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Forex Medium-Term Outlook

August 30, 2024

Overview of Outlook

USD/JPY continued to fall in August as JPY inevitably appreciated against USD amid the unwinding of previously accumulated JPY short positions, a marked improvement in the JPY supply and demand climate (as reflected in the cash flow (CF)-based current account balance), and the contrasting policy stances of the BOJ and the Fed. In this report, I had already been predicting a buying opportunity for investors during the July-September quarter. However, given the delay in the Fed's dovish shift, continuing expectations of an additional rate hike by the BOJ, and reflation trade as a result of Donald Trump's reelection beginning to seem doubtful, one has to factor in the possibility of speculative JPY long positions accumulating considerably during the October-December and January-March quarters, resulting in significant JPY appreciation. However, an ultra-strong JPY resulting from the generation and dissolution of JPY carry trade, as during 2005 through 2012, is not very likely. In terms of the structure of its current account balance, the Japanese economy is in a different stage now, and JPY is no longer the currency it used to be in terms of the size of demand for it. This, in my opinion, means that the response to domestic vs. foreign monetary policy differences (i.e., the domestic to foreign interest-rate differential) will also be quite different. There have been almost no phases of U.S. rate cuts since Japan became a trade deficit nation. My prediction is that, in contrast to the high levels of volatility accompanying JPY appreciation in the past, JPY appreciation this time around is likely to be more reasonable. Assuming a return to the halfway point from where JPY depreciation began 2.5 years ago, I believe USD/JPY could appreciate to around 135-140.

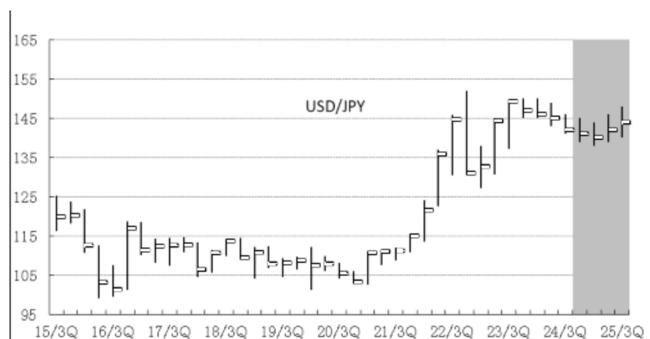
EUR continued to rise in August. The rapidly strengthening perception of the Fed's dovish stance has caused EUR to strengthen relatively, but the ECB itself is almost certain to cut interest rates in September or thereafter. With the Europe-U.S. interest rate differential unlikely to change significantly any time during the current forecasting period, EUR/USD may remain rudderless for an extended period. As the ECB predicted in its July Governing Council meeting, the euro area's negotiated wages for the April-June period (confirmed in August) show clear signs of stalling wage growth. Further, concerns about labor shortages in the region are now being replaced by concerns about a lack of demand, and as headline inflation growth stabilizes, it seems reasonable to expect two interest rate cuts by the ECB this year. However, given that the ECB's policy interest rate trajectory is not much different from that of the Fed, the impact on EUR is bound to be limited. On the other hand, wage growth is expected to bottom out around the New Year holiday period, and demand for EUR remains robust as ever, backed by the world's largest trade surpluses, so it is difficult to imagine a major collapse of the currency. During the current forecast period, my main forecast scenario envisages a battling range of 1.10 to 1.15 for EUR/USD.

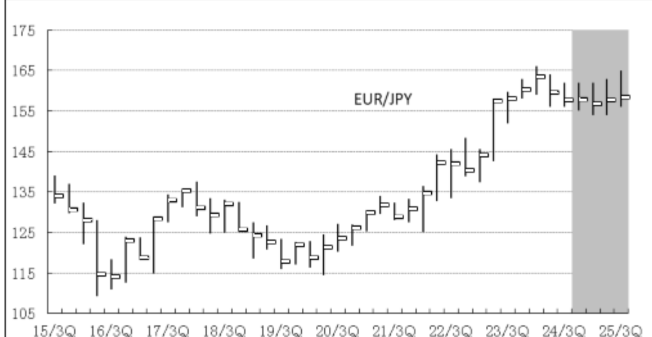
Summary Table of Forecasts

	2024 Jan-Aug (actual)	Sep	Oct-Dec	2025 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	140.80 ～ 161.96 (144.72)	141 ～ 146 (142)	139 ～ 145 (141)	138 ～ 144 (140)	139 ～ 146 (142)	140 ～ 148 (144)
EUR/USD	1.0601 ～ 1.1201 (1.1081)	1.10 ～ 1.13 (1.11)	1.11 ～ 1.14 (1.12)	1.11 ～ 1.14 (1.12)	1.09 ～ 1.14 (1.11)	1.07 ～ 1.13 (1.10)
EUR/JPY	154.44 ～ 175.42 (160.36)	156 ～ 162 (158)	155 ～ 162 (158)	154 ～ 162 (157)	154 ～ 163 (158)	156 ～ 165 (158)

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

Exchange Rate Trends & Forecasts



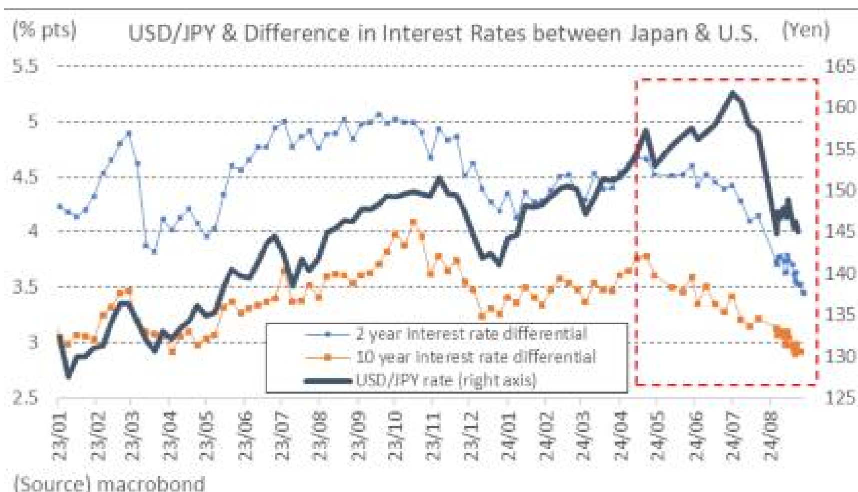


USD/JPY Outlook – Understanding the Unexpected JPY Carry Trade Turmoil

JPY Now and Going Forward – Expected Position Adjustments

Sudden Emergence of "JPY Carry Trade/Weak-JPY Bubble" Theory

From the end of July through early August, the Japanese financial markets went through a turmoil of historical proportions triggered by the BOJ's slight +15bp interest rate hike. In this section, I would like to first present my thoughts on this turmoil and the rumors surrounding it. The main explanation in the financial markets regarding the current turmoil, especially the rapid JPY appreciation, was that the "weak-JPY bubble promoted by JPY carry trade" had collapsed. However, I am not quite convinced by this theory. The phrase "weak-JPY bubble promoted by JPY carry trade," which specifically implies that global asset prices were being propped up by low JPY interest rates, appears to have suddenly gained popularity since the turmoil began.



(Source) macrobond

To be sure, Japanese share prices have been inflated by JPY weakness, as has frequently been pointed out. Also, the JPY depreciation trend, especially from April onward, had deviated away from the U.S.-Japan interest-rate differential trend, which made it quite precarious. The theory that JPY strengthened to close the gap, triggered by the BOJ's interest rate hike, and that Japanese stocks were forced to adjust is quite convincing (see figure). However, this is the first I have heard that JPY interest rates, i.e., the BOJ's policy operations, hold the key to the fate of U.S. and European stocks as well. Assuming that the drop in U.S. share prices had anything to do with BOJ policy operations is merely an attempt to put two and two together in hindsight, as it seems more likely that the coincidental downward adjustment in U.S. stock prices in late July through early August was in response to the sharp deterioration in U.S. job data. Of course, the flow generated by JPY carry trade may also have been a contributing factor, but discussing it as the main cause is a stretch.

What I especially disagree with is a theory that suddenly emerged following the stock market collapse of August 2 and August 5, that JPY600-trillion worth of JPY carry trading had caused JPY to weaken and stock prices around the world to appreciate. However, in all of the commentary on JPY depreciation since the beginning of the year, this is the first time I

have heard such an enormous figure (JPY 600 trillion) being mentioned. If there was such a straightforward reason for JPY depreciation, why did nobody point it out? Why has "household JPY selling," associated with structural changes in Japan's balance of payments and the launch of the New NISA scheme, attracted so much attention in the forex markets? Is it not because there were few other theories that could be put forward? No doubt, JPY carry trading (resulting from U.S.-Japan interest rate differentials) has been one of the causes of JPY depreciation. However, in the current climate of extreme antipathy to the recent BOJ interest rate hike, one fears that its power is being emphasized more than necessary. As I have often pointed out in this report, transactions driven by interest rate differentials influence the direction of forex rate trends, so it is natural for forex rates to fluctuate as a result of the expansion or contraction of JPY carry trading. However, I would like to caution against leaning too much on the aforementioned theory at the current time.

Ambiguous Definition of JPY Carry Trading

In the first place, the definition of JPY carry trade as a trading strategy is vague, which is why I avoid using the term as far as possible. Simply speaking, a carry trade is a transaction in which an investor borrows a low-interest currency and invests in a high-interest currency, thereby earning a stable profit from the interest-rate differential. Based on this definition, ordinary foreign currency deposits would also amount to JPY carry trading. Historically a "weak-JPY bubble promoted by JPY carry trade" was a market phenomenon that attracted attention during 2005-07, but these trades began to be rolled back in the wake of the August 2007 BNP Paribas shock and the September 2008 collapse of Lehman Brothers, leading to the subsequent phase of ultra-strong JPY. At that time, various analysts attempted to calculate the scale of the JPY carry trade, but no precise figures were able to be produced.

I myself attempted to come up with an estimate based on the volume of forex margin trading (through Click365, etc.), which gives a rough image of the volume of JPY selling; JPY short positions in IMM currency futures transactions; and JPY-denominated government bond credit statistics that can be confirmed from the Bank for International Settlements (BIS). However, in the end, I was forced to conclude that it was not possible to obtain a high degree of accuracy. While I cannot confirm the veracity or otherwise of the JPY600-trillion figure frequently thrown about in the markets since early August, I think it would have come up earlier had there been solid grounds for suspecting such an enormous figure. My view is that, when it comes to anything related to speculative trading, the JPY net position in IMM currency futures trading, which I frequently cite, serves the purpose well enough as a proxy variable. In this context, note that the JPY net position had already turned from short to long as of August 13, and a further swelling of the long position was confirmed as of August 20 (details follow).

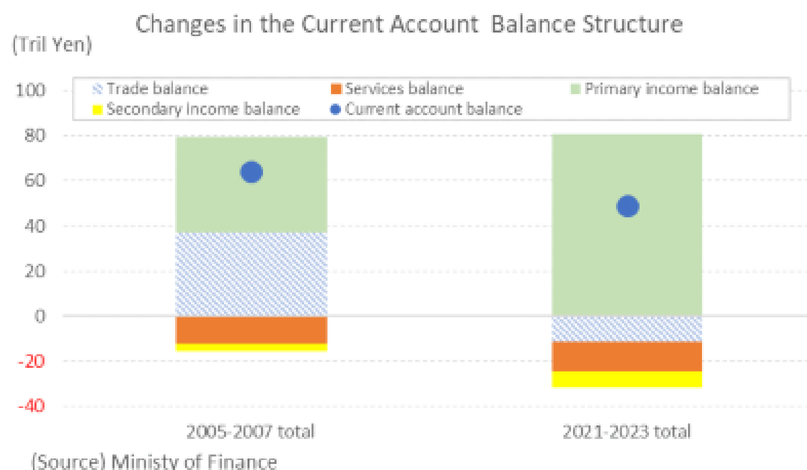
However, as in the case of the imaginary "non-life insurance repatriations following the 2011 Tohoku earthquake and tsunami disaster," which are said to have triggered the phase of ultra-strong JPY even though they were later shown (by Ministry of Finance statistics) to be non-existent, the fact of the matter is that, in financial markets during periods of frenzy, if everybody thinks something will happen, it happens. For the sake of argument, therefore, let us assume the existence of a "weak-JPY bubble promoted by JPY carry trade," which is not entirely beyond the realm of possibility. I have always argued that the only reason JPY is being bought at the moment is because it was previously oversold. Regardless of its magnitude, there is no denying that the unwinding of JPY carry trade is the result of JPY being oversold. The real concern for Japan now is figuring out the level at which the unwinding of speculative positions, symbolized by carry trades, could be considered complete, and at which the JPY net position could be considered completely neutral. Would there still be a reason to buy JPY at that point? At the time of writing, USD/JPY is still at the level of 140-150 despite the net position turning slightly long. I believe the real problem is the possibility of this level of JPY weakness becoming persistent.

Differences Compared with 2005-07

A supply and demand analysis is required to understand what a reasonable level for JPY is. Between 2005-07, when carry trade activity emerged and fizzled out, JPY and CHF were typical procurement currencies (low-interest-rate currencies borrowed for investment purposes), with even USD being considered a procurement currency when the target currencies were AUD or NZD. Of these, JPY was especially popular as a procurement currency because it was expected to have stably low interest rates. However, JPY was also the currency of one of the world's leading trade surplus nations, so, there was always a concern that it could suddenly appreciate if overseas interest rates, led by USD, were to be lowered, and this actually happened.

For nearly five years, from 2008 through 2012, the Japanese economy suffered from an ultra-strong JPY, and some believe that it was the resentment against this that resulted in "monetary easing of a different dimension" under Abenomics. At any rate, to make a comparison between then and now, the biggest difference in the case of Japan is the fact that JPY was the currency of one of the world's largest trade surplus nations in 2005-07, which means that there was a reliable level of demand for the currency. Japan's global exports of consumer electronics, as represented by flat-screen TVs from 2005 through 2007, were strong, and the country's trade surplus had a significant presence in its current account surplus. Again, those were the times when JPY weakness led to a virtuous cycle of increased production, income, and consumption through increased exports.

Let us take a look at the figures in detail. Looking at the three-year cumulative figures for 2005-07, the current account balance was about +JPY 64.0 trillion, of which the trade balance was about +JPY 37.0 trillion, the services balance was about -JPY 12.2 trillion, the primary income balance was about +JPY 42.6 trillion JPY, and the secondary income balance was about -JPY 3.4 trillion. In other words, Japan was a “young creditor nation” earning foreign currency through both trade and investment. By contrast, looking at the three-year cumulative figures for 2021-23, the current account balance was about +JPY 49.1 trillion, of which the trade balance was about -JPY 11.2 trillion, the services balance was about -JPY 13.3 trillion, the primary income balance was about +JPY 81.0 trillion, and the secondary income balance was about -JPY 7.4 trillion, indicative of a “mature creditor nation” that earns foreign currency through investment but not through trade (see figure).



(Source) Ministy of Finance

A “Weak-JPY Asset Price Bubble” This Time Round

Although Japan was a major current account surplus country during both the aforementioned periods, there is a strong suspicion regarding primary income surplus that most of it does not return to Japan through JPY buying. Rather, it remains overseas as foreign currency, as part of securities investment and reinvestment income, as I have repeatedly explained in this report. On the other hand, trade surpluses/deficits are manifested in the forex markets as definite outright (selling and buying) transactions. 2005-07 was when the Japanese economy was still capable of increasing exports in response to JPY weakness. In other words, it was during 2005-07 that Japan could generate trade surpluses large enough to be manifested as real demand capable of causing JPY to appreciate in the forex markets.

It is somewhat understandable, therefore, why this situation would be described as a “weak-JPY bubble.” The Japanese economy at that time was said to be in the midst of the longest economic expansion of the postwar period (73 months: January 2002 to February 2008), dubbed the “Izanami Boom” due to having surpassed the “Izanagi Boom” (57 months: October 1965 to July 1970), the then longest period of economic expansion (the finer points of this are still being debated, but this is the official verdict for the time being). It is, therefore, easy to visualize how JPY depreciation may have been benefiting the real economy through exports at that time, at least when compared with now.

Meanwhile, despite the sudden talk of the 2021-23 period as also having been a weak-JPY bubble, few will assess the Japanese economy as doing well. Rather, there are concerns of stagflation caused by JPY weakness and a marked absence of the kind of enthusiasm regarding JPY weakness that existed during 2005-07. It is only in terms of asset prices, especially stock and real estate prices, that one could say with any conviction that there was a weak-JPY bubble. The real economy actually suffered from high prices caused by JPY weakness. Perhaps the phrase “weak-JPY asset price bubble” would be more palatable.

No Longer the Same Currency

Given the change in Japan’s development stage between 2005-07 and now, it is not unreasonable to describe JPY as no longer being the same currency it used to be. This naturally implies that the response to domestic vs. foreign monetary policy differences (i.e., the domestic to foreign interest-rate differential) will also be quite different. There have been almost no phases of rate cuts by the Fed since Japan became a trade deficit nation. The JPY supply and demand climate has changed dramatically between then, when Japan was a major trade surplus nation, and now, when trade deficits have become the norm. At that time, Japan was a young creditor nation, which earned foreign currency through both trade and investment; now, it is a mature creditor nation, earning foreign currency through investment alone. Taking this into consideration, it is natural to expect a change in the response to domestic vs. foreign monetary policy differences (i.e., the domestic to foreign interest-rate differential).

The figure helps better visualize the situation. For example, JPY carry trade flourished during 2005-07 because the BOJ was expected to keep interest rates stable at zero percent while the Fed (and other central banks) were in the process of raising interest rates. However, Japan had a large trade surplus at that time, and there was no sense (as there is today) that JPY weakness could lead to social unrest. On the contrary, JPY weakness was eagerly welcomed as a market phenomenon that could trigger a virtuous cycle of economic growth (increased production → increased income → increased consumption) through an increase in exports. Under such circumstances, the “weak-JPY bubble” was a phenomenon even those not participating in the stock markets could see the benefits of.

JPY Supply and Demand and Fed Policy Operation

	Trade surplus		Trade deficit	
Phase	**(1)**	**(2)**	**(3)**	**(4)**
Fed policy direction	Tightening	Easing	Tightening	Easing
Speculative trading	**JPY selling**	JPY buying	**JPY selling**	JPY buying
Real-demand-driven trading	JPY buying	JPY buying	**JPY selling**	**JPY selling**
(Source) Compiled by auth	*2005-2007*	*2007-2012*	*2022-2023*	*2024-*

This is shown as phase (1) in the figure.
However, the August 2007 BNP Paribas shock and the collapse of Lehman Brothers in September 2008 triggered the sudden rollback of JPY carry trades, leading to dramatic JPY appreciation. This exerted strong downward pressure on the Japanese economy, which relied on exports to kick-start economic recovery. My understanding is that the strong upward pressure on JPY during this time was due to a combination of speculative JPY buying (caused by the rollback of JPY carry trades), as well as real-demand-driven JPY buying (as a result of Japan's enormous trade surplus). This led to a transition from phase (1) to phase (2). Incidentally, USD/JPY continued to appreciate until it hit 75 in 2012, and there remains deep-seated suspicion that this may be what subsequently accelerated foreign direct investment (by shifting production bases abroad, or acquiring foreign companies, etc.) by Japanese companies. In fact, starting this period, the Japanese economy stopped experiencing the cycle of export-led trade surplus expansion leading to JPY appreciation.

Entering a Phase of Fed Rate Cuts as a Trade Deficit Nation

The current situation corresponds to a transition from phase (3) to phase (4). As already evident, the unwinding of JPY carry trades in line with the upcoming Fed interest rate cuts, and the resultant JPY buying seem inevitable. However, Japan's trade deficit for January-June 2024 amounted to a total of -JPY 3.5 trillion, i.e., about -JPY 7.0 trillion when annualized simply. If the trade deficit for the whole of 2024 does indeed turn out to be -JPY 7.0 trillion, it would be the fifth largest trade deficit in the history of Japan (see figure). Incidentally, during 2005-07, Japan posted an average annual trade surplus of about +JPY 9.1 trillion. Interest rate cuts by the Fed may inevitably lead to JPY appreciation under the laws of a floating exchange rate system, but the extent of the appreciation may be different for a trade deficit nation than for a trade surplus nation.

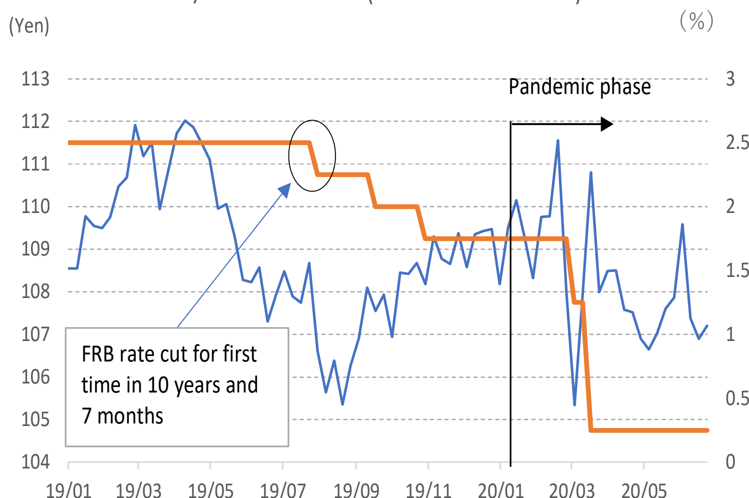
USD/JPY and Japan's Worst 10 Trade Deficits

		Trade balance (JPY tn)	Rate of change of JPY against USD (yoy)
(1)	2022	-20.3	-13.9
(2)	2014	-12.8	-13.7
(3)	2013	-11.5	-21.4
(4)	2023	-9.3	-3.3
(5)	2012	-6.9	-12.8
(6)	2015	-2.8	-0.4
(7)	1980	-2.6	15.5
(8)	2011	-2.6	5.2
(9)	2021	-1.8	-11.5
(10)	1979	-1.7	-23.7

(Source) Ministry of Finance, Bloomberg, *Figures for period starting 1973
The end-of-year rates for the year in question and the year before that have been used to compute the rate of change of JPY against USD (using Bloomberg data)

As mentioned above, <u>Japan has almost never experienced interest rate cuts by the Fed as a trade deficit nation</u>. The one exception to this may be the rate cuts starting end of July 2019. In this case, JPY did appreciate significantly in August, immediately following the first rate cut, although, to be more specific, it had begun to appreciate starting around April, when markets began factoring in rate cuts (see figure). However, despite a total of three rate cuts by the Fed starting with the one at the end of July, JPY rates at the end of December 2019 were the same as or even slightly lower than they were when rate cuts began. So, in the end, the best one can say about JPY during this phase of Fed rate cuts is that it did not appreciate significantly. This time round, the external environment has also changed, so this is just for reference, but I would like to make the point that Japan's supply and demand structure has changed too much to imagine a phase of significant, sustained JPY appreciation similar to 2005-07, when the unwinding of JPY carry trades resulted in an ultra-strong JPY.

USD/JPY and FF Rates (Jan. 2019 - Jun. 2020)

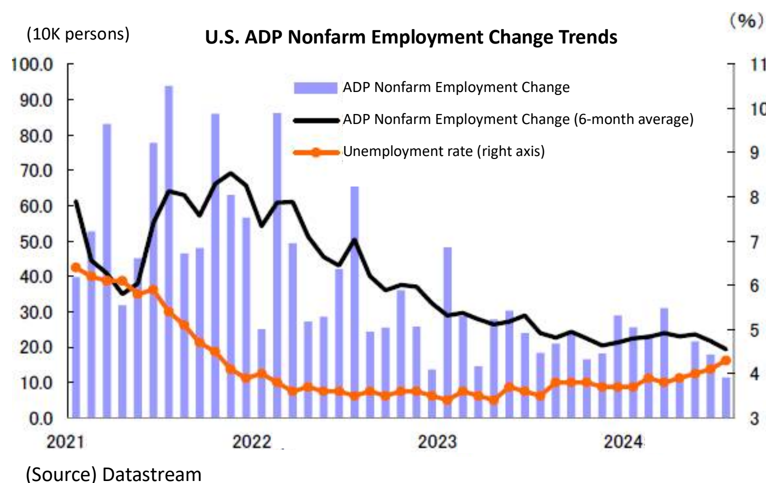


(Source) Bloomberg

At present, my main forecast scenario posits that it will not be easy for JPY to settle at a rate below 140. Of course, there are risks to any scenario, and in the case of mine, a potential risk scenario is a crisis of some sort becoming apparent in the US economy (e.g., financial institution management instabilities). Such a scenario would necessitate a significant rate cut by the Fed, and JPY appreciation will gain momentum, driven by the U.S.-Japan interest-rate differential. However, I view the steep JPY appreciation starting early August as merely an expected price movement due to the unwinding of JPY carry trades. <u>The "real landing point" in terms of JPY rates will become clear once speculative positions have been fully unwound;</u> and, at that point, will there still be a reason to actively buy JPY?

U.S. Monetary Policy Now and Going Forward – Perception of Labor Market a Concern

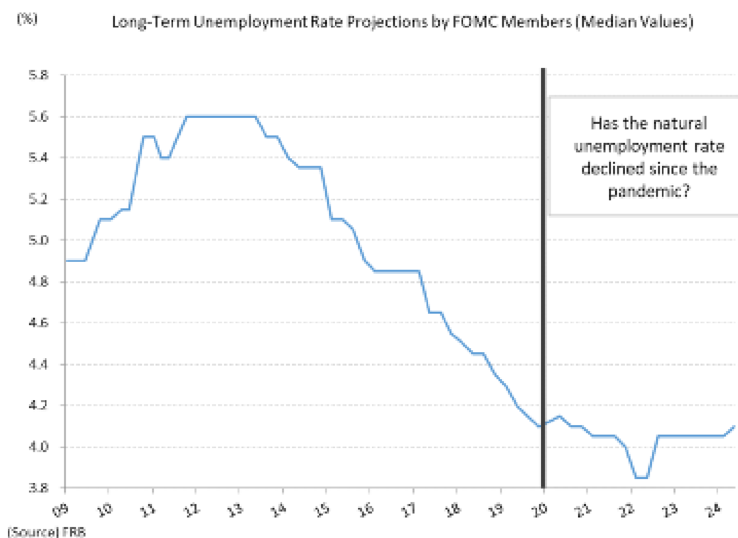
What the FOMC Should Communicate



(Source) Datastream

Fed Chair Jerome Powell's speech at the much-anticipated Jackson Hole Economic Symposium was simply themed "Review and Outlook," and the phrase "The time has come for policy to adjust" made the news headlines. However, the speech presented nothing new regarding policy operation, merely confirming the already-factored-in path of interest rate cuts. Meanwhile, the disclaimer following the aforementioned remark, namely that "the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks," makes it difficult to assume any promise of a -50bp rate cut, which some market participants are hoping for. As wage and price situations have not changed dramatically since the July 31 FOMC meeting, one feels that the decision to cut rates ought to have been announced at the FOMC meeting, especially if Powell was going to go as far as to say "the time has come for policy to adjust."
While it is true that the worsening employment situation has recently become a hot topic, the fact is that the trend has been ongoing since early this year on average (see figure). There is little reason to bring it up as an issue to coincide with the symposium in late August. The Jackson Hole symposium was originally a regional conference for broad discussions on structural issues related to the economic and financial situation, but it began to be seen as an event predicting the Fed's "next move" after former fed chair Ben Bernanke used it to hint at QE2 in 2010. Powell's remarks at the symposium this time are bound to make this event a platform for explaining near-term policy operation from next year onwards. As discussed in greater detail below, I feel that there were other structural issues regarding the U.S. economy that should have been discussed.

Danger of Using Extremely Low Unemployment Rate as the Benchmark

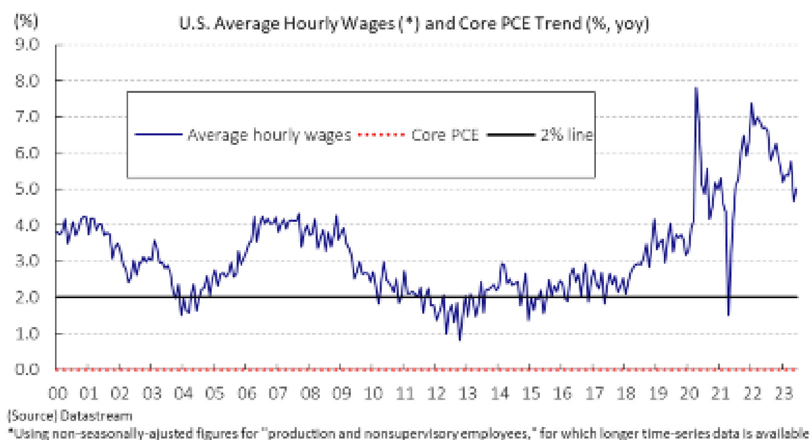


(Source) FRB

What stood out in Powell's speech this time was his weak assessment of the labor market. The adjective "cool" was used numerous times to describe the current state of the labor market. Especially noteworthy was the remark "We do not seek or welcome further cooling in labor market conditions," which made it clear the Fed would not tolerate any further cooling of the labor market. My impression is that this may be a lasting source of trouble going forward. While it is true that the unemployment rate has begun to deteriorate significantly on an mom basis, the 4.3% rate as of July is quite low from a historical perspective. As the figure shows, the (median of) long-term unemployment rate projections in the Fed Staff Economic Outlook (SEP), which is taken as the natural unemployment rate, was 4.10% as of June. This is clearly lower than the 4.43% average unemployment rate for the three years immediately preceding the pandemic (2017-19), or the 4.63% average for the five years preceding it (2015-19). If this level is used as the base point for stating that "we do not seek or welcome further cooling in labor market conditions," then there may be no need to worry about the Fed being forced to embark on monetary easing any time in the foreseeable future.
In this regard, Powell mentioned the possibility that the unemployment rate at full employment may be lower than it was before the pandemic. Specifically, given that the employment rate and the ratio of job openings to unemployed people had settled to pre-pandemic levels, and wage growth had also slowed, his judgment was that "labor market conditions are now less tight than just before the pandemic in 2019—a year when inflation ran below 2 percent."

Structural Changes in U.S. Labor Market Should Have Been Discussed

As of the present time, wages have clearly peaked, and given that this is depressing the trendline of the personal consumption expenditure (PCE) deflator, the FOMC's basic understanding as reflected in Powell's speech appears to be correct. Incidentally, Powell's remark that the unemployment rate at maximum employment is now lower than it was before the pandemic should be understood against the backdrop of the shrinking labor supply, with additional possible reasons being the increase in early retirement among seniors, who saw steep increases in asset prices triggered by the pandemic, immigration restrictions, and changing values.



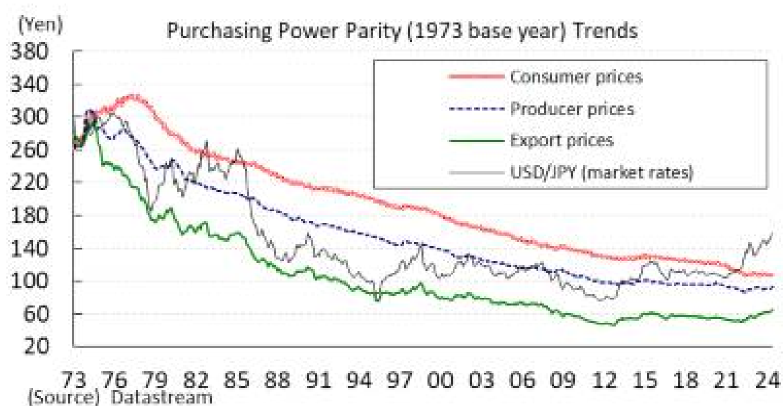
(Source) Datastream
*Using non-seasonally-ajusted figures for "production and nonsupervisory employees," for which longer time-series data is available

Whatever factor the Fed chooses to emphasize, so long as it assumes that the unemployment rate at maximum employment is lower now than before the pandemic, there is little reason to fear excessive rate cuts even if consecutive rate cuts are implemented for now. However, there seems to be no consensus on which factor to emphasize in connection with the possibility of decline in labor supply or how to view the sustainability of such a decline. This pandemic-related structural change in the U.S. labor market is bound to be extremely important for monetary policy operation, and Powell should have addressed the topic head-on at the Jackson Hole symposium.

Nominal JPY Exchange Rates Relative to PPP Rates – Goods PPP vs. Services PPP

Rethinking Purchasing Power Parity (PPP)

USD/JPY recently rose to levels approaching JPY162 – reflecting disparities between Japanese and U.S. monetary policies, and particularly reflecting concerns about a U.S. economic slowdown – but appears to have peaked out at those levels for the time being. Some people argue that USD/JPY can be expected to resurge to eliminate the discrepancy between actual USD/JPY levels and PPP levels, but I find those arguments unconvincing. The reasons for this have been discussed in previous issues of this article, but this time I would like to add a slightly different perspective and reaffirm that it will be difficult for nominal USD/JPY levels to converge with PPP levels. I have previously pointed out that the theoretical mechanism by which JPY nominal exchange rates might be strengthened and thereby brought closer to PPP exchange rates is not effectively functioning – this is because Japan has been unable to generate trade surpluses, as the country's export volume has not increased even when JPY is nominally weaker than its PPP value. Since Japan has already lost much of its domestic manufacturing bases and export power, the disparity between relatively weak nominal JPY exchange rates and relatively strong PPP rates has become more likely to remain uncorrected. This point is important to keep in mind. This situation is easier to understand if one compares trends in JPY's goods PPP and services PPP separately. The following subsections of this article reconsider and discuss the relationship between nominal USD/JPY levels and PPP levels.

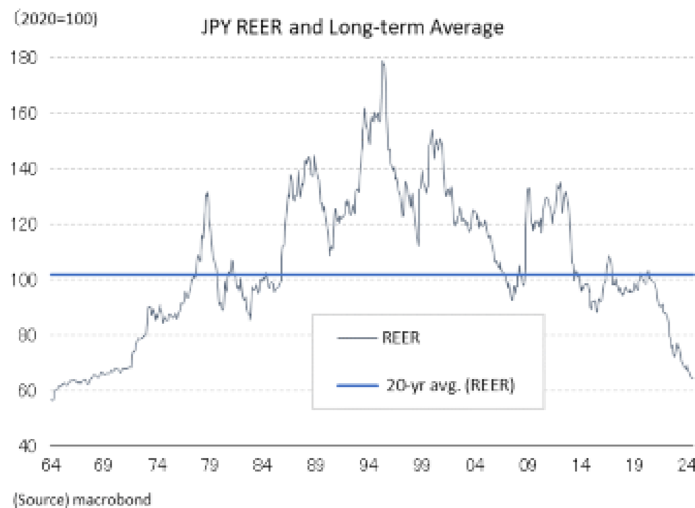


(Source) Datastream

Reverse Balassa-Samuelson Effect

It has long been said in Japan that the strong international competitiveness of Japanese manufacturing industries is the basis for JPY's strength. This interpretation is in line with the concept known as the Balassa-Samuelson effect (hereinafter referred to as the BS effect). The BS effect suggests that, if an economy has a sufficiently high rate of productivity growth in the manufacturing sector relative to that in the service sector, the general price level in the country in question will be higher than in other countries. This effect is based on the assumption that if manufacturing sector wages are boosted (reflecting that sector's high productivity), domestic labor mobility will cause service sector wages to be boosted to the same extent.

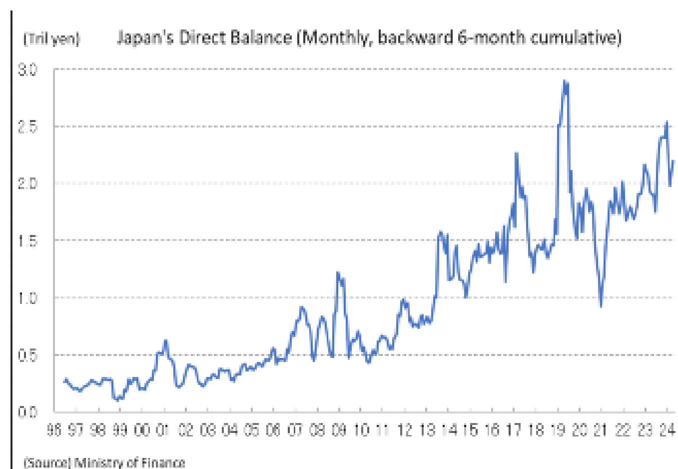
If a country's general price level rises, the real effective exchange rate (REER) of that country's currency will also rise. JPY's REER was on the rise until the mid-1990s (see graph on next page). The rise in the REER from around 1950 to the mid-1990s can be explained by the BS effect. Since the late 1990s, JPY's REER has been declining fairly steadily. Japan's trade surplus peaked in 1998 (at about JPY14 trillion), so it is easy to imagine that the BS effect began petering out at around the same time. If one accepts the idea that Japanese manufacturing industries' strong international competitiveness promoted JPY appreciation based on the BS effect, then is seems reasonable to consider the possibility that Japanese manufacturing industries' weak international competitiveness has promoted JPY depreciation. This latter situation of BS effect unwinding can be described as a "reverse BS effect".



However, it is important to be aware of the subtle difference between saying "manufacturing industries' weakness as an export base" and "manufacturing industries' weak international competitiveness". This is because Japanese manufacturing industries are actually quite internationally competitive and profitable. For example, the net profit of manufacturing companies listed on the TSE Prime Market reached an all-time high in the fiscal year ending March 2024. The real problem regarding Japan's manufacturing industry is not so much "weak international competitiveness" as "declining export power within Japan". If concisely stated as "Japan's manufacturing industries' weakness as an export base has been promoting the recent prolonged trend of JPY depreciation", the concept will probably be clearly understandable to most people.

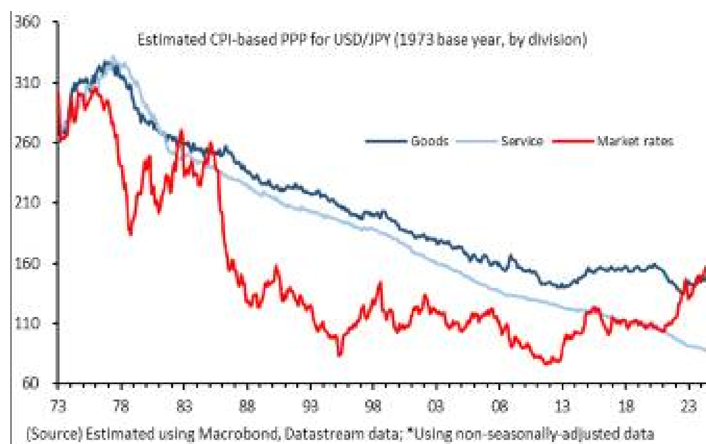
Shift from Productivity Improvements to Outward Direct Investments

Looking back at history, one finds that, for quite some time, Japanese manufacturing industries' high levels of international competitiveness enabled the generation of trade surpluses and promoted sustained JPY appreciation trends. Although the industries fought against strong-JPY-related challenges by realizing productivity improvements, they ultimately shifted to a strategy of giving up the fight within Japan and shifting operations to overseas bases. The accelerating transfer of production operations to overseas bases is reflected within Japan's balance of payments statistics as an increase in foreign direct investment (see graph). Essentially, Japanese companies chose the path of "leaving Japan in order to maintain their international competitiveness", and this has caused the Japanese economy to suffer from a growing structural weakness with respect to its manufacturing export base capabilities. The significant deviation of JPY's nominal exchange rates from PPP rates in the direction of depreciation (and the particularly strong deviation with respect to the goods PPP (as distinct from the services PPP) discussed below) is a clear reflection of Japan's current weakness as a manufacturing export base.



Goods PPP vs. Services PPP

When one examines JPY's goods PPP and services PPP separately, it is clear that the goods PPP indicates JPY should weaken while the services PPP indicates JPY should strengthen (see graph). In a world of tradable goods where a one-price-per-product rule is thoroughly enforced, JPY should weaken rather than appreciate. Incidentally, as of July 2024, the consumer price index-basis USD/JPY goods PPP level was JPY149. It is interesting that while PPP levels calculated as usual based on both the consumer price index (CPI) and the producer price index (PPI) deviate significantly from nominal exchange rates, goods PPP levels calculated based on the CPI are quite close to nominal exchange rates. As Japan's manufacturing industries have boasted high levels of international competitiveness enabling the accumulation of trade surpluses, there was a long period in which PPP levels consistently suggested that JPY should strengthen. However, as the graph shows, the goods PPP trend suggesting JPY appreciation stopped from the second half of 2012, at which time the trend suggested slight JPY depreciation. If one accepts the theory that JPY's recent depreciation reflects Japan's weakness as a manufacturing



export base, then one can also say that the harbingers of the depreciation began appearing around the 2011-2012 period. In fact, as shown in the graph above, Japan's outward direct investment began steadily increasing from around 2011. It is said that Japanese manufacturers began shifting production operations to overseas bases from around that time, against the backdrop of a number of factors including persistent JPY appreciation, a declining domestic population, and rigid employment regulations. Due to space constraints, I will not examine the details of the background circumstances in this article.
In any case, Japan's "weakness as an export base" has become entrenched, and the country's low productivity levels have made it an expensive place to manufacture and export goods. This is why a certain amount of JPY depreciation that would alleviate these challenges is theoretically justified (based on PPP levels). And in fact JPY has weakened, but the trade deficit has not been eliminated because Japan's export bases have been lost and there have been few efforts to restore them. Given these facts, it is understandable that Japan's government and ruling party are very enthusiastic about promoting inward direct investment.
On the other hand, the services PPP suggests a need for JPY appreciation, as it indicates that wages in Japan's service sector have been restrained compared to wages in other countries and are now undervalued from the perspective of international competitiveness. It has long been argued that Japan's service sector is characterized by low productivity levels (the merits of this argument will not be discussed here), but so long as service sector wages are kept in check, the sector will remain undervalued. JPY appreciation is theoretically justified (based on PPP levels) to normalize this situation.

Goods PPP a Key Basis for JPY Depreciation

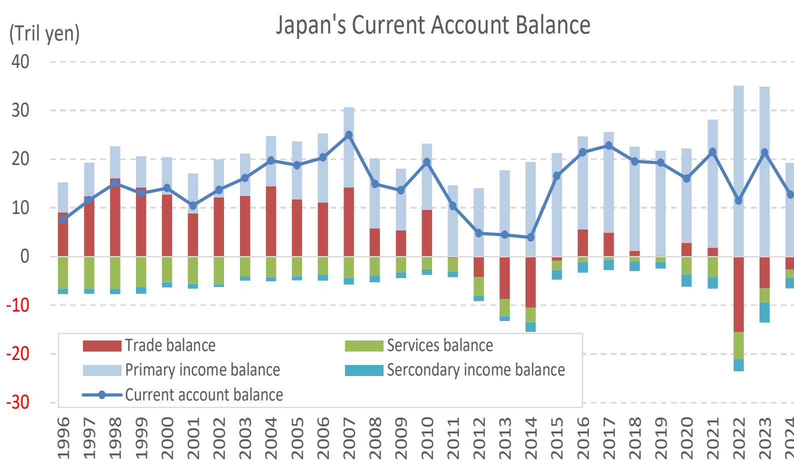
The immediate concern is whether JPY will actually appreciate as is suggested by the services PPP, and it appears that such JPY appreciation would be difficult to realize. The biggest difference between trade in goods and trade in services is that arbitrage in international services transactions is less feasible. For example, no one would travel from New York to a barbershop in Tokyo just because that barbershop is cheaper than New York barbershops. Even if they are relatively expensive, New York barbers will be able sustain their high prices, and Japanese barbers will remain undervalued. Given this, it is not very likely that the Japan-U.S. service sector wages gap (U.S. > Japan) will converge. Trade in services has recently been growing, reaching $8 trillion globally in 2023, which corresponds to about 25% of the world's total trade transaction value (see graph). The uptrend in trade in services reflects the expansion of digital trade and other factors, and it is showing no sign of decelerating. As discussed below, since the wage gap between Japan and other countries is expected to widen with regard to digital trade and other international services trade sectors, it seems highly likely that the Japanese services PPP situation suggesting JPY appreciation will continue to intensify.

Of course, the labor shortage stemming from Japan's declining birthrate and aging population is expected to promote nominal wage increases in Japan, which can be expected to narrow the U.S.-Japan service industry wage gap and perhaps diminish the JPY appreciation pressure implied by Japan's services PPP. However, Japan's nominal wage increases will not be enough to overtake nominal wage increases in the United States. It is true that, if the internationalization of services transactions progresses, arbitrage through labor migration may become more feasible than previously. Services trade is likely to increase in the digital, consulting, and R&D sectors, in which Japan has been recording what I refer to as "new era deficits", and it seems inevitable that services trade growth will have an increasing impact on the real economy. In fact, in Japan, the relatively high wages paid by foreign-based companies in the IT and consulting industries are a hot topic of conversation among certain people. This has been the case for a long time, but the impact of that wage differential appears to have grown in recent years and is likely to continue growing.
Nevertheless, if Japan's digital-related balance of payments trends accurately reflect the nature of services trade internationalization trends, it still seems difficult to see a potential for wages on the side ridiculed as "peasants" (Japan) to approach those on the side acknowledged to be "landlords" (the United States). At least in the information and communications technology industry at the center of digital trade, the wage gap is not shrinking and may even be widening, and it appears likely that this same trend is affecting such other key service industries as consulting and research and development. If this is the case, the Japanese services PPP (reflecting the Japan-U.S. services industry wage gap) will continue to justify a JPY appreciation trend, and that will structure Japan's overall PPP in a way that suggests a rationale for JPY appreciation. I believe the recent trend of JPY depreciation against USD is in line with the direction and level suggested by Japan's goods PPP.
However, because comparisons of PPP exchange rates with actual forex rates ordinarily employ overall PPP exchange rates based on both goods and service PPP levels, they inevitably show large divergences between PPP exchange rates and actual forex rates. Although one might argue that the divergence suggests a justification for an eventual resurgence of a JPY appreciation trend, it would be a fruitless argument. We should recognize that the JPY depreciation justification found in Japan's goods PPP level, which reflects actual international arbitrage, is a key real basis for a JPY depreciation trend.

JPY Supply-Demand Environment – Improvement Seen in First Half of 2024

Current Account Surplus on Track to Attain Record-High Level

Despite the clear contrast between Japanese and U.S. monetary policies, USD/JPY was remaining stable in the JPY140-145 range at the time this article was written. However, it is difficult to imagine an environment in which USD/JPY will continue decreasing over the next six months or so, particularly in light of recent trends in the JPY supply-demand environment. On August 8, the Ministry of Finance released its balance of payments statistics for the first half of 2024, and those statistics facilitate an overview of the current trends in the JPY supply-demand environment.



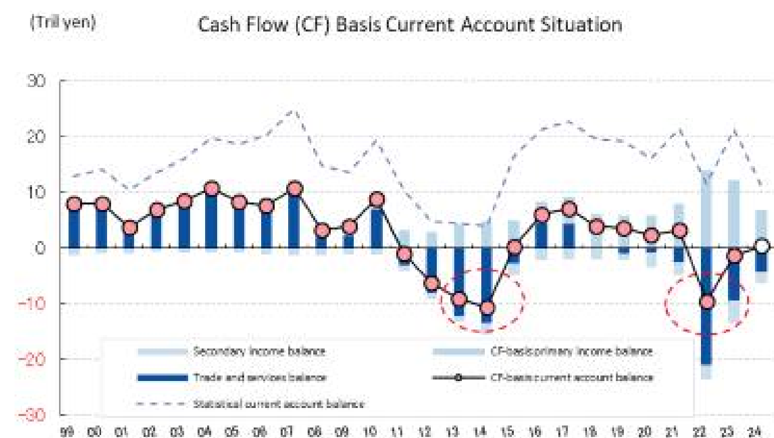
(Source) Ministry of Finance Figures for 2024 are totals for Jan-Jun.

For the first half of 2024, the headline current account surplus was +JPY12,681.7 billion. While the trade and services balance was a deficit of -JPY4,362.8 billion, the primary income balance surplus of +JPY19,196.9 billion (the largest half-year surplus ever) enabled the sizable current account surplus. The latest statistics indicate that the current account surplus is on track to surpass the previous record yearly level of +JPY24,949.0 billion recorded for 2007. It should be noted, however, that more than half that 2007 current account surplus (+JPY14,187.3 billion) was a trade surplus (see graph), reflecting the "JPY depreciation bubble" that engulfed the real economy at that time.

That 2007 situation is completely different from Japan's current situation, in which all the country's balance of payments surpluses are attributable to the primary income surplus, so even if the 2024 current account surplus becomes the largest ever, it will in no way guarantee a JPY appreciation trend going forward. As discussed below, however, <u>Japan's cash flow (CF) basis current account balance is showing a clear trend of improvement, and it is fair to say that, from a supply-demand perspective, JPY is gaining a significantly more-supportive environment than it had during the past two years</u>. The present state of Japan's CF-base current account balance is summarized below.

CF-Basis Current Account Balance Almost Balanced

Based on my estimate of the primary income surplus JPY conversion rate (the percentage of the surplus thought to be associated with JPY purchases), I have estimated that Japan's CF-basis current account balance for the first half of 2024 amounted to a slight surplus (+JPY275.4 billion). <u>It can be said to be roughly balanced</u>. As mentioned, the primary income surplus has surged to +JPY19,196.9 billion, and this nominal rise has been accompanied by a corresponding increase in CF-basis JPY buying. I estimate that it led to about +JPY6.8 trillion of JPY buying. On the other hand, the trade and services balance deficit was about -JPY4.4 trillion, which considerably diminished the overall margin of additional JPY buying. Looking at the trade and services balance, one finds the trade balance deficit halved, from about -JPY5.2 trillion in the same period last year to about -JPY2.6 trillion, which is a major positive factor affecting the JPY supply-demand environment, and the worrisome services balance deficit also improved slightly, from about -JPY2.1 trillion to about -JPY1.8 trillion. Although the other services deficit (centered on the digital deficit) expanded from approximately -JPY3.3 trillion to approximately -JPY4.1 trillion, the travel balance surplus grew by JPY1 trillion, from approximately +JPY1.6 trillion to approximately +JPY2.6 trillion (although this largely reflects the strict border control measures Japan kept in place until March 2023), and the expansion of Japan's services balance deficit was consequently restrained.

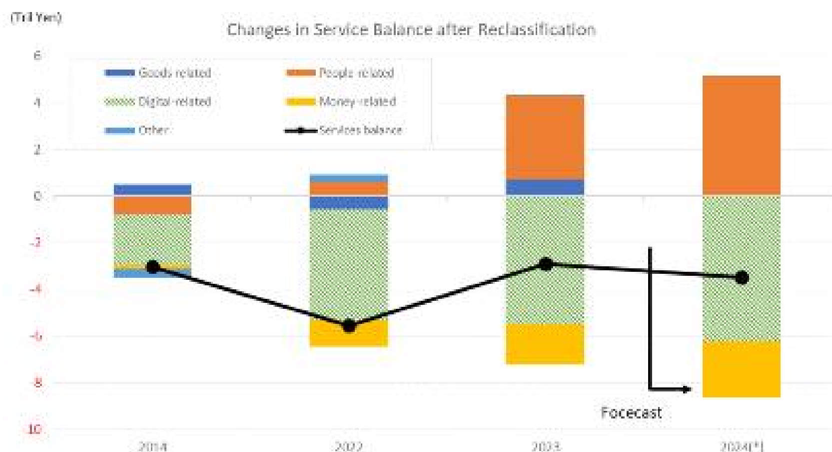


(Source) Bank of Japan For 2024 data until June.
Note: The "reinvestment income" of direct investment income and "dividends" of securities investment income and "bond interest, etc." are deducted on the assumption that no foreign exchange transaction occurred.

<u>In summary, the first half of 2024 can be said to be a period in which the JPY supply-demand environment improved due to such factors as a decline in mineral fuel imports and an increase in inbound travel-related demand</u>. In light of this improvement in the JPY supply-demand environment and the narrowing of the Japan-U.S. interest rate gap following the Fed's prospective interest rate cut, I believe it will be difficult for USD/JPY to return to levels above JPY150 in the near future.

"New Era Deficit" on the Rise

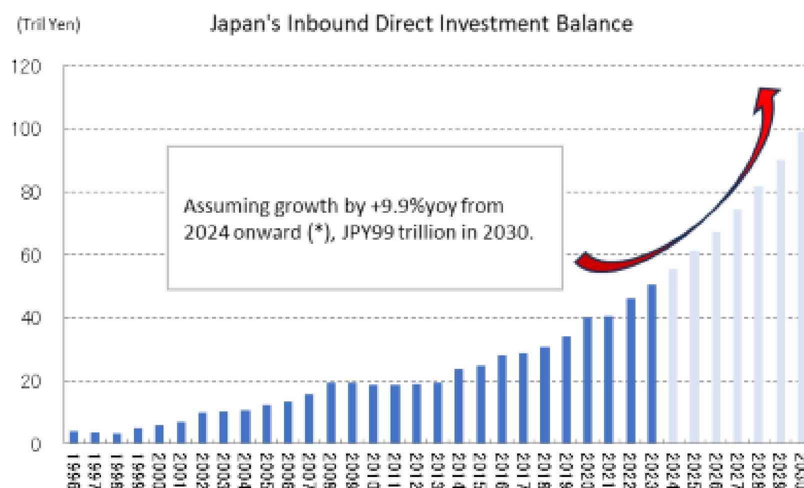
However, as mentioned above, <u>the deficit in the balance of other services, which I describe as a "new era deficit" is actually on a rising trend</u>. Analyzing the current services balance situation while focusing on trends in five qualitative categories of current account items (goods, people, digital, money, and others) that this article regularly monitors, one finds that, if current trends continue, the digital-related services balance deficit will surpass -JPY6 trillion for the first time in history. Reflecting surging inbound tourism-related demand, the people-related surplus is expected to reach +JPY5 trillion, offsetting most of the digital-related services deficit, but it still should be recognized that Japan's weak digital-peasant positioning is actually becoming worse. Largely reflecting reinsurance premium payments sent overseas, the money-related services balance deficit is sure to surpass -JPY2 trillion for the first time, so Japan's overall balance of services image of "physical labor (surpluses) vs. brain work (deficits)" is not likely to change significantly. Although it may seem that I'm harping on this point, it is important to recognize that the significance of media headlines touting Japan's current account surplus is superficial, and one should focus more attention on the Japanese economy's structural problems (only evident if one examines trends in individual current account components) and on how JPY weakness relates to those problems.



(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.

Corporate Acquisitions that Take Advantage of JPY Weakness

Regarding the JPY supply-demand situation, it is worth noting media reports from August 19 about a major Canadian convenience store company's proposal to acquire one of Japan's largest retailers. If realized, the takeover deal would be worth more than JPY5 trillion, making it one of the largest acquisitions of a Japanese company by a foreign company. Following the news, USD/JPY temporarily sank in anticipation of JPY-buying demand, and there was in fact a certain amount of increase in JPY buying. This news has occurred at a time when inward direct investment is attracting attention as a means of taking advantage of JPY weakness. While only the parties involved can know the truth, it cannot be denied that JPY's recent sharp weakening may well have incentivized the proposal. The Big-Boned Policy Outline announced by Japan's government and ruling party in June 2023 has set a goal of boosting the cumulative balance of inward foreign direct investment (FDI) to "JPY100 trillion by 2030" (see graph). Considering that the inward direct investment balance was about JPY50 trillion at the end of 2023, it is clear that a single deal with a value over JPY5 trillion would be extremely significant.

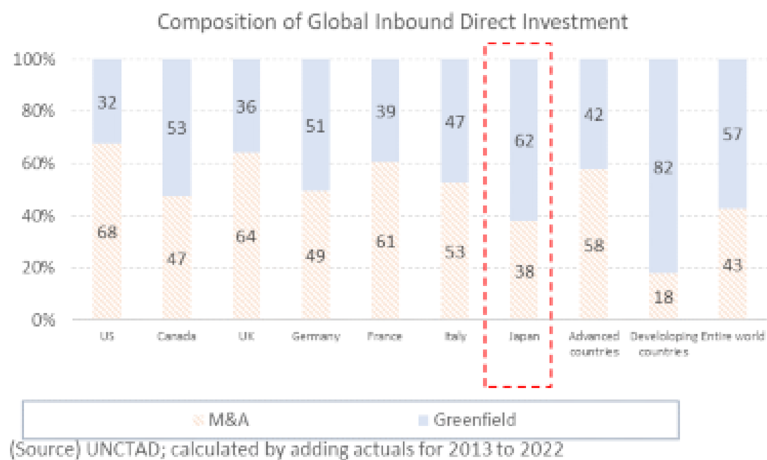


(Source) Ministry of Finance
Note: Average growth rate of inbound direct investment between 2014 and 2023

When foreign companies consider building factories in Japan (including much-discussed semiconductor production facilities), hiring workers, and getting production on track, they will inevitably have to take into account various obstacles and constraints associated with the country's labor shortage. However, it should be kept in mind that direct investments do not always entail building factories. Even in cases such as the convenience store acquisition proposal, if a Japanese company accepts its acquisition by a foreign company, it will augment Japan's inward FDI balance. Many Japanese companies have been undertaking such corporate acquisitions throughout the world since around 2011.

While Japan's small balance of inward FDI has been attracting attention in recent years, there has been little discussion focusing on the forms of such investment. Of course, one could argue that the inward FDI balance was not large enough to merit detailed discussion of investment forms, but even so, there have been some implicit assumptions about the forms of anticipated FDI initiatives. There are two main forms of FDI – establishing a new company in the host country or acquiring an existing company in the host country. The former is called new investment (greenfield investment), while the latter is called cross-border M&A, and the convenience store acquisition deal would fall into the cross-border M&A category. Cross-border M&A is sometimes referred to as brownfield investment to clearly indicate how it contrasts with greenfield investment. Greenfield investments are known for their high start-up costs related to such tasks as land acquisition, local labor hiring, parts and materials procurement, and sales network development.

Compared to greenfield investments, cross-border M&A transactions often require much less time and money to implement. It is said that the "two shortages" of labor and English language skills tend to be intimidating challenges for foreign companies entering the Japanese market, but acquiring a Japanese company that has a full staff of workers from the beginning can enable foreign companies to easily overcome problems related to labor shortages and sales channel development, leaving aside the issue of workers' English language skills. When considering acquisition targets in Japan, foreign companies should indeed give some thought to how they will cope with language skill challenges.



(Source) UNCTAD; calculated by adding actuals for 2013 to 2022

However, it is generally understood that the share of cross-border M&A transactions within Japan's inward FDI transactions is quite low. On the other hand, measures to facilitate growth in Japan's inbound cross-border M&A could effective help address the abovementioned "two shortages" and facilitate the attainment of the government's targets. A brief look at the graph showing the structure of FDI in various countries around the world gives one a strong impression that cross-border M&A is the mainstream FDI genre in developed countries and that greenfield investment is the mainstream in developing countries. Looking at the structure of Japan's inward FDI, however, one finds the ratio of greenfield investment to M&A is roughly 60/40, which is quite different from the roughly 40/60 ratio for all developed countries. Given that the ratio for developing countries is roughly 80/20 and the global ratio is roughly 60/40, one can see that the share of M&A within Japan's inward FDI is higher than that in developing countries but below the average for all countries. Given this, one might describe the structure of Japan's inward FDI being something in between that of developing countries and that of developed countries.

Inward FDI Strategy Not Excessively Focused on Greenfield Investment

Why has Japan's inward FDI situation become like this? One factor may be a general lack of understanding in Japan about the significance and effects of M&A, but even more importantly, there is a persistent view that many Japanese managers have an allergic reaction to potential acquisitions and restructuring by foreign entities. While it is difficult to pinpoint the true cause, there is no denying the fact that the level of cross-border M&A is noticeably low in Japan compared to other developed countries, and this has led some to deride Japan as having a lower ratio of cross-border M&A transactions to nominal GDP than North Korea.

Achieving the government's fairly ambitious "JPY100 trillion by 2030" target will undoubtedly require an approach somewhat different from previous approaches. In light of the above discussion, it seems clear that one element of the improved approach should be promoting not only greenfield investment but also cross-border M&A. However, the phrase "M&A" appears only twice in the 23-page "Action Plan for Attracting Human and Financial Resources from Overseas" released on April 26, 2023, by the government's Council for Promotion of Foreign Direct Investment in Japan (CPFDIJ). The phrase only appears in such vague articulations of objectives as – "Analyze the effects of management improvement and reform in cases of M&A and collaboration with foreign companies in Japan and disseminate the results" – and – "Strengthen support for cooperation and collaboration within Japan by such means as those to raise awareness, provide advice from legal professionals, and provide mentoring support for local companies that are unfamiliar with cooperation and collaboration with overseas companies and M&A in Japan" – making it unclear what specific M&A-related policies are to be implemented.

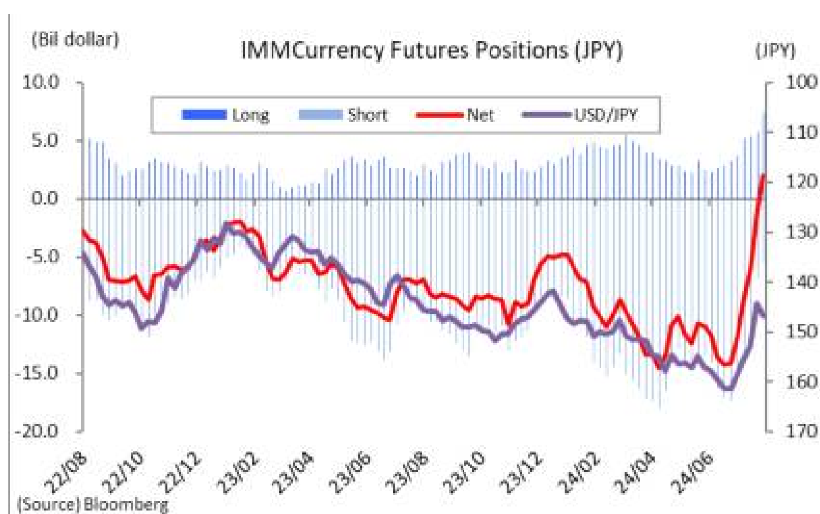
The CPFDIJ has mentioned a policy of – "disseminating information on successful cases of inbound M&A and collaboration in Japan" – as a way to evaluate progress in the promotion of cross-border M&A but, regarding specific measures, the council only refers to a policy of – "striving through our website and seminars to disseminate the results of analyses of the effects of management improvements and reforms related to inbound M&A and collaboration with foreign companies". The only realistic metric for evaluating the "disseminating information on successful cases" policy might be the number of seminars held, but, at the time this article was written, it was difficult to determine the extent to which foreign companies had become interested in Japan as a result of such seminars and other efforts.

From the buyer's perspective, cross-border M&A is a smart approach that can save a lot of time and money if successful. At the same time, however, it should be recognized that the barriers to business integration and the time and financial costs involved in selecting an acquisition target company are significant. Given the widely felt negative perception that cross-border M&A may be fundamentally incompatible with Japanese culture, which prefers homogeneity to diversity, one wonders what kind of direct and indirect support policies the government could utilize to effectively promote growth in cross-border M&A in Japan. Achieving the government's "JPY100 trillion by 2030" target will require an inward DFI promotion strategy that does not focus exclusively on greenfield investment.

Risks to My Main Scenario – Will JPY Long Positions Continue Growing?

Net JPY Long for First Time in 41 Months

JPY carry trade trends have been attracting great attention since early August and, looking at speculative positions as reflected in IMM currency futures trading figures, one finds that net JPY positions turned long for the first time in 41 months on August 13 and that the increase in the JPY net long margin subsequently had continued to increase through August 20. After plummeting to the JPY141-142 range in early August, USD/JPY has recovered, fluctuating about JPY147 around August 13 and about JPY145-146 around August 20. While IMM position movements do not completely capture speculators' movements, one gets the impression that JPY did not appreciate significantly despite speculative positions turning net long (see graph). In any case, the balance of JPY carry trades has been attracting great attention since the short position unwinding began and, although one should evaluate related trends with a reasonable degree of caution, it appears that the short position unwinding has been completed to a certain extent and new long positions are still being added. At the time of writing, the gross value of long JPY positions had risen to $7.638 billion, the highest level in roughly three and a half years. However, one has to wonder how long costly JPY long (USD short) positions can be accumulated and maintained. In light of interest rate and supply-demand fundamentals, the positions' sustainability does not appear to be strong.



Unwinding JPY Shorts Not Necessarily Linked to Building JPY Longs

First, regarding interest rates, the sharp deterioration of U.S. employment statistics in August, including retroactive revisions, became a market-moving issue. As a result, the financial markets are increasingly factoring in a sharp rate cut at the September FOMC meeting and another Fed rate cut within the year. Given this situation, it is only natural that JPY short positions will be unwound in anticipation of a narrowing of the Japan-U.S. interest rate gap. Fundamentally, however, unwinding JPY short positions and building new JPY long positions are not the same thing. While the former is largely prompted by rival currency (USD) weakness as evidenced in the prospective decline of U.S. interest rates, the latter requires a rationale for actively buying JPY. Looking at interest rates alone, the possibility of additional BOJ interest rate hikes has been virtually ruled out at the moment, so it cannot be said that there is any obvious reason to actively buy JPY. The JPY supply-demand environment does not offer such a reason, as Japan's trade balance is in the red, with the trade deficit for the first seven months of the year amounting to about -JPY3.9 trillion (annualized value of -JPY7.8 trillion). The trade deficit for the whole of 2024 is on track to become one of the five largest trade deficits Japan has ever recorded. Although it is understandable that JPY has appreciated as a result of the unwinding of JPY short positions due to JPY's "oversold" status, there remains a lack of persuasive evidence to suggest that a new trend of building long positions in JPY will emerge.

Risk of Growth in Speculative JPY Long Positions

What would happen if the previous scenario were to be reversed and a situation were to arise in which speculative JPY long positions continue to accumulate? If forced to rationalize such a situation, one might cite the possibilities of (1) the BOJ continuing its interest rate hike policy, (2) the emergence of a new Japanese government with hawkish currency and monetary policies, and 3) a sudden reduction in Japan's trade deficit. While factor (3) is not something likely to happen soon, it is possible that it could become a reality if crude oil prices were to fall sharply at some point.

Realistically speaking, it is probably factor (1) and the associated factor (2) that are worthy of some concern. Regarding factor (1), if the BOJ undertakes policy management in accordance with its latest public statement and the economic and financial situation is as anticipated in the Outlook Report as of October, it is reasonable to assume that there may be an additional rate hike. BOJ Deputy Governor Shinichi Uchida has suggested that a rate hike may not be feasible if financial markets are unstable in October, but if domestic and international financial market volatility is low at that point, there may no reason for the BOJ to refrain from another rate hike. At a lower Diet chamber Financial and Monetary Affairs Committee hearing held on August 23, BOJ Governor Ueda emphasized that the July rate hike was appropriate and stated that the BOJ was prepared to further hike interest rates if economic growth and inflation remained in line with its forecasts. Such a BOJ posture alone might be considered a reasonably strong basis for building JPY long positions. However, for the BOJ to confidently continue its rate hike path, factor (2) must be realized at the same time. It is generally assumed by the public at large that not only economic and financial conditions but also political conditions will be crucial factors enabling the BOJ's return to raising interest rates. While there is no proof that the BOJ's non-consensus decision in July to hike interest rates was in response to political prompting, given the nature of numerous statements from senior government and ruling party officials in the run-up to the July BOJ meeting, it is natural to assume that the political prompting may have played a role.

If political prompting did play a role, then one must anticipate that the outcome of the Liberal Democratic Party's (LDP's) presidential election on September 27 will determine not only factor (2) but also factor (1). (The LDP is Japan's ruling party, and its presidential election determines the party's leader, who subsequently becomes the country's prime minister. The new prime minister will form a new government administration and set the administration's policy agenda.) For speculators – especially foreign market participants who may not have in-depth understandings of Japan's economic and financial situation – the creation of a new Japanese government administration avowing a hawkish posture regarding monetary and financial policies offers a viable rationale for building JPY long positions. This LDP presidential election appears likely to promote some fluctuation in JPY exchange rates, particularly given the perception that the BOJ's policy management is influenced by political considerations. As memories of the forex market turmoil during early August remain fresh in people's minds, each LDP presidential candidate is likely to play it safe and avoid making too many detailed comments, but Japan's political situation should be probably be considered a potential JPY appreciation risk factor.

EUR Outlook – Labor Shortages Resolved, Wage Growth Starting to Decelerate

EUR Area Monetary Policies Now and Going Forward – Wage Growth Deceleration As Expected

July Governing Council Meeting Account and Negotiated Wage Trend

Although there was no ECB Governing Council meeting in August, the ECB released the Account of the July 18 Governing Council meeting along with euro area negotiated wage statistics for the April-June period, which are an important basis for predicting future ECB policy management decisions. Overall, it can be said that the Account and wage statistics buttress confidence that the ECB will continue on an interest rate cut path and, despite growing signs of weakness in the U.S. economic and financial situation and a corresponding decline in U.S. interest rates, EUR has not yet greatly depreciated against USD.

Regarding the Account of the July Governing Council meeting, it bears remembering that it was at the press conference following that meeting that ECB President Christine Lagarde emphasized that WPP (Wages, Profits, and Productivity) trends were the key factors keeping inflationary pressures in the euro area high. Of particular interest to the financial market was President Lagarde's statement that – “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.” There was not much explanation about the “many surveys” at the press conference, but the Account states that – “the ECB’s Corporate Telephone Survey (CTS) and the Survey on the Access to Finance of Enterprises (SAFE) had pointed to materially lower wage growth in 2025. [...] The participants in the ECB’s Survey of Professional Forecasters (SPF) also expected a marked deceleration in wage growth in 2025.”

Also mentioned at the press conference was the re-acceleration of growth in negotiated wages at the time of the meeting, and the Account explains that – “The forward-looking wage trackers had continued to signal elevated wage pressures this year, largely driven by catch-up dynamics. Wage agreements in the euro area’s largest economy [Germany] accounted for the bulk of the latest tracker information, as agreements had been reached in the wholesale, retail, chemical and construction sectors, which tended to have long contract durations and therefore a more pronounced catch-up component during this phase.”

The Account’s analysis emphasizes that the re-acceleration of wage growth was – “driven by catch-up dynamics” (to compensate for purchasing power lost due to previous inflation) – and is thus not expected to be sustained.

Negotiated Wage Growth Rate Decelerating as Anticipated

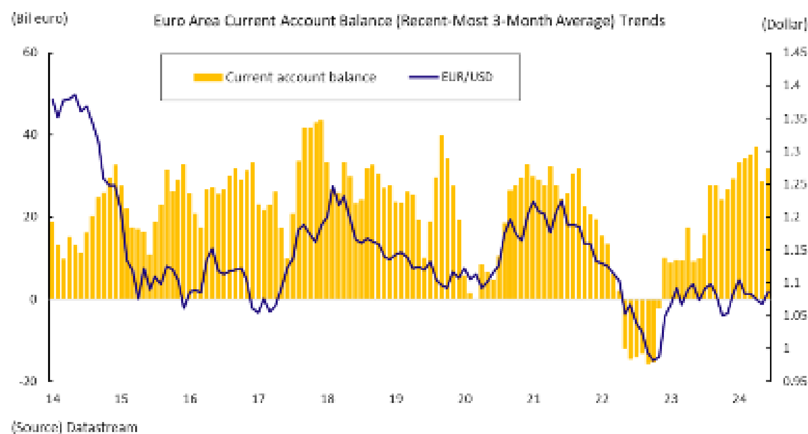
As the ECB had expected, euro area wage growth acceleration is coming to an end, as the ECB announced on August 22 that April-June period negotiated wages were up only 3.55% yoy, the first negotiated wage growth deceleration seen in two quarters. The deceleration was from 4.74% yoy growth in the previous quarter (a growth rate considerably higher than market expectations), and it appears inevitable that the deceleration will exert downward pressure on the euro area consumer price index (HICP) in the future. The July Governing Council meeting’s Account states that ECB Executive Board member and chief economist Philip Lane – “proposed keeping the three key ECB policy rates unchanged. The information available at the Governing Council’s next monetary policy meeting in September would incorporate a wealth of fresh data and the new staff macroeconomic projections for the euro area. Data for the second quarter would also be available – including GDP growth, compensation per employee, profit margins and productivity – alongside two more HICP releases, as well as monetary indicators and more timely soft indicators for activity and consumer confidence.” The significant slowdown in negotiated wage growth, described in the Account as “an important driver” of wage growth, suggests that a September rate cut is almost a foregone conclusion.

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

However, at the same time, surveys of job advertisement wages suggest that the negotiated wage growth rate will be bottoming out during the period from the end of 2024 through early 2025. At this point, there is no information on what kind of decision the ECB will make in response to that. So long as the negotiated wage growth rate remains in the 3-4% range, if the HICP growth rate stabilizes at around 2% and it is expected that further downward pressure may be exerted on HICP growth depending on trends in corporate profit margins and productivity, it will be reasonable to anticipate continued ECB interest rate cuts in 2025. However, there is a question mark over whether the once-per-quarter pace of interest rate cuts expected by many market participants can be maintained, and I expect about three rate cuts during 2025.

EUR Supply-Demand Situation as a Basis for EUR Appreciation

As mentioned above, it seems reasonable to assume that the ECB will continue to cut interest rates intermittently, but it is also highly likely that the Fed will continue to cut interest rates in a similar way. If this is the case, the Europe-U.S. interest rate differential should remain fairly stable, and it is difficult to imagine a situation in which EUR undergoes protracted depreciation against USD owing to ECB interest rate cuts. Furthermore, the EUR supply-demand situation is an additional factor supporting EUR's strength. As the graph shows, the euro area has been accumulating current account surpluses, mainly due to its trade surpluses, and those surpluses appear to have been exerting upward pressure on EUR/USD. The graph also seems to show that EUR's upside has been suppressed over the past year despite a rapid accumulation of euro area current account surpluses. Since July, EUR/USD has been pushed upward by the decline in U.S. interest rates amid a growing number of negative reports about the United States' economy and financial situation. While the euro area economy is also weak and has a need for interest rate cuts, it appears to have already passed through its worst period, so in the short term, economic conditions in the euro area may compare favorably to those in the United States, where the economic slowdown trend has just begun. Under these circumstances, it seems likely that that there will be times when U.S. interest rate declines induce considerable EUR buying.



(Source) Datastream

Euro Area Economy Now and Going Forward – Shift from Labor Shortages to Demand Shortages

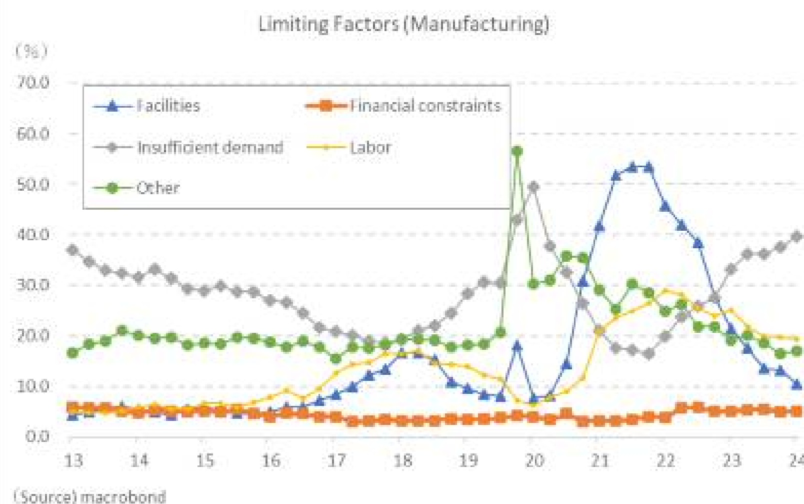
Euro Area Labor Shortage Easing

More attention has been focused recently on the economic and financial situation in Japan and the United States than on conditions in Europe, but it is quite important to grasp whether the ECB, having already entered an interest rate cut phase, will be positioned to fire a second and third monetary policy arrow. As mentioned above, additional ECB interest rate cuts after September are almost a given, and euro area microdata confirms the need for those cuts. The European Business Cycle Indicators (EBCI), published quarterly by the European Commission, are a good reference for evaluating the euro area's employment and wage situation as well as inflation trends. EBCI surveys gather quantitative and qualitative data related to companies' business conditions. The surveys ask corporate managers questions about the factors limiting their corporate business activities, and the answers to those questions are a good basis for understanding the actual state of the euro area economy. According to the latest survey for the April-June 2024 period (announced in July 2024), approximately 20% of manufacturing and 25% of service industry respondents cited "shortage of labour force" as a limiting factor. The shares of companies suffering from labor shortages are still high by historical standards, but there has been a clear trend of decline from their recent peak levels.

(Source) macrobond

From Labor Shortages to Demand Shortages

On the other hand, a limiting factor cited by a rapidly growing share of companies is "insufficient demand", and this uptrend is evident in both manufacturing and service industries. The graph on the right shows trends in factors limiting manufacturing operations, and it clearly indicates that, over the past year or so, "insufficient demand" has replaced "shortage of labour force" as the most important limiting factor. This may be interpreted as indicating that the effects of interest rate hikes have pervaded the real economy, causing consumption and investment appetites to begin declining. On the other hand, the percentage of companies citing "financial constraints" as a limiting factor has remained roughly the same, suggesting that the rise in euro area interest rates has not yet suppressed business activity. In any case, there is no doubt that the "shortage of labour force" problem that has plagued euro area companies in recent years is beginning to improve, but this may indicate that labor market tightness is easing as the real economy decelerates. Since employment and wage data lag behind actual economic trends, such business surveys as the EBCI are useful means of understanding the current situation in a more timely and accurate manner.



Because the ECB and Fed will begin cutting interest rates at the same time, my view has been that the Europe-U.S. interest rate differential will remain fairly stable, promoting stability in EUR/USD, and there are strong indications that this view will remain valid from September onward. The basic economic indicators emerging from day to day continue to be poor both in the United States and in the euro area, making it difficult to clearly determine which economy is in better shape. Given that the problematically rapid pace of growth in euro area wages is likely to decelerate considerably from early 2025, the ECB's interest rate cut phase may end in less than a year. However, considering that U.S. economic indicators remain reasonably strong, the Fed's interest rate cut phase may also not last so long. Since there seems to be little difference between the marginal changes seen in the economic and financial situations of the United States and those seen in the euro area, I expect EUR/USD to fluctuate with little sense of direction during the forecast period.

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