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Forex Medium-Term Outlook

January 31, 2025

Overview of Outlook

USD/JPY weakened slightly in January. Following an additional interest rate hike by the BOJ, the trend of unilateral JPY depreciation may be coming to an end, but the situation is still unpredictable. While the BOJ continues to raise interest rates at a slow pace, the markets are also steadily factoring in the end of rate cuts by the Fed, so the popular theory that JPY will appreciate as the U.S.-Japan interest rate differential narrows is hanging by a thread. My view is that this theory will only remain valid during 1H of the year, if that. One must take into consideration the possibility that the BOJ feels compelled to raise interest rates more than originally planned due to the continued rise in USD/JPY, while also noting that interest rate hikes do not necessarily equate to JPY appreciation. Meanwhile, in terms of JPY supply and demand, it is still true that more people want to sell JPY than those who want to buy it. While Japan's trade balance does seem likely to improve from the previous year, robust foreign direct investment and JPY selling by households are likely to result in a market environment dominated by JPY selling for some time to come. 2025 will likely reaffirm the new normal in which JPY depreciation cannot be explained by interest rate differentials alone. A risk for the current forecasting period is the extent to which the second Trump administration, which favors low interest rates and USD weakness, will tolerate an across-the-board appreciation of USD. USD's real effective exchange rate (REER) is already at its highest since the Plaza Accord, while Japan and Europe would like to correct the weakness of their respective currencies. China, which is hoping to internationalize CNY, would also welcome the U.S. inclination toward a weaker USD. Plaza Accord 2.0 is something to keep in mind as a potential black swan event.

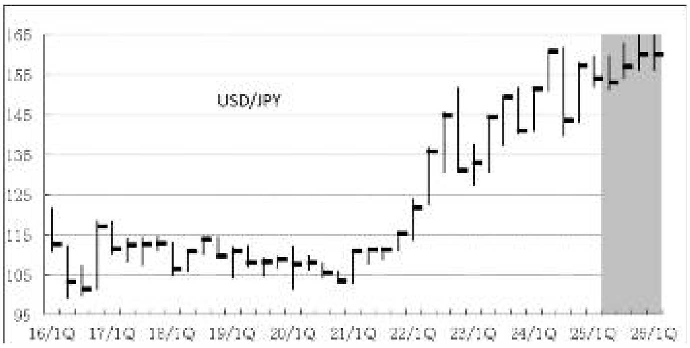
EUR, in January, recovered after hitting a new low. The currency seems to be at the mercy of the second Trump administration's actions as it fluctuates up and down, but fundamentally, it faces strong headwinds. The region's leading economy, Germany, is expected to post no more than zero percent growth in 2025 after two consecutive years of negative growth. This is in sharp contrast to the U.S. economy, which is growing stably above its potential growth rate. This disparity between the European and U.S. economic situations is likely to directly impact the EUR-U.S. interest rate differential, so EUR/USD falling below parity continues to be my main forecast scenario. The markets are currently factoring in four rate cuts by the ECB a year to bring European interest rates down to the neutral level, but are four rate cuts sufficient? At the Davos meeting, ECB President Christine Lagarde mentioned EUR fluctuation as an issue preventing a major interest rate cut. If the ECB considers raising interest rates amid concerns that a weaker EUR resulting from a rate cut would import inflation, the downward pressure on the regional economy could increase significantly. Based on European Commission surveys and other sources, the euro area's current problem is demand shortage, so what is needed in response is a significant interest rate cut. Signs of stagflation, with inflation refusing to cool down while the economy remains sluggish, are becoming more pronounced.

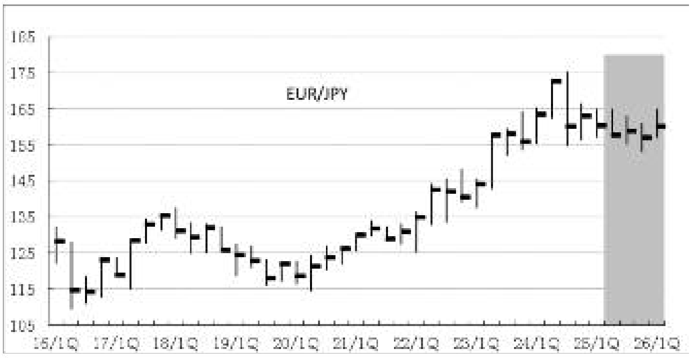
Summary Table of Forecasts

	2025 Jan (Actual)	2025 Feb-Mar	Apr-Jun	Ju-Sep	Oct-Dec	2026 Jan-Mar
USD/JPY	153.72 ～ 158.88 (154.31)	152 ～ 160 (154)	151 ～ 160 (153)	154 ～ 163 (157)	156 ～ 165 (160)	156 ～ 165 (160)
EUR/USD	1.0177 ～ 1.0534 (1.0386)	1.01 ～ 1.06 (1.04)	1.00 ～ 1.05 (1.03)	0.98 ～ 1.03 (1.01)	0.96 ～ 1.01 (0.98)	0.98 ～ 1.03 (1.00)
EUR/JPY	159.74 ～ 164.52 (160.27)	157 ～ 165 (160)	157 ～ 165 (158)	155 ～ 163 (159)	153 ～ 161 (157)	157 ～ 165 (160)

(Notes) 1. Actual results released around 10 am TKY time on 31 JANUARY 2025. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts





USD/JPY Outlook - JPY Continues to Depreciate Despite Inevitable Rate Hike

Summary of Key Points for 2025 Outlook: A Year to be Wary of Unilateral USD Dominance

Summary of Key Points: Main and Risk Scenarios

I have given the outline of my forecast for 2025 in several previous issues of this report as well as in Mizuho Market Topics since last year. Here, I would like, once again, to summarize and present the key points both from supply-demand and interest rate perspectives. In addition to my main forecast scenario, the chart below summarizes various risks that could result in moderate to extreme JPY depreciation or appreciation and their implications for USD/JPY. The chart is not exhaustive; it simply lists the most representative issues. <u>In a word, the key to formulating my outlook for 2025 is my prediction that both the Fed and the BOJ will end their current monetary policy operation path during 1H of 2025.</u>

Possible USD/JPY Forecast Scenarios From Interest Rate and Supply and Demand Perspectives

		Main scenario	Moderate JPY depreciation risk	Extreme JPY depreciation risk
Interest rate	FRB	**2 rate cuts in 1H**	No landing, no rate cuts	Rate hike speculations emerge
	BOJ	**2 rate hikes in 1H**	Only 1 rate hike for the year	Multiple rate hikes to defend JPY
Supply & Demand	Current account balance	**Some improvement in trade balance as crude prices fall**	Trade balance deteriorates as crude prices soar	Crude prices soar, exports slow down
	Financial account balance	**Household JPY selling remains robust**	Household JPY selling accelerates	FDI increases in addition to household JPY selling
Implication		**Buying opportunity (JPY appreciation) only in Q1/Q2**	USD/JPY settles at 160n level	USD/JPY hits 170 level

(Source) Created by author

Moderate JPY appreciation risk	Extreme JPY appreciation risk
4 rate cuts due to recession	6-7 rate cuts
1 rate cut per quarter	1 rate cut per quarter and increased pace of QT
Neutral trade balance as crude prices crash	Crude prices crash, exports accelerate
Household JPY selling slows	Household JPY selling falls to pre-New NISA levels
USD/JPY settles at 140 level	USD/JPY intermittently falls below 140 level

To be specific, the Fed is expected to end its rate cuts, and the BOJ is expected to end its rate hikes during 1H of the year. Of course, unforeseen circumstances (such as the emergence of systemic or geopolitical risks) could unexpectedly prolong the Fed's rate cut phase. In other words, barring unforeseen circumstances, the sustainability of the Fed's rate cut phase is highly doubtful. The neutral interest rate level in the U.S. may currently be underestimated (details later), so there is reason to worry about the Fed becoming more hawkish, which is a JPY depreciation risk.

On the other hand, from the BOJ's perspective, the upper limit for interest rates based on a level that can be expected to promote a virtuous cycle of wage and price growth is 0.75%~1%, which is close to the neutral interest rate. If it is 1%, then there will be two more rate hikes, and if it is 0.75%, then there will be one more. My main forecast scenario involves one more rate hike during 1H, following which, the BOJ will strengthen its wait-and-watch stance.

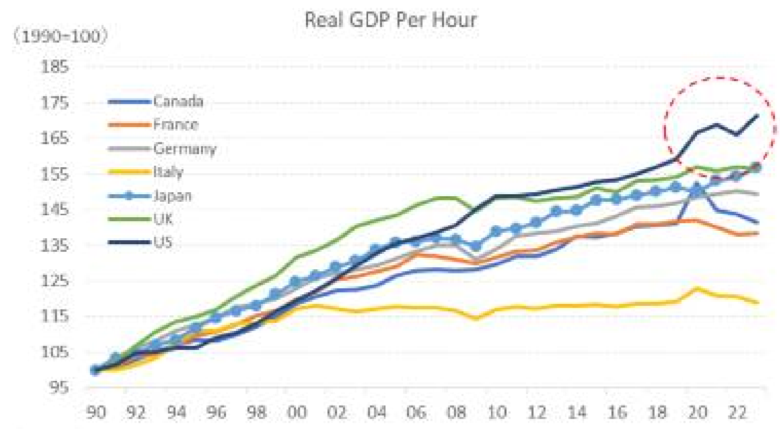
In this regard, a risk scenario for moderate JPY depreciation, as mentioned, is the postponing of rate hikes owing to the national elections scheduled for mid-year, which would leave the policy interest rate at 0.50%. On the other hand, given the robust state of the U.S. economy, the BOJ could be compelled to raise interest rates periodically, to well above 1%, or to accelerate its pace of quantitative tightening. Intuitively, these would constitute JPY-appreciation risks, but the fact is that JPY may already have been depreciating significantly for such a currency-defensive monetary policies to be implemented. I am afraid any rapid shift to a hawkish stance by the BOJ will be an event accompanied by great volatility in the direction of both JPY appreciation and depreciation.

In terms of supply and demand, my main forecast scenario is that the trade deficit will shrink due to a decrease in imports, assuming that crude oil prices fall by more than 10% yoy (to around USD70 per barrel). If so, this will be a reassuring factor checking JPY depreciation. However, in addition to the above import-suppressing factor, there are also export-suppressing factors, such as the Trump administration's protectionist policies and lackluster Chinese economic growth. Given that the travel surplus is also expected to plateau, the overall current account balance seems unlikely to change much from 2024. On a cash-flow (CF) basis, it may be neutral or post a slight surplus at best. Of course, the fall in crude oil prices is not guaranteed.

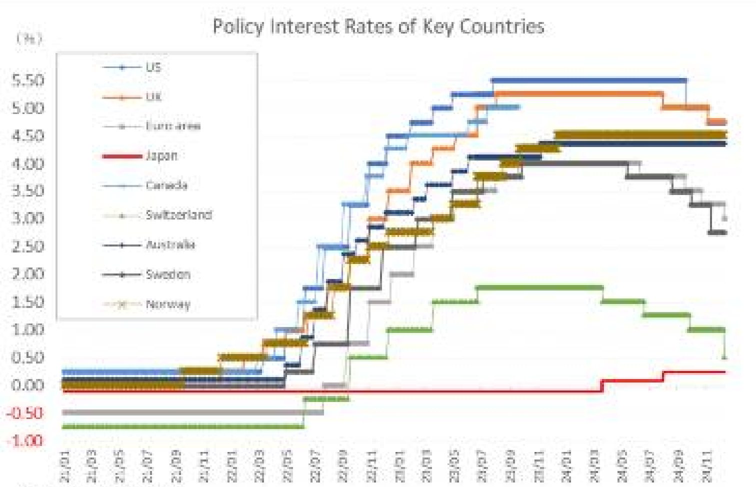
In the financial account balance, household JPY selling will remain sizeable despite the slowing down of foreign securities investment via investment trusts, which has so far been sustained at around JPY1 trillion per month. Direct investment is also a conspicuous item in the financial account balance, but its structure of strong outward flow vs. sluggish inward flow may not be easy to change. Ultimately, when the Japanese economy is taken as a whole, JPY supply and demand in 2025 will remain strongly inclined toward JPY selling rather than buying. Factors that could prove the above prediction wrong include a plummeting of crude oil prices or the normalization of the slower pace of household JPY selling as was temporarily seen starting September last year, but there are no good reasons to include these in my main scenario.

Unilateral USD Dominance Inevitable

While JPY continues to be inherently weak, it is also worth pointing out the continued inherent strength of USD. It would, therefore, not be surprising to see the aforementioned risk scenario of the Fed turning hawkish (halting interest rate cuts, or even starting interest rate hikes) being incorporated into their main forecast scenarios by some market analysts. Over the past three years, USD has essentially continued to appreciate with the exception of 2023, when it remained flat. Will the currency continue its appreciation in 2025? As of now, there seems a strong possibility of it. The second Trump administration's policy mix is inflationary, and this is a key factor, but one cannot afford to overlook the strong foundations of the U.S. economy either. Labor productivity growth in the U.S. is currently head and shoulders above that of other developed countries (see graph above right). One should assume that the country's potential growth rate and therefore its neutral interest rate are also high in line with labor productivity. This suggests a potential widening of the interest rate differential between the U.S. and other countries going forward. In worrying contrast with the BOJ, which is expected to end its rate hikes in 1H, the ECB and Bank of England, which are expected to continue cutting rates throughout the year, and the Swiss National Bank, which may even consider a return to negative interest rates, the Fed is expected to end rate cuts and potentially even start rate hikes again. Surveying the policy interest rates of key countries, the establishment of unilateral USD dominance in the forex markets may be inevitable (see graph below right).



(Source) macrobond, real GDP (PPP-based, base year 2015)



(Source) macrobond

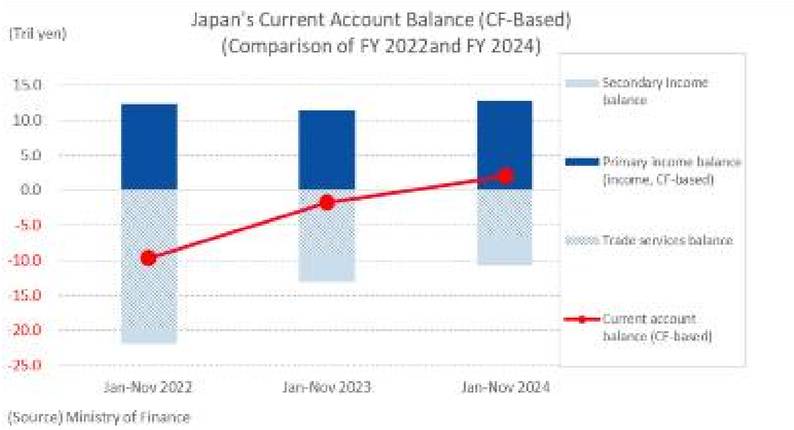
The question is – to what extent can USD be expected to appreciate? For 2025, should one expect 1~2 Fed rate cuts, none at all, or perhaps even rate hikes being priced in? The extent of USD appreciation will vary depending on the scenario, but USD appreciation itself is signaled by all scenarios. For Japan, in particular, the USD-JPY relationship from mid-2025 onward will be characterized by across-the-board JPY weakness vs. across-the-board USD strength, and the currency pair settling at the 160 level is by no means a risk scenario.

One concern is the extent to which the second Trump administration, which favors low interest rates and USD weakness, will tolerate this across-the-board appreciation of USD. Objectively speaking, USD has remained strong for the past ten years or more. At the same time, the U.S. has been building up a trade deficit, and some believe this is what created a climate conducive to support for Trump. I will discuss risk scenarios that take into account the possibility of Plaza Accord 2.0 in a later section.

JPY Supply-Demand Climate – Toward an Era of JPY10-Trillion Service Deficits

Impact from U.S. Interest Rate Hikes Painful Even as Supply and Demand Improves

As per the balance of payments statistics for November 2024 released by the Ministry of Finance on January 14, the current account balance was a surplus of +JPY3.3525 trillion. The total surplus for the period from January through November was +JPY28.1844 trillion, easily surpassing the previous record of +JPY24.949 trillion posted in 2007. However, while over half of the 2007 current account surplus (+JPY14.1873 trillion) was owing to trade and services surpluses, the 2024 current account surplus was solely owing to the primary income surplus (+JPY38.9317 trillion), while trade and services continue to post historic deficits (total of -JPY6.557 trillion).



From the perspective of whether actual forex transactions will occur, it goes without saying that the trade and services balances are of greater importance, and in this regard, the structural change in the balance of payments cannot be overlooked as the backdrop to persistent JPY depreciation. Still, my CF-based current account balance, which excludes items considered unrelated to forex supply and demand from the primary income balance, came out to be a surplus of approximately +JPY2 trillion for the January-November 2014 period. Considering that it was -JPY9.7 trillion for the same period in 2022 and -JPY 1.8 trillion for the same period in 2023, JPY supply and demand is definitely improving (see graph).

Despite this, JPY depreciation shows no sign of ending even in 2025, likely because U.S. interest rates are on the rise again, offsetting the improvement in JPY supply and demand. Even if the CF-based current account balance posts a surplus, at around +JPY2 trillion, it is hardly sufficient to offset the significant increase in foreign securities investment via investment trusts due to the launch of the New NISA scheme (which resulted in a net purchase of foreign securities worth approx. +JPY11.5 trillion in 2024; details to be discussed separately). Moreover, at the time of writing, speculative JPY selling, as reflected in IMM currency futures transactions, is not that large. Ultimately, one has to admit that JPY is depreciating in line with its fundamentals from both supply and demand and interest rate perspectives.

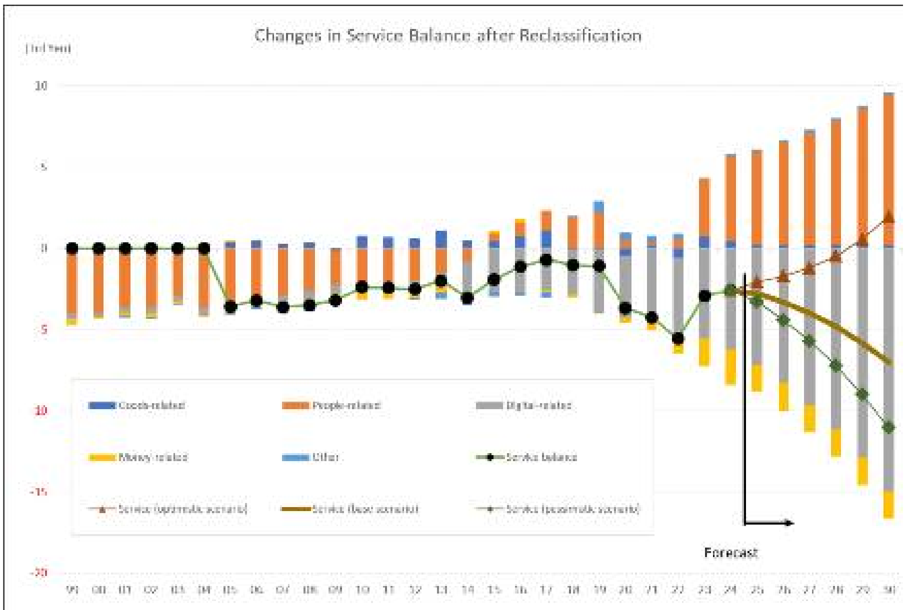
Growing Travel Surplus vs. Growing Digital Deficit

As I have repeatedly said in past issues of this report, Japan's balance of payments is expected to undergo some major changes going forward, mainly in its services balance. In brief, my preoccupation is regarding the extent to which the growing digital deficit can be offset by a growing travel surplus. As of November, the 2024 travel surplus has already reached +JPY5.3452 trillion, surpassing the 2023 record high of +JPY3.6314 trillion, so performance for the entire year is likely to post a solid +JPY2 trillion increase from the previous year.

However, as I frequently point out, this increase is partly due to the fact that Japan had border control measures in place during the January-March 2023 period. The real test of the travel balance's strength will come in 2025. While a precise prediction is difficult to make at the current time, given that the tourism industry is centered on accommodation and catering services, which are facing severe labor shortages, my basic stance is that it will be difficult to take travel surplus growth for granted after 2024.

On the other hand, there is no reason to expect a reversal in the growing digital deficit any time soon, as it reflects demand for digital services. The total digital deficit for the January-November 2024 period was -JPY6.7628 trillion, the latest in a series of record highs, and again a significant increase from the final figure for 2023, which was -JPY5.5194 trillion.

Long-Term Simulation of Services Balance



(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." The 2024 figures are annualized.

The figure to the right shows my simple simulation of Japan's services balance up to 2030. I have divided it into five categories, namely goods, people, digital, money, and others, as in the BOJ Review.[1] My simulation is simply a rough image created by extending the trends seen over the past three years (2022 through 2024) in each category.

There are three scenarios – standard, optimistic, and pessimistic, all centering around the people-related balance, which hinges mainly on the travel surplus. In the standard scenario, the people-related balance increases at the rate of 10% yoy, in the optimistic scenario, it increases at the rate of 25% yoy, and in the pessimistic scenario, it remains at the 2024 level. The 25% yoy pace of increase for the people-related balance in the optimistic scenario is based on the yoy growth rate for 2024, which may come out to be around 23% for the entire year (the actual results for all of 2024 will only be available in February; I will redo my calculations once they become available, but I doubt the results will be much different from my current estimate).

To begin with the conclusion, a services surplus can be expected if the optimistic scenario is realized. However, it is unrealistic to expect the people-related surplus to sustain growth at the pace of 25% yoy for the next several years (given that the growth rate in 2024 was partly due to a rebound following the pandemic). However, given the fact that demand for inbound tourism seems insatiable, I am presenting some figures on the stronger side for reference.

By contrast, in the standard and pessimistic scenarios, the services deficit will expand to about -JPY6.5 trillion and -JPY10.2 trillion, respectively. <u>To be very honest, I do not think it will be easy to sustain a 10% yoy increase in the people-related surplus (standard scenario). However, assuming it can be done, the hard truth remains that, if the digital deficit continues to grow at its current pace, an overall services deficit of over -JPY6 trillion will become normalized</u>.

The pessimistic scenario assumption that the people-related surplus will remain flat at the 2024 level is not an extreme assumption to make. Even so, if we consider the possibility that the trade balance may remain in deficit, a trade and services deficit of over -JPY10 trillion could become the new normal in the pessimistic scenario. Note that the trade and services deficit has exceeded -JPY10 trillion only three times since the start of records – in 2013, 2014, and 2022. These were three years in which JPY depreciated significantly, and also the years in which Japan posted its largest ever trade deficits (in the order of 2022, 2014, and 2013). <u>So as not to come across as whipping up a sense of crisis, my standard and pessimistic scenario assumptions are also somewhat on the optimistic side, but they still suggest an inevitable expansion of the services deficit</u>.

Of course, there are various possible outcomes depending on other assumptions. My assumption regarding the digital deficit is that it will expand at a pace of 16% or so a year. This is the average of the past three years' growth rate. It is not impossible that digital deficit growth will slow down to 5% or 10% a year, so the services deficit may not necessarily become normalized at -JPY10 trillion by 2030. However, regardless of the pace, it is reasonable to assume that demand for digital services is more likely to increase than to decrease going forward.

Incidentally, in the pessimistic scenario (people-related surplus remaining flat), the services deficit will hit -JPY10 trillion by 2030 even if the digital deficit grows by only 10% yoy, and it will hit -JPY10 trillion by 2036 if the digital deficit grows at the rate of 5% a year. When it comes to the services deficit, the focus must be on its future possibilities rather than current expansion.

Please refer to my book *The Truth of JPY Weakness – Japan Masquerading as a Current Account Surplus Nation* for a more detailed discussion of this issue. <u>One way or the other, it would not be surprising to see the advent of an era of -JPY10 trillion services deficits sooner or later</u>. Rather than being complacent about the current level of the services deficit (in the -JPY3-trillion range), one must also spare a thought for the future.

On the Argument that the Digital Deficit is Not All Bad

On a slightly different note, I have recently been hearing the argument that the digital deficit is not all bad, and that Japan should use digital services to increase productivity and add value to economic activity. This is a valid point, and I agree with it to a large extent. However, even if one were to take the stand that the deficit itself is not a bad thing, it is unwise to turn a blind eye to a future of even greater distortion of the JPY supply-demand balance due to the

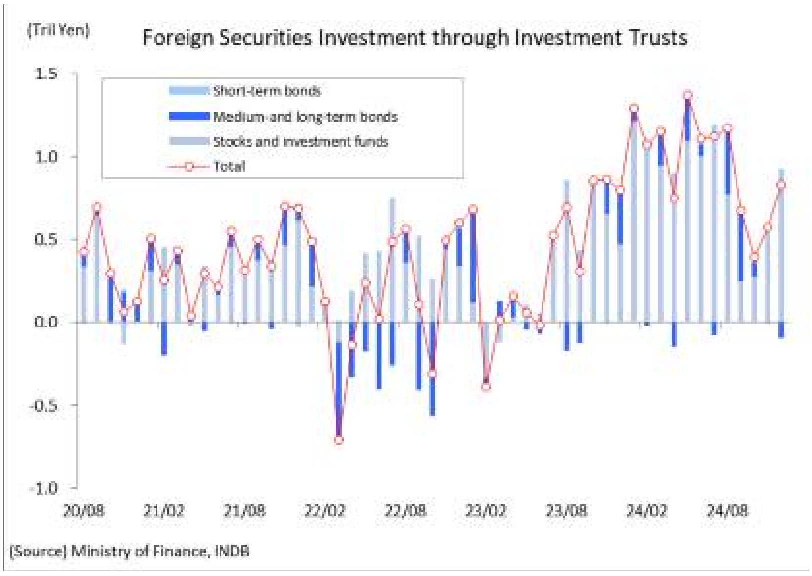
[1] Please see "Globalization of Services Trade as Seen in Balance of Payments Statistics," BOJ, August 2023

expanding digital deficit. At least from the perspective of limiting JPY depreciation, the expansion of the digital deficit is not praiseworthy.

Digital services must be seen as being similar to crude oil, in the sense that both are absolutely vital for economic activity, but the other party has the power to set the price. In response to a rise in crude oil prices and an expansion of the trade deficit, do we say, “A trade deficit is not bad, we must use it to provide high value-added goods and services...?” When it comes to digital services, therefore, we must consider the two questions of how to minimize the digital deficit and how to maximize the utility of digital services in parallel.

Household JPY Selling on the Rise Again

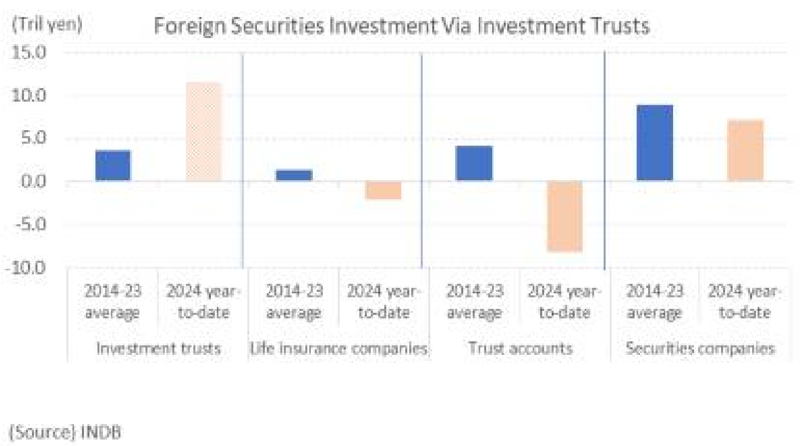
On January 14, the same day as the November balance of payments statistics release, the Ministry of Finance also released the International Transactions in Securities (based on reports from designated major investors) report for December 2024. With this, the actual results for household JPY selling for all of 2024 have become available, and I would like to share my thoughts on them. Foreign securities investment via investment trust management companies, which has been attracting attention as a proxy variable for household JPY selling following the launch of New NISA, was +JPY11.5069 trillion for the entire year 2024. This is about 2.5 times the amount for the entire year 2023 (+JPY4.5447 trillion). It seems fair to say that the impact of measures to develop Japan an asset management center became quite evident in 2024.



The recently released December figures revealed a net purchase of +JPY827.7 billion, the first net purchase in four months. Looking at just equity and investment fund shares, the net purchase was to the tune of +JPY909.9 billion, the sixth largest net purchase in 2024. While not yet certain, it appears that foreign securities investment via investment trusts, which had been declining since peaking in August last year when the market crashed (in what became known as the Reiwa version of Black Monday), may have bottomed out in October. Will it continue to recover and become a flow contributing to JPY depreciation in 2025? This will be an important point to consider in formulating my outlook.

NISA Poverty Also the Result of Inflation Tax

Summarizing the movements of the most visible forex market players for 2024 as a whole, life insurance companies posted a large net sale to the tune of -JPY2.12 trillion, and banks and trust banks (hereafter “trust accounts”) posted a large net sale to the tune of -JPY8.1544 trillion. The former was the result of the net sale of bonds, and the latter was the result of the net sale of equity and investment fund shares. Further, financial instruments business operators (i.e., securities companies) posted a net purchase to the tune of +JPY7.204 trillion, mainly of bonds. As a result, Japan as a whole posted a net purchase of foreign securities to the Tune of +JPY681.5 billion in 2024, which is not a very large amount.



Despite this, the trend of investment via investment trusts is attracting attention as a proxy variable for household JPY selling because many people view the household sector’s purchase of foreign equity as something similar to capital flight. Because they are being seen as similar to capital flight, exchange rate hedging is not assumed for these investments, so it becomes possible to equate the net purchase amount with the scale of JPY selling. Such associations, regardless of the facts, take on a life of their own in the forex market, which is driven by impulsive behavior. Of course, there are probably more than a few who would like to enjoy the benefits of JPY weakness in purchasing foreign stocks. In the ten years between 2014 and 2023, the annual average for foreign securities investment via trust funds was +JPY3.6 trillion. This has more than tripled since the revision of the NISA scheme, and it seems obvious that a new JPY seller has emerged in the Tokyo Foreign Exchange Market.

The question is, will household JPY selling remain as vigorous in 2025? Setting aside the question of whether or not a net purchase scale of over JPY10 trillion will become the norm, foreign securities investment incentivized by the new tax-free limit is likely to continue going forward. However, despite the incentive to invest, a problem that has recently surfaced is the lack of funds to invest. A new phrase, "NISA poverty," has been doing the rounds since last year. It refers to the phenomenon where, since the launch of New NISA, a large portion of assets are being diverted into investment, thereby restricting consumption. Naturally, if people are investing at the expense of consumption, such investment may be restricted due to a scarcity of funds going forward.

Cutting consumption in order to invest may not be altogether irrational. It may have the same root cause as another phenomenon that has been pointed out in the Japanese economy in recent years, namely the inflation tax suppressing personal consumption (*please refer last year's editions of this report for a detailed discussion of the inflation tax). It is generally known that the recent asset management activities of the household sector have a larger component of "protection" than of "investment." What are households protecting their assets from? Needless to say, they are protecting them from inflation.

Since March 2022, JPY has fallen by more than 40% against USD (from 113 yen to the dollar to 162 yen to the dollar). The defensive instincts of economic entities engaged in consumption and investment activities outside Japan, either directly or indirectly, are bound to have kicked in in response to even the safest JPY assets, namely cash deposits, losing over 40% of their value against USD. Given that Japan depends on imports for over 90% of its natural resource requirements and over 60% of its food requirements, a weak currency hits all residents equally through rising import prices.

At the same time, Japanese and U.S. stocks are relentlessly renewing their all-time highs, and the domestic real estate market is thriving, so it is natural for people to feel a sense of urgency that something needs to be done. Under these circumstances, the government's New NISA framework is bound to come as an opportunity for investment, and it is not irrational for households to choose risky assets such as stocks, especially those denominated in USD and other foreign currencies rather than JPY, over deposits.

Investing as a Form of Saving, not Diversifying from Savings to Investment

As households continue to use New NISA to increase their holdings of risky assets to protect against inflation, they will inevitably have fewer funds available for personal consumption. Ultimately, therefore, "NISA poverty" is an indirect form of holding back on consumption as a result of inflation and, in this sense, it is the same as the inflation tax suppressing consumption. The phrase "NISA poverty" seems designed to warn against excessive eagerness to invest, but such a warning seems unreasonable.

Accumulating cash as savings and deposits during deflation and investing in assets such as stocks, mutual funds, and real estate during inflation are the same in that they are both optimal actions in line with the economic and price situation. At the very least, it is disingenuous to say that people are becoming poor (and therefore unable to consume) as a result of investment. Investment via New NISA is likely driven by precautionary motives, and in that sense, it functions in the same way as savings. Savings and investment are often interpreted as alternative actions, but the current trend appears to be to invest as a form of saving.

BOJ Monetary Policies Now and Going Forward – Concerns about Monetary Policy Transitioning into Currency Policy

JPY Continues Weakening Despite Inevitable Interest Rate Hike

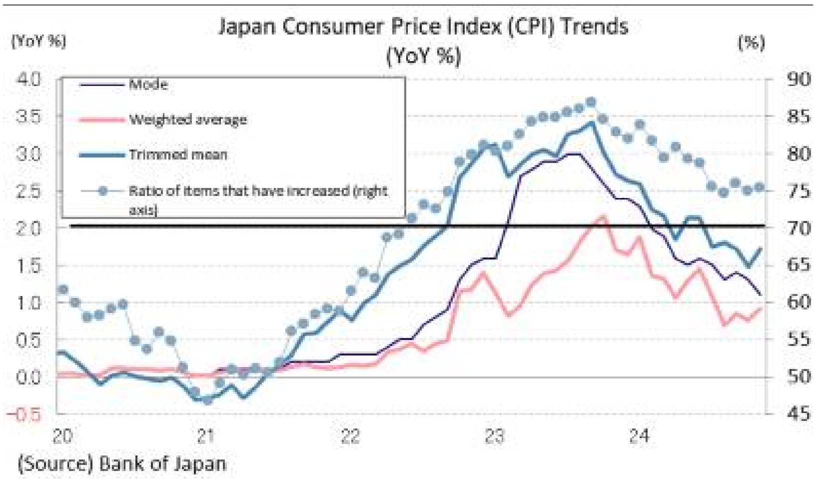
As expected by the financial markets, the BOJ's January 23-24 monetary policy meeting (MPM) raised the policy interest rate by +25bp, from around 0.25% to around 0.5%. This is the highest policy interest rate level in 17 years. It is inevitable that JPY interest rates will rise, however, given that USD/JPY is hovering around JPY160 (the lowest level in 34 years) and given that this degree of JPY weakness is damaging the domestic economic environment. In addition to the usual public statements and Outlook for Economic Activity and Prices (Outlook Report) ordinarily provided following MPMs, the BOJ also released a simple explanatory document entitled "Decision at the January 2025 MPM". This type of document has been seen in connection with complex and inter-related policy decisions under the BOJ's Kuroda administration (such as yield curve control and the three-tiered interest rate adjustment following the introduction of negative interest rates), but it is surprising to see one prepared to explain a simple interest rate hike, and there are grounds for suspecting that the document's preparation reflects the BOJ's concerns that an interest rate hike will place burdens on people's lives and invite a political backlash. In fact, the document made it clear (and emphasized in bright-red bold typeface) that "Real interest rates are expected to remain significantly negative, and accommodative financial conditions will continue to firmly support economic activity."

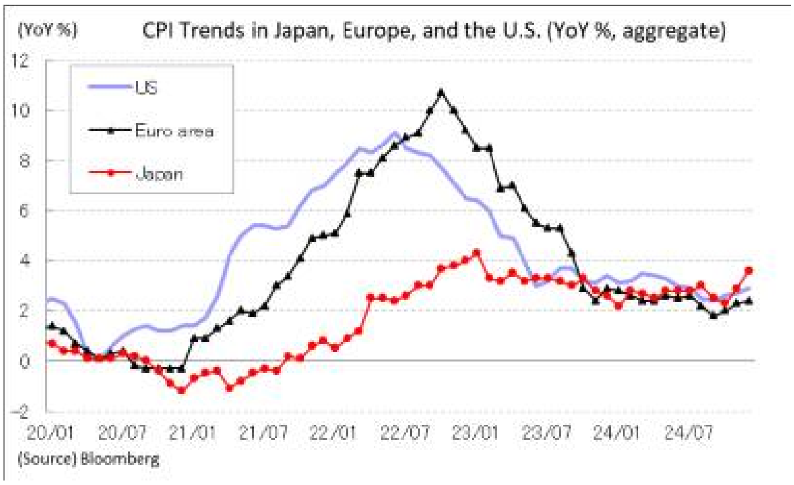
The December MPM's controversial decision to maintain the interest rate status quo can be explained primarily with reference to two kinds of uncertainties – those related to the wage situation in Japan and those related to the incipient Trump administration in the United States. In light of this, the latest outlook report points out that "firms' behavior [has been] shifting more toward raising wages and prices recently" – and – "While attention has been drawn to uncertainties surrounding policy conduct in the United States, the U.S. economy has been solid, and global financial and capital markets have been stable on the whole." These statements clearly suggest that the two kinds of uncertainties have been sufficiently resolved. The Outlook Report's baseline scenario indicates that financial markets remain stable and wages are expected to be rising, so the BOJ decided to raise interest rates in line with that scenario.

As for the future, the first sentence in the Decision at the January 2025 MPM document states that – "Japan's economic activity and prices have been developing generally in line with the Bank's outlook, and the likelihood of realizing the outlook has been rising." – and it can be expected that the BOJ's behavior will be in accordance with this view for the time being.

It is worth noting that the BOJ's latest rate hike has brought the policy interest rates of the BOJ and the Swiss National Bank (SNB) into alignment (see lower graph on previous page), but there is a huge difference in the movements of JPY and the Swiss Franc (CHF) against USD. This article has repeatedly argued that it is unreasonable to justify the current weakening of JPY solely from the perspective of interest rates, and this is self-evident when one compares JPY and CHF forex movements. The conspicuous fact that Switzerland has built up its trade surplus while Japan has begun recording trade deficits is surely having an impact.

Speculation about Already Being at a Neutral Interest Rate





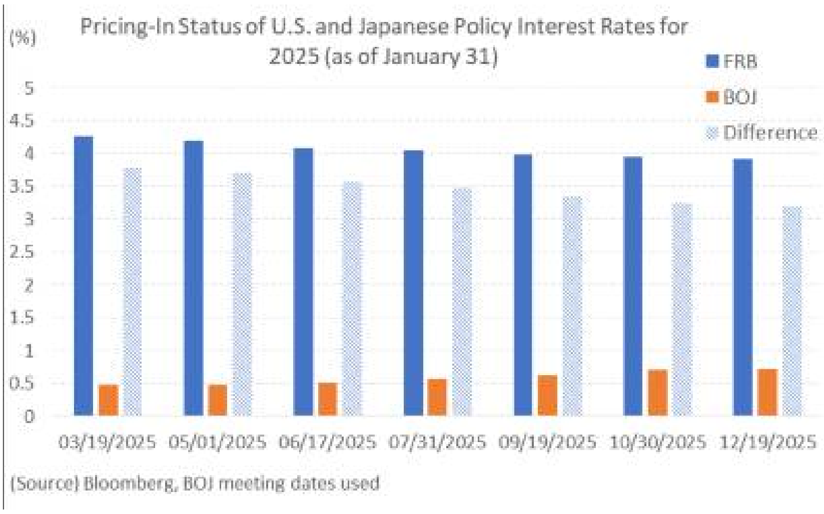
Some people are opposed to the rate hike in light of the weakness of the uptrend in the Consumer Price Index (CPI). The BOJ's "Measures of Underlying Inflation" research data suggest that the core inflation rate is only in the +1.0 to +1.5% range (see graph above right). If the natural interest rate is in the -1.0 to +0.5% range then, assuming an inflation rate of +1.5%, the neutral interest rate would be in the +0.5 to +2.0% range. From this perspective, the policy interest rate has already reached a neutral level and, moreover, if the actual inflation rate is +1.0%, it would mean that the BOJ has raised its policy rate to a level that is restrictive for the real economy, so it is not hard to understand why some are pointing out the possibility that the BOJ is being too quick to hike rates. However, it cannot be denied that the inflation experienced by the household sector is overall inflation rather than underlying inflation, and this point cannot be ignored. For example, in December 2024, Japan's CPI was up 3.6% yoy on an overall basis, reflecting large increases in fresh food prices (see graph below right). In 2024, the average rate of increase in Japanese wages (welcomed as rather large increase by historical standards) was almost the same as this, at +3.56%. Of course, the December rise in the CPI was a momentary increase, so it cannot be said that the two increases offset each other, but what is happening in the real economy is a cycle of price increases and wage increases. (I will refrain from calling it a "virtuous" cycle as the BOJ does.) Governor Ueda has warned against expectations of an additional interest rate hikes soon, saying people shouldn't be expecting the BOJ to raise the rates at one MPM after another as the BOJ wants to proceed carefully. but it does seem that an additional interest rate hike could be implemented at any time so long as the JPY-weakness-driven inflation trend continues. It also appears that a majority of the public supports a policy of raising interest rates with the aim of preventing additional JPY depreciation, and this is a point that Japanese politicians are likely to be aware of. A survey published by the Nikkei newspaper on January 26 found that 54% of respondents "approved" of the interest rate hike, far exceeding the 34% who "did not approve".

Some people cite the lack of shrinkage in Japan's supply-demand gap as a basis for opposing an interest rate hike, but this argument seems a bit superficial for various reasons, particularly the country's labor shortage, which is forcing capital utilization rates to remain stable at a low levels. If Japan's capital equipment cannot be fully utilized because of labor supply constraints, there is a risk that the country's economy will superficially appear to have more idle assets than it actually does, meaning that the supply-demand gap's tension may actually be relaxing. There are various theories on this point, but given the ubiquitous evidence of labor supply constraints throughout the Japanese economy, the argument that it is too early to raise interest rates because of the size of the supply-demand gap cannot be accepted at face value. As prices, wages, and JPY interest rates are all rising, isn't it a very natural market phenomenon that BOJ interest rates, which reflect JPY's price, are also rising?

Forex Rate Trend Ultimate Determinant of Additional Interest Rate Hikes

The "Decision at the January 2025 MPM" explanatory document ends with the statement – "If the outlook presented in the January Outlook Report will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation." The BOJ has thereby communicated to the general public its intention of implementing additional interest rate hikes in the future, and the financial markets' attention has thus shifted to the question of when the next hike will take place. The latest Outlook Report's upward revision of the inflation rate outlook reflects such special factors such as rice price increases and the scaling back of energy-related subsidies and, in the sense that they have been combined with unexpected volumes of JPY selling, can be said to be owing to growth of temporary cost push factors. Therefore, the Outlook Report's upward revision of inflation rates does not call for aggressive interest rate hikes. In fact, at the time this article was written, the markets were not factoring in an additional interest rate hike to 0.75% until the October MPM. At the press conference following the latest MPM, Governor Ueda said – "I expect [the inflation outlook] to be revised upward until around the middle of this year, and then to stabilize. I do not currently see a serious behind-the-curve situation." – suggesting that the need for interest rate hikes may be resolved during the first half of the year.

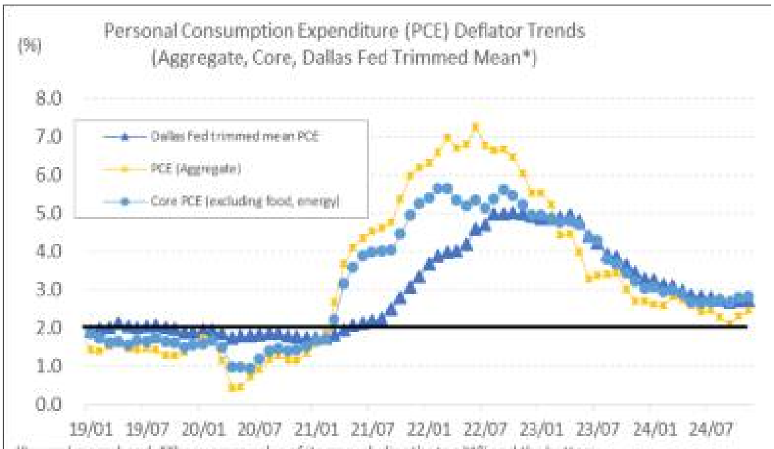
Frankly, however, it bears saying that the question of whether the BOJ interest rate status quo can be maintained will ultimately depend on JPY exchange rate trends. While it was not the case this time, there is always a concern that JPY selling will promote BOJ interest rates hikes, as was the case last July. The Outlook report states that – "The projected year-on-year rates of increase in the CPI (all items less fresh food) for fiscal 2024 and 2025 are higher [in the range of 2.5-3.0 percent for fiscal 2024, at around 2.5 percent for fiscal 2025], reflecting the rise in rice prices and the higher import prices stemming from factors such as the recent depreciation of the yen." – and this appears to hint at some factors behind the latest MPM's interest rate hike decision. In extreme cases, such as if USD/JPY is approaching the JPY170 range at the time of the next March MPM, financial markets' factoring in of prospective interest rate hikes is likely to change flexibly due to growing concerns about such situations as "higher import prices stemming from factors such as the recent depreciation of the yen." The real issue relates to how much JPY will weaken and how much JPY weakening will push up the general price level via import prices at a time when the FOMC is continuing to maintain its policy status quo for the time being and then shifts to clearly indicating the end of its interest rate cuts. At the moment, it is expected that U.S. policy interest rates will only be reduced by about -70 basis points over the rest of the year, but this is based on the assumption that the Fed will not be able to cut rates even twice (the assumption is around 1.8 times; see graph). If it becomes expected that the Fed may not be able to cut rates even once during 2025 or that the Fed's rate hikes may resume in 2026, it will naturally be a factor pushing up USD/JPY. At this point, it appears that the BOJ is likely to attempt to narrow the U.S.-Japan interest rate gap by raising interest rates as a means of preventing JPY from weakening further, although it should be noted that this tactic is no longer a standard practice among developed countries but remains common among developing countries. One gets the impression that Japan's monetary policy is slowly but surely transforming into something more-akin to currency policy.



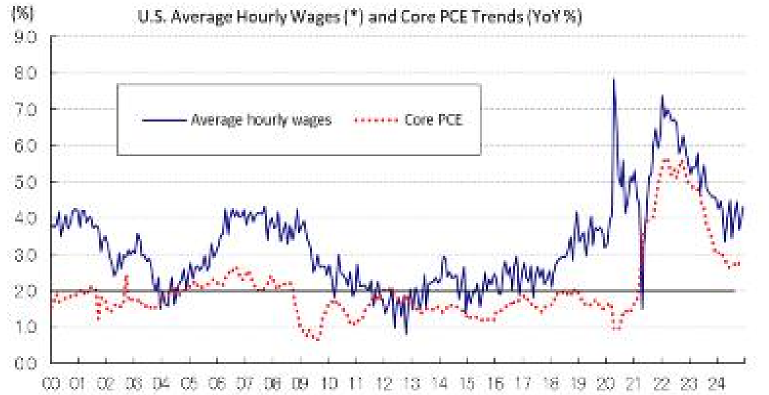
In any case, Governor Ueda's statement at the press conference that – "the pace and timing will depend on future economic and financial conditions, and I have no preconceived ideas" – should be taken seriously by both hawks and doves and, given the recent interest rate and exchange rate scenarios, we should continuously monitor the situation and be wary of the possibility of an unexpected BOJ shift to a more-hawkish stance.

U.S. Fiscal Policies Now and Going Forward – End of Interest Rate Cuts Approaching?

U.S. Economy Too Strong for Interest Rate Cuts until June



(Source) macrobond, *The average value of items excluding the top 31% and the bottom 24%

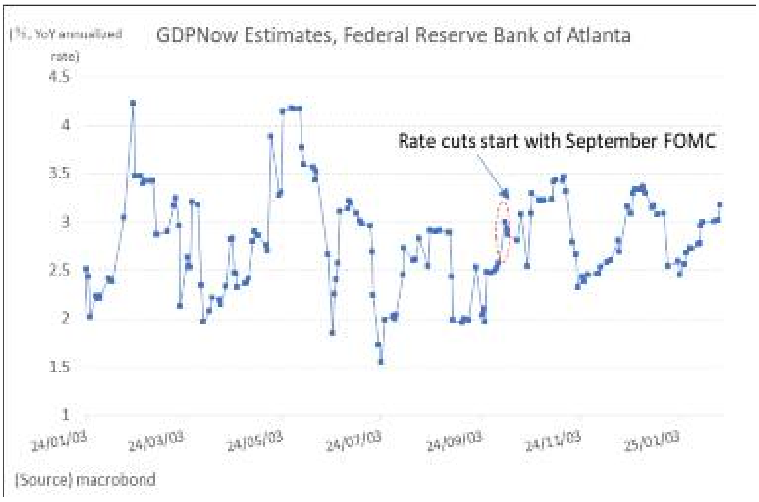


(Source) Datastream.
*Using pre-seasonal adjustment figures for production and non-managerial employment, for which longer time series are available

As expected by the financial markets, the January 28-29 FOMC meeting left the FF interest rate target at 4.25-4.50%. The FOMC members' policy interest rate outlook (dot chart) updated in December predicted two rate cuts in 2025, and the markets are factoring this in, so no policy changes are expected for the time being. Fed Chairman Powell stated at the post-FOMC press conference that – "With our policy stance significantly less restrictive than it had been, and the economy remaining strong, we do not need to be in a hurry to adjust our policy stance." – and <u>the prevailing view is that the Fed will maintain its policy status quo in March and May</u>. Of course, many unexpected events will likely occur during the period through May, but there clearly are currently few fundamental economic indicators that would prompt a rate cut. U.S. inflation indicators (the most important determinant of Fed policy decisions) have bottomed out at around 2% on both overall and underlying trend bases and now appear to be beginning to rise again (see graph above right). Behind this is a still-solid employment and wage situation, with average hourly wages also showing signs of beginning to rise again (see graph, below right). With military aircraft already being used to deport illegal immigrants, labor supply constraints are expected to intensify, and Chairman Powell expressed concern about the tight labor supply-demand situation, saying – "the flows across the border have decreased very significantly, and there's every reason to expect that to continue." – and – "construction [companies], for example, and businesses that are dependent on immigrant labor are saying that it's suddenly gotten harder to get people."
Of course, it is true that interest rate hikes have led to a decrease in demand for labor, which is why the unemployment rate has remained stable without falling or rising, but the graph (below right) makes it clear that the pace of wage and price increases remains higher than it had been throughout most of the past quarter century. This is consistent with the argument this article has frequently made that the U.S. neutral interest rate is rising because U.S. productivity levels are much higher than those of other countries. It is no exaggeration to say that the U.S. economic and inflation situations are too strong to allow the Fed to continue its interest rate cut policy.

No Impact from President Trump's Preference for USD Weakness and Low Interest Rates

As the January FOMC meeting was the first meeting since President Trump's inauguration, there were many questions related to the Trump administration at the post-meeting press conference, and the possibility of frictions stemming from disparities between the Fed's hawkish stance and President Trump's inclinations will continue to be a focus of attention going forward. <u>It is quite important to note that the Trump administration appears unaware that the effects of its policies – such as those to make tax cuts permanent and increase various tariff rates – are liable to raise prices in the United States rather than lowering them, and ultimately have the potential to promote persistently high inflation rates</u>. To a great extent, conditions in the U.S. real economy will depend on the administration's policy mix, and the central bank will have adjust its policy operations in line with the real economic situation. No matter how much President Trump says he wants to lower interest rates, this will be merely an opinion from the perspective of the Fed, which can be expected to simply implement the monetary policy operations it deems appropriate in light of the real economic situation. <u>I have received numerous queries about whether President Trump's preference for USD depreciation and low interest rates will affect the Fed's policy operations and associated forex rate trends, but I can only respond by saying that even the president cannot realize interest rate and forex rate trends that are not in line with the actual economic and financial situations</u>.



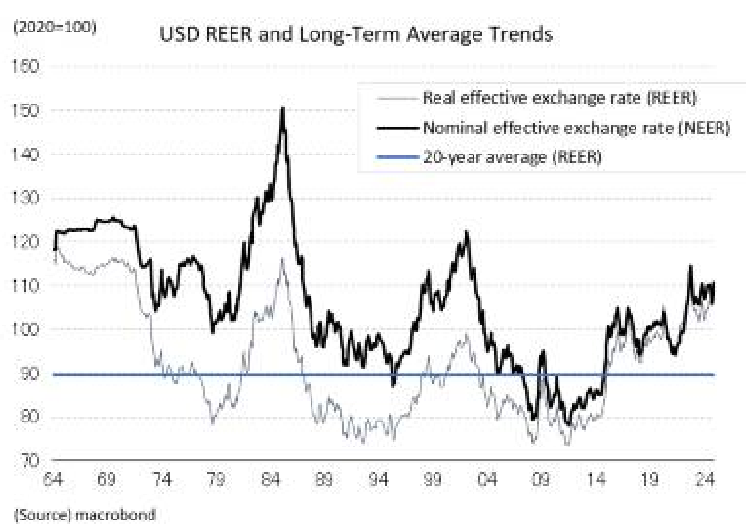
Of course, Chairman Powell's term will end in May 2026, and it should be recognized that President Trump may be able to implement Fed personnel changes that ultimately promote interest rate reductions. For example, newly confirmed Treasury Secretary Scott Bessent proposed an idea for a "shadow Fed chair" in a 2024 interview with Barron's. The concept involves nominating and seeking Senate confirmation of a Fed chairman's replacement well before the current chair's term ends, so that the confirmed candidate could provide forward guidance about future Fed decisions and potentially weaken the current chair's ability to provide forward guidance for 2026. This approach may enable the suppression of market interest rates to a certain extent without the Fed actually lowering the policy interest rate, but the approach is not sustainable, and monetary policy will sooner or later have to become more restrictive in light of the domestic economy's overheating. Following the latest FOMC, on January 29, the Atlanta Fed's GDPNow forecasting model increased its estimate of the annualized qoq real GDP growth rate in the fourth quarter of 2024 to +3.2%, about one percentage point higher than the potential growth rate estimated by the Congressional Budget Office (CBO). <u>It would not be surprising if future estimates of real GDP growth rates exceeding the potential growth rate were to cause the Fed to consider interest rate hikes rather than cuts</u>. What really matters at this point is Chairman Powell's statement that – "With [...] the economy remaining strong, we do not need to be in a hurry to adjust our policy stance." – so, for the time being, financial markets will continue to play the game of trying to guess when the end of interest rate cuts will be seriously considered. Regarding USD/JPY, it is gradually becoming apparent that the widespread expectations that JPY would significantly strengthen following U.S. interest rates cuts were not appropriate.

Risks to My Main Scenario – Plaza Accord 2.0 as a Black Swan Event

Can the U.S. Tolerate Further USD Appreciation?

As discussed above, many people are still predicting that USD will continue appreciating in 2025, and this is a reasonable forecast based on the information currently available. The rate of growth in U.S. labor productivity (≈ real GDP per hour) is much higher than in other developed countries, and it is natural to assume that the U.S. neutral interest rate is rising in parallel. Some analysts even suggest that, during 2025, we will not only see the end of Fed interest rate cuts, but that at some point the financial markets will begin factoring in the start of Fed interest rate hikes. The potential for such developments cannot be completely denied.

<u>The longer USD remains strong, the more the financial markets will be speculating about how much the second Trump administration (which favors low interest rates and USD depreciation) will tolerate across-the-board USD strength</u>. Of course, high inflation rates have become a high-profile social issue that is impacting all U.S. residents, undermined voter support for the Biden administration, and helped President Trump be re-elected, so while President Trump may appear to favor low interest rates and USD depreciation, his true intention may well be to tolerate USD strength until inflation rates are brought under control. There was a time when it was widely expected that, because newly confirmed Treasury Secretary Scott Bessent is a fervent proponent of fiscal discipline, U.S. interest rates would fall and USD depreciation would ensue, but high inflation rates are an economic phenomenon liable to negatively affect public support for the Trump administration, so it is natural to conclude that USD strength is basically more convenient for the administration.



However, <u>looking at trends in the effective USD exchange rate, one finds that the rate has been rising on both nominal and real bases for over 10 years, and the effective USD exchange rate is already approaching the level seen around 1985, when the Plaza Accord was concluded (see graph)</u>. As President Trump is known to favor protectionist trade policies, one wonders what his opinion would be about having the effective USD exchange rate at nearly the same level as it was when the correction of USD's excessive strength through international cooperation was generally considered justified even by non-protectionists. In 1985 President Jimmy Carter came to see a need for the Plaza

Accord out of concern that the U.S. (especially the U.S. Congress) would lean towards protectionism in the absence of such an agreement, but President Trump may simply call for reducing what he perceives as USD's excessive strength based on his own political beliefs. Alternatively, President Trump might choose to forgo exchange rate adjustment measures and allow USD's strength to persist while implementing punitive tariffs and other protectionist measures. In any case, if USD's strength is allowed to persist, it will be worth paying close attention to how politically acceptable that situation will be.

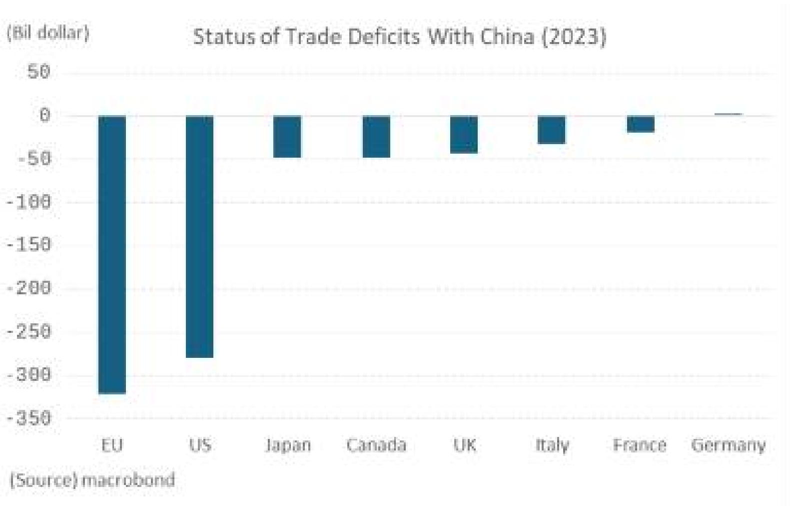
"Plaza Accord 2.0" as a Black Swan Event

Around the year-end and New Year holidays, there often appear astonishing forecasts related to the potential for unexpected 'Black Swan' events or situations that could cause considerable financial market disruption. While black swan events are by their nature almost impossible to predict, my view is that the most likely kind of black swan event that could occur in 2025 might be moves to arrange an international agreement similar to the 195 Plaza Accord, which might be dubbed "Plaza Accord 2.0". As mentioned above, there may not appear to be a strong need to correct USD's excessive strength while inflation is a significant societal problem in the United States, but if U.S. inflation rates decline, it seems likely that USD's excessive strength may become a more-controversial issue. It is worth considering what will happen if U.S. CPI and personal consumption expenditure (PCE) deflator growth rates descend to around +2%, for example, since basic inflation-related indicators are currently beginning to stabilize at levels close to 2% (see graph above on page 10). Of course, those indicators also seems to have bottomed out and begun rising, so they can still be considered to be in a transitional period. Under these circumstances, if USD were to reach historic highs on an effective exchange rate basis (not only against JPY but also against other major currencies) USD's strength would undoubtedly become a hot topic in the financial markets. Given that the Trump administration places considerable emphasis on reviving the fortunes of 'rust belt' companies and other U.S. companies suffering from international competition, it is possible that it will decide at that time that USD's strength is something requiring countermeasures.

In fact, the possibility of arrangements comparable to a "Plaza Accord 2.0" has already been discussed at such international conferences as G20 meetings. In particular, there are many rumors suggesting that a "Shanghai Accord" with USD-weakening goals similar to the original Plaza Accord was secretly concluded at the February 2016 G20 meeting in Shanghai[2]. While the extent to which the rumors are true remains unclear, it is a fact that the Fed shelved its interest rate hike policy after the Shanghai G20. If it actually deems a "Plaza Accord 2.0" necessary, the second Trump administration will likely cite the size of the U.S. trade deficit as a justification. In particular, it goes without saying that given China's huge trade surplus with the U.S., China will be viewed critically and its economic, monetary, and trade policies will be considered to be problematic policies requiring adjustments (as they have been in the past). It is worth noting in this regard that Japan is, after the U.S, the G7 country with the second largest trade deficit with China. The size of the trade deficit with China is not a major point of contention in Japan, but since the size of the trade deficit itself is attracting attention as one of the reasons for JPY depreciation, a "Plaza Accord 2.0" focused on reducing China's large trade surpluses and correcting USD's excessive strength might be a godsend for Japan.

"China vs. Western Bloc"

If the United States seeks to correct the excessive strength of its currency while Japan seeks to correct the excessive weakness of its currency, the two countries' interests will coincide. Not only Japan and the United States, but all G7 countries except Germany have trade deficits with China, and the EU as a whole also has a trade deficit with China (see graph). The EUR depreciation trend has become increasingly serious since the second half of last year, so it would seem easy to find support for an agreement that helps the United States correct excessive USD strength and helps Japan and Europe correct the excessive weakness of their currencies. Looking at changes in nominal effective exchange rates since January 2022, one finds that RMB has been generally stable but at times weakened up to -5%, while USD has appreciated by well over +10%. EUR's effective exchange rate has been stable, likely due to the fact that it has fallen against USD and CHF (total weight of both currencies is 19.5%) while it has risen against RMB and JPY (total weight of both currencies is 23.3%). Regarding the real euro area economy, the ECB and euro area governments are not likely to be happy about EUR's continued decline against USD, which is pushing euro area inflation rates upward.



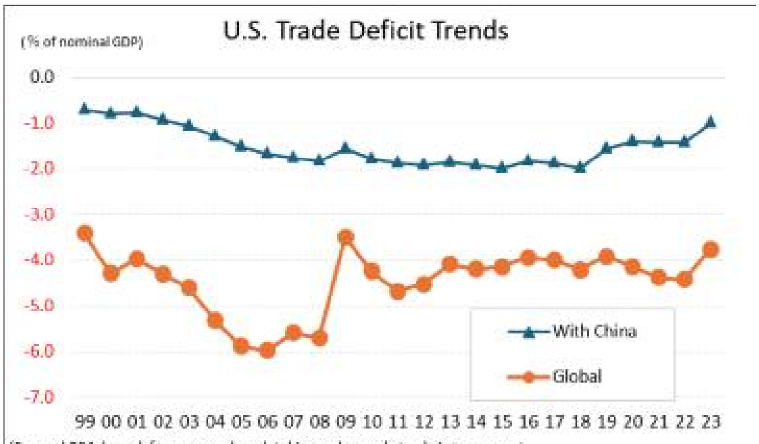
In any case, it is certainly possible to portray the current situation as one in which China (the hypothetical enemy) is intentionally devaluing its currency, with the United States and other Western countries suffering the consequences.

2 Bloomberg: "Shades of Plaza Accord Seen in Barrage of Stimulus After G-20 " March 18, 2016; Nihon Keizai Shimbun: "Speculation of a 'Second Plaza Accord' – Correcting Excessive USD Strength Becomes a Focus of International Finance" October 14, 2022

In light of this situation and President Trump's characteristic policy preferences, it would not be so surprising if the United States were to cooperate with other Western countries in efforts to diminish USD's excessive strength.

China Still Accounts for Almost 30% of the U.S. Trade Deficit

The U.S. trade deficit with China is expected to shrink to a 13-year low of USD278.7 billion (-1% of GDP) in 2023, reflecting the recent relationship between the two countries. However, China still accounts for about 20-30% of the U.S. trade deficit (about USD1 trillion, or -3.8% of GDP; see graph). Second to China in terms of the size of its trade surplus with the U.S. is Mexico ($161.4 billion), followed by Vietnam ($104.6 billion), but these countries' trade surpluses include the results of processing trade, in which components are imported from China and exported to the U.S. Such trade transactions are naturally considered problematic by the second Trump administration. To take an extreme example, if the administration were to consider the U.S. trade deficits with Mexico and Vietnam to also result from trade with China, it may estimate that roughly half of the U.S. trade deficit is with China. (Although the U.S. trade deficits with Mexico and Vietnam includes exports by such U.S. allies as Taiwan and South Korea as well as a quite large contribution by U.S. automobile companies.) Reflecting special free trade agreements (the North American Free Trade Agreement (NAFTA), which was replaced in 2020 by the United States-Mexico-Canada Agreement (USMCA)) Mexico and Canada (which has a USD72.3 billion trade surplus with the U.S.) host many U.S. auto companies' manufacturing facilities that export to the United States. Thus, while President Trump has said that during his second administration he will impose a 25% tariff on all imports from Mexico and Canada, such a tariff will also serve as a means of pressuring domestic companies to perform a greater share of their manufacturing within the United States. Japan has USD71.9 billion trade surplus with the United States, just slightly smaller than Canada's and, although Japanese companies have already undertaken a large amount of investment in U.S. manufacturing facilities, it will still be easy for the Trump administration to find fault with Japan.



(Source) BEA-based, from macrobond, taking only goods trade into account

The United States has quite large trade deficits with China and other major countries, so if the Trump administration were to move toward arranging "Plaza Accord 2.0", it would be logical for it to design the new accord in a way that corrects USD's excessive strength against RMB as well as against other major currencies. <u>It might be politically easier to focus primarily on USD/RMB, but if the Trump administration is intent on weakening USD in a way consistent with its "America First" philosophy, it may simply insist on international cooperation in implementing a broader range of measures designed to correct the United States' excessive trade deficit</u>.

Promoting USD Depreciation Could Spur RMB Internationalization

While "Plaza Accord 2.0" is not the main forecast scenario but merely a black swan risk scenario, it is a risk scenario that is well worth keeping in mind, especially given the Trump administration's avowed goals. In fact, it is only such a forceful move as a "Plaza Accord 2.0" initiative that would have the potential to cause a significant and rapid strengthening of the JPY real effective exchange rate, which has been pushed down to its lowest level in half a century. In the past, when a strong currency (JPY appreciation) was generally frowned upon by Japanese society, this would have been difficult to accept, but there is currently a political and economic atmosphere in which correction of JPY's excessive weakness is likely to be welcomed. While it remains a black swan risk scenario, the Plaza Accord 2.0 scenario has many interesting potential ramifications.

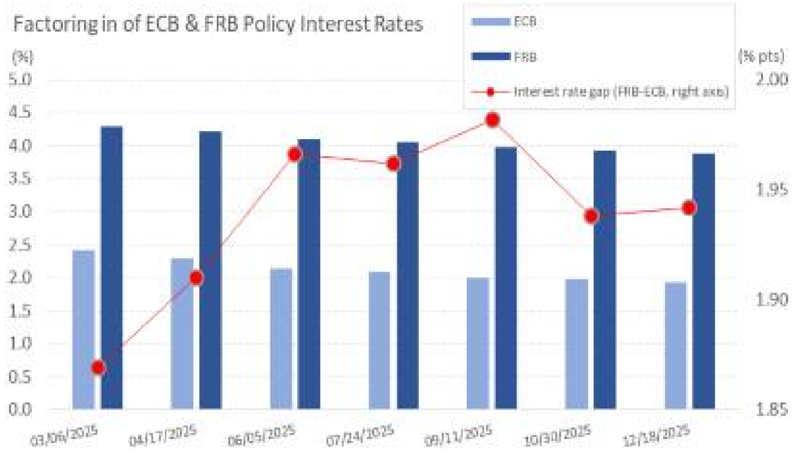
If the United States takes the lead in devaluing its own currency while appealing to protectionism, doubts may arise about the country's political will for sustaining USD as a reserve currency, but President Trump has made it clear that he intends to strongly counter any moves that challenge USD's status as the world's principal reserve currency, and he recently reiterated his threat to impose 100% tariffs on BRICS countries if they were to create a common currency to replace USD. <u>There is a contradiction between the goals of weakening USD and sustaining USD's position as a reserve currency and the main forecast scenario is that the United States will accept the degree of USD strength required to ensure USD's status as the world's principal reserve currency</u>. If the United States itself promotes USD depreciation, it could create a basis for China to internationalize RMB. In light of the current international political, economic, and financial situations, however, it appears that there is an environment in which Japan, the euro area, and China will not be strongly opposed to U.S. efforts to induce USD depreciation. It will be important to closely monitor this situation going forward.

EUR Outlook – Large Europe-U.S. Policy Disparity and Prospective EUR Weakening to Below USD Parity

EUR Area Monetary Policies Now and Going Forward – Interest Rate Cuts Based on Expectation of Wage Growth Slowdown

ECB Advance and Fed Halt Create Large Policy Disparity

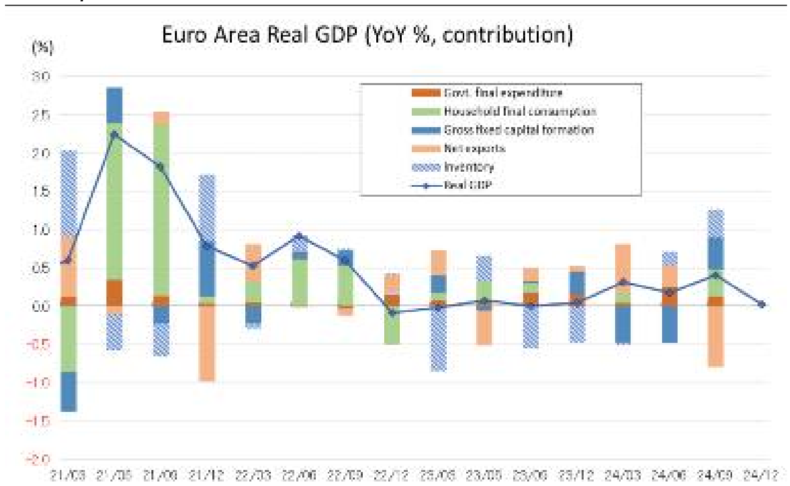
The January 30 ECB Governing Council meeting decided to cut the main policy interest rates by 25 basis points each. The ECB has now cut interest rates at four consecutive Governing Council meetings, contrasting with the Fed, which had cut rates for three consecutive meetings before the January 29 meeting decided to halt the rate cuts. The Fed is expected to halt its rate cuts until mid-year, while ECB President Lagarde has said that it is "premature" to halt the ECB's rate cuts, so there is likely to be a near-term trend of divergence in the two bank's policy interest rates. At the time this article was written, the financial markets were pricing in slightly more than three more cuts for the ECB and a slightly less than two more for the Fed, so the difference between the two is quite large (see graph). At the post-Governing Council meeting press conference, a reporter posed the question "Are you comfortable with going on cutting rates whereas the Fed has stopped? What impact do you foresee?" The weakening of EUR/USD is a direct reflection of the ECB/Fed policy disparity, and this article's main forecast scenario remains that EUR/USD will continue to move on its current trajectory for the time being before EUR falls below parity with USD.



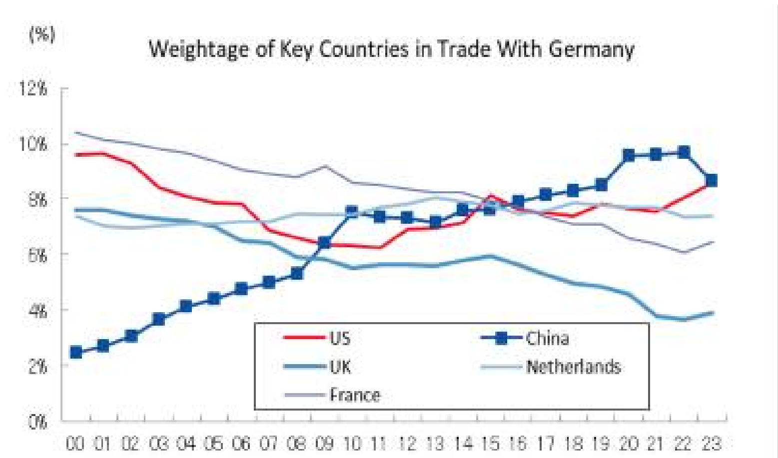
(Source) Bloomberg, as of January 31, 2025
ECB Governing Council meeting dates used (assuming same month FOMC for FRB)

Two Weakening Giants (Germany and France) and Trump's tariffs

Released on the same day as the Governing Council meeting, the euro area's fourth quarter GDP figures (first preliminary estimate) indicate that real GDP growth rate was flat at zero percent qoq and only +0.1% on an annualized basis (figures below are qoq unless otherwise specified). Looking at individual countries, Germany and France both fell into negative growth at -0.2% and -0.1%, respectively, and the slowdown in Germany and France (newly bereft of the extraordinary Olympic games-related demand enjoyed through the summer) dominated the overall euro area economic picture. Such southern European countries as Spain (+0.8%) and Portugal (+1.5%) are showing signs of growth, but not sufficient to offset the declines in Germany and France. For the entirety of 2024, the euro area recorded +0.7% real GDP growth. ECB and IMF forecasts indicate that Germany should regain a positive growth rate somewhat above +1.0% during 2025, but this performance will require a reasonable reduction in the ECB's policy interest rates, and it is questionable whether the ECB can really continue cutting interest rates while accepting the EUR-weakening effect of those cuts. President Lagarde naturally mentioned the Trump tariffs issue during the press conference and made it clear that she was wary, saying that increasing trade frictions would place a burden on the euro area economy's growth. With Germany in particular



(Source) Macrobond



(Source) Datastream

facing pressure to reduce its dependence on China-related business, it is now shifting towards making the United States its largest export destination, and it is likely that the drag on the euro area economy from additional U.S. tariffs will be even more severe than before (see graph on previous page). With unfavorable conditions prevailing in the euro area's domestic and international economic environment, the only option available to the ECB is to lower interest rates.

Neutral Interest Rate Concept

The focus remains on the neutral interest rate, and the first reporter to pose questions at the post-Governing Council-meeting press conference asked about it, saying – "Speaking in Davos, you gave a slightly different range for your neutral rate estimate than in the press conference here. Why did you change the estimate? Why did you lower the midpoint? What is the significance, if there is significance, of this change?" As described below, President Lagarde mentioned at Davos that the euro area's neutral interest rate was in the 1.75%-to-2.25% range, while following the staff analysis presented for 2023 until the Davos statement the neutral interest rate was frequently said to be in the 1.75%-to-2.50% range. President Lagarde avoided stating the reason for the revision, but replied – "On the r-star – natural interest rate – you will be pleased to see in eight days, on 7 February, a publication by staff on the revision of the natural interest rate. This is not something that we [the Governing Council] have discussed. It's a range, and it's a range that does not give a guideline or a destination. It's an indication and in many ways a conceptual principle that is elaborated by a number of models." It is likely that the staff publication released on February 7 will define the neutral interest rate as being within the range of roughly 1.75% to 2.25%. The first reporter to pose questions also asked about how the neutral interest rate may limit interest rate hike, saying – "Your fellow Board member Isabel Schnabel said that we are getting closer and closer to the point where you need to have a discussion about how much further rates can come down. Did you start having the discussion today and what is your own view on this point?" Lagarde replied that – "at this point in time we are still in restrictive territory, and we have not had a discussion, because it would be premature at this point in time about the point where we have to stop." – emphasizing that it is too early to begin discussing the lower limit of interest rate cuts.

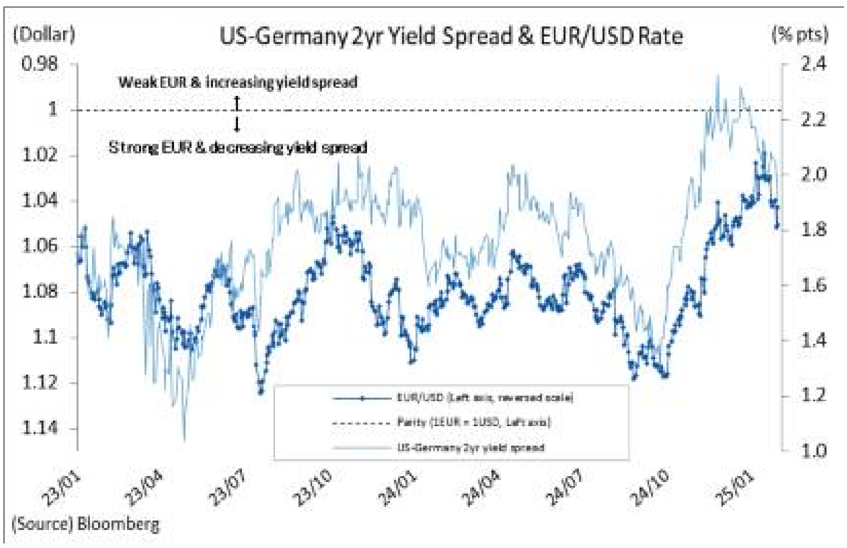
Future interest rate cuts will continue to depend on wage trends, and on this point, President Lagarde stated – "All the indicators that we have at the moment are heading downward and are confirming our confidence that wages in 2025 will be going down." – revealing that ECB policy adjustments are being made based on the assumption that the pace of wage growth will definitely slow during 2025. With the service sector inflation rate remaining high at +4% yoy, it would seem difficult to be sure that wage growth will decelerate, but the ECB appears to be confident in its own analysis on this point. In this regard, the press conference statements should ideally be evaluated with reference to ECB wage tracker data, which will be updated on February 5, but it seems likely that the ECB will maintain at the time of the March Governing Council meeting its confidence that wages will fall and that additional interest rate cuts are warranted. The ECB wage tracker is discussed in another section of this article below.

EUR Now and Going Forward – Euro Area Economic Slowdown Promoting EUR Depreciation to Below Parity with USD

Depreciation to Below Parity Already in Sight

This article's main forecast scenario is that EUR will fall below parity with USD during the forecast period. EUR/USD has been showing clear signs of weakness recently and has already fallen to the USD1.02 mark at one point since the beginning of the year. The expectation of EUR/USD weakening is not surprising given the tendency for Europe-U.S. economic disparities to be directly linked to the Europe-U.S. interest rate differential, which is likely to grow toward the second half of the year. Moreover, the policy environment in which the ECB finds itself is just as restrictive as that of the BOJ. The two central banks have in common the fact that their policy stances are circumscribed by their own currencies' depreciation. JPY selling is pressuring the BOJ to raise interest rates further, while EUR selling is pressuring the ECB to avoid cutting interest rates further.

At the time this article was written, it was expected that the ECB's main policy interest rate would be lowered to near 2% by the end of the year. ECB staff have previously estimated that the euro area's neutral interest rate is in the 1.75%-to-2.50% range, and the range mentioned by President Lagarde at the Davos meeting in January was 1.75% to 2.25%. If this is the case, it can be said that the ECB has not yet created a particularly accommodative financial environment, given the euro area economy's lackluster performance, and it appears that concerns about EUR weakness are part of the reason for this situation. Given the nature of EUR/USD, which reacts quite predictably to interest rate differentials (see graph), a significant interest rate cut would make it difficult to

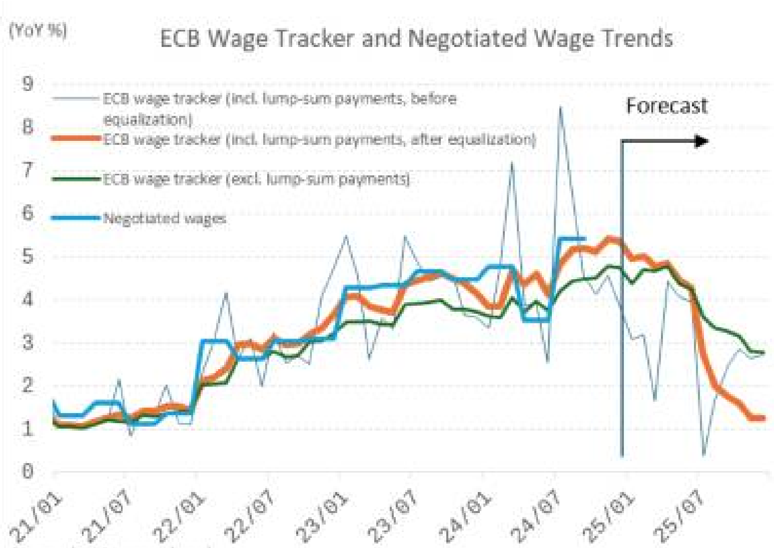


(Source) Bloomberg

suppress euro area inflation, which will be exacerbated by EUR depreciation's effect on import prices. This is why it is generally considered better to stimulate domestic demand with fiscal policies rather than monetary policies, but the euro area faces a unique situation in which the constraints of the EU Stability and Growth Pact make it difficult for countries to implement proactively stimulative fiscal policies. When asked at the Davos conference about the possibility of a large ECB interest rate cut designed to address the weakness of the euro area's real economy, Lagarde denied the possibility and said one reason was that such an initiative could have some consequences for exchange rates.

Deceleration of Wage Growth During 2025?

However, conditions in the euro area economy clearly justify a sizeable interest rate cut, and this can be seen particularly clearly from the wage trends that the ECB is closely watching. On December 18, the ECB finally began full-scale use of wage tracker statistics, which are important for evaluating the current euro area wage situation. The statistics had previously only been used as reference material in working papers, but from now on they will be updated regularly on the Wednesday following Governing Council meetings. The statistics will be an important tool for ECB watchers as a leading indicator for predicting euro area negotiated wage statistics, which are important but are not readily available in a timely manner. The seven countries covered are Germany, France, Italy, Spain, the Netherlands, Austria, and Greece, and the wage tracker's actual results for 2013-2024 are expected to capture 47.4% of the employees in the target countries. The latest wage tracker data published in December indicates that fourth quarter 2024 negotiated wages (not yet released) are likely to be up approximately 5.4% yoy (5.42%, all figures are yoy unless otherwise noted), but for the whole of 2025, the headline ECB wage tracker (including lump-sum payments, after equalization) indicates the pace of negotiated wage growth will decelerate to around 3.2%.



(Source) ECB, macrobond

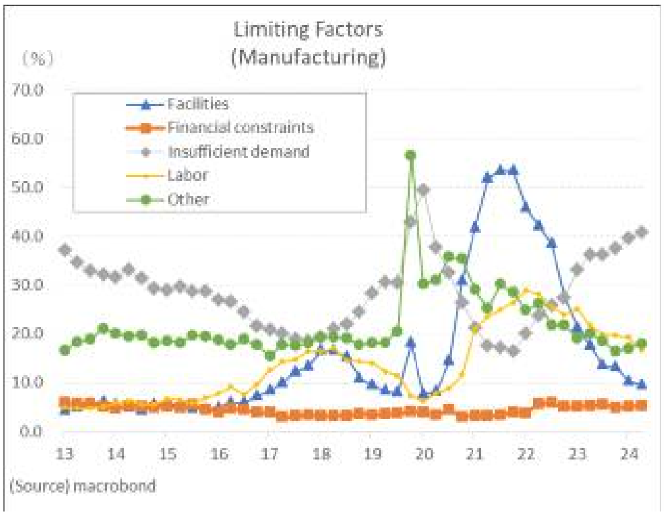
No Significant Growth in Euro Area Productivity

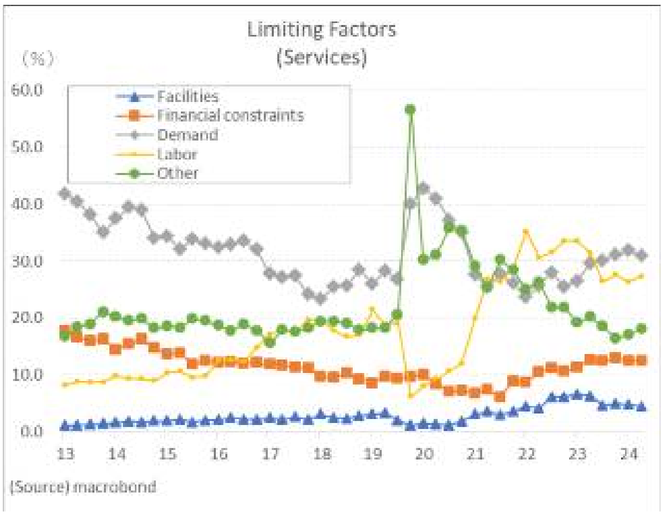
If the wage growth rate falls to around 3% in the future, the ECB will consider it to be a reversion to normal conditions because the assumption of "1% productivity growth rate + 2% inflation rate = 3% wage growth rate" is theoretically considered normal. However, the rate of growth in labor productivity (≈ real GDP per hour) in the euro area (20 countries, total economy) has not increased by even +1% recently – it finally reached +0.5% in the third quarter of 2024 and was almost flat for the first nine months of 2024 (see graph on right). If this is the case and the inflation rate is 2%, the restraint of productivity growth may cause the wage growth rate to slow further and, if it does not slow, unit labor costs (ULC) will remain high and the euro area as a whole will have a stronger tinge of stagflation. As can be seen from the graph, steady growth in euro area productivity has not been seen since around 2010 (since the European debt crisis), and productivity deterioration trends have become the norm since the COVID pandemic. This suggests that the trend of increases in remote work and reduced working hour arrangements has caused a corresponding decrease in output. The phrase "compared to leading Western economies" is often used when discussing Japan's economic problems, but many of the leading Western economies can no longer be considered to be worthy benchmarks.

(Source) macrobond

Key Problem Facing Euro Area Companies Now "Insufficient Demand"

The decelerating rates of growth in wages and prices are a direct reflection of the decline in domestic demand. A European Commission survey has found that the biggest concern facing euro area companies in both manufacturing and service sectors is shifting from "labor shortages" to "demand shortages" (see graphs below). In addition, the January 6 ECB Economic Bulletin has pointed out that the exceptional resilience or underlying strength of the domestic labor market is no longer expected to continue.





In this respect, it bears noting that there is a quite large gap between Europe and the United States, which continues to worry about wage and inflation trends being unexpectedly strong. The key problem, mentioned above, is that the current forex market situation makes it difficult for the ECB to continue simply lowering its policy interest rate in line with conditions in the euro area economy. If the ECB does continue lowering its policy interest rate, there is a risk that EUR depreciation will promote more-rapid inflation. There is a high possibility that EUR will fall below parity with USD when ECB lowers its policy interest rate to around 2.00%, which is seen as the lower limit of the neutral interest rate. However, it is possible that even a neutral interest rate will not be enough to improve the euro area economic situation, particularly in Germany, which is paying the price for its excessive reliance on business with Russia and China. Of course, it is possible that Germany's neutral interest rate may be higher, which would be helpful, but there are concerns that the constraints of the EU Stability and Growth Pact (which make it difficult for countries to implement proactively stimulative fiscal policies) will have an increasingly apparent impact in other euro area countries.

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