Daiwa Securities

Daiwa's View

Key differences between the yen and euro

➢ Corporate price setting behavior determines major difference between the two currencies

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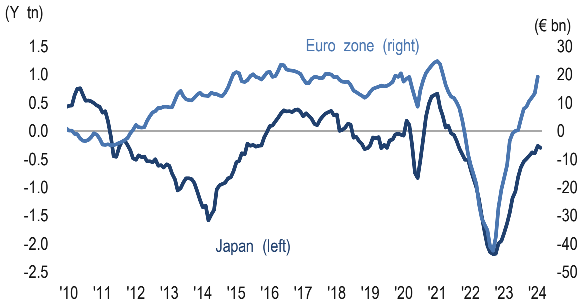
Impacted by the surge in energy prices due to the recovery in demand following the COVID-19 pandemic and the situation in Ukraine, both Japan and the euro zone saw their trade balances slip into the red (Chart 1). Subsequently, as the uptrend in energy prices has subsided, the trade balances of both nations (regions) have been improving. That said, with Japan's trade balance failing to recover to pre-pandemic levels, its trade deficit persists. However, the trade balance in the euro zone has recovered to pre-pandemic levels after showing a surplus in May 2023.

Confirming trends since the pandemic using data from the CPB Netherlands Bureau for Economic Policy Analysis (CPB) shows no major difference between Japan and the euro zone in terms of changes in import and export volumes. However, trends with (dollar-denominated) import and export prices, particularly export prices, show noticeable differences. While export prices in the euro zone rose 5.2% on average, those in Japan declined 0.4%. In other words, differences in the terms of trade between Japan and the euro zone are a major factor behind the difference seen in the degree to which their trade balances have recovered (Chart 2).

Looking at Chart 2 once again, we find that the terms of trade in the euro zone have been stable over the long term. However, the terms of trade in Japan have been quite volatile. Moves by Japanese companies to pass higher import prices and other costs onto export prices have been insufficient, which worsens the terms of trade during uptrends in the price of energy and other prices, leading to a trade deficit. Trade deficits since 2010, such as those following the Great East Japan Earthquake and the Ukraine crisis, fall into this pattern.

Chart 1: Trade Balance in Japan and Euro Zone



Source: MOF, Eurostat; compiled by Daiwa.
Note: 3-month backward moving average.

Chart 2: Terms of Trade in Japan and Euro Zone

Source: CPB Netherlands Bureau for Economic Policy Analysis; compiled by Daiwa.
Note: Terms of trade = Export price index / Import price index.

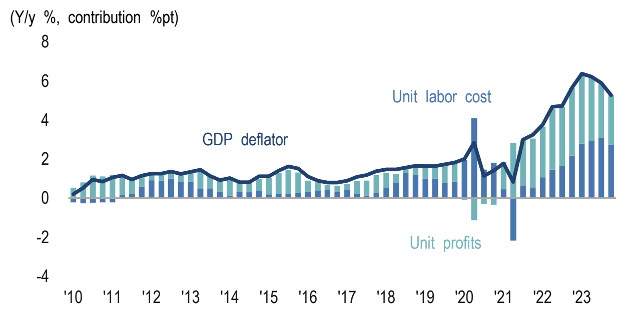
With many Japanese export products having a low share of the global market, they are facing severe price competition. Consequently, Japan's export prices are seen as being difficult to raise for structural reasons. However, Germany, which earns the largest trade surplus in the euro zone, does a significant amount of trade in differentiated finished products, making it easier for Germany to raise prices. That said, looking at price setting behavior by Japanese companies in Japan, we think that, in addition to the difference in global price competitiveness, price setting in Japan is also strongly influenced by the "norm" of not being able to raise prices indiscriminately.

Inflation in the euro zone temporarily reached 10% in 2022. The higher cost of energy and raw materials was not the only factor behind such high inflation. Looking at the GDP deflator, which shows homemade inflation (inflation led by domestic factors) but excludes import inflation, we find that it rose sharply from the Jul-Sep 2021 quarter onwards (Chart 3). Breaking this down into unit profits (corporate and other profits) and unit labor costs (workers' wages) shows that profits that accumulated through price-gouging accounted for more than 50%. This resulted in the coining of the term "greedflation."

Similarly, Chart 4 shows changes in the GDP deflator in Japan. Looking at this, we find that homemade inflation occurred in the Oct-Dec 2022 quarter, one year later than the euro zone. However, the euro zone has been securing unit profits continually due to steady markups, while Japan only succeeded in raising prices when it raised the consumption tax in 2014, and in 2023.

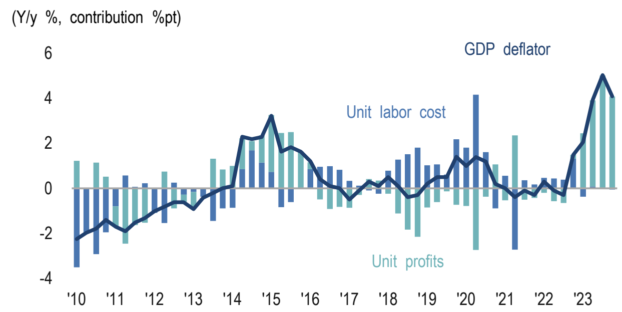
The fact that Japanese companies do not (cannot) raise prices weighs on the JPY exchange rate via two routes. The first route is "yen selling via real demand." If companies are unable to pass higher import prices onto export prices, the trade balance will see a deficit due to the worsening of the terms of trade. This leads to a situation in which yen selling by import companies is larger than yen buying by export companies. This "real demand" flow plays an important role in determining medium/long-term trends. The second route is "yen selling by speculators." When companies do not raise prices, it is difficult to envision achieving the 2% price stability target in a sustainable and stable manner, and the BOJ is unable to raise the policy interest rate. This results in the widening of interest rate differentials between Japan and other nations. In particular, with the USD/JPY rate having a strong correlation with the Japan/US interest rate differential, US interest rate hikes cause significant depreciation of the yen via speculative flows, such as those seen over the past two years.

Chart 3: GDP Deflator in Euro Zone



Source: Eurostat, ECB; compiled by Daiwa.

Chart 4: GDP Deflator in Japan



Source: Cabinet Office; compiled by Daiwa.
Note: Unit labor costs = Nominal labor compensation / Real GDP. Unit profits = (Nominal GDP – Nominal labor compensation) / Real GDP.

While the trade deficit widened substantially in autumn 2022, the euro was also sold significantly as it fell below parity with the dollar. However, the euro recovered later, and it is now trading at pre-pandemic levels. Factors behind this include the improvement in the trade balance mentioned above and substantial rate hikes by the ECB in response to inflation.

Although a bit late, prices in Japan have also been rising. And, 2024 spring wage negotiations are likely to see the highest wage hike in thirty-three years. In light of the substantial increase in wages, the BOJ decided to review large-scale monetary easing at its Monetary Policy Meeting on 18-19 March. However, it has not abandoned its cautious stance regarding additional rate hikes. One likely reason is that the BOJ is not confident about whether companies can pass higher wages onto prices. However, if the wage and price setting behavior of Japanese companies has really changed, downward pressure on the JPY exchange rate will likely ease.

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