

Forex Medium-Term Outlook

31 May 2019

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Forex Department

【Contents】

Overview of Outlook P. 2

USD/JPY Outlook – Speculative USD Buying is at Dangerous Levels

JPY Supply and Demand Climate – Courage Required to Buy USD Going Forward P. 3

U.S. Currency Policies Now and Going Forward – Takeaways from the Foreign Exchange Policies Report P. 5

U.S. Economic and Financial Situation Now and Going Forward - Is it Right to Declare Trump's Remarks "Inappropriate"? P. 7

Japan's Economic and Financial Situation Now and Going Forward – Consumption Tax Hike Developments Unlikely to Affect Forex Rates P. 9

Risks to My Main Scenario Recoveries in China and Europe are the Key Point P. 10

EUR Outlook Diminishing Confidence in the Baseline Scenario

The Euro Area Economy Now and Going Forward – Tired of Hearing "Temporary" P. 13

Overview of Outlook

USD/JPY weakened in May. The U.S., and consequently global, economic slowdown has begun to clearly affect the Fed's policy operation, and U.S. interest rates have also been steadily declining in line with this. The present situation, with the noise of the U.S.-China trade war and Brexit weighing down on an economy that has already matured, is enough to give a sense of declining interest rates going forward. Such a scenario is in line with what I have been expecting over the past two years. However, USD selling remains limited when considered in light of this significant narrowing of the U.S.-Japan interest rate gap. Several reasons for this can be considered, including a change in the JPY supply-demand structure (please see last month's issue of this report for details), but perhaps the simplest explanation is that the absolute value of U.S. interest rates is still high. Taking into account the miserable JPY and EUR investment climates, one has to conclude that, despite the decline in U.S. interest rates since last year, investors still find USD-denominated assets to be attractive investment options (or rather, they have few other options). However, if the current trend continues, there will naturally be a stronger move to sell USD. It is rather difficult to predict USD appreciation going forward even as some analysts predict that U.S. interest rates will fall below 2%. Taking into account the various political and economic factors, it seems wise to assume that USD/JPY risks are spreading on the down side.

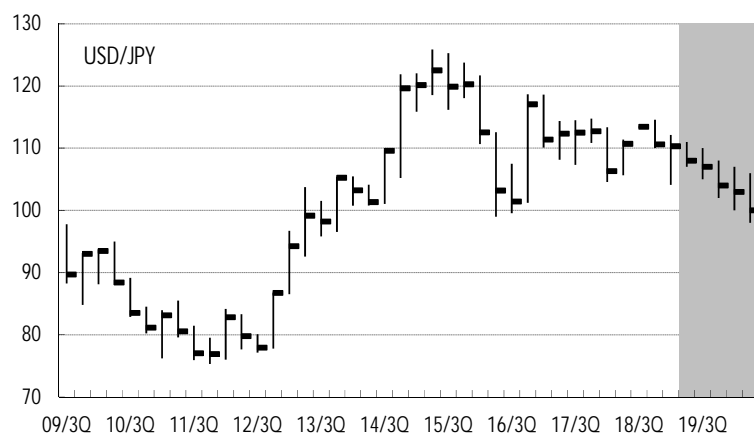
EUR remains same level. The climate remains unconducive to buying EUR, with both uncertainties over Brexit negotiations and the deterioration of economic indicators continuing. The outlook for a rate hike by the ECB has also receded, with markets anticipating the first one only in the fall of 2021. Going by the most recent discussions of the ECB Governing Council, there also seem some doubts whether the current economic slowdown is really only temporary, and confidence in the current basic scenario seems to be faltering. With regard to German exports, where the slowdown is especially conspicuous, it is no longer considered to be just owing to technical factors (delay in auto manufacturing caused by the need to comply with new exhaust standards) as had been assumed at first. The economic slowdown in emerging economies led by China is now seen as one of the factors, and even the ECB seems skeptical about exports recovering to drive economic growth any time soon. In terms of the forex outlook, however, taking into account that there is a buildup of a EUR speculative short position, that U.S. interest rates are on the decline, and that the euro area has the world's largest current account surplus, this report's basic forecast scenario for EUR/USD during the current forecasting period is a strengthening of EUR as USD's strength wanes.

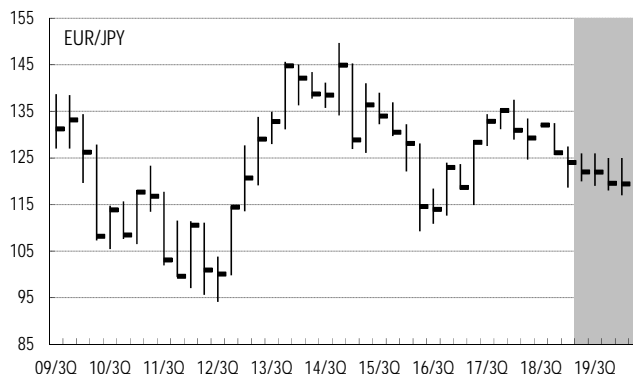
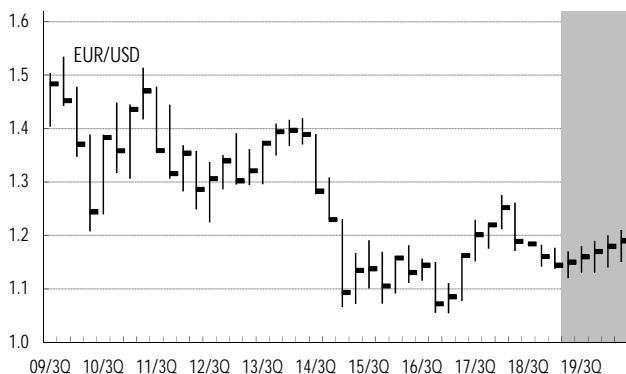
Summary Table of Forecasts

	2019				2020	
	Jan -May (actual)	Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	104.10 ~ 112.40 (109.27)	107 ~ 111 (108)	105 ~ 110 (107)	102 ~ 108 (104)	100 ~ 107 (103)	98 ~ 106 (100)
EUR/USD	1.1106 ~ 1.1570 (1.1135)	1.10 ~ 1.15 (1.13)	1.11 ~ 1.16 (1.14)	1.11 ~ 1.17 (1.15)	1.12 ~ 1.18 (1.16)	1.13 ~ 1.19 (1.17)
EUR/JPY	117.85 ~ 127.50 (121.65)	120 ~ 126 (122)	119 ~ 126 (122)	118 ~ 125 (120)	117 ~ 125 (119)	116 ~ 125 (117)

(Notes) 1. Actual results released around 10 am TKY time on 31May 2019. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts



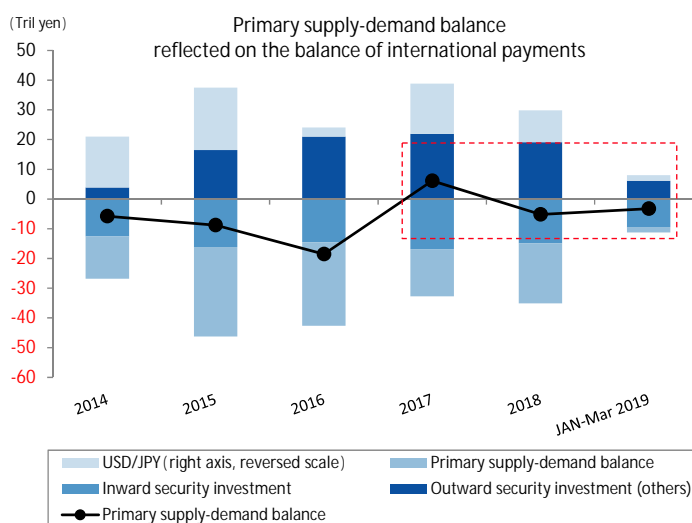


USD/JPY Outlook – Speculative USD Buying is at Dangerous Levels

JPY Supply and Demand Climate – Courage Required to Buy USD Going Forward

Could JPY Supply-Demand be Tilted Toward JPY Selling in Reality?

In May, Japan's March Balance of Payments was published. This revealed the current account surplus for FY 2018, which drew attention for being smaller year-on-year for the first time in five years. The forex markets are likely to be interested in this development from the perspective of a change in the supply-demand climate, but as the figure shows, the January-March quarter supply-demand balance (which I pay attention to in this report) has not tilted much one way or the other. Specifically, the January-March quarter supply-demand balance posted a net JPY selling at -JPY 3.2 trillion, but when you look at the trend (-JPY 2.4 trillion for the July-September quarter last year, +JPY 4.8 trillion for the October-December quarter last year), there is no clear sense of direction. This situation has been continuing since 2017 at the annual level and is considered one of the reasons for the low volatility of JPY. More precisely, as I have discussed in a past issue of this report as well¹, Japan's current account surplus is essentially synonymous with its primary income surplus, the larger part of which is a "surplus that is devoid of JPY buying," i.e., from which no JPY conversion can be expected. This being the case, perhaps the current on-the-whole balanced JPY supply and demand (albeit somewhat tilted toward JPY selling) is, in reality, exerting strong JPY selling pressure. And there is also the possibility that this is acting as a bulwark against JPY appreciation during risk-off phases.

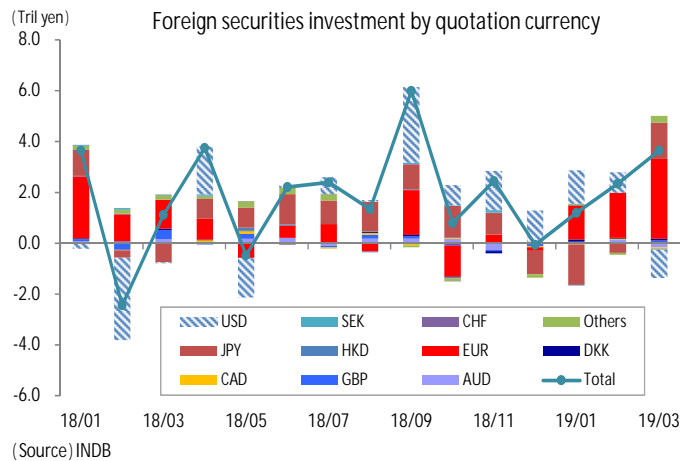


(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government

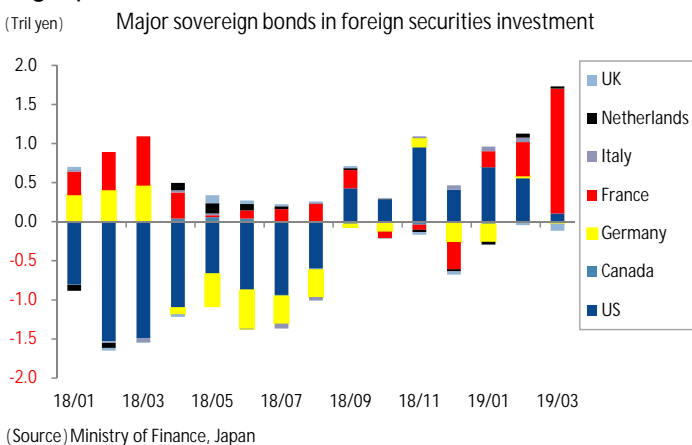
¹ Please see the April 2, 2019 issue of Market Topic titled "Change in Current Account Structure Hampering JPY Strength."

Largest Ever Net Buying of EUR-Denominated Securities in March

Taking into account the current difficult investment climate with regard to foreign securities investment trends, which often determine JPY supply-demand trends, it seems likely that net buying will essentially continue. However, because the ECB's policies are steadily turning more dovish, one should not bank too much on the robustness of this trend. Looking at the current state of foreign securities investment, USD-denominated securities posted a net selling for the first time in 10 months in March. March was when the U.S. 10-year interest rate plunged from the 2.70% to 2.30% level. The FOMC statement economic assessment as well as Policy Board members' interest rate projections (the dot plot) were downgraded significantly, and the decision was made to slow down balance sheet normalization efforts starting May and cease them altogether at the end of September. It was in March, therefore, that the Fed threw in the towel on its normalization process both officially and in practice. Following this, the U.S. 10-year interest rate dropped to the 2.60% level at one point in April, but slumped further to the 2.30% level early in May. As I have discussed previously in this report, the reason speculators and other investors maintain robust appetites for USD despite declining U.S. interest rates is because the rates are still high in absolute terms, but if the current trend intensifies, investors will be forced away from investing in USD-denominated securities (net selling). In March, I believe we were offered a glimpse of the start of such a trend.



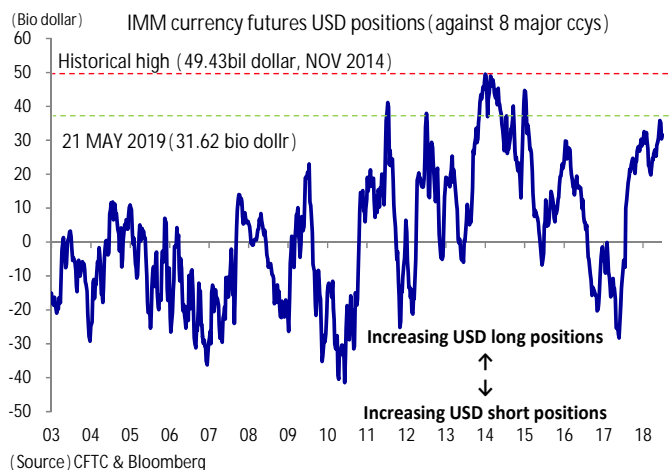
Meanwhile, EUR-denominated securities investment was conspicuously large, posting its largest ever net buying in March at +JPY 3.1 trillion. French securities led the trend, with Japanese investment in French government bonds posting their highest ever at +JPY 1.6 trillion in March (see figure). One often hears that French government bonds are promising investment options for Japanese investors in the current difficult investment climate, thanks to their strong rating, interest rate level, and liquidity, and for the January-March quarter, net buying of French government bonds amounted to a total of +JPY 2.2 trillion, which was much larger than the net buying of U.S. Treasury securities for the same period (+JPY 1.3 trillion).



However, concerns over Italy's fiscal discipline have begun to smolder again (because Deputy Prime Minister Matteo Salvini hinted at the possibility of fiscal expansion breaking EU fiscal rules), so it is unclear whether investors will continue to take euro area sovereign risks. If the investment climate deteriorates for both USD and EUR, Japanese investors will increasingly find themselves with nothing to invest in. In this report, I formulate my forex outlooks based on the assumption that the JPY supply-demand balance will tilt on the whole toward JPY buying as foreign securities investment continues to shrink.

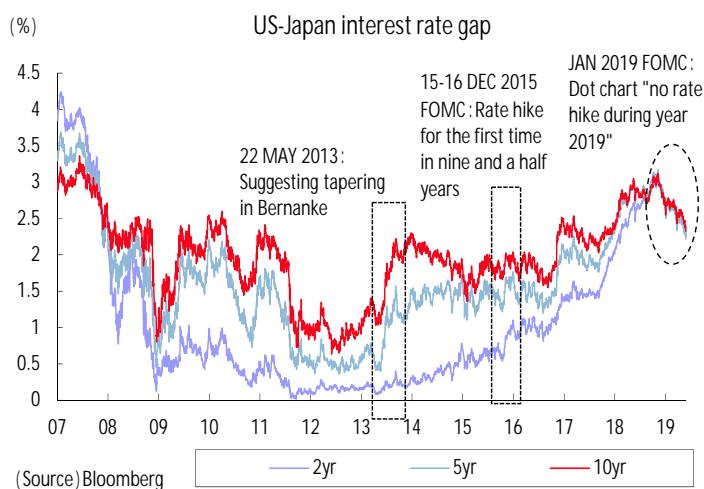
Speculative USD Buying Without Sufficient Reason

Meanwhile, as opposed to real demand, what are the speculative trends like? Speculative positions, as confirmed from IMM currency futures transactions, show a historically high buildup of the USD long position. For instance, (compared with the positions of eight other major currencies) the USD speculative position from end of April through early May was approximately USD 35 billion, the largest seen since December 2015 (see figure). Although the position has declined somewhat as of the writing of this report, it remains quite high at around USD 31.6 billion (for May 21). Incidentally, the largest ever posted was USD 49.43 billion, which was recorded during the week of November 25, 2014. Looking back at that time, the timing seems symbolic, in that the Fed had begun tapering its quantitative easing (QE) from January of that year and finished the process around October (given that USD underwent sustained appreciation following this, the speculative USD buying of that time can be said to have been successful). Again, over the past five years, a similar level of USD buying as the current was



seen in May 2013 and December 2015. The former was when former Fed Chair Ben Bernanke declared the Fed's intent to taper in his Congressional testimony (the so-called "Bernanke Shock"). The latter was when the Fed raised interest rates for the first time in nine and a half years. In other words, during the other times in the past five years when USD buying surged to current levels, there were good reasons for it

During those phases, U.S. interest rates were increasing and the gap between U.S. and Japanese interest rates, for instance, was expanding (see portion within dotted square in the figure). This time round, however, speculative USD buying has been robust despite the clear decline in U.S. interest rates since early this year (see portion within dotted circle in the figure). It is thought that this state of affairs is due to the fact that the absolute value of U.S. interest rates is still quite high, and sure enough, the interest rate gap is wider at present than it was either in May 2013 or in December 2015. However, the confusion over U.S.-China trade talks could be the trigger for the long-due correction in USD when seen in light of the interest rates. At the very least, it seems clear that the situation is becoming less conducive to an expansion in USD buying, leaving aside the question of the extent to which USD adjustment against JPY will take place.



At any rate, given that this is a speculative position, a reversal is inevitable, and one should be aware that, with this, the ammunition for boosting JPY strength is being loaded. Now it just remains to see what will be the trigger – will it be U.S.-China trade talks, the Fed's switching to a more dovish stance, or a missile test by North Korea? I know I repeat myself, but USD is being propped up by the fact that the absolute level of USD interest rates is still higher than other currencies. That being the case, the main trigger seems likely to be the Fed's switching to a more dovish stance (specifically, a stronger prospect of it cutting rates), and as is widely known, this is something U.S. President Donald Trump strongly desires. Based on this understanding of the situation, it seems fairly risky to bet on a further strengthening of USD, even though the USD-JPY stalemate seems to have become semi-normalized.

U.S. Currency Policies Now and Going Forward – Takeaways from the Foreign Exchange Policies Report

China Treatment Stands Out Even from Space Devoted

The U.S. Department of the Treasury released the latest Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States on May 28. The publication of this issue was delayed by a month and a half from the originally scheduled April 15 date. Once again, no country was named "currency manipulator," but the Monitoring List, while including the usual suspects China, Japan, South Korea, and Germany, no longer includes India and Switzerland. Their place has been taken by Ireland, Italy, Vietnam, Singapore, and Malaysia, bringing the total number of countries on the list from six to nine (see table on next page). Countries on the list do not face specific sanctions but will be continuously watched over the next six months. China, Japan, South Korea and Germany have been on this list ever since it was established in April 2016, so it is not a coincidence that U.S. trade negotiations with these countries are often in the news. The idea that a "U.S. trade deficit is bad" has become a fixed evaluation criterion for the Trump administration, which tends to change its policies time and again.

For a country to be put on the Monitoring List, it must meet at least two out of the following three criteria – (1) a bilateral trade surplus with the U.S. (worth at least USD 20 billion a year), (2) a current account surplus (at least 2% of GDP – *this was previously 3%), and (3) persistent and one-sided intervention involving the purchase of foreign currency (at least 2% of GDP in at least six out of the previous 12 months – *this was previously eight out of 12 months). If a country meets all three criteria, it will be declared a currency manipulator. China only meets the first, but it has been on the List because it "accounts for a large and disproportionate share of the overall U.S. trade deficit," in a decision that underscores the Trump administration currency and trade policy evaluation standard that an "excessive trade surplus is bad." This is also revealed by the order in which countries are listed in the chart titled "Major Foreign Trading Partners Evaluation Criteria" toward the end of the report. That order is based not on whether they meet the criteria for being put on the Monitoring List, but essentially based on the size of their trade surplus with the U.S.

Further, the report's treatment of China has clearly become more severe in comparison to the previous issue of this report (released in October 2018), as indicated by the separate section on "Treasury Conclusions Related to China" within the Executive Summary. In the April 2018 issue of the report, the "Treasury Assessments of Major Trading Partners" section provided a general assessment, but this section was changed to "Treasury Conclusions Related to Other Major Trading Partners" in October, making a clear distinction between "China" and "Other" trading partners. The change has been retained in the recent-most report. Looking at the country-wise assessments, the space devoted to China is significantly longer at 3 pages when compared to, say, the 1.5 pages devoted to Japan, or the 2 pages devoted to Germany including the euro area. The more intense problem awareness when it comes to China is obvious even from the space devoted to it. However, as I repeatedly say in this report, if we focus only on the current account balance, China's service (more specifically travel) deficit eats into its trade surplus, leaving it in no position to be blamed for "external imbalances." Further, most of China's trade surplus is with the U.S., with the imbalance not being so conspicuous with regard to its other trading partners. Consequently, given the full context of China's external economics, it is not surprising that CNY would be weak. However, it is easy for the Trump administration, which cannot think of the situation except through the lens of the U.S.-China bilateral relationship, to reach the conclusion that it is despicable for CNY to be weak despite the trade surplus. This makes for a complicated situation overall.

Monitoring list 3 conditions (Highlighted countries are on the monitoring list as of MAY 2019)

	Trade surplus vis-à-vis the U.S. (Bil dollar)	Current balance			Buying USD & selling own ccy intervention
		vs GDP (%)	Change in last 3 yrs (% pts)	Amount (Bil dollar)	vs GDP
China	419	0.4%	-2.4%	49	-0.2%
Mexico	82	-1.8%	0.8%	-22	0.0%
Germany	68	7.4%	-1.1%	298	-
Japan	68	3.5%	0.4%	176	0.0%
Ireland	47	9.2%	4.8%	35	-
Vietnam	40	5.4%	3.0%	12	1.7%
Italy	32	2.5%	1.2%	52	-
Malaysia	27	2.1%	-0.9%	8	-3.1%
India	21	-2.4%	-1.3%	-65	-1.7%
Canada	20	-2.7%	0.9%	-45	0.0%
Thailand	19	7.0%	-1.0%	35	0.0%
Switzerland	19	10.2%	-1.0%	72	0.3%
S.Korea	18	4.7%	-2.9%	76	-0.2%
France	16	-0.3%	0.1%	-9	-
Taiwan	16	12.2%	-1.7%	72	0.4%
UK	-5	-3.8%	1.1%	-109	0.0%
Singapore	-6	17.9%	0.7%	65	4.6%
Brazil	-8	-0.8%	2.2%	-15	-2.6%
Belgium	-14	-1.3%	-0.3%	-7	-
Netherlands	-25	10.8%	4.3%	99	-
HK	-31	4.3%	1.0%	16	-1.4%
Euro-zone	143	2.9%	0.2%	398	0.0%

(Source) U.S. Ministry of Finance (Notes) Trade surplus vis-à-vis the U.S., current balance & intervention amount counting from DEC 2018 for a year. Vietnam: Current balance data is up to JUN 2018

Euro Area Current Account Surplus Not Amusing to the Trump Administration

With the inclusion of Italy and Ireland in the Monitoring List, three out of the nine countries on the List are EU member states. Both Italy and Ireland were put on the list because they meet criteria (1) and (2). At the present time, Ireland is the fifth largest country in the world in terms of the size of its trade surplus with the U.S., and Italy is the seventh largest. As for current account balance (as a percentage of GDP), Ireland has +9.2% while Italy has +2.5% (all the figures pertain to the four quarterly periods through October-December 2018). These two countries have come under the radar this time, but the fact is that the euro area as a whole tends to post a current account surplus.

Intuitively, it is easy to assume that the euro area current account surplus is more or less equivalent to the German current account surplus. In fact, the current issue of the report points out that the region's external imbalances could be reduced by using the German "fiscal space" to expand domestic demand and, thereby, imports. However, over the past ten years, the number of surplus countries in the euro area has grown from eight to 12, so one cannot lay all the onus on Germany. In particular, there has been a marked improvement in the current account balances

Changes in Euro-zone current balance (% , vs GDP)

	2009 ()	2018 ()	- (% pts)
Malta	-6.6	10.1	16.6
Ireland	-4.7	10.0	14.6
Netherlands	5.7	9.9	4.1
Germany	5.7	7.4	1.6
Slovenia	-0.6	6.5	7.1
Luxembourg	7.2	5.2	-2.0
Italy	-1.9	2.6	4.5
Austria	2.6	2.3	-0.3
Estonia	2.5	1.7	-0.8
Lithuania	1.4	1.4	-0.1
Spain	-4.3	0.8	5.1
Belgium	-1.1	0.4	1.5
Finland	1.6	-0.5	-2.1
Portugal	-10.4	-0.6	9.8
France	-0.6	-0.7	-0.2
Latvia	7.8	-1.0	-8.7
Slovakia	-3.4	-2.0	1.5
Greece	-10.9	-3.4	7.5
Cyprus	-7.7	-5.6	2.0
Euro-zone (FYG)	0.2	2.9	2.7
Current account surplus countries	8	12	-
Average current account surplus(% , GDP)	4.3	4.8	-

(Source) IMF (Note) Colored rows were called PIIGS, former heavy debt countries

of all the PIIGS states (the colored rows in the table), which caused the European sovereign debt crisis through their heavy indebtedness. Most of them are now posting surpluses, with Greece being the only one that continues to post a clear deficit (albeit significantly improved). If the euro area's current account surplus as a percentage of GDP has been boosted by as much as 2.7 pp over the past 10 years, it is not just because of the expansion of the German surplus, but also due to the weaker member states (the external economies of which had once been considered problematic) posting surpluses. Of course, the current account surpluses are partly due to the savings-investment balance resulting from the euro area's unique austerity bias, and do not necessarily indicate the strength of the regional economy. For instance, one of the reasons for the improvement in Italy's current account surplus is the shrinking of its income deficit as a result of a reduction in its external debts. Meanwhile, Ireland is praised all around for a simple improvement in its competitiveness as a result of low corporate taxes and a flexible employment market, but it has mainly achieved growth as a result of successfully luring in foreign companies. The problem, however, is that there has only been limited improvement in the living standards of Irish residents. However, regardless of the background or circumstances, the Trump administration, which considers excessive surpluses in other countries to be bad, is bound to find the situation unamusing.

Basic Understanding that "USD is Overvalued"?

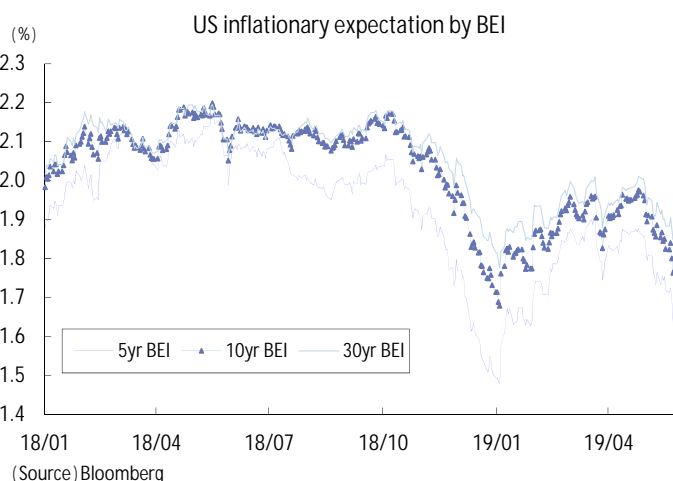
The section titled "Foreign Exchange Markets" expressed sentiments that can be interpreted as concern regarding the strength of USD. The section begins by noting that "The U.S. dollar appreciated 5.0 percent on a nominal effective basis over 2018, retracing most of its decline over 2017." The overall gist of the section seems to be that USD trends by and large reflect the relative strength of the U.S. economy (and the Fed's austerity path as a result of this). It also states, however, that "of concern (is the fact that) the dollar has strengthened at a time when the IMF judges that the dollar is overvalued on a real effective basis," indicating no perception that the present strength of USD may be fair. The report goes on to mention that "over 2018, the dollar appreciated by 4.5 percent in real effective terms to stand 8 percent above its 20-year average," and reason that "sustained dollar strength would likely exacerbate persistent trade and current account imbalances," indirectly suggesting that USD strength needs to be corrected.

Incidentally, this section presents currencies that are "undervalued despite current account surpluses" and those that are "overvalued despite current account deficits" as per IMF estimates, with Germany (EUR) leading the former and the U.S. (USD) leading the latter. JPY is also in the former group, but is also mentioned as "the only outlier among major currencies to appreciate () against the dollar in 2018" and appears not to be incurring that much antipathy. Incidentally, with regard to CNY, the impression is that it is "by and large neutral ~ somewhat undervalued," which poses a discrepancy compared with what the Trump administration would like to assert, but there is no particular mention of this analysis by the IMF in the report. At any rate, it is clear that the U.S. Treasury Department's basic understanding is that USD is overvalued, which is important information to take into consideration when attempting to understand U.S. currency and monetary policies.

U.S. Economic and Financial Situation Now and Going Forward - Is it Right to Declare Trump's Remarks "Inappropriate"?

Should Trump's Remarks be Declared "Inappropriate"?

In the financial markets, there is no question that the confusion surrounding the ongoing U.S.-China trade talks is a trigger, but I would like to turn my eye to a more fundamental problem. The forex markets have also begun to factor in the idea that the Fed's next move will not be a "resumption of rate hikes" but rather the "start of rate cuts," whether or not this next move takes place within the year. Since mid-last year, U.S. President Donald Trump has verbally intervened in the Fed's normalization process now and again, and there is even an impression that his interventions have gradually become more direct and specific. Recently, during the 10-day long Golden Week break in Japan, he tweeted "We have the potential to go up like a rocket if we did some lowering of rates, like one point, and some quantitative easing." It appears that what Mr. Trump, as President, would like the Fed to do in the near future is to cut rates and resume quantitative easing (QE). However, one wonders if this remark should be declared "inappropriate" as usual.



Of course, I have no intention of interjecting a major objection to the basic understanding that the "independence of the central bank is sacred and inviolable." However, perhaps we may learn something if we dared inquire into this assumption, which is generally taken for granted. In the first place, the reason why the independence of the central bank is important is because, if political intervention in the functioning of the central bank were allowed, it may result in self-serving monetary easing by the government in power, causing runaway inflation. To put it very roughly, the idea of the central bank's

independence is rooted in a desire to prevent and/or guard against inflation. At the present time, however, inflation rates remain suppressed around the world, and the problem rather the lack of inflation. The U.S. is no exception to this. The figure (top) shows the market-based (5-year, 10-year, and 30-year) inflation expectation trends, and all three show a clear decline starting last fall, when the Fed began to soften its policy stance. There have been no definite signs of recovery since the beginning of this year either, when share prices began to recover. Wages, the consumer price index (CPI), the personal consumption expenditure (PCE) deflator, and other general price indicators are also lackluster as is widely known

Persisting with Policy Normalization has Complicated the Situation

Let us return to the subject of President Trump's encouragement of monetary easing. If the textbooks were right, this kind of overt verbal intervention in a country's monetary policy by its head of state would trigger a negative chain of events: implementation of inappropriate monetary easing → overheating of the economy → strong rise in inflation → rise in interest rates. However, in reality, President Trump's verbal interventions mostly seem to trigger a fall in U.S. interest rates and selling of USD. If it were true that there were latent inflation concerns in the U.S. economy, and that President Trump's prompting of monetary easing was inappropriate, both inflation expectations and U.S. interest rates would rise and USD would depreciate due to a loss of confidence in the currency. True, USD does depreciate when President Trump intervenes, but there is a difference between "being sold in response to the fall in U.S. interest rates" and "being sold as a result of the loss of confidence in the currency." Ultimately, the fact that interest rates decline (U.S. share prices rise) despite this extent of verbal intervention from the president and inflation expectations remain as low as ever means that there are no inflation concerns to begin with. In other words, it is time to realize that the present situation does not justify rate hikes. One gets the impression that President Trump has proven the correctness of his assertions through his words and actions, whether they are appropriate or not.

President Trump has been publicly airing his grievances regarding the Fed's normalization process since summer last year. For instance, in response to the Fed raising rates, he said on July 22, "I'm not thrilled," and expressed concern over the possibility of further rate hikes. Despite this, the Fed quietly continued to raise rates in September and December. This resulted in rumors in December about the possible dismissal of Fed Chair Jerome Powell. Needless to say, the idea of the head of state holding the key to the fate of the governor of the central bank is quite dangerous, but it is not as though inflation expectations increased during phases of rate hikes by the Fed. Average wages and general prices were also quite subdued. From the perspective of a forward-looking policy operation, my basic understanding is that the Fed had many opportunities to reconsider its normalization process even before President Trump's interventions. Having put it off for this long, though, it seems that the Fed has made it difficult for itself to become more dovish (i.e., to follow a path to cutting rates), because that would seem like bowing down to political pressure. Though no more than hindsight-based reasoning, the Fed's obstinacy in persisting with its normalization process seems to have complicated the situation.

"Independence of the Central Bank Under Disinflation" vs. "Independence of the Central Bank During Periods of Inflation Concerns"

As of the writing of this report, the interest rate futures market puts the probability of a rate cut within the year at over 70%. It is difficult to imagine that such speculation would be strong in the spot trade-based forex market, but as the idea that the Fed's next move is more likely to be "the start of rate cuts" than "the resumption of rate hikes" becomes more real, it would appear that it is becoming more and more difficult to maintain speculative USD long positions, as I discussed above. To repeat, I think there ought to be an appropriate distance between the head of state (the government) and the central bank. However, it may be worth considering that the argument may change slightly when we consider the "independence of the central bank under disinflation" versus the "independence of the central bank during periods of inflation concerns." At the very least, that is my impression based on market responses to the series of remarks by President Trump.

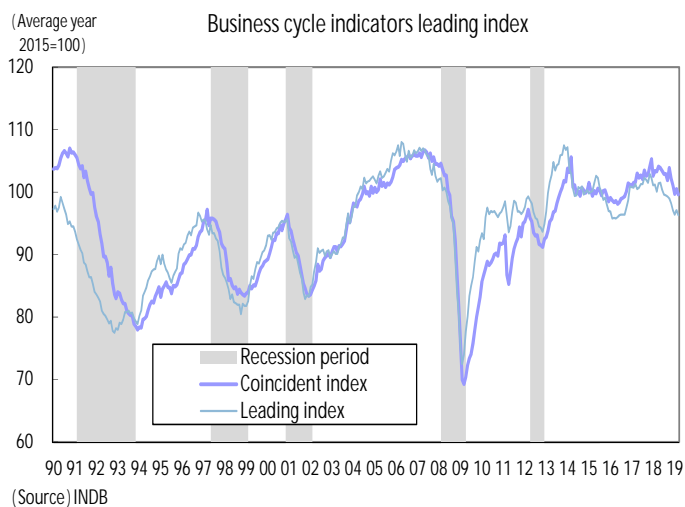
In the wake of the financial crisis, ideas such as deficit financing, helicopter money, the fiscal theory of the price level (FTPL, aka Sims Theory), and, recently, modern monetary theory (MMT) – ideas that would have been dismissed as taboo earlier – have begun to gain currency. This is probably proof that the traditional approach to monetary policy is nearing a bend in the road. It occurred to me that President Trump's "inappropriate remarks" held such surprisingly though-provoking aspects.

Japan's Economic and Financial Situation Now and Going Forward – Consumption Tax Hike Developments Unlikely to Affect Forex Rates

“Worsening” for First Time in Six Years and Two Months

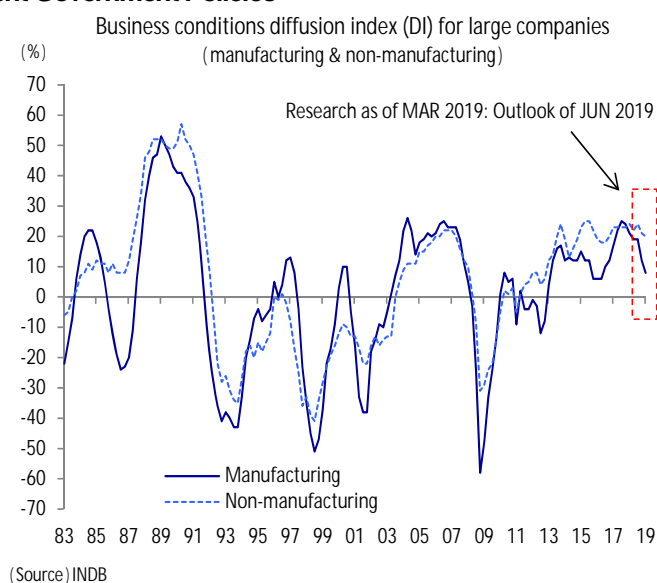
The global economy, centering on the U.S. and Chinese economies, seems to be passing through a phase of turbulence, but in Japan, the March Business Cycle Indicators Leading Index (released on May 13) drew attention due to the Cabinet Office economic assessment based on the deterioration of this index being downgraded to “worsening” for the first time in six years and two months, since January 2013. An assessment of “worsening” is one step below the assessment “signaling a possible turning point,” which was used in January and February this year. The assessment “signaling a possible turning point” indicates a high likelihood that the economic peak, seen retrospectively, came a few months previously. The criteria for an assessment of “worsening” are “a negative seven-month moving average (mom), with a negative margin (cumulative for one, two, or three months) of at least 1 standard deviation” and “a negative mom result for the month in question.”

Given that the assessment was changed to “worsening” this time, there will be doubts regarding whether the current phase, which was described as the “longest post-war phase of economic expansion” (74 months long) in the Monthly Economic Report published in January this year, was indeed the longest. The assessment of “worsening,” used from this time onward, indicates a high probability of economic recession, the criteria for which includes, as a rule, “a decline in the three-month moving average for at least three months in a row” and “a negative mom result for the month in question.” The three-month moving average had been declining for four months in a row as of February this year (i.e., the latest result for March is the fifth consecutive month of decline), which fulfils the former condition. As for the latter condition, the result was positive mom for February, but had been negative mom for the three months immediately preceding that (November 2018 to January 2019). In other words, an assessment of “worsening” was being barely kept at bay until February, but an official revision of the assessment had to be made this time (incidentally, the previous period of “worsening” continued from October 2010 through January 2013). The government’s official assessment of the economy (whether at a peak or in a valley) is published in the Monthly Economic Report following deliberation by the Index of Business Conditions study group, so obviously there is a stable relationship between the economy and Business Cycle Indicators Leading Index trends.



U.S. and Japanese Central Banks Forced to Complement Government Policies

The focus of market participants (and of Japan as a whole) now, is probably to find out how the government and ruling party will interpret the Index of Business Conditions and reflect its movements in policy operation. To be more direct, the main question in everybody’s mind is whether the government will raise consumption taxes this October. As it is, many market players and administrators have been worried about the latent upward pressure on JPY amid the protraction of the U.S.-China trade war and the accompanying shift of the Fed to a dovish stance. With the recent downgrading of the CO’s assessment adding to this, public skepticism over rate hikes is bound to strengthen. On May 14, the NHK acknowledged that the cabinet support rate as per the May survey was relatively high at 48%, and it is being reported that both the ruling and opposition parties consider it increasingly possible that Prime Minister Shinzo Abe will go for a double election of House of Representatives and of Councilors. If that really happens, “whether or not to raise consumption taxes” is bound to be on the agenda. In the first place, if we take into account the expected economic slowdown following an increase in consumption taxes through the period leading to the Olympic Games, it has to be said that the likelihood of a general election is low.



Meanwhile, as is widely known, soft indicators including the PMI have been deteriorating at such a rapid pace that it would not be surprising to see them bottom out soon. Going forward, we may see a gradual increase in those betting on the economy hitting bottom. The consensus regarding the global economy in 2019 seems to be that a recovery can be expected during the second half of the year as China begins to implement stimulatory measures, so it would not be that difficult for the government to revise its assessment of an economic recession and reconsider an increase in consumption tax. However, even if it does make that decision, it is likely to be only after the publication of the June BOJ Tankan and the April Index of Business Conditions. A further deterioration in the Business Conditions DI of Large Enterprises/ Manufacturing Industry is expected, and the extent of that deterioration will be a significant factor in determining the economic assessment (see figure on previous page). Assuming that the consumption tax hike does go ahead as scheduled in October, expectations of fiscal stimulus and monetary relaxation by the BOJ to offset the negative effects of the tax hike will naturally strengthen. Meanwhile in the U.S., the Fed is also being expected to ease monetary policy to offset the Trump administration's protectionist policies. In that sense, the central banks of both Japan and the U.S. are in a position of complementing (or being forced to complement) their respective governments' economic policies, and both are likely to move in the direction of monetary easing. The important thing to remember for Japan is that while the Fed's policy stance is clearly tilted toward an easing (weak USD), it will be difficult for the BOJ to find a way to counter USD weakness. That being the case, the Japanese economy is likely to face not just downward pressure due to the consumption tax hike, but also upward pressure on JPY due to the Fed's policies. As of the current time, the tax hike is expected to go ahead as scheduled unless some event of the magnitude of the Lehman Shock takes place, but the fact is that the climate, both domestically and internationally, is not conducive to a tax hike. Going forward, the scenario is quite likely to change in line with national election schedules and other things, and one must keep in mind that this could have a not insignificant impact on the BOJ's policy operations too. However, as I just said, it must be remembered that unless the Fed's policy stance becomes hawkish, a weak JPY trend cannot be expected whether or not the BOJ switches to monetary easing.

Risks to My Main Scenario – Recoveries in China and Europe are the Key Point

Markets Insensitive to Issues Unlikely to be Resolved in the Short Term

At this point, 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. In short, I think there has been no significant change in the nature of risk factors since the beginning of the year and that the key issue is whether the expected economic recoveries in China and Europe during the latter half of the year will be sufficient to offset a U.S. economic slowdown during that period. Before considering the relevant risk factors, I would like to overview the main scenario. The basic story line of this article's 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," and I do not see any need to revise this overall theme. The probability of an interest rate cut this year has already been factored into FF interest rate futures market prices and appears to be well over 70%. While it is difficult to imagine the spot forex market acquiring so much conviction, it appears certain that the Fed's "next move" is no longer a rate hike and, given that the U.S. economic expansion has already been sustained for a record-long period, I think it appropriate to create a forecast scenario based on the assumption of an upcoming decrease in U.S. interest rates. During the forecast period, the baseline Fed policy outlook scenario appears to be "status quo at best and possibility of additional easing depending on the circumstances". 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. There has been no change in my fundamental view regarding this. For the time being, despite the continued prominence of media headlines regarding the possibilities of a U.S.-China trade war and an implementation of Brexit, it appears that the financial markets will remain quite insensitive to issues unlikely to be resolved in the short term. More importantly, I think it reasonable to anticipate that a decline in the absolute level of U.S. interest rates will spur a progressive rise in outflows from USD-denominated assets.

Probably No U.S. Economic Slowdown Right Away, but...

There are several JPY depreciation risk factors that should be kept in mind with respect to the main forecast scenario (see chart). The biggest such risk factor about which this article had been particularly concerned is – "a situation in which the U.S. economy is surprisingly robust and the Fed therefore finds itself positioned to continue its normalization process". Another aspect of this is the risk that, amid signs of a bottoming out of economic conditions in China and Europe, the Fed might feel reassured enough to resume its normalization. In this regard, one may note the causal relationship between risk factors and . In any case, there is worldwide concern that the Fed might become eager to resume its normalization process in response to an improvement in market psychology, regardless of the reason for that improvement. In fact, the U.S. stock market has been robust since early this year against the backdrop of the Fed's increasing dovishness, and it is possible that the wealth effect's growing influence on the household sector may support positive U.S. economic trends going forward. Once the global economic recovery cycle has been interrupted, it would seem difficult for the U.S. economy to

regain its momentum independently; yet the U.S. economy has continued to demonstrate unexpected strength regarding consumption and employment, and this is disturbing situation for those anticipating U.S. interest rate cuts along with USD depreciation.

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. As this article has repeatedly argued, 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.

(Note that the 10-year and 3-month interest rate inversion occurred in late March.)

Although the potential lag period of one to two years is a fairly lengthy one, 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 current economic expansion may become the longest such expansion in U.S. history in July if it is sustained through June, it appears unquestionable that the remaining margin for improvement is small.

Amid these circumstances, frankly speaking, I believe the likelihood of progressive JPY depreciation is not high, but a JPY appreciation scenario cannot be realized in the absence of a clear-cut slowdown in the U.S. economy, and the likelihood of a recession occurring in the next 12 months has risen to 27%, as estimated by the New York Fed in April. Given that recessions have historically occurred more often than not after the likelihood level reaches this level, my view is, at least, we should not consider this a stage at which we should be preparing for a rise in U.S. interest rates and, moreover, it is within the realm of possibility that the Trump administration will implement some economic stimulation measures in the run-up to the upcoming presidential election. While it would be contrary to the historical rule of thumb, the possibility of additional U.S. economic acceleration from this point represents a major JPY depreciation risk factor.

JPY depreciation risk factors

	Risk	Detail	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
	BREXIT related	2nd referendum	low /medium
	Additional monetary easing by BOJ	Funds supply with negative interest rates	low
	Reacceleration in China & Europe	GDP acceleration	medium

(Source) Daisuke Karakama by Mizuho Bank

Decreased Risks Associated with the Potential for U.S. Protectionism Discontinuation and a Brexit Referendum Rerun

Last month, this article noted such worrisome political JPY depreciation risk factors as the potential for “a discontinuance of the Trump administration’s protectionist politics” (≈ “a complete resolution of the U.S.-China trade war”) and the possibility that “the Brexit initiative might be withdrawn following a second referendum”. Since May, however, it can be said that the likelihood of either such risk factors has become quite low. While many observers had recently thought that a deal to end the US-China trade war including the elimination of all supplementary tariffs was possible and imminent, the negotiations broke down, and there is still no end in sight to the trend of deterioration in trade relations between the two countries. As the situation has worsened, there is now concern that 25% tariffs will be imposed on the remaining approximately \$300 billion of U.S. imports from China. This article has repeatedly suggested the possibility that the US-China trade war reflected posturing related to the upcoming U.S. presidential election and, if this is true, then it is probably reasonable to conclude that there is zero likelihood of a complete end to the US-China trade war soon, at least during this year. 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 he intends to sustain his basic strategy aimed at keeping relations with China moderately strained while avoiding sharp trends of deterioration or improvement. Regarding the Brexit situation, U.K. Prime Minister May supplemented her efforts to gain parliamentary approval of her Brexit plan with a late-May proposal to make a second referendum possible, but she did not thereby gain additional support from opposition parties. Prime Minister May is now scheduled to resign on June 7, and it appears that the leading candidate to replace her is former-foreign secretary Boris Johnson, who is well known to be a staunch Brexit-supporter. Regardless of who becomes the next prime minister, he or she will have to work very hard to win approval for a Brexit plan from the divided parliament but, given that most members of parties staunchly promoting Brexit consider a second referendum as a major step toward preventing Brexit, it is reasonable to conclude that the likelihood of a second referendum has become quite low, at least during the period prior to the inauguration of the next administration. In fact, with respect to Brexit-related developments, there is relatively more basis for concern regarding JPY appreciation risk factors.

JPY Depreciation Risks Originating in Japan – Basically No Cause for Concern, but ...

It is basically much less likely that Japanese factors will strongly affect USD/JPY trends, but it is still worth paying close attention to the BOJ’s actions. The March BOJ Monetary Policy Meeting expanded its general appraisal of current conditions with downward adjustments to its assessments of export and production operations, and the BOJ’s forward guidance was adjusted in April to read – “the Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, at least through around spring 2020.” Many people are interpreting the indication that strong monetary easing policies will be maintained until “at least through around spring 2020” as suggesting the possibility that the policies will be further prolonged. While the possibility that the BOJ will decide to adjust its policies

soon is currently low, it seems quite likely that the “next move” during the forecasting period will be in the direction of easing rather than tightening. In particular, there is a possibility that there will be an upsurge in expectations that the BOJ will be groping toward additional easing measures that it can take in connection with the upcoming consumption tax rate hike. Even if such additional easing measures were to be undertaken, however, it seems unlikely that they would have much power to promote JPY depreciation. Basically, the Fed has also become more dovish, and leaving aside the issue of how much political pressure it might be subjected to, there are almost no signs that it might shift toward hawkishness during the forecast period. Since the direction of U.S. currency and monetary policies has overwhelming power within the floating exchange rate system, there is little concern that BOJ moves will spur major forex trends, but if the BOJ were to undertake a “next move” outside the scope of market expectations, it would undeniably generate a risk of a significant shift toward JPY depreciation.

Rise in JPY Appreciation Risk During May

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. In fact, the number of JPY appreciation risk factors appears to be relatively large. The 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. As this article has each month pointed out, the easiest 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 or the Chinese and/or European economies 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. Regarding the likelihood of these scenarios, it is safe to say that there was an increase in May at least with respect to trade war intensification and a no-deal Brexit. Generally speaking, few people would dispute a contention that these factors are characterized by greater JPY appreciation risk than JPY depreciation risk.

In any case, while the 2019 global economic forecasts of various institutions show various degrees of bullishness and bearishness, they agree on the point 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 such circumstances, it seems reasonable to posit the view that the JPY depreciation risk factors are extremely limited. Regarding the world economy in the latter half of 2019, U.S. economic deceleration is expected to result from the progressive dissipation of the supportive effects of the Trump tax reductions, but observers have been pointing out increasingly clear-cut indications of improvement in the economies of China and Europe, which have up to now been showing increasingly strong signs of deceleration. The key to the question of whether economic turmoil can be avoided during 2019 lies in the question of whether a general “U.S. weakness vs. Chinese/European recovery” scenario will eventuate or not. I do recognize that the trend toward recovery in China and Europe is quite important. Regarding the forex market, however, I believe the main tidal trend will stem from the US, which appears to have considerable leeway for rolling back its monetary policies, and that trends in other countries/regions will prove unable to completely offset the U.S.-determined trend. Amid these conditions, my basic understanding continues to be that it is difficult to forecast that the current situation will be conducive to a renewed rise in U.S. interest rates and USD accompanied by JPY depreciation.

EUR Outlook – Diminishing Confidence in the Baseline Scenario

The Euro Area Economy Now and Going Forward – Tired of Hearing “Temporary”

Difficult to Discount Regional Economic Deceleration as Being a Temporary Trend

The Account of the ECB's April 10 Governing Council meeting was released on May 23. As there was no Governing Council meeting in May, the Account of the April 10 meeting offers the latest currently available information regarding the ECB's "next move". It had been expected that the meeting would address such issues as the tiering of banks' excess reserves balances subject to negative interest rates, the precise terms of the new series of targeted longer-term refinancing operations (TLTRO3) and the need for forward guidance adjustments, although it turned out that the meeting made no concrete decisions or commitments regarding these issues. To the extent discernable from the Account, the ECB does not intend to adjust its baseline scenario, but portions of the Account do indicate that the ECB is increasingly unsure whether the economic deceleration seen since last year should be discounted as merely a temporary "soft patch". In any case, the Account does not appear to include any hints that the "next move" might involve an interest rate hike.

The Governing Council judged that the latest high frequency information "continued to signal positive, albeit subdued, growth in the first quarter of 2019" and that positive trends in employment and wages underpinned economic resilience. It identified four main factors behind the recent weakness in private consumption; the higher oil prices in the first half of 2018, car delivery bottlenecks owing to new emissions testing procedures, increased macroeconomic uncertainty, and some country-specific factors. The context seems to suggest that these four factors have a strongly temporary aspect and should not be considered very serious. It may be reasonable to consider factors and as being temporary factors, but factor is actually a general situation, and at this time it can probably be considered closely associated with uncertainty related to such situations as U.S. protectionist measures (as seen with respect to the U.S.-China trade war) and Brexit. It should be recognized that it difficult to characterize this situation as "temporary". In addition, although it is not clear what factor is referring to, it may be referring so such situations as the stubborn gap between the EU and Italy's Far-Right/Far-left coalition government with respect to fiscal spending policy rules. However, concerns about such situations have been persistent, and characterizing them as "temporary" would seem somewhat inappropriate. Although the economic deceleration seen in the euro area throughout 2018 to a significant extent reflected a deceleration in the region's net exports, the Account included a pessimistic assessment of that situation – "Based on leading indicators, no immediate recovery was in sight." This assessment is not surprising, given that the export deceleration may be strongly linked to China's economic deceleration. There remains an important question regarding the extent to which the euro area might be able to regain its economic momentum based primarily on domestic demand. There were signs of economic bottoming during the January-March quarter, and the euro area economy has mustered a reasonably good start in 2019.

Diminishing Confidence in the Baseline Scenario

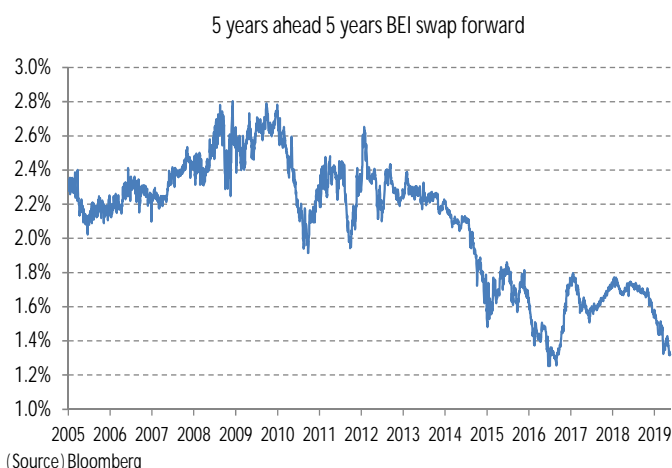
It appears that the Governing Council members generally agreed with the assessment of current and prospective economic developments presented by the ECB's chief economist Peter Praet, one portion of which is described in the Account as being that – "some of the country and sector-specific domestic factors dampening growth were fading, but global headwinds continued to weigh on euro area activity and were leaving marks on economic sentiment. [...] Some comfort was drawn from recent signs that economic activity in China was stabilising. Concerns were reiterated that the global outlook remained subject to the continued risk of an escalation of trade conflicts and the uncertainty surrounding the withdrawal of the United Kingdom from the EU." This seems to indicate that, given the difficulty of forecasting the results of U.S.-China trade negotiations, it can be expected that this factor will continue to exert a negative effect on business confidence.

At this point, the Account adds an noteworthy sentence – "It was also recalled that the complexity of global value chains made it difficult to gauge the precise implications of such risks for trade and activity over time." This appears to be associated with the fact that the ECB and numerous other international institutions have made surprisingly large downward revisions to their economic forecasts for the euro area (especially Germany) since last fall because they were unable to accurately measure the impact of contemporary developments. This February, for example, the OECD reduced its forecast of Germany's 2019 economic growth rate to -0.9 percentage point below the level it forecast last November, and it is somewhat rare to see such a large adjustment made in the absence of a significant newly emerged "shock" factor. The IMF has made a similar downward adjustment to its economic forecast for the euro area. The Account notes that the Governing Council members generally agreed that – "the more protracted "soft patch" suggested by the latest data remained consistent with the baseline scenario of a return to more solid growth in the second half of the current year." – and there was no need to rashly conclude that the baseline scenario is based on a miscalculation. Explanations for the protraction suggested by members included the view that – "Given that the euro area was running a persistent current account surplus, it was naturally more exposed to the slowdown in global trade than the rest of the world." – which appears to be playing down the significance of the protraction. However, the Account also notes that – "it was acknowledged that there was now somewhat less confidence in this baseline scenario and that the range of other possible outcomes had widened." The confidence reduction has apparently not become significant enough to spur consideration of monetary policy adjustments, but it can be expected that such an adjustments may be considered in June depending on the nature of the revised staff

forecast completed at that time.

Inflation “Uncomfortably” Low

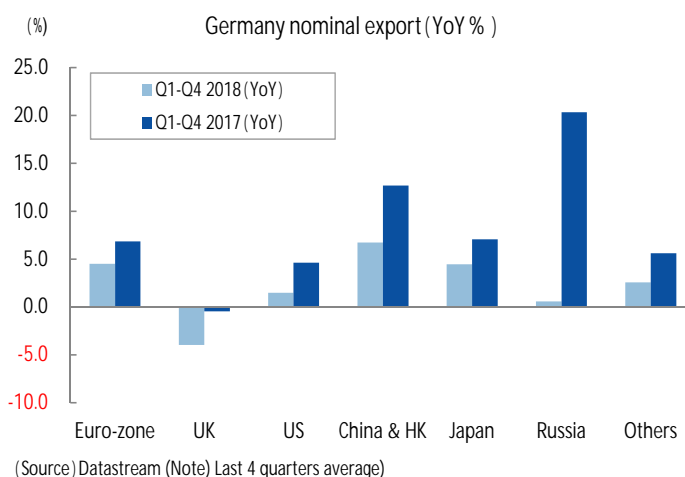
In light of the current situation and outlook, what is the outlook for the ECB’s monetary policy management? Interest rates in the region have fallen in line with the weakness of business sentiment, and this is the basis of Mr. Praet’s perception that “financial conditions had eased”. All Governing Council members agreed that maintaining the current monetary policy stance (indicating no change to policy interest rates this year) would provide significant monetary policy stimulus, reinforced by the reinvestments of the sizeable stock of acquired assets and the new series of TLTROs. While the meeting did not decide to make a “next move” at this point, the Account includes the noteworthy passage – “the point was made that inflation remained uncomfortably below the Governing Council’s inflation



aim and market-based inflation expectations had receded, while the projected inflation convergence had been repeatedly delayed.” Since the financial crisis, the level of five-year, five-year forward inflation swaps (5-year, 5-year forward BEIs) has been steadily weakening (see graph), to put it mildly, and in light of Japan’s experience it would seem quite difficult for it to return to previous levels. (The previous levels have still not been reattained in Japan.) For this reason, there was broad agreement among members that the ECB should communicate its intention not to hesitate with respect to launching its “next move” and should consider precise terms of the new targeted longer-term refinancing operations (TLTRO-III) “at one of the Governing Council’s forthcoming meetings.” It was agreed that the terms should be based on a thorough assessment of the bank-based transmission channel of monetary policy, as well as further developments in the economic outlook, and it was also proposed that the operations be priced “so that they would primarily serve as a backstop, providing insurance in times of elevated uncertainty.” Regarding negative interest rates, it was proposed that the Governing Council should regularly consider whether preserving the economic benefits of negative interest rates might require the mitigation of bank intermediation side effects. This discussion led to the inclusion of the sentence – “In the context of our regular assessment, we will also consider whether the preservation of the favourable implications of negative interest rates for the economy requires the mitigation of their possible side effects, if any, on bank intermediation.” – within the introductory statement after the April meeting.

Tired of Hearing “Temporary”

Looking ahead, it seems likely that economic recovery in China will elevate euro area exports and thereby facilitate a recovery in the euro area’s sluggish growth rate. The Account of the ECB’s April Governing Council meeting indicates that the Governing Council is anticipating this kind of trend. Just as is Japan, however, the euro area is engaged in negotiations regarding U.S. import tariffs on automobiles and, regardless of the results of the U.S.-China trade negotiations, it would not be surprising to see the euro area embroiled in a trade war. The fact that macroeconomic uncertainty associated with potential trade wars has not been dispelled seems likely to facilitate a continued trend of soft data deterioration, particularly with respect to manufacturing industries. That is probably why, although the ECB’s forward guidance represents a commitment to maintaining the status quo only during this year, interest rate expectations factored into EONIA futures suggest an increasing delay before the first rate hike, which is currently not expected until autumn 2021. It does appear that the euro area’s introduction of stricter exhaust emissions and fuel economy standards (the Worldwide Harmonized Light Vehicles Test Procedures (WLTP)) from September 2018 has temporarily restrained German automobile sales – although sales are gradually recovering from an initial depression caused by accelerated purchases prior to September, production volume is not recovering. That is why the trend in German manufacturers’ business sentiment, as reflected in the Purchasing Managers’ Index (PMI), has continued to be weak during 2019.



Given this, it does seem that the introduction of WLTP standards is a factor that has temporarily decelerated the German economy, but one naturally assumes that there have been other factors exerting downward pressure on exports. Although the deceleration of China’s economy is the first such factor many people will think of, the graph of yoy growth in German exports to various markets shows that, aside from China/Hong Kong market, there has been noteworthy deceleration in

exports to the United States, Russia, and “other” markets in recent years. The ‘other’ category includes Turkey and other emerging country markets that are important German export markets. The economic slowdowns in these countries/regions may reflect the impact of such factors as U.S. protectionist policies, which do not fall into the “temporary factor” category of such factors as the introduction of WLTP standards. It bears remembering that the euro area’s economic deceleration trend began in the first quarter of 2018, already a year ago now. At that time, the ECB cited the impact of temporary factors – such as an influenza epidemic, strikes, and major cold waves – and asserted that the economy would eventually recover from the effects of those temporary factors. The deceleration trend has now continued for a year, however, and the situation has actually worsened. While the deceleration trend has been sustained over the past year, it still seems reasonable at this point to anticipate that the euro area economy will bottom out, but it should be recognized that there is little basis for expecting the economy’s growth rate to accelerate. Under such circumstances, it appears that the ECB may be forced to adjust its forward guidance during June or July in anticipation of a longer period of low interest rates.

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