

October 31, 2022

Overview of Outlook

In October, USD/JPY hit the 150 level for the first time in around 32 years. Subsequently, JPY recovered due to what appears to have been a JPY-buying currency intervention by the government/BOJ combined with expectations of a change in the Fed's policy stance, but it would be difficult to conclude that the JPY-selling trend has changed. Moreover, it is important to remember: there is a possibility that JPY weakness has gone too far due to strong auto-correlation in the forex markets, but will the JPY appreciation phase in the coming months have the same vigor as the JPY depreciation phase has had over the past year? I highly doubt it. In the history of Japan, JPY appreciation against USD has been an opportunity for USD (USD buying), but going forward it may become important to view it from the perspective of an opportunity for JPY (JPY buying). Some are hopeful that a "cheap Japan" could result in a recovery of domestic manufacturing, but there are limits to this, given Japan's labor supply constraints, and one must not have excessive expectations of a recovery in Japan's trade surplus. Further, it seems natural to assume that a return to JPY strength as a trend will be difficult in the absence of a trade surplus. Going forward, as the Fed's rate hike pace slows, the mutually correlated decline of U.S. interest rates and USD is likely to draw attention. However, as the Fed is not expected to cut rates, the policy interest rate will probably remain unchanged for the foreseeable future. During the second half of the current forecasting period, one must be prepared to see another phase of JPY depreciation driven by carry trade when the markets become less volatile.

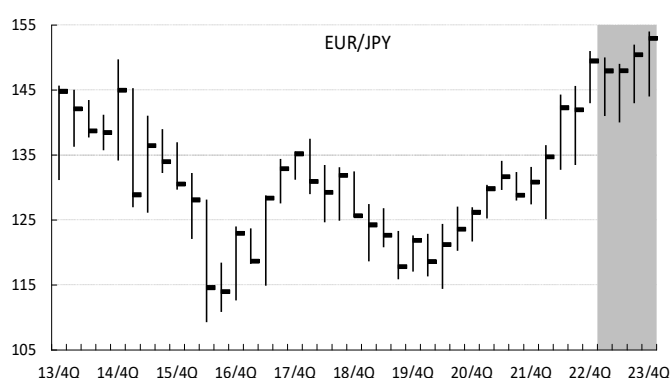
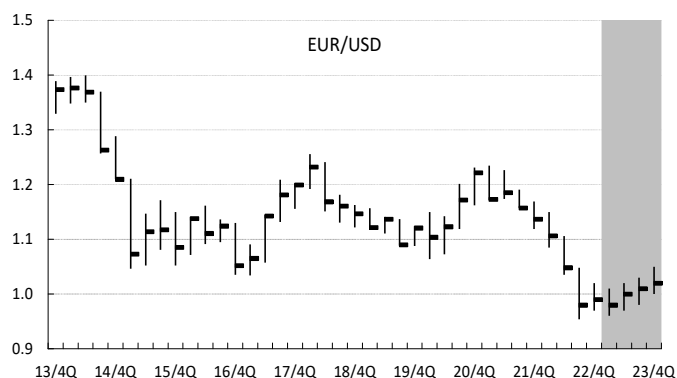
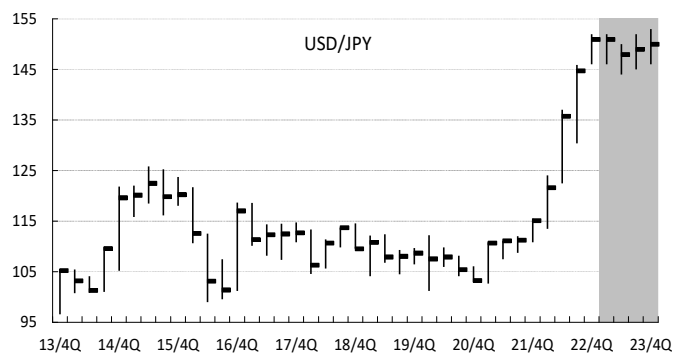
EUR remained strong in October. Amid fears that the euro area may be the economy closest to stagflation anywhere in the world, the ECB will find it difficult to implement monetary tightening to contain inflation. The European authorities, led by the European Commission, are frantically attempting to keep down soaring energy prices, but with repeated interventions to restrain private-sector economic activity, economic growth is bound to fall steadily. There are deep-seated concerns over whether the euro area can survive what threatens to be one of its harshest winters ever, so, except in the case of USD being sold off, the sustainability of any EUR buyback trend seems doubtful. Of course, it is not impossible for the more recent hawkish stance of the ECB to stand out as the Fed approaches the end of its own monetary tightening, resulting in a phase of EUR buyback as the U.S.-Europe interest rate gap shrinks. However, while relations with Russia remain tense, there is unlikely to be any marked progress in terms of energy price normalization, and the German trade surplus may continue to be pared back. Against the backdrop of this vulnerability in the euro area's supply and demand situation, one must remain wary of EUR intermittently falling below parity. During the second half of the current forecasting period, if energy prices stabilize, supply-demand concerns fade away, and the ECB's hawkish stance comes to be truly appreciated, EUR may be bought again. The key for the time being will be to see whether the ECB can persist with its hawkish stance in the face of deteriorating conditions in the region.

Summary Table of Forecasts

	2022		2023			
	Jan -Oct (actual)	Nov-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	113.47 ~ 151.94 (148.22)	146 ~ 152 (151)	146 ~ 152 (151)	144 ~ 150 (148)	145 ~ 152 (149)	146 ~ 153 (150)
EUR/USD	0.9528 ~ 1.1495 (0.9960)	0.97 ~ 1.02 (0.99)	0.96 ~ 1.01 (0.98)	0.97 ~ 1.02 (1.00)	0.98 ~ 1.03 (1.01)	1.00 ~ 1.05 (1.02)
EUR/JPY	124.41 ~ 148.38 (147.62)	143 ~ 151 (149)	141 ~ 150 (148)	140 ~ 149 (148)	143 ~ 152 (150)	144 ~ 154 (153)

(Notes) 1. Actual results released around 10 am TKY time on 31 October 2022. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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Exchange Rate Trends & Forecasts



USD/JPY Outlook – World Currencies Increasingly Competing for Strength

Forex Markets Now and Going Forward – Stronger Signs of Competition for Currency Strength

Speculations Based on G20 Chair's Summary

As in April and July, no joint statement was issued following the October G20 Finance Ministers and Central Bank Governors Meeting, which ended on October 14. This was as predicted and owing to the difficulty of consolidating member state opinions regarding a Russia policy. Rather, what attracted attention this time was the question of how to handle the distortions resulting from monetary tightening policies aimed at containing inflation; more specifically – how to soften the negative impact of USD appreciation accompanying the Fed's interest rate hikes. The G20 Chair's Summary (which replaced the joint statement) stated as follows in this regard:

- G20 central banks are strongly committed to achieving price stability, in line with their respective mandates. To that end, they are closely monitoring the impact of price pressures on inflation expectations and will continue to appropriately calibrate the pace of monetary policy tightening in a data-dependent and clearly communicated manner, ensuring that inflation expectations remain well anchored, while being mindful to safeguard the recovery and limit cross-country spillovers. Central bank independence is crucial to achieving these goals and buttressing monetary policy credibility.**

The underlined portion shows the resentment of other member states toward the U.S. Their real intent appears to be to seek U.S. considerateness toward other countries in view of the fact that U.S. policies are accelerating capital drain away from these other countries and weakening their domestic currencies. In a separate location, the Summary says, "Recognizing that many currencies have moved significantly this year with increased volatility [...]," which could be translated as "Please recognize that many currencies have depreciated sharply as a result of USD appreciation." However, the section quoted above does begin by stating that "G20 central banks are strongly committed to achieving price stability, in line with their respective mandates," which may reflect the wishes of the U.S., as it seems intended to assure central banks their independence when it comes to choosing monetary tightening as a means to achieve domestic price stability. On October 14, Treasury Secretary Janet Yellen said, "My position would be that market-determined exchange rates are the best regime for the dollar. That's what we are supportive of." The following

day (October 15), U.S. President Joe Biden said, “I’m not concerned about the strength of the dollar. [...] Our economy is strong as hell,” indicating that the U.S. government has no intention of being considerate of the negative impact of USD strength on the rest of the world. In her press conference, Yellen pointed out that “the appreciation of the dollar relative to many other currencies is largely reflecting differences in shocks that we face and differences in our positions in terms of what we’re doing, what our economic policies are, and what we’re focused on,” and went on to justify it. In reality, the Fed’s rate hikes have the effect of accelerating real economic slowdown, and given that USD appreciation is an immediately effective way to combat this, there is no reason for the U.S. administration to abandon it at present.

Stronger Signs of Competition for Currency Strength

Currently, many central banks other than the Fed are raising interest rates as a countermeasure against soaring domestic inflation rather than to prevent their domestic currencies from depreciating against USD. Rate hikes are necessary so long as domestic inflation continues to rise. The real problem for them is that U.S. interest rates will probably continue to rise even after their domestic inflation has been curtailed. In that situation, these central banks may be forced to continue raising rates simply to keep their currencies stable against USD. The possibility of the world facing such a situation early in the new year cannot be ruled out given the present state of affairs. If things do come to such a pass, one suspects that the world’s central banks could lose their monetary policy independence in an effort to stabilize their domestic currencies against USD.

Of course, such a structure is not altogether new. Looking back at the past few years in the context of the “trilemma of international finance” (see chart), emerging economies have had to follow in the footsteps of the Fed (i.e., abandon monetary policy independence) during the latter’s rate hike phases in an effort to maintain currency stability and free cross-border capital flows. What is exceptional about the present situation is that developed nations are suffering the same fate. In a forum such as the G20, there is usually a dichotomy between the developed economies and emerging ones, but right now, a dichotomy seems to be forming between the U.S. vs. the others. This dichotomy could become even clearer going forward, given that there is no end in sight to the Fed’s rate hikes. However, with both Biden and Yellen in favor of USD strength, correcting it through international coordination a forum such as the G20 may not be possible for the time being. Under such circumstances, central banks in the rest of the world may have no choice but to recklessly raise rates at the risk of harming their domestic economies.

Trilemma of international finance

	Policy objectives	Examples of adopting countries		
		U.S., Japan	Euro-zone, HK, etc.	China, etc.
①	Independent monetary policy	○	×	○ ^(*)
②	Free movement of capital	○	○	×
③	Stable FX rate	×	○	○

(Source) Created by Karakama, Mizuho Bank

(Note) However, China’s policy will be managed under the guidance of the State Council.

Japan’s actions and their impact on the rest of the world are also worth taking note of. Japan, a key member of the G7, has recently been implementing JPY-buying currency interventions. The U.S. has been tolerating this because Japan is the only country doing so at the moment. However, given that none of the other countries have raised any concerns in this regard either at the G7 or the G20, one cannot altogether rule out the possibility of other developed countries intervening to buy their own currencies and sell USD if they find themselves with their backs to the wall. China has already conducted a CNY-buying (USD selling) intervention at the end of October. It will be interesting to see if the trend spreads to the rest of the world.

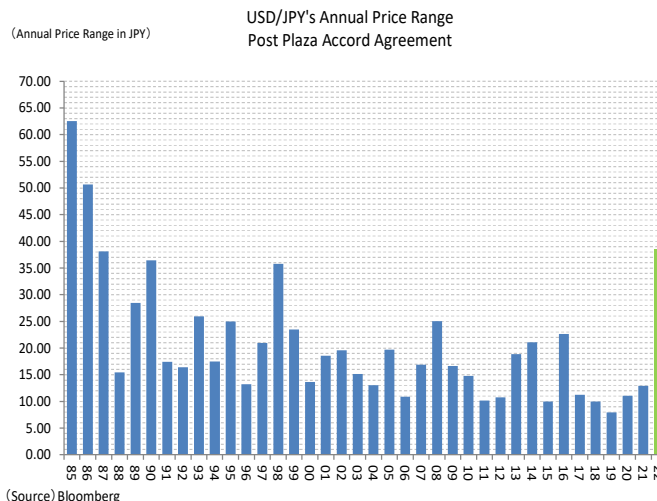
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Incidentally, the U.S. Treasury Department’s “Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States” lists “engaging in persistent one-sided intervention (in eight or more of the recent-most 12 months, with the total intervention amount adding up to 2% or more of GDP) in the foreign exchange market” as one of the key criteria for a trading partner to be declared a currency manipulator. However, the report assumes currency intervention in the form of selling the domestic currency. Of course, another option available for countries is to sacrifice free capital flow (in the trilemma of international finance), i.e., to impose capital controls, and thereby reign in the depreciation of the domestic currency. But this is not a step that can be taken lightly even by emerging economies, leave alone developed ones. Under such circumstances, countries are likely, as a temporary measure, to overcome the trilemma of international finance by adopting the practice of currency intervention (buying domestic currency) to stabilize their currencies while maintaining free capital flow and monetary policy independence. If, in the absence of concessions from the U.S., this practice of fighting back by buying the domestic currency becomes normalized in various countries, that would clearly amount to competing for currency strength. Would this not drive a wedge between the Western nations, which are currently politically and diplomatically aligned against Russia? Looking at it this way, one cannot help wondering if USD strength could become the fork in the road that divides the world.

USD/JPY Now and Going Forward – “Cheap Japan” is not Just Owing to Nominal Rates

Biggest JPY Depreciation Trend in History Continues Unabated

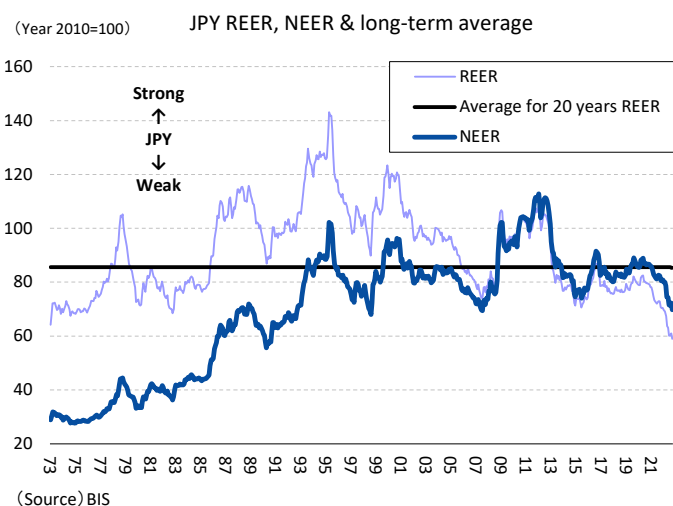
On October 20, USD/JPY eventually surpassed the 150 level (and is at the high of 151.94 as of the writing of this report). The year-to-date rate movement range has hit 38.47, the largest range since 1986 (range of 50.70), the year after the Plaza Accord was signed (see figure on next page). However, in the past, whenever there has been significant USD/JPY volatility, it has mostly been during phases of JPY appreciation against USD; it is very rare to see a large movement range when JPY is depreciating against USD. This year’s range, therefore, is noteworthy as the largest JPY depreciation against USD in history since the signing of the Plaza Accord. Under these circumstances, it is easy to avert one’s gaze from the possibility of a structural change in the Japanese economy and explain the situation away JPY depreciation gone too far. I have the impression that most analysts were stubbornly denying the possibility of a structural dimension to JPY depreciation when the trend began in early spring, but it is going to be difficult to sustain that attitude to analysis now. After USD/JPY hit the 150 level, JPY seems to be appreciating somewhat, thanks to what appears to be JPY-buying currency interventions by the government and the BOJ, but it is still too early to tell whether this signals a change in the trend.



Of course, given that the forex market tends to be strongly impelled by auto-correlation, the current level of JPY weakness may indeed have gone too far in terms of the movement range. However, even if it recovers half the strength it has lost since the beginning of the year (about 18 yen), that would still leave USD/JPY at the 130 level. A year ago, when the currency pair was in the 110-115 range, I predicted that it could become normalized at the 120 level. At that time, some found my prediction egregious. However, now, when USD/JPY would still be at the 130 level even if JPY were to recover half the strength it has lost so far this year, it is rather difficult to avoid the argument that the Japanese economy may have fundamentally weakened.

Nominally Strong JPY Resolves Nothing

Incidentally, USD/JPY hit its lowest at 75.32 on October 31, 2011. In other words, JPY’s value against USD has more-or-less halved in the past 11 years. However, it is not simply its value against USD that has suffered. JPY’s real effective exchange rate (REER) for September, as released by the Bank for International Settlements (BIS) on October 19, was 58.94, its weakest since September 1971 (58.31) – see figure. The markets tend to focus solely on JPY’s nominal rate against USD being at its weakest in 32 years, but the nominal effective exchange rate (NEER) has been more-or-less the same since July 2007, i.e., since the end of the so-called “weak JPY bubble” phase following the BNP Paribas shock. This gap between REER and NEER corresponds to the difference between prices in Japan vs. those in its main trading partners. It is easy to assume that Japan is cheap because its nominal exchange rate against USD is 140 or 150 yen, but the real problem is Japan’s relative disinflation, a fate it has been suffering over the past many years; in other words, the main issues at hand are such things as the lack of increase in wages.



Talking about wages, the minimum hourly wage for fast-food chain employees has been raised from around USD 15 to USD 22 (roughly JPY 3,278) in the state of California in the U.S. This was brought up for discussion in a Japanese news program recently, which also mentioned, for reference, that the minimum hourly wage in Japan was JPY 961. The program seemed to be suggesting that this was one of the ill effects of JPY weakness. However, even with an exchange rate of 75 yen to the dollar, USD 22 amounts to JPY 1650, which is 1.7 times the minimum wage in Japan. In other words, the Japanese wage structure is the more fundamental problem; JPY weakness against USD merely compounds it. Naturally, this difference in labor costs affects the prices set for goods and services, which eventually manifests in general prices (the CPI, etc.). This gap in general prices between Japan and its key trading partners is what lowers its REER and becomes symbolized through “cheap Japan.” During the aforementioned news program, an announcer commented that it was hard to imagine a job paying an hourly wage of JPY 3000 in Japan, but it is important to remember that the difference in wages between the two countries was quite significant even before JPY

began to depreciate against USD. Otherwise, one is at the risk of assuming that the wage-gap problem can be corrected simply by reversing the trend of nominal JPY depreciation against USD.

Doesn't a Disinflationary Currency Appreciate?

Of course, depending on the monetary and currency policies of Japan and the U.S., it would be natural for JPY to appreciate against USD at some point. Under a system of floating exchange rates, a unidirectional trend cannot last forever. When JPY does begin to nominally appreciate against USD, the media, which is currently boiling at the historical weakness of JPY, may heave a sigh of relief. However, as mentioned above, a reversal in trend to a nominally stronger JPY has fundamentally nothing to do with resolving the “cheap Japan” problem. As is generally known, the already existing gap between prices in Japan and elsewhere was only exacerbated by the pandemic. This is the true cause of the “cheap Japan” phenomenon in terms of REER. Even if JPY appreciates in nominal terms, so long as inflation in Japan remains relatively low, JPY’s REER will have no choice but to remain weak.

In this context, some may ask, “Isn’t a relatively disinflationary situation cause for currency appreciation?” In theory, yes. In terms of purchasing power parity (PPP), the currency of a country with relatively low prices holds higher value. However, in this context, I would like to trace the path by which excessive currency weakness is corrected keeping PPP (or REER) in mind. For excessive currency weakness to be reversed, it is first necessary for a large amount of foreign exchange to be earned through the export of goods and services spurred on by said currency weakness. This contributes to an accumulation of goods/services surpluses, which eventually manifest as the sale of foreign currency/purchase of domestic currency, resulting in the domestic currency’s appreciation. In the past, when Japan was a highly competitive exporter, such a path was certainly expected, and it was taken for granted that JPY appreciation would accelerate during trading hours in Tokyo.

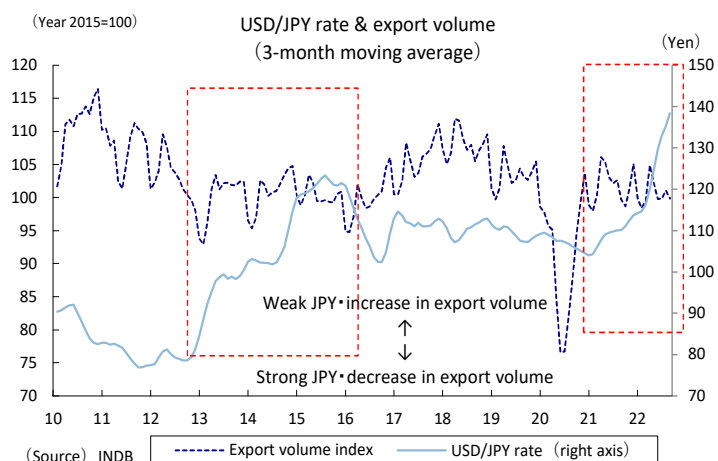
Can Service Exports Restore JPY Appreciation?

As the figure shows, the causal relationship that once existed between JPY weakness and an increase in export volumes has more-or-less ended. This is mainly thought to be because of manufacturing industries getting tired of intermittent JPY appreciation, frequent natural disasters, and the shrinking domestic market, and shifting their production bases abroad. This structural change is thought to have taken place gradually over the past quarter of a century, and one must take it into account in cool-headedly considering whether the theoretical maxim that a disinflationary currency tends to appreciate really applies in Japan’s present case.

Of course, given that Japan seems to be quite popular as a tourist destination among travelers around the world, it may have the potential to earn foreign currency through service exports over the longer term, even if the prospects for goods exports are no longer great. However, the protracted isolationist policies adopted by the Kishida administration and the strict countermeasures to prevent the spread of infections (symbolized by masking requirements) even after the end of the isolationist policy have certainly led to Japan being seen as an insular country.

The Economist ran an article titled “Many Japanese are still reluctant to go unmasked – Why get a face lift when you can get a face covering?” on October 6. It seems an honest reflection of people’s image of Japan around the world. The Japanese view countries such as China and North Korea as insular, and now it seems that the world is beginning to see Japan in a similar light. Earning foreign currency through the export of services holds promise as a path for Japan, but there is no guarantee it will succeed.

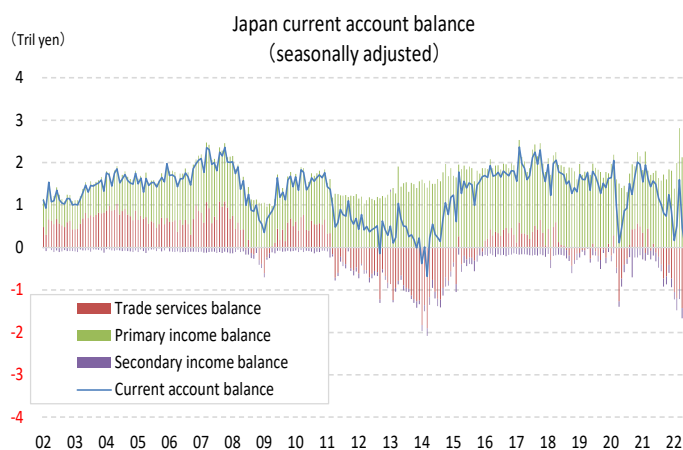
At any rate, JPY is extremely weak both in NEER and REER terms, and one would do well to brace oneself for a reaction to it. Contemplating potential medium- to long-term paths for restoring a JPY appreciation trend has definitely become important for those considering foreign exchange hedging and asset management strategies.



JPY Supply & Demand Now and Going Forward – Implication of Consecutive Deficits Reflected in Seasonally Adjusted Figures

Seasonally Adjusted Figures are More Noteworthy

Japan’s August Balance of Payments, released by the Ministry of Finance in October, revealed a current account surplus of JPY 58.9 billion, the smallest surplus for August in recorded history. As the trade balance for August, which had been released earlier, revealed the largest deficit in history (-JPY 2.8 trillion), the small current account surplus had been expected. Commodity prices peaked before summer began, but it will take some time for this to be reflected in mineral fuel prices in the import statistics. While it is easy, in these times, for JPY weakness to be blamed for ballooning import prices, one must take a more balanced view based on the understanding that the primary income surplus has also ballooned as a result of JPY weakness. It is reckless to simplistically blame Japan’s external deficit on JPY weakness.



(Source) Ministry of Finance

Moreover, this time, it is more important to look at the seasonally adjusted figure rather than the raw, unadjusted figure reported in news headlines (see figure). The seasonally adjusted current account balance for August was -JPY 530.5 billion, a deficit for the second month in a row. This is a first in the recorded history of this statistic, i.e., since records began to be kept in 1996. Since spring this year, this report has persistently explained the risks of simplistically assuming that the current phase of JPY weakness is the result of USD strength, and of attributing it to the U.S.-Japan interest rate differential. In my book titled *What Happened to the Strong Yen?* (Nikkei Premier series), I debate the possibility of Japan being in the process of graduating from the “mature creditor” to the “asset liquidator” stage and propose that the current phase of JPY weakness be discussed from a structural perspective. Whether Japan is, indeed, approaching the asset liquidator stage can only be confirmed in retrospect. To begin with, the theory of the six balance of payment stages does not assert that any of these stages are inevitable or that they happen in exactly that order, nor does it guarantee any specific future state. There are even cases such as the UK, which, despite having come full circle in transitioning from the asset liquidator to the immature debtor stage, has continued to enjoy stability simply because it happens to be the center of global finance (of course, it is still vulnerable to chaos triggered by negative market reactions, as evidenced by the recent turn of events under the previous, Liz Truss administration).

However, in the case of Japan (once a prominent current account surplus nation that has now lost its current account surplus in seasonally adjusted figures), refusing to discuss the possibility of structural factors behind JPY weakness in the face of a year of JPY weakness with the largest ever rate movement range cannot be considered a serious approach to analysis. In spring this year, when JPY had just begun to depreciate, pointing out the possibility of structural factors frequently resulted in rebuttals to the effect that Japan’s current account deficits were temporary and that JPY weakness could not be attributed to structural factors, but such rebuttals have now died down considerably. Of course, given that JPY is governed by the floating exchange rate system and USD is, in fact, extremely strong across the board at the present time, there is bound to be a swing back in the direction of JPY appreciation at some point going forward. However, when that happens, it may be prudent to interpret it as a brief respite in an otherwise long-term JPY depreciation trend.

The future of Japan?

Theory of the development stage of the balance of payments

	① Immature debtor country	② Mature debtor country	③ Debt-paying country	④ Immature creditor country	⑤ Mature creditor country	⑥ Asset liquidator country
Current account balance	deficit	deficit	surplus	large surplus	surplus	deficit
Balance of goods and services	deficit	surplus	large surplus	surplus	deficit	deficit
Primary income balance	deficit	deficit	deficit	surplus	large surplus	surplus
Net foreign assets	deficit	deficit	deficit	surplus	large surplus	surplus
Financial balance	surplus	surplus	deficit	large deficit	deficit	surplus
Examples	U.K.		China		Japan	U.S.

(Source) Created by Karakama, Mizuho Bank

Those Who Insist JPY Weakness is Positive for the Japanese Economy Are Removed from Ground Realities

I have the good fortune of interacting with businesspeople from diverse industry sectors on an everyday basis. Leave alone import companies, the extent of JPY depreciation we saw in the first nine months of the year is terrible even for export companies, and many companies are beginning to consider the need for a long-term forex strategy. High levels of forex volatility that result in protracted inability to settle upon an in-house rate make it difficult to formulate budgets. Some businesses consider such a situation itself to be a business risk. In macroeconomic terms, it may be correct to say that JPY weakness has merits for Japan’s large enterprises and, consequently, for the Japanese economy as a whole. However, export companies with production bases in Japan, while enjoying a favorable exchange rate for exports, are simultaneously facing supply constraints when it comes to procuring raw materials and parts. Some companies that hoped to take advantage of JPY weakness and export aggressively are finding that their production levels cannot keep up. Again, given that the Japanese economy overall is strongly driven by processing industries,

soaring prices of raw materials and parts combined with JPY weakness are resulting in a situation where companies have to import materials at high prices to export finished products cheaply.

This amounts to trading losses and is already being seen as problematic in GDP statistics (see figure). While merely a qualitative analysis based on the scope of information available to me, I feel that there are not many Japanese companies, whether export or import firms, that are convinced of JPY weakness being positive for the Japanese economy. Even if one were, somehow, to conclude that JPY weakness is positive for the Japanese economy, one cannot overlook the deep-seated problem in Japan of a dichotomy between economic entities that benefit from JPY weakness and those that suffer as a result of it. This is evidenced by the fact that wages have not improved as much as expected in the past 10 years since the introduction of Abenomics. The underlying causes for this are extremely macro-level issues related to the rigid Japanese employment system and must be discussed separately from issues related to forex rates of the Japanese economy.

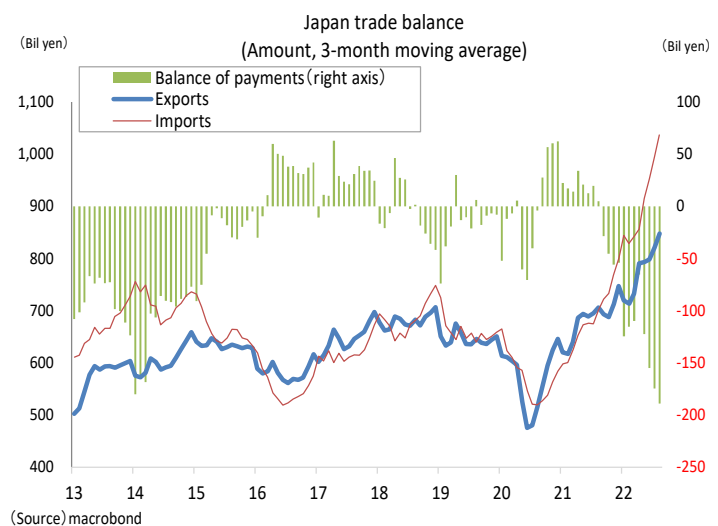
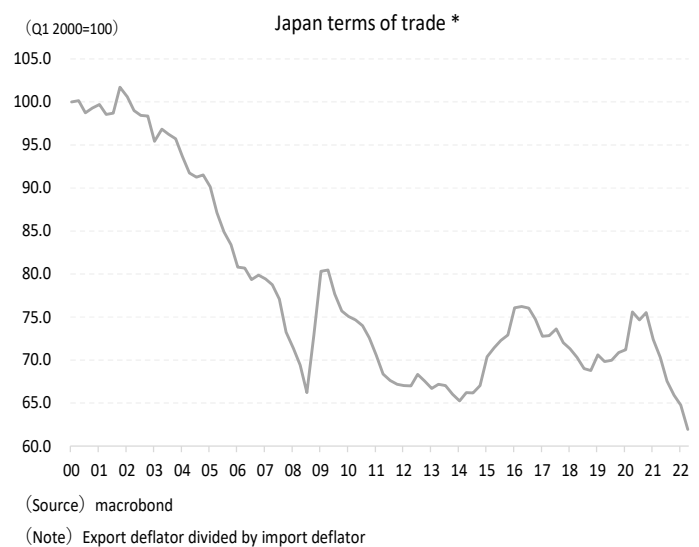
Imports May Have Peaked

In October, what appears to have been intermittent currency interventions by the government and the BOJ were in the news, and there were some phases of significant currency rate volatility. Of course, there is no way of knowing the complete truth regarding the intentions of the currency authorities, but the key point to note is that the effect of these interventions vaporized within a few hours going just by forex rate movements. Of course, import companies that managed to procure USD inexpensively when compared with before the intervention may have benefited, but one must remind oneself that currency interventions that go against the economic fundamentals are unlikely to have long shelf lives. The most important of these fundamentals propping up JPY weakness is the trade deficit. Of course, some of the JPY selling seen in 2022 may be due to domestic vs. overseas interest rate differentials, but one must respect the fact that, on a fundamental level, there are more people who want to sell JPY than there are those who want to buy it.

The September trade balance, which was released on October 20, amounted to -JPY 2.0940 trillion. This was the second month in a row of a deficit exceeding JPY 2 trillion. Of course, this is a historical first. With the release of the September figure, the trade deficit for the first half of FY2022 (April-September) adds up to -JPY 11.0074 trillion, the largest ever for a half-year period going back to 1979, when records began to be kept on this statistic (2H of FY2013, with a deficit of -JPY 8.8 trillion, held the record previously). Overall import value had risen by close to 40% yoy (+37.9%), but half of this (+18.8 pp) can be attributed to the increase in mineral fuel prices, which accounted for a fourth of the total import value (incidentally, the mineral fuel import value had increased by +105.7% yoy).

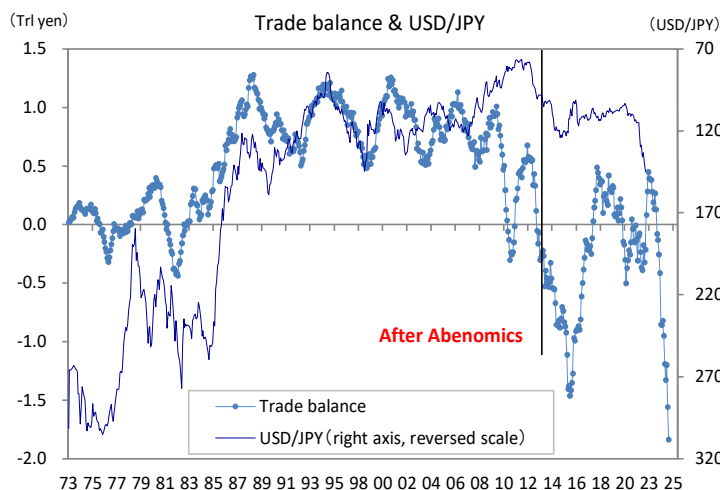
Breaking it down further, the biggest categories within mineral fuels are crude oil and unrefined oil, which increased by only +12.7% yoy in terms of volume, but by +106.3% yoy in terms of import value (calculated as volume x price), indicating a huge difference in the change rate of the two. This clearly reveals the extent to which soaring commodity prices have destroyed the trade balance. On October 21, Masato Kanda, the Vice Minister of Finance for International Affairs, was reported to have commented on the need to diversify the energy mix in order to correct the trade balance deterioration, and it is this very essential issue that must be tackled if the JPY-selling pressure is to be eased on a fundamental level.

From another perspective, commodity prices peaked in June, and this is expected to be reflected in mineral oil import prices and, further, in overall import prices with a delay. If so, criticism leveled against the largest trade deficit in history and the accompanying demand-based JPY selling may begin to taper off in the near term. Crude oil prices have already fallen by 40% since their peak, so the import value (led by mineral fuel imports) is very likely to begin dropping off soon. However, the Japanese economy, previously plagued by movement restrictions imposed at the slightest excuse, is now lifting restrictions on inbound tourism. This may cause a tug-of-war between “increase in imports driven by recovery of domestic demand” and “a decline in import value following the peaking out of commodity prices” for some time to come, so there is no guarantee of a unilateral shrinking of the trade deficit.



JPY Appreciation against USD an Opportunity for JPY Buying

The figure shows the correlation between Japan's trade balance and USD/JPY, projecting the 6-month moving average for the trade balance two years forward. To repeat myself, it is true that the expansion of the domestic vs. international interest rate differentials this year has contributed to JPY depreciation against USD to some extent. However, the more fundamental cause behind JPY depreciation is likely to be the collapse of demand for JPY. Looking back at the last 25 years or so, it is easy to see that Japan stopped earning trade surpluses as a trend in 2012-13, and there have been no phases of marked JPY appreciation against USD since then. Except on June 23, 2016, the day the UK voted in favor of Brexit and USD/JPY briefly sank to 99, the forex markets have not experienced any panicked JPY-buying sprees. Even assuming that this year's JPY depreciation trend is being driven by the marked expansion of the domestic vs. international interest rate gap, the image portrayed by the graph does not intuitively suggest that the JPY appreciation phase expected going forward will be anywhere as robust as the JPY depreciation phase of the past year. I personally think it highly unlikely. In the history of Japan, JPY appreciation against USD has tended to be an opportunity for buying USD, but going forward, it may begin to be considered an obvious opportunity for JPY (JPY buying).

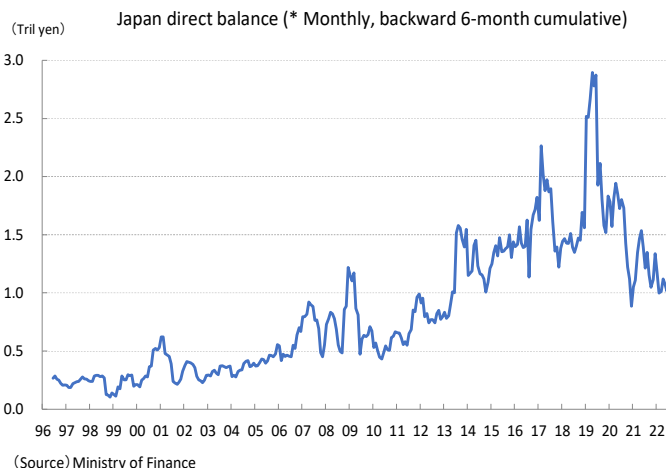


(Source) Bloomberg
 (Notes) Trade balance is presented two years in advance and is based on a six-month moving average.

The Japanese Economy Now and Going Forward – Could Manufacturing Return to “Cheap Japan”?

The Homecoming of Japanese Companies

On the previous page, I discussed the trade deficit as the true cause behind JPY depreciation. From a different perspective, it could be an opportunity – if Japanese companies were to take advantage of the bemoaned “cheap Japan” to make an earnest effort to shift their production bases back to Japan, this could trigger an increase in exports, shrink Japan's trade deficit, and ease up the demand-fueled JPY-selling pressure. Jiji Press ran an article titled “Japanese Manufacturers Increasingly Returning to Japan – Weak JPY may Help Expand Exports,” reporting that the historical weakness of JPY was proving to be the turning point for several Japanese manufacturers, who were shifting their production bases back home. The article cited several examples, including large manufacturers of everyday goods, apparel, acoustic equipment, and consumer electric appliances. However, it is difficult to say with any conviction how much of an impact on the Japanese economy these “increasingly returning to Japan” manufacturers will have. To begin with, only developments pertaining to well-known large enterprises gets reported, while the fact is that many SMEs and mid-sized companies affiliated with them are still based abroad. Naturally, not all companies can work with the same speed as a large enterprise. Moreover, the shifting of Japanese companies' production bases abroad is a phenomenon that happened over a period of many years, and even if decisions are made to return to Japan, the shift back will probably take a similar amount of time.



(Source) Ministry of Finance

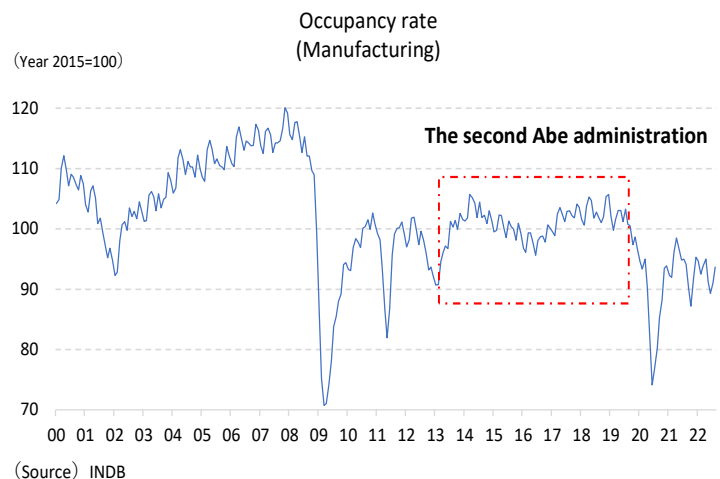
Moreover, it is important to review the reasons Japanese companies felt the need to shift their production bases abroad (“foreign direct investment” in the Balance of Payments statistics) in the first place. One assumed reason is the intermittent JPY appreciation phases, and it seems doubtful that companies will conclude based on this year's JPY depreciation that there will be no more phases of JPY appreciation. For instance, the USD/JPY trend switched to JPY appreciation in 2007, the year of the subprime mortgage crisis, and continued in this direction for around five years, until 2012 – a period during which the Japanese economy suffered from an excessively strong currency. This was followed by a big surge in foreign direct investments (see figure). Even before this point, the Japanese economy had been plagued by the tendency for JPY to appreciate at the slightest excuse – the corporate histories of automakers, especially, may be littered with inscriptions about the battles against JPY strength. It is only after long years of battling JPY strength that Japanese manufacturers eventually made the decision to move overseas. Regardless of how severe the 2022 phase of JPY depreciation may be, it still represents a single year, and one has to question if this is sufficient impetus for companies to decide to make the move back. Given the severity of JPY depreciation in 2022, many market players are predicting a significant correction. It is only if this “significant correction” fails to take place

that the corporate trend may change, if at all. If it does change, it will become common sense for Japanese companies to buy JPY during phases of JPY appreciation and embark on a return to Japan based on the understanding that the weak-JPY trend cannot be reversed. However, such a trend will take time to be established.

Constraints Imposed by Population Decline

Demographics is another fundamental factor behind Japanese companies' decision to shift overseas, in view of the domestic market shrinking as society aged and birthrates shrank. This factor still remains valid. In fact, it has just become clear that government policies during the pandemic were considerate of the conservative elderly population at the expense of the production-age population. A shrinking population is not just unattractive as a market for goods and services, but also as a supplier (of labor). In my day-to-day interactions with corporate acquaintances, the possibility of companies returning to Japan frequently comes up for discussion, but many of my acquaintances express concern that even if companies were to set up factories in Japan all over again, they may be unable to secure sufficient workers. In a country with a shrinking working-age population, raising factory capacity utilization is a challenging task.

In fact, despite the economy heating up under Abenomics starting 2013, capacity utilization in the manufacturing sector remained level (see figure). Perhaps "level" is a positive assessment in a country such as Japan, which is experiencing marked population decline, but the fact remains that a sufficient population is necessary for raising capacity utilization and making good use of JPY weakness.



A Need for Considering JPY Weakness Together with Economic Security?

Of course, it is not impossible that a trend of disregarding profits to buttress Japan's production capacity for the sake of economic security will gain momentum. As the aforementioned Jiji Press article pointed out, given the intermittent supply chain disruptions in recent years against the backdrop of things such as the pandemic and the U.S.-China trade war, it is possible to conclude that, costs aside, domestic production is the safe option. Viewed through the lens of economic security, it may be possible for SMEs also to consider moving back with some help from government subsidies. If one considers JPY weakness together with economic security in a comprehensive manner, the possibility of a return of manufacturing to Japan cannot altogether be ruled out.

However, as explained above, most companies moved overseas looking for greater managerial efficiency, so there may be limits to the extent to which manufacturing companies will agree to return to Japan disregarding profits. Although not mentioned above, another significant factor that propelled Japanese companies to move their production overseas may have been the desire to avoid earthquakes, typhoons, and other natural disasters, and it cannot be denied that, in some ways, a return to Japan will increase such companies' vulnerability to supply chain disruptions. Taking advantage of "cheap Japan" to revive Japan's trade surplus is not as easy in practice as it may seem in theory.

U.S. Monetary Policy Now and Going Forward – Fed Does Not Consider Recession a Risk

The U.S. Government/Fed Do Not View Recession as a Risk

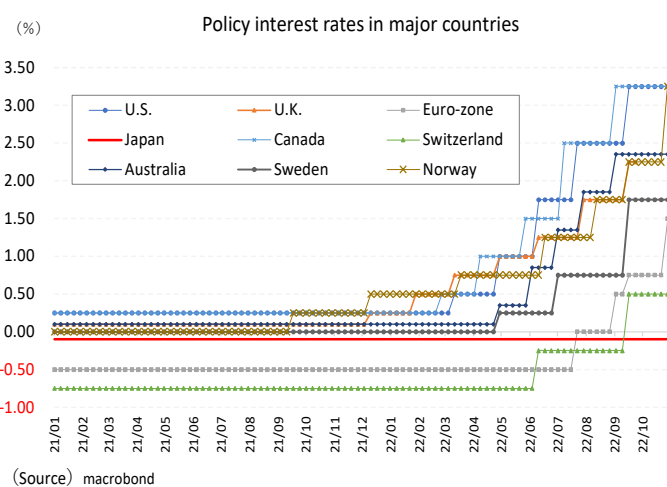
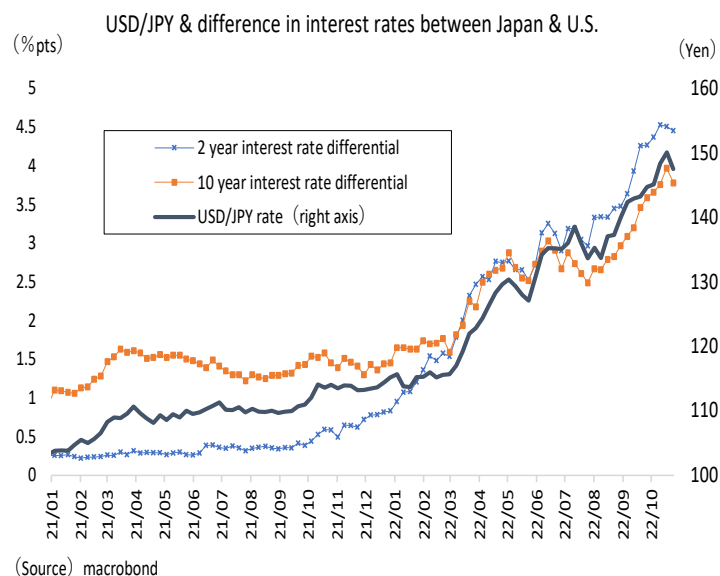
The minutes of the September 20-21 FOMC meeting were released in October. This was a meeting at which FOMC members' FF rate projections (dot plot projections) were significantly upgraded, and many discussion points in the minutes underscore the impression that the Fed will retain its hawkish stance for some time to come. There are several I would like to quote, but the line "Many participants emphasized that the cost of taking too little action to bring down inflation likely outweighed the cost of taking too much action" seems to summarize the Fed's policy stance for the present.

Meanwhile, going by the series of U.S. corporate financial reports released in October, U.S. interest rate and USD appreciation are clearly dampening corporate performance, heightening concerns for the U.S. economy. However, this is unlikely to cause the Fed to revise its hawkish policy stance given that a deterioration in corporate performance was the aim of its policies. According to the minutes, "Participants observed that a period of real GDP growth below its trend rate, very likely accompanied by some softening in labor market conditions, was required" for inflation to be reined in. In other words, the deterioration in corporate revenues is expected to cause a deterioration in labor market conditions, which is a necessary condition for inflation control, and is, therefore not something to be avoided. In October, Biden also acknowledged the possibility of a recession, but the U.S. government and the Fed seem to be of the understanding that the current situation cannot be resolved without a recession. In connection with the Fed's policy operation and the U.S. economic situation, I am frequently asked how the U.S. recession risk must be viewed, but the fact is that the concerned authorities do not view recession as a risk.

U.S. Interest Rates will Remain High in 2023

An especially significant observation from the perspective of predicting forex rates was, “Many participants indicated that, once the policy rate had reached a sufficiently restrictive level, it likely would be appropriate to maintain that level for some time until there was compelling evidence that inflation was on course to return to the 2 percent objective.” In this context, it must be pointed out that the forecast range for the core personal consumption expenditure (PCE) deflator for the same year in the Summary of Economic Projections (SEP), which had only just been revised earlier in September, is +3.0-3.4%, which is not even in the 2% level. Further, the dot plot predicts rate hikes amounting to at least 25-50bps in 2023 (although it is unclear whether this will be sufficient).

Going by the discussions in the minutes, rate cuts seem unlikely during 2023, and one would do well to assume a policy path of either rate hikes or no change in rates. In other words, a substantial U.S.-Japan interest rate differential, which is seen as the main factor driving USD/JPY, is almost certain for the next year or more. Further, assuming that market volatility will have subsided (and share prices will have strengthened) by the time rate hikes end, we may see the two key conditions required for carry trade, namely a sufficient interest rate gap and low volatility, coincide during 2023. There is something to be said for the simplistic theory that JPY weakness is a consequence of USD strength, and that JPY will stop depreciating against USD with the end of rate hikes. In fact, there is an extremely strong correlation (see figure, top) between the U.S.-Japan two-year interest rate gap and USD/JPY, so it is quite likely that the end of rate hikes will provide an opportunity for JPY appreciation. However, I do not believe this situation will continue through the whole of 2023. At the present time, the countries of the world are gearing up, in overt and covert ways, to compete for currency strength, and other key central banks may follow in the Fed’s footsteps as it continues with its rate hikes (see figure previous page, bottom). The BOJ’s policy isolation has been a topic of discussion since the beginning of the year, and this isolation may become even more conspicuous in terms of policy interest rates in 2023. One would do well not to be too easily swayed by the theory in the markets that JPY weakness will end next spring.



Incidentally, the October 21 Wall Street Journal (WSJ) opined that the Fed was likely to discuss a 75bp rate hike in November and a 50bp rate hike in December. The WSJ is widely seen as being a mouthpiece for the monetary authority when it reports on Fed-related matters. This could mean, therefore, that the FF rate will rise to around 4.5% before the end of the year and to 5% in the January-March 2023 quarter. While it is understandable why a decline in this pace of rate hikes is seen as potential opportunity to sell USD, it is doubtful how sustained a reason it will provide for buying JPY.

Supplement: Comprehending Monetary Tightening’s Repercussions – the United Nations’ Sound Arguments

The United Nations’ Sound Arguments

On October 3, the United Nations Conference on Trade and Development (UNCTAD) released the latest edition of its annual Trade and Development Report (TDR), which is quite interesting. The report argues that – “the attention of policymakers has become much too focused on dampening inflationary pressures through restrictive monetary policies, with the hope that central banks can pilot the economy to a soft landing, avoiding a full-blown recession.” – and it notes that excessive monetary tightening could lead to periods of stagnation and economic instability in some countries. UNCTAD Secretary-General Rebeca Grynspan urged a policy course adjustment away from what she perceives as excessive emphasis on monetary tightening, saying – “There’s still time to step back from the edge of recession ... We have the tools to calm inflation and support all vulnerable groups. This is a matter of policy choices and political will. But the current course of action is hurting the most vulnerable, especially in developing countries[,] and risks tipping the world into a global recession.”

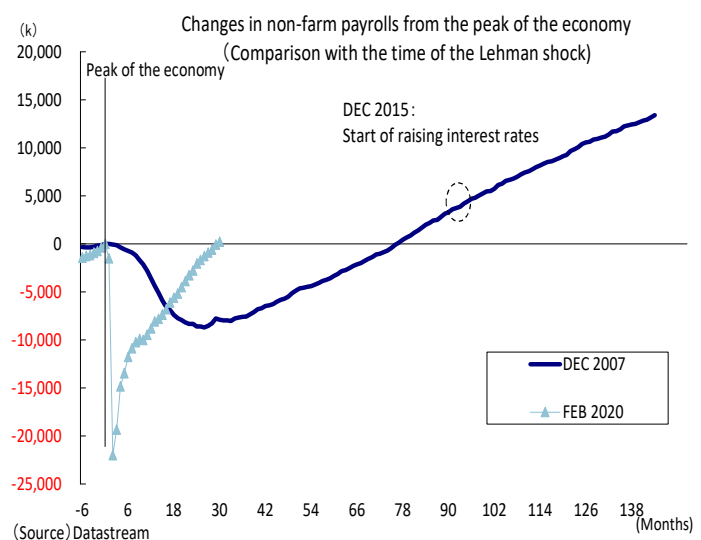
The UNCTAD TDR points out that inflation can be reduced through policies such as taxing companies' windfall profits, regulating speculation in commodity prices, and eliminating supply chain bottlenecks. As I pointed out a year ago, current inflation trends are largely stemming from supply constraints. Regarding fossil fuels, the world's production capacity had already begun declining in line with many countries' decarbonization programs prior to the covid-19 pandemic, but the pandemic caused widespread supply chain disruptions that have been compounded since this past February by the Ukraine crisis, which has hindered access to Russian resources. Against the background of supply chain disruptions and difficult-to-eliminate supply constraints, the world economy is effectively moving toward a lower equilibrium point by reducing excessive demand to bring it in line with insufficient levels of supplies. In its TDR, UNCTAD articulates its view that – in addition to fundamental corrective measures aimed at restoring supply capacities – countries should take measures to collect windfall profits from the corporate sector and prevent behavior that unnecessarily inflates commodity prices. These are sound arguments that the United Nations is seeking to present to the world's central banks.

In fact, the European Commission has already announced a policy proposal to collect windfall profits from energy companies and distribute them to the struggling household and business sectors, and it appears likely that the EU will adopt this policy. The UNCTAD recommendations should be considered realistic policy proposals for responding to the current challenges.

Rate Hikes Needed to Increase Unemployment

Although the UNCTAD's arguments may be sound, however, it is also true that the current situation is one in which interest rate hikes can no longer be avoided. Unlike a year ago, it should be noted that there are now signs of significant wage inflation in Western countries. As the inflation trend is likely to be sustained so long as wages continue rising, there will inevitably be a need to cool down the real economy's overheating by tightening monetary policy. In brief, moderating current inflation trends will require a temporary worsening of conditions in employment and wage markets that will entail an increase in the number of unemployed people. After the FOMC raised interest rates by 75 basis points at the September FOMC meeting, Fed Chairman Jerome Powell said – "Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions."

In the United States, for example, although there are signs that the increase in average hourly wages has finally peaked out, hourly wages continue to grow by more than 5.0% yoy, so the Fed is not in a position to relax its efforts to restrain the inflation trend. It can be intuitively understood that the current downturn and the prospective recovery from it will follow a trajectory quite different from the usual ones. When the pandemic hit the United States in the spring of 2020, the country lost 20 million jobs in a month. Comparing that figure to the corresponding figure during the post-Lehman Shock recession – the number of jobs lost then reached a maximum of only about 8.7 million two years after the recession began – one can see just how tremendous the pandemic-induced shock was (see graph). The pandemic-induced unemployment surged mainly due to such artificial measures as lockdowns, however, and employment recovered quite sharply as the pandemic petered out. Looking at the United States' latest employment statistics (for August), one finds that the jobs lost due to the pandemic have been completely restored – the U.S. labor market has overcome the impact of the pandemic in terms of quantity (number of employees) as well as quality (wages). While there would normally be no need to raise interest rates at this point, the pace of increase in demand for labor has been so rapid that the supply of labor has been unable to keep up with it, leading to an increase in wages.



There are various theories about why labor supply has been unable to keep up with labor demand, with some theories suggesting it is largely because the pandemic inspired many people to move to rural areas or that it largely reflects an increase in the number of people who do not want service jobs that entail face-to-face contact with customers. In addition, there are indications that higher inflation rates are causing many people to seek higher wages by quitting their jobs sooner than they normally would have and by spending relatively more time looking for better jobs. In any case, reducing demand for labor appears to be the only way to overcome the current inability of labor supply to keep up with labor demand, and it is inevitable that interest rate hikes will be viewed as a handy means of reducing demand for labor.

Unlikelihood of Central Bank-Government Coordination

Of course, the UNCTAD TDR does not completely reject the idea of interest rate hikes; its true intent is to suggest that it is a mistake to believe that inflation can be controlled solely by means of interest rate hikes. UNCTAD appears to be arguing that if strong measures are concurrently taken to expand supply capacities and control prices, the

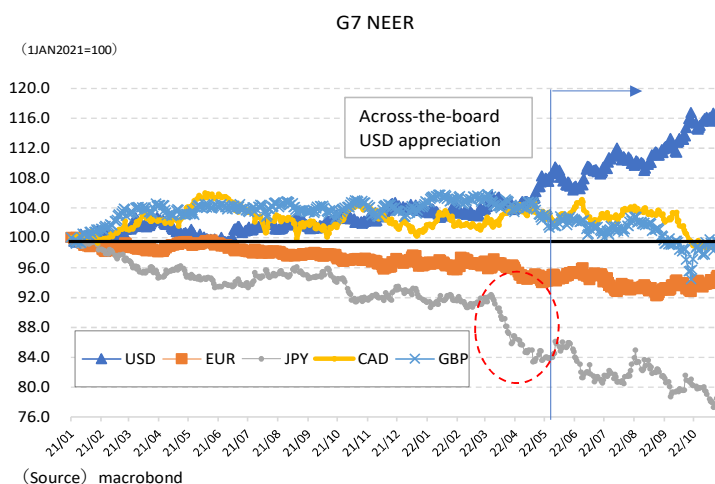
demand-supply gap can be expeditiously eliminated while taking steps to reduce demand for only limited time periods. In light of the current situations of the ECB and the Fed, however, it does not seem likely that the central banks will be able to skillfully adjust their interest-rate-hike margins based on due consideration of government sector responses by means of fiscal policy measures. It seems more likely that (as is conspicuously the case in the UK) the “fiscal spending policy economy boosting measures designed to counterbalance the monetary policy (interest rate hike) economy restraining measures” policy mix will become standard, and it probably can be expected that this kind of policy mix will generally tend to push inflation rates up further owing to the strong emphasis placed on governments’ proactive fiscal stimulus policies.

In any case, it can be said that the U.S. and European central banks were mistaken a year ago when they asserted that the sustained acceleration of inflation rates was a transient phenomenon. Moreover, it appears likely that the central banks are resolved not to repeat that mistake going forward and are determined not to relax their tightened monetary policies until the buds of inflation are completely extirpated. In such a situation, seems unlikely that the central banks will find it easy to accept UNCTAD’s argument against immoderate monetary policy tightening.

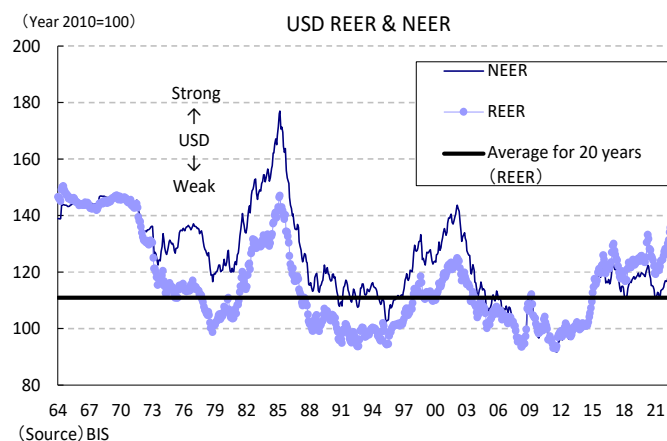
Risks to My Main Scenario – Potential for a USD Crash

Scattered Signs of Concern about the Potential for a USD Crash

One is beginning to see people here and there speculating about the possibility of a USD crash. As of this spring, the JPY depreciation trend was still strongly associated with factors unique to Japan. This past March, USD/JPY surged from JPY114 to JPY124, but when viewed on a nominal effective exchange rate (NEER) basis, USD remained flat while JPY dropped 5.0% across the board. At that time, JPY was depreciating even though USD had not yet started to appreciate, and there was definitely momentum behind JPY selling. Since then, some people have argued that the JPY depreciation trend at that time stemmed primarily from USD buying rather than JPY selling, but that view is completely wrong. On a NEER basis, USD’s appreciation accelerated in earnest from May, but JPY’s depreciation began before then (see portion of graph within dotted circle).



However, the forex market is now showing a genuine across-the-board USD appreciation. This can be seen from the fact that, GBP and EUR are beginning to collapse on a NEER basis, as is even CAD, which had previously maintained its firmness. At this point, the argument that “JPY depreciation is reflecting USD strength” seems to be correct, but even so, given the extent of JPY’s decline, the current situation appears to be stemming from an “across-the-board USD appreciation + Japan selling” situation. (The fact that across-the-board USD appreciation is proceeding concurrently with across-the-board JPY depreciation is not hard to understand.) NEER-basis USD rose 13.0% from the beginning of the year through September, and although this movement is fairly rapid, the graph shows that NEER-basis USD’s level is now about the same as it was in the October-December quarter of 2002. In light of that, one does not get the impression that the current level is excessively high. Looking at the trends in USD’s real effective exchange rate (REER), which reflects differences between domestic and foreign commodities prices, however, one finds that the margin of increase in REER-basis USD since the beginning of the year was 9.6% and that the current REER-basis USD level is the highest seen since around 1985. While REER-basis USD can theoretically be expected to move towards its 20-year average level, the margin of deviation from that average level has expanded to around +27%. As currencies of countries experiencing domestic currency inflation can theoretically be expected to depreciate eventually, forex market participants are beginning to feel concern about the potential for USD depreciation to emerge at some point.



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Where Will USD Appreciation’s Problematic Aspects Emerge?

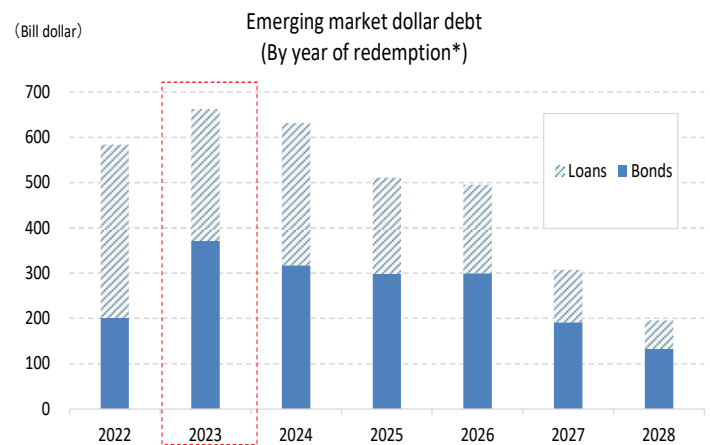
In anticipating a correction of USD’s current strength, one needs to gain an understanding of when and where challenges associated with USD strength may manifest themselves. There are various possible ways such challenges may emerge, and broadly speaking such challenges fall into the categories of impacts within the United States and impacts outside the United States. REERs are often used as a measure of a country’s international competitiveness,

and if current trends reach a critical point, there will inevitably emerge concerns about how the deterioration in U.S. export competitiveness stemming from strong REER-basis USD may negatively impact the U.S. economy. In the first half of the 1980s, the United States accumulated a “twin deficit” (a budget deficit and a current account deficit) considerably larger than its current twin deficit.

The upshot is that, if the United States faces a situation in which the U.S. economy is severely challenged by USD’s strength, it is possible that the country will consider means of reducing that strength by means of monetary policy (the U.S. Treasury Department) and monetary policy (the Fed). If such policies are adopted, they will undeniably trigger USD selling. However, the U.S. government and the Fed currently agree on the need to curb inflation, so until significant deterioration is seen in headline inflation indicators (such as the CPI, PCE deflator, etc.), it is more likely that the United States will continue considering USD appreciation to be helpful rather than problematic. Given this, it is unlikely that the United States will actively try to countervail USD’s strength for the time being. Although U.S. policy makers may not feel a need for concern about the country’s current account deficit, the level of that deficit has now surpassed its previous peak during the financial bubble period (2006-2007) and, going forward, an increasing number of observers are likely to begin anticipating that the USD supply-demand situation will spur a USD crash. When the current account deficit’s magnitude is considered as a percentage of GDP, however, one finds that present level (-3.0% to -3.5% range) is only about half the level in 2006 and 2007 (more than -6%), so it can be said that the present magnitude is not as unprecedented as it may seem in purely nominal terms. On the other hand, if the current account deficit as a percentage of GDP eventually attains historical record high levels, there are grounds for concern that there will be a major undercutting of USD’s strength at that point.

Emerging Countries’ Massive USD Debt Refinancing Burden in 2023

The negative effects of a USD appreciation may impact emerging countries before they affect the United States directly. Looking back at previous periods of U.S. interest rate hikes, one can see a frequently repeated pattern of capital outflows from emerging countries leading to major turmoil. Each time this happens, considerable attention has been focused on the question of whether the Fed should be taking other countries’ situations into account when making its monetary policy decisions. Data from the Institute of International Finance (IIF) indicate that the amount of emerging country debt (bonds and loans) maturing at the end of 2023 amounts to roughly USD662.5 billion, which is particularly large figure compared to that for other points in time during the next few years. So long as the concurrent trends of increase in U.S. interest rates and appreciation of USD continue, there are grounds for concern that emerging countries with USD-denominated debt may face serious debt repayment problems.



(Source) IIF (Note) *Total government, financial and non-financial sectors

The emergence of such problems are likely to spur selling of the currency and government bonds of such countries, causing such countries to suffer from unwanted rises in interest rate levels. If such countries allocate greater financial resources to repaying their USD-denominated debt, they are naturally liable to reduce their domestic spending, which would put downward pressure on their real economies. If multiple emerging countries simultaneously begin suffering from severe economic turmoil owing to such factors, one wonders whether the U.S. government and the Fed will feel forced to do something in response. It is possible that the timing of decisions to respond to such economic turmoil in emerging countries may correspond to the beginning of the end of the current USD appreciation trend.

How Much Could JPY Appreciate?

Until there are signs of an end to the United States’ inflation problem, however, it seems quite unlikely that the U.S. government and the Fed will consider U.S. current account deficit growth and emerging countries’ economic turmoil to be sufficient grounds for changing the anti-inflation policy course. The Fed mistakenly argued that the surge in U.S. inflation was a temporary phenomenon during the latter half of last year, and it now appears that the Fed will want to make sure that the buds of inflation have been thoroughly extirpated before shifting to more-dovish policies. Moreover, while economics textbooks may predict that the currencies of countries with serious inflation problems are theoretically fated to depreciate at some point, it would be dangerous to be excessively confident in the timely manifestation of such theoretical outcomes. As mentioned above, the depreciation of USD from 1985 was not an automatic adjustment in response to the United States’ high inflation rates – it was an artificial (diplomatically orchestrated) adjustment referred to as the Plaza Accord. The lessons to be drawn from that are that one cannot confidently assume that a country’s high inflation rates will naturally lead to a timely depreciation of that country’s currency and that appropriate action by economic and monetary policy authorities may be necessary to midwife that theoretically justified depreciation.

Regardless of whether the USD appreciation trend is eventually countervailed by a shift to dovishness on the part of the Fed or by a second Plaza Accord-like act of international cooperation, however, there is room for debate about how much JPY can be expected to appreciate after the USD appreciation trend is halted. At the time of the 1985 Plaza Accord, for example, the U.S. trade deficit with Japan was pointed out as a principal cause of the United States’ twin

deficits, and Japan had a huge trade surpluses with countries other than the United States. The BOJ's policy interest rate (official discount rate) was 5% at the start of 1985. Although JPY's rapid appreciation from 1985 was spurred by international cooperation, it should be noted that Japan's fundamentals were also in line with JPY appreciation. Today, on the other hand, Japan is the only country in the world that is both recording huge trade deficits and maintaining negative interest rates. Considering Japan's economic history from a comprehensive and longer-term perspective, one may note that Japan's nominal GDP per capita was sometimes higher than that of the United States during the 1980s.

When one compares Japan and the United States in terms of currency supply-demand situations, interest rates, and economic growth rates, it is clear that all these factors are quite different from their state at the start of 1985, so there are strong grounds for doubting whether the kind of sharp JPY appreciation seen immediately after the Plaza Accord could be repeated. Moreover, the grounds for doubting there is a potential for a surge of JPY appreciation will continue to be fairly strong even when the Fed discontinues its interest rate hikes. One gets the impression that, while the articulation of USD crash theories has only just begun, such theories cannot be said to be completely lacking in logical bases. Such theories are not at all likely to begin manifesting themselves in the real world during the next six months or so, however, and even if they do begin manifesting themselves at some point, one has to consider how much JPY appreciation could be expected to ensue at that time.

EUR Outlook – The Future of EUR Deprived of its Solid Supply-Demand Environment

EUR Area Monetary Policies Now and Going Forward – Questioning the ECB’s Policy Consistency

“Substantial Progress” on the Path toward Ending Monetary Tightening

The ECB’s October 27 Governing Council meeting decided to raise the deposit facility interest rate by 75bp from the current 0.75%, to 1.50%. In line with this, the ECB’s major refinancing operation interest rate was raised to 2.00% and the marginal lending facility interest rate was raised to 2.25%. This is the first time the ECB has implemented 75bp hikes at two consecutive Governing Council meetings, and the latest hike brings the major refinancing operation interest rate to its highest level since 2009, when the European debt crisis occurred and the ECB embarked on its long-term monetary easing course. As is generally understood, headline inflation rates in the euro area have been more severe than in the United States, and preliminary figures for the euro area September Consumer Price Index (HICP) have surpassed the 10% level. Depending on the HICP figures for October and November, it is quite possible that there may be a 75bp interest rate hike at a third consecutive Governing Council meeting.

The start of the Governing Council meeting’s statement features a sentence – “With this third major policy rate increase in a row, we have made substantial progress in withdrawing monetary policy accommodation.” – in which the phrase “substantial progress” is particularly noteworthy. It appears that this sentence is based on consideration of the remarkable deceleration of economic and financial activities in the euro area, and the sentence also seems to provide a hint about the timing of the prospective end of the ECB’s monetary tightening period.

“Number” and “Level” of Interest Rate Hikes

Now that “substantial progress” has been recognized, a growing amount of attention is being focused on the “number” and “margin” of prospective interest rate hikes. Regarding this point, ECB President Christine Lagarde said during the post-Governing Council meeting press conference that – “We will have further rate increases in the future so the normalization process continues.” – and this suggests that there will be no immediate change to the interest rate hike trend. At the post-September-Governing Council meeting press conference President Lagarde said regarding the remaining number of rate hikes that – “It’s probably more than two, including this one, but it’s probably also going to be less than five.” – and this statement attracted considerable attention. If one assumes that it will be four times, it may be reasonable to anticipate the hikes will be in October, December, January, and February, so the remaining interest rate hikes may be in December, January, and February. A reporter at the press conference noted that the word “several” was absent from the most recent Governing Council meeting’s statement and posed a question about whether the outlook presented in September is still valid. In response, President Lagarde said that the Governing Council would be evaluating the effects of monetary tightening on a “meeting-by-meeting” basis and that “it might well be several meetings”, and this hints that the outlook presented in September may still be valid. But President Lagarde also specified that – “how ‘several’ is, that will be determined meeting-by-meeting” – and basically restricted herself to saying that the number of prospective rate hikes would be decided at each meeting and that the number could change.

The second key question is about the “level” of interest rates, or the peak level prospective interest rate hikes may bring interest rates to. Several reporters asked about this, with the first reporter posing the question – “Could you tell us whether you are comfortable with the expectation that interest rate steps are going to slow after today’s decision and peak somewhere around 3% next year?” President Lagarde said she could not answer that question in terms of numbers but indicated that the December Governing Council meeting will be able to use newly revised Eurosystem staff projections to evaluate the euro area’s economic growth and inflation outlooks and likelihood of a recession as well as such situations as the amount of monetary policy transmission lag, so the December Governing Council meeting can be expected to be in a better position to determine how much interest hike margin is required. Every third Governing Council meeting has access to newly revised staff projections, and the ECB tends to answer all important questions posed at Governing Council meetings without newly revised staff projections by saying related decisions will not be able to be made until after the next revised staff outlook is available. In interest rate markets, the majority of forecasts are for the deposit facility interest rate to reach around 2.50% in the middle of 2023, about 100bp above the current level.

Adjustment of TLTRO3 Tantamount to QT?

The most prominent policy adjustment announced at the October Governing Council meeting was that to increase the rigor of terms and conditions for the third series of targeted longer-term refinancing operations (TLTRO3) and, as it will cause an increase in borrowing costs, the adjustment is akin to a monetary policy tightening measure. While TLTRO3 has already been implemented, there will be two changes to outstanding TLTRO3 assets from November 23: (1) the average deposit facility interest rate will be applied, and (2) three additional early repayment dates (including November 23rd) will be added. Adjustment (1) will cause a significant rise in borrowing costs, while adjustment (2) will increase the amount of liquidity that can be recovered. Adjustment (1) is consistent with the ECB’s policy of raising

interest rate levels, while adjustment (2) deserves more attention and analysis. President Lagarde pointed out that the early repayment dates are – “also going to reduce the size of the overall Eurosystem balance sheet, which also goes in the same direction as our monetary policy stance.” – referring to shrinking the balance sheets of financial institutions in the Eurosystem. As explained below, the ECB has not yet begun discussing a much-anticipated halt to reinvestment with respect to the Asset Purchase Programme (APP). The upshot, however, appears to be that quantitative tightening (QT) has been effectively begun by recovering liquidity through TLTRO3 prior to moves to reduce the amount of assets held by the APP. If this is the case, then there may be valid grounds for anticipating that the application of QT to the APP is also approaching.

From “Interest Rates” to “Quantity”

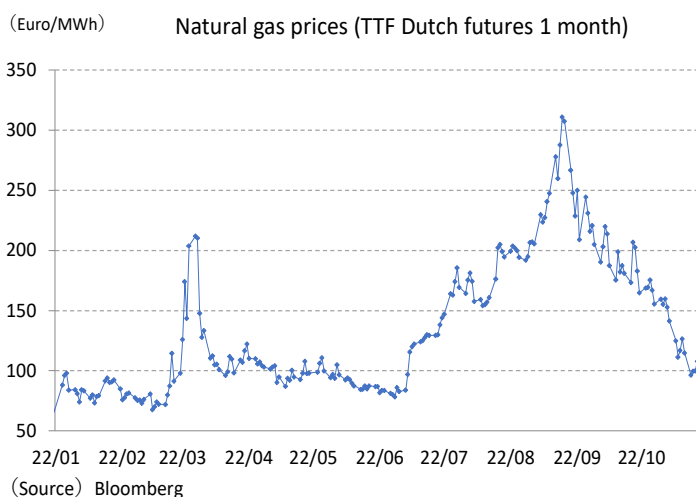
Amid increasingly active discussions about the prospective end point of the ECB’s interest rate hikes, a reporter posed the question – “would it be fair to assume that the ECB could be ready to lay out a plan for reducing its balance sheet at its next meeting in December?” In response, President Lagarde said balance sheet reduction was not discussed at the October Governing Council meeting because the meeting had to make many other issues to deal with but that – “we decided [...] we would decide the key principles of the reduction of our APP monetary portfolio in December.” As balance sheet reduction will be discussed at the December meeting and announced before implementation, there appears to be a fairly high possibility of a policy decision in December and a suspension of reinvestments (or commencement of asset sales) from January at the earliest. The “ECB’s next move” theme will at that point finally shift from “interest rates” to “quantity”.

In light of all this, the December Governing Council meeting can be expected to be a meeting at which the final point of interest rate tightening is seriously considered based on the latest forecast data and the issue of quantitative tightening (QT) added to the agenda. But the ECB faces a complicated problem in this regard. If a full-fledged QT were to be launched, the ECB would be concurrently implementing policies to (1) raise interest rates, (2) implement QT, and (3) assist economically and financially vulnerable countries by increasing the flexibility of reinvestments related to the Pandemic Emergency Purchase Programme (PEPP). Policies aimed at (1) and (2) are monetary tightening measures, but policies aimed at (3) are akin to monetary easing measures. While the ECB’s explanation is that simultaneously executing (2) and (3) measures will have no impact on the ECB’s overall monetary policy stance, it remains quite difficult to anticipate the prospective result. If the reinvestment of funds from the redemption of APP assets (which naturally include Italian government bonds) is suspended and the reinvestment of funds from the redemption of PEPP assets is made more flexible, will the ultimate policy effect be monetary tightening? Or might it be monetary easing? While monetary policies can be categorized based on their characteristics, money’s fungibility will allow money flows to have similar effects regardless of the nature of the policies that cause them, and it seems that we are entering a phase where the consistency of the ECB’s monetary policies may be called into question. This issue is likely to become a major focus of ECB watchers from the next Governing Council meeting onwards.

EUR Area Energy Policies Now and Going Forward – Euro Area Economy’s Vulnerability to Stagflation

Natural Gas Price Ceilings

In late October, it was reported that the European Commission was considering setting a cap on natural gas prices within the EU. In addition to the price cap, it was reported that a daily trading price fluctuation limit is being discussed. This is the preliminary story as reported by Reuters, however, and it has not yet been confirmed if European Commission has made decisions on these matters. Regarding the timing of such decisions, it is expected that the measures will be approved after deliberations at the October 20-21 European Council (EU Summit) meeting, the October 25 EU Transport, Telecommunications and Energy Council (Energy) meeting, and a subsequent extraordinary meeting. (The European Commission has a policy of not commenting on issues that have yet to be officially announced.)



Currently, Dutch TTF Natural Gas Futures prices are used as a benchmark for gas prices traded on the European continent (see graph), and it appears that the European Commission seeks to impose restrictions on the movement of this benchmark. The rationale for the restrictions is based on speculation that – as supplies of Russian natural gas to continental Europe have been greatly reduced – the TTF futures prices do not accurately reflect economic and financial conditions under current circumstances. It has been reported that the restrictions’ draft version states that the restrictions are aimed at helping to avoid extreme volatility, price increases, and speculation that could make natural gas supply to some member countries difficult.

European Commission President Ursula von der Leyen's September State of the Union address presented in Strasbourg also mentioned the intent to curb speculative transactions. However, the proposal to set a ceiling on transaction prices was shelved due to concerns about side effects. There are two kinds of natural gas transaction price ceilings – one is a cap on the price of gas sold from companies to consumers, and the other is a cap on the price of gas sold by suppliers to companies. Would a cap on TTF futures prices be likely to hurt suppliers (resource-exporting countries)? It is hard to answer that question given that details of the proposed price capping system are still not known, but if the proposed system were to put a burden on suppliers, many suppliers can be expected to eventually conclude that they are better off not selling to the EU at all, thereby causing the entire region to suffer from increasingly serious gas shortages. Suppliers may decide it is more rational for them to sell their gas to Asia rather than to the EU. However, the graph shows that TTF futures prices have been on a downward trend since peaking in September, so the European Commission's policy proposals may be positioned as emergency measures to prepare for the potential problems that may occur during severe winter weather conditions rather than as measures to overcome challenges presented by the current situation.

Energy Conservation and Endurance

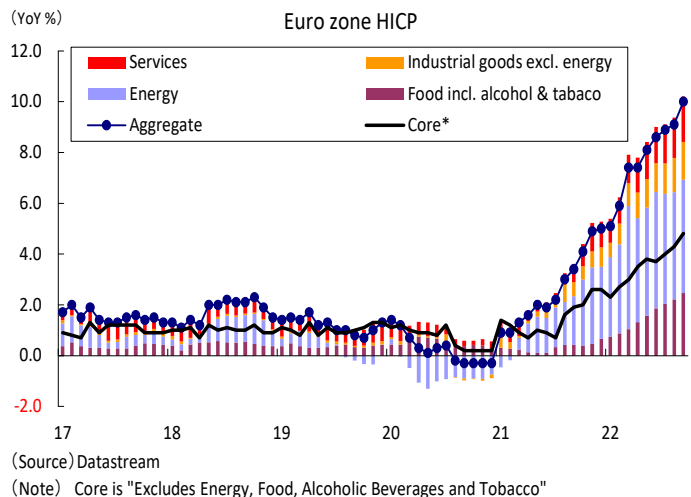
For the time being, the EU's energy policy essentially boils down to an appeal to "do your best to conserve energy and endure the inevitable tribulations". Although European Commission President von der Leyen presented a variety of energy-related measures in her State of the Union address, the policies for coping with prospective challenges this winter are limited to those to mandate electric power conservation and to collect (and distribute) energy companies' profits, so the address basically exhorts the real economy do its best to endure a rough winter (see chart). Programs to promote the use of hydrogen as a next-generation energy source cannot be expected to get on track this year or next. In addition, the European Commission seems to be considering a proposal for the EU as a whole to undertake joint gas procurement, but as the scheduled implementation date is "before the summer of 2023", it is not an idea likely to generate benefits this winter. The above-mentioned natural gas price capping, electric power conservation requirements, and collection of funds from energy companies all entail government sector interventions in the private sector. The fact that the EU economy is apparently becoming unable to sustain its functions without government sector intervention prior to the full-scale arrival of winter suggests that this may be an appropriate time to philosophically analyze why the economy's autonomous capabilities are so feeble. People have good grounds for having concerns about the potential for a severe recession in Germany and the rest of the euro area economy, and it is safe to say that, of all the world's major economies, the euro area economy is demonstrating the greatest vulnerability to what may become a persistent stagflation trend.

The European Commission President's State of the Union Address (Main Points Related to Energy Issues)

	Item	Details
①	Mandating power consumption reductions	Plans call for mandating 5% peak-hour electric power consumption reductions, aiming for at least 10% overall energy conservation, although no specific measures have been decided on.
②	Collecting funds from energy companies	Electric power charges for renewable energy and nuclear power companies (which are able to generate power at lower costs than companies operating fossil fuel fueled power plants) will be capped at EUR180/MWh, and payment receipts exceeding this level will be collected by EU member states. Regarding companies operating fossil fuel fueled power plants, member states will collect 33% of the portion of their profits exceeding "20% of the average profit level during the past three years" as a solidarity fee. Plans call for the distribution of EUR140 billion to households and businesses.
③	Establishing the European Hydrogen Bank	The EU will seek to develop next-generation energy systems to eliminate energy dependence on other countries. The European Hydrogen Bank will be established to promote the use of hydrogen, and EUR3 billion will be invested to develop the hydrogen market.

(Source) Compiled by Karakama, Mizuho Bank based on materials from the European Commission and news media

Looking at the inflation situation of the euro area as a whole, one may note that energy's contribution to HICP growth is increasing rather than declining and, given that global commodity prices are peaking out, this appears to reflect the fact that the euro area economy is increasingly vulnerable compared to the world's other major economies. As winter has not yet arrived and it is impossible to predict what Russia will do, it seems that the EU's efforts to cap natural gas prices reflects a desperate desire to "do everything that can possibly be done." As the euro area's labor markets are not yet as tight as U.S. labor markets, one wonders whether the euro area may be able to avert persistent inflationary pressures stemming from wage inflation. It can be said that the euro area is approaching the worst winter in its history.



Daisuke Karakama
Chief Market Economist
Derivatives & Forex Department
Mizuho Bank, Ltd.
Tel: +81-3-3242-7065
daisuke.karakama@mizuho-bk.co.jp

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