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Forex Medium-Term Outlook

August 1, 2024

Overview of Outlook

USD/JPY fell sharply in July. Given the various factors that have coexisted since the beginning of 2024 – JPY short positions swelling to their largest size during the current JPY depreciation phase; the discrepancy between USD/JPY market rates and the U.S.-Japan interest-rate gap; and the remarkable improvement in Japan's cash-flow (CF)-based current account balance – it was inevitable that speculative positions would be adjusted. Although the extent of the adjustment was greater than expected, the emergence of a buying opportunity during the July-September quarter is itself something I have anticipated all along. The July position adjustment was the largest in the past two years and similar adjustments will not occur too many times going forward. However, trading positions are still leaning toward JPY short positions, so there may be still some fuel remaining for another adjustment or two. If the BOJ's July monetary policy statement is taken at face value, one can assume interest rate hikes coinciding with each release of the Outlook Report, so investors must watch out for similar adjustments for some time to come, but with JPY long positions coming at a cost, the sustainability of speculative JPY long positions is doubtful. I would like to emphasize that the upcoming phase should be viewed as a brief phase of JPY strength punctuating what is otherwise a longer phase of JPY weakness. In this context, it must also be noted, taking into account the structural changes in Japan's balance of payments (as discussed many times in the past), that a phase of JPY strength does not mean a return to 100 or 110 yen to the dollar. One must be careful to distinguish between the "era" and "phase" timeframes and not allow short-term price movements to overshadow discussions about structural issues. A continuing risk to my forecast scenario is a heightening of awareness regarding the inflation tax.

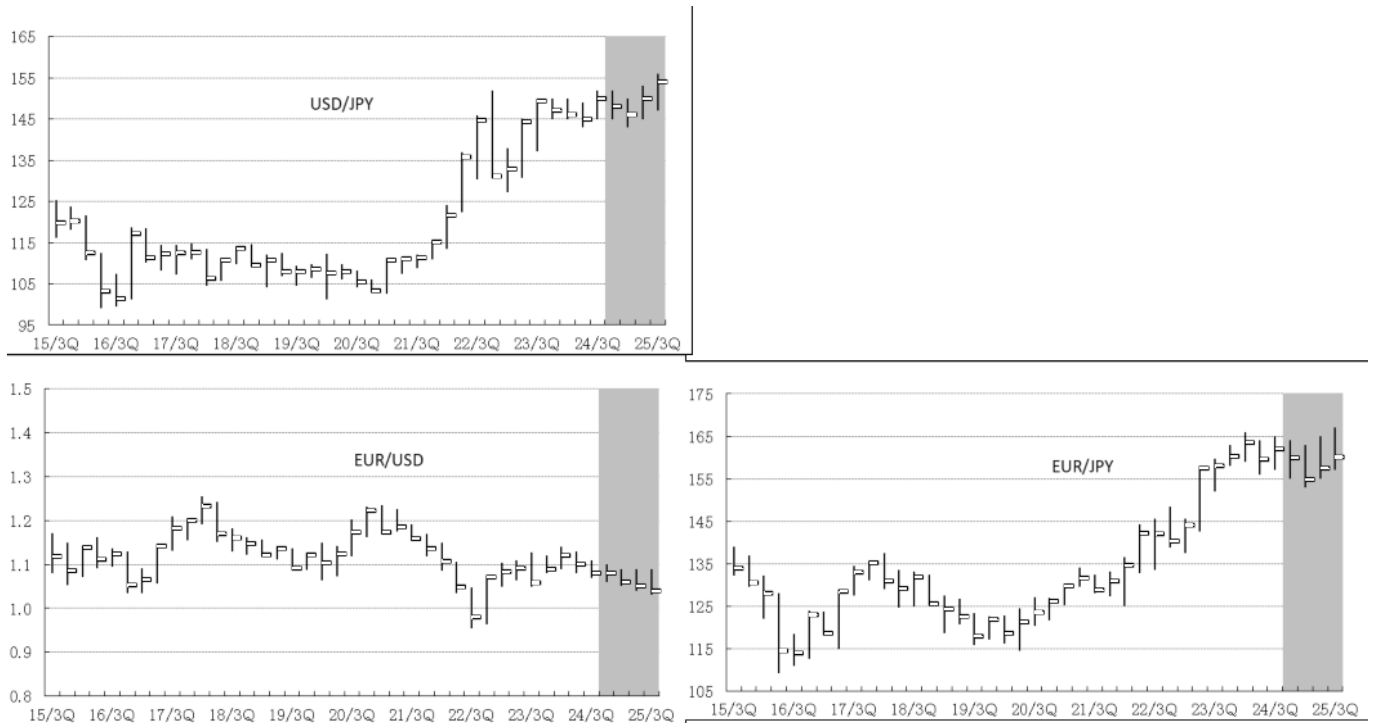
EUR was moderately strong in July. The ECB decided at its July Governing Council meeting not to implement consecutive rate cuts, and euro area inflation has also been strong, mainly centering on services. The image of wages obtained from job postings, which the ECB monitors, is also likely to be quite strong for the time being, giving the ECB no reason to cut interest rates in haste. However, ECB President Christine Lagarde seems confident of a slowdown in nominal wages, so around two rate cuts are expected this year. Going by the press conference following the Governing Council meeting, the ECB seems nearly certain of nominal wages falling from 2025 onward, so it seems safe to assume that rate cuts will continue during the second half of the current forecasting period, pushing EUR down. As regards the political situation in France, it seems quite unlikely that the new French government will get along with the EU (i.e., the European Commission), and given the state of France's finances, it is unclear whether the country can get through this period safely. At the time of writing this article, it is difficult to make any predictions, given that the new government has not even been formed yet, but the first issue for the financial markets will be to find out the extent to which the new government will insist on fulfilling its campaign promises. If French sovereign bonds are downgraded, there are concerns that EUR could be sold off.

Summary Table of Forecasts

	2024 Jan-Jul (actual)	Aug-Sep	Oct-Dec	2025 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	140.80 ～ 161.96 (149.44)	145 ～ 152 (150)	145 ～ 152 (148)	143 ～ 150 (146)	145 ～ 153 (150)	147 ～ 156 (154)
EUR/USD	1.0601 ～ 1.1046 (1.0828)	1.07 ～ 1.11 (1.08)	1.06 ～ 1.10 (1.08)	1.05 ～ 1.09 (1.06)	1.04 ～ 1.09 (1.05)	1.03 ～ 1.09 (1.04)
EUR/JPY	155.10 ～ 175.42 (161.80)	157 ～ 165 (162)	155 ～ 164 (160)	153 ～ 163 (155)	155 ～ 165 (158)	157 ～ 167 (160)

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

Exchange Rate Trends & Forecasts



USD/JPY Outlook – Position Adjustments as Expected

U.S. and Japanese Monetary Policies Now and Going Forward – The Real Problem Pertains to Subsequent Rate Hikes

Rate Hike Despite Strengthening JPY

At its much-anticipated July 30-31 Monetary Policy Meeting (MPM), the BOJ raised the uncollateralized overnight call rate, which is the official interest rate, from 0.0-0.1% to around 0.25%. Additionally, a plan was outlined for the reduction of monthly Japanese government bond (JGB) purchases, which had already been indicated at the previous MPM, from the current level of around JPY 6 trillion to around JPY 3 trillion in January-March 2026, by cutting back on purchases at the rate of JPY 400 billion per quarter. Both interest-rate and quantity-related policy decisions were as predicted by advance reports. The sharp decline in USD/JPY following the meeting was mainly owing to remarks by BOJ Governor Kazuo Ueda, and one cannot help but suspect that these remarks were made due to urging by the political establishment.

In my July 18 Mizuho Market Topics report titled "A Preview of the BOJ MPM – Interest Rates Will be Hiked Because JPY is Stronger," I predicted that, rather than deciding that the need for rate hikes had lessened amid the ongoing correction of JPY rates, the BOJ would take the opportunity to pragmatically carry on with policy normalization, because the motivation for raising interest rates at this time would be less likely to be attributed to forex trends. I also wrote in a comment to a July 29 Bloomberg article in this context, "I think interest rates will be raised. This could well be a turning point in the larger trend of JPY depreciation." While this is not something the BOJ will openly admit to, the timing may indeed have encouraged the Bank to raise interest rates (as raising interest rates at this time would not be seen as an attempt to contain JPY depreciation).

Weak Personal Consumption Not Acknowledged

Amid a clear weakening of personal consumption, some analysts predicted it would be difficult for the BOJ to raise interest rates on the pretext of spurring a virtuous cycle of wage and price growth. In this context, I argued that, since higher prices resulting from JPY depreciation are causing nominal and real GDPs to diverge, weak personal consumption is a good reason to raise interest rates rather than to postpone them. In his press conference, Governor Ueda made the following remarks: "While consumption is not at its most robust, the BOJ's consumption indices indicate that it is fairly strong;" "(The current rate hike) is a small correction within the band of very low real interest rates and is unlikely to negatively affect the economy in a big way;" and "Coming at a time when wages and prices are rising, I do not necessarily think the Bank's move will slow the growth of the economy or prices." These remarks reinforce the idea that consumer confidence is not so weak as to be dampened by a +15bp rate hike. In short, as the recent rate hike was intended to correct an accommodative financial environment rather than to tighten monetary policy, the decision may not have been based solely on recent data. It will be interesting to see whether such forceful arguments can continue to be put forward in light of future GDP results.

Globally speaking, 0.25% is the starting point for monetary policy operation, which mainly involves interest rate

adjustments, so there is no need to take a 15bp rate hike to return to that level too seriously. Again, there has always been speculation that political considerations may make it difficult for the BOJ to raise interest rates, but this time, a large number of comments from high-ranking government and ruling party officials calling for a rate hike were extensively covered by the media. This may have made it a historically good opportunity for the BOJ to raise the rates without a loss of political capital.
The real question is whether the BOJ can raise interest rates further, even if it coincides with an LDP presidential election or a snap general election at a time when the impact of its first two rate hikes (the recent one plus the earlier one to exit negative interest rates) becomes apparent in the real world, such as through an increase in interest payments on some home loans.

Implications for USD/JPY – Sustainability of Speculative Long JPY Positions
Regarding any additional rate hike, the last paragraph of the monetary policy statement clearly states, “Given that real interest rates are at significantly low levels, if the outlook for economic activity and prices presented in the July Outlook Report will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation.” If taken at face value, this could be interpreted to mean that an additional rate hike will be implemented in October, coinciding with the release of the next Outlook Report, if there is no significant deviation from the BOJ’s main scenario (in other words, wait and watch in September).
The sudden appreciation of JPY following the recent MPM may be largely due to such statements as well as Ueda’s remark, “I do not necessarily view 0.5% (policy interest rate) as a barrier.” This policy stance of the BOJ seems to be serving as the perfect excuse for the unwinding of short JPY positions. Given that the cumulative short JPY position is still extremely large at the time of writing this report, JPY strengthening against USD could be justified for the rest of the year, at least from the interest-rate-differential perspective, if the Fed is forecast to raise interest rates in September and December. However, unlike short JPY positions, long JPY positions have limited sustainability as speculators have to pay the cost of the interest-rate differential to hold them.
Further, despite continuing improvement in the supply-demand climate, the CF-based current account balance remains barely neutral. This, and the fact that household JPY selling in response to the New NISA scheme is likely to reach JPY 13-14 trillion a year, makes it unrealistic to expect the current momentum to result in a full recovery in JPY rates to around 110, which was the starting point of the current JPY depreciation phase. The halfway recovery point for the current phase of JPY depreciation (from about JPY 110 to about JPY 160) is JPY 135. Whether JPY can even recover that far in the next year will depend on the Fed’s pace of rate cuts, but the JPY supply-demand climate may not allow it. Moreover, the pace of rate hikes itself will depend to a large extent on the outcome of the presidential election. If a second Trump administration is taken as the main scenario, I expect the shrinking of the U.S.-Japan interest-rate gap to be limited by a fewer number of rate cuts under a strongly reflationary economic policy.
With JPY supply and demand leaning toward JPY selling, and the narrowing of the interest-rate gap expected to be limited going forward, this report’s position is that it will be difficult for USD/JPY to fall below 140 over the next year. It is possible that the BOJ, in anticipation of the next JPY depreciation phase, wants to raise interest rates and shrink the gap as much as possible while the Fed is in its rate cut phase. Of course, this is not an easy task, as there are concerns about the damage to the real economy due to rate hikes. However, it has become abundantly clear over the past two years that imported inflation due to JPY weakness is suppressing the real growth rate, so even if not overtly stated, raising interest rates as a measure to counter JPY depreciation (regardless of the magnitude of its effect) is necessary for the Japanese economy at this time. At any rate, since BOJ Deputy Governor Shinichi Uchida’s “this time is different” speech in May this year, this report has been predicting two rate hikes by the BOJ, so the recent rate hike did not come as a surprise.

Uneventful FOMC Meeting
The Fed, meanwhile, decided to maintain the status quo following its FOMC meeting, which was held on the same day as the BOJ MPM. The highlight was Fed Chair Jerome Powell’s statement at the press conference that interest rates may begin to be lowered in September. Both these things were in line with financial market expectations, so the meeting passed uneventfully. Since this report’s assumptions were also that the Fed would cut rates in September and December 2024, there is no impact on my forecast scenario.
Of course, the Fed’s policy operations for some time to come will be viewed from the perspective of closeness to the presidential election. One of the reporters at the recent press conference asked, “former President Trump reportedly said that cutting rates so close to the election is something the central bank knows they shouldn't be doing. (…) Do you believe it’s possible to really remain apolitical with the September rate cut?” Powell dismissed the question, saying, “We would never try to make policy decisions based on the outcome of an election. (…) We’re a nonpolitical agency, we don’t want to be involved in politics in any way.” The financial markets, however, will continue paying close attention to this issue. At the time of writing this report, it is not just U.S. economic and financial developments that are impacting the financial markets; rather, the reading of U.S. political trends seems to be playing a more important role. The next section takes a detailed look at how to understand the impact of U.S. politics on the financial markets.

How to Understand the Impact of U.S. Politics on the Financial Markets – My Current Interpretation of the Upcoming U.S. Presidential Election

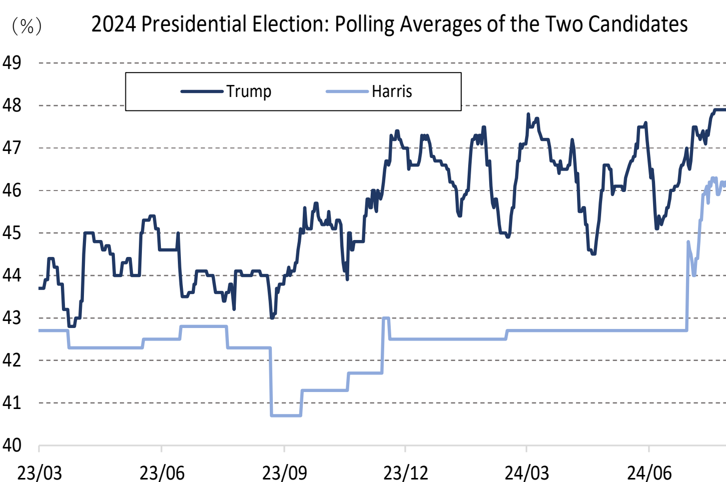
Biden's Withdrawal Leaves Impression of Divisions Within the Democratic Party

With less than three months to go before the U.S. presidential election, things have heated up considerably since the end of June. With market participants increasingly wondering about the impact of these events on the financial markets, I would like to organize my own thoughts on the matter based on currently available information. Looking back at the past over a month or so, the televised debate between the two parties' candidates held on June 28 (Japan time) clearly exposed the decline of current U.S. president, Joe Biden, making Trump's victory in the upcoming elections a near certainty even before the event. Add to this the shocking news on July 13 that Trump had been shot during a campaign rally and narrowly escaped death. The drama of a presidential candidate who survived a life-threatening crisis gave Trump a further boost, and the markets began to factor in reflation trade following a Trump victory. In this midst, Biden suddenly announced on July 21 that he would withdraw from the race. Since the TV debate, reports have been coming in almost every day of important Democratic Party figures and supporters urging Biden to withdraw, and he appears to have surrendered without a fight.

Biden has indicated his intention to support and recommend Vice President Kamala Harris as the official Democratic Party candidate, and her candidacy will be confirmed following the Democratic National Convention. Reports also mention California Governor Gavin Newsom, Pennsylvania Governor Josh Shapiro, and Michigan Governor Gretchen Whitmer as possible candidates. Over the next month or so, in the run up to the Democratic National Convention, which begins on August 19, the battle for the Democratic Party's presidential candidate will unfold. The victory of Harris, who is recommended by President Biden, is considered the default scenario. Harris' youth and the fact that she is a woman are even pointed out as her strengths, and indeed, it appears that her polling averages may soon rival Trump's. However, the fact that the Democratic Party has not yet chosen its candidate with only three months to go before the election gives a strong impression of divisions within the party.

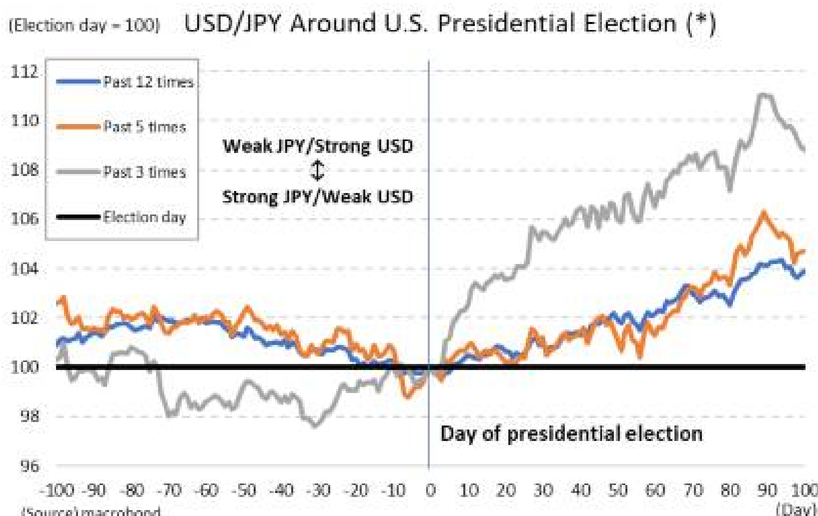
Market Sentiment Remains Unchanged

How is the market viewing the situation? The situation is quite delicate, but financial market movements following reports of Biden's withdrawal from the race remained modest, and Trump continues ahead of Harris in the opinion polls (see figure). At the time of writing, some reports suggest that Harris is leading, while others still report Trump to be in the lead. What can be said, however, is that the Democrats have a slightly better chance of winning with Harris than with Biden, and to that extent, reflation trade assuming a Trump victory has slowed down. For the purposes of this report, this is a factor that contributes to strengthening the correction of JPY weakness, thereby strengthening the forecast bias toward a stronger JPY during the current forecasting period.



(Source) RCP, Bloomberg

Taking a Trump victory scenario to still be the dominant one at this time, I would like to summarize potential future developments. In terms of currency and monetary policy, which are crucial for determining forex market trends, it seems likely that currency policy will support USD weakness, and monetary policy will be accommodative. However, during the previous Trump administration in 2016-20, these ideas combined with reckless statements from Trump to result in higher U.S. interest rates and stronger USD amid repeated interest rate hikes by the Fed. Regardless of what Trump says, monetary policy is unlikely to change, and currency policy is ultimately determined by monetary policy. Trump's preference for USD weakness notwithstanding, if all the policies likely to be implemented by his administration are strongly reflationary, currency and monetary policies are unlikely to take on dovish tones. In addition to this easy-to-understand image of Trump, it is worth considering the historical fact that USD has tended to appreciate against JPY after a U.S. presidential election regardless of the winning party (see previous figure) – as discussed previously in this report early this year. In light of all



(Source) macrobond
*All 12 elections since the switch to a floating exchange rate system

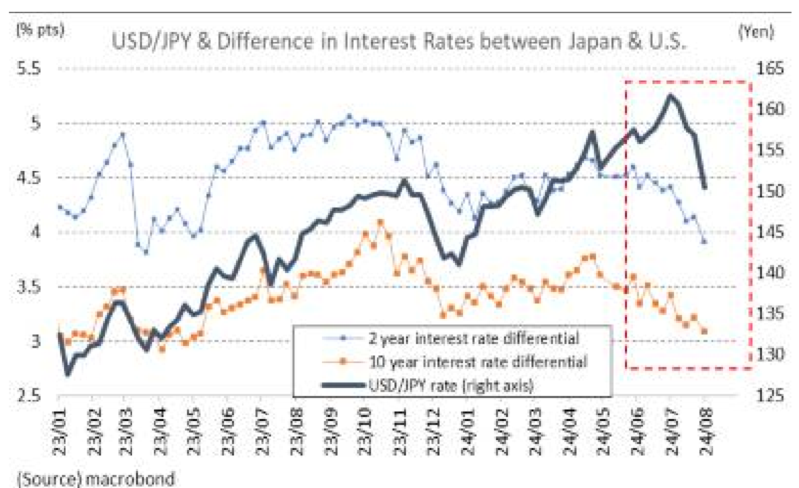
this, my assumption since the beginning of the year has been that the U.S. presidential election will serve as the trigger for a resumption of a JPY depreciation phase.

Potential Change in Policy Ideas With Change in Close Aides?
Note that, in November 2016, it was said that a Trump election would results in investors becoming risk averse, share prices plummeting, and JPY soaring. However, in reality, both USD/JPY and share prices soared following the announcement of election results. As mentioned above, this was because markets were aware that the Trump administration's economic policies would boost prices and wages. This time, the main market forecast, if anything, is that a Trump reelection will rekindle inflationary pressures, leading to an increase in U.S. interest rates and USD, but one must also think about the possibility of this not happening.
Let us make a realistic assessment of such a risk. Some say that Trump's policies (additional tariffs, immigration exclusion, etc.) will, in fact, bring about a recession and push down interest rates and prices. However, in terms of the likelihood, few would disagree that interest rates and prices are more likely to rise. There are also those who say that policy operation will change based on the brains behind it. It was frequently said that Trump did not seem to have a definite view on economic policy. An executive at a major American institutional investor I spoke with in July told me that Trump was a very good listener. That is the very definition of a person without a fixed view. If so, the Trump administration's policy direction could change based on the lineup of close aides related to economic policy, such as the chairman of the Council of Economic Advisers (CEA) and the Secretary of the Treasury, whose names have not yet been announced (although some have been mentioned). Given the urgent need for inflation control in the U.S. at the present time, it is not impossible that people who do not recommend Trump's high-pressure economic policy mix will be chosen. However, unlike the last time, when it was unclear what would happen, this time Trump already has a track record of four years in office. It is difficult to imagine any significant change in his basic stance of "America First." The selection of aides will also be based on that stance, and, as of now, no major surprises are expected.

Key Difference: Rate-Hike Phase Last Time vs. Rate-Cut Phase This Time
Trump's previous administration was during a phase of interest rate hikes, but if he takes office again this time, it will be during a phase of interest rate cuts. A simple reading of this could be that USD rate trends will be different this time because the premise is different. As an economist, the most straightforward prediction may be a steady decline in U.S. interest rates and USD irrespective of Trump's words and actions. Incidentally, Trump once said at a press conference during his term in office, "I do like a low interest rate policy,'' which was widely reported. This was somewhat of a pointed remark, as it was made at a time when interest rates were being raised, which was at odds with Trump's inclinations. This time, however, the Fed is getting ready to cut rates, so taking just the simple aspect of Fed rate cuts→lower interest rates→USD weakness, the fundamentals are in agreement with Trump's policy beliefs. An overlapping between currency/monetary policy and Trump's beliefs seems likely to result in a trend of USD depreciation.
However, to repeat, the Trump administration's economic policies may prove to be the biggest obstacle to the basic premise of rate cuts by the Fed. If tax cuts, an expansionary fiscal policy, and immigration restrictions are implemented, U.S. labor market conditions will inevitably tighten. This will make it difficult for the Fed to cut interest rates, so it may be wise to retain USD appreciation as the main forecast scenario assuming an upcoming Trump administration.
Of course, some have pointed out that labor market conditions may not tighten any time soon as the election of Trump will not necessarily result in an immediate rise in tariffs or the expulsion of immigrants. This is certainly true, but the financial markets are actively trying to factor in the most extreme scenario foreseeable. There have been occasions when USD was propped up due to persistently high U.S. interest rates following Trump's election. Rather than attempting to get to the truth of the matter, the markets tend to factor in developments that are of concern at the time. With the second Trump administration becoming the main theme of the markets starting the October-December period, I am of the view that the resumption of JPY depreciation should continue to be viewed as the main forecast scenario. However, as explained above, there are still many evolving aspects to the situation, and it must be said that they add a great deal of uncertainty to the main scenario.

JPY Supply-Demand Environment – What happens after Unwinding of JPY Short Positions?

Speculation Unwinding in Line with Expectations
USD/JPY fell sharply in July. This fall began with the mid-July release of June U.S. Consumer Price Index (CPI) figures indicating that the rate of inflation was slightly below market expectations. Those figures caused large-margin drops in U.S. interest rates and USD/JPY, the latter of which had plummeted to the JPY148-149 range at the time this article was written. When this article was written, there was also considerable speculation that the Japanese government and the BOJ would undertake JPY-buying intervention in the forex market. Regardless of whether such intervention eventuates, it is worth noting that this article has been intermittently sounding alarm bells about the potential ramifications of a JPY appreciation trend.

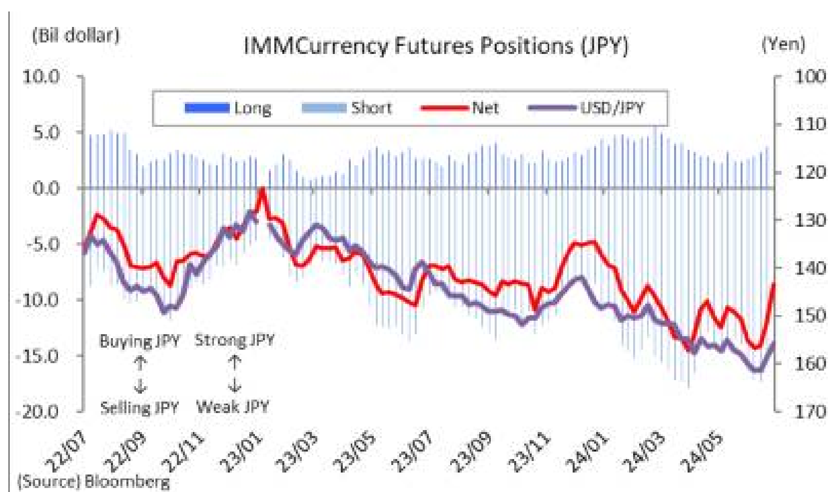


Assuming that anticipation of a narrowing of the Japan-U.S. interest rate gap will cause the unwinding of speculative JPY short positions and thereby magnify the degree of JPY appreciation, I have been expecting USD/JPY to bottom out during the July-September period at levels around JPY156. The actual adjustment turned out to be even larger than I had expected, but in light of the magnitude of JPY short positions (described below) the adjustment has been roughly in line with my expectations.

As discussed below, speculative JPY short positions swelled greatly during this latest period of JPY depreciation, and considerable adjustments to those positions have become inevitable given the JPY-related situation since the start of 2024 – the divergence between trends in actual forex market rates and in the Japan-U.S. interest rate gap (see graph, above right), and the notable improvement in Japan's cash flow (CF)-based current account balance (see graph, page 10). As I attach great importance to JPY supply-demand factors, it has seemed apparent to me that a continued JPY depreciation trend would be significantly countervailed by the fact that Japan's CF-based current account has become roughly balanced. It is worth noting that the net CF-based current account deficit for the January-May period of 2024 was -JPY1.4 trillion, but the net deficits for the same periods of 2023 and 2022 were -JPY4.5 trillion and -JPY3.6 trillion, respectively. Although there remains a deficit, the JPY supply-demand environment is clearly improving, and I believe this indicates we are in a period in which it should be recognized that short-term JPY depreciation pressures are diminishing. Of course, since the recent CG-basis current account balances are still much lower than the CG-basis current account surpluses recorded in previous years, it is obviously unreasonable to expect USD/JPY to descend back to the vicinity of JPY110. However, as discussed below, there remains a possibility that USD/JPY could reach levels close to JPY130 as a result of speculative position adjustments. What actually happens will largely depend on the degree of prospective Japan-U.S. interest rate gap shrinkage.

Largest JPY Buyback in Two Years

Recent adjustments to speculative JPY positions have been quite large and sudden, and it cannot be expected that shifts of this magnitude and speed will occur many times in the future. The latest IMM currency futures data available at the time this article was written indicate that there were -USD8.6 billion of JPY short positions as of July 23. This indicates that USD3.32 billion of JPY buybacks were executed since the previous week (when JPY short positions amounted to -USD11.93 billion), the largest single-week JPY buyback seen in the past two years (see graph). It is worth noting that the magnitude of JPY short positions during the current period of JPY depreciation peaked on July 2 at -USD14.26 billion and was reduced by about 60% in the subsequent three weeks. On the other hand, it remains possible that there is still leeway for another 60% speculative position adjustment. The scale of the downward adjustment to USD/JPY seen in the past month was large and, while it is unlikely that we will see many more such adjustments on that scale, it is important to note that accumulated JPY short positions were tantamount to the 'fuel' needed to drive a JPY appreciation trend and that some of this 'fuel' still remains.



Need to Differentiate Periods from Eras

Following the initial round of speculative position adjustments, the biggest near-term concern is about how much leeway remains for additional JPY appreciation. It is difficult to assess that leeway, but it is worth noting that the smallest JPY short position magnitude during the past two years was the -USD1.93 billion level recorded as of January 31, 2023, when USD/JPY was around JPY130. Given that the JPY supply-demand environment has improved since then, it is not surprising that the recent adjustment was so large.

However, the overall situation is not so simple. Objectively evaluating the current situation, one finds that a Fed rate cut is clearly factored in more than it was in January 2023, and a BOJ rate hike is also factored in to a certain extent. Nevertheless, it appears that USD/JPY has now settled in a range near JPY150. Of course, if the BOJ actually starts to raise interest rates and the Fed actually starts to cut interest rates, there is a possibility that JPY will suddenly appreciate and USD will weaken. Efforts to understand the situation based on levels of IMM short positions are useful but, unfortunately, the fairly loose correlation between movements in short positions and in exchange rates makes this approach difficult to use in making forex forecasts. A USD/JPY descent to around JPY135 does not appear quite so unlikely if one considers the facts that USD/JPY rose by about JPY52 (from around JPY110 to around JPY162) in about 27 months and that a descent to around JPY135 would correspond to only about half of that previous margin of change. It is impossible to predict the next U.S. president's economic policies, however, and it is also difficult to predict whether the Fed will be able to continue making appropriate interest rate cuts and, moreover, doubts remain as to whether it is really correct to assume that the magnitude of JPY short positions will steadily decrease. At present, I believe JPY short positions will not come to be completely eliminated.

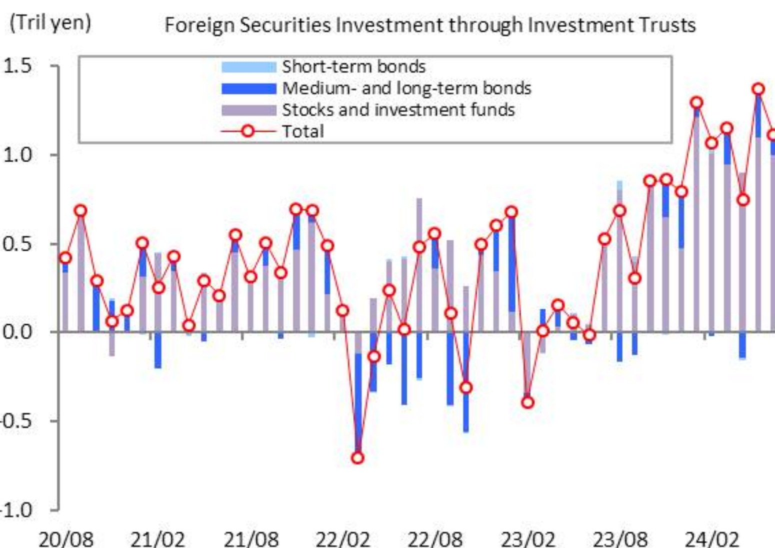
What I want to emphasize, as I did in this article at the start of 2024, is that the upcoming period of JPY appreciation is merely a short-term JPY appreciation period within a long-term JPY depreciation era that will can be expected to continue for a long time to come. Since the 1973 shift to a floating exchange rate system, there have been many JPY depreciation periods within a JPY appreciation era. So long as JPY is traded within a floating exchange rate system, one

can expect numerous short-term periods of JPY appreciation and depreciation that can begin at any time, but the shift from a JPY appreciation era to a JPY depreciation era is a more-stable phenomenon. Forex trend analyses should always strive to clearly differentiate short-term periods from long-term eras, as such analyses are often muddied by the placement of excessive emphasis on the most recent short-term trends.

"Household JPY Selling" Likely to Exceed JPY13 Trillion in 2024

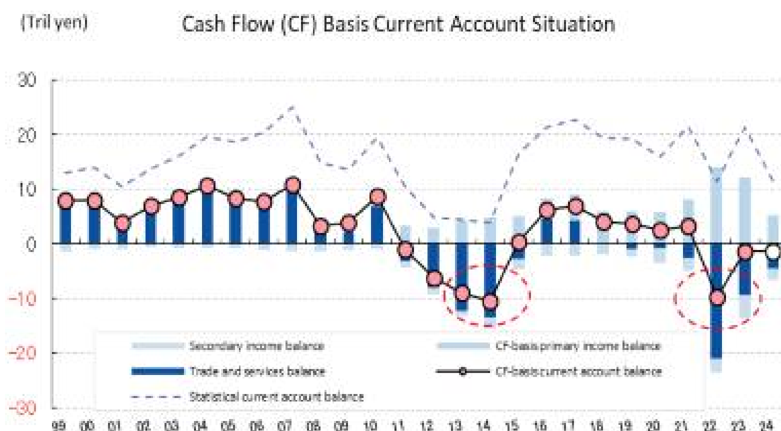
While speculative position fluctuations are thought to have promoted USD/JPY's dramatic drop in July, it remains important to assess the actual JPY supply-demand environment. I will briefly summarize the latest figures related to the JPY supply-demand environment that were available at the time this article was written. Japan's outward securities investment is attracting particular attention as a factor promoting JPY depreciation, and the Ministry of Finance's "International Transactions in Securities" report (a monthly report based on information from designated major investors) for June indicates that such outward securities investment was associated with -JPY4,929.4 billion of net JPY selling, the largest magnitude seen since related statistics have been tabulated. By product, medium- to long-term bond transactions shifted from +JPY2,298.1 billion of net purchases in the previous month to net selling of -JPY3,350.2 billion, while net selling of stocks and investment trust shares almost doubled, growing in magnitude from -JPY599.2 billion to -JPY1,004.5 billion. Net selling of short-term bonds more than doubled, growing in magnitude from -JPY204.1 billion in the previous month to -JPY574.8 billion. However, USD/JPY rose from around JPY156 at the start of June to JPY161 at the end of the month, a movement out of sync with the overall trend in outward securities investment (as the net overseas securities selling entailed JPY buying and foreign currency selling). It is possible that a substantial portion of the net overseas securities selling related to currency-hedged products, but the overall figures suggest that that outward securities investment had no major impact on the forex market.

Looking at the figures by investor type, one finds 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) had net purchases of JPY1,110.3 billion of securities, the fourth highest level since statistics began. With this, five of the first six months of 2024 are ranked between 1st to 5th in terms of the magnitude of monthly net purchases via investment trusts. The total amount of net purchases via investment trusts reached +JPY6,749.2 billion in the first six months of the year, which is 1.5 times the amount for the whole of 2023 (+JPY4,544.7 billion). If things continue this way, the total net purchases via investment trusts for the whole of 2024 will easily exceed +JPY13 trillion. As I wrote in last month's edition of this article, net securities purchases in 2024 are literally on another scale, and this new scale of net securities purchases appears to have become a "new normal" for Japan. Looking at the first six months of 2024 by product, one finds that net purchases of short-term bonds were up +JPY154 billion, net purchases of medium- to long-term bonds were up +JPY431.3 billion, and net purchases of stocks and investment fund holdings were up +JPY6,163.9 billion, with most of the stocks and investment fund holdings investment going into overseas stocks (probably U.S. stocks). Judging from the general trend of JPY depreciation during the first half of the year, one can surmise that much of the overseas investment undertaken under the New NISA system is not currency hedged.



Record High Nominal Surpluses but Continued CF-Basis Deficits

Japan's international balance of payments statistics for May showed the country had a current account surplus of +JPY2,849.9 billion. The trade and services deficit was -JPY1,106.6 billion in May, exceeding the -JPY1 trillion mark for the second consecutive month, but this continued to be offset by the primary income surplus which was +JPY4,211,1 billion in May, the largest surplus ever. Consequently, the current account surplus for the first five months of 2024 amounted to +JPY11,148.2 billion, and it is possible that the figure for all of 2024 will turn out to be the highest ever. However, when viewed on a cash flow (CF) basis (involving adjustments for reinvested earnings and bond interest income (included within the primary income account) and other income that remains



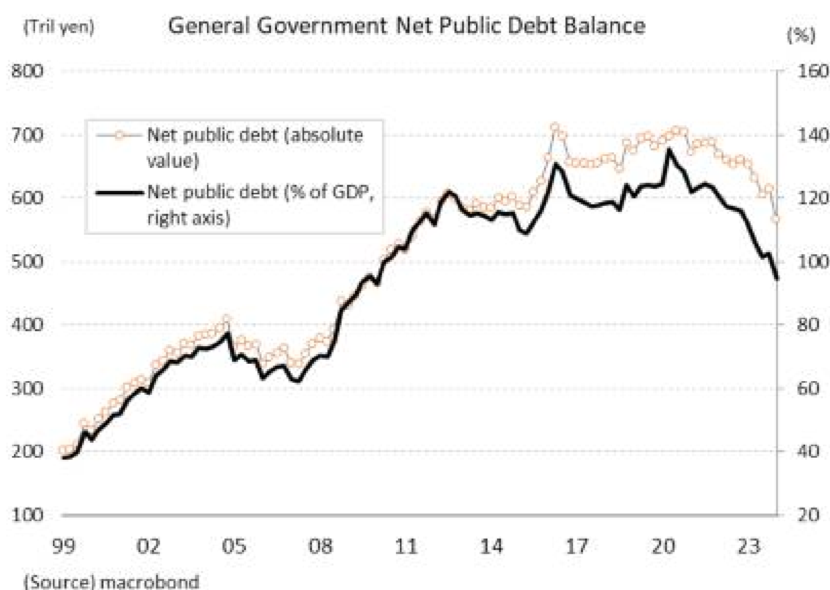
in the form of foreign currencies rather than being converted into JPY), Japan's current account balance for the first five months of 2024 was about -JPY1.4 trillion, a slight deficit. Of course, depending on methods used to estimate the percentage of income converted into JPY, the actual CS current account balance might be either a small surplus or a small deficit, but the key point is that it is misleading to take the statistical surplus of over +JPY11 trillion at face value, and there is now a consensus supporting this point among those discussing JPY supply-demand factors' influence on forex rates. So Japan's CF current account balance has come to have a relatively neutral effect on the JPY supply-demand situation, and the Japan-U.S. interest rate gap is shrinking, so the overall power of factors promoting JPY appreciation seems to be growing, but it is generally understood that intense "household JPY selling" is the underlying reason for the persistence of the JPY depreciation trend. Amid this situation, the reality is that JPY has been more likely to appreciate as accumulated short JPY positions are unwound, but it should be noted that the JPY supply-demand structure itself has not changed in a way that promotes JPY buying.

Risks to My Main Scenario – Concerns about a Financial Market "Inflation Tax" Theme

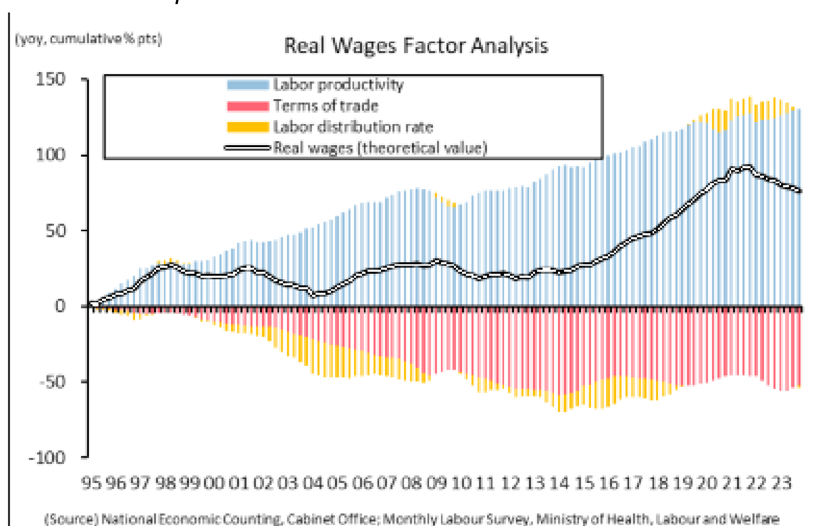
Remarkable Progress in Fiscal Reconstruction

Last month's edition of this article reported on the January-March Flow of Funds Statistics released at the end of June, which showed that the ratio of foreign currency assets to household financial assets hit a record high. In addition to changes in the household sector, however, the statistics also indicated notable movements in the government sector. This article has addressed this issue in the past, but given the Japanese economy's current state, it is hard to shake the suspicion that we are entering a situation in which the government will willy-nilly have to use an "inflation tax" (or "inflationary debt relief") to promote its fiscal reconstruction. The latest Flow of Funds Statistics are further strengthening suspicion on this point.

It is worth examining the first-quarter Flow of Funds Statistics in detail. The ratio of general government debt (the total of central and local government debt obligations) to nominal GDP was 241.3% on a gross basis, down from 241.5% in the previous quarter, and net debt was 94.7% of nominal GDP, down from 102.8% in the previous quarter. This is the first time in 14 years (since the April-June quarter of 2010) that net debt has fallen below 100% of nominal GDP (see graph). Total debt has been increasing in step with nominal GDP, preventing significant reduction of the total debt ratio, but total assets have been increasing at a faster pace than total debt, enabling a significant the decrease in the net debt ratio. Looking at changes in general government asset components compared to the previous quarter, one finds notable increases of +JPY22.7 trillion in outward investment in securities, +JPY11.9 trillion in equity and investment fund shares, and +JPY3.3 trillion in currency and deposits. With regard to overseas securities investments as well as to equity and investment fund shares, it can be surmised that rises in overseas currency denominated asset prices have been significantly supplemented by exchange rate gains due to JPY's weakness. Looking more closely at the increase in currency and deposits, one finds increases in transferable deposits (liquid deposits) and foreign currency deposits, and there is no doubt that the increase in the latter reflects JPY's weakness. The increase in the former reflects the effect of inflation in progressively augmenting household-to-companies and companies-to-government income transfers.

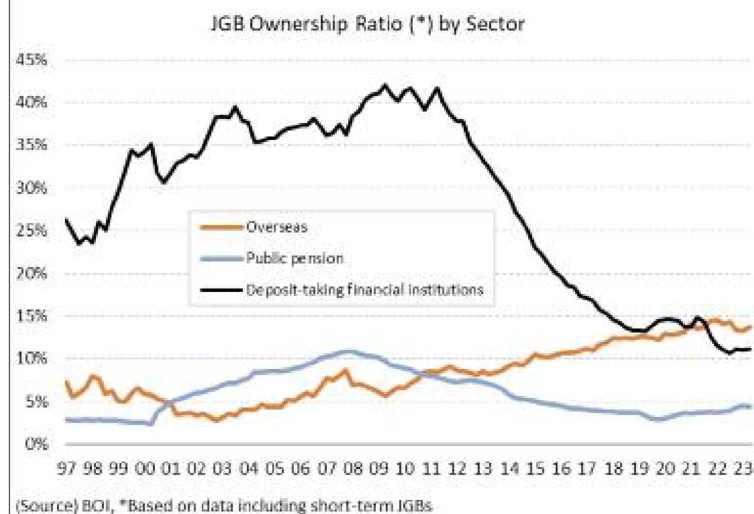


Speculation about Japan's "Inflation Tax" and Associated JPY Depreciation Risks



As can be seen from a glance at the above graph, never in the past quarter century has Japan's governmental financial position improved so significantly in just one or two years. As mentioned in previous editions of this article, there are three ways to reduce government debt (promote fiscal reconstruction) – (1) reduce government expenditures, (2) increase government revenues, and (3) promote inflation (or allow inflation to advance) – and all of these options can be used concurrently. For many years, Japan has been reluctant to utilize methods (1) or (2) and has almost always preferred to promote a weakening of JPY as a way to stimulate its economic and financial situation (or at least has done everything in its power to prevent JPY from appreciating). As a result, worsening terms of trade have caused a continued flow of income to overseas, which has depressed real wages (see graph). Naturally, the recovery of the real economy has been delayed, and fiscal reconstruction has not progressed. Regardless of whether the government has done this intentionally or not, there is sufficient circumstantial evidence to objectively conclude that Japan has begun using an inflation tax to promote fiscal reconstruction. <u>"Japan's inflation tax" has not yet become a clear theme in financial markets, but it has been covered in some media reports, and it seems that awareness of the inflation tax is gradually increasing</u>. For example, the Nihon Keizai Shimbun reported on this in a June 30 article entitled "Realism of 'Inflation Tax' Scenario: Weak JPY Tests Tolerance to Interest Rate Hikes". Still, so long as the government and the BOJ are taking steps to combat JPY depreciation and inflation (such as JPY-buying forex interventions and BOJ policy tightening measures), it is impossible to do more than make educated guesses about whether they are intentionally trying to create an inflation tax or not.

Risk of Market Tantrums



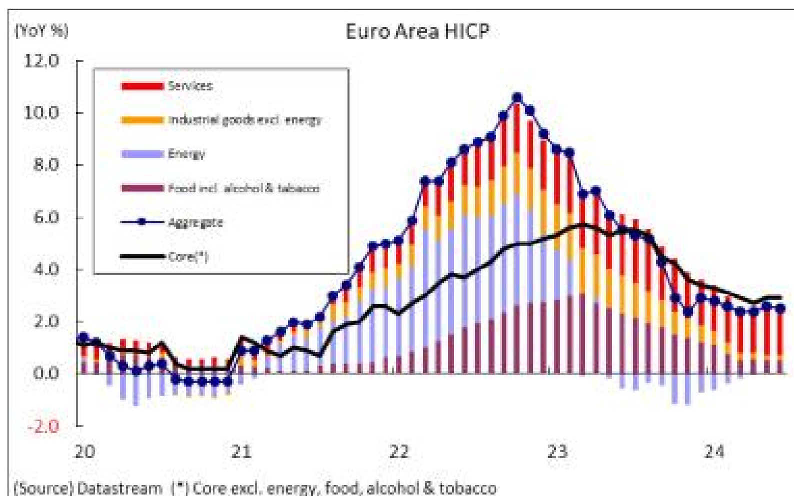
As the forex market has an impulsive nature and is prone to straightforwardly respond to the latest theme of the moment, however, <u>it seems quite possible that a situation may arise in which the market anticipates a forex intervention or interest rate hike that is not forthcoming, at which point the "Japanese inflation tax" theme may become a high-profile point of contention within the tantrum-prone forex market and elsewhere</u>. If this happens, the BOJ may find itself surrounded by adversarial forces stridently calling for interest rate hikes prior to each of its policy meetings. If it responds to such calls, the responses may be criticized as insufficient and a flurry of JPY selling may ensue based on appraisals that "the Japan-U.S. interest rate gap is still large". If the BOJ maintains the status quo, however, a flurry of JPY selling may ensue based on critical appraisals that the BOJ is "still seeking to create an inflation tax". <u>A particularly awkward aspect of the inflation tax theme is that it can become a contentious issue regardless of the intentions of the government and the BOJ, simply because of the willy-nilly existence of inflation and JPY depreciation trends</u>. Until recently, the fact that the bulk of Japanese government bonds were held by domestic investors has been a good excuse for keeping JPY interest rates low. As the graph shows, however, the share of Japanese government bonds (including short-term government bonds) held by the overseas sector has roughly tripled, from about 5% at the end of March 2000 to about 14% at present. <u>When considering JPY's medium- to long-term outlook, one should give due consideration to the possibility that the forex market may eventually become convinced that Japan is purposely promoting "uncontrollable inflation and currency depreciation" trends</u>.

EUR Outlook – ECB Confident about Interest Rate Cut Trajectory

EUR Area Monetary Policies Now and Going Forward – Confidence that "Wage Growth Will Moderate"

No Apparent Rush to Cut Interest Rates

As expected by the financial markets, the July 18 ECB Governing Council meeting decided to keep policy rates unchanged. Ever since ECB's last interest rate cut in June (the first such cut in 57 months), most ECB watchers have come to expect cuts may be implemented once every three months at times when revised the staff projections become available, so there will be considerable attention focused on whether another interest rate reduction will be approved at the September Governing Council meeting. The turbulent political situation in France (a core euro area country) and expectations that that situation will have negative impacts on euro area's economic and financial situations may come to be seen as factors justifying a September interest rate cut, but there are also various statistics emerging that suggest that euro area inflationary pressures have not sufficiently subsided. Many observers are expecting that the ECB may deem it difficult to continuously implement interest rate cuts in light of the lack of deceleration in the euro area consumer price index (HICP; see graph), particularly with respect to services. The ECB has not been showing signs that it is in a hurry to cut interest rates further, and the July Governing Council meeting's statement maintained previous statements' – "We will keep policy rates sufficiently restrictive for as long as necessary to achieve this [medium-term inflation rate] aim." – sentence. At the time this article was written, the financial markets appeared to be factoring in a 70% probability that an additional rate cut will be implemented in September, but ECB President Christine Lagarde has remained noncommittal, stating at the post-Governing Council press conference that – "the question of September and what we do in September is wide open and will be determined on the basis of all the data that we will be receiving."



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

ECB Confident WPP Factors will Restrain Wage Growth

The first reporter the post-Governing Council press conference posed the question "You said that domestic price pressures are still high. Could you elaborate a bit what the biggest lingering concerns were during your meeting around the issue of wages, profits and productivity" President Lagarde gave a very long answer covering each of the wages, profits and productivity issues, which she referred to as – "the WPP". Regarding the particularly noteworthy wages (W) issue, she said – "And we spent a lot of time actually looking under the hood of wages [...] on the basis of rather limited information because we don't have a lot of specificity at this juncture, and we will have a lot more of that in the coming weeks and months." – but acknowledged that wage trackers using such information as data from job advertisements currently being watched by the ECB indicate that wage growth will remain strong for the time being.

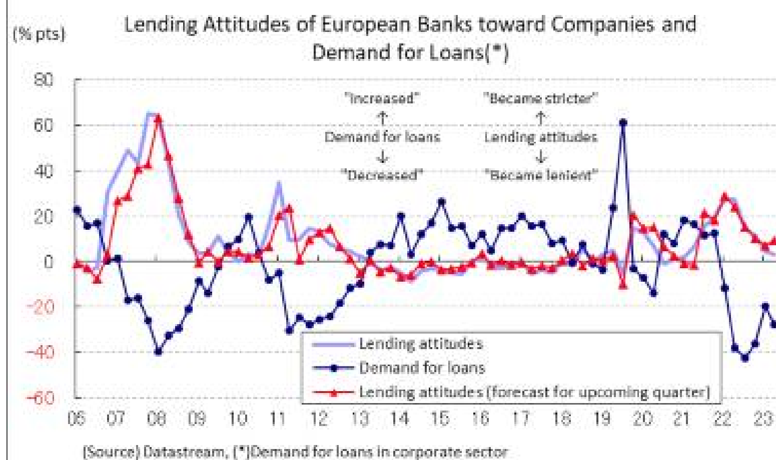
As the graph shows, even if the negotiated wages growth rate continues to decelerate in line with job advertisement data, it is expected that the rate will bottom out by early autumn without falling below +3% yoy level. However, President Lagarde stated that these wage growth trends are not a surprise and – "were embedded and totally taken into account in our June projections." She argued that it is natural for wages to rise to recover purchasing power lost due to the inflation of recent years and concluded that it is inevitable that – "nominal wages increase significantly this year". But she continued that sentence in a more-positive tone, saying – "many surveys and the corporate telephone survey, in particular, the SAFE survey that is published, indicate that this trend of elevated wages will decline significantly in the course of 2025 and even more so 2026. So directionally, that's the direction that it is heading for." Another reporter asked, "[H]ow much do you think the ECB will need to slow the economy and slow demand if wage growth does not moderate as you've forecast that it will?" – to which President Lagarde replied – "honestly -- on the basis of everything that we see,

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

the direction in '25 and in '26 is downwards." – and even went so far as to say – "I'm not going to entertain the hypothesis where all that would be wrong because there's too much corroboration of our assumptions." That last sentence appears to indicate that she has fairly strong confidence that wage growth will definitely decelerate.
Euro area productivity (P) has shown some improvement, being down 1.0% yoy in the fourth quarter of 2023 but down only 0.6% yoy in the first quarter of 2024, however, President Lagarde appraised that trend somewhat negatively, saying – "So there is a little bit of progress, but certainly not what we would like to see." But she went on to say she expects that demand will rise as consumption recovers and that "hoarded" (not fully utilized) employees will be assigned to respond to rising demand for goods and service, ultimately bringing about improved productivity. Of course, improved productivity can be expected to help reduce inflationary pressures. Regarding profits (P), President Lagarde pointed out that unit profits were improving in the last quarter of 2023 but have subsequently deteriorated owing to wage increases. As mentioned above, however, the ECB's view is that the wage increase pace has temporarily been high as workers seek to regain purchasing power lost to inflation "over the last couple of years" but that the pace will decelerate, profits will eventually recover, and the wage increase pace will not subsequently resurge. These evaluations of WPP trends suggest that the ECB is confidently expecting inflationary pressures to diminish in the future

Signs of Recovery in Household Mortgage Demand but Corporate Loan Demand Still Restrained

The European Bank Lending Attitude Survey (BLS) was released on July 16, just before the Governing Council meeting, and the meeting's statement summarized the BLS results as – "standards for lending to firms tightened slightly in the second quarter, while standards for mortgages eased moderately. Firms' demand for loans fell slightly, while households' demand for mortgages rose for the first time since early 2022." Looking ahead, President Lagarde indicated that she expects interest rate cuts will cause lending attitudes towards businesses to ease and loan demand will recover. The graph shows that, although banks' lending attitudes towards businesses are generally moving in the direction of easing, the majority of banks are still tightening their lending attitudes. (Moreover, the number of banks anticipating tightening over the next three months is increasing.) Euro area companies' loan demand has recovered somewhat from the record low level recorded in the third quarter 2023 BLS, but it has not yet reached a level indicating an actual recovery. This situation suggests that the effects of interest rate hikes have permeated the corporate sector and are continuing to restrain firms' demand for loans.



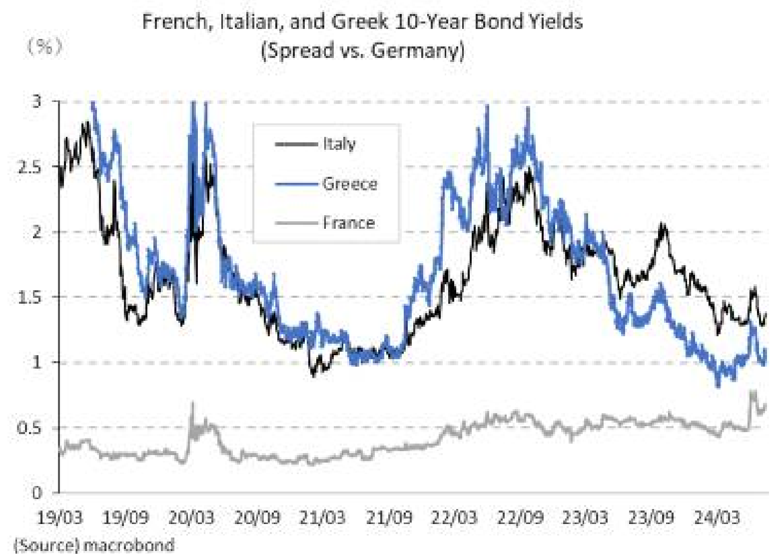
President Lagarde stated that, as the ECB has begun implementing interest rate cuts, it will be focusing greater attention on corporate responses to the BLS going forward. The degree of corporate credit recovery is closely related to inflation trends, so the ECB will be giving it considerable attention when considering the frequency of its future interest rate cuts. As mentioned in the meeting's statement, if one focuses on the household sector rather than the corporate sector, one finds that there are already indications that economic conditions are bottoming out, as household sector borrowing demand increased for the first time in two years. These are developments that should be cautiously interpreted with respect to their effect on future trends in personal consumption and personal consumption's contribution to GDP growth. In any case, the euro area's current fundamental economic indicators reflect the delicate nature of the current situation stemming from the transition from interest rate hikes to interest rate cuts. The current situation and outlook do not appear to require multiple large-margin interest rate cuts, but President Lagarde's statements at the latest post-Governing Council meeting press conference suggest that the ECB is fairly confident nominal wage growth will decelerate from 2025, and that is a reasonable basis for assuming that ECB interest rate cuts may continue through 2025.

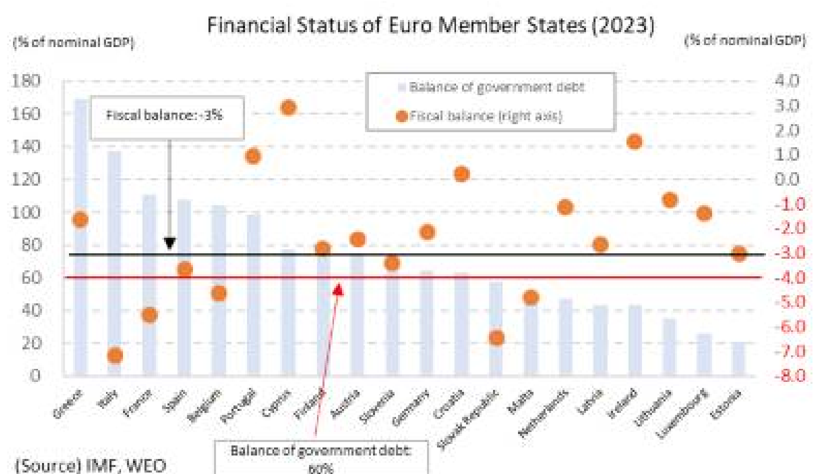
French Political Trends Now and Going Forward – Far-Right Defeated, but Concerns Remain

France Enters Political Limbo

Contrary to expectations, the French National Assembly (lower house) election held in June and July ended with the New Popular Front (NFP) left-wing coalition winning the most seats, while the far-right National Rally (RN) party and other right-wing forces came in third place. The Ensemble ruling coalition led by incumbent French President Emmanuel Macron fell from being the largest coalition to being the second largest. No party or coalition secured an absolute majority of seats in the election, resulting in a "hung parliament" and raising concerns about the difficulty of passing new legislation. (The National Assembly has been a hung parliament since elections held in 2022.)
It had been widely feared that the increasing popularity of far-right parties might lead to the creation of a far-right government in France that could promote a general rightward shift of the entire EU, and while that far-right government was avoided, the importance of left and right political ideology labels has been becoming less important insofar as parties and coalitions with all types of ideologies have been finding it increasingly difficult to alleviate widespread dissatisfaction among French people facing serious economic and social problems such as those related to immigration and inflation. As I have argued in previous editions of this article, the issue of lax fiscal discipline has become a focus of financial markets but, because French parties of all political ideologies have tended to promote lax fiscal discipline, one gets the impression that the election result will not have a great impact on the financial markets.

How Committed will the NFP be to Fulfilling its Manifesto Promises?





How are the financial markets responding to the current situation? At the time this article was written, there was no sign of any major shift toward gloominess. In the bond market, there has been no sign of a resurgence in French government bond yields, and levels of alarm and pessimism appear to be diminishing. However, the recent rise in those yields has not yet been completely rolled back (see graph, above right), and the biggest issue in French politics remains the country's financial situation. It is currently difficult to predict how things will develop, as a government has not yet been formed, but the left-wing NFP coalition's manifesto includes such policies as those aimed at lowering the pension eligibility age, reversing unemployment insurance reforms, raising public servant wages, and reducing value-added tax rates, all of which can be expected to worsen France's fiscal balance. In addition, since it is adamant about exempting France from the EU's fiscal discipline systems, some believe that the NFP may turn out to present the financial markets with more problems than far-right parties would have. There is a fairly high probability that situations will arise that cause relations with the EU (≈ European Commission) to deteriorate, and given the current state of France's finances (see graph, below right), it is not clear whether the country will avoid major problems in the near future. In light of how Italian Prime Minister Giorgia Meloni was originally considered a far-rightist but after taking power steered Italy towards fairly pragmatic policies and has now become a key figure in European politics, it seems possible that the NFP may aim to take a similar path toward pragmatic moderation, but given the current situation in which the NFP has found it difficult to even form a cabinet, it remains difficult to predict what will happen. In the medium term, the key issue for financial markets will be the extent to which the NFP-led government strives to fulfill its problematic manifesto promises.

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