April, the second consecutive month that figure exceeded 3 million. While many have suggested that the increase reflects the overlapping of Japan's cherry blossom season and a post-Ramadan surge in overseas demand, there have been relatively few comments about the decelerating rate of growth in the number of foreign visitors to Japan. As shown in the graph, the rate of growth in the number of foreign visitors to Japan (compared to the same month in 2019, just before the pandemic) has remained flat since last year, and it seems possible that this rate may decelerate (although the travel surplus has been increasing relatively faster because of JPY depreciation's effect of increasing JPY-denominated receipts). The accommodation occupancy rate has continued to rise but has not reached the levels of the same months in 2019, and it appears that the rise in the accommodation occupancy rate is also losing momentum. Because of JPY depreciation, qualitative information related to inbound-related consumption and investment appetite has tended to focus on "price" factors (high levels of tourist spending, etc.), but less attention has been given to the trends in "volume" factors (numbers of visitors and accommodation occupancy rates) that are only roughly at pre-pandemic levels.

Travel Surplus Won't Increase Forever

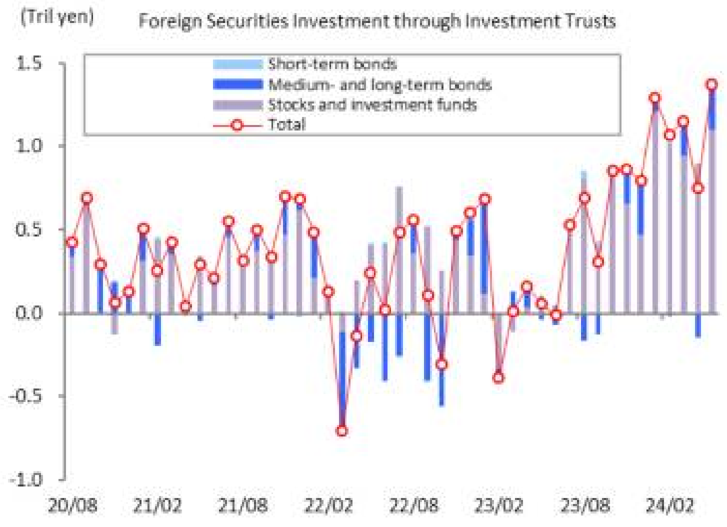
As previous editions of this article have argued, no matter how "cheap" Japanese tourism services may be by international standards, Japan no longer has sufficient services supply capabilities to handle the rapidly increasing demand. While most all sectors of the Japanese economy are suffering from labor shortages, the accommodation and food services sectors have been facing particularly dire labor shortages, so supply constraints can be expected to eventually cause travel services export growth to stagnate and potentially cause the travel surplus to peak out. In 2024, however, Japan's travel balance surplus may rise to unprecedented levels above JPY4 trillion and perhaps exceed JPY5 trillion, and it can be expected that media reports will generally focus on and celebrate this increase.

The problematic aspect of this situation will only become evident later, when it becomes clearer that the travel surplus is hitting a ceiling level while the other services deficit continues to expand. It is anticipated that there will be relentless rises in the foreign-currency-denominated prices of overseas digital and financial services to reflect nominal wage increases in relevant countries, and JPY depreciation will further magnify those price increases in JPY-denominated terms, so it can be expected that Japan's services deficits with respect to digital and financial services will be further enlarged in the future. As discussed in previous editions of this article, it is unlikely that Japan will soon begin recording statistical current account deficits, but it is quite conceivable that the country's trade and services deficits will continue to expand (led by the services balance), causing the cash-flow-basis current account deficit to become chronic. The effects of the "new normal" of JPY depreciation can be expected to continue ramifying in the Japanese economy, and it is likely that the new trend of chronic foreign currency outflows will be a major contributor to that situation.

Risks to My Main Scenario – Danger of “Everyone’s Doing It” Psychology

“Household JPY Selling” in January-May 2024 Surpasses Amount in Entirety of 2023

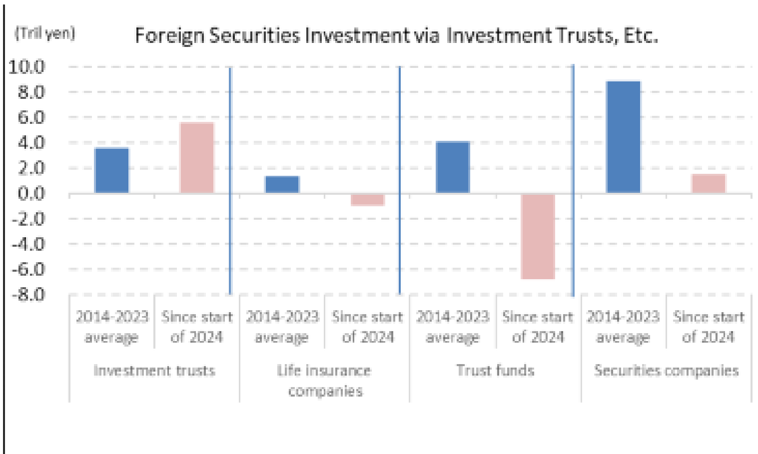
As repeatedly noted in previous editions of this article, the “household JPY selling” phenomenon has truly frightening potentials. Released by Japan’s Ministry of Finance in June, the “International Transactions in Securities” report (a monthly report based on information from designated major investors) for May indicates that investment trust management companies (hereinafter referred to as investment trusts, whose activities directly reflect the recent surge in “household JPY selling” in response to the introduction of the New NISA system) purchased JPY1,371.9 billion of securities, surpassing the previous record high of JPY1,293.7 billion recorded this past January. This brings the total amount of securities purchases via investment trusts in the first five months of the year to JPY5,638.9 billion, exceeding the total for the whole of 2023 (JPY4,544.7 billion; see graph on next page). If securities purchases continue at this pace, the amount for all of 2024 will easily exceed JPY13 trillion. Looking at the full-year statistics, the 10-year-average level of investment trusts’ net securities purchases from 2014 to 2023 was JPY3,611.1 billion, and the 5-year average level from 2015 to 2019 (just before the pandemic) was JPY3,645.6 billion. Investment trusts’ net securities purchases in the full year of 2023 were significantly higher than those previous average levels, but even that 2023 figure is unlikely to come close to the projected level for the full year of 2024. <u>The net securities purchases in 2024 are literally on another scale, and as will be explained below, this new scale of net securities purchases appears to have become a “new normal” for Japan</u>. Looking at net securities purchases in the first five months of 2024 by security product category, one finds that net purchases of short-term bonds were +JPY121.0 billion, net purchases of medium- to long-term bonds were +JPY354.5 billion, and net purchases of stocks and investment fund holdings were +JPY5,163.4 billion, and it is estimated that most of the net purchases of stocks and investment fund holdings represented investment in overseas stocks. <u>It is quite difficult to imagine that this surge of securities investment is unrelated to the JPY depreciation trend seen since the beginning of the year.</u>



(Sources) Ministry of Finance, INDB

Emergence of a Major New JPY-Seller Sector

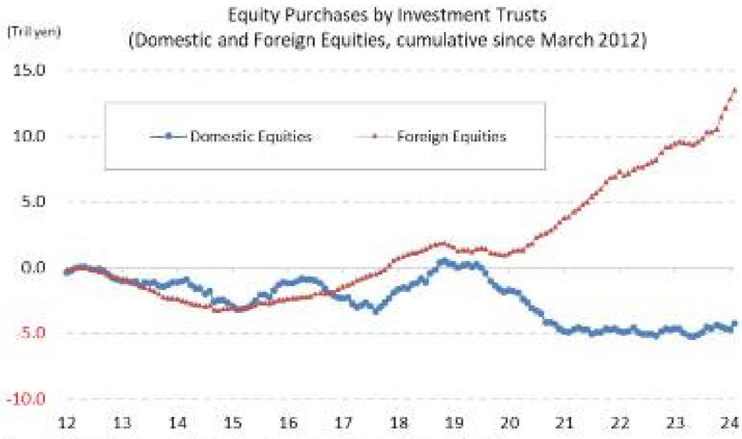
If this unprecedented high pace of overseas securities investment via investment trusts is the “new normal” following the launch of the New NISA system, then it is necessary to objectively reassess its impact as a permanent rather than temporary trend. If net securities purchases for the whole of 2024 are significantly more than +JPY13 trillion, it can be seen as reflecting the emergence of many new JPY sellers with purchasing capabilities far exceeding those of the previously dominant institutional investors with respect to Japan’s overseas securities investment. Looking at the 10-year average level of net securities purchases in the 2014-2023 period by other Japanese investor sectors frequently watched by forex market players, one finds the level for life insurance companies was +JPY1,398.7 billion, the level for trust banks (trust accounts; reflecting pension management trends) was +JPY4,088.0 billion, and the level for financial instruments traders (securities companies) was +JPY8,868.8 billion. In the first five months of 2024, life insurance companies’ net securities purchases were -JPY958.7 billion, trust banks’ (trust accounts’) net securities purchases were -JPY6,755.6 billion, while financial instruments traders’ net securities purchases were +JPY1,552.7 billion. It is clear that, in comparison to the net securities purchases of other Japanese investor sectors, the JPY5,638.9 billion increase of net securities purchases via investment trusts in the first five months of 2024 is extremely large (see graph). Although no quantitative evidence is available, it is worth noting that another characteristic of JPY selling by investment trusts is that their currency hedge ratio appears to be low compared to that of other investor sectors.



(Source) INDB, *Up to May 2024

“Household JPY Selling” Relentlessly Sustained

In addition to the Ministry of Finance figures, statistics from the Investment Trusts Association of Japan also provide a sense of the strength of “household JPY selling” and enable one to distinguish between domestic stock trading trends via investment trusts and overseas stock trading trends via investment trusts. As shown in the graph on the next page, the surge in households’ active participation in JPY selling via investment trusts is not something that began in the last one or two years – it has been a strong trend since around 2020. For roughly four years now, foreign stocks have been purchased to replace domestic stocks. The addition of a tax-free quota from 2024 under the new NISA system has inevitably had the outcome of further accelerating growth in purchases of foreign stocks. As can be seen from a glance at the graph, the previous pace of purchases has clearly undergone a sharp acceleration since the beginning of 2024. One gets the strong impression that this is a permanent rather than temporary transition.



(Source) The Investment Trusts Association, *Data until April 2024

Historically, forex market players have closely monitored life insurance companies' fiscal-year-based investment policies (particularly foreign bond investment policies) in light of their significant influence on market trends, and the investment policies each company announces at six-month intervals attract a fair amount of attention even now. Since the early days of Abenomics, the Government Pension Investment Fund (GPIF) and other major investors have attracted attention for their active revisions of asset management policies (gradually giving greater emphasis to stocks and foreign currency-denominated assets), and trust banks' (trust accounts') asset management policy trends have also attracted attention as factors promoting JPY depreciation. Investment trusts have now become an additional key investor category meriting close monitoring for the purpose of analyzing foreign-securities-investment trends. However, the tax-free investment quotas of the new NISA system have enabled investment trusts to unwaveringly continue to execute monthly purchases of considerable foreign stocks every month, making investment trusts' investment policies different from those of entities in other investor categories in terms of not only scale but also sustainability. After attaining their announced portfolio ratio targets, trust banks (trust accounts) have predictably restrained their JPY selling and foreign currencies buying activities, but it is questionable whether investment trusts would make similarly rational decisions based on portfolio ratio targets.

Danger of "Doing It Because Everyone Else is Doing It"

In theory, investment trusts may continue selling JPY so long as the household sector has sufficient risk tolerance to allow that. It is justifiably feared that the household sector investors, who do not necessarily adjust their investment policies based on rationally determined international diversification policies, may continue relentlessly increasing their foreign securities investments simply because everyone else seems to be doing the same thing, and I believe this situation is the biggest risk factor with the potential to powerfully promote additional JPY depreciation. For example, can investing in highly popular all-country or global index funds truly be considered a sound international diversification strategy? Of course, some Japanese people may be investing in all-country or global index funds with this international diversification objective in mind, but there are strong grounds for suspecting that the majority of investors in those funds selected their funds based on the fact that the funds were highly positioned in their securities company's sales rankings. How many individual investors are aware that, while all-country or global index funds may claim to be an international diversification investment, U.S. stocks generally comprise more than 60% of those funds' portfolios? Although all-country or global index funds may be excellent financial products, it seems reasonable to be wary of the possibility that individual investors selecting those funds merely because everyone else is doing it may lead to protracted overshooting of forex and interest rate market trends.

Looking ahead, when the Fed begins cutting interest rates, it could be expected that JPY will tend strengthen somewhat in light of the diminished Japan-U.S. interest rate differential, but such interest rate cuts may also be expected to generate a relatively more-powerful tailwind boosting U.S. stock prices. Against the backdrop of rising U.S. stock prices, Japan's "household JPY selling" is likely to grow in step with the increase in the buying of U.S. stocks both within and outside of the New NISA investment quotas. In such a case, Japanese people may undeniably come to contribute to the forex market perception that "JPY will continue weakening even when interest-rate differentials narrow". In any case, people in the future looking back at history may well conclude that 2024 was the year when Japan's household sector's forex market impact surged up to the level of major institutional investors' influence.

EUR Outlook – ECB Interest Rate Cut Phase and European Political Developments

EUR Area Monetary Policies Now and Going Forward – ECB Enters Interest Rate Cut Phase

Announcement of Interest Rate Cut Phase

The June 6 ECB Governing Council meeting decided to cut the ECB's key policy interest rate by 25 basis points, the first such rate cut in four years and nine months (since September 2019). Central banks of such developed countries as Switzerland and Sweden had already begun the process of lowering interest rates, and the ECB has now joined them. The deposit facility rate has been lowered from 4.00% to 3.75%, the major refinancing operation rate from 4.50% to 4.25%, and the marginal lending facility interest rate from 4.75% to 4.50%. Previous editions of this article have discussed the issue of whether the ECB might have prematurely committed itself to a June interest rate reduction, and the first question posed at the post-Governing Council-meeting press conference echoed those discussions, asking – "Cutting rates at the same time as hiking the inflation forecast needs perhaps a little bit more explanation and raises also the question whether you perhaps pre-committed yourself too early to that cut." In response to this, ECB President Lagarde stated that – "[W]e decided to cut, and we did so because overall our confidence in the path ahead, because we have to be forward-looking, has been increasing over the last months." In her response, President Lagarde also commented on upcoming decisions, saying – "We shall be data-dependent and we shall decide meeting by meeting." – and in answering a subsequent question she suggested a possibility that the ECB might refrain from additional cuts in the near future, saying – "<u>I cannot confirm that it is the dialling-back process that is underway. There's a strong likelihood</u>, but it will be data-dependent[.]" So, while the timing and pace of the ECB's future interest rate cuts remain unclear, it can be said that <u>President Lagarde's statements at the press conference implicitly acknowledged that the ECB's "next move" will be another rate cut</u>.

Pace of Prospective Rate Cuts

Regarding the pace of prospective interest rate cuts, a reporter asked – "[G]iven that you will need data and more data, do you think that projection round meetings of the Governing Council could be more suitable for interest rate decisions given that you will have also forecasts available?" President Lagarde was somewhat vague in her answer, saying – "it's obvious that projections produced by staff on a regular basis are very informative [...] and that this is very helpful for us to make decisions. But that doesn't mean to say, and I would not say that now, that we would only decide at the time of projection meetings. [...] But obviously, we have more data when we have projection meetings." <u>That answer strongly suggests that Governing Council projection round meetings (in March, June, September, and December) are likely to be chosen as the timing for policy adjustments</u>. However, the latest ECB staff projection indicates that the euro area consumer price index (HICP) will not stabilize near the 2% level until 2026, so it seems somewhat unlikely that the ECB will consider itself positioned to cut interest rates at each Governing Council projection round meeting in the near future. In fact, the latest Governing Council meeting's statement still includes language ("We will keep policy rates sufficiently restrictive for as long as necessary to achieve this aim.") that justifies keeping policy rates high, so <u>it seems reasonable to anticipate that the ECB rate cut pace will be "at most once every three months"</u>. This is not very different from the rate cut trajectory of the Fed, which is generally expected to implement rate cuts from September onwards, so EUR/USD appears somewhat likely to be increasingly stable in line with the stability of the U.S.-Europe interest rate differential. While President Lagarde seemed to be seeking to strike a balance between hawkish and dovish stances at the press conference, subsequent trends in euro area interest rates and EUR exchange rates suggest that many people are anticipating that the ECB will be acting fairly hawkishly.

ECB Assumptions about Prospective Wage Trends

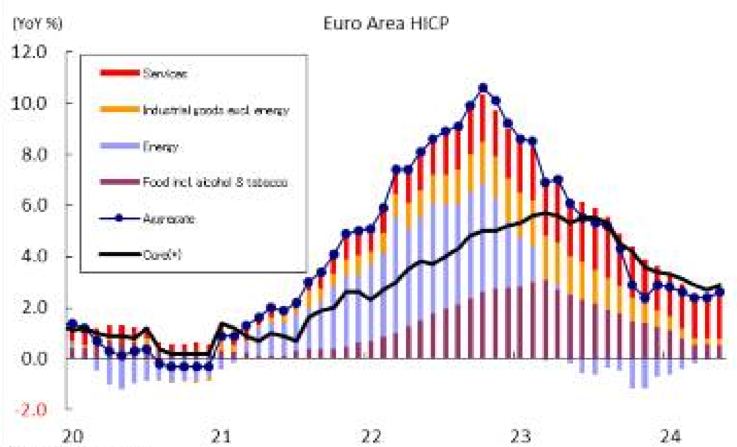
<u>Another reporter at the press conference asked – "You saw an acceleration in the wage data back to almost a record high. So can you explain why what you saw was still enough to allow you to cut?</u> And secondly, you've predicted that there will be a moderation in wages in the eurozone later this year. Do you need to see that moderation actually happen before you can cut again?" President Lagarde responded by saying – "[W]hat we wanted before making that decision was collectively to increase our confidence level that the path ahead was on its disinflationary rhythm that we needed in order to make our decision." – and noting that the recent pace of wage increases reflected temporary factors in some countries (including a collective agreement in Germany designed to compensate for purchasing power lost during the 2021-2023 period) and was therefore not expected to be sustained from 2025. <u>It appears that the ECB's main forecast scenario is that "the pace of wage growth will decelerate somewhat toward the end of 2024 and then decelerate considerably in 2025" and that this scenario is the basis of the ECB's appraisal that it is justified in initiating interest rate cuts at this point</u>. The ECB has presented its staff analysis of the forecast scenario on the ECB blog, and it is quite convincing.

In any case, the ECB is quite confident that the pace of wage increases will decline. Going forward, ECB watchers will be seeking to verify the ECB's assumptions based on analyses of monthly reports of service-sector HICP statistics, wages in job advertisements, quarterly reports of negotiated wage statistics, and trends in the ECB wage tracker scheduled to be released in the second half of the year.

Euro Area Economy Now and Going Forward – Rapid Inflation Growth Disharmonious with Interest Rate Cuts

Service Sector Driving Euro Area Inflation

The rate of growth in the euro area consumer price index (HICP) accelerated to +2.6% yoy in May (from +2.4% yoy in March and April), exceeding the market's median forecast of +2.5% yoy. The core basis HICP growth rate (excluding energy, food, alcoholic beverages, and tobacco, which are subject to large fluctuations) accelerated to +2.9% yoy in May (from +2.7% in April), and the services HICP growth rate (particularly noteworthy owing to its relationship with nominal wage trends) accelerated to +4.1% yoy in May (from +3.7% yoy in April). The services HICP growth rate acceleration reflects the strong growth in negotiated wages seen since last year. <u>The services sector accounted for +1.8 percentage points of the +2.6% HICP growth in May, indicating that the euro area's tight labor markets and rising wages are playing a key role in preventing HICP deceleration</u>. It is worth noting that the May acceleration of services HICP growth was the first such acceleration in 11 months, and one gets the impression that that growth rate has bottomed out. Also noteworthy was the fact that the energy HICP grew +0.2% in May, the first time the energy HICP has grown in 13 months (since April 2023). If the ECB decides to cut interest rates at a faster pace than the Fed, the resulting weakening of EUR will likely generate stronger upward momentum in euro area energy prices. Having begun cutting interest rates, the ECB is likely to consider the latest HICP trends disturbing.

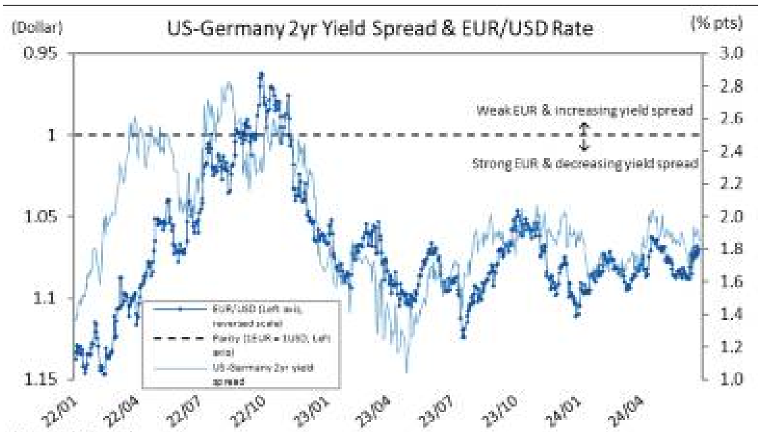


(Source) Datastream
(*) Core excl. energy, food, alcohol & tobacco

Strong Services Price Growth in Line with ECB Expectations

As mentioned above, however, the ECB has not been expecting wage growth to decelerate in response to an economic slowdown and considers the services-driven HICP growth acceleration to be within the scope of its expectations. In fact, <u>the ECB implemented its June interest rate cut despite the strength of growth in wages and prices, and it does not appear very likely that the ECB will waver in its determination to implement additional rate cuts at some point</u>. For example, it has been reported that Portugal's central bank governor Mário Centeno said immediately after the May HICP statistics were announced that the ECB had anticipated that inflation would accelerate slightly in May and the acceleration was slightly stronger than expected but did not significantly deviate from the ECB's expectations. Governor Centeno's perspective is probably close to the consensus of the Governing Council. In a recent interview with the Nikkei Shimbun, ECB Executive Board Member Isabel Schnabel hinted that there will definitely be ECB interest rate cuts after the June cut and the only unsettled issues related to the pace of such cuts, and she also suggested that it would be justified to make decisions about such cuts when information from revised staff forecasts become available (every three months). For now, the ECB appears most likely to progressively reduce interest rates in line with wage settlement data obtained from verifiable job advertisements (see graph on previous page), and the ECB has been making a fairly persuasive argument that the current pace of growth in nominal wages and services prices reflects special temporary factors rather than a fundamental trend of wage growth acceleration. The forex market appears to be anticipating that, after June, the ECB will cut interest rates two more times this year (in September and December). Expectations that the Fed will also implement two interest rate cuts this year have kept EUR firm, however, as it is anticipated that the U.S.-Europe interest rate differential will be roughly static. If it continues to be expected that there will no significant change in the U.S.-Europe interest rate differential, EUR/USD is expected to fluctuate with little sense of direction during the forecast period.

(Source) Macrobond, *6-month leading indicator for advertised job wages



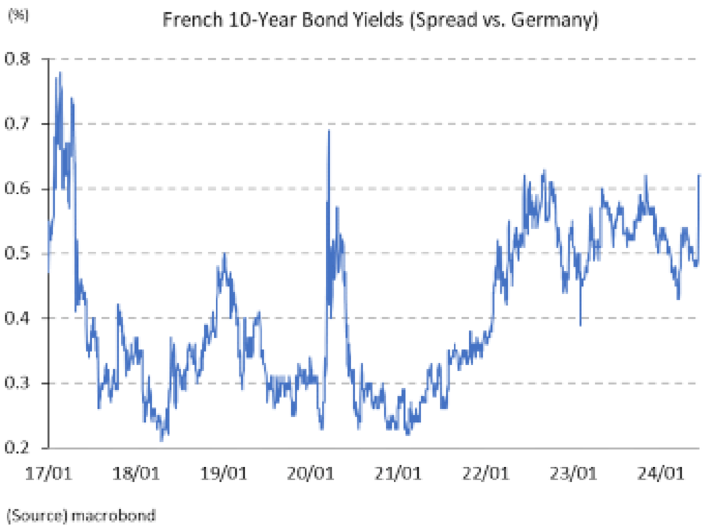
(Source) Bloomberg

European Politics Now and Going Forward – French Politics and the Financial Markets

Financial Markets Overthinking Frexit Potential

EUR sharply depreciated in June. On June 9, French President Emmanuel Macron decided to dissolve France's National Assembly and hold a snap legislative election, with the first round of voting on June 30 and the second (runoff) round on July 7. The current French National Assembly was elected in June 2022 for a term of five years, and the snap election will be held with more than half of that term (three years) remaining. The election is attracting considerable attention because it has the potential to enable the appointment of a far-right prime minister. EUR selling has increased, reflecting the widely held view that a problematic combination of a pro-EU president and a far-right (≈ anti-EU) prime minister may provoke domestic turmoil in France and ultimately cause the strengthening of centrifugal forces within the EU. Financial markets are always trying to factor in extreme scenarios, and the memory of repeated European debt crises since 2009 makes it easy for the markets to associate increases in the political power of far-right and far-left parties within various EU countries with concerns about the potential for such countries to leave the EU and/or the euro area, so the current election is causing renewed concerns about the possibility that France might depart from the EU (Frexit).

At present, however, such concerns simply reflect the markets' overthinking the situation and getting ahead of themselves. In the French presidential elections in May 2017 and May 2022, Marine Le Pen, leader of the far-right National Front (FN), ran under an anti-EU banner, advocating the exclusion of immigrants and a withdrawal from EUR. The 2017 election was a particularly close one, causing attention to focus on the possibility of a "third surprise" following Brexit and the election of President Trump in the previous year. Le Pen has sought to moderate her right-wing image in various ways since losing the 2017 election, however, and in 2018 she changed the name of her party from "National Front (FN)" to "National Rally (RN)". Although the RN is still considered a far-right party, it does not espouse such extremely ambitious goals as the arrangement of a Frexit or withdrawing from the euro area and is instead seeking to accomplish things within the realm of feasibility. Unlike in 2017 and 2022, when the FN party was weaker than other parties, it appears that the renovated far-right party (RN, led by Jordan Bardella) may be positioned to secure a majority in the National Assembly. The potential for such a success largely will depend on how well it presents a somewhat moderate image and avoids setting unrealistic goals. It is true that the spread between French and German government bonds has risen sharply recently (see graph), but the perceived threats causing that rise are not very realistic concerns, being much less worrisome than previous situations when national elections appeared to have the potential of leading to countries' exit from the euro area, such as the 2015 elections in Greece, the 2017 elections in France, and the 2018 elections in Italy. At present, the financial markets are prematurely concerning themselves about the possibility of a Frexit. On the other hand, the potential for the far-right to win the French elections has greatly increased compared past years, so it is understandable that some realistic concerns about the potential for political chaos to affect France's domestic affairs has encouraged the selling of French government bonds. Such concerns are described below.



Sense of Crisis Not So Effective this Time

The French National Assembly has 577 seats, so 289 seats constitute a majority. Based on a poll conducted by the Financial Times soon before this article was written, the RN is expected to win something in the range of 235-265 seats, so the RN will find it difficult to win a majority on its own but may form a majority by cooperating with other conservative parties. The current main scenario is that the National Assembly will be dominated by far-right parties, and center-right President Macron will have to name a prime minister acceptable to those parties. (The situation occurring when the president is from a different political party than the majority of National Assembly members is referred to as "cohabitation".) President Macron is seeking to foment a sense of crisis about the rise of the far right, but it will be difficult for him to reverse that rise, as the far right's France First policy advocating the exclusion of illegal immigrants and resistance to EU diktats has struck a chord with voters exhausted by the COVID pandemic, the war in Ukraine, and high inflation rates.

In previous National Assembly and presidential elections, the sense of crisis over the far right's rise effectively placed a ceiling on the far right's success, as supporters of candidates who lost in the first round of voting have often switched to supporting the president. In the past, far-right or far-left parties gaining power in France and other EU countries have generally moderated their policies somewhat or been restrained, but the current situation in France is different. It has been reported that other far-right and center-right parties may seek to form an alliance with the RN, which is likely to become the largest party. Of course, even if the RN becomes the largest party, there remains a possibility that alliance negotiations will not go well and no majority party will be formed. The prospective outcome remains non-obvious at this point.

Prospective Strife with the EU

What effects will the French situation have on the financial markets in the near future? It is likely that the sharp depreciation of EUR following President Macron's decision to hold elections resulted from forex market players pondering the possibility of the most-extreme potential ramification (Frexit), but the depreciation also reflected an initial reaction to the emergence of French political affairs as a market-disrupting factor, and that reaction will probably calm down gradually. As mentioned, the RN this time is not advocating such extreme policy targets as withdrawal from the EU or the euro area, so the financial markets should not be particularly more concerned than they were during the numerous EU political crises that the markets have weathered since the European debt crisis.

Rather than being related to extreme developments, the real cause for concern about France going forward is the possibility that the French National Assembly will begin to skirmish with the European Commission about the application of the EU's fiscal spending rules. If that possibility eventuates, the downgrading of French government bonds will push up yields and could lead to greater EUR selling, which could continue for some time.

While France's president is at the center of French politics and in charge of foreign affairs and defense, the country's prime minister and cabinet are in charge of domestic affairs. As the president has the power to appoint the prime minister and cabinet members and to dissolve the National Assembly, the president always retains a certain amount of power to countervail the prime minister's actions. The president does not have the power to veto bills passed by the National Assembly, however, and that creates the potential for considerable political strife and turmoil. For example, the RN is proposing that France should distance itself as much as possible from the Ukraine war, but national defense is ultimately the responsibility of President Macron, so no major changes to the country's policies regarding Ukraine are expected. On the other hand, the RN is likely to propose various controversial domestic policies, including those to oppose EU rules restricting fiscal spending (such as the Stability and Growth Pact (SGP)), those to insist on expansionary fiscal spending measures, and those to strengthen the regulation of immigration. It has also pledged to reduce value-added tax rates, which can be expected to clash with EU rules (≈ SGP), particularly given the damage the COVID pandemic has already inflicted on France's fiscal situation.

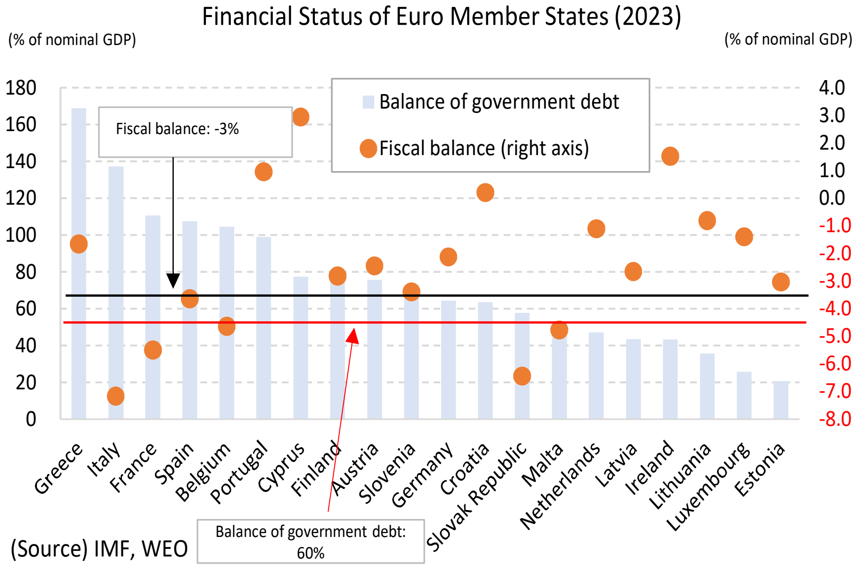
Regarding this point, on June 19, the European Commission recommended to the European Council (the EU's highest decision-making body) that it initiate the Excessive Deficit Procedure (EDP) as a corrective measure for seven member states (including France, Italy, Belgium, Slovakia, Malta, Poland, and Hungary) that are running fiscal deficits greater than permitted by the euro area's fiscal rules. The risks associated with this situation are discussed in a separate section below.

While the RN is attracting the most attention at this time, it is worth noting that the left-wing New Popular Front coalition (NFP, which has voter support second only to the RN) is also pushing for expansionary fiscal policies including those to hike the minimum wage. Both left- and right-wing parties are seeking to win votes by calling for handouts. Control of the National Assembly by such forces may be unacceptable to President Macron, who has committed himself to a pro-EU stance, and there appears to be a somewhat realistic possibility that he might resign in that situation.

Expectation of Moderation through 2027

In addition to taking control of the National Assembly, the RN and its allies have the ultimate goal of nominating France's next president. French presidents are prohibited from running for a third term in office so President Macron will have to retire from the presidency in 2027 (if he does not resign beforehand), when a presidential election will be held. Looking back at the EU's history, one finds that many governments that won elections by presenting extreme demands to the European Commission have been short-lived due to economic and financial turmoil. Considering that and given that they will be seeking to win the 2027 presidential election, the RN and its allies (even in the likely case that they come to dominate the National Assembly) are likely to avoid precipitously courting major conflicts with the European Commission. While France's current political instability is certainly not good news for EUR, it seems a bit excessive to make a fuss about it as if it were something that could cause EUR to plummet. As reflected in the recent European Parliament election results, there appears to be increasing momentum behind a long-term trend of increase in support for far-right parties in such major EU countries as Germany, France and Italy as well as in such countries as Austria. Eventually, one may look back at this point in time and consider it to be a major turning point at which the EU's policy management began significantly shifting toward more-conservative and inward-looking policies.

European Commission Issues Corrective Recommendations for Seven Countries



(Source) IMF, WEO

However, there remain concerns about whether the European Commission and the French far-right will be able to get along. On June 19, the European Commission recommended to the European Council that it initiate the corrective Excessive Deficit Procedure (EDP) with respect to seven member states (France, Italy, Belgium, Slovakia, Malta, Poland, and Hungary) that have fiscal budget deficits greater than levels permitted by euro area rules. As mentioned above, France's RN party advocates expansionary fiscal policies and may soon take control of the country's National Assembly, and there is a risk that France's fiscal policies will generate problems that the financial markets will be unable to ignore.

In 2023, France's fiscal deficit was 5.5% of its nominal GDP (the third largest such deficit ratio among euro area countries, after those of Italy and Slovakia) and its government debt grew to 110.6% of nominal GDP (second only to debt ratios of Greece and Italy, the euro area's most chronically problematic countries with respect to debt levels). France's fiscal deficit and government debt levels have thus become considerably higher than levels permitted by the Maastricht Treaty standards, which limit euro area members' annual fiscal budget deficits to 3% of nominal GDP and their public debt levels to 60% of nominal GDP. The French government originally planned to record a 4.9% fiscal budget deficit ratio in 2023, although it eventually ballooned to 5.5%, and this violation of EU rules caused credit rating agencies to downgrade France's credit rating from AA to AA- late in May 2024. At the time this article was written, the RN (expected to become the party with the greatest number of National Assembly seats after the general election) and the far-left NFP coalition (expected to win the second-greatest number of National Assembly seats) were in agreement on the desirability of an expansionary fiscal policy, the abolition of value-added tax on certain products, and the postponement of pension reform measures (including those to elevate the legal retirement age and adjust pension payment levels). <u>This agenda starkly conflicts with that of pro-EU President Macron, and there are also grounds for concern that French policies that provoke conflicts with the European Commission could undermine French credit ratings and could by inducing fluctuations in bond yields cause turmoil in the euro area's financial markets</u>. Considerable attention will also be focused on whether Italy (led by far-right Prime Minister Giorgia Meloni, who has been seeking to avoid conflict with the EU and adopt realistic policies) will also be subjected to the EDP process. Given the prospect of various political changes, it is expected that financial markets will intermittently be taking into account European political risk factors throughout 2024, and that situation is likely to place unexpected downward pressures on EUR.

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