Forex Medium-Term Outlook

October 30, 2024

Overview of Outlook

USD/JPY rose consistently in October. Given that speculative positions had been tending toward JPY long positions, it was natural that the rollback of these speculative positions would force JPY to weaken. The momentum of the trend exceeded this report's expectations, but the question now is – will JPY continue to weaken even after JPY long positions have disappeared? JPY depreciation during 2022-2023 was supported by a range of factors, including speculative JPY selling encouraged by interest rate differentials, JPY selling by both institutional and individual investors, and Japan's enormous trade deficit. This is what resulted in a weak-JPY phase of such magnitude and persistence. Looking at the JPY supply and demand environment today, the cumulative current account balance on a cash-flow basis posted a deficit of about -JPY 2.9 trillion for the January-August period 2023, but has recovered to post a surplus of about +JPY 1.9 trillion for the same period this year. Even if JPY falls sharply as a result of the unwinding of speculative long positions, I am doubtful of the trend's sustainability from a supply and demand perspective. For JPY to continue weakening over a longer period, there must be reason to believe that interest rate cuts by the Fed, interest rate hikes by the BOJ, or both, will no longer take place as expected. However, there is no certainty regarding either of the above at the present time. The issue of the Fed suspending interest rate cuts could become pertinent during the second half of the coming year, and at that time, we will discuss the resumption of JPY depreciation once again. One of the areas of expectation from the government and ruling party, which suffered a major setback in the recent general elections, is the revision of the government-BOJ joint statement ("Accord"), which would be an easy and fundamental way to address rising prices. Japanese people no longer need to worry about deflation. They need to shift their concern to curbing weak-JPY-induced inflation.

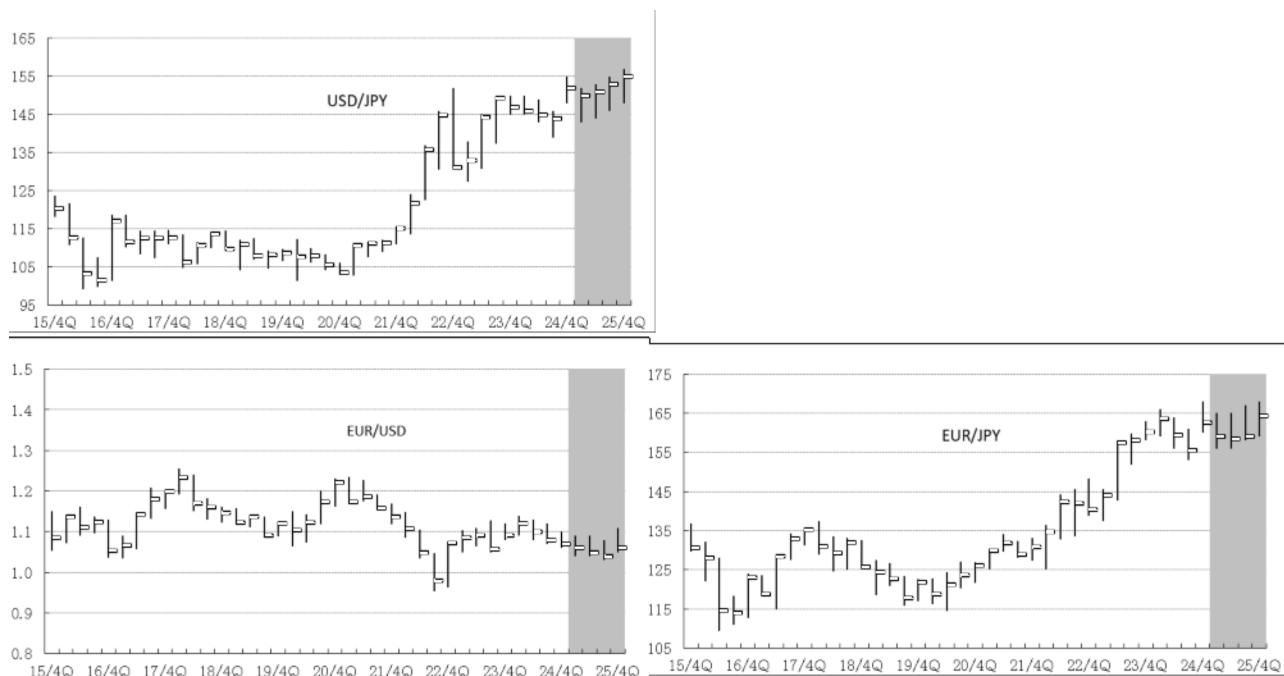
Meanwhile, EUR weakened in October. The headwinds are clearly getting stronger against EUR. Going by the current state of fundamental economic indicators, there is a marked expansion in the gap between Europe and the U.S. The expected path for interest rate cuts by the ECB for the foreseeable future is a single 25bp rate cut by the end of this year, and two 25bp rate cuts (a total of 50 bps) during the January-March period of 2025. The need for rate cuts is backed also by the ECB staff macroeconomic projections (revised in September), given that the September HICP, which fell below +2% for the first time in three years and three months, was below the base scenario. The good news is that, compared with recently, when the ECB was struggling with stagflation, uncertainty has receded, making it clear what path the ECB must take. By contrast, even if a November rate cut by the Fed is a given, the U.S. economy is strong enough that no guarantees can be made for December and beyond. There is an all-too-clear contrast between the euro area, where a return to a recession scenario, centering around Germany as the leader, is being discussed, and the U.S., where a "no-landing" scenario (avoiding a recession) is being discussed. This is likely to be directly reflected in the interest rate differential between Europe and the U.S., and ultimately in EUR/USD. The focus will be on whether EUR/USD could fall below 1.05 in the year ahead.

Summary Table of Forecasts

	2024		2025			
	Jan-Oct (actual)	Nov-Dec	Jan-Mar	Apr-Jun	Ju-Sep	Oct-Dec
USD/JPY	139.58 ～ 161.96 (153.25)	148 ～ 155 (152)	143 ～ 152 (150)	144 ～ 153 (151)	146 ～ 155 (153)	148 ～ 157 (155)
EUR/USD	1.0601 ～ 1.1214 (1.0822)	1.06 ～ 1.10 (1.07)	1.04 ～ 1.09 (1.06)	1.04 ～ 1.09 (1.05)	1.03 ～ 1.08 (1.04)	1.05 ～ 1.11 (1.06)
EUR/JPY	154.44 ～ 175.42 (165.85)	160 ～ 168 (163)	156 ～ 165 (159)	156 ～ 165 (159)	158 ～ 167 (159)	159 ～ 168 (164)

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

Exchange Rate Trends & Forecasts



USD/JPY Outlook - Has Weak-JPY Trend Re-started?

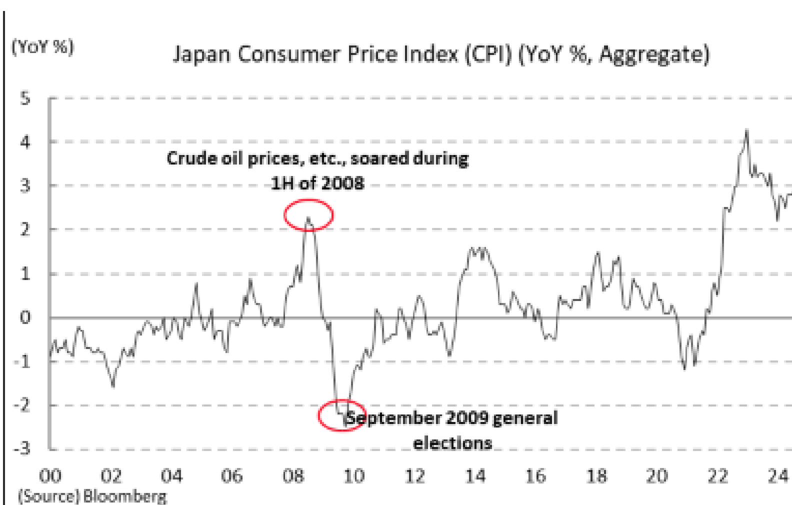
Japanese Politics Now and Going Forward - Time to Reconsider "Deflation" as a Political Issue

Realization of My Risk Scenario; High Prices a Harsh Political Reality

As previously reported, the general election ended with a major defeat for the ruling party.

Since I appeared on TV Tokyo's election special program, I paid close attention to voting and counting trends as well as comments by leading figures. What was striking was that the expressions on the faces of not only Prime Minister Shigeru Ishiba, but also opposition party leaders such as the president of the Constitutional Democratic Party (CDP), Yoshihiko Noda, and Leader of the Democratic Party for the People (DPFP), Yuichiro Tamaki, who had made great gains, were gloomy. Going by their responses, it seemed clear that they were aware that the results reflected voter displeasure with the Liberal Democratic Party (LDP) owing to the slush fund scandal, rather than a preference for the opposition parties. Perhaps, given that the opposition did not emerge as the largest party relative to the others, they were unhappy about the political instability that awaited going forward. I made some comments during the program, but one that subsequently provoked a major public response was a comment to the effect that, since the LDP-Komeito coalition losing majority, which was categorized as a risk scenario in the financial market, had come true, the first market reaction might be an all-out "Japan selling," resulting in a "triple depreciation" (of JPY, stocks, and bonds).

This is a point I have discussed many times in this report even before the election. In the event, there has been no triple depreciation as of the morning of October 30, Japan time, when this report was written, as JPY has depreciated, but stocks have appreciated, and bonds have depreciated (interest rates have risen). One possible interpretation is that the markets had already factored in a loss of majority for the LDP-Komeito coalition, or perhaps it simply reflected JPY weakness. Incidentally, some seem to interpret this as a revival of "Takaichi trading," a move in anticipation of the next political development. However, given the major setback for the ruling party and obvious political instability going forward, one wonders about the sustainability of high stock prices. In the context of its recent crushing defeat, the LDP's fall from power in September 2009 is being widely cited. At that time, it was said that the ultra-strong JPY trend in the wake of the Lehman Brothers' collapse, and the resulting slowdown in domestic economic growth had heightened public displeasure with the government and ruling party. However, that election came in the wake



of several confirmed price rises during the year before, including the Consumer Price Index (CPI) surging to well over 2% after oil prices had soared to over $140 per barrel (see figure). This time's general election was also held amid a sharp increase in CPI over the past two years, with rising prices becoming a major issue. As in the case of Europe and the U.S., it may be that general elections held at a time when the public is struggling with rising prices tend to result in harsh judgments against the ruling party.

Cooperation with Opposition may be Difficult

Nothing can be said for certain yet as the details of the new administration are yet to be revealed, but the Executive branch, led by Ishiba, will have to accept responsibility for the LDP and Komeito failing to secure a simple majority, which is a requisite for election victory. In this regard, as of now, Ishiba has indicated that he intends to continue in office while hinting at the possibility of cooperation with some of the opposition parties. The defeat for the ruling party has been so devastating that simply re-endorsing candidates who had run without the party's endorsement or taking in independent candidates will not be sufficient to achieve the required numbers, but cooperation with the opposition parties will not be easy. First, it goes without saying that the CDP, the main opposition party, will not join an LDP-Komeito administration, but the DPFP and the Japan Innovation Party (JIP) have also stated that they have no intention of doing so. As in most countries, while it is certainly possible for an opposition party that has previously cornered the ruling party on various issues to offer a helping hand in the form of a partial coalition and get involved in running the government, such a thing does not usually happen, as that would rob the opposition party of its raison d'être. For many years, the Social Democratic Party (SPD) of Germany was forced into a situation where its raison d'être was called into question as it joined hands with the Christian Democratic Union (CDU) led by former Chancellor Angela Merkel as its junior partner. Lightly cooperating with the ruling party could lead directly to a loss of strength for an opposition party, so it is not easily accepted.

Has Monetary Tightening Gained Acceptance?

From the perspective of the financial markets, one must also consider the implications for monetary policy operation. Leaving aside the market reaction immediately after the election, an important issue is how to interpret the CDP's campaign promise to "change the BOJ's price stability target from 2% to above 0%," which sparked debate in financial markets. Even if the main cause of the LDP's crushing defeat this time was the slush fund scandal, the suffering of the people due to high prices has certainly eroded their approval rating (in fact, this may be the main cause). The public also probably understands that the weak JPY was behind it. While this is only speculation on my part, it seems that more and more people are beginning to understand that the BOJ's accommodative monetary policy has been an indirect cause of JPY weakness. The LDP's campaign promise this time did not clearly include a message about monetary policy operation, but it was widely reported that Ishiba had expressed a desire to continue with an accommodative monetary policy immediately after taking office.

Even if it is true that the LDP's slush fund scandal was one of the reasons for the CDP's big electoral gains, given that the CDP has a strongly hawkish image when it comes to fiscal and monetary policy operation, it may be time for Japanese politics to come to terms with the importance of gradually raising JPY interest rates rather than promoting monetary accommodation to please the financial markets. It must be mentioned, of course, that there tends to be some public opposition to interest rate hikes even in the U.S. and the euro area, but central banks, which are independent of politics, simply go ahead and make whatever decision is necessary, and this is what is expected in Japan as well.

Of course, there is some scope for reconsidering the "above 0%" price stability target pledged by the CDP as it is too extreme in terms of wording. There is certainly room for revision of the current Accord between the government and the BOJ, which aims to achieve price increases "as soon as possible" and is probably not healthy. Even if it would be politically difficult for the government and ruling party to boldly ask the BOJ to raise interest rates, revising the Accord is something that can be done directly and without significant cost. Specifically, deleting the phrase "as soon as possible" or replacing it with "in the medium to long term" are desirable measures. Amending the Accord is one of the easiest measures the new administration could undertake, not to mention one of the most fundamental ways to address rising prices.

DPFP Played the Game Cleverly

At any rate, it takes political courage to talk about the need for a hawkish monetary policy. In this regard, the DPFP came up with the clever strategy of capturing the support of young people with its slogan of increasing the take-home pay. This slogan addresses several policy issues at once. In addition to addressing the issue of social security costs, which should be the core of reform, it also serves as a check against monetary easing, which is pushing down real wages and contributing to JPY depreciation. Further, it relates to Japan's energy policy with a view to restarting the nuclear power plants (the DPFP favors using nuclear power). It is highly likely that the DPFP will continue to use its "increase the take-home pay" slogan going forward, and that is not a bad thing.

As mentioned above, unless Japan finds a way to change its attitude toward "deflation" as an idea, many people will feel forced to continue participating in political arguments for overcoming deflation with a strong sense of discomfort. In the current situation, ending the weak-JPY trend (which is the indirect cause of low real wage growth), and the persistently low JPY interest rates that come as a set with it, may seem like a roundabout way to restore real economic growth, but it is in fact the orthodox solution. Given the recent election results, where the LDP, with its emphasis on "exiting deflation in three years," suffered a major setback, while the CDP, which stressed the need for reversing monetary accommodation, and the DPFP, with its message of increasing the take-home pay (i.e., real wages), made great strides, it seems obvious that the tired-old message of overcoming deflation no longer resonates with most people. The issue at stake is no longer deflation, but inflation. Without diagnosing the problem accurately, the right prescription cannot be given.

The People Want to Overcome Inflation, not Deflation

To repeat myself, what the people really want is probably to overcome inflation, not deflation. Given that measures to combat rising prices have become a major political issue and there is a need to ensure consistently positive real growth wage, the BOJ's reluctance to raise interest rates and the accompanying rise in USD/JPY are clearly unnatural. What is holding the Japanese economy back at the present time is rising prices (inflation), rather than stagnant prices (deflation). This can be confirmed from the disparity between nominal and real GDP (see figure). However, in a situation where rising prices (inflation) are a major concern, it is not easy for the government to declare the end of deflation. This is because such a declaration is likely to increase the household sector's resentment of the administration, since life remains difficult (despite the end of deflation). That is why the Fumio Kishida administration never managed to declare the end of deflation despite intermittent smoldering of such expectations. Deflation – whether setting targets to overcome deflation or declaring the end of deflation – is a thorny issue when it comes to managing public sentiment, which is complicated regarding the issue. Still, I would like to see the government go ahead and declare the end of deflation.

(Source) Macrobond

Understanding the Definition of Deflation

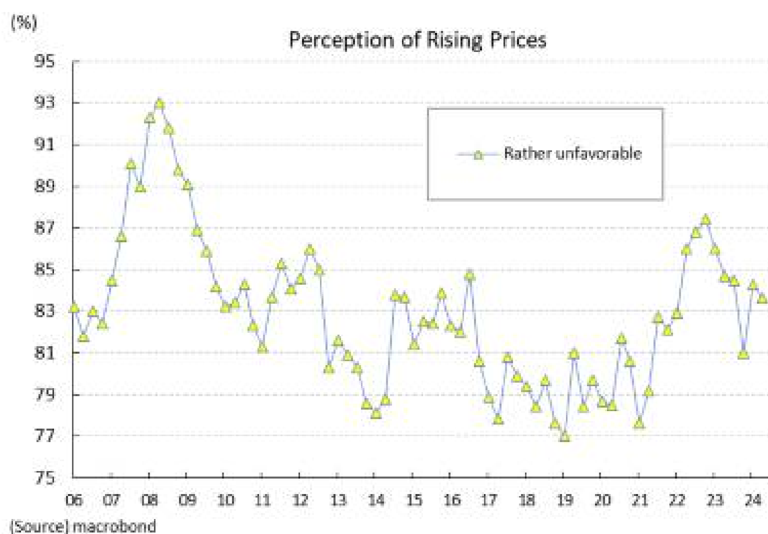
Why is the situation surrounding deflation so difficult? I believe it is mainly because the definition of deflation has been left vague. In Japan, deflation has become a catch-all term to describe a situation in which the economy is generally lackluster, and it tends to be thrown about casually by all economic entities. However, different economic entities seem to use it to mean different things (see figure). Since the late 1990s, deflation has meant "a sluggish CPI" for the government and the BOJ, a protracted period of "JPY strength and falling stock prices" for companies, and similarly "JPY strength and falling stock prices" for overseas investors. Before the launch of "monetary accommodation of a different dimension" in 2013, the Japanese economy was seen as being chronically plagued by JPY strength and falling stock prices. In fact, most of the BOJ's additional monetary easing measures were implemented to counter JPY strength and falling stock prices. Chronic JPY strength also suppressed import prices, making it difficult for general prices to rise (of course, JPY strength was not the only reason for prices not rising). At least until about 10 years ago, the word deflation was a very convenient term that expressed the greatest common denominator for many economic entities.

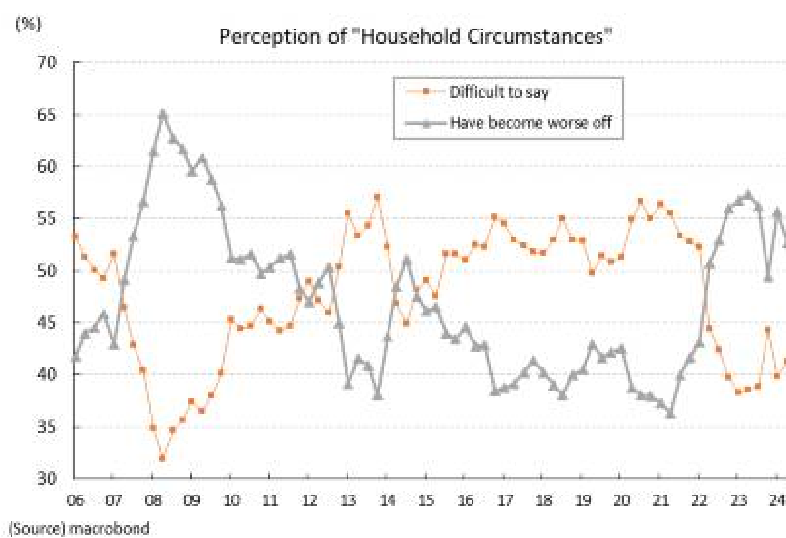
Different Economic Entities' Image of Deflation

Entity	Image of Deflation
Government/BOJ	Sluggish CPI
Corporations	JPY strength, weak share prices
Households	Low real wage growth
Overseas investors	JPY strength, weak share prices

(Source) Author

In particular, the government and the BOJ put all their efforts into solving the superficial problem of a sluggish CPI through Abenomics, which was symbolized by monetary easing of different dimension implemented by the BOJ under Haruhiko Kuroda. As a result of this, thanks to the continued monetary accommodation, the recent JPY depreciation (caused partly by the former), and high impact prices, the superficial problem of sluggish CPI growth has been resolved, with JPY weakness also serving as a catalyst for rising stock prices. At the present time, therefore, it is completely safe to say that we have successfully overcome deflation in all the senses of the term, whether it be sluggish CPI, or JPY strength and falling stock prices.





The household sector (i.e., the general public), however, probably feels strongly betrayed in that this is not how they expected things to turn out. This is because, for the household sector, deflation has meant sluggish real wage growth. According to the BOJ's Opinion Survey on the General Public's Views and Behavior (September issue), 83.6% of respondents' perception of rising prices were "rather unfavorable" (see figure). Under such circumstances, could anyone expect the public to be grateful to the government for aiming to "fully overcome deflation"? Rather, such statements are only likely to arouse resentment. Further, when asked specifically about "household circumstances," 52.7% of respondents answered that they "have become worse off." As the figure shows, the response rate for the above response seems to have risen a notch since the start of the current JPY depreciation phase (March 2010). Incidentally, going back to the previous question, a majority have always responded that they had a "somewhat unfavorable" perception of rising prices. In fact, the only reason the price stability target had public support was because it remained unachieved, but now that it has been achieved, people feel betrayed and are turning their backs on it. One learning of the past decade, it can be said, is that monetary policy decisions should not be determined by public opinion.

The government and the BOJ do not see eye-to-eye with households on deflation. There seems to be a difference in perception regarding prices, with the former wanting them to rise and the latter not wanting them to rise (it is also true that the household sector does not have a precise understanding of deflation as a concept). For many years, Japanese households have been forced to accept no rise in wages, either on a nominal or real basis. The idea that we need to overcome "deflation" seems firmly established in the consciousness of the household sector based on the misperception that deflation is a situation symbolized by chronic recession and low real wages. Until recently, this misperception was not problematic, but with the emergence of inflation, it has become apparent that the household sector's understanding of the term "deflation" is different from that of the rest of the economy.

End Use of the Term "Deflation"

Since taking office, whenever Ishiba has spoken about "overcoming deflation," he has probably had in mind the household sector's definition of deflation as "low real wages," rather than the government/BOJ's definition as "sluggish CPI." If that is indeed the case, his awareness is spot-on. However, his real intent appears to have escaped a large number of people. Taken at face value, his message is inevitably viewed as a call to further increase prices, so the more Ishiba emphasizes overcoming deflation, the greater the household sector's resentment against him for being clueless.

Going forward, having explained that deflation in the sense of "sluggish CPI" has ended, the government could gradually back off from using the term, thereby putting an end to its use altogether. It could declare the end of deflation in one fell swoop while further stressing that the real issue now is to overcome inflation and resolve the associated low real wage growth. This will eliminate the need for unnecessary restraints on the BOJ against raising interest rates, thereby inviting further JPY depreciation. It will also eliminate the need for damage control through currency policy.

In any case, unless there is a change in the way people think about deflation, many will be forced to continue participating in the political debate on overcoming deflation with a strong sense of discomfort. The consequence of this will be a crushing election defeat for the government and ruling party of the time. The only way out of this situation is to accept either JPY weakness or an interest rate hike regardless of which party is at the helm. Given that the exchange rate is not easy to control, I think it is important to accept a gradual rise in interest rates to release some of the JPY-depreciation pressure.

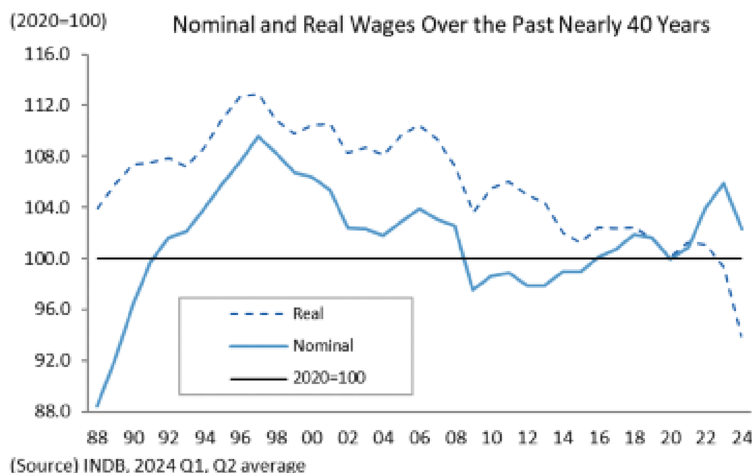
Of course, I understand that it would be difficult for the BOJ to implement consecutive interest rate hikes. However, what can be done is for the government to refrain from political meddling in the BOJ's operations, as that risks causing an unnecessary JPY weakening. As JPY weakness promotes sluggish real wage growth, it is bound to invite the displeasure of the household sector and will ultimately result in a critical view of the government. The BOJ is currently attempting to move toward policy normalization while assessing the domestic and international financial situations. While

there is no need to actively support an interest rate hike, there is also no need to make it more difficult to assess the need for one by causing a stir.

Japanese Economy Now and Going Forward -- Rising Awareness of Inflation as a Problem

Real Wage Growth Turns Negative

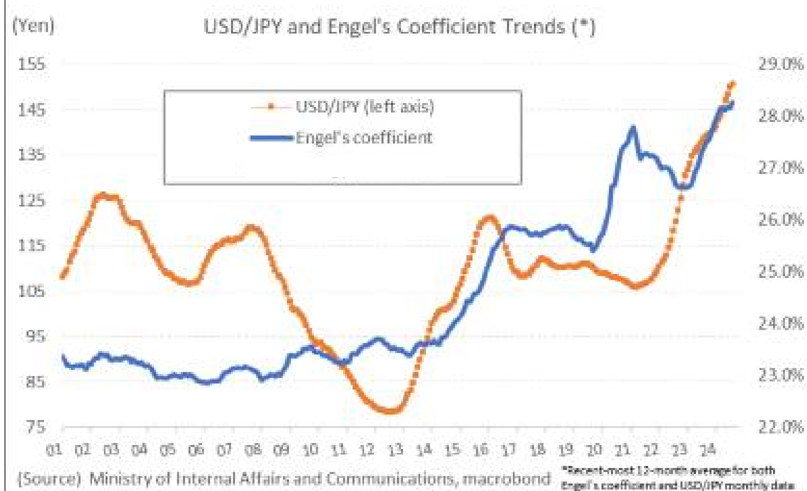
Let us turn our attention to Japan's economic situation. In the August Monthly Labor Survey released by the Ministry of Health, Labour and Welfare, Real Wage growth (Preliminary, Establishments with 5 or more employees) fell to -0.6% yoy, the first negative growth in three months. The June figure made the news headlines as it was the first positive growth in two years and three months since March 2022, and the positive growth trend was maintained in July, but June and July figures also reflected a temporary boost from special cash earnings, i.e., bonuses. In August, Contractual cash earnings (i.e., wages including scheduled cash earnings, overtime pay, holiday allowances, etc.), an important item for judging sustainability, grew by +3.0% yoy, the highest in 32 years and four months, but Real wages were pushed into negative growth as CPI excluding imputed service of owner-occupied dwellings accelerated from +3.2% yoy in July to +3.5% yoy in August (see figure). Of course, a closer look reveals some positive trends, such as positive growth in Real wages for part-time workers and continued positive growth in real wages on an hourly basis, but it is clear that the rise in general prices due to high import prices as a result of JPY weakness and high resource prices is hurting incomes for the household sector.



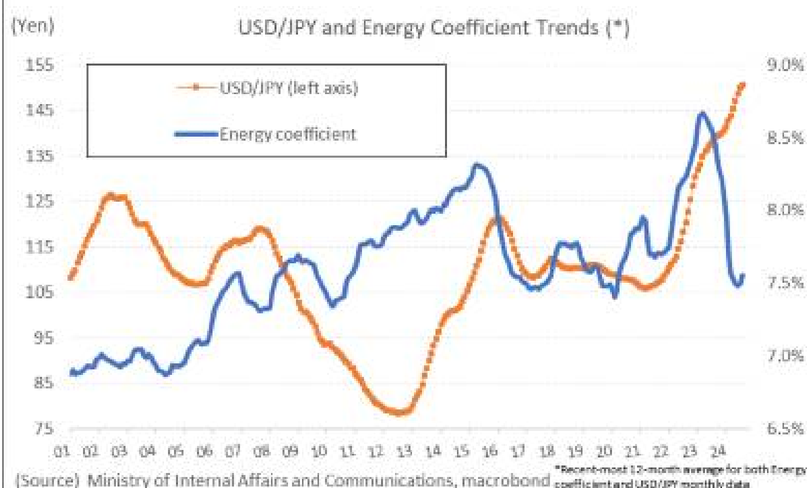
(Source) INDB, 2024 Q1, Q2 average

Engel's Coefficient Hits Record High

That households are experiencing inflation rather than deflation is particularly obvious from the fact that expenditure toward daily necessities is expanding. The Nihon Keizai Shimbun reported on October 18 in an article titled "Engel's Coefficient Hits 42-Year High at 28% of Household Spending" that the ratio of food expenses in household consumption expenditure has risen to a record high. Regarding Engel's Coefficient (expenses toward food ÷ total consumption expenditure), as calculated from the Family Income and Expenditure Survey (two-or-more-person households), the headline figure of 28% is based on the average for the period from January through August (28.1%), but is even higher for August alone, at 30.1%, or in terms of the 12-month average, at 28.3%. This is a level that has not been seen since the start of the period dubbed the "three lost decades" (starting the second half of the 1990s), and is a development that portends a shift from deflation to inflation. The lower the income bracket, the higher the proportion of spending on necessities such as food and energy, and with disparities said to be widening in Japanese society, political choices will inevitably begin to lean toward handouts.



(Source) Ministry of Internal Affairs and Communications, macrobond



(Source) Ministry of Internal Affairs and Communications, macrobond

Further, the Ministry of Agriculture, Forestry and Fisheries has announced that Japan's food self-sufficiency rate for fiscal 2023 was 38%, and even the calorie-based domestic food production rate was 47%. In other words, Japan currently depends on imports for about 50 to 60% of its food requirements, the cost of which will undeniably increase as JPY weakens. The same argument applies to the ratio of spending toward energy (electricity, gas,

kerosene, gasoline). This point is one that does not require much explanation. Currently, Japan's energy self-sufficiency rate is around 13%, meaning that just under 90% is dependent on imports, and as expected, costs will tend to increase as JPY weakens. The ratio of energy expenditures to household consumption expenditures (the energy coefficient) was in the upper 8% level from the end of last year to the beginning of this year, which is historically high. Since then, it has returned to the lower 7% level thanks to subsidies, etc., but this comes at the cost of fiscal spending and cannot be considered sustainable. Some commentators still have a negative knee-jerk reaction to the term "undesirable JPY weakness," but the reality is that JPY weakness has increased the poverty of the Japanese household sector.

Handouts Ultimately Have the Reverse Effect

Under such circumstances, it is only natural that politicians, who are extremely sensitive to public opinion, should come up with measures to combat rising prices as an election issue, regardless of whether they belong to the ruling party or the opposition. In doing so, most politicians realize that there is no room for doubt whether JPY depreciation is good or bad, and that correcting JPY weakness is the key to combating rising prices. However, they also realize that another way of saying JPY weakness should be corrected is to say that the BOJ should push forward with policy normalization, which is not an easy thing to say during election season. Consequently, they are forced to talk about cash handouts instead. However, have repeated cash handouts boosted Japan's real growth rate? As already mentioned, the gap between nominal and real GDP remains very large even from a historical perspective. Also, an expansionary fiscal policy will likely become an excuse for overseas investors to sell JPY, so even if the pain of high prices is alleviated by cash handouts, it will ultimately be offset by higher prices as a result of higher import prices resulting from JPY depreciation. When it comes to combating rising prices, measures such as handouts and tax cuts have very limited short-term impacts and may even be counterproductive in the medium to long term. Efforts to correct the widening gap between domestic and foreign interest rates are necessary even if they do not eradicate the root cause of JPY weakness. We may have no choice but to accept a gradual rise in interest rates going forward. As already explained, it would be reasonable to start by revising the Accord between the government and the BOJ, which is not altogether healthy.

BOJ Monetary Policy Now and Going Forward -- How to Interpret "Above 0%"?

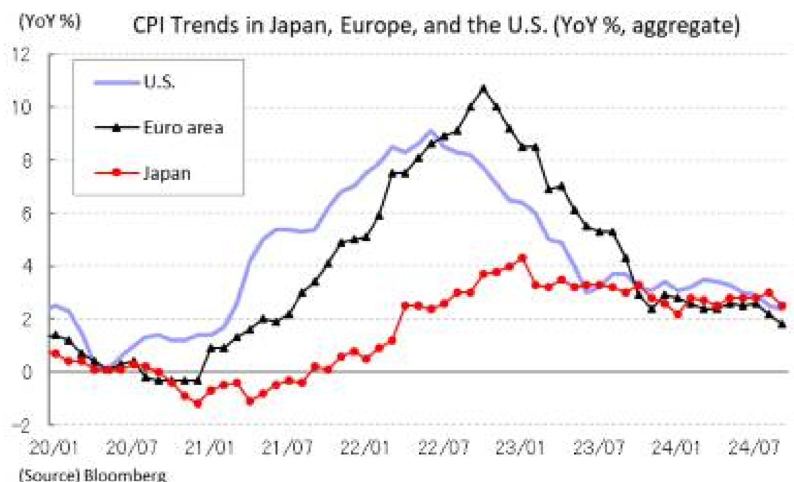
Interpreting "Above 0%"

Post the general elections, the financial markets are focusing on the new administration's measures to combat high prices (which are also of great political interest) and the associated monetary policy direction. The CDP's campaign promise included "adopting a new monetary policy," and its proposal to change the BOJ's price stability target from "2%" to "above 0%" attracted some attention. While not everybody agreed with this proposal, ultimately, the CDP's seats increased significantly. How should this proposed change in price stability target be interpreted? Since this is a topic that will remain important going forward, I would like to present my impressions here.

I think the idea has advantages and disadvantages. The disadvantage is that the wording (of revising the price stability target from "2%" to "above 0%") could unnecessarily give the impression of hawkishness on the part of the BOJ. Since 1.8% or 1.5% are also above 0%, "above 0%" does not in itself indicate an excessive tightening. However, the words "above 0%" have a big impact. Unfortunately, market participants and ordinary people judge the merits and demerits of monetary policy operation based on first impressions. The excessively simple wording could cause an unexpected JPY appreciation and fall in stock prices due to unintended hawkish interpretations. In fact, the proposal has predominantly received criticism as being "too hawkish."

On this point, former CDP leader Kenta Izumi has been forced to explain on X: "I meant to say 'in the positive range' rather than 'around 0%.'" The CDP shadow cabinet's Minister of Finance and Financial Services Takeshi Shina also posted on X, saying, "It is clearly a misunderstanding. Our aim is to achieve positive real wage growth, not 0% inflation," and "We are not aiming for 0% inflation; if the real wage growth rate is positive, even a 2% inflation rate is no problem." Further, in interviews with the Nihon Keizai Shimbun and other publications, CDP Leader Noda has said, "Our intent was to say that, so long as the inflation rate does not fall below 0%, it is better to have flexibility in our efforts to overcome deflation." In short, it is clear that the CDP's proposal was to stop fixating on the 2% target. While the choice of words was bad, their awareness of the need for flexibility is good.

As I have already pointed out, the biggest problem with the current Accord on the price stability target is the part about aiming to achieve it "as soon as possible." There is no doubt that this mission of "as soon as possible" created a situation where the BOJ could not back down, and this became the indirect cause of irrational monetary policy operation symbolized by yield curve control (YCC). With the birth of the Kuroda administration, this Accord led to policy operation that encouraged the expectation (or rather misunderstanding) that the BOJ would double the monetary base in two years and achieve a 2% inflation rate. However, there is no overseas precedent for incorporating a timeframe for achieving the target inflation rate. The choice of words



(Source) Bloomberg

(“above 0%”) notwithstanding, Noda’s awareness of the need for flexibility in efforts to overcome deflation is commendable. In fact, despite the CPI being above 2% for over two years now (see graph), the end of deflation has not been acknowledged, and the pace of interest rate hikes is also quite slow, indicating that Japan’s inflation target is, in reality, quite flexible. In such a scenario, it would be better to use a more appropriate expression.

“2%” Because it is the Norm

Ordinarily, it is considered good to achieve inflation targets “over the medium to long term.”
For example, the ECB uses the words “over the midterm,” but it is unclear how long that period is. There is no point clarifying the exact length of time, since pursuing time-related transparency would only impose an unnecessary strain on policy operation. Given that the 2% inflation target, which is the current global standard, is not based on any strict theoretical principle, it is difficult to see the point in strictly defining a timeframe for achieving it. As you may already know, the 2% figure was first set by New Zealand, at a time when it suffered from severe inflation. Specifically, the parliament of New Zealand set the target at “0 to 2%” in December 1989 when it passed the Reserve Bank of New Zealand Act. This subsequently led to the adoption of the 2% target around the world for the simple reason that “everyone is doing it.”
However, one thing that is common among countries other than Japan that have adopted the 2% inflation target is that they are trying to bring inflation down to 2% based on the premise of high inflation, rather than attempting to push it up to 2% based on the premise of low inflation. In other words, their intent is the exact opposite of the BOJ’s intent, which is to promote inflation with the aim of overcoming deflation. In this context, it is important to note that a central bank trying to bring inflation down to the 2% level would have to discuss raising interest rates, but the BOJ, which is trying to push inflation up to 2% would need to discuss lowering interest rates. While the former has no limit, the latter has a zero interest rate constraint (more accurately, an effective zero interest rate constraint, or a Zero Lower Bound (ZLB)). I need hardly explain how the BOJ’s policy operation became so complex and irrational in the face of the ZLB, with the introduction of negative interest rates and the accompanying YCC policy, and how difficult it is to find a way out of this. Essentially, the irrational and complex zero interest rate policy and YCC are the result of trying to overcome the ZLB in an effort to achieve a difficult target with no theoretical basis within a set deadline.

Ideally Abolish the Accord; Or, at Least, Delete “as Soon as Possible”

In light of the above, the CDP’s willingness to allow flexibility in the inflation target is a good thing, but the extremeness of its wording leaves something to be desired. To repeat, revising “2%” to “above 0%” is a very hawkish move, and is likely, in the words of BOJ Governor Kazuo Ueda, to cause intermittent shocks; also, it is unlikely to gain widespread support in reality. So, how should the Accord be revised? In the first place, since no such accord existed before January 2013, it could well be abolished when a new government comes in (although that seems unlikely in the foreseeable future), but if it is simply to be revised, deleting the phrase “as soon as possible” would be acceptable.
When the transition from the Kuroda administration to the Ueda administration took place, there was talk of deleting “as soon as possible” or replacing it with wording such as “in the medium to long term,” but in the end things were left as they were. If Japan has already overcome deflation (in terms of CPI), there is also the option of burying the Accord altogether with a declaration of the end of deflation. In my view, the fact that the opposition has questioned the intent of this unhealthy Accord, and the fact that this has received a certain degree of appreciation from the public through the general election verdict, is in itself a step forward.

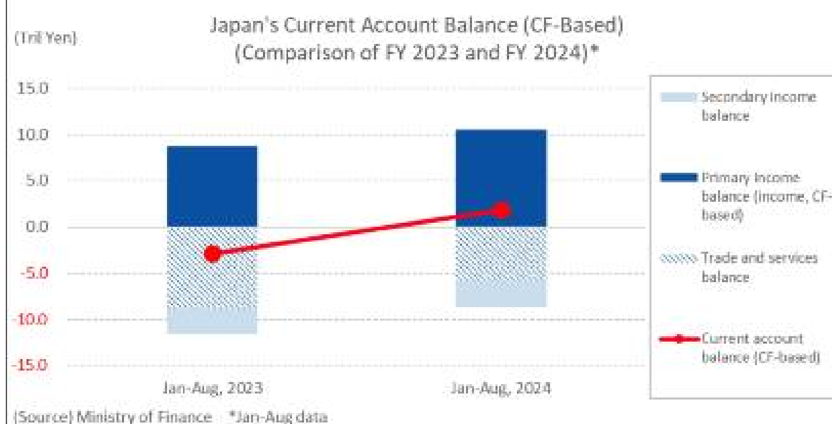
JPY Supply-Demand Environment – Weak Forces Propelling JPY Depreciation Trend

Questions about JPY Depreciation Trend’s Strength and Sustainability

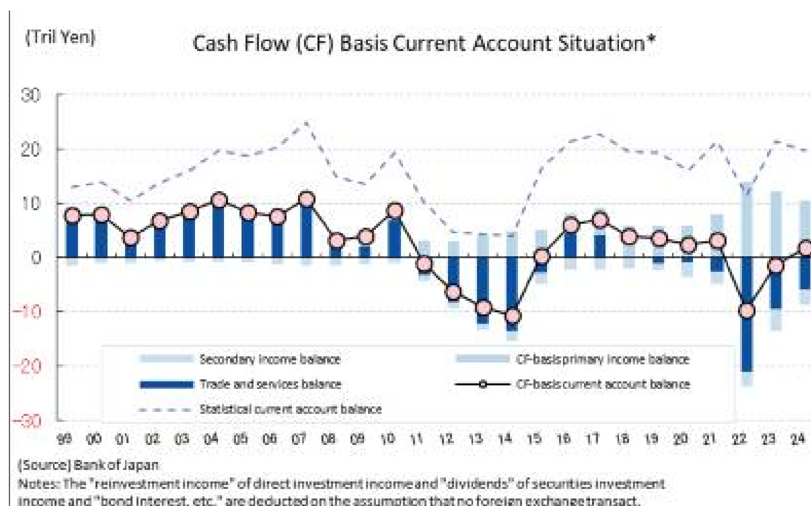
In October, USD/JPY re-ascended to the JPY150-154 range and stabilized there. Given that speculators’ net positions in IMM currency futures trading remain long JPY, it is only natural that the unwinding of those positions will place downward pressure on JPY. The momentum of that downward pressure was much greater than this article had anticipated, but there remain doubts about its sustainability.
It is worth pondering the question of whether the current market mood can be expected to continue even after the speculative JPY-long positions have been unwound. Many factors supported JPY’s depreciation from 2022 to 2023, including speculative JPY selling due to interest rate differentials, JPY selling by both institutional and individual investors, and Japan’s huge trade deficits. These factors combined to create a JPY depreciation phase with considerable scale and durability. Looking back at the JPY supply-demand situation, my calculations show that Japan recorded cash flow (CF)-based current account deficits of approximately -JPY9.7 trillion in 2022 and -JPY1.3 trillion in 2023. (In nominal statistical terms, the country recorded surpluses of approximately +JPY11.4 trillion and +JPY21.4 trillion, respectively.) Regarding interest rates, the BOJ maintained negative interest rates during this period, while the Fed raised its policy interest rates at the fastest pace ever. In light of that, it can be said that JPY depreciation was inevitable.
At present, however, I do not believe the current JPY weakening trend is particularly powerful or sustainable. It is true that September U.S. employment statistics spurred a significant amount of JPY weakening and USD strengthening, but this does not appear to be a sustainable trend. If U.S. employment statistics continue to produce positive surprises with respect to October and November, it may generate a serious debate about whether the time has come for the Fed to discontinue its interest rate cuts, but it seems premature to assume that this will be capable of making a resumption of JPY’s weakening phase the main forecast scenario.

Supply-Demand Situation not Promoting JPY Depreciation Compared to the Past Two Years

Currently, the JPY supply-demand environment is showing clear improvement. Japan's current account surplus for the period from January to August was approximately +JPY19.7 trillion – the largest surplus recorded for a January to August period since 1996, when comparable data became available. It is worth noting that the current account surplus for the same period last year was approximately +JPY13 trillion. These statistics alone indicate that the JPY supply-demand environment has improved significantly compared to last year, and this improvement is also seen in the CF-basis current account balance figures that I have calculated. Japan's CF-basis current account surplus for August alone was approximately +JPY800 billion, and such surpluses were recorded in three consecutive months through August. This is the first time since the May-July 2021 period that the country's CF-basis current account balance has been in the black for three consecutive months, as the CF-basis current account balance was relatively weaker during the current JPY depreciation phase that began from March 2022. The CF-basis current account balance for the January-August period in 2023 was a deficit of approximately -JPY2.9 trillion, but the balance for the same period this year recovered to a surplus of approximately +JPY1.9 trillion (see graph). This is largely due to the balance of payments for goods and services deficit shrinking from approximately -JPY8.7 trillion to approximately -JPY5.9 trillion, but even on a CF basis, the primary income surplus has expanded from approximately +JPY8.7 trillion to approximately +JPY10.5 trillion. Determining reinvested earnings is important in calculating CF-based figures, and such reinvested earnings levels will largely remain unclear until the full-calendar-year statistics are finalized, so it is difficult to make definite conclusions at this point, but it is clear that the JPY supply-demand environment is not currently promoting JPY depreciation as much as it did during the previous two years.

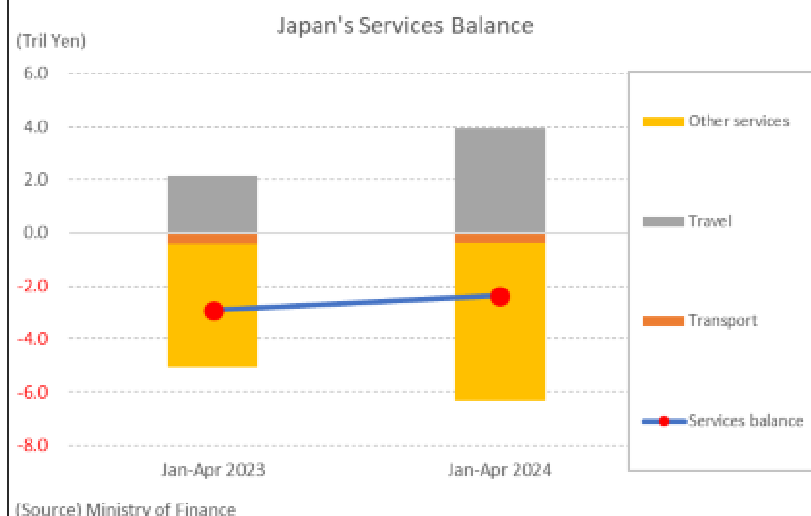


It is worth noting that, from 2017 to 2019, the average level of Japan's CF-basis current account balance was a surplus of +JPY4.9 trillion (see graph). As a recovery to that level is now within sight, even if speculative JPY long positions are unwound and JPY suddenly weakens, I believe the supply-demand situation suggests such a weakening trend will not be easily sustained. To project that JPY will continue weakening over an extended time period, one would need to be confident that there is no possibility of Fed interest rate cuts and/or BOJ interest rate hikes, but there is still no basis for such confidence at this point. While the JPY depreciation trend is advancing due to strong U.S. economic indicators and rising U.S. interest rates, there seems to be little interest in carefully examining and interpreting the JPY supply-demand environment.

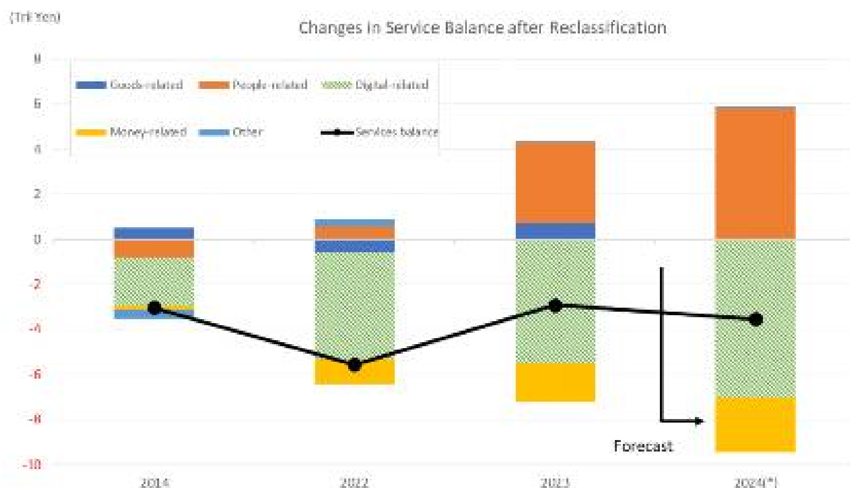


Digital Deficit Could Reach -JPY7 Trillion

As I frequently receive inquiries about Japan's other services deficit – which is sometimes referred to as the "new era deficit", within which the digital deficit is particularly significant – it is worth taking a moment to overview current trends related to the other services deficit. While Japan's overall current account balance is improving, the other services deficit is continuing to expand. Looking at January-August periods, one finds that the overall services balance has improved slightly from approximately -JPY2.6 trillion last year to approximately -JPY2.4 trillion this year. The other services deficit (including the digital deficit) expanded from approximately -JPY4.1 trillion to



approximately -JPY5.9 trillion, although this expansion was partially offset by the travel surplus, which doubled from approximately +JPY1.9 trillion to approximately +JPY3.9 trillion (see graph). This pattern of travel surpluses partially offsetting other services deficits has become familiar in recent years.



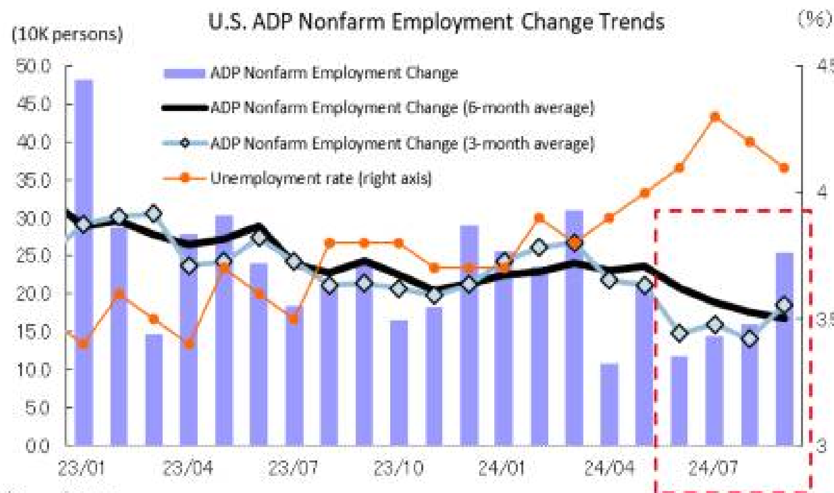
(Source) Created by the author based on the Bank of Japan paper entitled "Globalization of Service Transactions from the Perspective of Balance of Payments Statistics". 2024 data are annualized.

However, it is highly doubtful that this pattern of using foreign currency earned by the tourism industry to cover foreign currency payments to digital industries can be sustained over the medium term. As Japan's labor shortages are becoming increasingly severe, the foreign currency that the labor-intensive tourism industry can earn is likely to peak out. In contrast, the foreign currency paid to capital-intensive digital industries will probably increase, considering society's burgeoning demand for AI services. Humans are already losing ground to digital technologies from the perspective of the "human vs. digital" aspect of Japan's service transactions structure, and there are grounds for concern that the digital side will continue to expand its lead over humans going forward.
From January through August, Japan's total digital deficit was about -JPY3.8 trillion last year, and it has expanded to about -JPY4.7 trillion this year. The digital deficit for all of 2023 was about -JPY5.5 trillion, and this deficit it may surpass -JPY7 trillion this year (see graph). It is important to keep in mind that Japan already has a digital deficit that is comparable to its trade deficit. Of course, the country's people-related surplus (≈ travel surplus) is also growing – and may surpass +JPY5 trillion for the first time this year – but taking into account the fact that digital deficit growth is more sustainable than travel surplus growth, it seems likely that foreign currency leakage from Japan will inevitably increase (largely owing to the digital sector) and that the only way to balance the books will probably be through JPY depreciation.

JPY Outlook from Short-, Medium-, and Long-Term Perspectives
To summarize the overall JPY exchange rate situation, in the short term, it is expected that JPY will tend to weaken as speculative positions are unwound, and this is actually what is happening at the time this article was written. From a medium term perspective, after speculative positions have shifted toward neutrality over the next year or so, it will be necessary to take into account the likelihood that improvement in the JPY supply-demand environment (caused by such factors as the current account balance turning into a surplus on a cash flow basis) will create market conditions more conducive to the halting of JPY depreciation.
From a longer-term perspective, however, one must recognize that Japan's travel surpluses are only capable of temporarily slowing the expansion of the country's services deficits. If the services deficits expand in the future (mainly owing to the digital sector) and the travel surpluses peak due to labor shortages, Japan's current account surpluses will shrink. In light of this, it is reasonable to conclude that the structural basis for JPY weakness is increasing.

US Monetary Policies and Economy Now and Going Forward – Focusing on What is likely to Happen a Year from Now

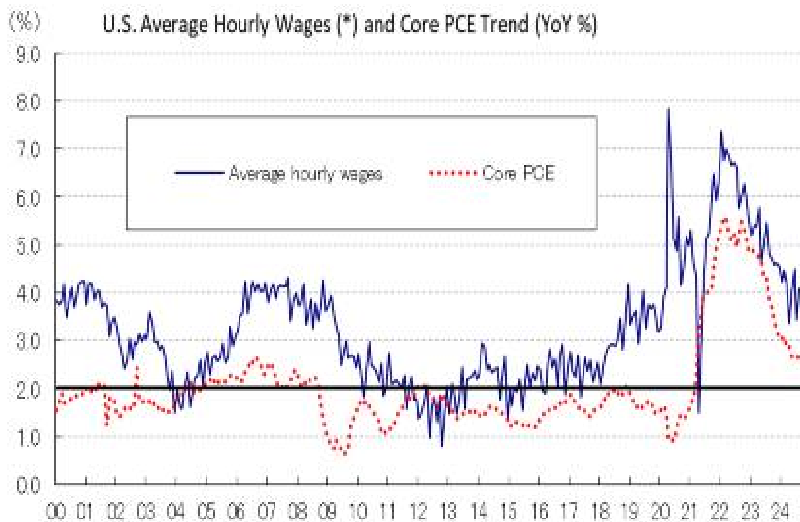
U.S. Employment Stalling Out or Bottoming Out?



(Source) Datastream

The U.S. September employment statistics released on October 4 indicate that non-farm payrolls (NFP) grew +254,000 from the previous month, far exceeding the market's median forecast (+150,000), and that the unemployment rate fell by 0.1 percentage point, from 4.2% to 4.1%. These very strong figures (particularly the NFP growth, which easily exceeded the upper limit of Bloomberg's forecast (+220,000)) caused U.S. interest rates to soar and promoted JPY selling and USD buying in response to the widened U.S.-Japan interest rate gap. Reflecting the similar strength of the subsequently released U.S. September retail sales figures, the U.S. 10-year interest rate exceeded 4% – a level thought to be difficult to re-attain – at the time this article was written and was temporarily above 4.3% at the end of October. As explained below, growing expectations that the U.S.

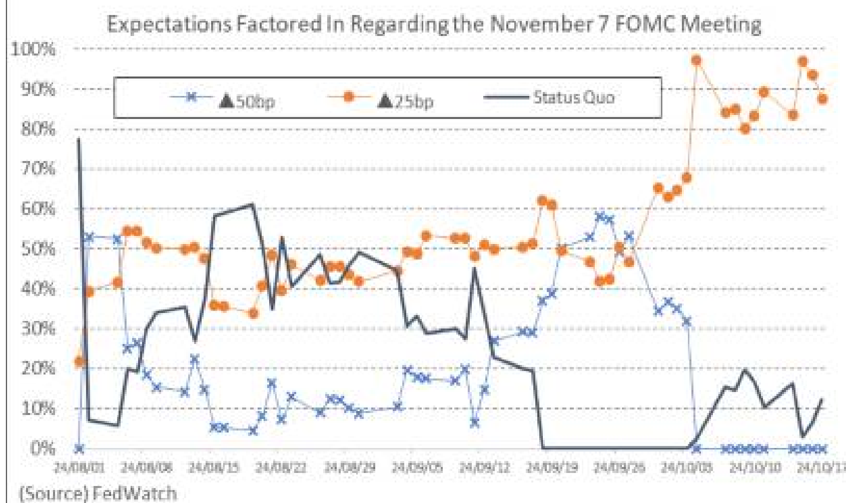
economy will achieve a soft landing (or avoid a landing) are causing some observers to begin to factoring in the possibility that the FOMC meeting on November 6-7 will maintain the status quo. Furthermore, while growth in NFP appears to be stalling out when the focus is on six-month average figures, it appears to have bottomed out when the focus is on three-month average figures (see graph on previous page). At the very least, the situation does not suggest a need for a significant interest rate cut. While expectations in August were generally for successive rate cuts of -50bp from September onwards, the prospective scenario has dramatically changed in just two months. However, the overall economic picture remains unchanged, in light of a fundamental trend of declining wages placing downward pressure on prices (see graph), so at the time this article was written it still appeared premature to make a Fed interest rate cut discontinuation the main forecast scenario.



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

Prospective FOMC Decisions from November

So what should we be expecting regarding FOMC meetings from November? At least with respect to the November 6-7 FOMC meeting, the reality is that the FOMC's actions cannot be predicted until the very last moment, as the FOMC will be considering such late-arriving information as U.S. October employment statistics (released on November 1) as well as information related to the U.S. presidential election (to be held on November 5). The nature of the next presidential administration's economic and financial policies will not yet be clear at the time of the November FOMC meeting, and if Donald Trump is re-elected, the speculative noise about those prospective policies is likely to be particularly loud. Such factors make it very difficult to predict what the November FOMC meeting will do, but it is worth making an effort based on the available information. At the time this article was written, FedWatch suggested that the Federal Funds futures market had almost 100% factored in a 25bp rate cut at the November FOMC meeting, but during October there were some intermittent rises in expectations that the meeting would maintain the status quo in response to the strength of U.S. economic indicators (see graph). Given the nature of FOMC discussions in September, it would be safest to assume a 25bp rate cut, but if the October U.S. employment statistics again show an improvement that exceeds expectations, expectations that the status quo may be maintained are likely to increase dramatically. Under these circumstances, the current outlook can only be described as uncertain – so one should perhaps prepare for a 25bp rate cut while keeping in mind that status quo maintenance cannot be ruled out. It has been widely reported that Atlanta Fed President Raphael Bostic told the Wall Street Journal on October 10 regarding a potential November rate-cut pause that – "I'm definitely open to that." Although the main forecast scenario is for a 25bp cut, one should still be prepared for the possibility of status quo maintenance.



(Source) FedWatch

What is likely to Happen a Year from Now

The current presidential administration will still be in charge at the time of the November FOMC meeting, not to mention the December meeting – the implementation of monetary policy under a new administration will not commence until January 2025. It is generally assumed that if Trump is re-elected, he will aim for low interest rates and a weak USD, but since his economic policies would tend to put upward pressure on interest rates and prices, I anticipate that, ultimately, it will not prove possible to lower interest rates significantly. (There is a growing view that Kamala Harris will have opposite aims if she is elected, but this does not seem to be based on any tangible evidence.) Given the numerous important uncertainties, it does not seem to be worthwhile at this point to undertake a detailed discussion about the Fed's "next move".

When considering the medium- to long-term outlook for forex rates, it is often most productive to focus on what is likely to happen a year from now. Leaving aside the issue of how many interest rate cuts will be implemented in the next year, one can anticipate that by the October-December period next year, the 2026 policy interest rate trajectory is sure to be a hot topic of discussion. The current dot chart suggests that the neutral interest rate will be reached in 2026 (see chart). In light of that, it is highly likely that the "end point of interest rate cuts" will become a point of contention in a year's time, at which point the impatient financial markets will be talking about a re-widening of the Japan-U.S. interest rate gap and an ensuing resumption of a JPY weakening trend. Although there is currently a high level of interest in the Fed's short-term policy management, the markets' focus will gradually shift to the "end point of interest rate cuts" and associated changes in asset prices. In the very short term, JPY will continue to weaken as JPY long positions in IMM currency futures transactions continue to be unwound, but as those positions become neutral, there is likely to come a time when USD/JPY once again becomes heavy on the upside. I am wary about the ramifications of such a shift occurring around the end of the year and start of the new year (and, of course, the U.S. presidential election results could change many things). As mentioned above, there is no doubt that the fundamental JPY supply-demand environment is becoming more supportive of JPY, and there currently seems to be no additional factor with sufficient power to promote JPY depreciation against USD. However, this article assumes that the "end point of interest rate cuts" may become a point of contention as early as next year's July-September period (or, more likely, the October-December period) and assumes that JPY will begin weakening again at that time. We should consider the outlook for 2025 while keeping in mind the possibility that the "strong JPY period in a weak JPY era" prompted by the narrowing of the U.S.-Japan interest rate differential may end up being much shorter than many people had expected. This is a point I have discussed in the past, but it should be remembered that the Fed's latest rate cuts are merely preventative measure against a "normal economic downturn" and are not the kind of policy response that would be appropriate for an acute shock like a financial crisis or pandemic. It is quite possible that the moderate degree of prospective Fed interest rate cuts will disappoint those market participants who tend to assume that monetary easing phases will inevitably culminate in zero interest rates and large-scale asset purchases.

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

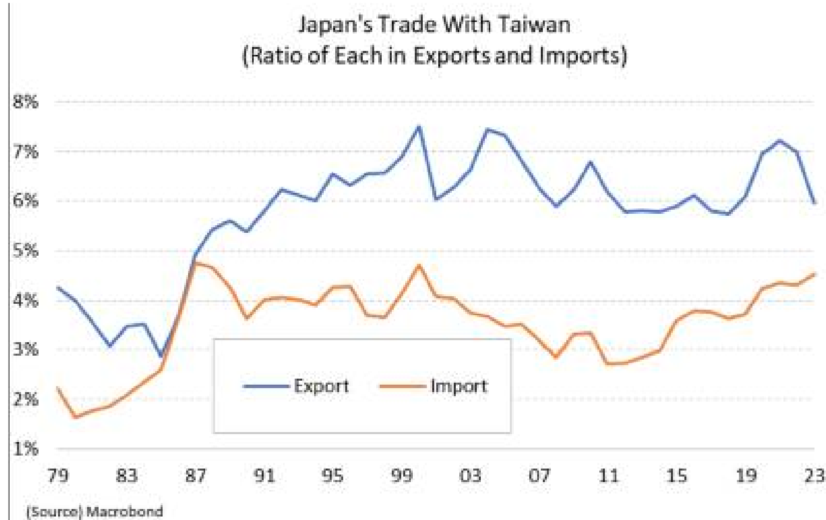
Risks to My Main Scenario – Reasonable to Ignore Taiwan Emergency Situations?

Recent Taiwan Emergency Not Considered Material

On October 14, it was widely reported that China's armed forces conducted a large-scale exercise around Taiwan, demonstrating their ability to completely surround Taiwan. The exercise was intended to intimidate Taiwan's Lai Ching-te administration, which opposes the "unification of the motherland" advocated by China's Xi Jinping administration, and frictions related to the unification issue can be expected to continue intermittently and become relatively serious in the future. I will leave the international political situation's details to the analysis of experts, but although news reports about the exercise caused a risk-on market conditions in Tokyo's financial markets, those markets did not seem particularly affected by geopolitical risks, and the Nikkei Stock Average Index uptrend actually strengthened. Rather than being affected by the Taiwan emergency, it appears that Japanese stock prices were pushed upward by expectations that the Chinese economy will bottom out due to large-scale fiscal spending and that JPY will resume its depreciation trend. It may be easy to discount the seriousness of the Taiwan situation insofar as it was a military exercise and not an actual invasion, but I still felt surprised at the humdrum reaction to the situation, given the general recognition that a full-scale Taiwan emergency has long been a major geopolitical risk factor expected to eventually eventuate.

Genuine Taiwan Emergency Would Expand Japan's Trade Deficit

Since a genuine Taiwan emergency situation is one of the most realistic geopolitical risks Japan faces and would generate significant burdens if it were to occur, it seems overly blithe to consider it reasonable to ignore the recent large-scale military exercise based on the assumption that such a military exercise could not possibly develop into something more serious. What would happen if Taiwan were blockaded by China and trade between Japan and Taiwan was cut off? Various detailed analyses of the impact of such a blockade have been undertaken, but it is worth noting regarding Japan's exports in 2023 that Taiwan absorbed approximately JPY6 trillion, or about 6.0%. A simple calculation shows that if exports to Taiwan were lost, Japan's nominal GDP in 2023 would have been reduced by around 1% (approximately JPY592 trillion).



Of course, the actual situation would be more complicated than that. As the graph shows, aside from Taiwan's market for Japanese exports, Japan's dependence on Taiwan has increased significantly over the past decade. Taiwan accounts for about 4.5% of Japan's total imports, which is equivalent to about 0.8% of nominal GDP. The recent increase in Japan's imports from Taiwan reflects strong growth in semiconductor imports. It is generally understood about half of Japan's imports of semiconductors and other electronic parts come from Taiwan, and it is highly likely that Japanese demand for Taiwan's electronic goods will continue growing in the future. If semiconductor imports from Taiwan were to be cut off and replaced by Japanese products, it might have a positive effect on the Japanese economy. However, it is also generally understood that there are high-performance semiconductors that can only be procured from Taiwan. Given that, the suspension of imports from Taiwan could exert a serious direct impact on Japan's real economy by disrupting supply chains in various industries. As we all learned during the covid pandemic period, semiconductor supply shortages will affect the production of diverse goods, including goods that ordinary people have come to consider basic requirements in their daily lives, such as cars, smartphones, computers, cameras, and air conditioners. Recognizing the enormity of the impact of a full-scale Taiwan crisis, TSMC has been geographically diversifying its production bases by establishing new bases in Japan's Kumamoto Prefecture and in the U.S. state of Arizona.

While I will not undertake a detailed analysis of the economic effects at this time, it should be noted that since automobile exports (which make a major contribution to Japan's trade balance) are also expected to be affected, it is highly likely that Japan's overall exports (not just exports to Taiwan) would be depressed, and the resulting contraction of domestic production activity would weigh heavily on the Japanese economy[1]. On the other hand, no significant structural changes to Japan's imports would be expected aside from the disappearance of imports from Taiwan, so Japan's imports of mineral fuels and other products would be expected to remain strong. Consequently, a full-scale Taiwan emergency appears to be a factor that would expand Japan's trade deficit.

Lack of "Risk-off JPY buying"

The lack of "risk-off JPY buying" has become so commonplace in recent years that it is no longer even a topic of discussion, but it is still worth noting the lack of "risk-off JPY buying" in response to the news about the large-scale military exercise around Taiwan. Given that Japan has lost its huge trade surpluses and that direct investments comprise half the country's net external assets, it is safe to assume at this point that emergencies will now promote JPY selling. This is a topic that many previous editions of this article have discussed, so I will not examine it in detail here. From an objective perspective, given that it is somewhat foreseeable that Japan's trade deficit will expand in the event of a Taiwan emergency, it may be considered good and proper for JPY to weaken, and it is understandable in light of that perspective that USD/JPY rose almost to JPY150 following the military exercise. Looking back at the past, one may recall that North Korean launches of missiles toward Japan used to be considered a factor promoting JPY appreciation, but such launches nowadays are no longer considered to have such an effect. In the future, any event that could cause severe damage to the Japanese economy – whether it be a Taiwan emergency or a North Korean missile – will be interpreted as a legitimate basis for selling JPY. The possibility that a regional emergency may occur is a risk factor that should always be kept in mind as a factor that could promote JPY depreciation during the forecast period.

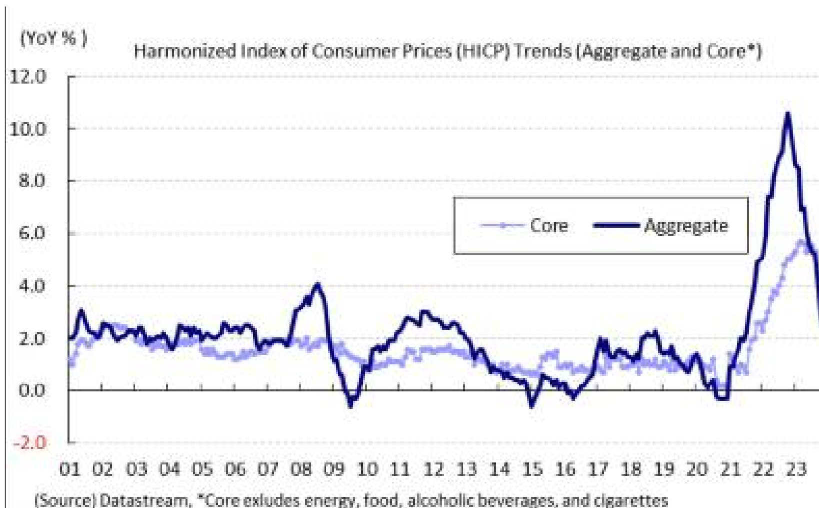
[1] According to calculations by Yasuyuki Todo, a professor at Waseda University, if 80% of all intermediate goods imported from China were to be cut off for two months, Japan's overall production value would fall by approximately JPY53 trillion. Source: Nikkei Business, " Taiwan Emergency could Halt Automobile Production? For China, Japan Less Indispensable than South Korea," February 1, 2023

EUR Outlook –Ominous Data Regarding the Euro Area's Economic and Financial Situation

EUR Area Monetary Policies Now and Going Forward – Increasing Contrast Between the Euro Area and the United States

ECB Still on Expected Interest Rate Cut Trajectory

The October 17 meeting of the ECB's Governing Council decided to cut the main policy interest rates by 25 basis points, reducing the deposit facility rate (of particular interest to the financial markets) from 3.50% to 3.25%. Looking at basic economic indicators, the rate of growth in the euro area's September HICP consumer price index fell below 2% for the first time in three years and three months (see graph), and manufacturing PMIs and other indicators suggest a significant deterioration of economic sentiment in the region, especially in Germany. In addition, comments made in early October by Banque de France Governor Francois Villeroy de Galhau suggesting that euro area recession concerns were resurfacing made it clear in advance that the ECB was almost certain to implement an October interest rate cut. Given that and the euro area's clearly weakening economic and financial situation, the ECB's decision can be said to have been a given. As discussed in previous editions of this article, the HICP growth rate is already below the ECB staff forecast (average growth of +2.2% for the July-September period, compared to the ECB's assumption of +2.3% growth), so the arguments for this latest rate cut were quite persuasive.



Backwards Looking Policy Management Stance?

The euro area's economic and financial situation was the main focus of discussion at the post-Governing Council-meeting press conference. The first reporter to pose a question at the press conference asked – "Does the decision to cut today really represent a shift of gear? Do you expect a cut at every meeting for the next few meetings now to be the most likely scenario?" – and ECB President Christine Lagarde replied that cutting interest rates was natural since – "we believe that the disinflationary process is well on track and all the information that we received in the last five weeks since our last monetary policy decision was heading in the same direction – lower! Whether you looked at inflation numbers, headline core, whether you looked at PMI numbers, all categories, composite manufacturing, services, employment – are heading downwards as well." Overall, her remarks seemed to point to concerns about a potential recession rather than about curbing inflation.

President Lagarde went on to say – "We have also reiterated that we will continue to be data dependent and honestly, this decision [to reduce interest rates] is a case in point of us being data dependent." – and she emphasized that – "We are going to continue doing exactly the same thing." – in making policy decisions based on all the new data received during the period prior to the next Governing Council meeting in December. All her words made sense on one level but also seemed a bit problematic insofar as many observers as of July were anticipating that any additional rate cut would be in December, and those expectations have now been revised based on economic indicators released in the last two months – a revision process that can positively be characterized as "data dependent" yet can also be uncharitably described as simply "backward looking". On the other hand, as of the summer, I and the financial markets were concerned about the risk of a euro area wage inflation resurgence, but the ECB was firmly predicting that the wage situation would calm down and, in that sense, the ECB's rate cutting course can be said to be based on forward-looking policy management stance.

However, it is not clear whether the ECB could have predicted the continuous deterioration in the euro area's real economy that has occurred. The reason the ECB cited as a basis for predicting a deceleration of nominal wage increases was that the re-acceleration of wage growth observed during the summer was – "driven by [temporary] catch-up dynamics" (to compensate for purchasing power lost due to previous inflation) – and was thus not expected to be sustained. The ECB was not explicitly basing its prediction on anticipation of a significant slowdown in the euro area economy (that could perhaps ultimately culminate in a recession). The current slowdown in the euro area economy may not have been entirely within the realm of the ECB's expectations.

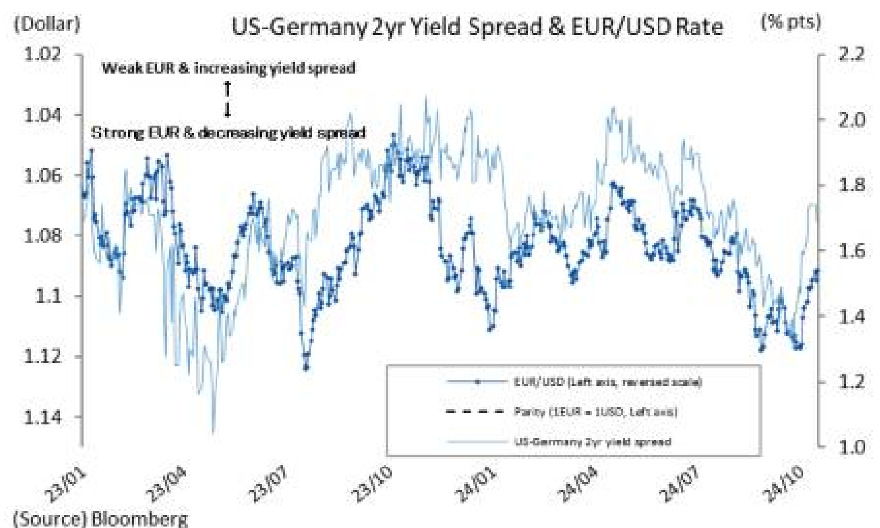
Shift from Inflation Control to Economic Stimulation?

Another reporter asked with a hint of concern – "Is a soft landing still your main scenario, and am I correct to see that perhaps your attention has shifted slightly from inflation concerns to growth concerns?" – and this question precisely reflects my own impression of the situation. President Lagarde has repeatedly stated that the euro area economy's current situation is bad from whatever perspective one adopts and that a disinflation process is underway. However, it is

obvious that if the disinflation process goes too far, the risk of a recession will inevitably emerge. It is natural that many market participants may increasingly come to sense that the objective of the ECB's interest rate cuts is shifting from inflation control to economic stimulation. President Lagarde has dismissed the sudden rise in recession-related concerns by saying – "we certainly do not see a recession." – and it is understandable that this is the only answer she can give under the current circumstances.
That said, the Governing Council meeting's statement clearly states that – "The incoming information suggests that economic activity has been somewhat weaker than expected." – and President Lagarde herself said that – "we were all a little bit surprised" – that the HICP inflation rate had so greatly decelerated in September. There is no doubt that the euro area economy's deceleration has been greater than anticipated by the Governing Council, but it appears that the Governing Council's current basic understanding is that the slowdown will not lead to a recession. In any case, there is a longer-than-usual gap of eight weeks prior to the next Governing Council meeting in December. This means that more new information than usual will be available at the time of that meeting – ample material for the data-dependent approach emphasized by President Lagarde. It will be interesting to see whether the Governing Council's perception of recession-related risks remains unchanged in December.

Inflation Vigilance Remains
However, the October Governing Council meeting's statement and press conference make it clear that the ECB's inflation concerns have not disappeared. One reporter at the press conference asked – "some months ago [...] you promised the population in the eurozone to break the neck of inflation. [...] [W]ould you say that the neck is broken or not?" – and President Lagarde responded – "Have we broken the neck of inflation? Not yet." She went on to say – "But are we breaking the neck of it? Yes, I think so. It's not broken completely yet, but we're getting there." – and, while this is essentially a rephrasing of her oft repeated – "the disinflationary process is well on track" phrase, it does create doubts about the legitimacy of successive rate cuts going forward. Also, the inflation section of the Governing Council meeting statement clearly states that – "Negotiated wage growth will remain high and volatile for the rest of the year, given the significant role of one-off payments and the staggered nature of wage adjustments." – so the Governing Council has not yet declared that wage inflation concerns have been resolved. While the financial markets are clearly pricing in successive ECB interest rate cuts, the ECB appears to be indicating that such a prospect is not assured.

Contrasting Conditions in U.S. and European Economies –EUR to Fall below USD1.05?
EUR is facing clearly strengthening headwinds. As mentioned, there are still eight weeks before the December Governing Council meeting, and it is not impossible that euro area economic and financial conditions could suddenly improve during that period, but it seems more likely that the current economic deceleration trend will become still more apparent.

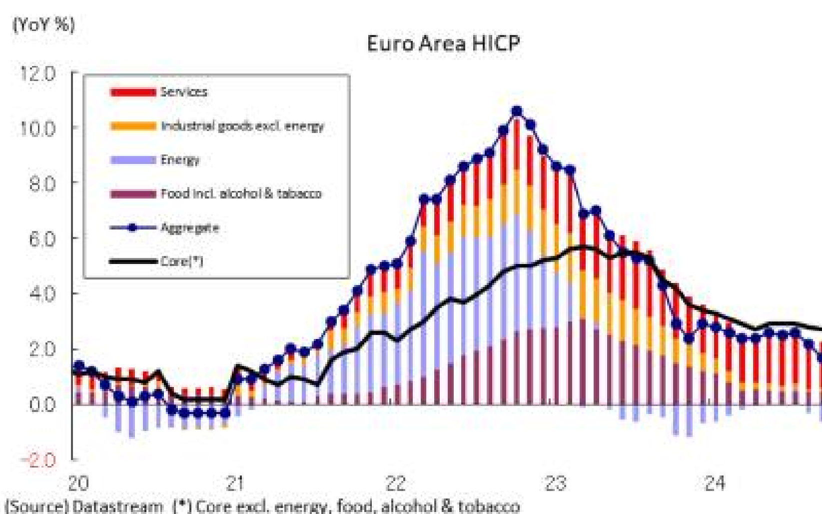


At this point, it is expected that the deterioration of emerging hard data (GDP, etc.) will become increasingly clearly in line with the deterioration seen in previously released soft data (business confidence, etc.). This article's main scenario is anticipating that the ECB will implement one more -25bp interest rate reduction by the end of this year and reduce rates by as much as -50bp (-25bp x 2) in the January-March quarter of next year. In contrast, the Fed has made no promises about any moves from December, although it is assumed that it will reduce rates once in November. Attention has focused on the fact that the recently released U.S. September retail sales figures exceeded market expectations, but if the U.S. October employment statistics (announced on November 1) are strong, even a November rate cut will become seriously questionable. The increasingly striking contrast between economic conditions in the euro area (where there is a potential return to a recession scenario) and the United States (where there is potential for a recession avoidance (no-landing) scenario) is likely to be reflected directly in the US-European interest rate differential and, ultimately, in the level of the EUR/USD (see graph). We will be keenly watching to see if EUR/USD falls below USD1.05 during 2025.

Euro Area Economy and EUR Now and Going Forward – Dark Clouds over the Euro Area Economy

Euro Area Inflation Rate Finally Descends Below 2%

Looking more closely at the euro area inflation situation, it has been widely reported that the rate of growth in the HICP euro area consumer price index in September fell below 2% for the first time in 39 months (since June 2021), and this clearly suggests a trend toward deceleration in the euro area economy (see graph). This mainly reflects an accelerated pace of year-on-year declines in energy prices, which increased from -3.0% to -6.1%, but even on a core basis excluding energy, food, alcoholic beverages, and tobacco, year-on-year HICP growth has slowed from +2.8% to +2.7%. These trends can be said to be good news for the ECB as it continues along its path of interest rate cuts. While the pace of year-on-year services inflation remains relatively high, it has slowed down from +4.1% to +3.9%, and the concerns about wage growth acceleration that were a hot topic last month have temporarily eased.



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

The September HICP growth rate has even fallen below the base scenario of the ECB staff forecasts that were revised in September (see graph on next page), and this is in line with French central bank governor Villeroy de Galhau's assertion in an interview with an Italian newspaper on October 7 that – "In the last two years our main risk was to overshoot our 2% target. Now we must also pay attention to the opposite risk, of undershooting our objective due to a weak growth and a restrictive monetary policy for too long." The HICP growth deceleration trend alone clearly suggests that the euro area's economy may be stalling and, as discussed below, it can be confirmed that this situation justifies an additional ECB interest rate cut.

ECB Staff Macroeconomic Projections (September 2024) (%)

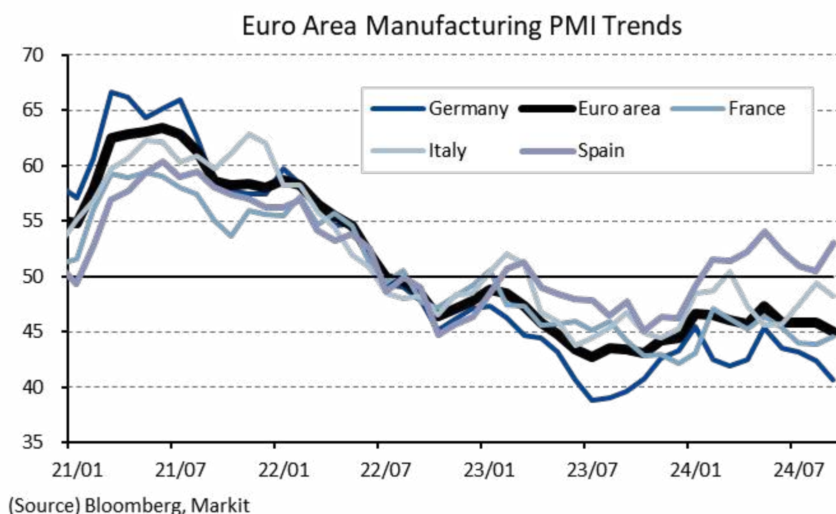
	2023	2024	2025	2026
HICP	5.4	2.5	2.2	1.9
(previous: June 2024)	5.4	2.5	2.2	1.9
Core HICP	4.9	2.9	2.3	2.0
(previous: June 2024)	4.9	2.8	2.2	2.0
Real GDP	0.5	0.8	1.3	1.5
(previous: June 2024)	0.6	0.9	1.4	1.6

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

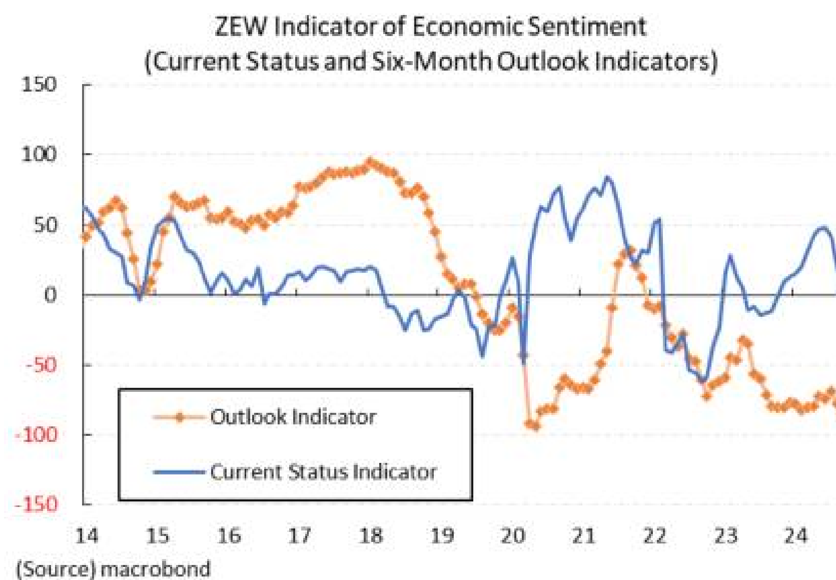
*Core excludes energy and food

Business Sentiment Trends Suggesting Recession Concerns

The "opposite risk" mentioned by President de Galhau appears to be the risk of a disinflationary trend stemming from an economic recession. Data on the business confidence of euro area companies confirms the reality of this risk. The euro area manufacturing Purchasing Managers' Index (PMI) for September was 45.0, down 0.8 point from 45.8 in August, and the lowest level seen since the beginning of the year (see graph). The production slowdown suggested by the manufacturing PMI has inspired strongly worded predictions of impending euro area economic stagnation. The manufacturing PMI in Germany, where the closure of Volkswagen's domestic factories has been a hot topic, has seen a further deterioration, especially regarding the employment situation, and it appears that the already relatively low business confidence of Germany's manufacturing companies has further worsened. The financial markets pay close attention to such indices of German economic conditions as the ZEW Indicator of Economic Sentiment, which has further highlighted Germany's dire situation each month – the August figure (released on August 13) showed the largest mom drop in the past two years, and the September figure (released on September 17) fell more than had been expected (see graph). The ZEW indicator measures the expectations of market participants including analysts regarding economic conditions six months in the future, and it is confirming the increasingly chronic nature of business sentiment deterioration indicated by the Ifo Business Climate Index.



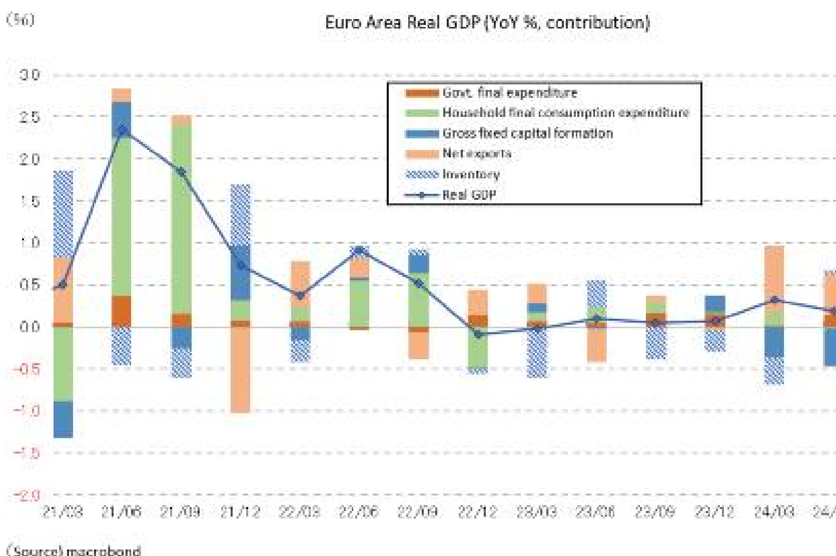
(Source) Bloomberg, Markit



(Source) macrobond

Diminishing Policy Uncertainty

The recovery in the euro area economy's growth rate since the start of 2024 is thought to stem from an improvement in the real income environment due to the peaking out of inflation rates along with an increase in inbound demand (service exports) due to the special factors related to the Paris Olympics. In fact, it has clearly been net exports that have accelerated growth in the last two quarters (see graph). The current situation is that, in addition to a trend of decline in exports, the tightening effects of fiscal and monetary policies are beginning to permeate the euro area. It appears that significant increases in interest rates over the past two years and the 2024 resumption of fiscal policy restrictions in line with the EU's Stability and Growth Pact are depressing private sector proclivities to consume and invest. The slowing pace of wage increases is expected to reduce pressures on corporate profits, and it is anticipated that household sector consumption increases will be restored, but although Germany has traditionally served as a locomotive of growth for the euro area economy, the German economy has not been able to progress toward recovery (largely due to high energy costs), and the situation in Germany appears slowing the overall pace of growth in the euro area economy as a whole.



(Source) macrobond

The euro area economy has recently benefited from the peaking out of inflation rates and special demand associated with the Paris Olympics, but as the twin tailwinds fade, the chronic fear of recessionary trends that dominated the euro area in the 2022-2023 period is poised to resurface. However, a situation in which inflation rates are descending throughout the entire euro area is less difficult to deal with from a monetary policy perspective than a stagflation situation in which the ECB would be forced to face the negative consequences of either raising and lowering interest rates. As the ECB's options have become clearer, it is becoming increasingly unlikely that the ECB will show any hesitation about lowering interest rates going forward, and this situation can be said to have reduced uncertainty regarding prospective forex trends.

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