

Forex Medium-Term Outlook

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Forex Department

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Overview of Outlook

USD and JPY are continuing their back-and-forth dance. The Fed ended its policy normalization process both in terms of interest rate and quantity following the January and March FOMC meetings, so expectations of a rate cut as the next move have suddenly become much stronger. I think it would be too early to predict a rate cut within the year, but given current circumstances, it would take a lot of courage to predict a further weakening of JPY based on expectations of an interest rate gap expansion. During the current forecasting period, the Fed is likely to keep its policy unchanged at best, or, depending on the circumstances, implement a monetary easing, which leads to a prediction of either “current level” or “JPY appreciation” when it comes to USD/JPY direction. It is also difficult to imagine that the international financial markets will continue to tolerate increases in U.S. interest rates and USD if we take into account the fact that USD-denominated debt has been building up over the past 10 years, especially in emerging economies. Of course, it is also important to accept the possibility of JPY’s failure to appreciate despite market participants factoring in a Fed rate cut. One of the reasons for this could be the change in the structure of Japan’s external credit due to the rapid expansion of foreign direct investment by Japanese companies (I discussed this in great detail in last month’s issue of this report, so please take a look at that for details). However, that is an issue that relates to forecasting the USD/JPY level rather than direction. A low level of JPY 90 or 95 is not predicted, but as far as the direction is concerned, it remains my basic understanding that there is a high probability of a move in the direction of JPY appreciation/USD depreciation.

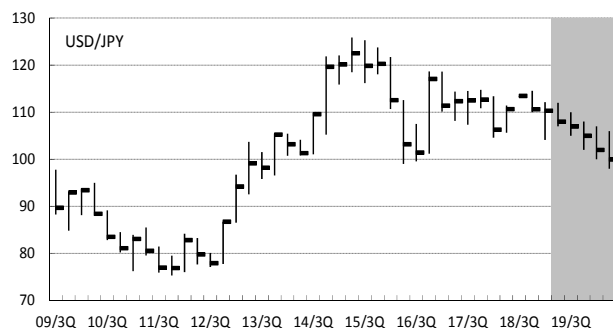
Meanwhile, despite the dire political and economic situation in Europe, EUR remains in a range. In addition to the uncertainties surrounding Brexit negotiations, there is also discord between euro member states (Germany and France) and a deterioration in fundamental economic indicators, so there seems hardly anything positive in the climate surrounding EUR. The fact that the currency still hasn’t crashed may have to do with the fact that the ECB’s policy normalization stance remains steady. Despite the weakening of predictions, if a rate hike is still assumed to be the ECB’s next move, that could put EUR in a position of advantage (vis-à-vis USD, given that the Fed has already ended its normalization process). Also, recently, we have been seeing attempts to explain the “Japanization of the euro area” or the “EUR market becoming like JPY market”, and there are those who focus on EUR as a currency well able to withstand crisis. These arguments are not unfamiliar to me, as I have been pointing out these very things over the past five years through my various publications. As the U.S. and global economies come to a standstill, it is only natural that currencies propped up by strong demand and low prices may be difficult to devalue. I predict that EUR/USD will continue to remain strong.

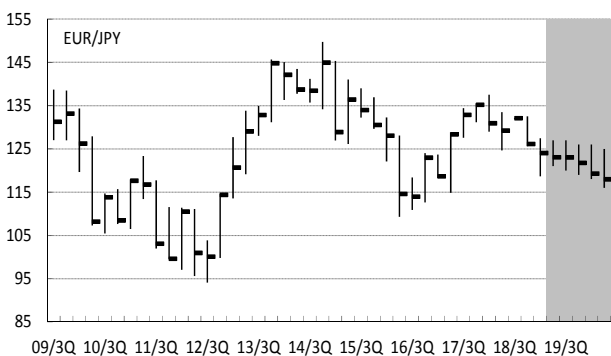
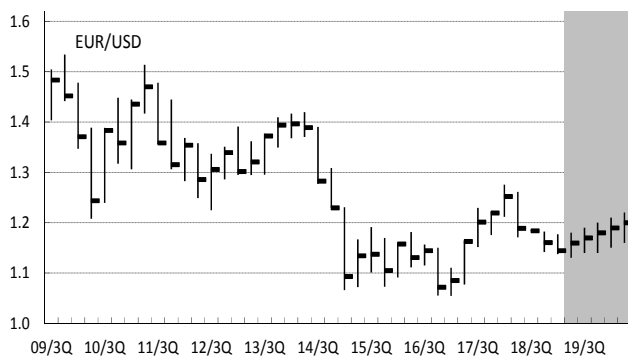
Summary Table of Forecasts

	2019				2020	
	Jan-Mar (actual)	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	104.10 ~ 112.13 (110.31)	107 ~ 112 (108)	105 ~ 110 (107)	102 ~ 108 (105)	100 ~ 107 (102)	98 ~ 106 (100)
EUR/USD	1.1177 ~ 1.1570 (1.1248)	1.11 ~ 1.16 (1.14)	1.12 ~ 1.17 (1.15)	1.12 ~ 1.18 (1.16)	1.13 ~ 1.19 (1.17)	1.14 ~ 1.20 (1.18)
EUR/JPY	117.85 ~ 127.50 (124.06)	121 ~ 127 (123)	120 ~ 127 (123)	119 ~ 126 (122)	118 ~ 126 (119)	116 ~ 125 (118)

(Notes) 1. Actual results released around 10 am TKY time on 28 March 2019. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





USD/JPY Outlook – How to View Forex Rates in a Dollarized World

USD/JPY Now and Going Forward – JPY Depreciation Difficult in a Dollarized World

The Need to Take Another Look at the Reason Why the Fed Turned Dovish

Following the March FOMC meeting, there has been a significant decline in those predicting a U.S. economic recovery, an accompanying return of the Fed to a more hawkish stance, and a resulting increase in U.S. interest rates and USD appreciation. Earlier this year, we did see some temporary strengthening in optimism over stock price and forex rate outlooks. However, another look at the reasons why the Fed made a sharp turn in its policy stance since last fall serves as a reminder to approach optimism with caution. There are several reasons why the Fed may have turned dovish, but at least two easily stand out: (1) out of consideration for asset prices (prices of real estate and stock, etc.), and (2) out of consideration for a “dollarized world” centering on emerging economies. These two issues caused the greatest financial market turmoil in 2018. Surely, they could not have been forgotten in a matter of just three months? In this month’s report, I would like to focus particularly on the latter and reiterate the idea that international financial conditions will not tolerate a continued increase in U.S. interest rates or USD.

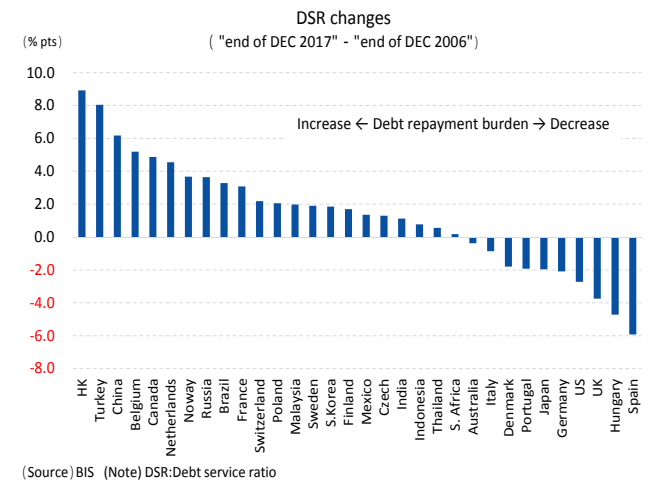
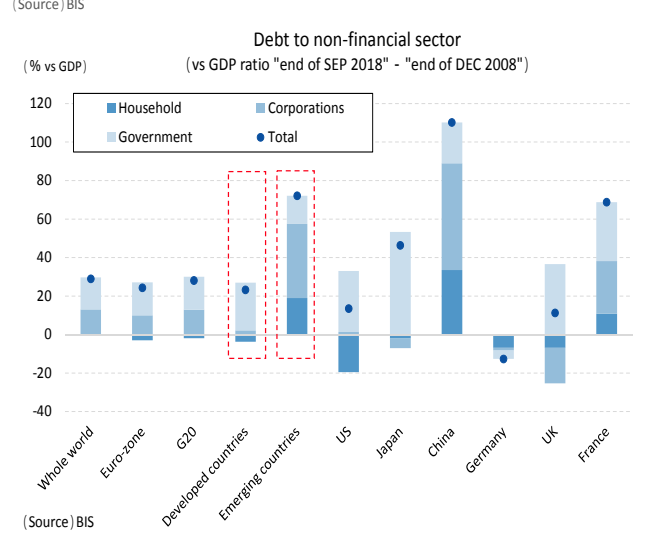
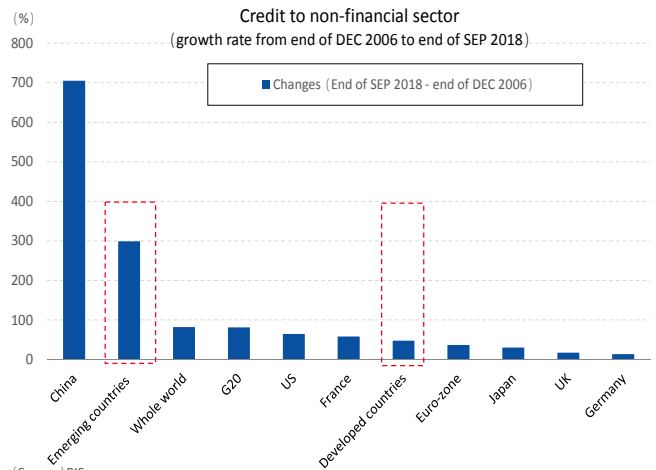
Consideration for Asset Prices

Reason (1) above does not need much explanation, but I would like to summarize it briefly all the same. Looking back at the past 10 years or so, I tend to think that, for the first time in 2018, the increase in U.S. interest rates began to be used as a reason for selling of shares. Some of my readers may no longer remember this, but up until 2017, an increase in U.S. interest rates was considered by most to be a positive development. An increase in U.S. interest rates used to indicate an improvement in the U.S. economy, and therefore, also the global economy. This led to shares being bought whenever this happened. However, with the January 2018 job data (published in February 2018) revealing a nine-year high of +2.9% yoy in wage growth, people suddenly began to talk about inflation concerns. The Fed responded by accelerating rate hikes, causing U.S. interest rates to rise further, and as a consequence share prices crashed. Subsequently, both interest rates and share prices settled down for a while, but share prices became quite volatile again during the October-December period, and the idea that an increase in U.S. interest rates was perceived as a threat began to gain currency. Note, however, that both in February and during October-December last year, the stock markets hit turbulence immediately after U.S. interest rates entered new levels of high (specifically, the triggers were a 3% level in the case of the former, and a 3.2% level in the case of the latter).

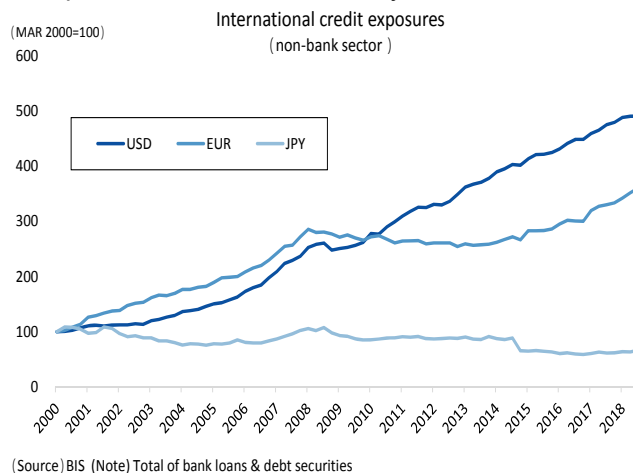
In the current climate, it would be appropriate to assume that any rise in U.S. interest rates is viewed completely unfavorably by the stock markets. In which case, it would be quite difficult, going forward, to forecast a simultaneous rise in U.S. interest rates and USD, pushing up USD/JPY. For that to happen, one would have to assume that the stock markets (and the U.S. economy) can withstand a further increase in U.S. interest rates, but given that U.S. 10-year interest rates over 3% repeatedly caused the stock markets to go into turmoil in 2018, such an assumption would be unrealistic. Of course, there is also the fact that over the past year or two, JPY has failed to appreciate as much as it was traditionally wont to despite stock market turbulence. That does not mean, however, that JPY would depreciate at times of stock price crash. Stock price developments are not something the Fed takes into special consideration when deciding on rate hikes, but given that over 30% of U.S. households’ financial assets are in the form of equity, it is natural to worry about the negative impact on the real economy due to the reverse wealth effect when share prices fall, which is not something the Fed can afford to overlook.

Consideration for a Dollarized World

When predicting the outlook for forex rates from a wider perspective, reason (2) is worth paying greater attention to. Reason (1) addresses the question “can the U.S. economy (stock markets) withstand the rise in interest rates,” while reason (2) addresses the question “can the global economy (especially emerging economies) withstand the rise in interest rates.” Ten years since the collapse of Lehman Brothers, I am often asked by customers “What is the biggest change that has taken place?” and “Where should we look for signs of the next crisis?” My response to these questions is that the biggest change has been the steep surge in debt, especially in the emerging economies. If we compare debt levels at the end of 2006, before the financial crisis began in real earnest, with recent levels (as of June 2018), global public plus private sector credit to the non-financial sector has increased by around +82% from USD 97 trillion to USD 178 trillion or so. More specifically, debt in the developed world has increased around +48% from USD 84 trillion to USD 124 trillion or so, but debt in emerging economies has increased by as much as +300% from around USD 13 trillion to USD 53 trillion. In terms of the value of money, the developed world still accounts for 70% of the debt, but it must be noted that leverage expanded rapidly in emerging economies against the backdrop of accommodative post-crisis monetary conditions. Further, it is important to note that, when evaluating the risk level of a debt, it is not the absolute level of the debt, but rather the size of the debt relative to the scale of the economy that is important. To take an extreme case, even if the level of debt doubles, it should be okay so long as the scale of the economy also doubles. In this context, the size of debt as a ratio of GDP is a useful reference. During the period in question, the debt level of developed economies has grown from 236% to 259% of GDP, but that of emerging economies has grown from 107% to 179% of GDP, which is clearly a much more conspicuous increase. In particular, a rapid accumulation of debt can be confirmed in Hong Kong and China. One would like to make some concession when thinking about Hong Kong’s debts, given that it attracts a great deal of capital flow as an international financial center, but it is a matter of some concern that the accumulation of debt in China and emerging economies is driven by business corporations and other non-financial sector entities.



I would also like to take a look at the debt service ratio (DSR). DSR is the ratio calculated by dividing the amount of private-sector debt repaid by the sum of disposable income and interest expenditure. As well known, many central banks around the world (not just in emerging economies) lowered their official interest rates after the financial crisis, and pre-crisis interest rate levels have still not been restored (in other words, policy has not yet been normalized). However, of the 32 countries targeted for reporting, only 10 countries showed a decrease in DSR compared with the end of 2006 (as of the end of 2017). As one can easily tell, the greater the accumulation of debt relative to scale of a country's economy, the higher its DSR tends to be. One of the topics that came up in discussions often during 2018 was the fact that some emerging economies were reluctantly forced to increase their policy interest rates in an effort to protect their domestic currencies as capital began to drain out of their countries with the increase in U.S. interest rates. This has had the effect of a monetary tightening in these economies, as symbolized by an increase in their DSRs, and there is concern about the resulting dampening of consumption and investment appetites.



Apart from Hong Kong, Turkey, and China, countries like Canada and EU member states have also seen an increase in their DSRs compared with the end of 2006. Most of these countries have been specifically singled out and warned by the Bank for International Settlements (BIS) regarding the increase in their debts as a ratio of GDP. In the case of Turkey, the fact that it actually suffered a financial shock is still fresh in the memory (of course, it was political instabilities that triggered the shock, but one may be justified in assuming that the conditions were ripe for it to begin with).

I do not intend to use the BIS indicator to fan the flames of insecurity by suggesting that emerging economies will all fall prey to some shock or other. However, the risk obviously exists. It is not unheard of for countries to be unable to withstand the burden of interest as debts accumulate and fall into a crisis. The key question from the perspective of forecasting forex rates, however, is whether the mutually correlated increase in U.S. interest rates and USD can be sustained given these international financial conditions. Emerging economies are already susceptible to a punishing outflow of capital with the rise in U.S. interest rates, and last year, their fragility was exposed. Going by the data presented above, this has happened due to an expansion in debts relative to economic scale – in other words, due to a partially “dollarized world” that has become sensitive to U.S. interest rate increases. Ultimately, no matter how solid U.S. economic and political conditions, many emerging economies appear to have put their capital markets at the mercy of the rise or fall of U.S. interest rates, and though there may be differences in the level of dollarization, the fact remains that global economics and finance are becoming dollarized. Under such circumstances, the Fed's financial policies and Federal Funds (FF) rate regulate the cost of capital for emerging economies, and the Fed may no longer be able to turn a blind eye to turmoil in emerging markets. As the chart shows, in the years following the financial crisis, the move to borrow EUR or JPY as foreign currency did not gain much steam, but USD-denominated loans have been increasing consistently. If we dig into BIS data, it becomes clear that these loans often took the form of debt securities in emerging economies. In the international financial markets today, one of the main concerns may be “USD-denominated debts in the non-banking sectors in emerging economies.” In other words, forecasting a scenario based on a more hawkish Fed and the accompanying increase in U.S. interest rates and USD involves judging that this is possible in view of international financial market conditions. In my view, this seems rather difficult to do, objectively speaking.

Forex Rate “Level” and “Direction” are Two Different Subjects

One would assume that, over the past three months, there might have been a change in the situation concerning the two reasons above, which forced the Fed to change its policy direction, but the fact is that things have not changed much. So long as conditions persist that make the stock markets and emerging markets hinder any increase in U.S. interest rates, the Fed's ability to return to a more hawkish stance will be limited, and so will any expansion in the U.S.-Japan interest rate gap. The fact that most predictions of JPY depreciation are predicated on the logic that a weak JPY trend is a nonstarter without an expansion in the U.S.-Japan interest rate gap automatically makes such predictions difficult at this time. Even taking a cautious stance, my basic understanding remains that it would be prudent to bet on either “level” or “JPY appreciation” when it comes to the outlook for USD/JPY.

Of course, it is a different matter whether JPY will appreciate to such an extent that USD/JPY falls to the 80- or 70 level as it once did. One gets the impression that Japanese companies' outright selling of JPY (through the acquisition of foreign companies) is too large for that to happen (I discussed this in detail in the previous month's issue of this report, so will keep it brief this time). However, such arguments relate mainly to the predicted “level” of USD/JPY, which is different from arguments related to the predicted “direction.” When it comes to direction, I believe that the U.S. domestic and international economic and financial climate described above will hinder an increase in U.S. interest rates, so my view is that JPY will find it difficult to further weaken.

U.S. Currency Policy Now and Going Forward – Countering Absurd Arguments with the

Right Arguments; The Key to Trading with the U.S.

President Trump Turns His Attention to Forex Rates Again

At a March 2 conference, President Trump remarked, "I want a strong dollar, but I want a dollar that does great for our country, not a dollar that's so strong that it makes it prohibitive for us to do business with other nations and take their business." Although he did not single him out by name, he referenced Fed Chair Jerome Powell, saying sarcastically, "We have a gentleman that loves quantitative tightening in the Fed. We want a strong dollar, but let's be reasonable." The forex markets have toned down their reactions to such remarks by Mr. Trump thanks to his repeating them so often, but one finds the president's continued criticism of the Fed surprising given that the Fed made a sharp switch to a dovish stance at the January FOMC meeting. The basic stance indicated in the January FOMC meeting statement could correctly be described as a "sudden change" from that at the December 2018 and previous meetings. It was also a real declaration of the end to rate hikes. The minutes of this meeting (published on February 20) also nearly declared an end to the balance sheet normalization process within the year (continuing the trend, the Fed indicated an even more dovish stance at the March FOMC meeting – details later).

Ultimately, though, the world of forex rates is such that it always involves at least two parties. Thanks to the ECB and BOJ being virtually unable to normalize policy, USD has not depreciated. It is not clear how right President Trump is to focus on forex trends, but the fact is that the forex rate trends remain stubbornly wedded to a structure of USD strength against all other currencies. Perhaps President Trump's unhappiness stems from the fact that USD remains strong despite the Fed's behavior (perhaps he believes that this unshakable strength of USD is a result of the Fed's rate hikes up to now). It may also not be all that far-fetched to assume that the president is simply looking for an imaginary enemy to bash following the not-so-remarkable outcome of his summit meeting with the North Korean leader. At any rate, there is no question that, in some corner of his mind, Mr. Trump feels that USD strength is a bad thing.

The Idea Based on the Method of Elimination that "It is the Other Country's Fault"

What is of concern here is that if the president wants USD to weaken but USD remains strong despite the Fed switching to a more dovish stance, he may arrive at the idea that "it is the other country's fault" based on the method of elimination. For instance, it would be just like him to arrive at the logic that "USD remains strong because the ECB and the BOJ remain stubborn in their monetary easing." Of course, this is an absurd idea, but the fact that both Europe and Japan have large trade surpluses with the U.S. is liable to give credence to such a mistaken assumption. Given that both economies face bilateral trade negotiations with the U.S. in the near future, such developments are bound to induce nervousness. More specifically, we may be likely to start hearing more about "currency provisions," which were introduced during the U.S. Mexico Canada Agreement (USMCA, previously NAFTA) negotiations. It is a matter of some concern amid the emergence of some reports suggesting that China has also agreed to provisions of a similar nature.

Japanese Companies' Contribution to U.S. Economy Large

However, trade policies and monetary policies should be managed separately. It has been reported that Japan's Vice Minister of Finance for International Affairs, Masatsugu Asakawa, said at a conference in Tokyo on March 3 that Japan's current account surplus stems from the country's income account surplus and should be considered separately from trade issues, and there will be a need to emphasize during trade negotiations going forward that a large portion of Japan's current account surplus results from the proceeds of overseas investments made in the past. Efforts to reduce those proceeds would directly lead to discussions about such moves as those to decrease the production capacity of Japanese automobile companies in the United States or closing down those companies' U.S. factories. This is an aspect of President Trump's views that can be considered particularly ferocious. The U.S. Department of Commerce's annual survey, "Activities of U.S. Affiliates of Foreign Multinational Enterprises" reports that, as of the end of 2016, Japanese companies had 860,000 employees in the United States and accounted for about 12% of all employees of foreign companies in the United States (approximately 7 million people). This 12% share is second only to the 17.5% share of U.K. companies in the United States. Regarding foreign-owned companies' total assets in the United States, Japan has the largest share (15.8%), exceeding that of the United Kingdom (14.7%). Japan's strong presence is also reflected in its share of total remuneration to foreign-owned companies' employees in the United States (13.3%), second only to the United Kingdom's share (16.6%). While there are various other ways to measure foreign-owned companies' contribution to the U.S. economy, it is clear at least that the contribution of Japanese companies is quite large and greater than those of companies from most other countries. It is worth noting that the 'proceeds' of Japan's overseas investments is generally considered to correspond to the country's primary income surplus, measured at the stage in which foreign currency is deposited in Japan residents' overseas bank accounts, so the magnitude of the proceeds does not necessarily correspond to the magnitude of pressures promoting JPY appreciation.

Forex Rate Adjustments Won't Eliminate U.S. Current Account (Trade) Deficit

At the abovementioned conference, Vice Minister of Finance Asakawa also said that Japan's current account surplus also reflects a natural trend of increase in savings for the future as Japan's population ages. This point about the effects of savings and investment (IS) balance trends highlights the fact that the U.S. current account deficit reflects the nature of the United States' IS balance, which is characterized by excessive consumption and investment. In other words, due consideration of IS balance trends suggests that, rather than focusing exclusively on criticizing other countries, it would be

more constructive for the Trump administration to concurrently examine the structural causes of U.S. deficits, and this is a highly sound argument. Looking at recent trends in the U.S. IS balance, one finds that the government sector's huge saving deficit has been roughly mirrored by the foreign sector's huge saving surplus (\approx current account deficit). Having promoted expansionary fiscal policies and thereby expanded the U.S. current account deficit owing to the government sector savings deficit, the Trump administration should recognize that, given the United States' IS balance situation and related theories, it is highly unlikely that even aggressively expending time and political resources will ultimately bring about its desired result (the reduction of the U.S. trade deficit).

Going forward, there is a possibility that the Trump administration may be able through aggressive bilateral negotiations to forcibly increase the levels of U.S. exports to Japan and the EU, but it is highly likely that those efforts will be fruitless so long as the United States is unable to change its own pattern of excessive consumption and investment. One wonders whether any of President Trump's advisors are capable of or inclined to explain to him the fact that forex rate adjustments alone will not suffice to eliminate the U.S. current account (trade) deficit. (It seems likely that any advisor attempting such a mission might well be dismissed or transferred.) Many observers are anticipating progress will be made in the U.S.-Japan Trade Agreement on Goods (TAG) negotiations from this month through early May, and U.S. Trade Representative (USTR) Robert Lighthizer has expressed his intention to visit Japan within the next month.

Given the Trump administration's recent record of repeated failures to make progress in such negotiations at the U.S.-China trade talks and U.S.-North Korea summit talks, the timing of the TAG negotiations does not seem very auspicious. From the Japanese perspective, efforts to emphasize the contemporary contributions of Japanese companies in the United States along with careful and thorough efforts to elucidate theoretically correct facts may seem to be a roundabout approach, but I believe it could well prove to be a relatively direct shortcut to mutual understanding and agreements.

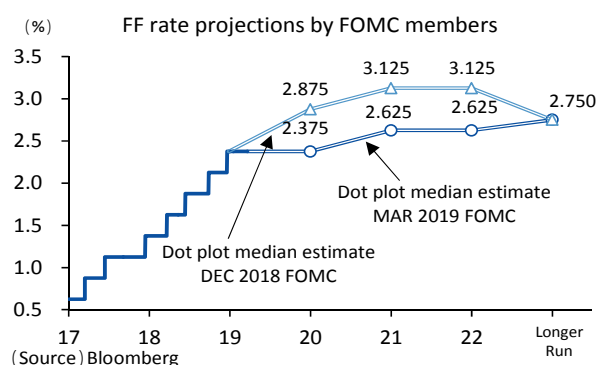
U.S. Fiscal Policies Now and Going Forward – FOMC Communications Turn Rough

Dot Plot Gives Impression of Putting Cart Before Horse

The March FOMC meeting kept the federal funds (FF) target interest rate unchanged in the 2.25-2.50% range. However, the Fed's assessment of the economy as stated in the FOMC statement as well as the Board members' FF rate projections (the dot plot) were significantly downgraded, and it was also decided that balance sheet normalization, which has been ongoing since October 2017, would start slowing in May this year and end at the end of September. Going by the changes in the Summary of Economic Projections (SEP; Fed staff members' economic and inflation projections) released at the same time, one cannot help thinking that the figures have been put together in significant haste. From the perspective of market participants, it could even be said that the Fed's communication has become rather 'rough.' This article has been anticipating this kind of policy transition on the part of the Fed.

The economic assessment in the FOMC has changed significantly from the previous time's "economic activity has been rising at a solid rate," to this time's "growth of economic activity has slowed from its solid rate in the fourth quarter." The Committee's basic stance of remaining "patient" with regard to policy operation has not changed. Fed Chair Jerome Powell explained at his press conference that "Patient means that we see no need to rush to judgment," noting that "It may be some time before the outlook for jobs and inflation calls clearly for a change in policy." The tone of the FOMC statement and Mr. Powell's remarks at the press conference are consistent with the fact that a majority of Board members now predict zero rate hikes this year. As I will explain again later, my guess is that the Fed was forced to revise its overall economic assessment considerable to align with the significant downward revision of the dot plot projections. The reason I say this is because even though the SEP (see chart) has been downgraded, the extent of the downgrade is not significant enough to signal a sharp turn in the overall assessment or the dot plot. Specifically, looking at the (median of) projections for 2019, real GDP growth rate has been downgraded from 2.4% to 2.1%, the unemployment rate has been downgraded from 3.6% to 3.7%, and the personal consumption expenditure (PCE) deflator has been downgraded from +2.0% to +1.9% – as downward revisions go, these are quite modest.

Meanwhile, looking at the FF rate projections in the dot plot, as of December 2018, two members predicted 0 rate hikes, four members 1 rate hike, five members 2 rate hikes, and six members 3 rate hikes for 2019. This time, 11 members have predicted 0 rate hikes, four members 1 rate hike, and two members 2 rate hikes (see graph). One cannot help thinking that the difference is quite considerable given the relatively modest change in economic and inflation forecasts. It offers a glimpse into the likely backstage developments – a hasty downgrading of dot plot projections → significant downgrading of the overall assessment to be consistent with the dot plot. Ordinarily, a major economic, financial, or political shock that inevitably forces a significant downgrading of overall economic assessment would come first, and this would be followed by a strong downward revision of the FOMC statement and dot plot. However, the assessment of the real U.S. economy has not deteriorated that much over the past three months. Rather, the U.S.-China trade war and other matters of concern even seemed to have been temporarily shelved (of course that sense of security vanished



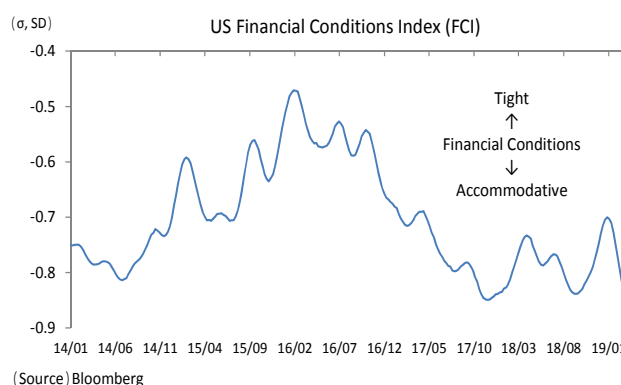
following President Trump's remarks this week). Even as early as December 2018, the financial markets had already begun forming the prediction that not just would there be no rate hikes in 2019, rather there could even be a rate cut. I think more appropriate reading of this time's downgrading of the dot plot would be that the previous time's dot plot projections suggesting a high likelihood of rate hikes in 2019 were merely revised to be more in line with reality (the markets).

Balance Sheet Policy Comes Full Circle

With regard to balance sheet normalization, the Fed decided to slow the runoff of its assets from the current pace of USD 30 billion a month to a maximum of USD 15 billion a month starting May, and cease runoff entirely in September. At the December 2018 FOMC, Mr. Powell and other officials remarked that the process was on "auto pilot," which caused a great deal of chaos in the financial markets. However, at the January FOMC meeting, the Fed attempted to change course and be "flexible" in its policy operations and base them on economic and financial market developments. Two months later, the declaration of an end to the process came at this month's meeting. I repeat myself, but one cannot help feeling that the Fed's communications have become rather rough over the course of the past few months, since December last year. At any rate, this brings the balance sheet normalization policy full circle: expansion → slowing pace of expansion → end of expansion → contraction → slowing pace of contraction → end of contraction. It also makes it easy for the next move to be "expansion." The decision taken at the recent meeting was flexible and based on economic and financial market trends as promised in January (as opposed to being "on autopilot"), and one must be prepared for another expansion as a logical extension of the process.

Implications for Exchange Rate Forecasts

The March FOMC meeting can be considered the official end to the policy normalization process both in terms of interest rates and quantity. Under this stance, it is not practical to assume that U.S. 10-year interest rates will return to the 3% level again this year. Most market forecasts assume that JPY cannot weaken unless the U.S.-Japan interest rate gap expands – it would be difficult to predict a further weakening of JPY based on this. It would, however, be an overreaction to go so far as to predict a rate cut. The Financial Conditions Index (FCI), which is a simple way to check on the status of the financial markets, continues to suggest an accommodative financial climate (conditions are judged to



be "tight" when this index is positive, and "accommodative" when it is negative). From the Fed's perspective, an accommodative climate indicates that even a rate hike is possible. Of course, there is also the practical matter that the more hawkish the Fed turns, the tighter the financial conditions as indicated by the FCI, forcing a correction in asset prices led by stock prices. Although expecting a rate cut is undeniably expecting too much, the fact is that a rate hike at this time will not be an easy decision either. Again, with the Fed in this position, the possibility of the ECB starting its normalization process has become much more hopeless, to say nothing about the BOJ. As widely known, forex rates are a major component of the response functions of both central banks' policy operation (there being no room for debate in the case of the BOJ), so formulating strongly hawkish policies under these conditions would amount to suicide in the sense that it would result in the domestic currency strengthening. This report's forecast scenario of "the collapse of the Fed's normalization process, decline in U.S. interest rates and USD across the board, appreciation of EUR" remains unchanged.

Risks to My Main Scenario – What are the JPY Depreciation Risks Worth Considering?

Rolling-Back of Monetary Policy Normalization Market Begins

As I do each month, I would like to review the risk factors related to my main forecast scenario. As has been discussed numerous times, since this article's main scenario anticipates USD depreciation along with JPY appreciation stemming from the USD depreciation, the most important risk scenarios are those related to JPY depreciation. In view of this, I will focus here mainly on JPY depreciation risks.

Before examining the risks, I would like to quickly review this article's main forecast scenario. For more than a year, the basic story line of the scenario is – "The end of the Fed's normalization process is accompanied by U.S. interest rate decreases and USD depreciation, and that situation forces JPY to appreciate." After the halt of interest rate hikes at the January FOMC and the halt of balance sheet reductions at the March FOMC, the Fed's normalization process has been completely halted with respect to both "interest rates" and "quantity". Actually, it is probably more accurate to describe the normalization process as having been ended rather than halted. As mentioned above, although the dot plot still indicates "one rate hike in 2020", the Fed has given the financial markets a considerable shock as it has made a sharp swerve toward dovishness since last year. A quite clear improvement in the economic and inflation outlooks would probably be required before the Fed would resume communications about returning to the interest rate hike route. Given the

information currently available, it is hard to imagine such a clear improvement happening within the next 12 months, so the baseline Fed policy outlook scenario is "status quo at best and possibility of additional easing depending on the circumstances". My view is that the Fed's normalization process – sustained for roughly six years since May 2013 – has ended. Under such circumstances, it has become difficult to forecast a JPY depreciation scenario based on expectations of an increase in U.S. interest rates and, for the time being, I think it safe to assume that the end of the Fed's normalization process will cause a U.S. interest rate decline and across-the-board USD depreciation, resulting in the progressive appreciation of JPY and EUR.

Risk Factor of "Unexpected U.S. Economic Robustness" Receding

There are several JPY depreciation risk factors that should be kept in mind with respect to the main forecast scenario (see chart). Up through last month's edition of this articles, the biggest such risk factor seemed to be a situation in which 'the U.S. economy is surprisingly robust and the Fed therefore finds itself positioned to continue its normalization process'. Now that the Fed's normalization process has

JPY depreciation risk factors

Concrete examples	Symbolic	Possibility
U.S. economy is surprisingly robust	Unemployment rate not rising, Recovering stock price and ISM index	medium /high
Discontinuation of the Trump administration's protectionist policies	Complete resolution of US-China trade war	low
Discontinuation of BREXIT	Re-national referendum implementation	medium /high
Additional monetary easing by BOJ	Supply negative-interest funds	low

(Source) Daisuke Karakama by Mizuho Bank

ended, however, this risk factor is probably no longer the most worrisome. Nevertheless, there is a possibility that the Fed's inclination toward dovishness will have a positive effect on the stock market and that strong stock prices will generate a wealth effect in the household sector that supports positive trends in the U.S. economy going forward. In the case that the high-profile increase of nonfarm employment growth at rates around 200,000 MoM is sustained and the Fed shows increasing bullishness in its statements, dot plot, and press conferences, it would probably be easy for USD/JPY to stabilize at levels of JPY110 or higher. Given that the markets are increasingly assuming the Fed will remain dovish following the January and March FOMC meetings, if the perception that the U.S. economy is unexpectedly strong spreads, there is of course concern about the possibility of an upward jump in U.S. interest rates and USD.

Looking at events in the past, it would not be surprising to see a lag of about one to two years following the U.S. yield curve inversion before the stock market undergoes a major adjustment. This may be considered a kind of bonus period stemming from the Fed's shift from tightening to easing in response to the economic sluggishness. On the other hand, if investors are fairly confident that a major stock market adjustment is inevitable in the near future, one wonders how motivated they will be to buy stocks going forward. Moreover, given that the U.S. economy has been expanding for an extraordinarily long period of time, it appears unquestionable that the remaining margin for improvement is small. Frankly speaking, I believe the likelihood of progressive JPY depreciation is not high, but given that a JPY appreciation scenario cannot be realized in the absence of a clear-cut slowdown in the U.S. economy, the "unexpected U.S. economic robustness" risk is still the top JPY depreciation risk factor.

Possibility of Brexit Referendum Rerun Greatest Political JPY Depreciation Risk Factor

While "unexpected U.S. economic robustness" is an economics-related JPY depreciation risk, there are also political JPY depreciation risk factors. This article has previously noted the need to monitor the potential for "a discontinuance of the Trump administration's protectionist politics" and considered the ramifications of a complete resolution of the U.S.-China trade war, which would be a potent symbol of trade war threat elimination. What I am referring to here is literally a complete ending of the U.S.-China trade war involving a complete discontinuation of the cycle of additional tariffs met with additional counter tariffs along with other initiatives symbolically conveying the message that the two parties were moving to normalize their relations, and I imagine that the markets would respond in a highly positive manner to such a scenario. However, the reforms the United States is demanding from China – such as intellectual property rights protection and the ending of forcible technology transfers – are not amenable to rapid resolutions, so the likelihood of a complete resolution of the U.S.-China trade war is probably not high. Moreover, with an eye to his reelection campaign, it appears that President Trump desires to continue playing the role of "the president who confronted China on behalf of fair trade", and it seems that his basic strategy is to keep relations with China moderately strained while avoiding sharp trends of deterioration or improvement. In fact, even after the postponement of the previous March 1 deadline for raising tariff levels, President Trump has constantly shifted between hard- and soft-line approaches in his information dissemination activities in line with that basic strategy. It is clear that the provocative nature of President Trump's communications and actions related to trade wars and other situations are background factors promoting the deterioration of business sentiment, but if the situation were to deteriorate to an extreme degree, there is a greater-than-zero possibility that the president might take bold measures to realize reconciliation deals. In such a case, the forex markets would probably become more receptive to a trend of rising JPY selling.

Another political JPY depreciation risk factor that potentially requires the most vigilant monitoring relates to the possibility

that the Brexit initiative might be withdrawn following a second referendum. The March 22 EU summit meeting rejected U.K. Prime Minister May's request to delay the United Kingdom's withdrawal to the end of June, stipulating that an extension of negotiations until May 22 would be allowed only in the case that the U.K. Parliament is able to approve a withdrawal arrangement during March. If the parliamentary approval of such a withdrawal arrangement proves impossible, the United Kingdom will have to undertake a no-deal withdrawal or present a new plan by April 12. The April 12 and May 22 dates are significant. If the United Kingdom is to remain in the EU, it must participate in the European Parliament elections, which start from May 23, and such participation will require notification six weeks in advance. Six weeks in advance of May 23 is April 12.

In connection with this decision, European Council president Donald Tusk has made such statements as – “The fate of Brexit is in the hands of our British friends.” – and – “... until 12 April anything is possible.” Although “anything” includes such various possibilities as the approval of the current withdrawal proposal, the proposal of a new withdrawal agreement, and a no-deal withdrawal, the possibility of cancelling Brexit altogether also remains. This is because the Brexit referendum is not actually legally binding, and the European Court of Justice (ECJ) announced last December 10 that the United Kingdom could cancel Brexit without the EU's consent (During March, a large number of people signed an online petition to cancel Brexit on the U.K. parliamentary website, and the ECJ ruling was made in connection with this petition.) The U.K. government theoretically has the discretionary power to cancel Brexit, but even if it desired to cancel Brexit, it would probably do so only after implementing a second referendum. Given the momentous nature of national referendums and the respect accorded to them, it seems that the only legitimate way to reverse a referendum would be through another referendum. Given that noteworthy U.K. public opinion surveys have indicated that “remain” supporters are in the majority, it is worth keeping in mind the possibility of a “second referendum risk-on mood generated JPY depreciation” sequence. If a second referendum were to be held, the magnitude of the ensuing earthquake would probably be similar to that caused by the first referendum.

JPY Depreciation Risks Originating in Japan – The BOJ's "Next Move"

Compared with overseas factors, it is basically much less likely that Japanese factors will strongly affect forex trends, but it is still worth paying close attention to the BOJ's actions. The March 15 BOJ Monetary Policy Meeting decided to retain its general appraisal of economic conditions essentially unchanged. However, the general appraisal in January was – “Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating.” – while the general appraisal in March was a bit more verbose, being – “Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating, although exports and production have been affected by the slowdown in overseas economies.” The expansion of the general appraisal is an early sign suggesting that the BOJ is having difficulty in maintaining its current appraisal and, as a rule of thumb, one can consider such a situation to be one that is likely to eventually lead to additional monetary easing. Accordingly, it seems quite likely that the “next move” during the forecasting period will be in the direction of easing rather than tightening. Given that a downward revision of the risk balance assessment was clearly made in the BOJ “Outlook Report” released in January and that the general situation is one in which consideration of additional relaxation is not at all surprising, one must keep in mind the possibility that the BOJ may suddenly announce an easing initiative.

However, the BOJ does not have many policy cards left to play. Within the current framework, a further lowering of the level of negative interest rates must be accompanied by a downward adjustment to the long-term interest rate target, but that is no longer a viable option. In this regard, the proposal of introducing a negative lending rate recently made by a former BOJ executive director has spurred media headlines that could potentially promote large forex rate movements. Of course, given that such a measure could be considered a direct subsidy to financial institutions and that it almost surely would not augment lending volume, it is not considered a viable option at this time. In the case of considerable JPY appreciation, however, it cannot be said with certainty that such a measure will not be taken. As a policy to supply negative-interest funds has already been implemented overseas in the form of the ECB's second round of targeted long-term refinancing operations (TLTRO2), it cannot be said that such a measure would be unprecedented.

Stickling about JPY Depreciation Risk Factors

While this article has focused primarily on JPY depreciation risk factors worthy of being concerned about, the risk factor range naturally encompasses JPY appreciation risk factors also. Although a certain amount of JPY appreciation is consistent with the main forecast scenario, factors with the potential to promote considerably greater JPY appreciation than the main scenario anticipates are unquestionably risk factors. However, the financial markets often tend to view a wide range of ‘negative’ situations as being factors that promote JPY appreciation, and it would not be worthwhile to examine each situation individually. One way to focus on relatively significant JPY appreciation risk factors is to take another look at the JPY depreciation risk factors just discussed and consider what would happen if the situation in question were to be exactly opposite to that associated with the JPY depreciation risk factor in question. For example, it is worth considering a case in which the U.S. economy unexpectedly stalls, pressuring the Fed into cutting interest rates and resuming quantitative easing measures, or a case in which the U.S.-China trade war suddenly intensifies. Other JPY appreciation risk scenarios worth thinking about include a case in which there is a complete breakdown of Brexit negotiations, making a “no-deal” Brexit inevitable. Unlike many of the JPY depreciation risk factors, the eventuation of each of these JPY appreciation risk factors seems quite possible. There are both bullish and bearish perspectives on the global economy in 2019, but most forecasters agree that “deceleration is inevitable.” Many observers are already whispering about the incipient peaking out of the global economy, and there is probably a high likelihood that numerous

and diverse 'negative' situations will occur here and there in the world during the forecast period. Intuitively, I am expecting that numerous factors capable of promoting sharp JPY appreciation will present themselves. In these circumstances, it may seem that only sticklers for comprehensive perspectives will feel a need to give much attention to the JPY depreciation risk factors.

U.S. economic deceleration during the latter half of 2019 has been expected to result from the progressive dissipation of the supportive effects of the Trump tax reductions. It clearly appears that the sharp unemployment rate decline to below 4% has been realized only with the assistance of government policy measures, and most observers would agree that such strong employment trends are unlikely to persist over the long term. However, the lagging indicator of wage levels may remain strong for the time being, and it is also likely to receive a boost from the Fed's shift toward dovishness. However, I think one must keep in mind that employment and wage figures are lagging indicators that do not immediately reflect the latest economic trends. From the perspective of USD/JPY forecasting, the key point is that it is unreasonable to expect the current situation to be conducive to a renewed rise in U.S. interest rates and USD accompanied by JPY depreciation. Based on the assumption of a peaking out of the global and U.S. economies, it seems safer to anticipate that JPY appreciation will strengthen amid the upcoming decline of U.S. interest rates and USD, and this is what this article has for some time been expecting to happen. This is not to mean to suggest that USD/JPY would be likely to make a dramatic shift down into the JPY95-90 range. If one calmly considers the relative likelihood of upward and downward movements in USD/JPY, I think drafting a forecast for the coming year is not so difficult.

EUR Outlook – ECB Officially Gives Up on Interest Rate Hike this Year

The Euro Area Fiscal Policies Now and Going Forward – President Draghi to Resign Without a Single Rate Hike During His Term

Two New Revisions: One as Expected, One as Surprising

At March ECB Governing Council meeting, it was decided to keep the interest rates on the main refinancing operations (MROs), the marginal lending facility (which is the ceiling of market interest rates), and the deposit facility (which is the floor of market interest rates) unchanged at 0.00%, 0.25%, and -0.40%, respectively, thereby also maintaining the interest rate corridor (the difference between the ceiling and the floor) unchanged at 0.65pp. On the other hand, there have been two major changes. The first is a revision of the forward guidance, while the second is the indication of the ECB's policy for the implementation of the third round of targeted longer-term refinancing operations (TLTRO-III). Regarding the forward guidance, a revision of the current guidance ("at least through the summer of 2019") was considered inevitable, as the commitment to retain low interest rates had been reduced to a mere formality. However, my first impression regarding the revised language of the forward guidance is that it involves a piecemeal extension. This could necessitate another revision in the language in the event of unforeseen developments. Meanwhile, the TLTRO-III implementation policy was quite surprising. Of course, taking into account that a considerable portion of TLTRO-II will be repaid in June 2020, TLTRO-III, which is designed to restore a favorable liquidity ratio within a year, would have to be implemented by June 2019. However, no particular advance notification had been given at the January Governing Council meeting, and ECB President Mario Draghi also stated that the larger part of the discussion at the January meeting had been devoted to revising the risk-balance assessment. It comes as too much of a surprise that the decision to implement TLTRO-III would suddenly be taken in a single step. (However, the Introductory Statement merely mentions the policy, while the precise terms have been put off for later. In this sense, perhaps the mention of the policy this time is intended as an "advance notification.") The markets have, naturally, responded by selling EUR, resulting in EUR hitting a low of 1.1177 against USD, the lowest in 21 months. At the press conference following the recent meeting, Mr. Draghi summarized the key points to give "a broad account" of the meeting in response to the first reporter's question. In other words, it would appear that the meeting necessitated that kind of explanation and was an important meeting ("a live meeting") from the ECB's perspective too. However, one remembers that as recently as in January, Mr. Draghi had said that the Bank was currently in "assessment mode" rather than "policy mode," suggesting that this was not the time for policy changes. It would appear that there was a significant change in attitude during the six weeks leading up to the March meeting.

Staff Projections Downgraded by Unusually Large Margins

In addition to the above two points, there was a third important point – the margin of change in the ECB Staff Macroeconomic Projections (see chart). It is rarely that such drastic downward revisions to projections are made in ordinary times. In that sense, the recent drastic revision may be providing a glimpse of the ECB's intent to suggest that "these are not ordinary times." Compared with the projections as of December 2018, the real GDP

	2019	2020	2021
HICP	0.9 ~ 1.5	0.8 ~ 2.2	0.8 ~ 2.4
(Previous : DEC 2018)	(1.1 ~ 2.1)	(0.9 ~ 2.5)	(0.9 ~ 2.7)
Real GDP	0.7 ~ 1.5	0.7 ~ 2.5	0.5 ~ 2.5
(Previous : DEC 2018)	(1.1 ~ 2.3)	(0.8 ~ 2.6)	(0.5 ~ 2.5)

(Source)ECB (Note) EURUSD is assumed to be 1.14 year 2019-2021

growth rate projections have been downgraded from +1.7% to +1.1% for 2019, from +1.7% to +1.6% for 2020, and retained at +1.5% for 2021. It is unusual for near-term GDP forecasts to be downgraded by as many as 0.6 pp within the space of three months. Considering that no particular crises have taken place during this period, perhaps it is merely that the ECB, which is supposed to be the organization most closely monitoring the economy of the euro area, has only just woken up to the extent of the economic slowdown of Germany and the rest of the euro area, which it had been underestimating thus far. (The simultaneously released OECD Economic Outlook offers an even weaker forecast of +1.0% growth.) Meanwhile, ECB staff projections related to the euro area Harmonized Index of Consumer Prices (HICP) were downgraded from +1.6% to +1.2% for 2019, from +1.7% to +1.5% for 2020, and from +1.8% to +1.6% for 2021. The significant, -0.4 pp downward revision of the HICP projections are in line with that of the GDP projections. As in the January Introductory Statement (following the meeting at which the risk balance assessment was downgraded), "the persistence of uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets" were cited as factors contributing to the region's economic stagnation. Note that the ECB's downgraded projection figures are even weaker than what was reported by the IMF's World Economic Outlook Update, January 2019. The IMF's projections for the euro area real GDP were +1.6% for 2019 and +1.7% for 2020. Perhaps it all boils down to the fact that, before it could declare an end to its policy normalization process and introduce a new liquidity provisioning policy (without advance notification), the ECB needed the backing of staff projections congruent with such a move.

Minor Change in the Forward Guidance Gives Impression of Being a Bad Move

However, speaking of the congruency of the staff projections, one cannot help feeling that the revision of the forward guidance was somewhat half-baked. Intuitively, one wonders “is it appropriate to suggest a rate hike within the year when a +1.2% HICP is projected for 2019?” Rate hike expectations factored into EONIA futures indicate no change in interest rates at least until spring 2020, so there was no reason to fixate on a forward guidance that was within the current year. In this context, the theory that “Mr. Draghi insisted on keeping it within the year in order to persuade Germany and other hawkish members of the ECB, in order to attain a unanimous decision” seems quite likely to be true. However, thinking about the future, it is a matter of concern that the new ECB president, who will take office on November 1, will find it difficult to handle this guidance. Greek and Portuguese elections are expected to be held by October, and it is difficult to tell where Brexit (the UK’s withdrawal from the EU) will be by then. Given the nature of policy operation, it is desirable to have fewer revisions to the forward guidance, so, rather than being particular about a three-month or so (September → December) extension, the ECB could have avoided concerns about the future by removing the calendar date and using a vaguer descriptor such as “for a while.”

In this context, one reporter asked, “On your forward guidance you kept the state-contingent part and the time-contingent part. Why have you kept the time-contingent part, because you also said it could be pushed further ahead and would it not give you more flexibility to just have the state-contingent part?” Mr. Draghi’s response to this was to the effect that, while a state-contingent forward guidance does provide greater flexibility, its vagueness takes away from its effectiveness. That is true, but the fact is that frequently revising the forward guidance is likely to be even more damaging to its effect. At any rate, having committed to keeping the low-interest-rate policy until December, Mr. Draghi, who steps down at the end of October, will have to leave office without having implemented a single rate hike. The Draghi presidency will have been dominated by crisis response right through to the end.

No “Rewards” Under TLTRO-III

Let us move on to TLTRO-III, the highlight of the recent meeting. At the press conference following the January meeting, Mr. Draghi said that “several speakers (had) mentioned a new TLTRO,” but nothing had been decided, as “we are still in the assessment mode and today’s meeting was about that, not so much the policy mode.” As of the time of the press conference, therefore, the possibility of a new TLTRO had merely been “mentioned.” The Account of the January meeting, which was published in February, showed that there had, in fact, been a somewhat earnest discussion of the matter, but noted that, “While any decisions in this respect should not be taken too hastily, the technical analyses required to prepare policy options for future liquidity operations needed to proceed swiftly.” The reason EUR was sold off following the recent meeting is likely to be because of the paucity of prior communications, which led the decision to come as a surprise. Incidentally, the precise terms of TLTRO-III have not been published as of the moment. Going by the line in the Introductory Statement, “Further details on the precise terms of TLTRO-III will be communicated in due course,” it seems that the details of the series will be considered going forward. What we know as of the present is that (1) the operations will start in September 2020 and end in March 2021, (2) each operation will have a maturity of two years, (3) the interest rate of these operations will be floating interest rates indexed to the interest rate on the main refinancing operations, and that (4) counterparties will be entitled to borrow up to 30% of the stock of eligible loans as at 28 February 2019. Going by these, under TLTRO-III, the reward offered under TLTRO-II, in the form of lower interest rates for banks that outperform their benchmarks in terms of lending, are not expected. As Mr. Draghi explained at the press conference, the objective of TLTRO-III is to respond to the tightening (Mr. Draghi calls this a “congestion”) of the funding climate for financial institutions in the euro area over the next two or three years. TLTRO-II was intended more as a subsidy for banks that were facing a deterioration in profitability due to the introduction of negative interest rates. So, perhaps the Bank sees no reason to provide any “rewards” for TLTRO-III, which will be implemented due to compulsions. Mr. Draghi also emphasized that “What (...) we wanted to achieve with the “T” (in the TLTRO, i.e., “targeted”) was to make sure to (...) make sure the banks borrow at a very good rate, but in order to lend to the economy and to firms and households in the private sector, not to buy sovereign bonds.”

In addition to the first repayments on the existing TLTRO-II, which are expected to take place in June 2020 (the larger part of the first operation, which amounted to close to EUR 400 billion, is still outstanding), the redemption of large amounts of bank bonds, and compliance with various regulations are also pointed out as factors contributing to the “congestion.” In this sense, analyses and reports that portray TLTRO-III as a monetary-easing or stimulatory measure are wrong. Although not widely reported, the ECB also decided at the recent meeting that it would continue its usual liquidity provisioning operations (unlimited access to liquidity at a fixed rate) until March 2021. TLTRO-III itself, a pseudo monetary-easing measure aimed at sorting out the funding climate for financial institutions, was brought up as a topic of discussion within the Governing Council even before the euro area economy began to decelerate.

Impact on Forex Markets

However, given that the ECB has so drastically downgraded its economic growth and inflation projections, centering on 2019, it may find it difficult to implement additional monetary easing in line with a revision in economic/financial understanding, unless there arises some unforeseen crisis. As a practical problem, the ECB does not even have that many options remaining, except the one significant move of restarting the expanded asset purchase programme (APP), and the Bank will have to exercise considerable caution in determining the right time to use this move. Of course, many expect the forward guidance to be extended yet again, but this is simply in imitation of market expectations, and I would like to believe that it will not trigger as much of a selling of EUR in the markets, as in the case of the recent announcement.

Under such circumstances, my view is that there is not much likelihood of the ECB giving the markets much reason to sell EUR in the foreseeable future. Meanwhile, as Mr. Draghi mentioned also in the press conference, there is expected to be a “waning effect of the fiscal package” of the Trump administration on the U.S. economy in 2019. Given that USD (both the currency and its interest rate) is head and shoulders above other world currencies, it is more likely to face correction pressures. It appears that there is a relatively large risk of an upward adjustment of EUR against USD.

The Euro Area Economy Now and Going Forward – Renewed Attention to the “Japanization of the Euro Area” Trend

Sell EUR on rally is recommended

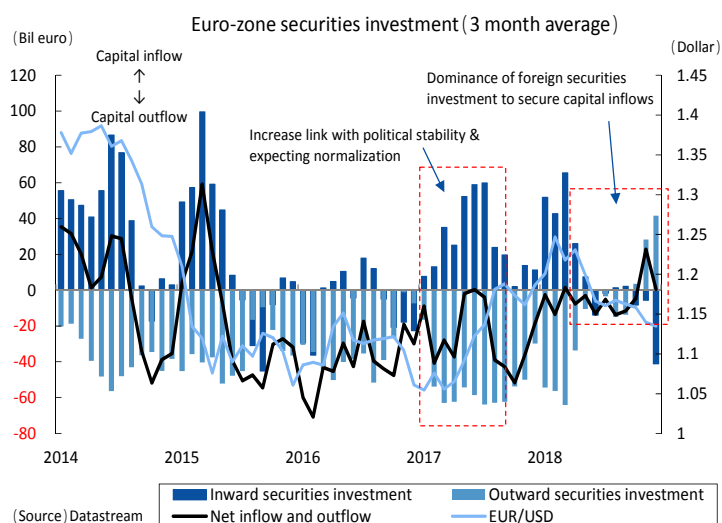
Since March, a growing number of people have become concerned that the euro area may become Japanized. Last week, Bloomberg published a story entitled “The Chorus Is Getting Louder: Euro Area Going the Way of Japan” in which it was reported that a large group of foreign financial institutions were starting to point to a “Japanization of the euro area” trend. In this regard, about five years ago, I published a book entitled *Ready for the Japanization of Eurozone, Euro and ECB* (July 2014, Toyo Keizai Inc.), which revealed the risks that the euro area may become Japanized in the future. In the light of this background and in response to the recent tone of argument, I have been asked about my opinion on this. In the above article, the facts that volatility of the EGB market has declined and the German bond yield has approached zero are introduced. This shows only a side effect of the Japanization of the economic and financial structures in the euro area, without explaining whether the euro area is actually experiencing Japanization. Such a phenomenon has also occurred in major countries outside the euro area. The real problem is to consider “Why is the market like this?” and to consider specific changes in the macroeconomic structure.

Seven common experiences in the euro area and Japan

If the euro area is Japanized, the EUR market are becoming like the JPY market, and the ECB like the BOJ, and some common experiences will inevitably emerge in the economic and financial situations of both sides. In this respect, I noted seven common experiences in my book. Specifically, “1) currency appreciation while experiencing economic recession”, “2) slowdown in bank lending”, “3) excessive private saving”, “4) accumulated current account surpluses”, “5) monetary policy = currency policy”, “6) population decline”, and “7) dis-inflation” can be listed as common experiences. While 3), 4), and 7) are progressing and 1), 5), 6) also largely reflect the situation, 2) seems not to be happening in the euro area. Concerning the demographic trend 6), which is expected, this is largely because of the situation in Germany. As is well known, Germany has actually mitigated its demographic decline by accepting more immigrants. However, this decision toppled the stronghold of the Merkel administration and fueled anti-EU sentiment in the region (Merkel’s decision to unrestrictedly accept refugees came about a year after the book was published). In particular, in the sense that the dis-inflation (or deflation), which is a symbol of Japanization, is intensifying, the progress of 7) is likely to attract attention. Indeed, the fact that inflation expectations, which are unlikely to recover easily, are subsiding is important. However, as we shall see later, I think the structural changes in the macroeconomy resulting from 3) excessive private saving” and 4) accumulated current account surpluses are crucial for us to understand the Japanization of the euro area. This will be discussed below.

Currency appreciation during recession: “EUR that will not decline” is alive and well

Regarding “1) currency appreciation while experiencing economic recession” I wrote in the book, “If the accumulation of current account surpluses and dis-inflation continue, the EUR will become a risk-averse currency, just like the JPY.” In this regard, many foreign exchange market participants may feel that “the EUR is not sold because of its miserable political and economic conditions,” even though the phrase “risk aversion to EUR” is not widely used in the foreign exchange market. In the current situation, there are plenty of negative factors for EUR, such as the rapid deterioration of sentiment in the euro area, the recession of the Italian economy, the rapid slowdown of the German economy, intensified demonstrations in France and worsening diplomatic relations between France and Italy. It was only in the last three months that the ECB became dovish as international organizations and other organizations repeatedly lowered their forecasts amid signs of a slowdown in the euro area economy, but the EUR/USD sell-off during that period was roughly flat at -0.3% (18 December 2018 – 18 March 2019). Needless to say, the world’s largest current account surplus is likely to be contributing to the increase in the value of currencies in terms of



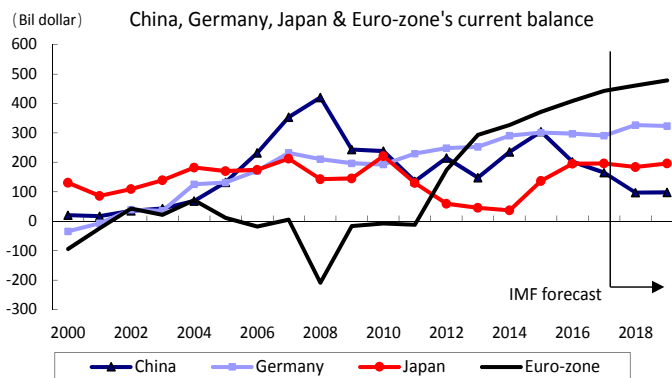
purchasing power parity. At the very least, the EUR clearly shares the conditions that led to the JPY being called a risk-averse currency.

The capital flow also suggests that the EUR is likely to appreciate. Looking at the trends in securities investment in the euro area in recent years, while inward securities investment (i.e. foreign investors buying securities in the euro area) has declined, net selling of outward securities investments (i.e. repatriation) has increased. This results in net inflows. It is intuitively obvious that capital flows are likely to turn to the EUR if they are avoiding taking risks outside the euro area while maintaining a large current account surplus.

Even though economic and financial conditions are not strong, capital flows will produce a strong currency. It is a fact that we Japanese know well.

The current account surplus in the euro area has increased by about 1.5 times over the past five years

I would like to focus on 3) excessive private saving and 4) accumulated current account surplus. The two are two sides of the same coin, but let's start with the latter. In 2013, the current account surplus was about USD290 billion, the highest level at the time of the publication of my book. In 2018, it became USD420 billion (x1.5 increase). Needless to say, this is the largest in the world, about 4 times the size of China (about USD97.5 billion in 2018). As a percentage of GDP, which is more important, the current account surplus increased from + 2.2% to + 3.0% of GDP. This contrasts with China's decline from + 1.5% to + 0.7% over the same period. The euro area's current account surplus was, of course, led by Germany, which increased its current account surplus (ratio to GDP) from + 6.7% in 2013 to + 8.1% in 2018. It is obvious that the main cause of global imbalances is the euro area, particularly Germany.



(Source) IMF "World Economic Outlook Oct, 2016"

"I do not think that the United States will overlook the policy management of a country with a huge current account surplus that seeks to lower the value of its currency through monetary easing," I wrote in the book. At the time of writing (July 2014), the tension had not reached that level, but depending on how Germany and the euro area react, trade friction between Europe and the U.S. could become an important topic. Although U.S.-EU trade negotiations have yet to begin in earnest, it is well known that trade relations between the United States and Europe are fragile. It is inevitable that themes such as the current account surplus and the exchange rate will get more attention. Frustrations over Germany's free ride on the weak euro have been heard since the inauguration of the Trump administration, and the foreign exchange market is expected to show keen attention.

Japanization of Macroeconomic Structure: Excessive Saving in the Private Sector

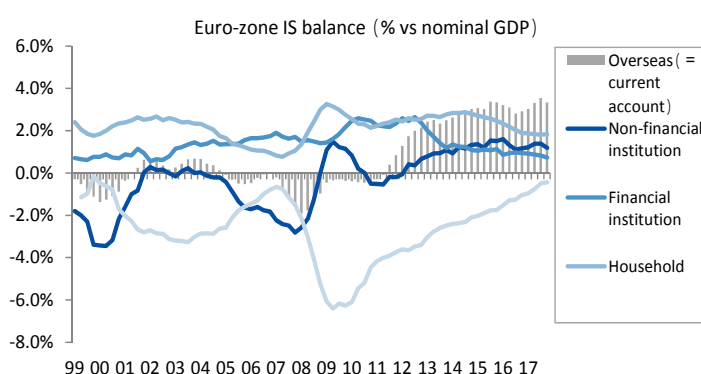
In theory, the current account surplus is also a result of the savings and investment balance (IS balance). The IS balance simply reflects the macroeconomic structure of the country or the region. In my book, I compared Japan and Europe, focusing on "excessive saving in the private sector signs deflation". Here's a long list of what I consider to be the most structural and important factors for the seven common experiences:

(Underlined portions are those deemed worthy of particularly strong emphasis.)

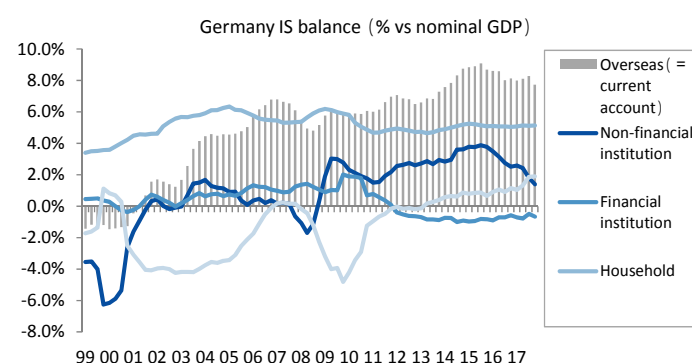
- Excessive private saving in Japan began in the early 1990s, shortly after the collapse of the bubble economy. More precisely, the household sector has always been over-saving since the 1980s, but since 1990, the household sector and the corporate sector, which had been under-saving, have also been over-saving. Before the collapse of the bubble economy, the corporate sector borrowed money from the savings of the household sector (through banks and other means) for vigorous consumption and investment activities. After the bubble economy burst, however, the corporate sector tried to restore its damaged balance sheet. It is no exaggeration to say that the non-adjustment of excessive savings in the private sector is a reflection of the real economy's lack of vitality, and together with price declines and the JPY appreciation, it is a symbol of a deflationary economy.
- Following the collapse of the bubble economy in 2007-2008 and the financial crisis, the phenomenon of excessive savings in the private sector has begun to be seen in the euro area. Since the introduction of the EUR in 1999, neither the household sector nor the corporate sector has experienced a surplus in savings. The serious problem in the euro area is that the government sector has to borrow money for consumption and investment while the private sector has a surplus of savings, but the government sector has joined hands to refrain from consumption and investment and has shifted to a surplus of savings. This is evidenced by the rapid decline in savings in the government sector since 2009. As long as households, businesses and the government do not actively consume and invest, the euro area economy as a whole will naturally suffer from excessive savings, resulting in current account surpluses. After the Japanese bubble burst in 1989 followed by the financial crisis in the 1990s, Japanese companies are said to have become reluctant to consume and invest by borrowing money. (This is evidenced by

the over-saving seen in the corporate sector.) Likewise, if we look at the IS balance in the euro area since the financial crisis, it seems that the same sign has come to light.

As shown in the figure on the chart, the IS balance of the euro area as a whole has further increased in excess savings since 2013. As a result of fiscal austerity, the government's savings deficit has rapidly narrowed. The aforementioned current account surplus only provides an interpretation for the fact that the private sector in the euro area is over-saving as a result of the balance sheet adjustment from the perspective of the overseas sector. Because there is no investment opportunity to stimulate private consumption and investment, money goes to the bond market, and interest rates can be stable at low levels. Low interest rates and low volatility of German government bonds are not simply referred to as Japanization. The ECB's quantitative easing (QE) is not called Japanization. This QE trend is also seen in other major countries. It is important to note that there is a corresponding change in the macroeconomic structure behind such trends, particularly in the IS balance, which is the cornerstone of dynamic resource allocation. The shape of the euro area's IS balance clearly changed before and after the crisis. Since 2013, Germany has had a peculiar structure in which oversaving occurred in all domestic economic sectors, including the government sector, but excess saving has continued for five year up until now (see chart). In this respect, I think it is an extraordinary situation that goes beyond Japanization. Japan has been able to take action by fiscal spending in the government sector, but Germany may have felt that it is unnecessary to do so partly because of the existence of a "perpetually undervalued currency". This is a natural result because the amount of fiscal expenditure is restricted by EU rules preferential to Germany, but the euro area is being forced to become German-oriented as well as Japanized.



(Source) Eurostat (Notes) Household including non-profit organizations Domestic & overseas balance are not always matched due to statistical error



(Source) Eurostat (Notes) Household including non profit organizations Domestic & overseas balance are not always matched due to statistical error

Monetary policy that becomes subordinate to exchange rates

As for 5) monetary policy = currency policy, it is also undeniable that currency policy will become a monetary policy. As described above, since the macroeconomic structure relies on the overseas economic sector (external demand), currency fluctuations are not favorable. In recent years, for example, 2017 was the year when the EUR appreciated across the board, with a maximum increase of 15% against the USD. At the ECB's annual meeting in June of that year, Mr. Draghi shrugged off price concerns, saying "deflationary pressures were replaced by inflationary pressures" and half-declared that the process would now begin. Later, at a press conference after a policy board meeting in September of the same year, Mr. Draghi said the topics at the meeting were summarized into three areas: growth, inflation, and the exchange rate, revealing that exchange rates were the main topic. "The recent appreciation of the EUR has clearly tightened the financial environment in the euro area" he said. It is rare for a central bank governor in a developed country to take such a clear stance on currency movements. The statement included the phrase "the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regime to its possible implications for the medium-term outlook for price stability" indicating that the strong euro is an issue that cannot be overlooked. Euro area economy stalled significantly, with some countries experiencing recession. Net exports are the main reason for slowdown in economic growth. The fact that EUR appreciated in 2017 is not irrelevant to the slowdown of the euro area economy in 2018. The ECB, which must stabilize economic and financial conditions in the euro area, will remain more sensitive to EUR developments in the euro area. Although monetary policy is not yet as dependent on the exchange rate as the BOJ, it is inevitable that monetary policy will have to be carried out with an eye toward the exchange rate under a growth style in which external demand (exports) is a lifeline of the euro area.

Symbol of Japanization “dis-inflation/deflation”

For many foreign market participants, “Japanization (Japanification)” and “the state of not having prices rising (dis-inflation)” or “a decline in prices (deflation)” are synonymous. In this regard, the euro area consumer price index has clearly stalled since the debt crisis, and the aggregated average CPI of the past five years remained flat at about + 0.8%, and on a core basis at about + 0.9%. Considering that in the five years before the European debt crisis, the inflation rate was approximately + 2.4% and approximately + 1.7%, respectively, dis-inflation is certainly progressing, if not deflation. Also, as an inflation expectation, developments in the 5-year break-even forward rate (5y5y BEI), which the ECB has traditionally been monitoring, should not be overlooked. In my book, I have stated “If the 5-year BEI falls below 2% clearly, Mr. Draghi’s words may sound a bit more deflationary.” Since July 2014, 5y5y BEI has not yet returned to the 2% level. Based on Japan’s experience, deflation is very sticky, and there is no prospect of a return.

“What will happen beyond Japanization?”

The above is only a simple selection and confirmation of the important parts of my book from five years ago. The discussion is more extensive. Again, lowering interest rates or losing volatility in bond markets itself is not “Japanization”. This is only a result of the establishment of a macroeconomic environment characterized by low prices due to low economic growth and a social situation in which consumption and investment are curtailed mainly by the private sector. It is important to grasp such social conditions by some kind of data, and I believe that IS balance is the essence of structural change. At the very least, the fact that the EUR is a “perpetual undervalued currency” for Germany and that the European Union controls fiscal spending as a rule have been an endless discussion in the euro area. (It may be called a chronic disease.) However, this issue has led to huge current account surpluses and excessive savings in the private sector, leading to troubling events such as currency appreciation and dis-inflation. Over the next five years, those issues will not be resolved, and the euro area’s Japanization trend will continue. Japan’s trade balance is no longer a breadwinner, partly because of the “Current account surplus (trade surplus) to JPY appreciation” mechanism. But in the euro area, these mechanisms don’t work. Under the current system, the EUR will never rise to a level of strength commensurate with Germany. In this sense, the fact that there is room for “What will happen beyond Japanization?” seems to hint at an advanced understanding of the Japanization of the euro area. It is an issue that will require a considerable amount of paper, and I would like to make my future research subject.

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