

# Forex Medium-Term Outlook

31 August 2018

Mizuho Bank, Ltd.  
Forex Department

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## Overview of Outlook

USD/JPY continued to lack direction in August. The Trump administration remains as protectionist as ever in its stance, and I believe this will continue to be the biggest risk factor for the current forecasting period. Again, the Turkish currency crisis that took place in August could trigger a reversal of last year's trend, and capital may outflow from emerging markets, so cautious is still prudent in this regard. The Fed's policy normalization process will be negatively affected should the outflow of capital actually happen. While the Fed continues to shrink the size of its balance sheet, USD-denominated asset becomes more attractive with higher yields to investors, and this may also pressure capital outflows from relatively risky emerging markets and corporate bond markets. The U.S. economy may be able to withstand an increase in interest rates, but that may not necessarily be the case for other entities, making it increasingly necessary for the Fed to take overseas conditions into account in its policy operation. Looking at the stock markets, there is a clear trend of U.S. stocks being the sole winners. However, Fed Chair Jerome Powell seems conscious of the need for a tightening of monetary policy aiming at curbing asset price bubbles. This would involve preemptive policy operation based on the "BIS perspective," but is dangerous as it could invite a swift adjustment to asset prices as a result of some crisis. There seems no need to change my basic understanding of the current forecasting period that the Fed's normalization process will collapse as domestic and foreign problems surface, causing U.S. interest rates to decline and resulting in a weak-USD trend.

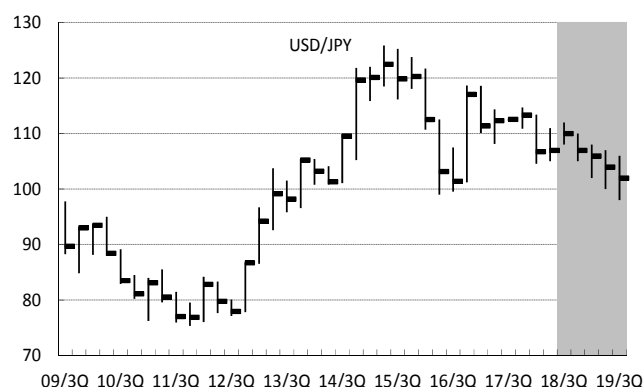
EUR found itself at the mercy of the Turkish currency crisis in August. The crisis in Turkey, a mere emerging economy, rattled the whole market because of concerns that some European financial institutions may have significant Turkish bond holdings. However, although Europe is an important creditor for Turkey, the fact remains that Turkey is not an especially large debtor for Europe. Therefore, concerns of the European financial system becoming destabilized are overstated. Meanwhile, concerns related to the unstable political situation in Italy have not yet been dispelled and are likely to become a major theme in September and October. A confrontation between the Italian government and the EU seems unavoidable amid rumors that the country's budget for the upcoming fiscal year will exceed the EU budget ceiling. Some senior Italian government officials are also hinting at the possibility of a compromise on this problem in return for a solution to the migrant problem. The EU internal situation could get increasingly chaotic as Brexit negotiations approach a crucial point, prompting investors to keep away from EUR. This report's basic understanding 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.

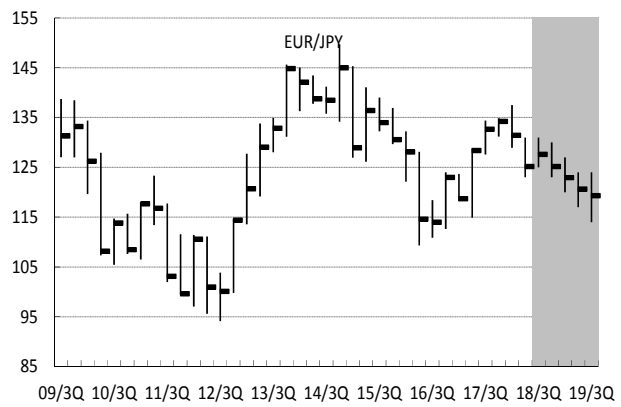
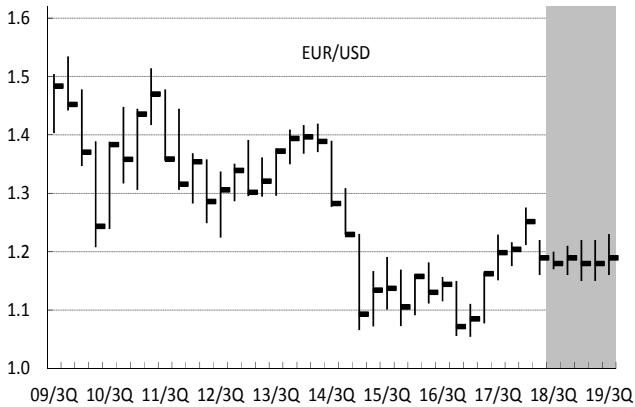
### Summary Table of Forecasts

	2018 Jan - Aug (actual)	Sep	Oct-Dec	2019 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	104.64 ~ 113.40 (111.01)	108 ~ 112 (110)	105 ~ 110 (107)	102 ~ 108 (106)	100 ~ 107 (104)	98 ~ 106 (102)
EUR/USD	1.1300 ~ 1.2556 (1.1664)	1.15 ~ 1.18 (1.16)	1.14 ~ 1.19 (1.17)	1.13 ~ 1.20 (1.16)	1.13 ~ 1.20 (1.16)	1.14 ~ 1.21 (1.17)
EUR/JPY	124.62 ~ 137.51 (129.43)	125 ~ 131 (128)	123 ~ 130 (125)	120 ~ 127 (123)	117 ~ 124 (121)	114 ~ 124 (119)

(Notes) 1. Actual results released around 10am TKY time on 31 Aug 2018. 2. Source by Bloomberg  
3. Forecasts in parentheses are quarter-end levels

### Exchange Rate Trends & Forecasts



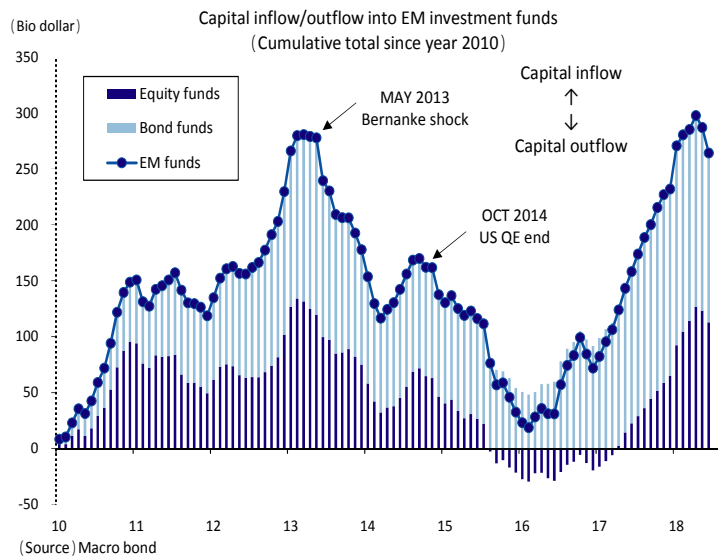


## USD/JPY Outlook – Turmoil in Emerging Countries and USD Outlook

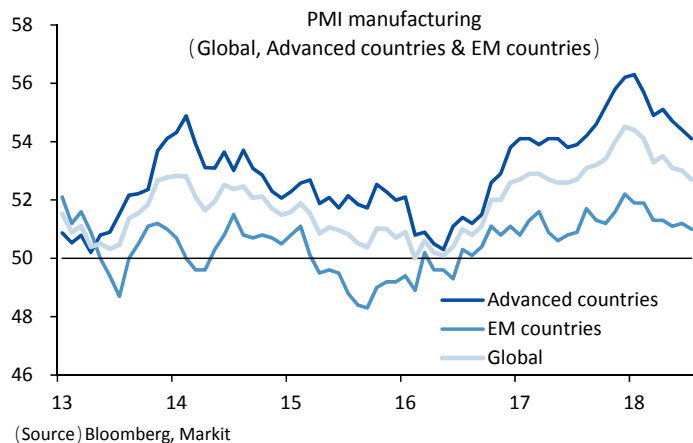
### Emerging Markets and International Financial Markets, Now and Going Forward – Has the Second Phase of Capital Outflow Begun?

#### First Phase of Capital Outflow – May 2013 to Early 2016

Shock waves from the Turkish currency crisis continued to ripple through the markets throughout August. Turkish President Tayyip Erdoğan has rejected both rate hikes and international financial aid, refused to release the American pastor, incurred an expansion of additional tariffs from the U.S., and attempted to deal with the situation solely through liquidity supply and capital controls. Naturally, there is not much appreciation from the markets for this stance, and though the situation is temporarily calm as of the time of writing this report, it has not been fully resolved yet. What is more, the Central Bank of Argentina raised its policy interest rates from 40% to 45% on August 13 after its domestic currency went into a freefall in reaction to the crisis in Turkey. As I will explain later, this kind of chain-reaction is quite likely to continue for some time to come.



I have repeatedly stressed in this report that, even if the U.S. economy is able to withstand rate hikes by the Fed, emerging economies may not be able to do so. My concerns are due to the fact that an enormous amount of funds was channeled into emerging economies on the assumption that the Fed would maintain its accommodative monetary policy (see figure). I would like to take a look back at the cumulative amount of funds that has flown into emerging economies since 2010. During the period when the European sovereign debt crisis was raging, funds were unilaterally channeled into emerging economies thanks to the Fed's increasingly accommodative monetary policy. However, in his Congressional testimony in May 2013, then Fed Chair Ben Bernanke hinted at a gradual tapering of quantitative easing (QE), resulting in a sudden

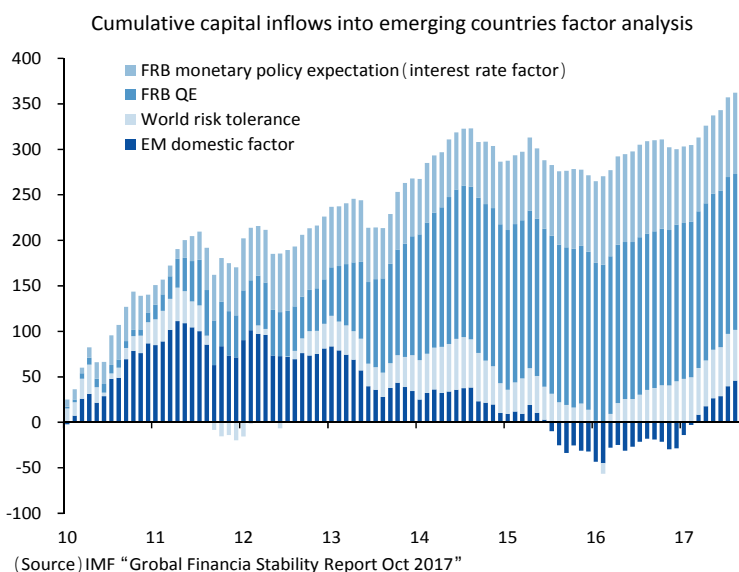


reversal in fund flows. The outflow of funds from emerging economies continued for around two and a half years, through early 2016. This was the period of the so-called “taper tantrums,” which did also at times impact the pace of the Fed’s policy normalization efforts.

Incidentally, this period is also known to have coincided with a phase of economic slowdown in emerging economies. The PMI for developing countries as a whole (see figure) was consistently under 50 during the 2015 through early 2016 period (the PMI for developed countries and for the world economy as a whole was over 50, but emerging economies remained below 50). One of the reasons why crude oil prices fell below USD 30/barrel in early 2016 could be because of the shrinking of speculative funds as the Fed continued tapering, but another reason is bound to have been the decline in real demand as emerging economies went into a period of stagnation. It is not clear whether the dwindling of capital flow into emerging economies (which are also resource-based economies) due to the Fed’s tapering efforts caused these economies to slow down, or if emerging economies had been in a contracting economic phase to begin with, or if, perhaps, both the above factors had contributed. However, during this phase, the NY Dow Jones Industrial Average plateaued, USD/JPY saw a reversal of its up-to-then consistently upward trend, and the markets overall remained lackluster. For the moment, let us call this the “first phase of capital outflow” accompanying the Fed’s policy normalization efforts.

### ***The Second Phase of Capital Outflow May Have Begun in May 2018***

During the latter half of 2016, emerging economies also began to recover and the global economy entered another phase of expansion. My understanding is that asset prices soared first in the U.S. and then spread to other countries due to a delay in the Fed’s normalization efforts following the “taper tantrums” and thanks to the U.S. economy being in a state of full employment. For instance, in the Fed staff projections, the long-term unemployment rate (≈ natural unemployment rate) outlook was 5.6% in March 2013 but declined to 4.9% three years later, in June 2016. Even so, no more than one rate hike had been managed at that point, and balance sheet size reduction was still a distant dream. A series of risk-off events of great magnitude followed after this point, including the China currency crisis in August 2015, Brexit in June 2016, and the election of President



Trump in November 2016, forcing the Fed to put off its tapering efforts. There is strong suspicion that maintaining an accommodative monetary policy despite the state of full-employment in the world’s largest economy might have been what led to the soaring of asset prices both within and outside the U.S.

Incidentally, the latest U.S. unemployment rate as of the writing of this report is down to 3.9% (for July 2018), and this is one factor that justifies the Fed going ahead with its normalization efforts. However, turmoil in emerging countries, which have come to expect an inflow of funds against the backdrop of the Fed’s accommodative monetary policies, seems unavoidable. As you may know from past issues of this report, where I cited and discussed the IMF’s analysis, almost 90% of all funds flowing into emerging economies since 2014 has been owing to the accommodative monetary policy in the U.S., with only around 10% attributable to the fundamentals of these economies themselves (see figure). Given the start of balance-sheet size reduction efforts last autumn as well as the recent unwavering quarterly interest rate hikes, an outflow of funds from emerging economies would be no surprise and quite inevitable. As a market participant, the interesting question here would be to ask what the trigger for such an outflow could be. In this context, the figure seems to indicate a peaking of fund inflows in April 2018 and the start of the second phase of outflows from May. In other words, the crashing of the Argentine peso (ARS) in early May may have been that trigger. I would like to monitor the situation going forward with a view to discerning if the August Turkish currency crisis firmly establishes the advent of the second phase.

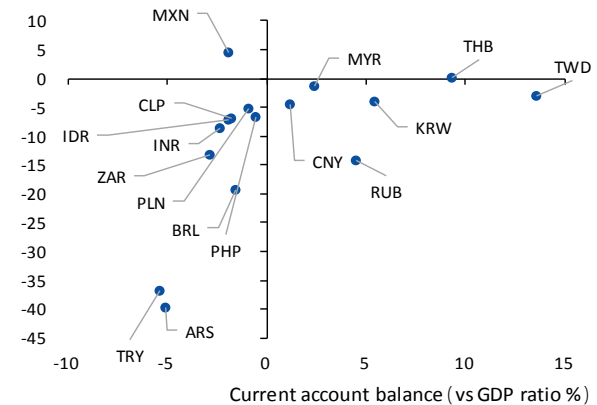
### Turkish Lira Crisis Not Unique

Of course, a large part of the blame for the present panic in Turkey goes to the unique policy stances (obstructing rate hikes, refusing to release the American pastor, refusing to seek financial aid from the IMF, etc.) of President Erdoğan, and these are factors that do not apply to other emerging countries. However, one must remember what happened during the European sovereign debt crisis – Greece and Italy were the only countries that had severe problems with their public sectors, but the crisis spread to Spain, Ireland, and other PIIGS states based solely on the fact that they had current account deficits, although in terms of fiscal balance, those countries had surpluses. This time, though none of the other emerging countries are faced with the same kind of political risks as President Erdoğan, many of them have fragile external economic sectors, so the crisis in Turkey could be a trigger for a draining out of the excess funds that had previously been poured into these economies.

In fact, currencies that have lost a great deal of value recently have been currencies of countries with large current account deficits (see graph on previous page). As TRY and ARS carry the largest current account deficits (see graph on previous page), it is no surprise that these two countries have drawn the most attention since early this year. Also, the devaluation of these two currencies has been so large as to eclipse that of other currencies in the graph, but ZAR (South African rand) and BRL (Brazilian real) have also lost about 10 to 20% of their value, which is quite significant. Therefore, any argument suggesting that the Turkish currency crisis is unique to Turkey holds no water.

Amid suspicion that the second phase of capital outflow may have begun, will the Fed really be able to persist with its normalization process at the current pace? As I'll explain in detail below, Mr. Powell seems to have no intention of aborting rate hikes amid the continued rise in U.S. stock prices, but one must be warned that this decision may prove costly for emerging markets.

Current account balance of emerging countries & FX market  
FX % changes in price (from the beginning of this year)



(Source) IMF, Bloomberg  
(Notes) Current account balance:2018 outlook  
FX: from the beginning of this year to 27AUG

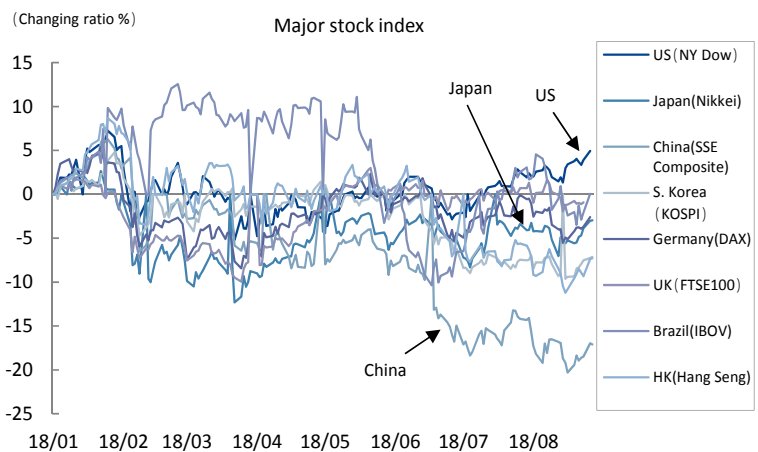
### U.S. Stock Markets Now and Going Forward – What Does it Imply that U.S. Stocks are the Sole Winners?

#### U.S. Stocks are the Sole Winners

Since early this year, there has been the impression that the stock indices of leading economies have been strong overall, but when one looks at their performance more closely, it becomes obvious that U.S. stocks have been the sole winners. As the graph shows, for the five-month period from January to May-end this year, the leading countries' stocks were bunched up together. However, since June, while most other countries' stocks have levelled off, Chinese stocks have been big losers and U.S. stocks have taken a clear lead. As the U.S. economy is the strongest, perhaps this is simply a matter of that strength having come to the surface.

However, as far as the timing goes, June is when the U.S. announced the imposition of a 25% tariff (worth JPY 50 billion) on Chinese imports as a punitive measure against China's violation of intellectual property rights.

As I discussed also in a Market Topic<sup>1</sup>, mid-June turned out to be an important turning point for the forex markets as well. The currencies of current account surplus countries (such as South Korea, Thailand, and Taiwan), which had until then been strong, suddenly began to weaken. To be more specific, before mid-June, the main point of concern was the outflow of funds from emerging economies amid the continuation of U.S. rate hikes, but since then, concern for current account surplus economies with an intensification of U.S. protectionism has been added to this. This is my understanding of the situation (and my impression is that emerging currencies are not all that suitable for investment under these circumstances).



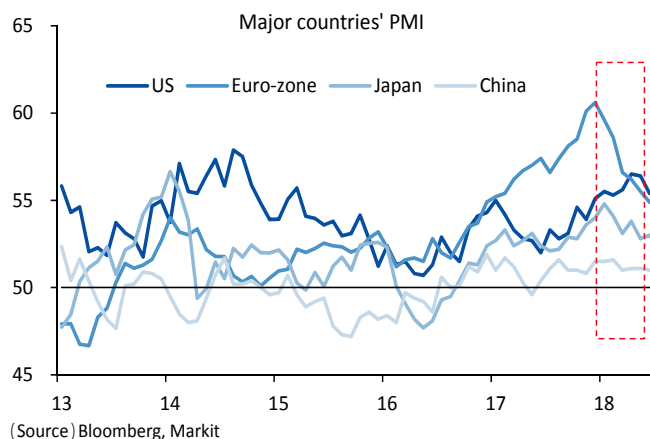
(Source) Bloomberg

<sup>1</sup> Please see the August 6, 2018 Market Topic titled "Global Economic Slowdown Implied by Soft Data."

In this context, how should one interpret the fact that U.S. stocks are the sole winners as of the moment? U.S. stocks are the only ones continuing to strengthen since June – does this reflect the dominant view that trade wars benefit the U.S. economy? Or is it the case that, though trade wars are just as bad for the U.S. as for the rest of the world, amid a continued state of surplus available funds, U.S. stocks are chosen over other stocks by the method of elimination as being the most likely to survive? Given that the U.S. has initiated trade wars at a time when its economy is fundamentally strong, perhaps the latter interpretation is more appropriate. However, there is no room for doubt that trade wars are a negative for the global economy as a whole, including the U.S. economy, with the IMF estimating in its July analysis, for instance, that they would dampen the U.S. economy by 0.8% and the world economy by 0.5%. In the final analysis, therefore, the trade wars will hurt the U.S. economy too.

### Resemblance to PMI Trend

If so, it seems logical to believe that the current widening gap between U.S. and other stock indices is likely to narrow going forward, as U.S. stock prices undergo adjustment. The graph on the previous page reminded me of the PMI trends of countries around the world. As the graph to the right shows, from the beginning of the year to April, the U.S. PMI alone continued to rise even as the PMIs of other countries reflected their deteriorating economic conditions (see portion inside dotted-line box). Subsequently, the U.S. PMI also began to decline (the latest figures are for July). If we take the PMI to be an immediate leading indicator of the economy, its trends are likely to soon spill over, first into stock prices and then into hard data (production, income, consumption, etc.).



Aptly, at the Jackson Hole Economic Symposium in August, Mr. Powell pointed out the possibility of high growth continuing despite inflation rates remaining low, based on modern economic theory from the late 1990s. He mentioned that the current situation was reminiscent of the former period of “Great Moderation.” In addition, Mr. Powell said, “in the run-up to the past two recessions, destabilizing excesses appeared mainly in financial markets rather than in inflation,” and expressed his understanding that complacency in “stability” (rise in asset prices/ price stability) was what brought on the crisis. How will continuing with rate hikes when the PMI has already begun to fall help change this situation of U.S. stocks being the sole winners? Going by Mr. Powell’s speech, the purpose of rate hikes is to suppress the soaring of asset prices, so it seems likely that stock prices will weaken going forward.

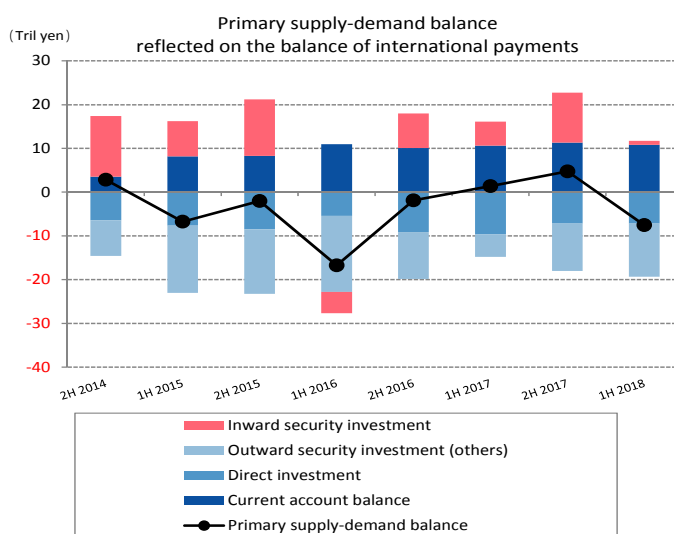
### The Risky BIS Approach

Such policy operation, based on the understanding that it is important to conduct preemptive monetary tightening before a bubble can form, is called the “BIS approach,” which is in contrast with the “Fed approach” of soothing the damage from a bubble with another bubble (i.e., responding with accommodative monetary policy after the crisis erupts). Going by Mr. Powell’s speech, it appears that his administration’s policies are more inclined toward the former, but one must note that the BIS approach assumes that one can accurately gauge the ongoing situation as being a bubble. In other words, it assumes that the central bank is omnipotent, which is somewhat unreasonable. The BIS approach always goes hand in hand with a tightening overkill, so it is best taken with caution except when there are concerns of runaway inflation. However, it is precisely in order to eliminate blunders arising from arbitrary decisions by bureaucrats that the Fed’s dual mandate exists. As of the present, the “employment maximization” mandate has been more-or-less realized and inflation indicators are also stable, so it seems wise to approach rate hikes with caution. At any rate, given that the Fed under Mr. Powell is holding up the example of policy operation under former Fed Chair Allan Greenspan, it will probably consider rising U.S. stock prices a target for suppression. Under such circumstances, it does seem quite likely that U.S. stock prices will undergo revision.

## JPY Supply-Demand Situation – Net JPY Selling for First Time in 18 Months

### Net JPY Selling for First Time Since 2H of 2016 for the Six-Month Period

In August, Japan's June Balance of Payments was published, revealing the JPY supply-demand balance for 1H of the current year. For January-June 2018, the supply-demand balance amounted to a total net selling of -JPY 7.5473 trillion (see figure). Looking at the results for each quarter, domestic securities investment from overseas investors expanded during April-June, mainly driven by short-term debt securities, which posted net buying worth +JPY 2.8512 trillion, but as the January-March period posted an enormous net selling worth -JPY 10.3984 trillion, the total for 1H as a whole amounted to a net selling of JPY (note that the JPY selling during January-March was also due to foreign investors selling off Japanese assets, mainly equity and short-term debt securities). For the six-month period, this was the first net selling since 2H of 2016, a development that is consistent with the recent strength of USD/JPY.

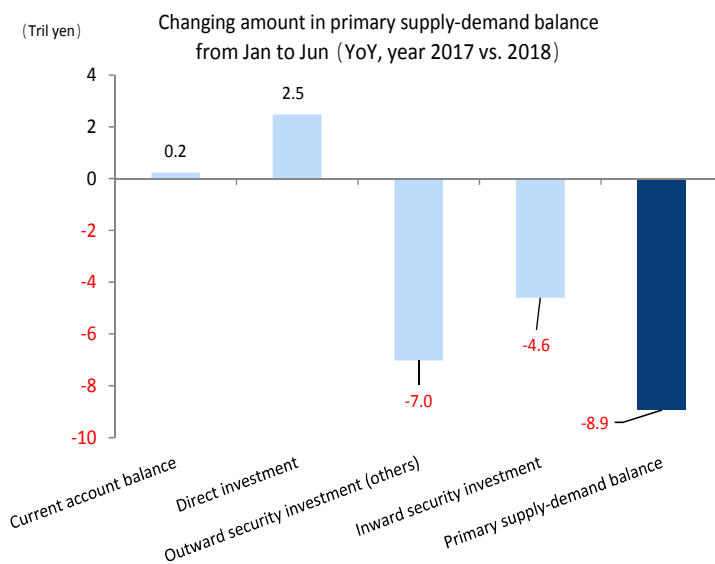


(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government

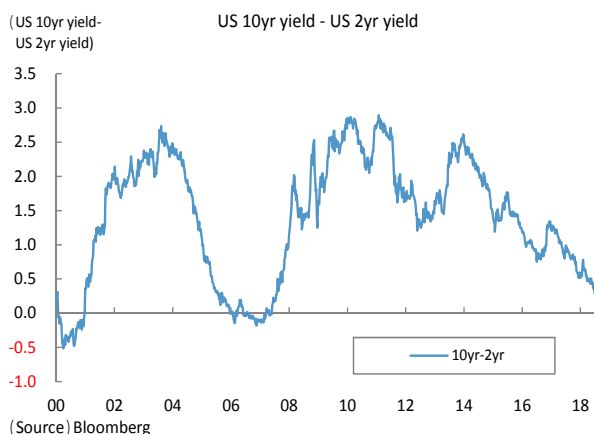
### Harsh Climate for Overseas Securities Investment

The biggest different between last year and 1H of the current year is the foreign securities investment trend. The net buying of foreign securities has increased by ≈JPY 7 trillion year-on-year, which explains most of the change in supply-demand balance (see figure to the right). As usual every year, the foreign securities investment trend seems likely to be an important factor determining both the JPY supply-demand and USD/JPY trends. Since the introduction of negative interest rates in January 2016, some have consistently assumed that institutional investors would have no choice but to take foreign investment risks given the wretched JPY interest-rate climate. This is the logic used by most of those who forecast JPY depreciation based on the expanding U.S.-Japan interest rate gap.

However, even though a robust net buying of foreign securities drove a net JPY selling trend in 2016, that trend weakened in 2017, and eventually a net buying of JPY was posted for the whole year. The Fed's rate-hike process remained steady, but the neutral interest rate level (as the terminus of rate hikes) drew more attention than the projected number of future rate hikes. In the context of the forex market, it can be said that USD was too strong as of early 2017 for there to be a robust investment in open-ended foreign funds leading to a net buying. In fact, USD lost considerable value during 2017 (falling by about 7% on a real-effective basis, and about 10% in terms of the USD index). As mentioned above, foreign securities investment has posted a significant level of net buying so far for 2018, and if things continue at the same pace, a net JPY selling can be expected for the whole year. However, some say that the recent BOJ decision to be more flexible in its target for long-term interest rates may encourage the reversion of Japanese bonds, and it remains to be seen whether this will dampen foreign securities investment going forward.



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



(Source) Bloomberg



Given that some in the securities market are already forecasting (expecting?) “second” and “third” arrows, it could be that the investment climate has begun to change somewhat compared with the past two years, when a net purchase of open-ended foreign funds was the obvious thing to do because of the poor JPY interest rate climate. If, in addition to this, we look at the U.S. interest rate climate, the gap between 10-year and 2-year interest rates has shrunk to as little as 30bp as of yesterday, the smallest it has been since July 2007 (see figure). That was just over a year after the end of a long spate of 17 rate hikes by Mr. Greenspan, then Fed Chair, in June 2006, and also coincided with the start of the sub-prime mortgage crisis. Under such circumstances, with U.S. bond market trends suggesting a peaking of the U.S. economy, it is difficult for me to believe that Japanese institutional investors would accelerate their net buying of foreign securities.

## Risks to My Main Scenario – Rising Level of Political Risks in Europe

### Level of Political Risks in Europe Rising

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 it should be noted that risks related to Europe (risk factor ) have increased. On August 23, the U.K. government began issuing guidance notices to help citizens and businesses prepare for a scenario in which the Brexit without an agreement (a “no deal” scenario). On July 19, the EC issued a policy statement that includes the sentence – “there is still no certainty that there will be a ratified withdrawal agreement in place on that date [March 30, 2019]” – and goes on to point out that the U.K will become a foreign country from the EU’s perspective as of that date and to ring the alarm bells regarding Brexit’s impact on government entities, businesses, and citizens in both the EU and the U.K. In short, it is an official document telling all EU and U.K. stakeholders that they should be prepared for a “no deal” scenario, and this indicates that the cliff-edge risk can no longer be considered a “tail risk.” Moreover, Italy has recently insisted that it will not pay its annual contribution to the EU unless other EU members accept their shares of refugees. It is generally believed that the October 18 EU summit meeting represents an effective negotiation deadline for resolving that situation, and that can be considered rather bad timing. Incidentally, the shrinking of the expanded asset purchase programme (APP) will begin from October. What will happen if the euro area economy – already acknowledged to be suffering from growing trend of deceleration – is confronted with such unforeseen circumstances? There is a possibility that the most disturbing market-moving factors this autumn may stem from Europe. In addition, there has been no alleviation of risks related to risk factor . On August 23, U.S. and Chinese government delegations completed another two-day round of trade negotiations for the first time in two months, but the vice minister-level negotiations proved once again unable to overcome the deadlock. That same day, the U.S. put supplementary 25% tariffs on USD16 billion of Chinese goods based on Section 301 of the Trade Act of 1974 in addition to the tariffs that were placed on USD34 billion of Chinese imports on July 6, and this suggests that there will be no slowing in the pace of U.S. protectionist policy measures. If things progress in line with statements made by President Trump, supplementary tariffs will be imposed in two stages on a total of USD400 billion of Chinese goods going forward – it now appears possible that such tariffs will be placed on nearly all imports from China. The outcome of U.S. threats to impose import tariffs (of up to 25%) on motor vehicles is also uncertain so, from the perspective of forex forecasting, the risk that the US currency and trade policies will cause unexpected forex market fluctuations should not be underestimated.

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

### ***“President vs. Fed” Situation Unchanged***

With respect to risk factor     , I am concerned about the fact that President Trump has begun expressing an interest in the Fed's monetary policies since late July. His August 20 comment that he was “not happy” with the Jerome Powell-chaired Fed's policies caused a decrease in U.S. interest rates along with USD depreciation. And the comment should be considered amid the still-developing context of his complaints about currency manipulation on the parts of China and the EU. While I posted an article during August about the USD appreciation situation in which I expressed my suspicion that President Trump might not fully understand the causal relationship between interest rates (the Fed's rate hikes) and exchange rates (USD appreciation), his expressed aversion to the Fed's rate hikes can probably be considered to have a sound basis.

The current market mood is not yet one in which significant market flow changes occur in response to such oral intervention measures aimed at the central bank. However, while concerns about political intervention into monetary policies are ordinarily focused on the potential for runaway inflation trends, the president's remarks have promoted trends in the opposite direction – toward interest rate declines and USD depreciation. The reason for this is simple; basically, it appears that the market is not particularly worried about inflation. If there were concerns about a future surge of inflation and if there were a large number of market participants afraid that the Fed's policies might fall behind the curve, it stands to reason that the markets would link the president's oral intervention measures to potentials for an obstruction of progress in the normalization process along with accelerating inflation and rapid USD depreciation. The reason the markets are not making this linkage is probably because they consider the current stage of the Fed's normalization process to be merely aimed at creating additional elbow-room for future policy adjustments.

In fact, the truly worrisome aspect of the president's remarks is that they risk igniting a “president vs. the Fed” political struggle that might cause the Fed to stubbornly demonstrate its independence by continuing to undertake interest rate hikes (and ultimately running the risk factor      risk of overkill). I think that it is particularly easy for such risks to eventuate given the subtleties of the bases for determining whether to proceed further with rate hikes. There is probably a very low likelihood that President Trump will change his views regarding interest rate hikes (and this may well be attributable to his long history as a real estate developer). Given fundamental affinity between the concepts of “protectionism” and “currency depreciation,” it is natural that President Trump would be averse to a rise in interest rates and the accompanying appreciation of USD. Going forward, if the president's repeated complaints about the normalization process were to cause the Fed to boldly advance with rate hikes to the point of overkill, there would probably be a risk that the subsequent U.S. interest rate cuts and USD depreciation might proceed at an unexpectedly rapid pace. In any case, the “president vs. the Fed” situation can be considered a new potential market-moving factor that has emerged since July.

### ***Continued Risk of BOJ Normalization***

With respect to Japan, it continues to be impossible to exclude the possibility that the BOJ might shift toward policy normalization (risk factor      -1) even after the adjustments seen at the July BOJ Monetary Policy Meeting. The July Meeting made some adjustments in the “not-toward-easing direction,” largely by means of moves to increase the flexibility of asset purchasing operations. 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 Meeting, but going forward for so long as the global economy continues stable. As noted above, President Trump is beginning to express antipathy to the U.S. interest rate hikes and USD appreciation. Against this backdrop, while it would require courage for the BOJ to undertake policy adjustments highly likely to promote JPY appreciation, the fact that such adjustments may only be feasible now and not later suggests that there is a possibility that the BOJ might actually take the plunge. Regarding risk factor     , the LDP will hold its intraparty election on September 20 and, given that roughly 70% of Diet members are said to support Prime Minister Abe, he is almost certain to win reelection for his third term as the LDP leader. Regarding 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 – the risks associated with this theme now appear extremely low. If he achieves an overwhelming victory, however, Prime Minister Abe is expected to focus on constitutional amendment issues, and it is worth keeping in mind that that focus might have an impact on his rate of support.

### ***Limited Number of JPY Depreciation Risks***

On the other hand, there is not so much that needs saying about JPY depreciation risks. As already discussed, the JPY supply-demand environment continues to be not supportive of JPY appreciation. This point can be considered the most powerful risk factor with respect to this article's JPY appreciation forecast, but given the perception that the potential for a peaking out of U.S. economic expansion has become evident, a scenario in which Japanese institutional investors accelerate growth in their net foreign securities investments does not seem very realistic. In addition, some observers are strongly suggesting that the recent start of revisions to BOJ policies will encourage investors to return to JPY bonds, and there is a possibility that this may restrain investment in foreign securities going forward. While net foreign bond buying accompanied by JPY selling and USD buying (open foreign bond investment) has been recommended as a matter of

course during the past two years, it is worth keeping in mind that the domestic investment environment is beginning to change. It is also important to note that U.S. yield curve flattening has already advanced to its limit and that, in light of the history of such situations in the past, it would not be surprising to see the situation undergo an important change going forward. It seems reasonable to expect that many Japanese investors will be inclined to have similar views regarding the situation. 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, but I do not consider it to be that serious of a risk. 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 at this point they are not cause for much concern. At a time when President Trump is intensifying his protectionist policies and appears displeased with U.S. interest rate hikes (along with the associated USD appreciation trend), there are high political hurdles on the path to further easing on the part of the BOJ.

### ***Continued Focus on the Cumulative Impact of Interest Rate Hikes***

The above sections suggest that the Trump administration's currency and trade policies may represent the biggest risk during the forecast period as a whole, but political risks in Europe cannot be disregarded, especially in the near future. Particularly important from the perspective of financial markets is the fact that Brexit cliff-edge risk – until recently considered no more than a tail risk – is now appearing increasingly likely to eventuate. In addition, Italy's political situation is showing great potential for promoting turbulence, and it is probably wise to concur with the IMF's July characterization of risks to the euro area outlook as "particularly serious."

This article continues to anticipate that the cumulative effects of the Fed's previous tightening measures will cause the U.S. economy to decelerate, and it is expected that the Fed will then moderate its hawkish posture. 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. The 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, there is probably only limited scope for further improvement in the unemployment rate, which recently fell below the 4% level. While accurately appraising the natural unemployment rate level is difficult even for the Fed, and while there is nothing that can be done about the Fed's misreading of the level, I believe that there is no great need at this point to adjust the direction of trends forecast in the main scenario (JPY appreciation/USD depreciation).

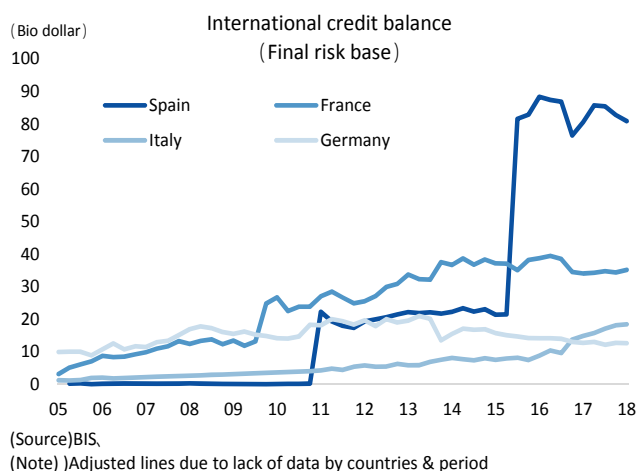
## EUR Outlook – Fetters of “Turkey Shock”

### Impact of “Turkey Shock” on Europe – Real Danger Lies in Refugees Rather than Finance

#### Market Concern about Crisis Contagion Routes

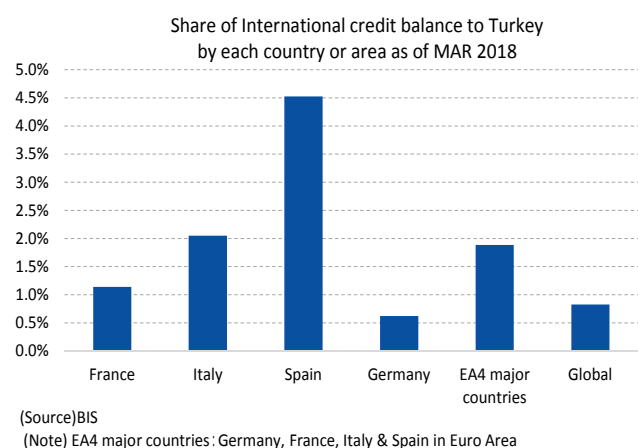
The August emergence of “Turkey shock” affected not only such emerging markets as those of Turkey and Argentina but extended to such developed country markets as those of Japan, the United States, and Europe, and this reflects concerns about the financial ties between Turkey and Europe. In many cases, when turbulence in emerging economies reaches a critical level, it will lead to concerns about developed countries’ financial institutions that have large amounts of exposure to such emerging countries, and the concerns can spur widespread turmoil in such asset markets as the stock, forex, and bond markets. That was the case this time also. On August 10, the U.K.-based Financial Times reported<sup>2</sup> comments made by unidentified people familiar with the matter suggesting that the ECB is concerned about the magnitude of loans to Turkish entities held by Spanish, French, and Italian

domestic banks. The sources did not appear to consider the situation “critical” at that point, but the naming in the article of specific major banks in Spain, France, and Italy caused considerable drops in the prices of those institutions’ stocks on that day, and this appears to have led to a worldwide weakening of stock prices. If one examines the international credit statistics of the Bank for International Settlements (BIS), the names of those countries are conspicuous. As of the end of March 2018, Turkish domestic banks had debts to foreign banks totaling USD223.2 billion, of which Spain accounts for about USD80.9 billion, France for about USD35.1 billion, and Italy for about USD18.5 billion (all figures calculated on a final-risk basis). In other words, these three countries alone account for about 60% of Turkey’s total external debt (see graph). In light of such data, the financial markets are concerned about the spread of the crisis from Turkey – via Spain, France, and Italy – to the euro area. Given that TRY has depreciated against USD by more than 30% since the beginning of the year, there is a possibility that some Turkish domestic banks with foreign currency-denominated debts not sufficiently covered by currency hedging may be at risk of default. The sources quoted in the abovementioned Financial Times article are concerned that problems of such banks will spread.



#### Impact on European Financial System Minor?

However, it is worth putting this into perspective. Spanish banks, which have the greatest exposure to Turkish debt, have a total international credit balance (outstanding foreign credit balance) of USD1,787.2 billion. The total international credit balances of French and Italian banks are USD3,082.6 billion and USD901.1 billion, respectively. Although Germany was not mentioned in the above article, it is noteworthy that that country’s banks’ international credit balance is USD2,039.9 billion, of which exposure to Turkey amounts to about USD12.7 billion. Thus, with respect to the total international credit balance of banks in the four largest euro area countries (Germany, France, Italy, and Spain), the share of loans to Turkey appears to be less than 2% (see graph on previous page). Looking at individual countries, Spanish bank’s share of loans to Turkey is the highest, at 4.5%, but in light of the BIS statistics, it does not seem surprising that the sources quoted in the Financial Times article do not consider the situation to be “critical.”



<sup>2</sup> Financial Times “ECB concerns grow over EU banks’ Turkey exposure as lira slides – Lenders from Spain, France and Italy viewed as vulnerable to weak lira”, Aug.10 2018

### ***Key Word Going Forward Likely to Be “Refugees”***

However, the situation still offers due cause for concern – the key word is “refugee.” Although it cannot be said to have devised a fundamental solution, the EU has been restraining the European refugee influx that began in 2015 largely based on the “EU-Turkey agreement” concluded with Turkey in March 2016. In this regard, it is impossible to ignore the risk that the refugee crisis could become more severe again if the agreement were to be scrapped owing to political instability in Turkey. To explain the great importance of this issue, I will first give a simple overview of the European refugee crisis as it relates to the EU-Turkey agreement before going on to discuss the associated outlook.

Between the spring and autumn of 2015, more than one million refugees flowed into the EU, with tens of thousands losing their lives on the way. (The widely published photographs of a 3-year-old refugee whose drowned body washed up on the coast of Turkey attest to a particularly shocking example of such deaths.) In September that year, German Prime Minister Merkel responded to the situation by adopting a policy of accepting an unlimited number of refugees, and it is well known that this decision has subsequently weakened her political support to a considerable extent. Hungary was greatly affected by the situation. Its prime minister, Viktor Orbán, criticized Merkel’s policy as being “moral imperialism,” and that reflected and promoted a deepening divide separating EU countries in the east from those further west. A series of riots in 2015 over such refugee inflows marked the start of a European refugee crisis that is said to be even more serious than the debt crisis, and a fundamental solution to this refugee crisis not yet been devised. In fact, there is not even a prospect of a solution. How has Europe avoided extremely serious unrest despite those situations? It is largely because Turkey has stopped its outflow of refugees in accordance with an agreement it made with the EU. Many of the refugees flowing into the EU are Syrians fleeing the intense civil war in their homeland and using a route (known as the Balkan route) that passes through Turkey to enter Greece on the Balkan peninsula. As most of the refugees were entering the EU via Turkey, the EU had to somehow decrease the refugee outflow from there. Accordingly, on March 18, 2016, the EU and Turkey concluded an agreement that calls for the return to Turkey of all new irregular or illegal migrants crossing from Turkey into Greece, the legal acceptance by the EU of up to 72,000 Syrian refugees already in Turkey, and the doubling of the EU’s funding for the care of refugees within Turkey, from EUR3 billion to EUR6 billion. Essentially the agreement is somewhat dangerous in that it calls for paying Turkey money to keep refugees within Turkey, but it was immediately effective – the number of refugees entering the EU since April 2016 has been dramatically reduced compared to the 2015 level. There is no doubt that the EU-Turkey agreement has given the EU (especially Germany) a crucial amount of psychological and time leeway to deal with the situation.

### ***Ultimate Power in the Erdoğan Administration’s Hands***

On the other hand, the effective control of European refugee crisis now depends on how committed the Turkish government led by President Recep Erdoğan is to such tasks as patrolling Turkey’s coastline. Diplomatic relations between the EU and Turkey have been strained owing to disagreements about human rights issues and other situations, but since the EU-Turkey agreement was concluded, many observers have noted that the direction of refugee crisis will basically be determined by the situation in Turkey. Problematically, the Erdoğan administration’s active intervention in the policy management of Turkey’s central bank is not in harmony with the EU concept of central banking, and the administration has also tended to side with Russia against the United States. Judging from President Erdoğan’s statements and actions, there does not appear to be a risk that he would deliberately diminish the rigor of Turkey’s refugee management systems going forward. But even in the absence of a deliberate decision, it seems conceivable that political and economic turbulence in Turkey might make it difficult to maintain that rigor. In any case, there is no guarantee that Turkey will keep holding back the tide of refugees from Europe forever.

Frankly speaking, a renewed refugee influx would be very unpleasant for the EU. Such a renewed influx would be likely to further magnify the power of populist parties in Italy, which would be expected to accept many of those additional refugees. Given that Italy has already assumed a tough negotiating stance with the EC while using the acceptance of refugees as a trump card, still more refugees can be expected to further complicate that situation. And Germany’s Merkel government is facing an impending threat associated with the Bavarian state election to be held this October. Just this past June, the Merkel-led Christian Democratic Union (CDU) faced great pressure from its sister Christian Social Union (CSU) party over the immigration issue, with the CSU threatening to withdraw from the ruling coalition, and a worsening of the refugee situation could probably be expected to further exacerbate the CDU-CSU relationship. Furthermore, there is a European Parliament election scheduled to be held May 2019, and EU supporters consider it extremely important to forestall a deterioration of the refugee situation as a means of preventing an additional surge in the popularity of Eurosceptic parties. While there are substantive concerns that current financial market trends might cause Turkey’s domestic financial system’s problems to negatively impact the euro area, there appear to be even greater causes for concern about the fact that the Erdoğan administration has the ultimate power to control the European refugee crisis, which has the potential to greatly undermine the EU’s political stability.

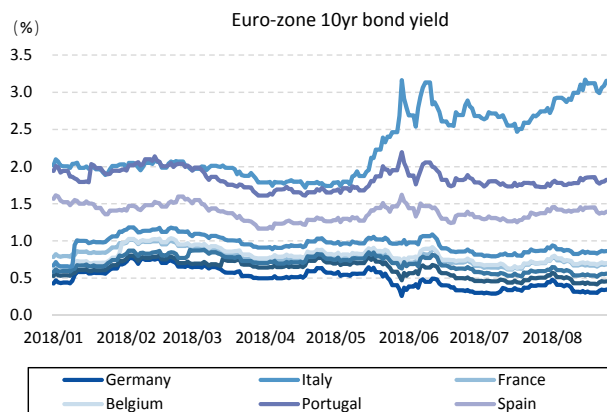
## Italian Populism Now and Going Forward – Latent Dangers

### **Another Potential Crisis**

While it has been somewhat obscured by Turkey shock, the latent crisis now brewing in Italy merits keeping a close eye on. As overviewed above, there has been extensive coverage about concerns regarding the potential impact of Turkey shock impact on the euro area's financial system and, on August 13, EC spokesman Christian Spahr made the statement – “The commission is closely following developments on the global markets. We are aware of potential impacts on European banks of the development of the Turkish lira.” That situation is indubitably making it difficult for EUR to appreciate, but there is yet another situation quite dangerous for EUR that is in the process of emerging.

Among the euro area countries with particularly large exposure to Turkish debt – such as Spain, France, and Italy – only Italy is seeing a sharp surge in the yields of its government bonds (see graph).

That indicates that Italy is understood to have its own unique problems. While Turkey shock is a crisis in the process of progressing, the situation in Italy is a latent crisis regarding which there is particular concern regarding potential developments in October.



(Source) Bloomberg

### **Italian Coalition Government Not Monolithic**

Italian government bond yields began rising in August, slightly before the Turkish shock. This was a response to the fact that the Italian populist government began discussing its fundamental fiscal management policies on August 3 in preparation for deliberations this autumn on the next fiscal year's budget. Comprehending the nature of the confusing scenario requires understanding the situations of each current minister along with the upcoming political schedule, so I start out by overviewing these situations. First of all, Italy's current coalition government is not monolithic. As is well known, the coalition includes extreme right and extreme left parties with some disharmonious ideologies, but the two largest coalition parties are in agreement regarding their support for expansionary fiscal policies, and the likelihood of those policies leading to noncompliance with the EU's fiscal rules has been widely discussed. To avoiding an immediate and overt confrontation with the EU, it was necessary to select a minister of economy and finances with reasonably balanced views. Just before the coalition government was launched, Paolo Savona, an economist considered a senior Euro-skeptic with strong anti-EU views, was regarded as a candidate for minister of economy and finances position, but Italy's President Sergio Mattarella rejected that nomination, putting the government formation process into danger. In response, the position was given to Giovanni Tria, who has earned strong confidence from the EU and financial markets owing to the emphasis he places on fiscal discipline.

However, the policies advocated by Mr. Tria are fundamentally incompatible with those of two other important ministers – Matteo Salvini (the effective leader of the far-right League, serving as Minister of the Interior and as Deputy Prime Minister) and Luigi Di Maio (the leader of the far-left Five Star Movement, serving as Minister of Economic Development, Labour and Social Policies and as Deputy Prime Minister) – and, consequently, there have already been reports of strife and antagonism. In late July, for example, it was reported based on information from unnamed sources that both Salvini and Di Maio opposed Tria's nominee to head the state-run lender Cassa Depositi e Prestiti SpA (CDP) and threatened to demand Tria's resignation unless he backed down, to which Tria replied that he would not resign in the absence of an official request to resign. Although the report was subsequently denied by related parties including Deputy Prime Minister Salvini himself, it is noteworthy that Italian government bond yields began rising at that time. Suspicions regarding such conflicts have not been completely dispelled. On August 28, for example, Deputy Prime Minister Di Maio suggested that the fiscal deficit for next year would exceed the limit according to EU rules, and interest rates rose in response to this. However, Minister of Economy and Finances Tria denied the suggestion on that same day, providing a glimpse of the continued gap between Tria and Di Maio

### **Vigilance Regarding the Potential Resignation of Minister of Economy and Finances Tria**

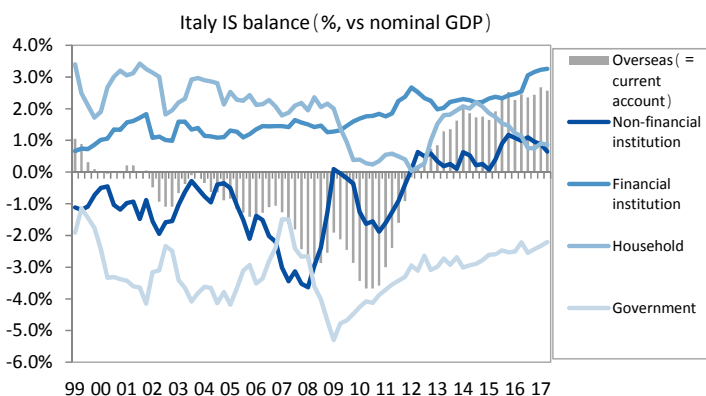
Regarding the plans to be drafted for the next fiscal year's budget, first, a budget plan will be proposed by the minister of economy and finances based on the budget requests of each individual ministry and agency. After its approval by the Cabinet, the budget plan will be submitted to the Italian Parliament in September, and the government's budget proposal formulated on this basis is to be submitted to the EC by October 15. The EC will express its opinion on the proposal by November 30, and if necessary, it will recommend adjustments. In response to this recommendation, the Italian Parliament is to pass a budget bill during the current year (during December). The discussions that began this month are the starting stage for building the foundation of the plan to be submitted to Parliament. The key questions are, how can the government harmoniously blend conflicting emphases on fiscal discipline and on growth into one plan, and can it persuade the EC to accept that plan? There is currently no clear route to attaining those two objectives, and it is uncertain whether attaining those two objectives will prove to be feasible in the end.

Although the discord within the government has been mostly concealed at this stage, there remains a possibility that, as the

budget planning process becomes progressively more concrete, there will be reports of such discord each time there is conflict between Minister of Economy and Finances Tria and other ministers. It is precisely because of this remaining possibility that, as the budget-related debate within the Cabinet began, Italian government bond yields have risen, and they are likely to remain high. Moreover, because Mr. Savona (whose nomination for the minister of economy and finances position initially prevented the coalition government's formation) has joined the Cabinet as minister of European affairs, it can be expected that (together with the two deputy prime ministers) at least three Cabinet members will be pushing for expansionary fiscal policies. Despite officially being the government's leader, Prime Minister Giuseppe Conte has not been playing a prominent role in these situations, as one might guess from the fact that he has not yet been mentioned in this article, and one gets the impression that he is a figurehead serving at the deputy prime ministers' convenience. It is highly likely that Italy's deliberations about next fiscal year's budget will generate market-moving news items that promote EUR selling from September, and I think it will be wise to keep a close eye on the process while vigilantly considering the possibility that Minister of Economy and Finances Tria might resign.

### **Well Positioned to "Buy Time"**

On August 12, Giancarlo Giorgetti, a senior leader of the extreme-right Alliance party within the coalition government, said in a newspaper interview that he expected Italy to be the target of speculative attacks in August, but Deputy Prime Minister Di Maio sought to offset that remark the next day, telling another newspaper that – "I do not see the concrete risk of this government being attacked, it is more a hope of the opposition." While it is unclear what kind of discussions are being held within the coalition government, the government does seem to be somewhat aware that its emphasis on expansionary fiscal policies could make it the target of attacks from financial markets.



(Source) Eurostat (Note) Household including non-profit organizations

By the way, Mr. Giorgetti also commented during the abovementioned interview that – "If the (market) storm comes, we will open our umbrella. Italy is a big country and has the resources to react, thanks in part to its large amount of private savings." – and that is actually true. As can be seen in the graph of Italy's investment-savings (IS) balance, the savings shortfall of the corporate sector (excluding financial companies) was eliminated following the financial bubble collapse and the European debt crisis, and that sector has played a central role in promoting Italy's transition from a current account deficit to a current account surplus. The household sector's savings decreased sharply during the period between the 2008 Lehman Shock and the 2012 peak of the European debt crisis, but they have recovered considerably since that period. These factors, along with a trend of decrease in the government sector's savings deficit, have enabled the country to enter a period of smoothly accumulating current account surpluses.

Of course, these IS balance trends reflect a stagnation of consumption and investment activities within Italy's domestic economy, which will make it difficult to elevate the country's low GDP growth rate or realize a significant improvement in the country's fiscal budget situation. On the other hand, the IS balance trends also make it difficult to generate the pattern frequently seen during the European debt crisis, in which accelerating fund outflows caused domestic banking sector crises forced several countries to beg the ECB for Emergency Liquidity Assistance (ELA). In other words, Italy has realized a financial situation that positions it to "buy time," and this positioning may well increase the difficulty of the process, expected to commence from this Autumn, of harmonizing the objectives of Italy's populist government and the EC.

## **ECB Presidency or EC Presidency – Chancellor Merkel's Change of Heart**

### **EC Presidency Superior to ECB Presidency**

Yet another news theme developed during August that is extremely important with respect to the forecasting of the European situation going forward. On August 22, the German newspaper Handelsblatt reported the Chancellor Merkel has changed her priority ranking regarding the German nominees for top EU posts scheduled to be filled during 2019. According to the article, the Merkel-led German government had previously been said to be giving top priority to successfully nominating a successor to ECB President Draghi, whose term will expire on October 31, 2019. A fairly convincing argument can be made that the time is ripe for a German ECB president given the abnormality of the fact that a German has never yet occupied the top position at the ECB – 20 years after since the euro was introduced and after the ECB was created to a large extent based on the model of Germany's central bank (Bundesbank). There are currently two candidates for the ECB presidency – Central Bank of Ireland Governor Philip Lane (who lost his bid for the ECB vice-presidency this past June) and Deutsche Bundesbank President Jens Weidmann. Both candidates are considered to lean toward hawkishness, and either candidate would become the ECB's youngest president if they were to win. According to the abovementioned report, however, Prime Minister Merkel has shifted her top priority from the ECB presidency to the European Commission (EC) presidency. There are several possible reasons for this, of which the most

likely two may be that she considers the EC presidency to be superior in status and power and that she believes she has a greater chance of succeeding in placing her candidate in the EC presidency position than in the ECB presidency position. While the EC president may seem less impressive and less of a major player than the ECB president from a Japanese perspective, the EC president actually has overwhelmingly greater authority. Chancellor Merkel is renowned for her political perspicacity, and it appears that she is calculating that, if the chances of winning the EC presidency are higher, then she should set aside the issue of Germany's pride in its Bundesbank and give priority to winning the EC presidency. At this point I would like to overview the situation regarding the EC presidency. The term of office is five years and normally begins a half a year after the European parliamentary election. The next European Parliament election will take place in May 2019, and the new EC president will take office in November of that year. The current EC president is Jean-Claude Juncker (previously Prime Minister of Luxembourg), and his predecessor, José Manuel Barroso (previously Prime Minister of Portugal) served as EC president for two terms, amounting to ten years. However, President Barroso announced in February 2107 that he will retire from the post when his first term expires on October 31, 2019. In other words, it has been confirmed that the occupants of two important posts – the ECB president and the EC presidency – will simultaneously change on October 31, 2019. There are many rumors to the effect that Germany and France will divide these posts between themselves.

The EC president is considered to be particularly powerful because he controls the EC policy agenda and has the right to submit bills to the European Parliament. Because the EC is the EU's executive branch, the EC president is effectively positioned to determine the directions he believes the EU should be moving toward. He also has the right to dismiss other EC commissioners<sup>3</sup>. As one may note from day-to-day newspaper reports, the EC president attends such conferences as G7 and G20 meetings as a representative of the EU. (The EU is represented at such meetings by both the EC president and the European Council president, which attests to the particularly high level of those two positions.) In addition, there are many additional aspects of the EC president's authority but, in short, it can be said that the EC president is roughly equivalent to what would be the EU's head of state if the EU were a country, and he has an exceptionally large presence. In this respect, the EC president is on a hierarchal level quite different from that of the top (president) of the ECB, which merely one of the EU's specialized agencies.

### ***Still Not Obvious Who the Top Contenders Are***

How is the EC president selected? Ordinarily, it is highly likely that candidates nominated by the faction with the greatest number of seats in the European Parliament will be appointed. Currently the faction with the most seats is the European People's Party (EPP), a center-right group, but all parties including the EPP will this autumn choose a candidate that they would like to nominate for the EC presidency. The last German in a post comparable to that of the EC president was Walter Hallstein, who served as the president of the first commission of the European Economic Community (EEC) from January 1958 to June 1967. Since the EU took its current form, there has never been a German EC president, just as there has never been a German ECB president.

Among the most frequently mentioned potential candidates for the EC presidency is Michel Barnier, who is currently the EU's chief Brexit negotiator and previously served as France's minister of foreign affairs and as an EC commissioner. Another leading candidate is Margrethe Vestager (formerly Denmark's minister for economic and interior affairs). Currently serving as the European Commissioner for Competition, she has a high-profile presence within the current EC (often referred to as the Juncker Commission) as she has been boldly active in obtaining huge settlements from U.S. IT companies for alleged antitrust violations. Aside from EU officials, there are calls for the nomination of IMF Managing Director Christine Lagarde, but since her name is proposed almost each time an important position becomes available in Europe it is hard to be sure if her nomination this time would be serious or the latest celebration of a long-standing tradition. Managing Director Lagarde was also nominated for the EC presidency at the time that President Juncker ultimately assumed his post, and there have been calls for her to be made ECB president and even the president of France. Since her term as the IMF's managing director will not end until June 2021, however, the likelihood of her shifting to a different post is not considered high. (It is noteworthy that Managing Director Lagarde is said to have had Chancellor Merkel's support for her EC presidential candidacy the last time that post was open, which may reflect a generally positive perception of her in Germany.)

Currently, Michel Barnier – who has been given abundant media coverage in his role as the EU's chief Brexit negotiator and has experience as an EC commissioner – seems to be a perfect candidate for EC president, but he is a member of The Republicans, the largest opposition party in France. It does not seem likely that France's President Emmanuel Macron – being the leader of France's ruling party, La République en marche (LREM) – would fully support Chief Negotiator Barnier from the initial stages of his candidacy. As LREM is a newly established party, it is not clear which faction it would join in its first European Parliament election in May 2019, but there is talk that LREM might join such a moderate faction as Alliance of Liberals and Democrats for Europe (ALDE). However, it is said that Commissioner Vestager is ALDE's preferred candidate, and this may prove to be an impediment to Chief Negotiator Barnier's candidacy. On the other hand, there are those who consider Commissioner Vestager to have less name recognition than other candidates, and there are probably also those who will question whether she would be optimal as the EU's "face." In short, the situation regarding the

<sup>3</sup> The European Commission includes one commissioner from each member country, and the total number of commissioners is currently 28. Defined narrowly as including its president and those 28 commissioners, the European Commission is the EU's "cabinet". In a broader sense, the European Commission includes 44 general offices and bureaus with about 30,000 staff members and, in this sense, the European Commission corresponds to Japan's central government ministries and agencies. In 2007 and 2008, I worked at the European Commission's Directorate General for Economic and Financial Affairs (DG ECFIN), a unit that combines the functions of Japan's Cabinet Office and Ministry of Finance.



nomination of the next EC president remains highly liquid, and it is thought that this is precisely the reason that the reports of Chancellor Merkel's change of heart have emerged so early – at a point when the various factions have not yet narrowed down their slates of potential nominees. (Of course this is speculation and may well be untrue.)

### ***Difficult for Germany to Obtain ECB Presidency***

Deutsche Bundesbank President Jens Weidmann has frequently opposed the ECB's monetary policy decisions since the financial crisis (as did his predecessor as Bundesbank president, Axel Weber), but regardless of their personal views, both men have conscientiously acted as a ECB representative in directing the Bundesbank to procure the largest shares of euro area countries' central banks' government bond purchases. Also, without focusing exclusively on monetary policies, it bears noting that the size of the European Stability Mechanism (ESM) and its predecessor, the European Financial Stability Facility (EFSF) would have been considerably smaller in the absence of German guarantees. These are some of the reasons why there is not much opposition to the concept that, as Germany is EUR's chief guardian, it would be appropriate to have a German become the "face" of the ECB. Financial market participants seem to have found common ground in supporting the simple proposition that "it is only logical that Germany should have the ECB presidency this time."

But the situation is not quite so simple. It appears highly likely that, rather than 'promoting a normalization process,' the next ECB president's main job will be "dealing with a recession." Looking at the record of ECB President Draghi as an example, one finds that soon after taking office in November 2011, he decided to implement the surprise interest rate reduction and launch a 36-month long-term refinancing operations program (LTRO, which ultimately supplied roughly EUR1 trillion of liquidity), and subsequently worked to strengthen or maintain easing measures over a period of six years and two months, until this past January. The ECB finally dropped the easing bias of its forward guidance this past March, and in June it decided to end the expanded asset purchase programme (APP, also referred to as QE) within this year. At present, attention is focused on whether the ECB will be able to undertake an interest rate hike in September next year, but even if that eventuates, only somewhat less than 20% of the 8 years of ECB President Draghi's 2 terms will have been associated with policy management measures "in the direction of tightening." While some of this can naturally be attributed to the misfortune of being passed the baton at the nadir of the European debt crisis, it is nonetheless true that the next ECB president will inherit a set of unusually protracted easing policies that have essentially not been moderated at all.

Moreover, there has been a major premise that ECB normalization will be facilitated by the fact that the United States has finally shifted to a normalization process and the U.S. economy is robust. However, as the FF rate is considered certain to attain the neutral interest rate level sometime next year, it is unlikely that the next ECB president will be able to smoothly sustain tightening measures after being passed the baton in November 2019. Will a young German ECB president be able to manage the ECB Governing Council smoothly during such a phase? It appears to be a very severe challenge even when viewed from a distance. In any case, it cannot be expected that the southern European countries that have been forced to undergo hardships during recent crisis periods will be looking on with cheerful benevolence.

Under such circumstances, it is plausible that Prime Minister Merkel might maintain the posture of seeking the EC presidency as her first choice so that, if that goal is not attained, she can ask for special consideration regarding the ECB presidency race in light of Germany's concession with respect to the EC presidency. Such a strategy may be quite wise given the difficulty of obtaining southern European countries' support for a German EC presidency candidate. As was pointed out in a previous edition of Mizuho Market Topic<sup>4</sup>, there is a need to decide who will succeed Peter Praet in the position of Chief Economist of the ECB from February 2019, and it has been rumored that if the choice falls to either Central Bank of Ireland Governor Philip Lane or Deutsche Bundesbank President Jens Weidmann, the one of those two not chosen will be considered the favorite for the ECB presidency. By the same logic, however, if France is passionately seeking the EC presidency but concedes it to Germany, could the result potentially be a "French ECB president and German EC president" scenario?

In any case, if the newspaper reports about Chancellor Merkel's change of heart are true, then the results of the upcoming European Parliament election will become considerably more important to Germany. Each European Parliament faction will choose their preferred ECB presidency candidate this autumn, and if the EPP faction were to select a promising German candidate, it would be widely considered an almost fatal blow to Mr. Weidmann's chances of becoming ECB president. Given the ECB's plan to begin scaling down its QE, Italy's commencement of budget deliberations, the upcoming Brexit negotiation deadline, and other factors, it will be particularly important to vigilantly monitor the course of events in Europe this autumn.

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<sup>4</sup> Please see the February 26, 2018 edition of Mizuho Market Topic, entitled "Interpreting ECB Executive Board personnel decisions – Implications for the future."

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