

Forex Medium-Term Outlook

1 August 2018

Mizuho Bank, Ltd.
Forex Department

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Overview of Outlook

In July, USD/JPY hit year-to-date highs. There seems to have been no particular reason other than increase in USD buying momentum based solely on the fact that the Fed may raise interest rates. My basic understanding of the situation is that, as the U.S. yield curve becomes more markedly flat and inflation expectations peak, the Fed's policy normalization efforts will begin to seem more and more likely to be overkilled. The global economic cycle is also showing stronger signs of peaking, and it must be remembered that even if the U.S. economy is able to withstand rate hikes, other economies around the world will not. In addition to such background, in July, U.S. President Donald Trump suddenly began talking about the Fed's monetary policies, resulting U.S. interest rates and USD to form a trend. Mr. Trump's protectionist policies have always had a strong affinity with weak USD, so it is unlikely that he was ever happy with the rise in U.S. interest rates and the accompanying USD appreciation. If the Trump administration were to pull out its "trump card" (and encourage USD weakness), this would be a major development for the forex markets and could be a turning point. It seems fair, therefore, to assume that the Fed's normalization process is nearing its end both due to political and real economic pressures. My basic understanding is that U.S. interest rates will begin to fall during the second half of the forecasting period, causing USD to depreciate across the board and making JPY appreciation inevitable.

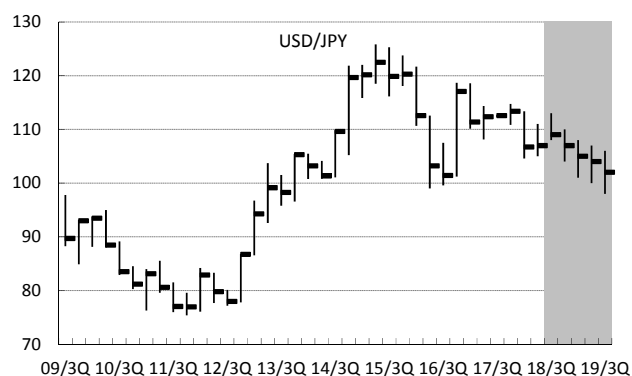
Meanwhile, EUR remains rudderless. There was a great deal of speculation regarding the correct interpretation of the interest rate guidance released after the June Governing Council meeting, "We continue to expect them to remain at their present levels at least through the summer of 2019." After the July Governing Council meeting, however, it seems safe to assume that the phrase "at least through the summer of 2019" means "at least until the end of the summer." This in turn seems to indicate that rate hikes will take place next September at the earliest, but it is a different question whether that is, in fact, possible. My view is that it may be difficult. Given that the Fed's normalization process may be on the verge of ending in September next year, it would be practically impossible for the ECB to raise interest rates at that time. The ECB, which has never been comfortable with EUR appreciation, will not find it easy to boldly embrace a narrowing of the gap between its own monetary policies and those of the U.S. Given the economic and financial situations, it is quite possible that there will be no rate hikes in 2019. The main scenario envisaged by this report continues to be that EUR may be able to avoid a crash thanks to USD weakening across the board, but it will also find it difficult to reach its upper bound.

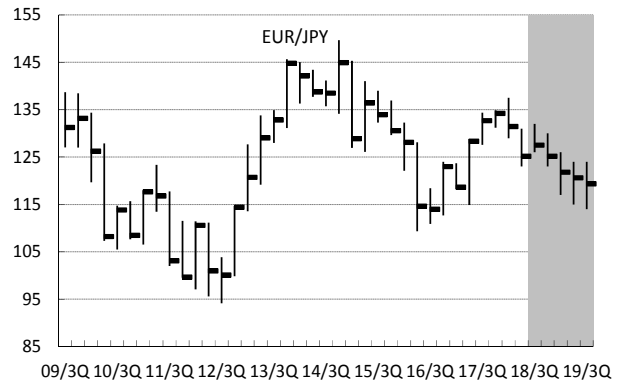
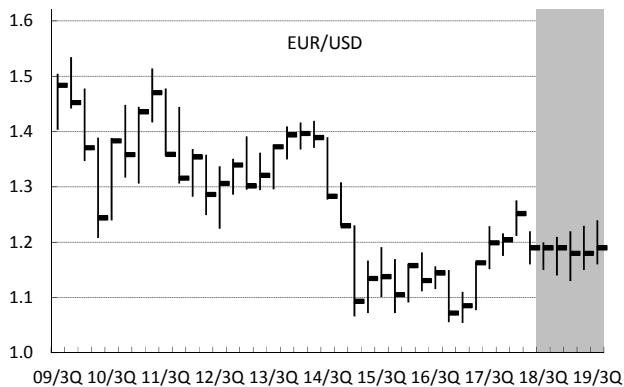
Summary Table of Forecasts

	2018			2019		
	Jan - Jul (actual)	Aug-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	104.64 ~ 113.40 (111.82)	108 ~ 113 (109)	104 ~ 110 (107)	101 ~ 108 (105)	100 ~ 107 (104)	98 ~ 106 (102)
EUR/USD	1.1508 ~ 1.2556 (1.1689)	1.13 ~ 1.18 (1.17)	1.12 ~ 1.19 (1.17)	1.11 ~ 1.20 (1.16)	1.13 ~ 1.21 (1.16)	1.14 ~ 1.22 (1.17)
EUR/JPY	124.62 ~ 137.51 (130.72)	126 ~ 132 (128)	123 ~ 130 (125)	117 ~ 126 (122)	115 ~ 124 (121)	114 ~ 124 (119)

(Notes) 1. Actual results released around 10am TKY time on 1 Aug 2018. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





USD/JPY Outlook – the Most Straightforward Forecast remains valid

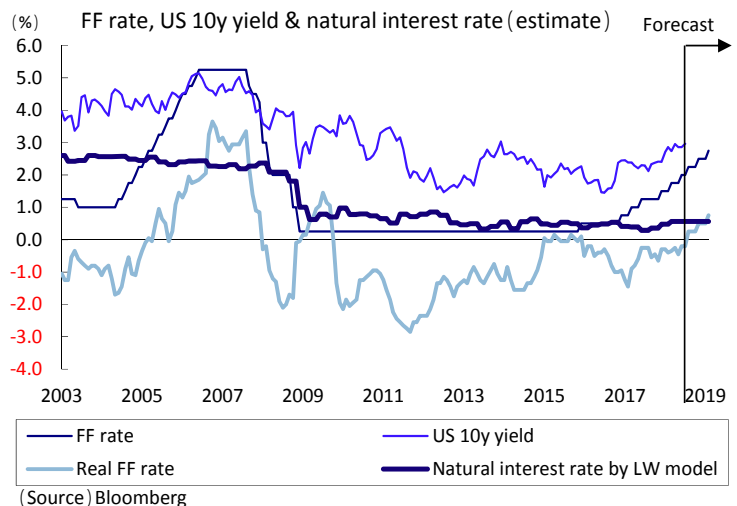
USD/JPY Now and Going Forward – The Same Themes will Continue During 2H

The Most Straightforward Forecast is that as the FF Rate Turns Positive on an Effective Basis, it will then have a Tightening Effect

We have entered 2H of 2018 with July. Forex market volatility during the first half of the year has been extremely low and quite reminiscent of last year, which saw movement within the third narrowest range in the past 30 years. The markets have become quite insensitive both to the trade wars and the rise in U.S. interest rates, and now that the North Korea risk has receded, some say that the only thing left is to wait patiently for the U.S. economy to run out of steam. Under such circumstances, most of the predictions point to USD/JPY movements remaining within a reasonable range, similar to last year. However, my basic understanding is that, if “the U.S. economy running out of steam” seems highly likely at the next stage, it would be even more appropriate to bet on a decrease in U.S. interest rates, an adjustment of risky asset prices, and an appreciation of JPY. In the first place, the prediction that USD/JPY will remain “within a reasonable range” does not add any value. Given that now is the turning point for economic and financial situations, it is important to clearly indicate whether the direction in the coming phase will be up or down.

The central themes for 2H are likely to remain the “tightening effect of the Federal Funds (FF) rate approaching to the neutral interest rate” and a “chilling of market sentiment in the face of trade wars.” In other words, I believe that a situation that could trigger a risk-off mood will prevail. The most straightforward forecast, I do believe, is that, as the FF rate approaches effectively positive levels, it will have a tightening effect on the real economy. As I have said many times, the Fed’s policy operation will enter an overt phase of monetary tightening within the year (see figure). It is because the Fed is conscious of this change in phase that the guidance “the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run” was altogether deleted from the FOMC statement in June. The decision to hold press conferences after all meetings from 2019 onward is also likely to have been taken because of Fed Chair Jerome Powell’s awareness that more careful and detailed communication will become necessary.

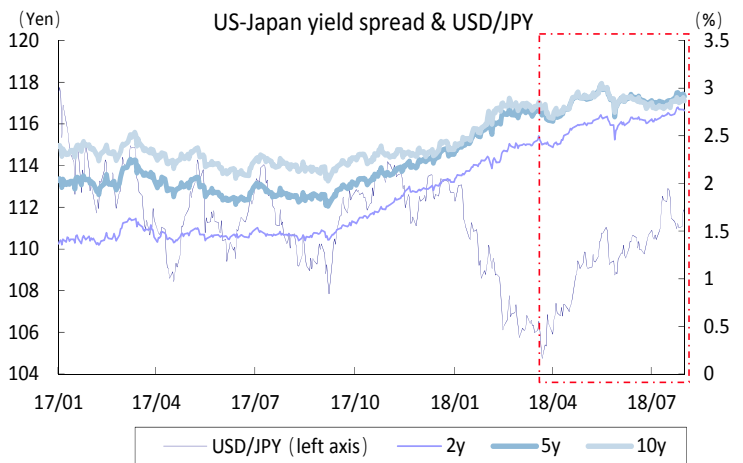
Going by the U.S. 10-year yield, which has already peaked at 3%, it seems we have entered a phase of having to patiently wait for the yield-curve flattening and inversion processes to finish (see figure). At the point when the yield curve finishes flattening/inverting, it is very likely that the dominant market prediction would be that no more rate hikes are possible. This report’s basic forecast scenario is that USD will weaken across the board alongside the decline in U.S. interest rates at that time, and that JPY will also strengthen its appreciation. Incidentally, the undervaluation of JPY in terms of its real effective exchange rate has not been corrected at all (as of June, it was -22% weaker than its long-term average). If USD is downwardly adjusted against a number of currencies, the safest assumption is that JPY would be the most affected as the currency at the receiving end of that adjustment.



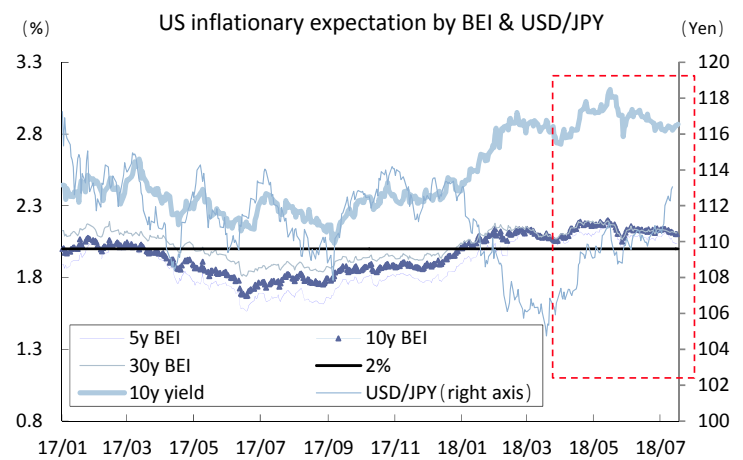
Peaking of U.S. interest rates and inflation

USD/JPY recovered to the level of 113 at one point in July, posting a year-to-date high, but we have not heard any convincing explanations as to why this may have happened. One gets the strong impression that no one really understands; most explanations are merely trying to justify the event in retrospect. Given this situation conducive to inexplicable rises in USD/JPY taking the markets by storm, I would like to once again examine and present my basic arguments here. The most typical reason used to justify any increase in USD/JPY is the U.S.-Japan interest rate gap, but as the figure shows, there are strong indications that the gap may have peaked for five-year and ten-year interest rates, even though some expansion in the two-year interest rate gap can still be seen. At the very least, there seems to be no correlation between the reversal of the USD/JPY trend over the past three months and the U.S.-Japan interest rate gap. In fact, USD/JPY was plunging rapidly during the first four months of the year even though the interest rate gap was expanding. One must remember that the correlation between USD/JPY and the interest rate gap is not as stable as the general impression seems to be.

Incidentally, inflation expectations during this period have also not grown at all and show strong signs of having peaked (see figure to the right). Wages have not been increasing sufficiently to boost inflation expectations, the final destination for nominal interest rates. And because inflation expectations are not growing, they are not contributing to growth in long-term interest rates either. At the very least, it is not easy to justify the significant rise in USD/JPY during July based on U.S. inflation or interest rates. Ultimately, it may just boil down to the markets over-reacting to the Congressional testimony of Mr. Powell and remarks by other senior Fed officials, taking them to mean that Fed rate hikes will continue for some time to come and buying up USD on the strength of that single factor. However, such a trend does not seem very sustainable.



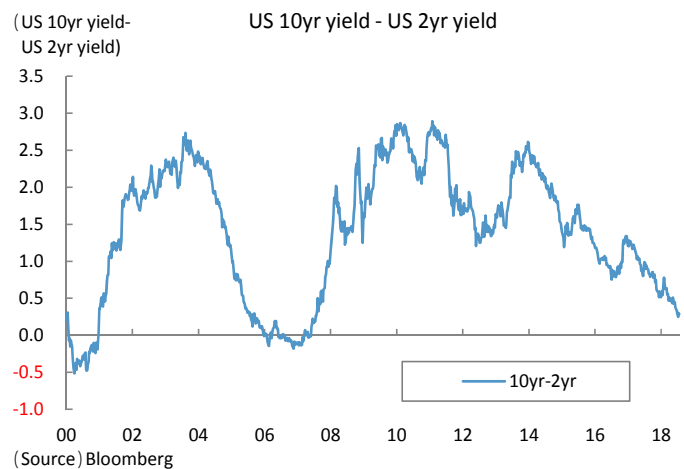
(Source) Bloomberg



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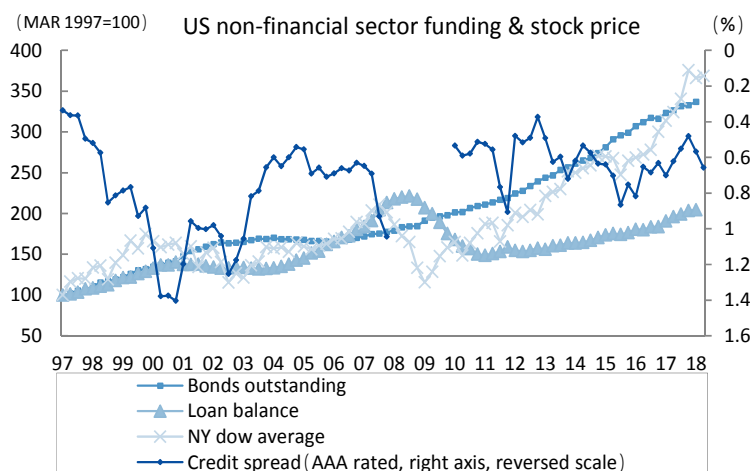
Dangerous to be blindly led by inexplicable increases in USD/JPY

It is true that the two-year interest rates have been rising in line with rate hikes, and USD/JPY also shows strong signs of correlation with the U.S.-Japan two-year interest rate gap. It may still be a while before the gap between two-year and 10-year yields vanishes (the yield curve flattens), so perhaps one can expect some further increase in USD/JPY (having said that, there is only 30 bp gap remaining as of the time of writing this report). However, the rise in interest rates will eventually tighten fund procurement conditions and hurt consumption and investment appetites in the real economy. This is an area of true relevance for monetary policy, and assuming that such a thing will not happen is essentially a mistake. The real question now is to find out when and in which markets such a scenario will first surface. One possible answer is that it may take place in the form of a major adjustment in the stock market around the time the FF rate reaches the neutral interest rate (2.50-3.00%), and assume that household consumption and investment appetites will be affected by the reverse wealth effect. The main scenario of this report is consistent with this assumption.



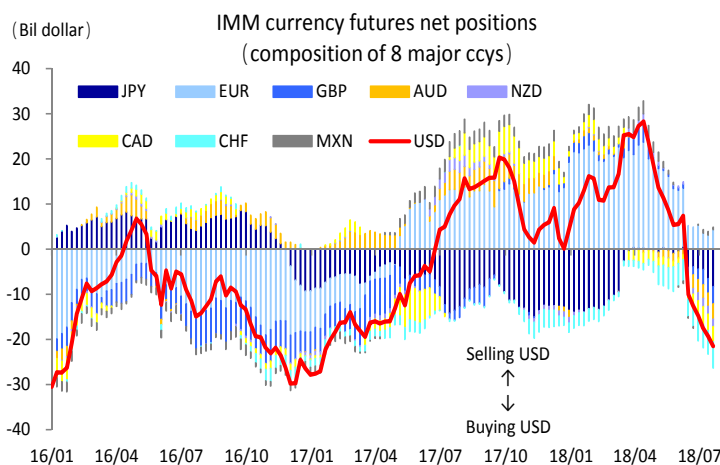
(Source) Bloomberg

If we go by conservative estimates (such as those by NY Fed President John Williams), the FF rates may reach the neutral interest rate level within the year at the earliest. But how will the turmoil in the stock markets begin? In this context, there are already visible signs of trouble in the corporate bond market, where the credit spreads are beginning to widen. Under the low-interest-rate climate post the financial crisis, the U.S. corporate sector has relied more on the issuance of corporate bonds than on bank loans for fund procurement (see figure). In connection with this, many say that the issue of corporate bonds contributed to vigorous stock buy-backs causing share prices to rise, and that this resulted in wealth effect which help household consumption



(Source) Macrobond (Note) Credit spread excluding outliers from year 2008 to 2009

and investment. If this is true, it would be right to see the gradual widening of the credit spreads since early this year as a leading indicator of a future adjustment in stock prices (details later). Of course, the stock buy-backs may not be the sole reason behind stock-price strength, but there is no question that changes in the corporate bond market could trigger the selling of stocks. However, this is the original expected effect of rate hikes and also something intended by the Fed.



(Source) CFTC, Bloomberg & Mizuho Bank

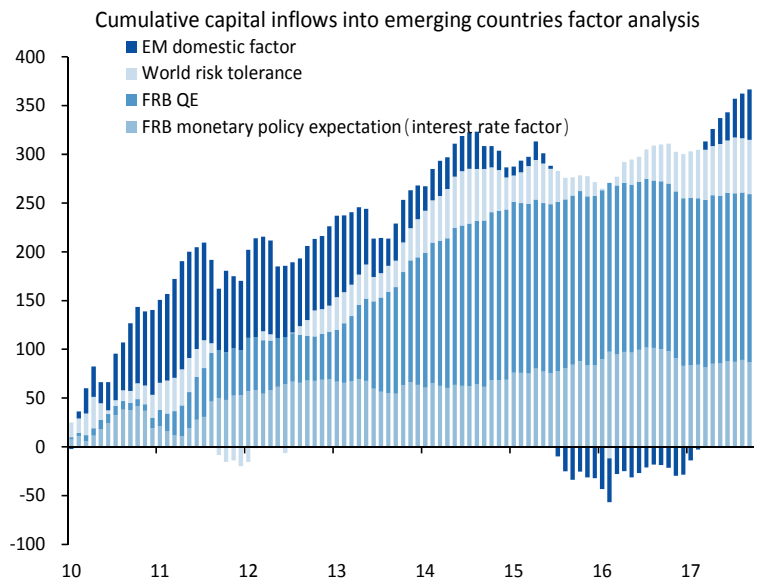
Going forward, as mutual sanctions and tariffs are imposed by the U.S. and China, the evils of trade wars are very likely to come to the fore, triggering an adjustment especially in the corporate bond and other high-risk markets. Inexplicable increases in USD/JPY similar to

what was seen in July could take place again in the coming months, and rather than being blindly led by them, I would like to work at seriously understanding the markets where changes are taking place and what they indicate about the future. USD/JPY did appreciate for no good reason in July, but the USD long position (as of July 24, 2018) as seen in IMM currency future trading has already expanded to a level last seen about 18 months ago, on March 21, 2017 (see figure). It is worth paying attention to the fact that even extremely short-term supply-demand indicators are beginning to suggest that the markets are going overboard.

Turmoil in emerging markets is bound to happen, but will it?

Naturally, so long as the Fed tightens monetary conditions, it is natural to assume that funds will continue to be channeled out of relatively high-risk areas in terms of international economic and financial conditions. With the FF rate (which regulates the global cost of capital) now at the 2% level (a level that would be difficult to describe as low interest rate), investment options that were available so far will increasingly become unavailable. In this connection, the first matter of concern is the draining of capital from emerging economies – a problem that did indeed surface in early May in countries including Argentina and Turkey. Last June, Argentina, a regular defaulter, issued (non-investment grade, B-rated) 100-year government bonds, which saw more than three times as much demand as foreseen (over USD 9 billion as opposed to the under USD 3 billion that was expected). This could not have been the case but for the fact of surplus available funds. The amount of money channeled into emerging economies through the course of 2017 was of an extremely large scale, and as the Fed's policy operation tilts toward monetary tightening going forward, it will be natural to prepare for a flow in the reverse direction.

A graph presented in the Global Financial Stability Report (GFSR) released by the IMF in October last year directly indicates the danger of such a situation. As the graph indicates, quantitative easing (QE) is the biggest contributor to the flow of capital into these economies since 2014, but the Fed's low interest rates are the second largest contributor. To be more specific, according to the analysis, just under 60% of the funds that were channeled into these economies between 2014 and 2017 were due to QE, while just under 30% were due to the low FF rates. Only about 1% is owing to domestic factors such as the fundamentals of the economy in question. As of the current time, a tightening is underway both in terms of QE and low FF rates, so it can be said that we are currently in a phase where a reversal of the situation seen until now can be assumed. During the second half of the year, as the FF rate attempts to return to

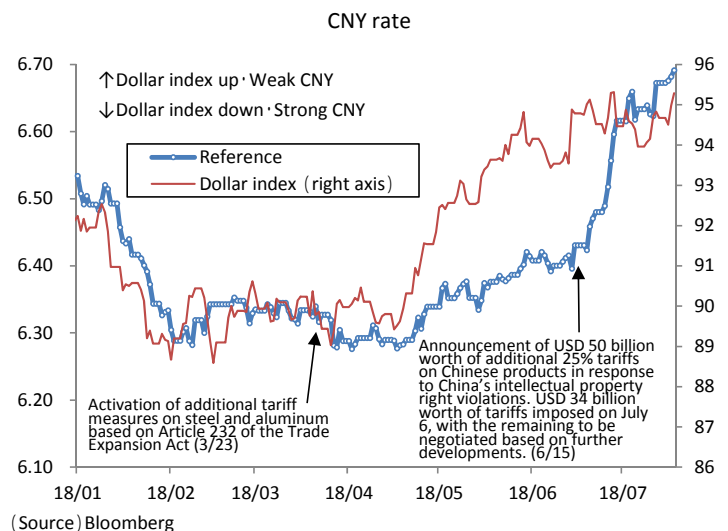


(Source) IMF "Global Financial Stability Report Oct 2017"

effectively positive levels, the expected returns from emerging currency-denominated assets will inevitably deteriorate compared with those from USD-denominated assets. Leaving aside the question of whether this situation could trigger a financial "shock," the natural assumption is that there will be a draining out of capital from emerging economies if things continue as they are now. I hardly need to point this out, but the reason for higher interest rates is because the risks are greater, and as risk tolerance declines in the wake of tapering, naturally some countries/regions will no longer be investment targets. The Argentinian 100-year bonds were hardly more than barren flowers that grew out of the presence of surplus funds.

The danger of domestic attempts to weaken emerging currencies coinciding with an effectively positive FF rate

The Fed's normalization process (rate hikes and QE tapering) alone would be an adverse development for emerging markets, but the intensification of the U.S. protectionist policies could also trigger an outflow of capital from these markets. What would the impact of a declining CNY be on other emerging markets, for instance? As most people are aware, the weakening of CNY since spring this year is probably the result of a retaliatory action against the Trump administration, going by the timing and pace of depreciation. It could not be pure coincidence that CNY stopped soaring and began to fall at around the same time as various additional tariffs were announced by the U.S. Given that the value of Chinese imports from the U.S. is much smaller than that of U.S. imports from China, simply slapping tariffs on imports from U.S. would not be sufficiently retaliatory from China's perspective. It would, therefore, be logical to conclude that the Chinese government has begun using currency policy as part of its "comprehensive measures" against the U.S., and if this is in fact so, the devaluation of CNY is likely to continue going forward.

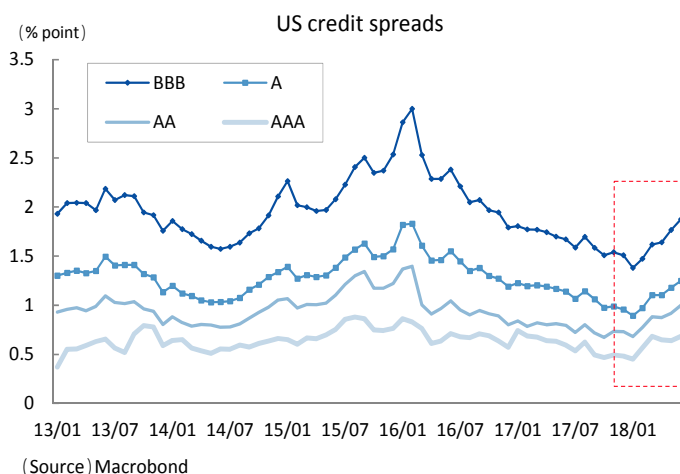


(Source) Bloomberg

The problem is that if CNY continues to depreciate at the current pace, other emerging economies will find their competitiveness deteriorating and will have to respond by weakening their own domestic currencies. If that happens, the milestone event of the FF rate's turning effectively positive will coincide with emerging economies led by China intentionally guiding their domestic currencies weaker. To be sure, some say that the currencies of China and South East Asian nations, which have abundant foreign currency reserves, will be able to avoid a major crisis. However, foreign currency reserves merely act as counters against speculative moves; they do not prevent said speculative moves from taking place to begin with (if the size of a country's foreign currency reserves were a deterrent against crisis, China would not have experienced a currency crisis in August 2015). There is never any guarantee that the financial authorities of a country can fully regulate the flow of capital, and at the present time, there seems a high chance of specific emerging economies suffering from a major capital drain and throwing international financial markets into turmoil. At any rate, the impact of the Fed's normalization process will first surface in countries/regions/products that are relatively high-risk.

Could credit spreads be the canary in the coal mine?

Following the emerging markets, turmoil will spread to developed economies, especially the epicenter of the normalization process, i.e., the U.S. economy (of course, the two could even be affected simultaneously). Of particular concern are the trends in the credit market. Already U.S. credit spreads (against 10-year yields, see figure on next page) have been gradually widening since the beginning of the year, revealing that the tightening of monetary conditions is beginning to have an effect starting from high-risk markets. As already mentioned, some pointed out that “an accommodative monetary climate → an increase in corporate bond issues → stock buy-backs” could have been behind U.S. share price strength. Given this, if the credit spreads continue to widen, the above path could become dysfunctional. This could be a problem, given that share-price strength has been the basis of the U.S. economy’s strength.



As I argued in a past issue of this report, it is thought that the wealth effect resulting from strong share prices has played a significant role in promoting robust household sector consumption and investment, which prop up U.S. economic growth. Despite no acceleration in wages, the household savings rate has declined dramatically, and this is bound to be due to the increase in unearned income as a result of stronger share prices (as of the end of March 2018, the household sector’s net asset balance was over 500% of GDP, a new record high).

If corporate bond issues slow down against the widening of the credit spreads, causing stock buy-backs to decline and weakening share prices, the consumption and investment appetites of the household sector will also, naturally, be affected. Could this widening of credit spreads be the canary in the coal mine, issuing warning signals of the downside risks? There is no sign of any concern regarding this critical situation in the financial markets as of the moment, but my understanding is that the situation will become increasingly hostile to the Fed’s ability to persist with its hawkish policies. Over the next year or so, it is likely that the policy stance will become clearly neutral, and U.S. interest rates will also begin to factor in the possibility of a monetary easing as the “next step.” At that time, with USD weakening across the board, JPY appreciation will probably become inevitable.

Trade Wars and Forex Rates – Trump Administration Worried about Repercussions

Retaliatory Wars

Concerns regarding trade wars, which have been smoldering since early spring, still haven’t receded as of July. The ceasefire declared by U.S. Secretary of the Treasury Steven Mnuchin in late May has faded into oblivion, and perhaps few market participants even remember it. The U.S. government announced plans to impose a 25% tariff on Chinese products, which will amount to a total of USD 50 billion, as a sanction in response to China’s intellectual property violations¹. In the first stage, USD 34 billion worth of additional tariffs (on 818 products) were imposed on July 6, with the remaining (USD 16 billion worth of tariffs on 284 products) to be implemented based on China’s counter move. Of course, the Chinese government has also declared that it will impose the same value of retaliatory tariffs on U.S. products. Mr. Trump criticized this saying, “China is now threatening United States companies, workers, and farmers,” and asked the U.S. Trade Representative (USTR) to consider imposing an additional 10% of tariffs on USD 200 billion worth of Chinese products. On June 19, following these developments, a Chinese government spokesperson declared the Chinese stance that “China will have to adopt (strong) comprehensive measures that combine quantity and quality (vis-à-vis the U.S.),” suggesting moves that will involve a wide range of areas including restrictions on permits and licenses toward investment in China for U.S. companies as well as restrictions on Chinese tourists to the U.S., going well beyond the area of bilateral trade. As mentioned in a previous section, these “comprehensive measures” are surfacing in the form of a weakened CNY.

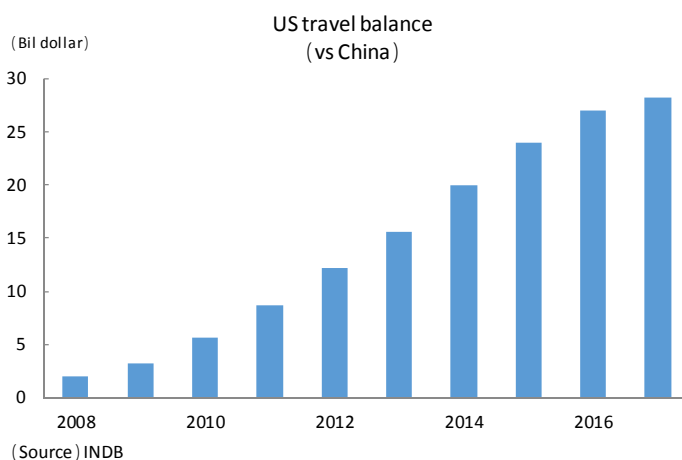
The Trump Administration’s Stance is Bound to Benefit the Enemy

Taking the 2017 figures as an example, in terms of goods trade, U.S. imports from China amount to USD 506.3 billion, while U.S. exports to China amount to USD 130.4 billion, resulting in a trade deficit of -USD 375.9 billion for the U.S. Taking into account this difference between its exports and imports, the Trump administration’s basic position is that China would be the loser in any trade war between the two countries. As is obvious from his remarks and actions so far, President Trump seems to erroneously believe trade surpluses and deficits to be the same as corporate surpluses and deficits, and to expect that restricting the other party’s (China’s) exports is bound to deal a severe blow. It is probably because he believes that erecting tariff as well as non-tariff barriers can check the exports of exporting countries that he once tweeted, “Trade

¹ The Office of the United States Trade Representative (USTR), “USTR Issues Tariffs on Chinese Products in Response to Unfair Trade Practices” May 29, 2018

wars are good, and easy to win.” On June 19, Peter Navarro, Chairman of the National Trade Council (NTC) remarked that “China has a lot more to lose” (in any retaliatory back and forth), perfectly echoing the Trump administration’s stance on the matter. Within the administration, Treasury Secretary Mnuchin and National Economic Council Chairman Larry Kudlow appear to want to moderate this biased policy stance, but Mr. Navarro and United States Trade Representative Robert Lighthizer are firm in confronting such efforts, with the President backing the latter. What is more troubling is that China does impose higher tariffs on U.S. products than the U.S. does on similar Chinese products, so the stance of the President and his supporters is not altogether unjustified.

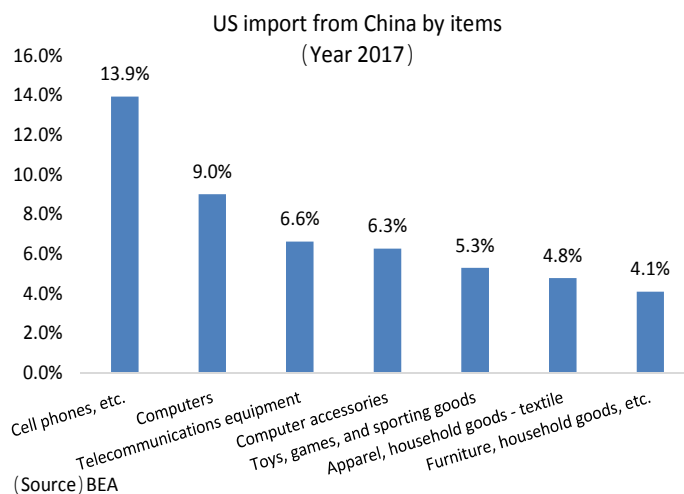
Reality, however, is a complex thing. Tariffs may lower exports, but if that happens, what will happen to U.S. companies that are engaged in production activities in China? Trade sanctions could directly affect the operations of such U.S. companies in China. Again, what will happen to U.S. companies that provide goods and services to Chinese consumers? If the trade friction between the two countries gets more complicated, the situation could escalate to a boycott of U.S. products like in the case of Japanese cars in the U.S. Companies like Starbucks, McDonalds, and Nike could be targeted. Meanwhile, there are not that many Chinese companies that provide goods or services to U.S. consumers. Ultimately, the Trump administration’s trade policies could end up benefitting Chinese companies.



Similarly, there are not that many U.S. tourists to China as there are Chinese tourists to the U.S. In other words, the U.S. has an overwhelming travel surplus with China, and this is bound to decline if anti-U.S. sentiments flare up. As the figure on the previous page shows, the U.S. travel surplus with China has swelled up to over 10 times over the past 10 years. Accepting inbound tourists is an “export” in that it earns foreign currency, but perhaps this is an argument that cannot be got through to President Trump, who puts America first to the exclusion of all foreigners.

U.S. Household Sector Exposed to Danger

It is well-known that products manufactured in China have been flooding markets throughout the world, and the U.S. market is no exception to this. It is not clear the degree to which those within the Trump administration have analyzed and forecast the effects on U.S. consumers of the high tariffs being placed on Chinese products. Looking at U.S. imports from China in 2017, for example, the top three product categories were mobile phones (a 13.9% share of such imports, worth USD70.36 billion), personal computers (a 9.0% share, worth USD45.52 billion), and communication equipment (a 6.6% share, worth USD33.49 billion), followed by such product categories as toys, clothing, and furniture (see graph). In short, these are mostly products closely related to consumers’ daily lives.

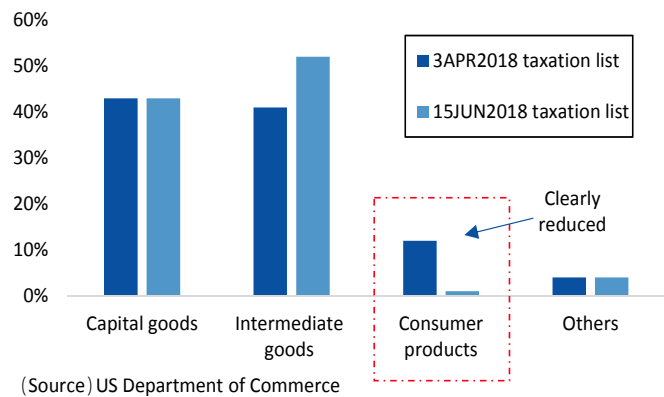


Moreover, imports of goods from China account for the majority of total U.S. imports in numerous individual product categories; for example, almost 70% of U.S. imports of mobile phones and personal computers come from China. While such product categories as furniture and toys do not account for a large share of the total value of U.S. imports from China, it is worth noting that 70%-80% of U.S. imports of such products come from China. Therefore, it is easy to gain a general understanding that the (bad) inflationary pressures exerted on the U.S. household sector by the raising of tariffs on Chinese goods will be correspondingly large. That is unlikely to be a desirable scenario from the perspective of President Trump, who is aiming to promote Republican victories in this year’s midterm election as well as the 2020 presidential election, and it is extremely unlikely that the Trump administration is unaware of the negative factors that I am pointing out. Given that, it appears likely that the administration is giving priority to the goal of putting pressure on China even at the expense of subjecting the U.S. household sector to a certain amount of harmful inflationary pressure. This is seems quite possible.

Efforts to avoid splashback

Of course, while the United States is intent on maintaining the offensive, it is also showing signs of giving attention to measures designed avoid subjecting itself to 'splashback' from the bloodletting associated with its offensive measures. According to an analysis of the U.S. move to place tariffs on USD50 billion of Chinese goods undertaken by the Peterson Institute for International Economics², almost all of the 'first set' of goods to be affected are non-consumer goods – 43% capital goods and 52% intermediate goods – with consumer goods accounting for only 1% of the goods affected (see graph on previous page). On April 3 this year, the U.S. Trade Representative (USTR) issued a list of Chinese products (worth approximately USD50 billion) to be subject to supplementary 25% tariffs, but at that time, the composition of affected products was 43% capital goods, 41% intermediate goods, and 12% consumer goods. In response to the views expressed in public hearings on China tariffs held in mid-May and in the public comments on the tariffs that have been received so far, it appears that additional emphasis is being placed on consumers' interests. The majority of observers believe that the trade war is an element of President Trump's strategy for making a 'deal,' and this view is probably correct but, going forward, there seems to be a potential for a situation in which the countries involved cannot clearly assess their counterparty's attitude but still feel compelled to implement additional rounds of tariffs. Even if such a scenario is realized, there are signs that a certain minimal level of consideration is in fact being given to designing the tariffs so as to place most of the burdens on the corporate sector rather than on ordinary individuals in the household sector.

Custom duty against China
(3APR2018 vs. 15JUN2018)



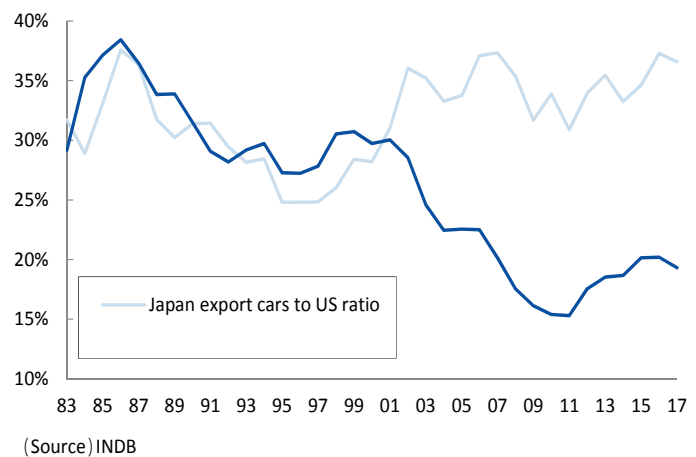
As President Trump appears to be in a position where he cannot immediately support generalized free trade, it seems likely that he will increase U.S. negotiations with individual trade partners while subtly increasing and decreasing the pressure exerted on those countries. From an administrative perspective, this seems likely to become an extremely troublesome process. If President Trump anticipates that the process will be extremely troublesome in this way, there is a possibility that he might choose to resort to the quickest alternative strategy – promoting USD depreciation. Since the economic effects of a "10% tariff" and "10% USD depreciation" are fundamentally the same, it can be considered natural to consider this alternative strategy. Moreover, the alternative strategy is less blunt and therefore less likely to provoke retaliation.

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Likely Impact on Japan

What about the influence of such U.S.-China trade friction on Japan? There are clearly grounds for concern that Chinese companies shut out from the U.S. market will begin seeking alternative markets. While there is no real substitute for the huge U.S. market, it is reasonable to anticipate that companies will try to target the next-best thing in terms of geographic proximity, economic power, and population size, and I think this next-best market is obviously Japan. There are already reports that Japanese government officials are anticipating the possibility of a sudden surge in imports of Chinese structural steel products, processed aluminum goods, color televisions, air conditioner components, and other products, and a bureaucrat was quoted as saying the competition from Chinese imports could be devastating for Japan's small and medium-sized companies (June 30, *Jiji Press*). Japanese policymakers are also giving consideration to the possibility that Chinese companies excluded from the United States will shift their focus to Japan. However, all these concerns relate only to indirect effects.

Japan trade against US



A particular matter of concern with respect to direct effects is the automobile tariff that the Trump administration has begun hinting about. It has been reported that the administration has begun investigating whether increased imports of motor vehicles and related components constitute a threat as defined by Section 232 of the 1962 Trade Expansion Act and is considering new tariffs of as much as 25% on such imports. On June 29, the Japanese government officially stated that such measures could have a destructive effect on the world economy, and industry groups within the United States have expressed similar views. The Japan Automobile Manufacturers Association has pointed out that the implementation of additional tariffs could cause a decline in automobile production and related employment in the United States, and it seems

² Chad P. Bown, Euijin Jung and Zhiyao (Lucy) Lu, "Trump, China, and Tariffs: From Soybeans to Semiconductors" The Peterson Institute for International Economics, June 18, 2018

that most automobile industry stakeholders are now expressing opposition to the prospective tariffs. Compared to other foreign companies in the United States, Japanese manufacturing industries have made particularly large contributions to increased local employment, so one might think they should have particularly strong powers of persuasion. On June 27, Toyota released a statement in opposition to the tariffs, arguing that the tariffs would increase the cost of producing mainstay Camry sedan models produced locally in the United States by USD1,800 per unit and that the corresponding increase in selling prices would be a burden on consumers.

Nonetheless, reflecting his somewhat exaggerated perception of the U.S. victimization by current trade frameworks, President Trump may feel that Japan's exports of automobiles to the United States is due cause for Japan bashing. As shown by the graph on the previous page, the share of Japan's total exports to all countries that is exported to the United States has clearly decreased over the past 30 years, but the share of automobile exports within Japan's exports to the United States has smoothly increased. With respect to U.S.-Japan trade in goods during 2017, the United States recorded a USD69.9 billion deficit, of which almost 80% stems from its trade deficit in automobiles and related components. Reflecting this, Japanese vehicles' share of the U.S. market has risen to almost 40%.

Thus, although the importance to Japan of its exports to the United States has declined, Japanese car imports' presence in the U.S. market is considered quite large from the U.S. perspective. Given this situation and President Trump's detestation of trade deficits, there will inevitably remain concerns that the Trump administration will target Japanese automobile exports in the course of discussions of U.S. trade relations with Japan. However, since U.S. automobile manufacturers have already effectively withdrawn from the Japanese market, it is unlikely that they will increase their sales in Japan in response to changes in tariff levels. Accordingly, it seems likely that criticism of Japan going forward will generally have the theme that "Japan's automobile manufacturers (as well as its other manufacturing industries) are profiting by taking advantage of the excessive weakness of JPY." In the case such criticism intensifies, there probably is a possibility that the BOJ's monetary policy management will be singled out for particularly harsh critiques. If one assumes that Japanese companies are already approaching the limits of feasibility with regard to such self-help efforts as those to shift production overseas, then one can anticipate that the focus may shift to the differences between U.S. and Japanese monetary policies, and there is a clear risk that the United States may eventually decide to leverage its potential power as the world's key-currency country. Because Japan does not have the means to counter pressures to enable JPY appreciation in such a case, it can be said that there is a need for careful and farsighted negotiations designed to forestall such a development.

BOJ Monetary Policies Now and Going Forward – Opportunities Won't Last Forever

Even "Desire" no Longer Able to Attain the 2% Target Level

The July 30-31 BOJ Monetary Policy Meeting (MPM) can be considered to have earned good marks from the perspective of those inclined to anticipate measures promoting movement in the direction of policy normalization. Although the MPM decided to maintain the short-term policy interest rate (unsecured overnight call rate) of -0.1%, its standard description of its policy operation goal of keeping the long-term interest rate (10-year JGB yields) at around 0% was supplemented with the added text – "the yields may move upward and downward to some extent mainly depending on developments in economic activity and prices." It goes without saying that phrase – "may move upward and downward to some extent" – reflects a consciousness of the potential for a rise in interest rates. Given the apparent BOJ decision to conduct fixed-rate operations with a ceiling of 0.10%, lower than the 0.11% ceiling seen previously, it appears that the meeting's announcement that yields may move both upward and downward to some extent may have been designed to prevent observers from interpreting that 0.10% ceiling as representing a 'tightening' measure. This is exactly as was predicted beforehand. At the post-meeting press conference, BOJ Governor Kuroda said the BOJ would allow yields to fluctuate within a "-0.2% to +0.2% range," twice as wide as the previous "-0.1% to +0.1%" range. This can be said to be a fruit of fluidity depletion.

Regarding purchases of stock-index-linked exchange-traded funds (ETFs), the MPM statement states that – "With a view to lowering risk premium of asset prices in an appropriate manner, the Bank may increase or decrease the amount of purchases depending on market conditions." – and it is noteworthy that this policy description positions the BOJ to reduce its ETF holdings at its own discretion going forward. Such an initiative to reduce ETF holdings would address the generally held concern that, compared to bond purchases, purchases of ETFs without maturity dates are problematic with respect to the eventual disposal of the ETF holdings, and there has recently been an increase in the number of observers pointing out the unsavory aspect of the BOJ's large-scale holdings from the perspective of corporate governance. Given these circumstances, it appears that the BOJ made the appropriate judgment in this regard.

Major outlook by BOJ policy board members (YoY %)

	Real GDP	Core CPI (ex fresh food)	Ex consumption tax impact
FY 2018	+1.3 ~ +1.5 <+1.5>	+1.0 ~ +1.2 <+1.1>	
Outlook as of Apr	+1.4 ~ +1.7 <+1.6>	+1.2 ~ +1.3 <+1.3>	
FY 2019	+0.7 ~ +0.9 <+0.8>	+1.8 ~ +2.1 <+2.0>	+1.3 ~ +1.6 <+1.5>
Outlook as of Apr	+0.7 ~ +0.9 <+0.8>	+2.0 ~ +2.3 <+2.3>	+1.5 ~ +1.8 <+1.8>
FY 2020	+0.6 ~ +0.9 <+0.8>	+1.9 ~ +2.1 <+2.1>	+1.4 ~ +1.6 <+1.6>
Outlook as of Apr	+0.6 ~ +1.0 <+0.8>	+2.0 ~ +2.3 <+2.3>	+1.5 ~ +1.8 <+1.8>

(Source) Bank of Japan

(Note) < > indicate the median estimate by policy board members

This is not the only adjustment made in the direction of normalization. Regarding the Policy-Rate Balance to which a negative interest rate is applied, the MPM statement states that – “The Bank, under the condition that yield curve control can be conducted appropriately, will reduce the size of the Policy-Rate Balance in financial institutions’ current account balances at the Bank – to which a negative interest rate is applied – from the current level of about JPY10 trillion on average.” – and this decision was taken based on consideration of the side effects of those balances on financial institutions. In view of the downward revisions to both economic growth rate and inflation rate forecasts in the concurrently released “Outlook Report” (see chart on previous page), the BOJ can be seen to be undertaking seriously for normalization measures despite its unfavorable assessment of conditions in the real economy. Truly, these initiatives make it hard not to get the impression that withdrawal-type adjustment measures have been implemented with respect to the current policy framework. Incidentally, the BOJ’s CPI forecast is only 1.6%, even as far ahead as fiscal 2020. Looking at BOJ forecasts made since the start of the Kuroda regime, it is unprecedented to see such a low inflation rate forecast made even for the final year of the forecast period. For that reason, the “Outlook Report” has often been scornfully referred to as a “Desire Report,” but we have reached a point at which even the BOJ’s desire is no longer attaining the target level.

Background of Forward Guidance Introduction

However, there are some glaring discrepancies. Despite the above-noted decisions strongly suggestive of normalization, the latest MPM statement was given the title – “Strengthening the Framework for Continuous Powerful Monetary Easing.” This reflects the newly introduced ‘Forward guidance for policy rates’ (FG), which reads – “The Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019.” Specifically, there is some controversy about just how long a time period the “for an extended period of time” phrase is meant signify, but it is probably safe to assume it means at least through the autumn of next year. In that case, the upshot is that the BOJ’s FG can be interpreted as precluding policy rate adjustments for a period just about as long or slightly longer than the ECB’s FG does. It appears that this aspect of the MPM statement may be responsible for promoting selling of JPY and bank stocks following the meeting, and this is natural and to be expected, since the admixture of easing references was outside the scope of market expectations. By the way, it really seems unclear whether the phrase “the current extremely low levels of short- and long-term interest rates” is meant to refer specifically to the “-0.1% to +0.1%” range or whether it refers to a kind of general or abstract concept. The FG’s level of ambiguity seems quite high. Honestly speaking, it may well be that the BOJ decided that, at the time it was approving various normalization measures, it was necessary to ‘neutralize’ the effect of those measures with a few easing measures. Indeed, since JPY depreciated after the meeting, it seems that such a neutralization plan may have proven successful. Also, in light of the government’s plan to raise taxes in October 2019, it may be that the BOJ believed due consideration of that situation is necessary when embarking on its normalization process. However, it is also likely that, in view of President Trump’s renewed expressions of dissatisfaction with U.S. interest rate hikes and USD appreciation during late July, the BOJ felt it must limit the easing-oriented measures to the extent that it did. Oddly, it was reported precisely on the day of the MPM meeting that August 9 had been chosen as the date of the upcoming Japan-U.S. “free, fair and reciprocal” (FFR) trade dialogue meeting to be held in Washington. Since Japan will not be in a position to flaunt easing-oriented monetary policies in the run-up to the FFR meeting, it can be assumed that the BOJ will take pains to refrain from any conspicuous actions for the time being.

Normalization opportunities won’t last forever

Various types of conflicting predictions were voiced prior to the MPM meeting, and there is a possibility that this kind of situation will persist in the future. The key point, though, is that the kind of BOJ measures in the “not-toward-easing direction” announced at the latest MPM meeting are only really feasible when the economic and financial situation in Europe and the United States is robust and the Fed and/or the ECB are therefore making progress in their own normalization processes. It would have been difficult to implement those measures, for example, if U.S. interest rates were declining, USD/JPY was near JPY105, and the Nikkei was on the verge of descending below the JPY20,000 level. Fine tuning BOJ policies is difficult in the absence of a perception of a reasonable level of safety stemming from positive trends in the overseas economic and financial environment. It was fortunate that the BOJ was able to make the relevant decisions this time, but it cannot be assumed that the conditions necessary for such decisions will always be present. One must not assume that the window of opportunity for normalization will last forever.

In light of this, the BOJ should not necessarily determine its “next move” while focusing exclusively on the current situation in Japan. As economic cycles progress and the U.S. and the euro economies extend their record-long expansion phases, monetary policy authorities naturally need to give due thought to preparing for the next economic-cycle phase. In other words, it is to be hoped that monetary policy authorities are motivated by a healthy amount of fear regarding how necessary it is to make sure they have some policy option cards available to play when the next recession begins. It appears that the reason the Fed and ECB are sticking with their normalization processes despite a lack of acceleration in wages and inflation rates is because are conscious of how important such “elbowroom theory” will prove to be, and they have the foresight to anticipate that the more policy option cards they have available, the better off they will be when the inevitable happens.

Players in the financial markets have already been analyzing and debating about the effectiveness of the BOJ’s current policies and their side effects for quite some time, and it should not be so difficult to recognize that there is a generally emerging consensus that the downsides of those policies outweigh the benefits. Given the widespread expectations that the FRB’s interest rate hikes will reach their end point this year, the BOJ should be giving top priority to considering what it

will be positioned to do when it faces the “next recession (≈JPY appreciation) scenario.” If nothing has changed by the time the next recession begins, there is probably a risk that the BOJ will feel pressured to undertake such previously taboo policies as those associated with helicopter money and foreign bond purchases.

Of course, it will not be easy for the government and BOJ to promote better awareness of the virtues of elbowroom theory all by themselves. To a certain extent, this is probably a theme that cannot be effectively developed without harmonious dancing to the same beat on the parts of the BOJ, politicians, and market participants. In this sense, while the BOJ and market participants (particularly bond market players) have generally been at odds with each other since the Kuroda regime’s April 2013 inauguration, the latest MPM appears to be showing some signs of bringing about an increase in constructive engagement. There is even a possibility that we might eventually come to look back at that MPM as a positive turning point. It is to be hoped that we are now witnessing the start of a true exit strategy campaign.

Risks to the Main Scenario – Finally Playing the ‘Trump Card’?

Concern About the Trump Administration’s ‘Trump Card’

As I do each month, I would like to review the risk factors related to my main forecast scenario. There have been no major changes since last month regarding the listed risk factors (see table), although risks related to risk factor are steadily increasing, to the point that it might be considered reasonable to elevate the status of those risks from that of a ‘risk scenario’ to that of a ‘main scenario’.

However, since not many of the various trade measures

Potential Risks to the Main Scenario

	Risk Factors	Remarks	Direction
US	Economic policy by President Trump	· Developing trade friction between U.S. & Japan, possibility of weak USD policy?	Strong JPY Weak USD
	Continual excessive monetary tightening by FRB	Plunge into complete “tightening” stage	Strong JPY Weak USD
Japan	Political risk in Japan	· Retrogression of reflation policy by Abe resignation	Strong JPY Weak USD
	FX risk-taking by Japanese investors	· From hedged to unhedged position expansion? · Increasing cross border M&A continuously	Weak JPY Strong USD
	-1 Risk of BOJ monetary policy change	· BOJ might use a reversal rate discussion to begin considering means of reducing its easing measures	Strong JPY Weak USD
	-2 Risk of BOJ monetary policy change	· Radical easing monetary policy such as purchase foreign bonds, helicopter money & etc	Weak JPY Strong USD
Europe	Political risks in EU	· Conflict intensified between Italy and European Commission · Conflict intensified about Brexit negotiation	Strong JPY Weak USD

(Source) Daisuke Karakama, Mizuho Bank

announced by the Trump administration have actually been implemented other than the July 6 imposition of additional tariffs on USD34 billion of Chinese goods, my view is that the potential scenario of a full-fledged trade war causing across-the-board USD depreciation and depressing USD/JPY below JPY90 level should still be considered a risk scenario. A target list for additional tariffs on USD200 billion of Chinese goods was announced in July, but the final decision on these tariffs is not expected to be made until September at the earliest owing to review process of congressional hearings and post-hearing public comment submissions, and if the implementation of the tariffs were to be restrained, the situation would not advance to the level of a trade war. Given this, I believe the risk factor still belongs in the risk scenario category. However, there has been a disquieting development of a different nature. Since late July, President Trump has begun commenting on the Fed’s monetary policies and the U.S. interest rate and USD exchange rates stemming from those policies. Specifically, he frankly stated that USD strength puts the United States “at a disadvantage” and that he was “not happy” about the Jerome Powell-led Fed’s interest rate hikes. Although these comments are not surprising in light of President Trump’s well-known proclivity toward speaking his mind, it does raise concerns about a potential movement away from traditional respect for the central bank’s independence. Given this and President Trump’s various other statements critical of the Fed, I get a strong feeling that this may be a situation worth additional pondering.

As this article has argued since the Trump administration’s inauguration, given that ‘protectionism’ and ‘currency depreciation’ are extremely compatible concepts, President Trump cannot be expected to be pleased with U.S. interest rate hikes accompanied by USD appreciation. I had previously been wondering whether he might have been intent on diplomatically avoiding these issues, but at this time it seems more likely that he was just preoccupied with other situations, particularly his own personal scandals and the North Korean issue. U.S. Treasury Secretary Steven Mnuchin is generally considered to have more liberal views than President Trump and has often been called on to patch things up following the president’s problematic statements but, although it cannot be said to be certain at this stage, there is concern that Secretary Mnuchin has also come to play a supporting role in promoting a mood conducive to USD appreciation correction (promoting USD depreciation) by making such statements as “There’s no question that the weakening of the currency creates an unfair advantage for them (China)” at roughly the same time as the president’s recent criticism of the Fed. It is possible that, in response to the moves by trade-war-nemesis China to brazenly promote the depreciation of its currency, President Trump has finally decided to leverage the United States’ potential power as the world’s key-currency country. If the Trump administration were truly to play the ‘trump card’ (≈ promoting USD depreciation) it holds as the world’s key-currency country, would be a major development for the forex markets. The difficult-to-forecast forex world recognizes only one iron-clad rule – “The direction of U.S. monetary policy has an absolute effect in the forex market.” – and if the United States seriously begins showing that it desires USD depreciation, it is almost sure to get its way. My basic understanding is

that this is more akin to recognizing one of the world's natural laws than it is to forecasting. Over many years, it has been precisely because this is already generally understood that, even when presidents and treasury secretaries have subtly promoted USD depreciation, they have rarely (although not never) made clear statements to the effect that USD appreciation was "disadvantageous for the United States." If the president and his cabinet members repeatedly make similar statements about desiring USD depreciation, the forex market is likely to make assumptions about increasing dovishness on the part of the Fed, leading to across-the-board USD depreciation. Given that the U.S. Treasury Department has given JPY the 'undervalued' label, there is a high likelihood that the adjustment range of JPY would be quite large in such a case.

At the time this article was written, the upcoming Japan-U.S. trade dialogue meeting (intended to promote "free, fair and reciprocal" (FFR) trade) was scheduled to be held in Washington on August 9, and it seems likely to be a tough meeting given the current mood. Although President Trump himself has not yet made a clear-cut complaint about JPY weakness, it is impossible to discount the possibility that such complaints might be made in the case that the negotiations stall. This can be said to be the biggest concern at this time.

Possibility the FRB May React Stubbornly to Presidential Remarks

So, while risk factor is the risk factor calling for the most concern, there is also concern about an increase of monetary normalization process overkill risk (risk factor) owing to the FRB's potential reaction to President Trump's related comments. One intuitively senses that, if President Trump hopes to stop the interest rate hikes and promote USD weakening, his comments may prove to be counterproductive with respect to those objectives. High-level Fed officials have been disseminating information to communicate the message that the president's comments will have no effect on the policy of hiking interest rates. Of course, this is a standard response that they must make regardless of their real intentions. The forex market is assuming that two more interest rate hikes this year (in September and December) is the default route and, barring a significant unexpected development, any Fed move to adjust its policies may lead to speculation about the Fed succumbing to political pressure. As that speculation is likely to extend to future policy forecasts, it may elicit self-fulfilling expectations of a weakening of USD and a decline in interest rates. Even I can anticipate this, and it can be assumed that high-level FRB officials are harboring similar thoughts.

As a result of the presidential oral intervention, it may well be that, even at a point when the justification for an additional interest rate hike is tenuous and disputed, the Fed might feel a stubborn need to demonstrate its independence by implementing the hike. Quite a few observers have been anticipating that merely going ahead with the already-assumed two interest rate hikes (bringing the FF rate to 2.50%) may represent the attainment of the neutral interest rate's level and therefore the end-point of the hikes, so one gets the sense that the president's statements were superfluous and may just complicate the situation. It is quite possible that the previously existing grounds for concern about the possibility of policy normalization overkill have only been magnified by the statements.

Continued Presence of BOJ Normalization Risk

Other JPY appreciation risk factors have not greatly changed since last month. Although the political situation in Japan continues to be a JPY appreciation risk factor, a growing number of observers have begun agreeing with the assessment of LDP Secretary General Toshihiro Nikai, who said on June 26 that Prime Minister Abe is sure to win reelection for his third term as the LDP leader in the party's election this September. Thus, it can be said that the likelihood of risk factor has been declining from early this spring, and the "Abexit" theme embraced primarily among overseas investors – along with the surges of JPY appreciation and Japanese stock price declines anticipated based on that theme – now seems likely to prove illusory. The theme can be expected to be a hot topic of discussion in financial markets after Prime Minister Abe announces his candidacy and other candidates subsequently begin announcing their candidacies.

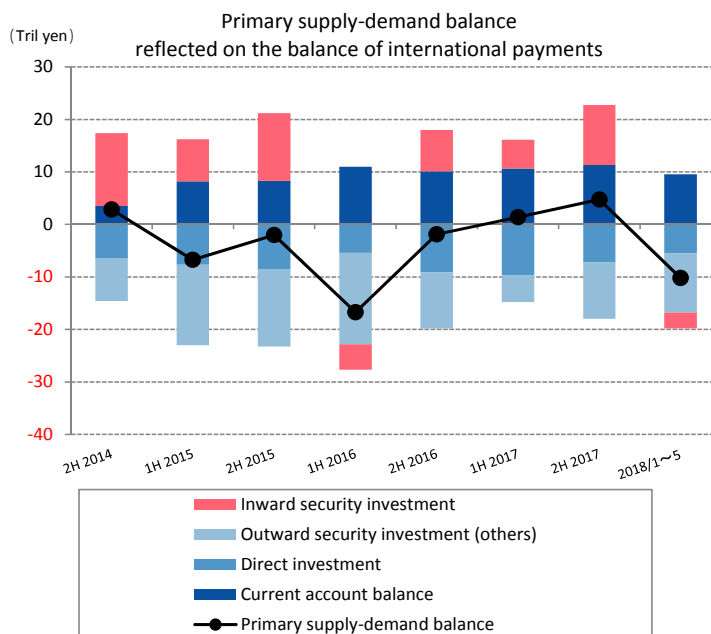
Moreover, it continues to be impossible to exclude the possibility that the BOJ might shift toward policy normalization (risk factor -1). The BOJ's July MPM made some adjustments in the "not-toward-easing direction", with moves to increase the flexibility of asset purchasing operations being particularly prominent. In light of whispered rumors about the limits of financial institutions' capabilities for coping with the current interest rate environment, one should probably anticipate the possibility that the BOJ will adjust its yield curve control (YCC) framework. Regarding the risk scenario that the BOJ might decide to discontinue negative interest rates, such a move would clearly represent an interest rate hike, and it could have a powerful effect in promoting JPY appreciation. In fact, since doing that may only be feasible at a time when the central banks of the United States and Europe are striving to normalize their policies, it would not be unreasonable to conclude that conditions are ripe for the BOJ to move toward policy normalization, not only at the July MPM, but going forward for so long as the global economy continues stable. As noted above, that President Trump is beginning to express antipathy to the U.S. interest rate hikes and USD appreciation. Given that that alone is enough to create an environment conducive to JPY appreciation, while the likelihood of a BOJ decision to move toward normalization is definitely not high, it is still worth closely monitoring the related situation.

Other JPY appreciation risks include those associated with the European political situation (risk factor), and those risks remain viable. Although Italy's political turmoil appears to have died down for the time being, that country's government bond yields remain stubbornly high, and it is easy to understand why market players' concerns have not been alleviated. The new populist government inaugurated in June is likely to pursue the expansionary fiscal policy route during its October discussions of the fiscal budget for next year, and that is highly likely to provoke a confrontation with the European Commission. There remains concern that a worst-case development of strife between the Italian government and the

European Commission might lead the Italian government to call for a referendum. In addition, the political scenario associated with negotiations over the United Kingdom's withdrawal from the EU (Brexit) has been chronically liquid, and the outlook is not good for finalizing an agreement including provisions for post-Brexit U.K.-EU trade relationships by the effective negotiation deadline this autumn. There remains good cause for concern whether a U.K. withdrawal from the EU without a negotiated agreement – referred to as jumping off the 'cliff edge' – can be avoided, and there is also a worrisome possibility that a Brexit-inspired risk-off mood might directly lead to JPY appreciation.

Overview of JPY Depreciation Risks – JPY Supply-demand Environment Dominated by JPY Selling

On the other hand, there have been no major changes regarding JPY depreciation risks. As mentioned last month, one can argue that the JPY supply-demand environment (see graph) has not up to now been very supportive of JPY appreciation. For example, the proactive external risk taking (essentially JPY selling) of Japanese institutional investors and companies (risk factor) cannot be excluded from the list of JPY depreciation risk factors. When USD/JPY fell below JPY105 in March, some observers noted that USD/JPY did not drop as much as it was expected to owing to an increase in Japanese investment in foreign securities. In fact, this interpretation may have some basis, given that net buying has been sustained in Japanese investment in foreign securities since the start of 2018. In addition, as this article has repeatedly argued, it should be noted that a gradually growing number of observers suspect that JPY selling associated with Japanese companies' cross-border M&A activities may be the underlying reason why USD/JPY does not decline even during risk-off mood periods. While there is no way to verify this, if "vigorous JPY selling" is stemming from Japanese companies and the proceeds are accumulating overseas as external assets, then one gets the impression that that the supply-demand balance may be becoming structurally averse to JPY appreciation³. I believe risk factor cannot be ignored, as it is a risk factor potentially capable of preventing USD/JPY from descending below JPY100 in line with this article's main forecast scenario. It is probably also worth mentioning the potential for the BOJ to introduce radical new easing methods, such as those involving foreign bond purchasing and helicopter money (risk factor -2), but decisions to utilize such methods would not be likely to be taken until after considerable progression of a JPY appreciation trend, so they are not cause for much concern at this time. Also, at a time when President Trump is beginning to call for USD depreciation, further easing on the part of the BOJ cannot be considered a politically acceptable option. In light of the impact of the impending FFR trade dialogue, the BOJ should probably be considered not at liberty to make imprudent moves.



(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government

As can be seen from the above sections of this article, the biggest risk in forecasting the exchange rate in the coming year relates to the Trump administration's currency and commerce policies. The kind of attacks previously made on other countries' currency and trade policies have ultimately come to be directed at the U.S. central bank's monetary policies, and intermittent expressions of intentions to actively rectify the height of interest rates and strength of USD are emerging. While there is no way to be sure how serious those intentions are, since a U.S. president truly determined to depress USD will probably succeed, this situation should be regarded as a new dimension of JPY appreciation risk. At a time when President Trump has begun expressing his concerns, the FF is expected to reach the neutral interest rate level (end-point of rate hikes) within the year and perhaps begin entering the positive interest rate range on a real basis next year. It is impossible to ignore the incongruity of those situations. Both politically and from the perspective of the real economy, it is probably fair to consider the Fed's normalization process to be close to its end point. And I will run the risk of repeating myself by pointing out that it is worth noting that the increasing flatness of the U.S. yield curve also implies such an evaluation. As previous tightening measures cumulatively exert their effects, it can be anticipated that the U.S. economy will decelerate, and there appears to be a high likelihood that the Fed will then moderate its hawkish posture (perhaps facilitated by presidential comments). Consequently, we will probably see a shift to a trend of decline in U.S. interest rates along with a trend of across-the-board USD depreciation. This main scenario this article has presented for the past year anticipates that this situation will also have the effect of strengthening a trend of JPY appreciation. Although the unexpectedly persistent robustness of the U.S. economy has delayed the realization of this scenario (largely because of a misinterpretation of the natural unemployment rate level in line with the FRB's misreading of the level), I believe the direction of trends forecast in the main scenario continues to be correct.

³ Please see the May 30, 2018 edition of Mizuho Market Topic, entitled "Japan's external asset/debt situation at the end of 2017 –The basis of JPY's 'safe currency' characteristics."

EUR Outlook –Can the ECB Overcome an ‘Autumn of Challenges’?

ECB Monetary Policies Now and Going Forward – Reading the Interest Rate Guidance Correctly

Risk of Trade Friction “Prominent”

At the ECB Governing Council meeting held yesterday, the interest rate on the main refinancing operations (MRO), which is the key ECB interest rate, the ceiling of market interest rates, which is the rate on the marginal lending facility, and the floor of market interest rates, which is the rate on the deposit facility, were all kept unchanged at 0.00%, 0.25%, and -0.40%, respectively, while the interest rate corridor, which is the difference between the ceiling and floor, was also maintained at 0.65 pp. At the previous Governing Council meeting, it had surprisingly been decided to end the expanded asset purchase programme (APP) earlier than expected. In light of that and other factors, there were no new development at this time. As of the moment, the current EUR 30 billion/month pace of asset purchases is scheduled to end with September. Purchases will continue at the pace of EUR 15 billion/month during the October-December period and will end altogether at the end of the year. Since the previous meeting of the Governing Council, certain views have also been expressed regarding the interest rate guidance, the translation of which into other languages invited various speculations, and to some extent, clarity has been restored.

The Introductory Statement also naturally mentioned the trade friction between the EU and U.S. President Donald Trump’s administration, stating that the uncertainties related to “the global trade environment” remained “prominent.” There were many questions regarding this point at the press conference. As widely reported, trade negotiations between the U.S. and the EU are showing signs of a soft landing, and this itself has been greeted positively. Having said that, ECB President Mario Draghi stated that the ECB did not really “know the substance of” the agreement struck with the U.S. yet and has not changed his basic stance that the increasing protectionism of the U.S. is a risk factor. This opinion is shared by other central banks and international organizations.

Reading the Interest Rate Guidance Correctly

There have been a number of speculations regarding the new interest rate guidance, “We continue to expect them to remain at their present levels at least through the summer of 2019,” since its introduction at the previous meeting. Naturally, there were reporters who wanted to know the exact intent of the statement, with one reporter asking for clarification on the phrase “through the summer,” and whether it meant “at least until the end of the summer” or “at least until the summer of next year”? These questions were the result of a translation of the phrase “through the summer” in the English version of the June Introductory Statement into phrases meaning “until the summer” in German and French.

In response to the question, Mr. Draghi clarified that “the only version that conveys the policy message is the English version,” and mentioned that market expectations were also formed on the basis of the English version (meanwhile, the non-English versions of the Introductory Statement have also been revised to reflect the English more accurately). Although Mr. Draghi did not address the meaning of the phrase directly, it seems safe to assume that “at least through the summer of 2019” means “at least until the end of the summer,” indicating that rate hikes will begin in September next year at the earliest. (Of course, it is a different question whether this will be possible; my opinion is that it may be difficult).

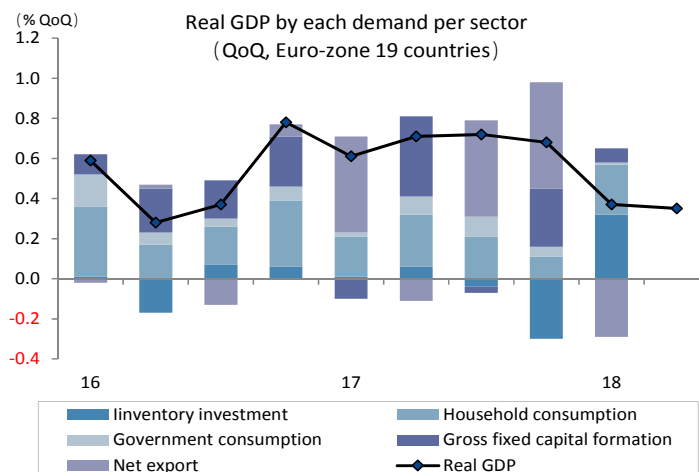
No Information Available Regarding Reinvestments Despite the Interest

It seems certain that QE will end within the year, and that rate hikes will begin in September next year (at the earliest), but there is one other important question that remains up in the air – that of the termination of reinvestments (i.e., balance sheet size reduction). Several reporters asked about this, but Mr. Draghi maintained that the issue had not been discussed. One reporter asked a technical question, taking into account that the once-in-five-year revision of capital key shares⁴ is due to take place next year, whether this revision would have any implications for the reinvestment policy, to which Mr. Draghi categorically responded that matters related to reinvestments had not been discussed at all. It seems safe to assume, therefore, that the ECB does not have any information to provide regarding this matter at the moment. Given that even the Fed took three years after the end of QE to stop reinvestments, one would have to assume that it is still too early to even discuss this topic.

⁴ The ECB revises the capital key shares of its member states once every five years or whenever there is a new member state. The current capital key shares pertain to the revision made on January 1, 2015.

Euro Area Real Economy Assessment and Outlook

Policy operations going forward will naturally depend on the assessment of the euro area's real economic performance, which has increasingly shown signs of a slowdown since early this year. In this context, one is reminded that the IMF Article IV Consultation report for the euro area pointed out that the risks for the euro area economy were "particularly serious." The ECB, however, does not appear to have been much shaken by the report. One reporter at the press conference even asked, "What makes you still so optimistic?" In response, Mr. Draghi, though accepting that there were clear signs of a slowdown in growth, attributed this to a "pullback from the unusually strong growth rates" of the previous year. He went on to say that this strong growth had been mainly due to "an unusually



(Source) Eurostat

strong exporters' performance," which has been slowing down recently. As the graph shows, more than half of the growth rate seen during the July-September and October-December quarters last year could be attributable to net exports, and it seems clear that it will be difficult to expect further growth based on this. However, if we assume that the slowdown in exports is due to the weakening of the global economy in the face of concerns regarding trade wars, that concern is no longer a transient one. With regard to the euro area in particular, the impact of the ~15% appreciation of EUR against USD over the past year is also not irrelevant. Considering that difficult times lie ahead with regard to policy normalization processes such as the start of rate hikes and the end of reinvestments, it is quite uncertain whether the ECB will be able to go about its work solemnly while trying to avoid a currency appreciation shock. I predict that it will be difficult to expect a euro area economic/inflation recovery from 2019 onward, and that this will cause the normalization process to become stalled, making it difficult for EUR to further appreciate. However, given that an even greater slowdown is predicted for USD as the Fed earnestly sets its sights on an end to its own policy normalization process, my view is that one can expect EUR to appreciate in reaction to USD depreciation.

Anniversaries and End of Term

Incidentally, yesterday (July 26) also happened to be exactly six years since Mr. Draghi's 2012 "Whatever it takes" speech. There were some reports on this in advance of the meeting as well as a question at the press conference regarding the "anniversary." (The same questioner also pointed out that it was also the anniversary of the previous rate hike, but perhaps this refers to the rate hike of July 2011, which was seven years ago.) The gist of the question was whether Governing Council members were satisfied with the current lineup of policy tools six years since that speech. Mr. Draghi himself appears not to have realized that it was the anniversary of these events and admitted that he had been surprised to read about it in the papers. "I think it shows that these are very distant times. Especially the anniversary from the 2012 speech tells that basically, today the euro is – they look so distant because the euro is now on much stronger foundations than it was then at that time," he said, recalling those times. He added that it was thanks to the reforms undertaken by the various national governments toward completing the monetary union. While admitting that there was still a long way to go, he said, "The real reason for the Governing Council to be proud is that it has delivered price stability in the most difficult circumstances through all these years. I'll stop here because I speak too much about these anniversaries."

Another reporter asked with regard to the impending end of Mr. Draghi's term in office, "will the presidency succession debate be unduly influenced by expectations of a rate hike somewhere around the time of your departure?" Mr. Draghi responded saying that his point was "kind of strange," and asked "why should rate hikes be influenced?" He went on to add, "Maybe in the perverse minds of some market players (...) this may be true, but certainly not in the Governing Council members' minds." To be sure, policy operations are determined chiefly in response to economic and financial circumstances, and there is no real scope for them to be influenced by the character of the president. Also, the Governing Council's decisions are made by majority votes and the president's view does not hold any significance except when the votes are divided equally. In this sense, what Mr. Draghi said is certainly true.

Having said that, in reality it is a problem that there exist a certain number of "perverse" market players, and it cannot be denied that this does impact asset prices. In this sense, if Mr. Draghi hands over to Deutsche Bundesbank President Jens Weidmann, the leader of the hawkish faction, sometime between September-December 2019, the period during which the first rate hike is expected to take place, there is a definite possibility that the market mood to celebrate a "strongly hawkish ECB" will strengthen even more.

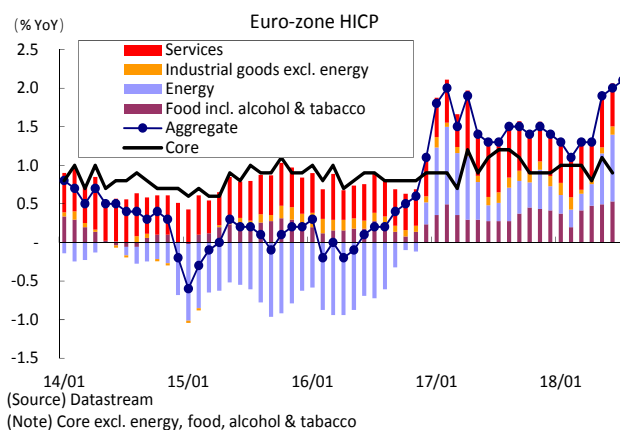
However, as I have said many times in this report, given the high likelihood that the Fed's rate hikes may be coming to an end at around the same time, the ECB is likely to have arrived at a phase of realization that an ECB rate hike is, frankly, impossible. If this happens, even Mr. Weidmann would find it impossible, institutionally, to resist the majority faction.

The Euro Area Economy Now and Going Forward – Anticipating an ‘Autumn of Major Challenges’

Inflation Outlook Still Weak

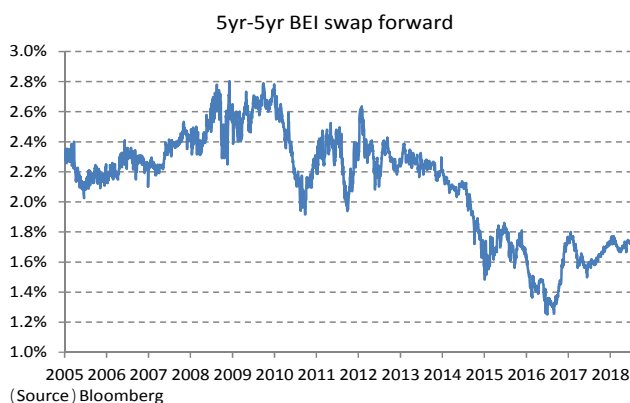
Turbulence within the European political situation continued to draw attention during July, as concerns deepened regarding the instability of the Merkel government in Germany as well as Brexit-related developments, although the ECB maintained a clear determination to promote policy normalization, and that undoubtedly contributed to the robustness of EUR. On July 5, Bloomberg reported that anonymous internal ECB sources had opined that the end of 2019 was too late a date for initiating interest rate hikes, and that report spurred a bout of EUR appreciation. Also on July⁵, the ECB's chief economist, Peter Praet expressed his confidence about the nature of prospective euro area inflation trends after the termination of the expanded asset purchase programme (APP), stating in a speech that –

“The underlying strength of the euro area economy, together with well-anchored, longer-term inflation expectations, provides grounds to be confident that the sustained convergence of inflation [toward the target level] will continue in the period ahead, even after a gradual winding-down of net asset purchases.” It is true that July's euro-zone consumer price index (Harmonized Index of Consumer Prices (HICP)), preliminary figures, which are the latest available at the time of this writing) was up 2.1% yoy – the highest rate in five years and seven months, since December 2012 – however, as the graph shows, a large share of the growth is attributable to rising energy prices. This is of course merely a reflection of the surge in crude oil prices since the start of this year so, if crude oil prices are flat in 2019 and subsequently following the termination of the APP, the contribution of energy prices to the inflation rate can be expected to diminish. The core basis HICP has remained flat at levels near 1.0% for more than a year, and one does not get a sense that there has been a change in the situation. (ECB President Draghi also noted at the press conference following the July Governing Council meeting that “the underlying inflation remains muted.”) Even so, Mr. Praet's confidence appears to stem from the robust conditions in the real economy, which are generating positive trends in the employment and wages situations that can be expected to promote autonomous inflation increases. The euro area's real GDP has shown positive growth in consecutive 21 consecutive quarters through the April-June 2018 quarter (the latest quarter for which figures are available) – the longest period of such sustained growth ever recorded. Given the apparent tail wind of the continuation of the euro area's longest ever economic expansion period, it would seem reasonable to expect inflation based on virtuous economic cycles. As mentioned above, however, there are persistent concerns about the Trump administration's protectionist orientation and, amid a deceleration in the exports that were a locomotive force for the euro area economy through last year, it should be recognized that it would be difficult to project a trend of recovery going forward.



Inflation Expectations Actually Leveling Off

Mr. Praet described longer-term inflation expectations as “well-anchored,” but since the overall situation is one in which we are monitoring possible trends of acceleration in figures that had previously fallen, one gets a feeling that the “well-anchored” description may not be perfectly appropriate. Regarding the market-based inflation expectation indicators traditionally emphasized by the ECB, the ECB tends to focus on movements in the five-year, five-year forward inflation swap (5-year, 5-year forward BEI), which has indeed bottomed out since the latter half of 2016, but it has



⁵ Please see the July 4, 2018 edition of Mizuho Market Topic, entitled “The EU faces an additional crisis – Advancing from the debt crisis to the refugee crisis.”

been hitting a ceiling of slightly below 1.8% since the start of this year. The ECB staff forecast also anticipates that the euro area HICP will only rise to +1.7% in 2020, and this can be considered a reasonable forecast. Given the current circumstances and outlook, it would seem more appropriate to say “inflation expectations are leveling off” rather than “inflation expectations are well-anchored.” At the very least, it should be recognized that the inflation situation itself does not justify accelerating the normalization process, so it is probably appropriate to characterize the ECB’s interest rate guidance as being “a blank page after the end of the APP.” The 5-year, 5-year forward BEI was consistently above the 2% level before the introduction of negative interest rates in June 2014, so it is reasonable to expect it to surmount its current ceiling when the ECB’s interest rate hikes are back on track.

Anticipating an ‘Autumn of Major Challenges’

While related issues have been discussed in a recent Mizuho Market Topic edition⁵, the European Council (EU Summit) meeting this autumn will be discussing the issue of refugee allotment, an issue on which it appears that there is no common ground of understanding and little prospect of a compromise agreement. At just about the same time, the Italian legislature will begin its deliberations on Italy’s budget for the upcoming fiscal year. It seems likely that the European Commission will be disturbed by the expansionary fiscal policy of the budget proposed by the populist government, and an even more complicated situation is expected to ensue if that government’s moves impact the agenda at the concurrent EU summit. Moreover, the reduction of APP asset purchases is scheduled to begin at roughly the same time. And it is also worth keeping in mind that the effective deadline for negotiating the United Kingdom’s withdrawal from the EU is this autumn. In light of all this, it appears highly likely that this autumn will be an ‘autumn of major challenges’ for the EU. Given these situations, I am not as optimistic as Mr. Praet regarding the environment for the ECB’s policy management operations going forward. Of course, it is unlikely that the environment will stymie the APP termination plan, which has become the default route. However, it do think that the ECB will find it hard to implement its objective of beginning interest rate hikes in September or October of 2019 unless both euro area inflation and inflation expectations rise firmly and stably to near the 2% level, and unless the FRB is smoothly moving ahead with its interest rate hikes. If the ECB seeks to begin its interest rate hikes at a time when the Fed is seeking to discontinue its interest rate hikes on the basis of having attained the neutral interest rate, I think it bears keeping in mind that the ECB’s strong aversion to EUR appreciation will make it unlikely to actually begin those hikes. Rather than focusing on the question of whether ECB interest rate hikes are likely to begin in September of 2019 or perhaps in December of 2019, I am formulating my forecast based on the assumption that it will basically be difficult for the ECB to undertake an interest rate hike during 2019.

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