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Forex Medium-Term Outlook

September 30, 2024

Overview of Outlook

In September, USD/JPY temporarily fell below the 140 level, but remained stable overall. In addition to the contrasting policy stances of the BOJ and the Fed, the JPY supply-demand climate has improved, as symbolized by the cash-flow-based current account balance turning positive, so the situation seems likely to favor JPY appreciation for some time to come. Given that the speculative JPY position has turned into a net long position, and that long positions have been accumulating, there may be times in the near future when JPY weakens, but I believe that the USD/JPY direction for the rest of the fiscal year will be dictated primarily by a narrowing of the interest rate differential. As of the time of writing, I have not yet formed a firm assessment of how the new LDP president Shigeru Ishiba's election will affect USD/JPY. The hysterical market response (JPY appreciation, stock price weakening) immediately following his election was due partly to the building up and then collapsing of expectations for his rival, Sanae Takaichi, so it would not be fair to link these price movements to a negative evaluation of Ishiba. The main forecast scenario for this month's report is based on the assumption that the BOJ will not rush to raise interest rates, and that it will postpone measures likely to cause a strong allergic reaction in the markets, such as those related to consumption tax hike and financial income tax. With rumors of a snap election as early as October, and given a strong incentive for the incoming administration to avoid an early interest rate hike, a December rate hike at the earliest, and (if all goes well) an additional rate hike coinciding with the publication of the Outlook Report in January next year seems realistic. The current trend of JPY appreciation should also back this reading. Even if JPY appreciation in response to the narrowing domestic-foreign interest rate differential is inevitable, the best one can hope for may be about 135 yen to the dollar, which is the midway point of the current phase of JPY depreciation.

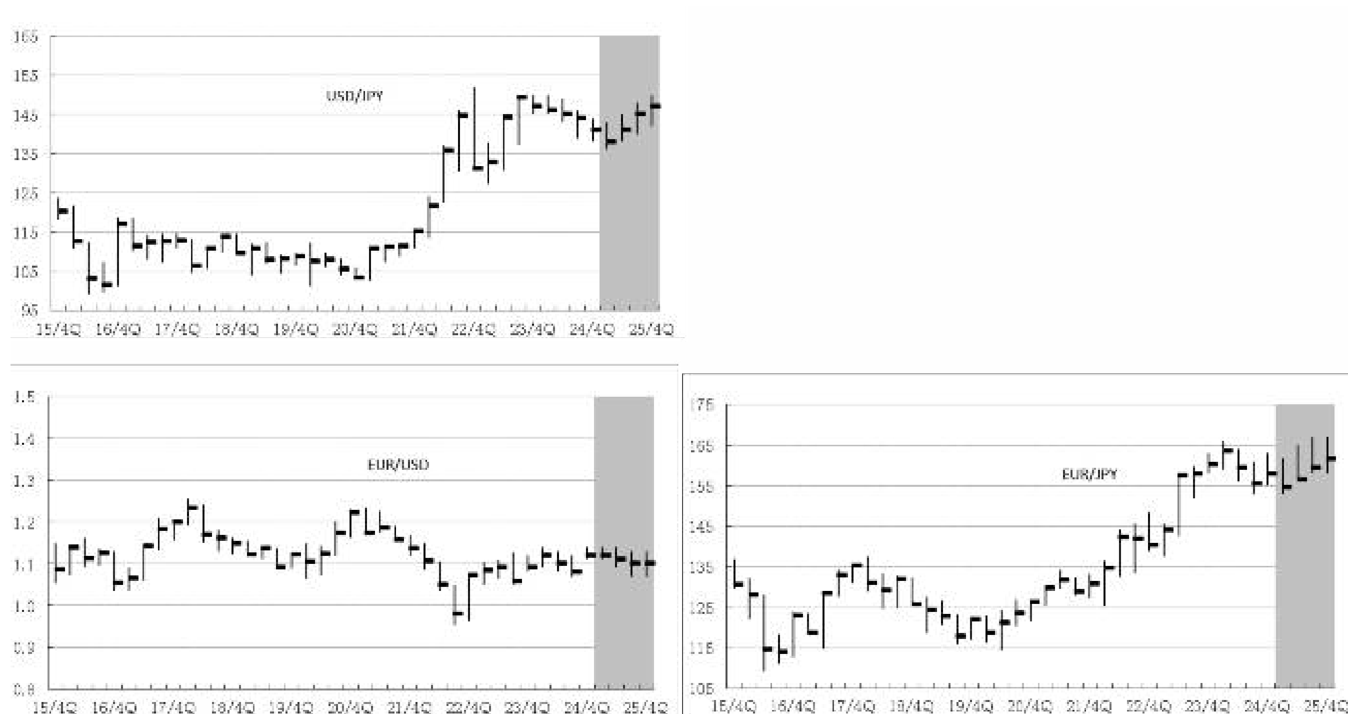
On the other hand, EUR appreciated strongly in September. This appears to have been largely the result of the Fed's significant interest rate cut. Going by negotiated wage statistics and job postings data, it may not be difficult for the ECB to implement a third interest rate cut at its December meeting. From Lagarde's press conference, the main forecast scenario for the ECB as of present appears to be firmly continuing on its rate cut path for the rest of 2024 and possibly sustaining its pace of rate cuts next year. However, setting aside the rest of this year, it is unclear to what extent employment and wage growth will slow after the start of 2025. Regarding the neutral interest rate target, Lagarde was vague, saying, "And as we get closer to it, we will know certainly better," and emphasizing a cautious stance of being ready to act promptly, whether to continue with or stop interest rate cuts. In September, news of Volkswagen's closure of its German factories also attracted attention. With successive developments raising concerns of industrial hollowing out, will Germany, like Japan, be driven into a corner in terms of its trade balance? Blessed by advantageous conditions overall, Germany is unlikely to be pushed that far, but I think this is an issue worth paying attention to in the sense that it could cause a crack in the rock-solid supply-demand structure of EUR.

Summary Table of Forecasts

	2024 Jan-Sep (actual)	Oct-Dec	2025 Jan-Mar	Apr-Jun	Ju-Sep	Oct-Dec
USD/JPY	139.58 ～ 161.96 (142.65)	138 ～ 144 (141)	136 ～ 143 (138)	138 ～ 145 (141)	140 ～ 148 (145)	142 ～ 150 (147)
EUR/USD	1.0601 ～ 1.1214 (1.1170)	1.11 ～ 1.14 (1.12)	1.11 ～ 1.14 (1.12)	1.09 ～ 1.14 (1.11)	1.07 ～ 1.13 (1.10)	1.07 ～ 1.13 (1.10)
EUR/JPY	154.44 ～ 175.42 (159.35)	155 ～ 163 (158)	153 ～ 162 (155)	156 ～ 165 (157)	158 ～ 167 (160)	158 ～ 167 (162)

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

Exchange Rate Trends & Forecasts



USD/JPY Outlook - Improvement in JPY Supply-Demand Climate Contributes to JPY Appreciation

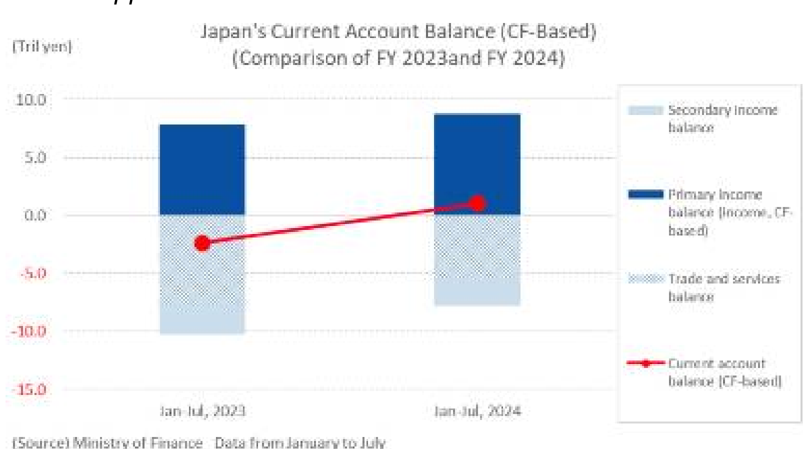
JPY Supply-Demand Climate – Supply-Demand Balance Indicates Upward Pressure on JPY

Explanation Based on Interest-Rate Gap Gaining Momentum

In mid-September, USD/JPY fell to the 139 level for the first time in about a year and two months. This was a movement that had factored in the start of a rate-cut phase by the Fed, and there was, indeed, a significant rate cut of -50bp at the much-anticipated September FOMC meeting. In the end, however, the meeting did not suggest a continuation of the major rate cuts, thereby leading to JPY weakening, but it is not unreasonable to assume that the U.S.-Japan interest-rate differential will continue to narrow for the time being. While this is already the case to some extent, one predicts that the argument that JPY depreciation could, after all, be explained solely based on the U.S.-Japan interest-rate differential will gain further momentum going forward. As I have explained before, the U.S.-Japan interest-rate differential is undoubtedly an important explanatory variable determining the direction of USD/JPY. I have never denied its importance, despite emphasizing the importance of paying attention to changes in the supply and demand structure. I do, however, believe that it is unreasonable to attribute the entire depreciation of JPY against USD, from the level of around 110 to 162, to the interest-rate differential. So, apart from the interest-rate differential, what other explanatory variables could there be? The JPY supply-demand climate, as summarized in the balance of payments statistics, general prices as symbolized by the Consumer Price Index (CPI), etc., and speculative position-making influenced by the domestic and international political and economic climate are some other variables. Since the power of each of these variables ("coefficient" in quantitative analysis) is changeable, none of them can be the "only, absolute factor for eternity" in any circumstance.

Improvement in JPY Supply-Demand Climate Behind JPY Appreciation

To emphasize that there has been no change in the core of my argument that the focus should be on the JPY supply-demand climate, I will show that the recent JPY appreciation is due not just to the narrowing of the interest-rate differential but clearly also to the improved JPY supply-demand climate. Over the past two years (2022-23), Japan posted an unprecedented trade deficit worth approximately -JPY 30 trillion. Consequently, the CF-based current account balance, as per my calculations, were in deficit, at approximately -JPY 11 trillion. However, more recently, the CF-based current account balance has recovered to post a total surplus of

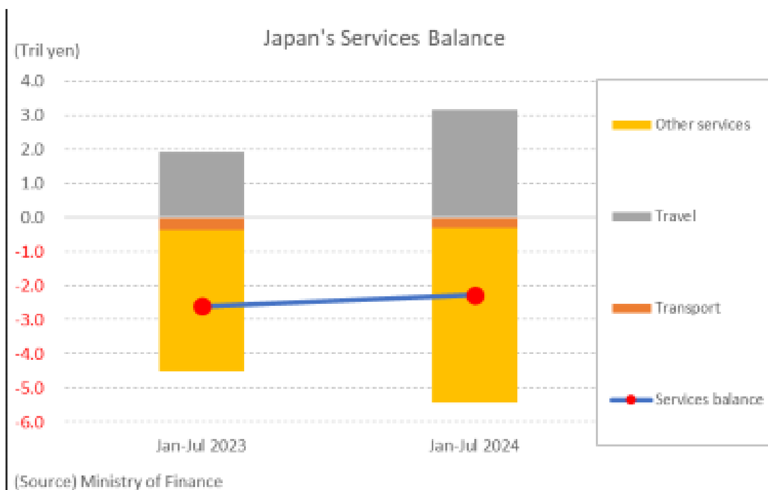


approximately +JPY 1 trillion for the January-July period, 2024. For comparison, it was approximately -JPY 4.5 trillion for the same period last year (see figure). There is no question that the remarkable narrowing of the U.S.-Japan interest-rate differential is driving JPY appreciation, but so is the improved JPY supply-demand climate, and one must not overlook its role. There are multiple reasons behind this improvement in JPY supply and demand, but two factors stand out: (1) the narrowing of the trade deficit and (2) the expansion of the travel surplus. I will discuss (2) in detail later, but regarding (1), following 2022, which recorded a trade deficit of about -JPY 20 trillion, and 2023, which recorded about -JPY 9.4 trillion, 2024 has recorded about -JPY 4.6 trillion for the January-August period (currently known), and this comes out to a deficit of -JPY 6.9 trillion for the year as a whole when annualized. JPY weakness and high resource prices have peaked, which has kept down import values and contributed to a trade deficit reduction.
Of course, one must also keep the long-term trend in mind. An annual trade deficit worth -JPY 6.9 trillion is the fifth largest in history. The average annual trade deficit for the 10 years before COVID (2010-19) was about -JPY 2.6 trillion, so, taking the long view, it is not wrong to point out that JPY has a structural weaknesses in terms of supply and demand.

Digital Deficit Still Going Strong

I receive many inquiries asking what happened to the Other Services balance, or the "new-era deficit," symbolized by the digital deficit, that I have previously proposed. This deficit is expanding rapidly. The total Other Services balance for January-July this year was a deficit of -JPY 5.1144 trillion, about JPY 1 trillion larger than the total deficit of -JPY 4.1336 trillion for January-July last year. This is the highest pace at which this deficit has ever grown. Though only a rough estimate, the Other Services deficit is set to surpass -JPY 8 trillion for the whole of 2024 if it continues expanding at this rate. Considering that it was less than -JPY 1.4 trillion in 2000, this deficit will have expanded fourfold in a quarter century, but this is not at all strange given the pace of expansion of the Other Services deficit in recent years. It would be brazen for analysts to refuse to acknowledge the structural factors behind JPY weakness even in light of these trends.

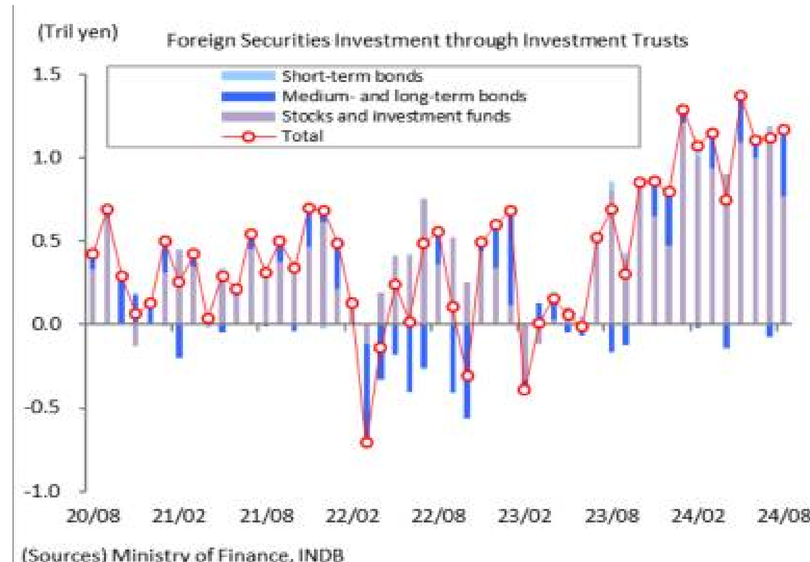
Currently, the travel surplus is also expanding steadily, and as a result, the overall services deficit remains in check. The travel balance for January-July this year reached a surplus of +JPY 3.1473 trillion. This is about 1.7 times the surplus for the same period last year (+JPY 1.9014 trillion). A unilateral expansion of the overall services deficit, led by the digital and other capital-intensive service sectors, is being prevented by the surplus expansion in tourism and other labor-intensive service sectors (see figure). However, looking into the future, it seems clear that the amount of foreign currency that can be earned from the tourism sector, which is already facing supply constraints, will be limited. By contrast, the foreign currency paid through the digital sector, far from decreasing, seems highly likely to increase as the prices for various services increase.



Ultimately, it would be accurate to roughly describe the current state of Japan's external economic sector as "barely managing" to prevent an expansion of the overall services deficit. So far, we have no way to stop the services deficit from expanding in the long term, and this could eat away at the current account surplus. Therefore, rather than discussing JPY weakness solely in the context of near-term interest-rate differential trends, one must carefully consider the background factors causing JPY weakness and then think about suitable prescriptions for the Japanese economy in this light.

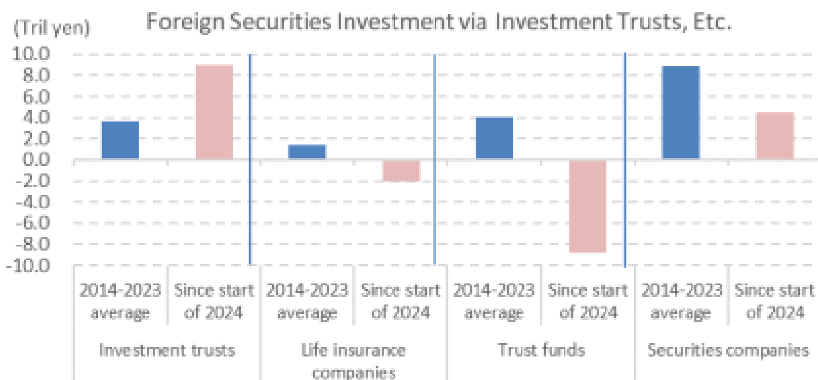
Net Acquisition Via Investment Trusts Hits JPY 9 Trillion Since Start of Year

In the context of JPY supply and demand, one must also take stock of the current status of household JPY selling. The August International Transactions in Securities, released by the Ministry of Finance, was very interesting in terms of confirming how the household sector's investment appetite has changed following the sudden dip in USD/JPY. Since January 2024, with the introduction of New NISA (with an expanded tax-exempt limit), the household sector has been investing in foreign currency-denominated assets (especially U.S. stocks). The momentum of this investment is on a different level from that of last year, and this has been seen as one of the factors behind JPY depreciation. In August 2024, foreign securities investment via settlor companies of investment trusts, etc., posted a net acquisition of +JPY 1.1702 trillion, the third highest in history



(following after May 2024 and January 2024 in first and second place, respectively).
However, what is noteworthy is the breakdown of the assets, with equity and investment fund shares at +JPY 768.9 billion, long-term debt securities at +JPY 388.1 billion, and short-term debt securities at +JPY 13.2 billion. The net acquisition of stocks and investment fund shares was the lowest since the beginning of the year, while that of long-term debt securities was the highest. This can be read to mean that individual investors distanced themselves from stocks and investment fund shares in light of economic cycle-related currents, and bet on bond investments taking into account the -50bp rate cut at the September FOMC and the rise of expectations of successive large rate cuts. In short, it could be said that the statistics are reflecting expectations of lower U.S. interest rates and a corresponding rise in JPY going forward.

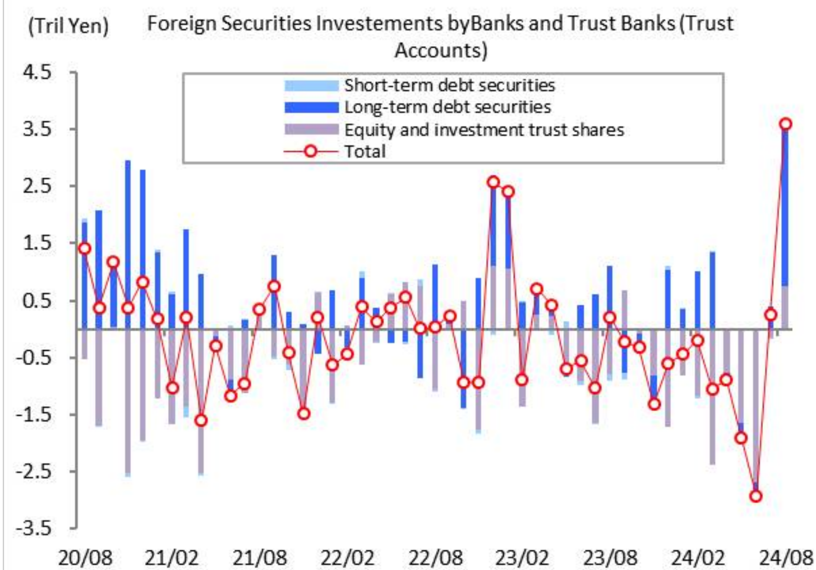
At any rate, the total of foreign securities investment via investment trusts was +JPY 9.397 trillion for the first eight months of the year, which is roughly double the actual figure for the whole of 2023 (+JPY 4.5447 trillion). This is clearly a different type of movement even when compared with that of life insurance companies and financial instruments traders (securities companies) (see figure to the right). For now, it is safe to say that the household sector's investment appetite is still strong despite the USD/JPY crash in early August. While one cannot be sure that these investments are not currency hedged, they are almost certain to be contributing to JPY selling pressure. Whether the trend can be confirmed after September will have a significant impact on the future of JPY rates. For now, a U.S. economic slowdown and a corresponding decline in U.S. interest rates are expected, and this could temporarily change the feeling in the financial market that betting on JPY weakness and high stock prices is a surefire way to profit. The household sector, which has continued to win, will be put to the test in the upcoming phase, but if net acquisitions continue with flexible adjustment of target investment assets, as in the recent release, this may indicate a refinement of the household sector's financial literacy.



(Source) INDB, *Up to August for 2024

Institutional Investors' Also Revise Market Outlook

Another point of interest this time was that net acquisition by Banks and Trust Banks (Trust Accounts) hit +JPY 3.5972 trillion, the largest since statistics began. This was driven by the huge net acquisition of long-term debt securities (+JPY 2.8065 trillion). Basically, Banks and Trust Banks (Trust Accounts) are determined by the movements of Trust Banks (Trust Accounts), and are known to generally reflect the movements of pension funds (GPIF in recent years). It could be said that the expectations of lower U.S. interest rates and corresponding JPY appreciation strengthened among both individual and institutional investors in August, and this was reflected in asset selection. Of course, it is difficult to view institutional investors in the same light as individual investors, whose flows are often assumed not to be hedged against forex risks. However, movements in August confirm that the rules of the game, namely that betting on JPY weakness and high stock prices is a surefire way to profit, which have continued since March 2022, are beginning to change. Meanwhile, inward securities investment posted the third consecutive month of net disposition of stocks and investment fund shares for the first time since the July-September quarter of 2020, soon after the pandemic began. The valuation of Japanese stocks was downward revised alongside correction in JPY weakness, and this cannot but be seen as evidence that the rise in Japanese stock prices so far had been supported by JPY weakness.



(Source) Ministry of Finance, INDB

BOJ Monetary Policy Now and Going Forward – October Rate Hike Gets more Difficult

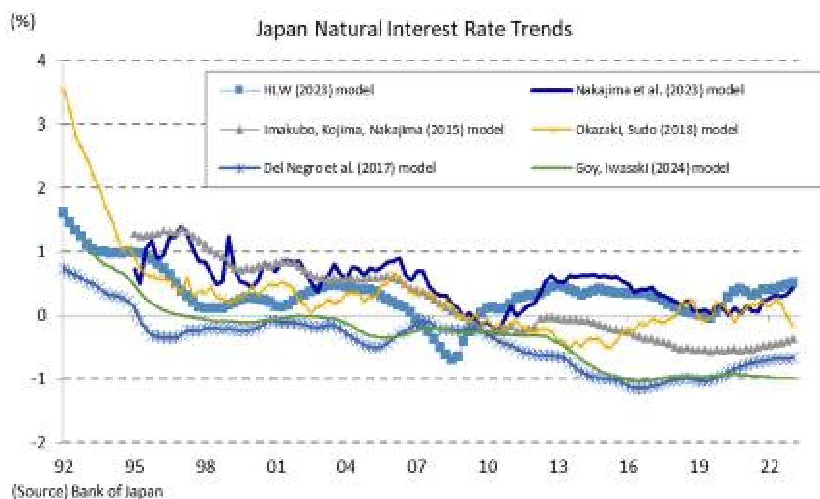
Difficulty of October Rate Hike…

At the BOJ's September 20 Monetary Policy Meeting (MPM), it was decided to keep the uncollateralized overnight call rate at 0.25%. There is no change in expectations of an additional rate hike if the economic and financial situations progress as indicated in the July Outlook Report (Outlook for Economic Activity and Prices) and the financial markets are stable at the time of an MPM. However, with the LDP presidential election scheduled for September 27, almost no one expected a rate hike at the September MPM. This was inevitable, especially given the suspicion that the July interest rate hike may have been driven by political will.

The focus now is on whether an additional rate hike will be implemented at the October 31 MPM after confirming the contents of the new Outlook Report. In a month from now, if the economic and financial situations are not much different from the present, a consensus may easily be reached in favor of a rate hike, but distance from political will is also inevitably an issue. Can the newly formed government accept a rate hike that carries the risk of a stock market crash? It is also important to bear in mind that a snap general election is scheduled to take place before the end of the year. Under BOJ Governor Kazuo Ueda, the Bank's mission is to normalize monetary policy – specifically, to secure policy space for future interest rate cuts in anticipation of the next crisis. However, given that a rate hike will not earn the BOJ any political brownie points via positive public opinion (rather, it seems likely to result in points lost), the end-of-October timing for a rate hike may be rather difficult. Notwithstanding the assertion that there is no causal relationship between political will and monetary policy management, the shadow of politics has flickered around important monetary-policy decisions from time to time, so it would be naive to take the assertion at face value.

Consensus Around Neutral Interest Rate of 1%

Many questions about the natural interest rate were asked at Ueda's press conference. This was expected, since the phrases "natural interest rate" and "neutral interest rate" had captured the public imagination between the recent meeting and the one before. As I have mentioned in previous issues of this report, on August 28, the BOJ published a working paper titled "Recent Trends in Natural Interest Rate Measurement" as part of its Review of Monetary Policy from a Broad Perspective series, and on September 11, BOJ Policy Board Member Naoki Tamura's view that the neutral interest rate should be "at least around 1%" made the headlines. The working paper presented a general image of the natural interest rate as currently being in the range of -1.0% to +0.5% and estimated that the neutral interest rate (which is natural interest rate + inflation rate) might be between +1.0% and +2.5%, assuming an inflation rate of 2%. Tamura's statement of "at least around 1%" was in line with the paper's estimate.



(Source) Bank of Japan

However, these estimates are based on the assumption that the medium- to long-term inflation rate will stabilize at 2%. If the inflation rate were to decline to half that, i.e., around 1% (which is still high when compared with inflation in Japan over the past 30 years), it would be a different story. If the medium- to long-term inflation rate stabilizes at around 1%, the neutral interest rate would be between 0% and +1.5%. In which case, it would be possible to say that the current 0.25% interest rate is already above the lower bound. Of course, this is not a good enough reason to oppose further rate hikes, given that securing policy space for future rate cuts is more important for Japan than for the Fed. Public opinion seems to have arrived at the consensus that the neutral interest rate of 1% is the end point of BOJ interest rate hikes, assuming an inflation rate of 2%, but one would do well to distance oneself to some extent from such absolutes.

Correlation Between October Outlook Report and JPY Appreciation

The Statement on Monetary Policy includes a phrase used in the last Outlook Report: "exchange rate developments are, compared to the past, more likely to affect prices." In July, JPY weakness was mentioned as an upside risk to the price outlook, and this led to an interest rate hike. Given this, the impact of USD/JPY falling by about 13% (to around 143 JPY) from its high in July (at around 162 JPY) may naturally be taken into consideration in future policy management. In fact, the Japanese economy showed signs of stagflation during 1H of 2024 against the backdrop of worsening real incomes, partly due to JPY weakness. Given the above, one could argue that the justification for an additional rate hike weakens if a correction in JPY weakness reduces the upside risk to the price outlook.

At present, core CPI (i.e., excluding fresh food) is growing at a much higher rate than 2% yoy, but has fallen to around +2% on a core-core basis (excluding food, less alcoholic beverages, and energy). (August figures, released on September 20, showed core CPI at +2.8% yoy, while core-core CPI was +2.0% yoy). Naturally, the high core CPI growth is due to some remaining impact of JPY weakness and high resource prices via import prices. Given that both JPY weakness and resource prices have been significantly corrected downward from their peaks, the CPI forecast may be downwardly revised in the October Outlook Report. Of course, various interpretations are possible, but a view is

circulating in the markets that an additional rate hike will only occur if the situation is as outlined in the July Outlook Report. If JPY strengthens (and crude oil prices fall) as the MPM date approaches, market participants may increasingly expect that the BOJ would rule further rate hikes unnecessary.

Logically speaking, one can conclude from the above that the BOJ itself acknowledges that forex rates are the most important variable in explaining monetary policy management. Of course, domestic prices and forex rates are two sides of the same coin. The general price index, symbolized by the CPI, is an indication of internal value, while the forex rate, symbolized by USD/JPY, is an indication of external value. Since the former is the domain of monetary policy (BOJ) and the latter of currency policy (Finance Ministry), they are often discussed as separate entities, but it is important for the direction of both to coincide. At the very least, it must be noted that maintaining ultra-low interest rates while simultaneously implementing JPY-buying currency intervention to prevent further JPY depreciation involves a contradiction between monetary and currency policies, and was theoretically unsustainable. In fact, it would be accurate to say that Japan's monetary policy is belatedly converging with its currency policy (politics), which desires a correction of JPY weakness. In this sense, it is possible that interest rate hikes will continue in accordance with the currency/monetary policy interpretation that "JPY cannot be considered strong in the 140 or 130 range."

However, since the BOJ specifically declared in its monetary policy statement that "exchange rate developments are (…) more likely to affect prices," the trajectory of policy interest rates seems likely to be affected by the strengthening of JPY appreciation trends. It is quite difficult to present a preview of BOJ policy decisions before assessing market trends in October, but the least I can say at the time of writing this article is that it is dangerous to take an October rate hike for granted.

U.S. Monetary Policy Now and Going Forward – Recalling the Policy Space Argument

Rate Cut by -50bp Including the July Portion

At the September 17-18 FOMC meeting, the federal funds (FF) target rate was cut by 50bp, from 5.25-5.00% to 4.75-5.0%. This was the first rate cut in four and a half years. Given U.S. economic/financial conditions, I had reasonably expected a 25bp rate cut, but from Fed Chair Jerome Powell's press conference, the rationale for the 50bp rate cut seemed to be that it included the unimplemented July portion, even though a 25bp rate cut would have been sufficient for this time. Specifically, Powell described the rate cut this time as part of the Fed's "commitment to make sure that we don't fall behind." He added, "I do not think that anyone should look at this and say, 'Oh, this is the new pace.'" He also described the base case as "We're recalibrating policy down over time to a more neutral level." Going forward, it seems very likely that the Fed will return to a -25bp pace of rate cuts, and this is causing USD buying to prevail in the forex markets.

Of course, it must be noted that the FOMC is not monolithic. Member of the Board of Governors Michelle Bowman voted against the -50bp cut, asking for a -25bp cut instead (this was her first dissenting vote as a Board member since 2005). Opinions were also divided when it came to FF rate projections by FOMC members (the dot plot), with predictions ranging from no rate cuts to effectively three rate cuts for the two remaining meetings this year. Nine out of 19 members supported the median of two cuts (-50bp), while seven supported one cut (-25bp). Meanwhile, two members supported no rate cut, and one supported a -75bp cut. Given this lack of consensus, the size of future rate cuts should be viewed as variable and depending on the results of economic indicators released during the month in question. In fact, Powell mentioned in his press conference that a rate cut would have been implemented in July had that month's July job data become available before the FOMC meeting. The likelihood and extent of rate cuts at upcoming FOMC meetings has an endless potential to change based on day-to-day evolution of economic indicators and the domestic and international situations.

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

FOMC Date	2024	2025	2026	2027	Longer run
Sep-23	5.125%	3.875%	2.875%	—	2.500%
Dec-23	4.625%	3.625%	2.875%	—	2.500%
Mar-24	4.625%	3.875%	3.125%	—	2.5625%
Jun-24	5.125%	4.125%	3.125%	—	2.7500%
Sep-24	4.375%	3.375%	2.875%	2.875%	2.8750%

(Source) FRB

Recalling the Policy Space Argument

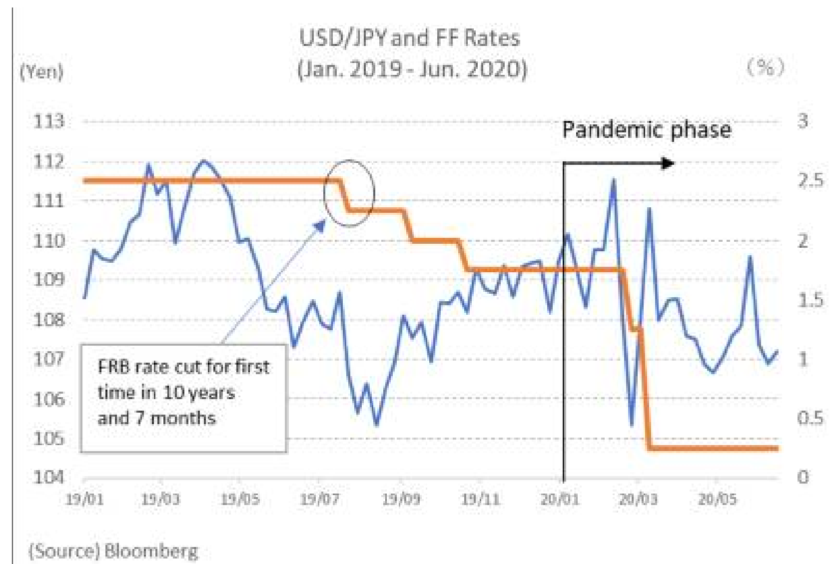
Essentially, a 25bp rate cut would not be a problem. The current phase of rate cuts is in response to an ordinary period of economic slowdown (or recession), which is different from policy management in response to a crisis of some sort. The financial markets have experienced numerous crises over the past nearly 20 years, including the 2008 global financial crisis, the European sovereign debt crisis, and the COVID-19 pandemic, and central banks have been forced to implement significant monetary easing each time. Compared with the past, it has become easier to recall scenarios in which an extreme crisis triggered an extreme response. The current case, however, is as Powell said in his press conference, "The U.S. economy is in good shape, and today's decision is to maintain that." In other words, the recent interest rate cut was intended to prevent a crisis rather than as a response to one. At this time, it is unclear whether the U.S. economy will even enter a recession, nor are CPI and personal consumption expenditure (PCE) deflator growth stably below +2% yoy. Under such circumstances, it was surprising that the Fed would begin with a 50bp rate cut, but it is understandable if the intention was to make up for getting behind the curve in July.

I would like to recall the "policy space" argument. During the Fed's 2015-18 phase of interest rate hikes, it was frequently mentioned that interest rates had to be raised so that they could be lowered again when the economy went into a recession (i.e., that policy space had to be secured for future rate cuts). This attracted attention as the "policy space" argument. The logic of this argument is quite twisted, but it was supported at the time. In light of this, the Fed ought not to

waste precious policy space by implementing successive 50bp rate cuts under current U.S. economic conditions. Of course, it sounds good to call it a forward-looking response, but in reality, staff economic projections are unlikely to be all that accurate. Realistically, I predict that the Fed will periodically explore 25bp rate cuts while keeping an eye on future policy space requirements. The dot plot projects two rate cuts this year and four next year, but nothing definitive can be said about next year until after we have seen the January-March period under a new president. As shown in the chart on the previous page, the dot plot already approaches the longer-run federal funds rate (which is also the neutral interest rate) toward the end of its projection period, and "when will rate cuts end" is likely to become the pressing question in the not-too-distant future. In his press conference, Powell made it clear that the Fed does not intend to return to the ultra-low interest rates of the past. Inevitably, the situation is conducive to a correction of the strong appreciation of JPY against USD in anticipation of a rapid narrowing of the U.S.-Japan interest-rate gap, and this is already happening.

Fed's Rate Cut Phase This Time is a Novel Experience for Japan

Japan will face the current phase of rate cuts by the Fed as a trade-deficit nation. I have discussed this point many times before using the figure to the right. Even if only temporarily, USD selling is bound to prevail in the forex markets when the FF rate, which is the world's cost of capital, falls. Naturally, this will also result in commensurate JPY buying. However, the magnitude of trading would be based on the supply-demand climate of the currency in question. Japan has been a trade-deficit nation for barely over 10 years, so it has little experience of Fed rate cut phases as a trade-deficit nation. It did get a precious glimpse around five years ago, during the Fed's July 2019 rate cut phase, which was its first in 10 years and 7 months. At that time, even though JPY strengthened immediately before and after the rate cut, the sentiment did not become established as a unilateral trend. In 2019, when interest rate cuts began, Japan's trade deficit was approximately -JPY 1.7 trillion, and it was approximately -JPY 1.2 trillion the year before that (2018). More recently, Japan's trade deficit was approximately -JPY 9.3 trillion last year, and it has posted a total of approximately -JPY 4.6 trillion for the January-August period this year (giving approximately -JPY 6.9 trillion when annualized). Of course, given the dramatic change in its rate over the past two and a half years, JPY recovery could well be stronger than expected. However, it is important to remember that Japan's trade deficit now is larger than during any previous phase of Fed rate cuts. It is, therefore, not easy to agree with the reading that the current phase of rate cuts will result in a return to strong JPY appreciation.



(Source) Bloomberg

Risks to My Main Scenario – Household Foreign Currency Assets Larger than Expected

Japan's Next Leader to Face Challenges of a "World with Significant Interest Rates"

The Liberal Democratic Party's (LDP's) internal election on September 27 selected Shigeru Ishiba as the new LDP president. (The LDP is Japan's ruling party, and its internal election determines the party's leader, who subsequently becomes the country's prime minister.) After the new prime minister is officially elected at a plenary session of both the House of Representatives and the House of Councillors on October 1, he will deliver a policy speech and the ruling and opposition parties will hold a question and answer session. As the full details of the new administration's economic policies were not yet known at the time this article was written, I will discuss those policies in detail in the next edition of the article. Regardless of who takes the reins of the Japanese economy, however, it is almost a given that Japan will be facing a major economic transition from generally deflationary trends to inflationary trends in the future, and the country will have to deal with challenges associated with a decrease in its population and a sustained rise in nominal wages. In other words, Japan will have to cope with a transition from a world of negligible interest rates to a world with significant interest rates. Japan's new government administration will be forced to implement its economic policies amid changes to the basic premises of the country's fiscal and monetary policies, which have remained unchanged for more than a quarter of a century.

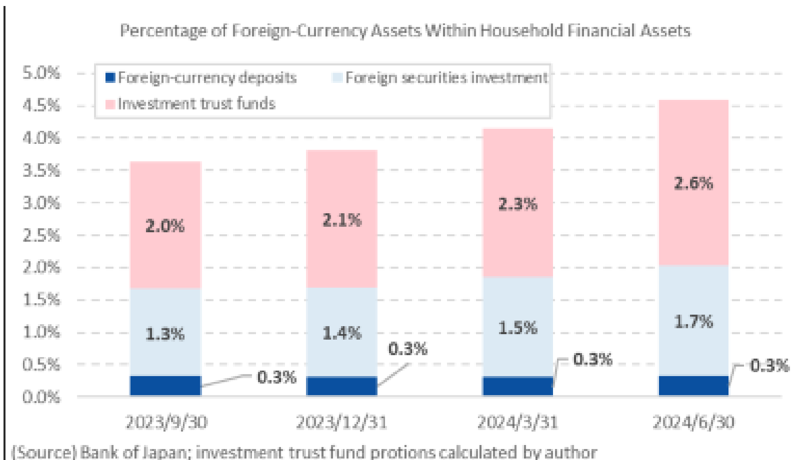
What is the significance of this change to basic fiscal and monetary policy premises? Generally speaking, in a world with significant interest rates, the Japanese government will have to restrain its spending more than it did in a world with negligible interest rates – whether it likes it or not, the government will have to acknowledge the increased difficulty of continuing to implement expansionary fiscal policies that often have often included various types of handouts. On the other hand, if the government strongly dislikes that prospect and therefore aims to revive a world without significant interest rates, JPY will weaken again. Ultimately, the new administration will be forced to choose between a weaker JPY or rising interest rates, and it will have to govern with a more-limited array of economic policies (fiscal and monetary policies) than previously. If the administration continues to manage its finances while generously using fiscal resources to support low-income households, as it has done in the past, it will increase the risk of unbridled JPY depreciation in the forex market, which is difficult for the government to control. It is inevitable that the new administration will have a smaller

scope of feasible economic policies than previous administrations had. In this regard, there are concerns about the skills of LDP President Ishiba, who has a record of promoting generous support to elderly people in rural areas, so attention will be focused on his ability to make corrections and adjustments.

Households' Foreign Currency Assets exceed JPY100 Trillion

President Ishiba attracted attention during the LDP presidential election by actively promoting the introduction of a financial asset tax, although it remains unclear how likely it is that such a tax will be introduced. As a result of the government's initiative to promote a shift from household savings to household investments, a financial asset tax certainly has aspects that will make it difficult to casually introduce in Japan, where the such a tax's wealth effect is likely to be increasingly greater than previously. In this regard, the Flow of Funds Statistics for this year's second quarter, released on September 19, reaffirmed the domestic household sector's progressive shift from savings to investment and from JPY to foreign currencies. One must keep a close eye on this situation when considering the bases for the reluctance of USD/JPY to decline, and the situation should also be kept in mind as an important aspect of the policy environment in which the new administration finds itself. Sections of this article below will offer more details about that situation at this time and also consider future risk factors related to the situation.

Japan's household financial assets have been attaining record high levels for the past six consecutive quarters, and they amounted to JPY2,211.7 trillion at the end of June, up 4.6% from the previous year. As JPY's depreciation trend and Japan's stock market rally peaked in early July, this outcome was expected. As of the end of June, households' foreign currency assets (which I always pay close attention to) exceeded JPY100 trillion for the first time, reaching JPY101.7 trillion, and their share of total household assets rose to 4.6%, a record high level. Compared to the end of March 2000, the amount of foreign currency assets has grown by about 7.7 times, and the ratio has risen by about 5 times. The savings to investment shift is gradually but surely progressing while concurrently promoting a shift from JPY to foreign currencies. The value of households' stocks and similar investments reached the JPY300 trillion mark for the first time, and the share of total household assets in such investments was 13.6%, also a record high (see table below, strictly speaking, the highest level was 13.7% at the end of March). Compared to the end of March 2000, the amount of stocks and similar investments has grown by about 2.2 times, and the ratio has risen by about 1.4 times. At least through the first half of this year, Japan's household sector appears to be fully demonstrating its willingness to increase its investments in line with the country's "Asset Management Nation" strategy.



(Source) Bank of Japan; investment trust fund protions calculated by author

Financial Asset Composition of the Japanese Household Sector (As of End of June 2024)

	Amount (tril yen)	(%)
Total assets	2,211.7	100.0
Foreign currency	101.7	4.6
Foreign currency deposit	7.1	0.3
Foreign securities investment	37.7	1.7
Investment trust	56.8	2.6
JPY-denominated	2,110.0	95.4
Cash and deposits (excluding foreign currency deposits)	1,119.8	50.6
Government bond, etc.	29.8	1.3
Stocks and investments	300.8	13.6
Investment trusts (excluding the foreign currency portion)	77.1	3.5
Insurance and pension reserv	544.7	24.6
Deposit, etc.	37.8	1.7

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

	Amount (tril yen)	(%)
Total assets	1,401.1	100.0
Foreign currency	13.2	0.9
Foreign currency deposit	3.1	0.2
Foreign securities investment	4.7	0.3
Investment trust	5.3	0.4
JPY-denominated	1,387.9	99.1
Cash and deposits (excluding foreign currency deposits)	741.6	52.9
Government bond, etc.	50.6	3.6
Stocks and investments	138.3	9.9
Investment trusts (excluding the foreign currency portion)	52.2	3.7
Insurance and pension reserv	369.9	26.4
Deposit, etc.	35.3	2.5

Changes from the End of MAR 2020 to the End of June 2024

	Amount (tril yen)	(%)
Total assets	810.5	
Foreign currency	88.5	3.7
Foreign currency deposit	4.0	0.1
Foreign securities investment	33.0	1.4
Investment trust	51.5	2.2
JPY-denominated	722.0	▲ 3.7
Cash and deposits (excluding foreign currency deposits)	378.2	▲ 2.3
Government bond, etc.	▲ 20.8	▲ 2.3
Stocks and investments	162.5	3.7
Investment trusts (excluding the foreign currency portion)	24.8	▲ 0.2
Insurance and pension reserv	174.9	▲ 1.8
Deposit, etc.	2.5	▲ 0.8

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

Foreign Currency Assets already Account for 10% of Household Assets?

Of course, household financial asset figures as of the end of September will be different, as they will reflect the impact of market fluctuations in July and early August. However, monthly external securities investment by investor sector statistics confirm that the household sector's investment appetite has not weakened much since August. Owing to JPY's recent strength, flow of funds statistics as of the end of September may show a decline in the household foreign currency asset ratio, but this does not mean that household JPY selling has subsided. As mentioned in previous editions of this article, foreign currency-denominated insurance, which has been rapidly increasing in recent years, is included in the insurance and pension reserves item due to statistical constraints. This is a very large amount, amounting to JPY544.7 trillion and representing 24.6% of household assets. If we assume that even 10% of insurance and pension reserves are foreign currency-denominated assets, the household foreign currency asset ratio would exceed 7%, and if 20% of insurance and

pension reserves are foreign currency-denominated assets, the household foreign currency asset ratio would be close to 10%. It appears realistic to estimate that nearly 10% of Japanese household financial assets are already denominated in foreign currencies.
When looking at growth in households' foreign currency assets by asset type, it is clear that investment trusts are the main driving force behind the overall trend. My calculations indicate that investment trusts account for 2.6% of total financial assets, considerably more than the shares of overseas securities investment (1.7%) and foreign currency deposits (0.3%). If we assume that such foreign currency-denominated insurance products as those mentioned above account for 10% of insurance and pension reserves, however, their share of household assets would exceed that of overseas securities investment and be comparable to that of investment trusts. It is worth reiterating that the Japanese household sector's shift from JPY to foreign currencies is progressing more rapidly than can easily be captured by statistics, and there is no denying the possibility that this trend is the principal underlying reason for the JPY's weakness.

Weaker JPY More Politically Acceptable than Higher Interest Rates
As mentioned above, whoever drafts Japanese economic policies going forward will have to accept either greater JPY weakness or higher interest rates. The Flow of Funds Statistics at the end of March and June this year are snapshots of what would happen if JPY weakening and the resulting rise in stock prices were left unchecked – the March and June numbers alone are a basis for getting a fairly clear image of what future statistics would be like. If the same statistical
Need to Avoid a Japanese-Style "Truss Shock"
There appears to be little cause for concern about prospective Prime Minister Ishiba, who is known for his hawkish stance on currency and monetary policy issues. However, Ishiba won the LDP presidency in a close race with the relatively dovish Sanae Takaichi, so if the Ishiba administration's policies were to be perceived as unsuccessful at an early stage, it is possible that hopes for reflationary policies will resurface. The most commonly held theory about why the second Abe administration was so committed to reflationary ideology is that a rift between the government and the BOJ deepened in August 2000, when the BOJ decided to discontinue its zero interest rate policy despite the government's request for a postponement of that move. Abe was deputy chief cabinet secretary at the time. If Ishiba's hawkish fiscal and monetary policies are perceived as failing, it is entirely possible that the LDP will at that point decide to turn to someone proposing diametrically opposite policies.
However, if the Japanese government blatantly opposes the BOJ's policy management, particularly regarding interest rate hikes, there will almost certainly be a trend of JPY depreciation in the forex market. If JPY weakness inflicts great pains on Japanese society, a view that "some degree of interest rate hike is necessary after all" will inevitably become more popular. If public opinion moves substantially in that direction, the government will have no choice but to accept interest rate hikes. As a result, there is a risk that JPY will weaken and interest rates will rise simultaneously, but the reaction of public opinion to such a situation is likely to be extremely negative. Ultimately, if the BOJ's policy management is ineffectually restricted, the sustainability of the government may come into question. The weakness of JPY during the past two and a half years has been a historically outstanding trend, and although the peak of that trend appears to have passed, I hope that those in power will recognize that Japan's interest rate and forex markets are in an extremely delicate situation.
trend were to proceed from September onwards, it may suggest an "assuming interest rates rise, household financial assets will decrease" pattern. That outlook is not pleasant from a political perspective. Furthermore, interest rate rises have long been politically frowned upon owing to their association with rising mortgage interest rates. While JPY depreciation that promotes real income environment deterioration is not easily tolerated, politicians are likely to consider a trend of rising interest rates rises as being a trend that is likely to cause serious political challenges in the short term, and they can be expected to make strenuous efforts to avoid such problems.
Based on this understanding, I believe that when leaders are forced willy-nilly to choose between rising interest rates and JPY depreciation, they are likely to choose JPY depreciation. In terms of policy mix, fiscal policy might be likely to lean towards austerity while currency and monetary policies might be likely to lean towards monetary easing and JPY depreciation. Because it is highly doubtful that a Japanese government would actually implement more-austere fiscal policies, however, I am concerned that unrestrained macroeconomic policy management may create a situation in which the government bond market is strongly impacted and the forex market is flooded with JPY selling.
Furthermore, we should also be prepared at this stage to accept the possibility that having to choose between greater JPY weakness or higher interest rates is not the worst-case scenario. As previous editions of this article have argued, if we imagine a future in which the BOJ continues to raise interest rates, it is highly likely that this will be done as a means of defending JPY, and I am concerned about the strong possibility that, at that point, JPY weakening and interest rate rises will proceed concurrently. If a so-called "world with significant interest rates" becomes established, one can imagine an near-term situation in which JPY's depreciation can only be restrained by additional interest rate increases. Although Japan's new government will be more likely to tolerate JPY weakening than interest rate increases, one should also keep in mind the risk that both market phenomena may occur simultaneously.
This brings to mind the United Kingdom government led by Prime Minister Mary Elizabeth Truss, who became prime minister in September 2022. As a result of the Truss government's insistence on an expansionary fiscal policy that went against market expectations, the United Kingdom was confronted by sharp trends of GBP depreciation and rising interest rates, and Prime Minister Truss was forced to resign just 45 days after taking office (the shortest U.K. prime minister term in history). It is not an exaggeration to say that the financial markets forced her to resign. The capital circulation structures of the United Kingdom and Japan are quite different, of course, so it is not feasible to make a simple comparison of the "Truss shock" with a potential "Ishiba shock". Moreover since this is merely one of many potential risk factors looming in the distant future, I will refrain from a detailed discussion of this at this time. As Japan's household sector is already beginning to become less resistant to selling JPY, however, there is a basis for fearing that, if government actions generate information that strongly promote JPY selling, Japan might possibly face the same kind

of chaos that the United Kingdom faced during the Truss shock period. With the “shift from savings to investment” trend already gaining momentum and focusing largely on foreign currency assets, I think it would be wise to be wary of the possibility of a Japanese version of the Truss shock occurring as a possible future “tail risk” factor (although the election of LDP President Ishiba appears to have diminished the possibility of this risk factor for the time being).

EUR Outlook – Sustainability of Interest Rate Cuts from 2025 Remains Unclear

EUR Area Monetary Policies Now and Going Forward – Policies Implemented as Planned, but Continued Uncertainty about Developments from 2025

Outlook for Further Interest Rate Cuts but Status Quo Maintenance in October
As expected by the financial markets, the ECB's September 12 Governing Council meeting decided to lower the ECB's main policy interest rates by 25 basis points each. This decision itself was considered a given in light of expectations of a slowdown in the euro area labor market as well as data confirming a recent deceleration of inflation rates in the euro area. As explained below, the euro area's economic and financial situations are changing in line with the Eurosystem staff projections, and ECB President Lagarde expressed confidence in her institution's policy management, saying – "[T]hat decision to cut by 25 basis points was perfectly legitimate and, as I said, unanimously decided." The post-Governing Council-meeting press conference included some interesting comments regarding the ECB's future policy management. Movements in the euro area consumer price index (HICP) have been attracting attention, and President Lagarde commented on those movements, saying – "September will certainly deliver a low reading of inflation. Very likely. We expect, because of the base effect, particularly on energy, our inflation numbers to be up in the fourth quarter, so the last three months of 2024." – but she also said – "During the course of 2025 in particular, inflation will decline towards our 2% target." The Governing Council's view appears to be that the high levels of inflation rates expected to be seen during the October-December period are merely temporary and the ECB should not overreact to such a temporary inflation acceleration.
It is interesting to note that President Lagarde acknowledged that HICP is likely to accelerate in the fourth quarter of this year, but then undercut expectations that such acceleration might diminish the likelihood of additional rate cuts by saying – "data dependency does not mean data point dependency. We're not going to be fixated on one single number. We are looking at a whole battery of indicators." That approach seems to indicate she has a quite high level of confidence in the ECB's policy management. Regarding the time remaining before the next Governing Council meeting on October 17, President Lagarde stated that it is – "a relatively short period of time compared with other intervals" – suggesting that there is not enough time to make data dependent decisions based on the relatively small amount of new data that will become available before October 17. In view of this, it appears safe to assume that the October Governing Council meeting will maintain the status quo.

Significance of the Draghi Report
Reporters at the press conference posed several questions about a report released on September 9 suggesting ways to improve the EU's international competitiveness. The report – called the Draghi Report because it was compiled by Mario Draghi, a former president of the ECB and a former prime minister of Italy – is a product of the European Commission that had been attracting considerable attention even before its publication. (The decision to create the report was made roughly a year ago.) This article will discuss the details of the Draghi Report on another occasion, but at this point, it should be sufficient to understand that the report primarily proposes methods for improving the EU's industrial competitiveness, which is generally acknowledged to be inferior to that of the United States and China. One reporter asked if – "the Mario Draghi report [c]ould [...] have an impact on monetary policies and the ECB's mandates?" – but President Lagarde did not take the question seriously, simply replying that – "I didn't see in Mario Draghi's report any suggestion that the mandate of the ECB should be modified." After the next reporter asked an additional question about the report, President Lagarde stated – "Mario Draghi's report includes so many important structural reforms that are going to be the responsibility of governments" – and she went on to emphasize the role of governments by saying – "While structural reforms are not the responsibility of a central bank, they are the responsibility of the governments." In fact, the Draghi report states that the EU needs to invest an additional EUR750-to-800 billion per year, calling for a much larger fiscal outlay than the U.S Marshall Plan that promoted Europe's post-war reconstruction from 1948 to 1952. In light of that, it should be understood that the report is primarily aimed at EU member states and their executive body, the European Commission. The history of the EU and the euro area has been one in which the ECB has been frequently called on to compensate for and clean up the results of government mismanagement, so it seems likely that the ECB will cooperate with the implementation of the Draghi Report to a great extent, although President Lagarde's comments suggest that cooperation will be within the scope of the ECB's existing mandate.

No Commitment Regarding Policies from 2025
In light of the situation suggested by the already released negotiated wage statistics and surveys of job advertisement wages, the labor market slowdown and the increased stability of HICP appear likely to be confirmed by the end of this year, so there appears to be a fairly strong basis for anticipating a third ECB interest rate cut at the December Governing Council meeting. Reflecting that, President Lagarde said at the press conference that – "when you look at the incoming information, it confirms our previous projections and it comforts us in our confidence that we are heading towards our target in a timely manner. During the course of 2025 in particular, inflation will decline towards our 2% target." The current main forecast scenario is that the ECB interest rate-cut course in 2024 is solid and that further rate cuts will be sustainable even from 2025. One reporter asked about the ECB's concept of the neutral interest rate level (r*; at which point further rate cuts would be unproductive), but President Lagarde made a vague response, saying – "I'm not going to give you any idea as to where r* is because this is an unobservable concept anyway. And as we get closer to it, we will know certainly better."

ECB Staff Macroeconomic Projections (September 2024)

(%)

	2023	2024	2025	2026
Harmonized index of consumer prices (HICP)	**5.4**	**2.5**	**2.2**	**1.9**
(previous: June 2024)	5.4	2.5	2.2	1.9
Core HICP	**4.9**	**2.9**	**2.3**	**2.0**
(previous: June 2024)	4.9	2.8	2.2	2.0
Real GDP	0.5	0.8	1.3	1.5
(previous: June 2024)	0.6	0.9	1.4	1.6

(Source) ECB, EUR/USD exchange rate for 2024-26 assumed to be between 1.09 and 1.10

*Core excludes energy and food

However, as this article has repeatedly argued, even if one has confidence in job advertisement wages as a leading indicator (the ECB has predicted a labor market slowdown based on that indicator), it remains unclear whether wage growth and inflation rates will continue decelerating after the start of 2025. Looking at the September staff projections (see chart), one finds that overall basis HICP is now forecast to grow at +2.5%, +2.2%, and +1.9% during the three years from 2024 to 2026 (the same figures presented in the June forecast), but the core basis HICP growth rates for the first two of those years have been raised to +0.1% above the June forecast levels. A reporter pointed out that the latest figures show an acceleration of HICP growth in the services sector and asked if the ECB is concerned about related risks going forward. President Lagarde responded by reiterating her previously expressed view that the upward trend in services inflation will diminish as strong corporate profits enable companies to absorb wage increases without hiking their selling prices, but she also noted about the services sector that – “it’s obviously a sector that is resistant and to which we have to be very attentive.” – suggesting that the ECB is not relaxing its wary posture with respect to the services sector.

It is worth noting that real GDP growth rate for each of the three years from 2024 has been revised downward by 0.1 percentage point – reducing the growth rate to +0.8% in 2024, +1.3% in 2025, and +1.5% in 2026 – and this adjustment appears to be based on the factoring in of the weak personal consumption trend along with prospective decreases in net exports due to geopolitical risks. It may not be problematic if such downward revisions remain as small as they have been to date, but if the GDP growth rate continues to be revised downward while the HICP growth rate stops falling, the situation would suggest a growing potential for something akin to stagflation, and that could be considered a significant risk scenario for the ECB, whose default course is to continue cutting interest rates.

Dangerous Assumption of Dovishness on the Parts of All Central Banks but the BOJ

If the scope of this analysis of the European economic and financial situation is expanded to include international factors, it seems necessary to remain cautious when attempting to factor in potential for dovish tilts on the parts of the ECB and the Fed. There are currently strong expectations that the ECB, the Fed, and other central banks around the world will continue cutting interest rates, and in September there was also much talk about the elimination of the US Treasuries market’s inverted yield curve (the establishment of a positive yield curve). The majority of financial market players appear to strongly believe that interest rate cuts will continue to be implemented through the near future. On the other hand, given that prospective policy adjustments by the BOJ contrast sharply with prospective policy adjustments by the ECB and the Fed, the markets are becoming predominated by bullish views on JPY.

How solid is the assumption that all central banks but the BOJ are doves? Many market participants seem to take it for granted that the European and U.S. economies will continue decelerating as an inevitable outcome of the increasingly apparent effects of previous interest rate hikes. However, it is worrying that many market participants, after observing events associated with the Lehman Shock and the COVID pandemic, have come to believe that it is common sense to employ ultra-low interest rates to deal with a slowdowns in the real economy. Over the past 15 years, many market participants have become unaccustomed to “normal cyclical economic downturns” but increasingly accustomed to extreme slowdowns and extreme responses. With respect to JPY interest rates, there are increasing calls for the BOJ to significantly narrow Japan-U.S. and Japan-Europe interest rate differentials and thereby promote JPY appreciation, but in reality, it is quite conceivable that the economic slowdowns in Europe and the United States (where the natural interest rates are probably higher than in Japan) will be limited and that those interest rate differentials will not actually narrow much.

Lagarde's statements at the recent press conference highlighted the flexibility of her stance, which allows her to act dovishly while remaining prepared to shift toward hawkishness at any time. While keeping in mind that the euro area situation could suddenly change depending on nature of upcoming HICP and employment and wage figures, one must carefully consider whether the simple EUR outlook of EUR weakening in response to interest rate cuts will really be sustained over the next year.

Euro Area Economy Now and Going Forward – Full-Scale Start of Industrial Hollowing Out Process in Germany?

VW Factory Closure as a Symbol of Industrial Hollowing Out

It was announced on September 2 that Volkswagen (VW), Germany's largest automobile company, was considering closing a factory in Germany. This article has long been monitoring signs that Germany's direct investment flows are shifting toward growing levels of net outflows due to the sudden rise in the cost of domestic economic activities. Signs of this shift have already been confirmed in balance of payments statistics – in particular, from 2022 to 2023, inward direct investment from abroad into Germany fell sharply, and overall balance of inward and outward direct investment caused an unprecedentedly high level of net outflow. While the news about VW focused attention on German companies shifting operations to foreign bases, it was actually foreign companies that responded more quickly to Germany's worsening business environment. The decrease in Germany's inward direct investment has been attracting considerable attention since 2022, and the news about VW is likely focus greater attention on the increase in the country's outward direct investment.

(Source) Macrobond

VW has an 87-year history as a conspicuous symbol of Germany's powerful manufacturing industries, and it never previously decided to close a domestic factory. This decision's shockwaves will certainly be keenly felt by Germany's government, led by Chancellor Olaf Scholz, and they will also have an impact on the German economy's medium- to long-term outlook. In addition to the prospective factory closure, it has also been reported that VW is considering terminating an agreement with its labor unions to guarantee current workers' employment through 2029. As it is estimated that almost half (300,000) of the 650,000 people VW employs worldwide are workers in Germany, VW moves to shrink its domestic presence will have an impact that cannot be ignored on the German labor market as a whole. A German economic slump is tantamount to a slump in the overall euro area economy, so these developments could be important factors to consider when forecasting the ECB's next policy move.

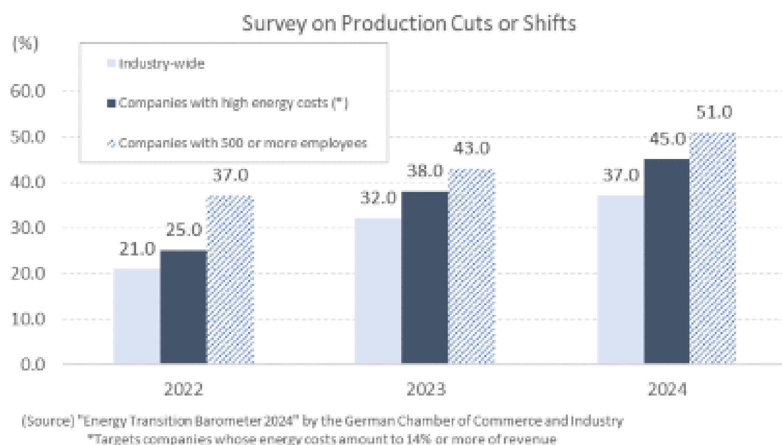
Germany's Fading Position as the Euro Area's Economic Dynamo

Published in 2021, my book entitled "After Merkel: What's Next?" argues that Germany's greatest difference from Japan (and a key source of its outstanding economic strength) is that it has been able to maintain its power as an export base owing to support by such factors as the permanently undervalued nature of EUR, strong demand for German products in neighboring countries with which German can trade without facing currency exchange risks and tariff and non-tariff trade barriers, and the ability to obtain high-quality and relatively inexpensive labor from Eastern European countries. The decelerating pace of Germany's population decline, partly reflecting the country's September 2015 declaration that it would accept an unlimited number of immigrants, has also been noted as a major factor differentiating Germany from Japan. (Although the side effects of such unlimited immigration has caused German society to struggle with formidable challenges related to education and public safety[1]).

Recent trends suggest that Germany is now beginning to lose its longstanding power as an export base. When announcing the factory closure decision, VW CEO Oliver Blume was reported to have said – "The economic environment has become even tougher and new players are pushing into Europe. Germany as a business location is falling further behind in terms of competitiveness." – and this is first-hand testimony to the dramatic change Germany's business environment has undergone, particularly since the COVID epidemic. After long having been warned that its reliance on Russia for inexpensive natural gas supplies was dangerous, Germany lost its access to those supplies with the outbreak of the Russia-Ukraine war in March 2022 and, in April 2023, the country made a highly-idealistic but economically challenging decision to discontinue the operation of nuclear power plants, further pushing up its already-high energy costs. Meanwhile, the significant Chinese market shares Germany had acquired by dint of what some derided as pro-China diplomacy have also been becoming increasingly tenuous due to economic stagnation in and diplomatic frictions with China. The foundations for Germany's power as an export base – including energy and currency factors enabling stable low production costs along with access to China's huge markets – are beginning to crumble, especially with respect to energy factors. (There are various ways to analyze the currency factors, so that analysis will presented in a future edition of this article.)

[1] For example, it has been noted that the large number of immigrant children has led to a shortage of teachers and caused a decline in student's academic achievement. It has also been pointed out that the increasing number of elementary school students with poor German language skills is another factor contributing to the decline in academic performance. The negative aspects of immigration in Germany can serve as a lesson for Japan.

The results of a survey of approximately 3,300 member companies published by the German Chamber of Commerce and Industry (DIHK) on August 1, 2024, clearly illustrates German companies' plight. The survey indicated that the percentage of domestic companies considering reducing production or shifting operation to foreign bases was 37%, up from 21% in 2022 and 32% in 2023 (see graph). The rise in the number of companies considering reducing production or shifting operation to foreign bases has been particularly sharp among companies with high energy costs (companies whose energy costs amount to 14% or more of their revenue) and large companies (with 500 or more employees), with roughly half such companies considering reducing production or relocating as of 2024.



(Source) "Energy Transition Barometer 2024" by the German Chamber of Commerce and Industry
*Targets companies whose energy costs amount to 14% or more of revenue

The survey's results demonstrate that the consequences of high energy costs are crucially undercutting Germany's viability as a business location, and the survey's text portion asserts that the survey "confirms the trend of leaving Germany as a business location". The survey's free-form comments section includes mentions of such "positive aspects" of Germany's energy policy as potential contributions to combatting climate change and protecting the natural environment (goals that Germans are reputed to be exceptionally intent on attaining), but it was noted that these did not reflect the majority opinion. The survey also included direct quotations of corporate representatives expressing their distress via such comments as – "Germany's deindustrialisation has begun, and no one seems to be doing anything about it." – and – "If organisationally possible, we will move (part of) our production bases to other countries." Such comments give a glimpse into the mind-state of German corporate leaders as they feel forced to deemphasize idealistic goals and realistically confront concrete challenges.

It is worth noting that many of the current difficulties faced by Germany's economy and society are often seen as a "negative legacy" of governments led during by Chancellor Angela Merkel, which embarked on the nuclear power phase-out program and promoted greater dependency on Russia and China. However, Chancellor Scholz's Social Democratic Party (SPD) was a coalition partner during 12 of the 16 years of Merkel-led governments, and it was the Scholz government that took the plunge and actually phased out nuclear power on April 15, 2023, when the country's energy situation was already considered dire. A public opinion poll conducted when the nuclear phase-out was being finalized found that 52% of respondents were opposed to the phase-out policy (as reported in the April 9, 2023 edition of Bild newspaper), so it would be difficult for the Scholz administration to claim it has not made a major contribution to Germany's current difficulties.

Comparison of Deindustrialization in Germany and Japan

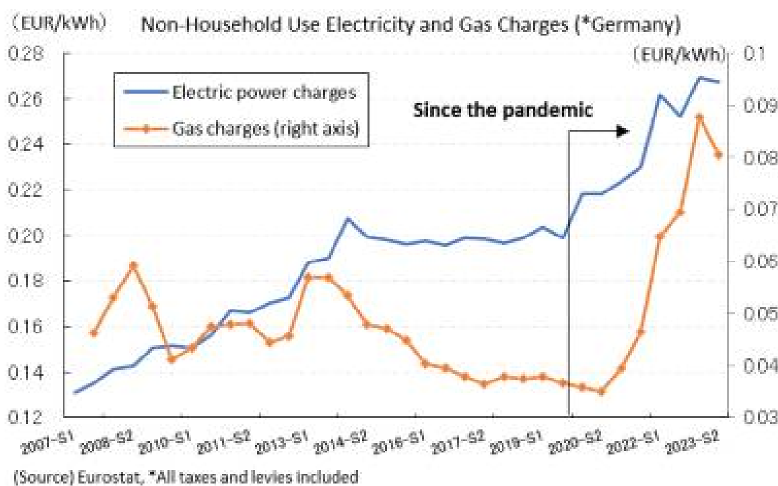
When thinking about the phenomenon of a major exporting country going through deindustrialization and then stagnation, one example that comes to mind is Japan. When Japan was struggling with the extraordinarily sharp JPY appreciation trend that followed the global financial crisis and the Great East Japan Earthquake of 2011, considerable attention was attracted by commentaries about six kinds of difficult challenges Japanese companies were facing. Specifically, these were: 1) the highly appreciated state of JPY, 2) delays in the arrangement of economic partnership agreements, 3) high corporate tax rates, 4) rigidity in the labor market, 5) environmental regulations, and 6) electricity shortages and high electricity costs. As I have repeatedly noted in this article and my books, it was around 2011-2012 that Japanese companies accelerated their overseas direct investments and Japan began regularly recording trade deficits (and Japan has not experienced an extraordinary JPY appreciation period since 2013). In mid-2011, when Japan's mood regarding its economy and other issues was the most gloomy, Teikoku Databank conducted a "Corporate Awareness Survey on Deindustrialization", and the top three deindustrialization-promoting factors cited by respondents were the "strength of JPY", "high labor costs", and "problems with electric power and other energy supplies". Concerns about the country's strong currency were particularly prominent, followed by labor costs and electricity costs.

Corporate Awareness Survey on Deindustrialization

Top 10 factors accelerating a shift out industry of Japan (multiple answers possible)	Ratio (%)
JPY strength	49.2
High labor costs	39.5
Electric power, etc., energy supply problems	37.9
Tax systems (corporate tax/preferential tax systems, etc.)	28.3
Overseas shift of business partners	26.5
Population decline	23.4
Emerging economy/overseas market growth potential	22.4
Economic globalization	21.4
High raw material procurement costs	12.9
Forex risk hedging	12

(Source) Teikoku Databank's "Corporate Awareness Survey on Deindustrialization," August 3, 2011
*The suvey period was 19-31 July, 2011. 23,065 companies from around Japan were surveyed, and 11,006 companies provided valid responses.

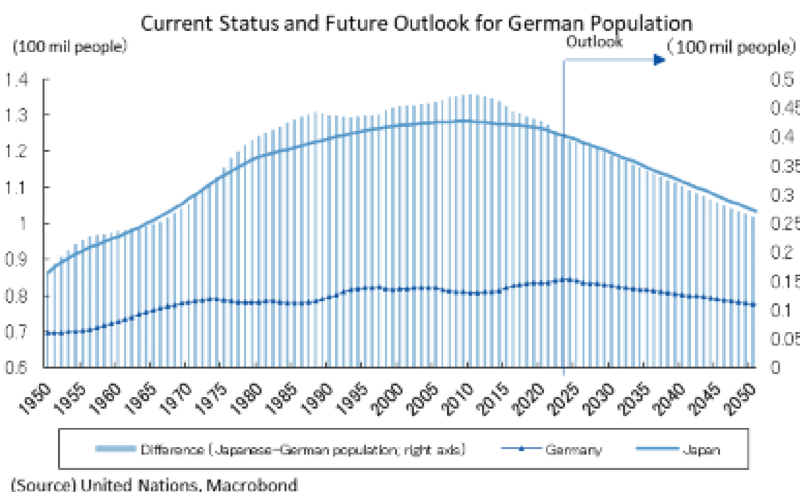
It is likely that both Japanese and German companies' representatives will give similar responses when asked about factors promoting an industrial hollowing-out trend, and the most of responses will include the three factors cited above. Given the nature of EUR, German companies have no need to worry about the kind of excessively strong currency situation faced by Japanese companies, but they must deal with more-acute problems with electric power and other energy supplies than Japanese companies. There is no need to confirm the views of German companies, which have already been elucidated in the DIHK survey, and there have clearly been very sharp rises in German energy costs with respect to both electric power and gas (see graph). Those cost increases are finally showing signs of peaking out, but compared to pre-pandemic levels, gas prices as of the end of 2023 remained about 2.2 times higher and electric power prices about 1.3 times higher. Although it can be argued that the disruption of natural gas procurement due to the deterioration of relations with Russia was somewhat unavoidable, it is difficult for the German corporate sector to accept the idealistically inspired political decision to stop operating nuclear power plants while disregarding the severe challenges higher energy costs present to domestic companies. In response to this situation, the German government presented a "10-Point Plan for Germany as a Business Location"[2] on August 29, 2023, but this plan merely declared such goals as maximizing the utilization of renewable energy and hydrogen, which had already previously been repeated in a manner akin to mantras. Even if the plan proves to facilitate long-term solutions (though even that is doubtful), it will certainly not be effective in suppressing energy prices in the short term.



(Source) Eurostat, *All taxes and levies included

Germany to Suffer the Same Fate as Japan?

The current situation is one in which German companies have lost patience with political decisions exacerbating the challenges they face and are generally considering the reduction of domestic production operations and the shifting of those operations to other countries, but I remain optimistic about Germany's ability to avoid following in Japan's footsteps. First, while the United States and China are Germany's largest export destinations outside the euro area, EU markets still account for more than 50% of German exports. Even focusing on exports to euro area countries, which are not susceptible to exchange rate risks, such exports account for just under 40% of German exports. So roughly 40% of Germany's exports are free of exchange rate risks and exempt from tariffs and non-tariff barriers (and geographic proximity enables relatively low transportation costs), which is an advantage that Japan does not have. In addition, the Japan-Germany population-size gap is clearly shrinking and, assuming that the UN population forecast is accurate, the gap may narrow to about 2.6 million people by 2100. Labor shortages are a key factor making it difficult for Japan to maintain its export base power, and Germany has a clear advantage in this regard.



(Source) United Nations, Macrobond

However, the question of whether Germany will become like Japan is also a question of whether Germany will become a trade deficit country, and that remains a distant scenario for Germany. Yet if no consideration is given to amending the nuclear power phase-out policy and relations with Russia and China remain as they are, Germany will have no choice but to accept some degree of progressive deindustrialization. This suggests that the country boasting the world's largest trade surpluses may be at a crucial turning point, and it is fundamentally important to

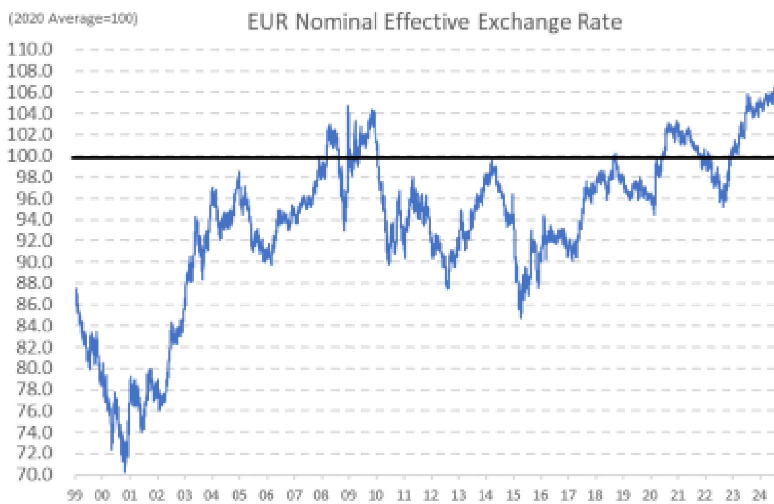
(Source) macrobond

2 German Government "Kabinettsklausur: 10 Punkte für den Wirtschaftsstandort Deutschland vorgestellt" August 29, 2023

consider what direction Germany will turn at this point when considering the medium- to long-term value of EUR. Although Germany's challenges may not be as great as Japan's, the recent news about VW's plans is also focusing attention on how Germany's economic evolution may affect EUR, which has enjoyed a solid supply-demand structure to date. For example, there seems to have been a fairly stable relationship between Germany's trade balance and EUR exchange rates (see graph), and it is noteworthy that Germany's trade surplus was at an exceptionally low level when EUR fell below parity with USD. (Germany was on the verge of recording a trade deficit in 2022.) The extent to which Germany can maintain its power as an export base is an important issue from the perspective of the forex market.

EUR Strength and Germany's Industrial Hollowing Out

As mentioned above, a main reason for VW's decision to close a factory in Germany was the soaring cost of energy, which reflects idealistically driven political mismanagement promoting a phase-out of nuclear power and a shift to renewable energy sources and other energy sources that are relatively expensive and unstable. However, some observers are arguing that, in addition to energy costs, the strength of EUR is an important factor promoting Germany's industrial hollowing out. Indeed, following a period of interest rate hikes following the start of the Russia-Ukraine war, EUR's nominal effective exchange rate (NEER) has continued to reach new all-time high levels (see graph). As discussions about EUR exchange rates mainly focus on EUR/USD and EUR/JPY, this NEER trend is an underappreciated aspect of EUR exchange rates. There is also a general tendency to compare Germany's experience directly with Japan's, as JPY's persistently excessive strength during a certain period was one of the factors behind Japan's industrial hollowing out.

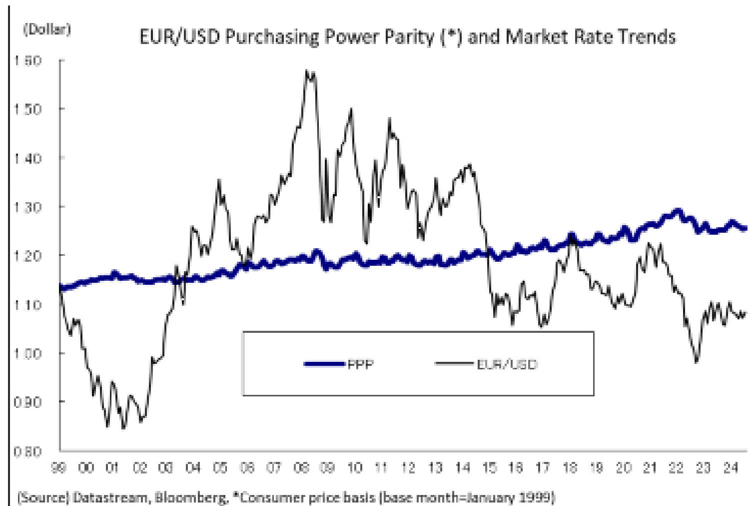


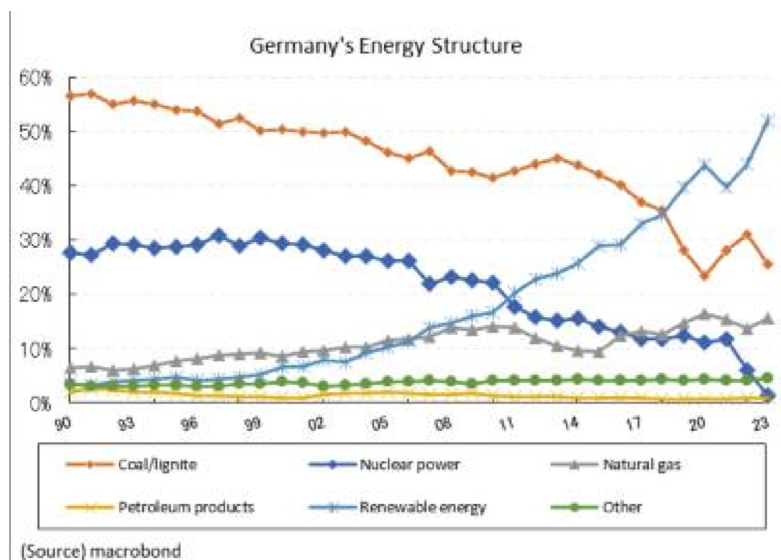
(Source) macrobond, until August 27, 2024

However, that comparison is too simplistic. The fact that EUR's value is high by historical standards is an issue quite separate from the question of whether EUR's value is so high that it presents challenges to German companies. There is no way that EUR could be considered too strong for Germany – the world's third largest economy (fourth until last year) – and arguments that EUR's strength is an important factor explaining the recent surge in Germany's outbound foreign direct investment (German companies' shift of production to bases in other countries) are not convincing. Given that EUR is also used in Greece and Italy, it is theoretically not expected that EUR would strengthen to a level that Germany would find too strong. If EUR had risen so much that German manufacturers were forced to consider undertaking foreign direct investments, it would be strange if Italy and other southern European countries had not started to cry out in distress much earlier. The graph shows movements in the ECB's Harmonized Competitiveness Index (HCI), which is published quarterly. Simply put, this index is calculated by taking the real effective exchange rate (REER) of individual euro area countries and adjusting the REER based on each country's unit labor cost (ULC) level in order to clarify the significance of labor costs, which have in recent years attracted attention as a factor affecting competitiveness. As the graph shows, Germany's HCI has basically remained relatively low and stable since the introduction of EUR. Compared to southern European countries, which have experienced sharp HCI rises since the introduction of EUR, particularly following the European debt crisis, it can be said that Germany's domestic manufacturing industry has long enjoyed the benefits of a stably cheap currency.

(Source) ECB, unit labor cost (ULC)= nominal employee wages/real GDP

With EUR's Nominal Value Being Below Its PPP Level, the Key Factor is Energy Source Structure





Incidentally, although EUR's NEER is reaching all-time high levels, EUR's purchasing power parity (PPP) level against USD is roughly in the 1.25-1.26/1 range, and the current nominal level of EUR against USD is more than 10% lower than that. It does not appear that EUR has appreciated to the point that it would seem overvalued from Germany's perspective, so it would seem strange to argue that EUR's strength is a major cause of Germany's industrial hollowing out process. This is particularly clear when one considers that about 40% of German exports are exported to euro area countries without being affected by exchange-rate risk factors, and the share of German exports exported to EU countries is about 60%. Essentially, it should not be expected that EUR's strength would be sufficient to motivate German companies to shift their operations out of Germany at great cost. As already mentioned, because of its acceptance of a large number of immigrants, Germany has no worries about population decline, and the country is also positioned to procure additional supplies of labor from Eastern Europe. Discussions of industrial hollowing out in Japan need to address several key issues, particularly those related to exchange rates and demographics, but Germany's industrial hollowing out stems overwhelmingly from the energy policy factor. Germany's energy structure has been distorted by the nuclear phase-out policy (see graph, below right), and one can only wonder whether associated problems will be effectively addressed by the country's current government, or by the next government that will be formed after next year's general election. Putting aside such exogenous factors as relations with Russia and China, the question of whether or not the Germany's idealistic energy policy will change will be a crucial determinant of whether the country's increasing economic weakness will continue inspiring the "sick man (of Europe) returns" media theme.

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