

Forex Medium-Term Outlook

31 October 2019

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Derivatives & Forex Department

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Overview of Outlook

USD/JPY rose strongly in October. Due to the U.S.-China partial trade deal, market sentiment has improved, and U.S. interest rates have continued to increase despite multiple rate cuts by the Fed. As is widely known, roughly half the FOMC members predicted a resumption of rate hikes in 2020 in the dot plot released following the September FOMC meeting – a consensus seems to be building around an early resumption of rate hikes. Perhaps some in the markets have begun to take such predictions at face value. However, as the U.S. labor market matures, the Fed is bound to find an early resumption of rate hikes difficult. Incidentally, though USD appreciated during the second half of the month, it has depreciated quite a bit if the entire month of October is taken into account. Regardless, JPY has not appreciated against USD much, an issue that needs to be addressed, and I propose to tackle the reasons for this in this report. As I have argued also in the past, the change in the structure of Japan's net external assets owing to an increase in the balance of foreign direct investments could be suppressing the trend of selling foreign currency in exchange for JPY. If this continues, USD/JPY will post an all-time record low range for the second year in a row. If, as in the past, the Fed's policy operations become more accurately predictable, perhaps the path of USD/JPY can also be more accurately predicted going forward. However, there seem unlikely to be many who believe that U.S. interest rates will continue to rise at the current pace. I believe there is a high possibility of JPY appreciating against USD in terms of direction, even if the extent of the appreciation is not that great.

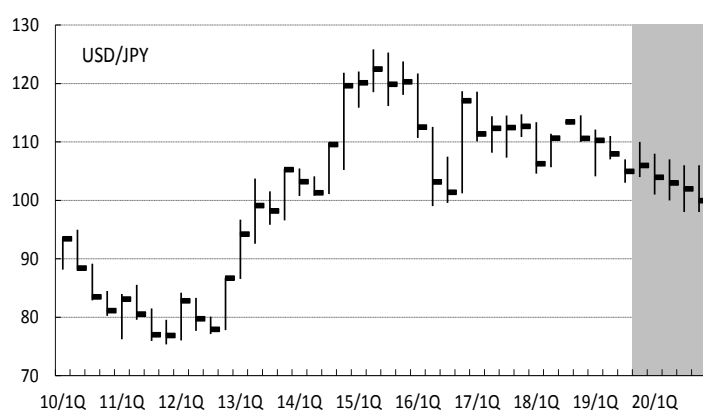
EUR, meanwhile, showed signs of strengthening. The currency was bought essentially out of a sense of relief when a no-deal Brexit, which was thought inevitable at the end of October, was avoided – not because of any improvement in the economic or financial situations in the euro area. Having said that, the manufacturing PMI trend and the extent to which rate cuts have been factored in seem to suggest that the recessionary economic phase may finally be bottoming out. If one additionally takes into account the switch to an expansionary fiscal policy in Germany, the sense of bottoming out could become stronger going forward. In connection with monetary policy, thanks to the rift created within the Governing Council by ECB President Mario Draghi, the new regime under Christine Lagarde (starting November) will find it difficult to boldly implement accommodative monetary policies for some time to come (many also point out that the ECB exhausted its policy options at the September meeting). U.S. interest rates, on the other hand, still have scope for decline, so during the current forecasting period, the possibility of EUR appreciating as a result of the Fed's actions cannot be ruled out – this was precisely what happened during early and mid-October. One would hope that EUR can continue for some time to be a magnet for funds released by selling USD.

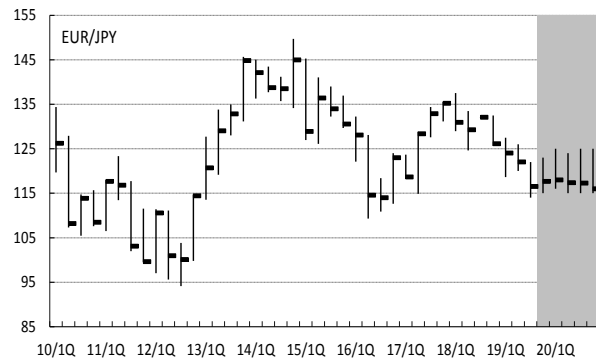
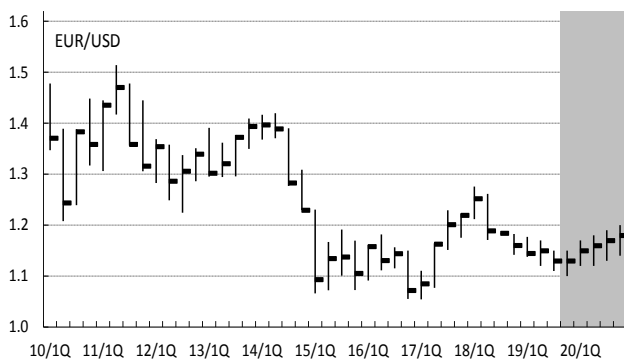
Summary Table of Forecasts

	2019		2020			
	Jan -Oct (actual)	Nov-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	104.10 ~ 112.40 (108.77)	104 ~ 110 (106)	101 ~ 108 (104)	100 ~ 107 (103)	98 ~ 106 (102)	98 ~ 106 (100)
EUR/USD	1.0879 ~ 1.1570 (1.1162)	1.08 ~ 1.13 (1.11)	1.10 ~ 1.15 (1.13)	1.10 ~ 1.16 (1.14)	1.11 ~ 1.17 (1.15)	1.12 ~ 1.18 (1.16)
EUR/JPY	115.87 ~ 127.50 (121.40)	115 ~ 123 (118)	116 ~ 125 (118)	115 ~ 124 (117)	115 ~ 125 (117)	115 ~ 125 (116)

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

Exchange Rate Trends & Forecasts



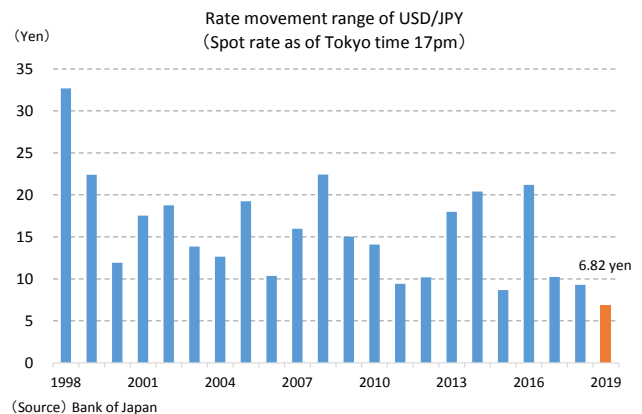


USD/JPY Outlook – Understanding Why USD/JPY Remains Deadlocked

JPY Supply-Demand Balance – USD/JPY Headed Toward New All-Time Small Range

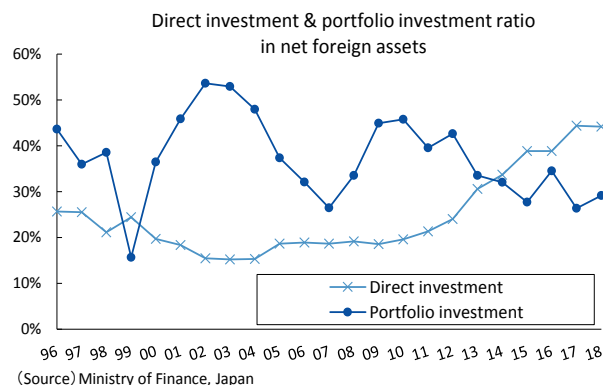
Effective Movement Range of Less than JPY5?

There are only two months to go before this year, too, goes by, and USD/JPY remains as range bound as ever. Even though USD has depreciated overall in the forex markets since the beginning of October, USD/JPY movement has been limited. True, in terms of direction, USD seems to be slowly depreciating against JPY, but the extent of the decline is nothing to write home about, and one gets the impression that there is very little interest in U.S. interest rates or USD. The rate movement range of USD/JPY this year has been 8.30 (104.10 to 112.40, see graph), over JPY1.5 narrower than the previous all-time narrow range of 9.99 posted last year. Incidentally, the rate movement range for USD/JPY as of 17:00 Tokyo time every day, as released by the BOJ, is even smaller, at 6.82 (105.20 to 112.02. Further, the only time this year that USD/JPY remained stable at the 110 level was for a month and a half between February and April, while the only time it remained stable at the 105 level was during early August, so it may be no exaggeration to say that Tokyo market participants experienced an effective movement range of less than 5, between 106 and 110 or so, this year. Never before has the movement range for USD/JPY remained below 10 for two years in a row, but if things continue this way, this may be the first time that happens. Incidentally, the USD/JPY range for 2017 was barely over 10 at 10.24, which was also a historically small range. Given that U.S. interest rates plummeted from a high of 3.2% to less than half that (at 1.4%) at one point within the past year, this stalemate with regard to USD/JPY is abnormal. The main forecast scenario of this report has been that USD would depreciate against JPY as U.S. interest rates fell. If we focus only on the direction of currency movement, that prediction has been correct, but given that the extent of depreciation has been negligible, it seems difficult to say one way or the other whether the prediction was right or wrong.



An Increase in Flows Unaffected by U.S. Interest Rates

It is not clear why JPY has lost its volatility to this extent. In this age of the rising popularity of AI transactions, there does seem some volatility from the second decimal place and below, so one does occasionally hear the view that this may be the new normal. Perhaps there is some truth to this. However, given that USD/JPY movement has been so limited despite the dynamic volatility of U.S. interest rates, one could also assume that there has been an increase in flows unaffected by U.S. interest rates. As I have repeatedly pointed out in this report, it seems quite likely that the change in the structure of Japan's external asset and liability balance may be affecting USD/JPY. As the figure above shows, the movement range of USD/JPY

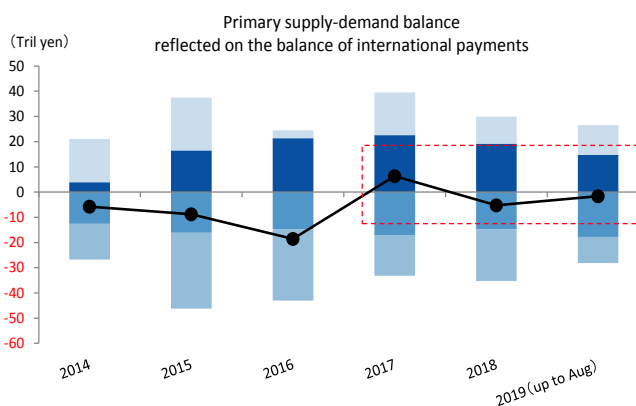


has been stable around the 10 level since 2011 and has been particularly small in more recent years (the reason for a larger range in 2016 was owing to special factors such as the UK referendum to leave the EU and the U.S. presidential elections). In this context, it is interesting to note that the ratio of direct investment within Japan's net external asset balance caught up to that of securities investment in the year 2013 and has since been increasingly outpacing the latter to become the largest component of the net external asset balance. Intuitively speaking, securities investment trends seem more directly affected by U.S. interest rate volatility (coinciding with risk-on and risk-off moods in the market) than direct investment trends. Therefore, the relative dwindling of the securities investment flow seems likely to be the reason behind the weakening correlation between USD/JPY and the Fed's monetary policy operations, as symbolized by U.S. interest rates.

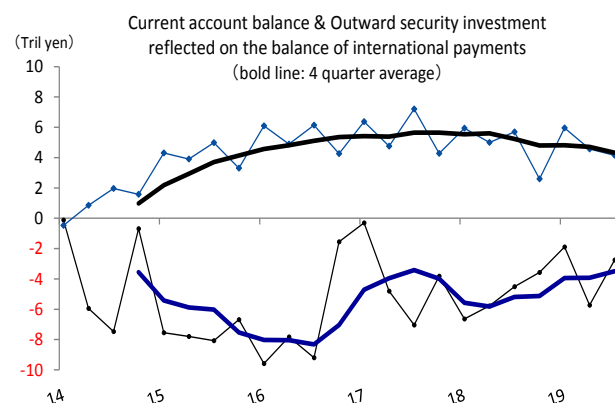
Of course, given that the forex market is one of the vastest and deepest markets in the world, my theory is no more than just that, but I do believe that it merits investigation. However, the fact remains (though I repeat myself) that JPY continues to appreciate gently as U.S. interest rates continue to decline, and this trend seems likely to continue going forward, given that almost no one thinks U.S. interest rates will rise over the next year. There seems no need, therefore, to make any significant changes to my basic understanding that, in terms of direction, JPY will continue to appreciate against USD.

Are JPY Trading Volumes Dwindling?

Japan's August Balance of Payments was released in October. The JPY supply-demand balance for the January-August period was a mere -JPY 1.6 trillion (net selling), so as usual, supply and demand were more or less balanced. It remains difficult to determine the direction of USD/JPY from fundamental economic indicators, so as I mentioned at the start, this may be the reason why the currency pair has been at the mercy of qualitative headline figures. The state of balance is also inherently at a smaller level of JPY supply and demand. As the figure to the right (top) indicates, the JPY supply-demand trend gives the strong impression of being determined by the size of the current account balance and foreign securities investment (direct investment is quite a big component, but it has limited volatility). The figure to the right (bottom) shows the trends of these two categories over the past five years. It is clear that, as current account balance growth peaks, so does the net purchase of foreign securities. In other words, as JPY buying pressure recedes, so does JPY selling pressure, resulting in a state of balance with regard to JPY buying and selling, which have both contracted. Of course, one must not make a judgment based only on indicators reflected in the Balance of Payments, but perhaps the lack of volatility in recent years' forex rates should be understood against the backdrop of the decline in JPY transaction volumes.



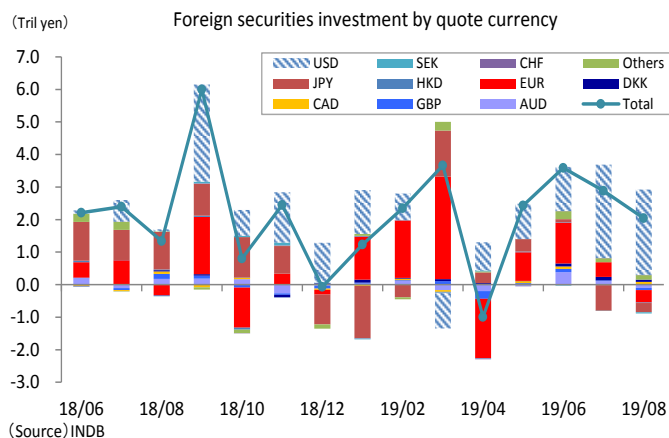
(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government



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Recovery of USD-Denominated Assets

Looking at foreign securities investment by quote currency, investment in EUR-denominated assets, as symbolized by French government bonds, was robust during 1H of this year, but slowed down in 2H amid predictions that the negative interest rate margin may be deepened. Meanwhile, investment in USD-denominated assets began to increase in 2H. In terms of the central bank taking a rate-cut path, the situation in the U.S. is no different from that in the euro area, but the high absolute level of U.S. interest rates is probably viewed favorably by investors. In June this year, the Fed's policy operation swung sharply from rate hikes to rate cuts, and it appears that investment interest in USD-denominated assets



began returning from April or so, when this change in policy direction began to be hinted at. Ultimately, in phases of a decline in U.S. interest rates, other countries' interest rates are also dragged down. Consequently, even during such phases, USD is still the only currency that investors can buy, even if only in a passive way based on a process of elimination. This results in a situation where USD remains strong despite the Fed's switch to a more dovish stance, making it difficult to predict market trends – a fact that is quite obvious just looking at trends by quote currency. However, can such a situation be sustained even if U.S. 10-year interest rates fall below 1%? Despite the introduction of the tiered interest rates system in Europe, one would do well to understand that JPY and EUR interest rates, which are already negative, are approaching their lower limits. Meanwhile, U.S. interest rates still have considerable scope for decline. That is why I think it only right, in terms of risk management, to prepare for a significant correction of USD, which remains stubbornly high on a real-effective basis.

U.S. and Japanese Monetary Policies Now and Going Forward – Fed Suspends Rate Cuts, BOJ's Reading of Situation Proven Right

October FOMC – “Suspension of Rate Cuts” Decidedly Different from “Resumption of Rate Hikes”

As expected, the target range for the federal funds (FF) rate was lowered by 25 bps to 1.50-1.75% at the October 30 FOMC meeting – the third consecutive rate cut following on from the July and September meetings. The phrase “will act as appropriate,” which had been included in the FOMC statement from June to indicate the possibility of future rate cuts, was replaced by the more ambiguous “The Committee will continue to monitor the implications of incoming information for the economic outlook as it assesses the appropriate path of the target range for the federal funds rate.” As a result, more market participants predict that the target range for the FF rate will be kept unchanged at this year's final meeting in December, a prediction that caused no major turmoil. For the first time this year, there is no impending sense of a rate cut. The phrase “mid-cycle adjustment,” which inflamed the financial markets considerably in July, was originally interpreted by most as indicating “two or three rate cuts.” This was based on a similar previous experience, when former Fed Chair Alan Greenspan implemented “preventative rate cuts” three times between August and November 1998.

However, a declaration of the suspension of rate cuts is decidedly different from a declaration of the resumption of rate hikes. Fed Chair Jerome Powell acknowledged the enormous hurdles against resuming rate hikes when he said, “I think we would need to see a really significant move up in inflation that's persistent before we would consider raising rates to address inflation concerns.” However, the fact that neither U.S. interest rates nor USD/JPY have increased markedly despite the FOMC statement and the press conference hinting at an end to rate cuts seems to suggest that there is no need to significantly revise my understanding of the forex outlook.

Sometimes the Guile of Making Use of Misconceptions is Necessary

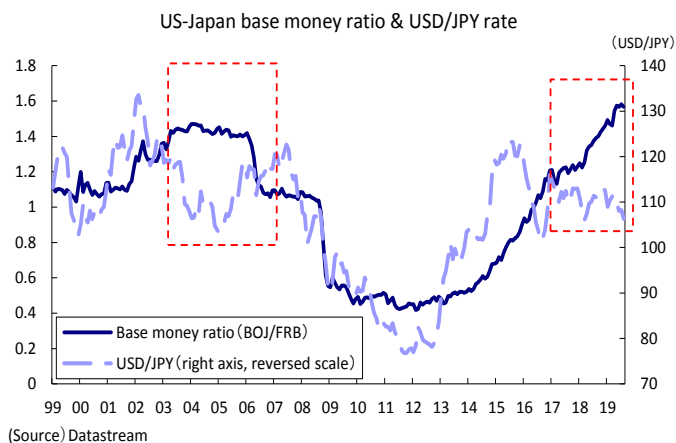
In the run up to the FOMC meeting, the Fed announced on October 11 that it would begin purchasing Treasury Bills (TBs) to the tune of USD 60 billion a month starting October 15, in order to ease the strains on the short-term financial markets. The purchases will be continued until April-June 2020. The matter was reportedly discussed at the October 4 (unscheduled) FOMC meeting held by video conference, and it was unanimously agreed that the Fed should try and quiet the situation down by expanding its balance sheet through the purchase of TBs. Presumably, the Fed switched to this measure as a way of curbing short-term financial market volatility by raising the total reserve deposit after finding out that it was difficult to control the situation using quick, superficial measures. In other words, the recent measure should essentially not be seen as a resumption of quantitative easing (QE) for economic

stimulus purposes. In this context, the Fed itself has warned that “These actions are purely technical measures (...) and do not represent a change in the stance of monetary policy.” Incidentally, it has also been pointed out that the recent turbulence in the short-term financial markets is a side effect of excessive regulations, which are reducing liquidity, so a holistic remedy should include more wide-ranging discussions that include rethinking regulations, but I will not take this issue up for discussion here.

However, taking the Fed’s recent position into consideration, the latter part of the statement (that its actions “do not represent a change in the stance of monetary policy”) almost seem redundant, given how unconcerned the Fed was even amid rampant speculation in the financial markets that QE would be resumed. Rather, it is a desirable move to make, as in addition to quieting down financial market volatility, it could earn the Fed favor from both political circles (President Trump) and the forex markets (strong USD to weak USD). As we have repeatedly seen so far, when it comes to political issues including U.S.-China trade talks and Brexit, the situation can change rapidly, making it difficult to fine-tune monetary policy in line with the changes. As I will discuss later, if the U.S. economic and financial outlooks become uncertain going forward, it is quite likely that the markets will expect QE to be resumed. It would be wiser for the Fed to realize that the more it denies the possibility of QE resumption now, the more attention it will draw if such a move were to become necessary going forward. Given that some market participants still believe in the quantity theory of money, it seems the Fed could benefit from using some guile in terms of making good use of misconceptions.

Soros Chart Typically Meaningless

Whether a certain measure is merely technical or intended as an economic stimulus, some in the forex market still believe that the amount of the base money supplied by the central bank to the banking sector determines the direction of forex rate trends. To be more specific, the theory is that the ratio of two currencies’ base money determines the currency rate of that currency pair – a theory that is commonly represented in the form of the “Soros chart.” In some ways, it is a nostalgic idea that did have currency at one point. The figure compares the ratio of base money in the U.S. and Japan versus USD/JPY rate trends over the past 20 years. True, there seems a stable correlation between the two in some phases, but there are also many phases in which that is not the case. In recent years, especially since 2017, while Japan’s base money has been rising, that of the U.S. has been declining, so that the ratio of Japan’s base money to that of the U.S. has increased sharply. However, USD/JPY has either remained flat or declined slightly.



In recent years, especially since 2017, while Japan’s base money has been rising, that of the U.S. has been declining, so that the ratio of Japan’s base money to that of the U.S. has increased sharply. However, USD/JPY has either remained flat or declined slightly.

There is no theoretical basis for linking the ratio of base money to currency rates in the first place, so there can be no causal relationship between the two. Of course, the Soros chart would have some utility if the quantitative theory of money (that an increase in base money directly leads to an increase in money supply through an increase in lending, thereby bringing about inflation) were true (because inflation would lower the purchasing power of the currency in question, which would cause it to depreciate). However, it is generally understood that the correlation between base money and money supply has disintegrated (the monetary multiplier has decreased), so it makes no sense at this time to take the Soros chart seriously in terms of theory. The Soros chart is a uniquely Japanese hypothesis that became popular at a time when the correlation between the two variables mentioned coincided with the chance transpiring of the intuitive idea regarding financial markets that a currency would depreciate if quantity was increased. In truth, however, the hypothesis does not hold water.

Although the Soros chart is widely recognized as having been used by famous investor George Soros, a simple Google search for “Soros chart” reveals how minor its relevance is. Of course, increasing quantity seems inevitably likely to result in lower interest rates, and it is not altogether impossible for the currency to lose value through this route. Having said that, currency trading based on interest rate gaps is losing momentum as the interest rate levels of key countries/regions approach their lower limits. Precisely for this reason, considering whether a currency is undervalued or overvalued in light of its real effective exchange rate (REER) is becoming more important, relatively speaking. Currency rates are often determined by the intuition of market participants, but I think it is dangerous to get in the habit of abandoning theory.

BOJ Monetary Policy Meeting – Bank’s Reading of Situation Proven Right

Meanwhile, as expected, the BOJ retained the *status quo* at its October 31 Monetary Policy Meeting, held right after the FOMC meeting. The addition of the phrase “the Bank will reexamine economic and price developments at the next Monetary Policy Meeting” in the September statement stirred up expectations of an additional easing, but it appears that the Bank found no reason to make any changes following the re-examination. As mentioned above, the end of the Fed’s “mid-cycle adjustment” means a break in U.S. rate cuts (i.e., not much reason to expect JPY appreciation), which would have made it easy for the BOJ to retain its current policy. Looking at the markets, stock prices have remained high since the beginning of the year and USD/JPY seems stable at the 108 level, so it is somewhat strange that an additional easing was even being expected. Things have also calmed down somewhat in the contexts of the U.S.-China trade wars and Brexit, dissipating the ominous political atmosphere that had been hanging over the markets all summer. The BOJ’s position since July was probably to wait and watch in the hope that things would resolve themselves, and it can be said that that is exactly what happened. The Bank’s reading of the situation was proven right.

Of course, the bank is still considerate of easing expectations. Until September, the forward guidance for the policy rates was “As for policy rates, 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, taking into account uncertainties regarding economic activity and prices including developments in overseas economies and the effects of the scheduled consumption tax hike.” This was revised to “As for the policy rates, the Bank expects short- and long-term interest rates to remain at their present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability target will be lost.” The new language makes it easier for a decision to be made based on qualitative factors, helping to keep easing expectations alive. However, given that the Bank has few options remaining to it, its main intention may be just to buy time and stay out of the limelight. I think it is rather unlikely that the BOJ’s policies will be a disrupting factor when it comes to thinking about the USD/JPY outlook.

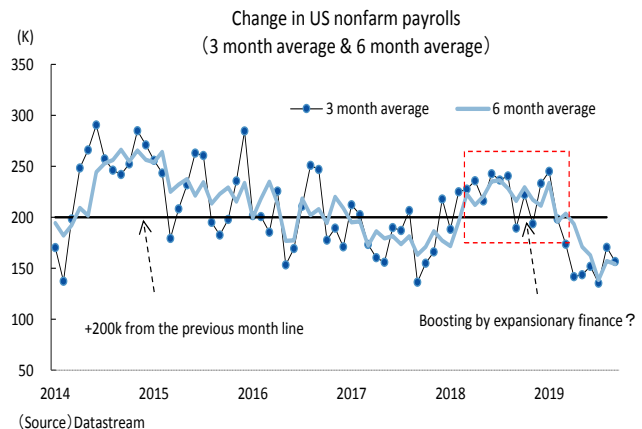
U.S. Economy Now and Going Forward – “Not as Bad as Expected” is a Complacent Reading

“Not as Bad as Expected” is Ultimately “Bad”

In the first week of October, the deterioration of U.S. economic indicators drew a lot of attention with the release of the ISM Manufacturing and Non-manufacturing indices and the ADP National Employment Report, etc., but the big report, the September Employment Situation Summary released on October 4, led to the impression that things were not as bad as expected, which brightened up the gloomy mood in the financial markets. However, “not as bad as expected” ultimately boils down to “bad,” so it will be important to closely monitor the trend going forward.

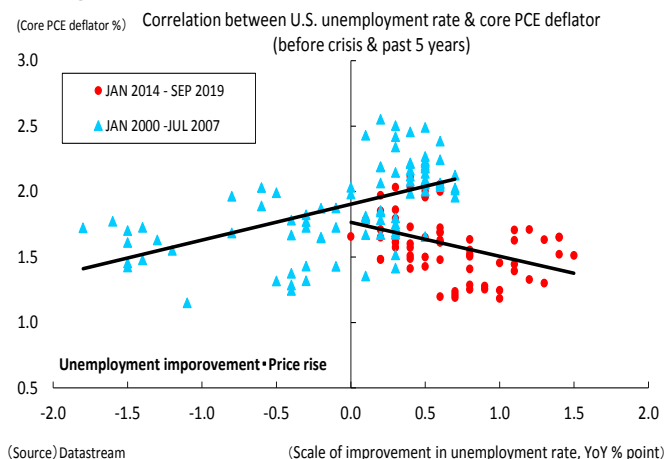
The September Nonfarm Payroll (NFP) change fell short of the median of market forecasts (+145K mom) at +136K mom. Although not “as bad as expected,” the fact is that it fell short of market forecasts.

Average hourly earnings also fell short of market forecasts (+3.2% yoy) by as much as -0.3 pp at +2.9% yoy, posting the smallest growth seen in the past year (the -0.3pp shortfall is the largest since August 2017). The fact that the unemployment rate fell to 3.5%, the lowest it has been in 50 years, was received favorably, but it is rather strange that wage growth has begun to slow despite such tight conditions in the labor market. As is generally understood, employment statistics tend to experience high levels of volatility, and retroactive revisions are commonplace. It is important, therefore, to closely monitor the trend over a longer period rather than feel complacent that a single month’s data was not “as bad as expected” compared with market predictions. As the figure on the previous page shows, 3-month or 6-month average trends show that NFP growth has clearly been losing momentum. A total of 1.447M NFPs have been added from January through September this year, but this is the smallest growth in employment for the same period in the past five years. It is important, therefore, to realize that the volume of employment the U.S. economy can generate is slowly but surely declining.



It May be Too Late when Things are “Bad by any Reckoning”

The fact that unemployment is lower than it has ever been in the past 50 years seems very likely to suggest that the U.S. economy is approaching a state of full employment, i.e., the unemployment rate is very likely to begin increasing in the months to come. As the potential labor force of a country is inevitably limited, the fact that employment rates decline after having peaked at full employment is nothing to be surprised about. As of October, the current phase of U.S. economic expansion has entered its 125th month, which is an all-time record (the previous all-time longest phase of economic expansion lasted only 120 months). Under such circumstances, it is inevitable that, having hit the point where all those who want to work are working (i.e., a state of full employment), the headline figure of employment statistics will gradually weaken.



The problem is that, despite this state of full employment, average hourly earnings are not gathering but starting to lose steam instead. The Fed, which had been in a rate hike phase until last year, was continuing with this policy out of concern that wages could start growing non-linearly in light of full employment in the labor market. However, the rate hike phase ended without those concerns surfacing, and now the Fed is being forced to implement successive rate cuts. The graph is an image of the Phillips Curve, which shows the correlation between the U.S. unemployment rates and the inflation trend (Core PCE Deflator). Pre-financial-crisis, there was a stable correlation between “decline in unemployment rate” and “rise in prices,” but over the past five years there seems to be developing a stable correlation between “decline in unemployment rate” and “fall in prices.” In other words, despite the tightness of the labor market, wages are failing to grow commensurately or lead to heightened general inflation, making it very difficult for the central bank to gauge the appropriate moment at which to switch to monetary tightening.

The most noteworthy points in the September Employment Situation Summary are the (1) slowdown in NFP growth, and (2) the concurrence of “unemployment falling to a 50-year low level” and “slowing growth of average hourly earnings,” so it seems hardly appropriate to talk in sentimental abstractions like “not as bad as expected.” By the time the labor market, which lags behind the economy, is “bad by any reckoning,” both U.S. interest rates and USD might be searching for new lows. As of the present time, therefore, I advise being prepared based on the outlook that U.S. interest rates and USD are unlikely to strengthen in the foreseeable future.

Risks to My Main Scenario – Economic Recovery Trends in Europe/China?

Global Economic Sluggishness and Fiscal Policy Measures

At this point, I would like to review the risk factors related to my main forecast scenario. This article’s main scenario anticipates ‘a correction of the USD appreciation that has occurred over past five years’, and this correction is expected to cause appreciation of JPY and EUR. In fact, USD has shown an across-the-board trend of progressive depreciation during October, but this has shown no sign of leading to a JPY appreciation trend. It seems possible that the chaotic political and economic situations in Europe are a major factor

JPY depreciation risk factors

	Risk	Detail	Possibility
①	U.S. economy is surprisingly robust	Economic policy by the Trump administration such as elimination of tariffs, tax reduction	medium/high
②	Discontinuation of the Trump administration’s protectionist policies	Complete resolution of US-China trade war (Complete elimination of additional tariffs)	low
③	BREXIT related	General election and 2nd referendum	low/medium
④	Additional monetary easing by BOJ	Funds supply with negative interest rates	low
⑤	Reacceleration in China & Europe	GDP acceleration	low/medium

(Source) Daisuke Karakama by Mizuho Bank

preventing EUR from acting as a powerful magnet for the shifting of USD selling proceeds. However, my fundamental view is that conditions in the euro area’s real economy will bottom out owing to an increase in Germany’s fiscal expenditures that is expected over the next year. In light of this and the fact that the most important risk scenarios are those related to JPY depreciation, I think it important to focus here mainly on JPY depreciation risks.

The main risk factors are listed in the table, and these have not changed since last month. The IMF World Economic Outlook released in October forecasts a continued trend of global economic weakness. The report's subtitle – “Global Manufacturing Downturn, Rising Trade Barriers” – reflects the IMF's view that there is no sign that there will be a simple resolution of the current situation, in which US-China trade war-related uncertainties are depressing manufacturing sector business sentiment as well as real economic activities. Under such circumstances, it is expected that there will inevitably be a continued increase in the number of people in each country and region who consider it vitally important to make more-proactive use of fiscal stimulus policies. In connection with this, it should be understood that the most important of the risk factors is risk factor ①. During September, President Trump tweeted that a Fed interest rate cut would lower the burden of interest expenses “while at the same time substantially lengthening the [repayment] term.” Soon afterward, U.S. Treasury Secretary Steven Mnuchin said he was seriously considering the issuance of 50-year government bonds. Secretary Mnuchin's statement – “We are going to start with 50 years, and if [...] 50-years is successful, we'll consider 100-year bonds.” – appears to indicate a strong willingness to procure funds that could be used for fiscal stimulus measures. If 50-year bonds are issued in 2020, there will naturally be a need to closely monitor the likelihood of an surge in government spending associated with a consciousness of the upcoming elections. In fact, he issued a statement at the October annual meetings of the IMF and World Bank expressing concern that the slowdown in growth in such key countries as China and Germany could be longer and deeper than initially expected and stressing the importance of promoting economic growth by avoiding excessive reliance on monetary policies and by more-proactively mobilizing fiscal policies. One must keep in mind the possibility that the United States may launch fiscal stimulus measures including tax cuts during the next 12 months.

A key question here is whether such measures would be approved by the U.S. Congress. While it seems natural to expect Congress to resist such measures, it is also probably true that the Democratic Party would not want to be seen as bearing responsibility for economic deceleration just before the upcoming presidential election. Ultimately, there will remain a possibility that stimulative fiscal policy measures may be implemented. Moreover, if such measures proves difficult to implement, progressive reductions of the supplementary tariffs that have been levied based on the president's discretionary authority will still be possible. In the case that existing tariffs were eliminated or lowered, the financial markets (particularly forex markets) are quite likely to perceive that as a tax cut and respond positively. Although President Trump might be justifiably criticized for stirring up trouble to get credit for the solution, such an approach is very likely to be a successful means of boosting financial market sentiment.

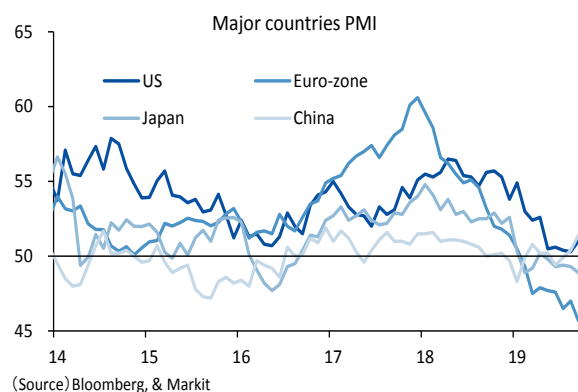
JPY Depreciation Risk Associated with Resolution of U.S.-China Trade War

This year, most movements in financial markets (especially stock markets) have continued to be explainable based on references to observable trends in the US-China trade war. The IMF's global economic forecasts, for example, have been formulated with a strong emphasis on future trade-war trends. The reality is that the nature of trade-war trends can completely change the direction and momentum of economic trends. This naturally constitutes a good reason for paying close attention to risk factor ②. Much of this risk factor revolves around political bargaining factors that are difficult to rationally forecast. However, it appears that the approval of a preliminary trade deal by the United States and China during October reflects growing concern about economic deceleration in both countries that is encouraging both sides to become more accepting of something akin to a temporary truce. Going forward, it seems reasonable to expect that the longer economic uptrends in the United States and China are delayed, the more the two countries' desires to avoid a trade war will strengthen, and it is impossible to completely preclude the possibility of an unexpected upside scenario involving the complete elimination of punitive tariffs. Of course, there remain important issues (such as the revision of industrial subsidies for China's state-owned enterprises) that are said to be extremely difficult for the United States and China to reach agreement about, so it is basically impossible to consider the complete elimination of punitive tariffs as the main forecast scenario. In the case that U.S. economic growth were to be disrupted and China's economic growth rate were to descend below 6%, however, it seems unlikely that the two countries would be obstinately foolish enough to continue ignoring feasible compromise routes for reducing the intensity of trade frictions. As part of the preliminary trade deal approved in October, the U.S. Treasury Department is said to be reconsidering the August placement of China on its list of ‘currency manipulation’ countries, but headlines about this symbolic move toward relationship thawing generated only negligible JPY selling pressures in the forex market, and they should be considered merely a temporary noise factor with respect to this article's JPY appreciation scenario.

In any case, financial markets are ineluctably influenced by the ups and downs of the U.S. economy, and forex market trends are probably likely to take shape in response to positive and negative U.S. economic trends. Naturally, if the U.S. economy shows more resilience than expected, there is a possibility that any moves by the Fed to cut interest rates might end up being short-lived, and this possibility is given further credence by the FOMC's current dot plot. If this possibility eventuates, U.S. interest rates are likely to rise, and USD/JPY should move in accordance. This JPY depreciation risk may be an extremely large risk factor for the JPY appreciation scenario.

Risk of Potential Upturns in China and Europe

Having played important roles in promoting global economic deceleration, trends in China and Europe (particularly Germany) are exerting a major effect on the Fed's policies, and this situation corresponds to JPY depreciation risk factor ⑤. When considering the forex trend outlook, should one assume that the Fed will wisely chose to take the opportunity to re-begin normalizing again when it perceives a trend of economic bottoming out in China and Europe? The likelihood of this does not seem high in light of the political pressures on the Fed (principally from President Trump), but given that the September dot plot indicates that the share of FOMC members expecting interest rate hikes to resume in 2020 has risen to almost half, it is fully possible that



the FRB will become more hawkish when it sees overseas economic conditions improving. In China, it is possible that that benefits from the country's tax cuts will become apparent and combine with the benefits of the RMB depreciation trend seen since early this year. Regarding Germany, there are reports that the government will finally become serious about launching fiscal stimulus programs. Economic bottoming out trends in China and the euro zone would brighten global economic sentiment and thereby inevitably improve global economic conditions. In this regard, it is noteworthy that the trend of deterioration in China's manufacturing industry PMI appears to have stopped (see graph). While it is unclear whether the PMI will continue improving, it is very important to note that when China's economy resurges, the benefits to Germany exports may well promote a general recovery in the euro area economy. Sustained signs of recovery in those regions could sharply change the mood of international financial markets. This is the JPY depreciation risk associated with risk factor ⑤.

Risks Related to Brexit and the BOJ

At the time this article was written, it was difficult to clearly evaluate the magnitude of risk factors ③ and ④. Regarding risk factor ③, the EU's October 29 postponement of the Brexit deadline to January 31, 2020 appears to have eliminated the need for problematically urgent decisions. However, Prime Minister Boris Johnson's strong opposition to such a postponement (he said he would rather be "dead in a ditch" than ask for one) and France's opposition to a postponement without a specific rationale have led to the scheduling of a U.K. general election on December 12. If it brings structural changes to the U.K. parliamentary structure, the election may enable progress in resolving the Brexit situation, which has been at a standstill since 2017. If the Labour and other opposition parties were to win the election, it might be expected to cause considerable JPY depreciation. However, Prime Minister Johnson's approval rate has risen in response to his calls for a general election, and it seems relatively likely that he may win the election and finally succeed in implementing a Brexit.

Regarding the BOJ, it would be impossible for it to do nothing in the case of significant JPY appreciation, and it will doubtlessly have to pursue measures in line with the easing-oriented policies of the Fed and the ECB. As explained above, however, the BOJ's real intention is probably simply to promote interest rate reduction expectations while basically maintaining the status quo and playing for time. This appraisal is shared by many market participants, so there is only a small risk that JPY selling might gain momentum in the case that negative interest rate deepening were to proceed. I believe that measures to further depress negative interest rates will only be considered if USD/JPY descends below JPY100 but that one should be prepared for the possibility of a rise in USD/JPY if the BOJ were to take initiatives in advance of expectations. In the case that the BOJ were to further depress negative interest rates despite concerns about the potential damage to Japan's financial system, some observers are predicting JPY appreciation owing to risk alleviation, but it is worth keeping in mind the risk that unexpected BOJ moves will promote JPY depreciation.

Potential Danger of Coincidental Recovery Trends in Europe and China

While this article has focused primarily on worrisome JPY depreciation risk factors, the risk factor range naturally encompasses JPY appreciation risk factors also and, although this article will not examine such risk factors in detail, my view continues to be that the number of JPY appreciation risk factors is actually larger. In September, however, nearly half of the FOMC members foresaw a return to interest rate hikes during 2020. Given this, in the case that of a coincidental timing of recovery trends in China and the euro area, there is a danger that the FOMC might mistakenly saddle the U.S. economy with higher interest rates at a time when the U.S. cyclical expansion period is close to ending. Since the augmentation of expansionary fiscal policies is under consideration in the United States, China, and Europe, I believe that dangerous possibility is worthy of concern.

Despite a temporary improvement in U.S. business sentiment, it is clear that the U.S. labor market has almost achieved full employment and that the leeway for further improvement is limited. Even if the Fed undertakes a rate hike, there seems to be a large risk that – as in the 2018-2019 period – the expected path of policy interest rates will later be adjusted downward in response to renewed bearishness about the economic outlook, resulting in unnecessary market fluctuations. If something along the lines of a return to rate hikes were to occur during the forecast period, it would represent an extremely large JPY depreciation risk for this article's main scenario, but it does not appear to be a realistic likelihood. As the United States continues to extend its record-long period of economic expansion and its unemployment rate descends to the 3.5% level, one should be anticipating the possibility that 'distortions' stemming from the expansion may manifest themselves in innumerable problematic forms and locations. In light of current and prospective political and economic situations, most people would probably continue to be disinclined to disagree with the view that the eventuation of JPY appreciation risk factors is more likely than that of JPY depreciation risk factors.

In addition to the Trump administration's hallmark radical protectionist measures and the U.S. economy's decreasing growth impetus and leeway for further growth, it appears that U.S. interest rate factors are more likely than not to be downside risk factors with respect to USD over the next 12 months, so it seems safe to assume that USD/JPY will be susceptible to softening. Japan's sensitivity to forex trends in the direction of JPY appreciation has diminished owing to such factors as changes in the country's external net asset structure, and it is still debatable whether it will be possible for USD/JPY to move down to a level close to descending below USD1/JPY100 during the forecast period, but I believe there is no need to adjust the directionality of this article's main forecast scenario, which anticipates JPY strengthening and USD weakening.

EUR Outlook – Ms. Lagarde Takes Over ECB Policy Management

Euro Area Monetary Policies Now and Going Forward – Key Aspects of the Draghi-Lagarde Transition

Goodbye to Draghi – Many History-Making Scenes

On October 24, ECB President Draghi's last Governing Council meeting ended without much commotion. Some reporters did make reference to the September Governing Council meeting, which led to an unprecedented internal division within the Governing Council, but the October meeting generally seemed to have a stronger emphasis on examining past events rather than the current state and prospects of policy management. The meetings led by President Draghi, a superb communicator, have always been witty and enjoyable to watch, and I am very impressed when looking back over his eight years in office. My book "Ready for the Japanization of Eurozone, Euro and ECB" (published in July 2014), offers a fundamentals-based analysis of how the Draghi-led ECB ushered in a new era following the financial crisis. Rather than being resolved, the "Japanization" issue continues to be a theme that merits and is attracting considerable attention. My subsequent book, "ECB European Central Bank: From Organization, Strategy to Banking Supervision" (published in 2017), devotes many pages to reviewing the highlights of President Draghi's press conferences. From the perspective of market participants, President Draghi was unquestionably an outstanding ECB president who played the leading role in many history-making scenes. Prominent survivors of the European crisis, President Draghi and German Chancellor Angela Merkel (scheduled to retire in 2021) are eminent representatives of a particularly turbulent era, and their retirements seem to be marking an inter-epochal transition.

When Draghi assumed the ECB presidency in November 2011, the European debt crisis was in its most-severe stage, and many people believed it quite possible that a departure of Greece from the euro area might cause the area to collapse. In view of that, the second Draghi-led Governing Council meeting (December 8) decided to supply about EUR1 trillion of liquidity via a 36-month longer-term refinancing operation (LTRO) and thereby dramatically changed the mood of stagnation. (The first Draghi-led Governing Council meeting – on November 3 – decided to reduce interest rates.) These debut initiatives caused the "Draghi Magic" phrase to come into widespread usage. His statement within a July 2012 speech in London – "The ECB is ready to do whatever it takes to preserve the euro" – is probably the most famous of all the statements he made during his eight years in office. At the latest post-Governing Council meeting press conference a reporter posed a question related to that time and noted that President Draghi has been widely credited with saving the euro. One concrete manifestation of the 'whatever it takes' phrase was the creation of the Outright Monetary Transactions (OMT) program, through which the ECB was prepared to purchase an unlimited number of government bonds. In fact, it is clear that the OMT program's creation successfully dispelled the atmosphere of ominous doom prevailing during the financial crisis, as President Draghi brazenly boasted during the post-Governing Council press conference on June 6, 2013, saying – "When we all look back at what OMT has produced, frankly when you look at the data, it's really very hard not to state that OMT has been probably the most successful monetary policy measure undertaken in recent time." It should be noted that throughout President Draghi's term in office, the OMT program was never actually implemented. President Draghi's ability to create an 'ace up the sleeve' and thereby tranquilize market anxiety appeared to stem from a combination of policy content and policy introduction timing along with superlative communication skills. That was certainly the Draghi-led ECB's greatest achievement.

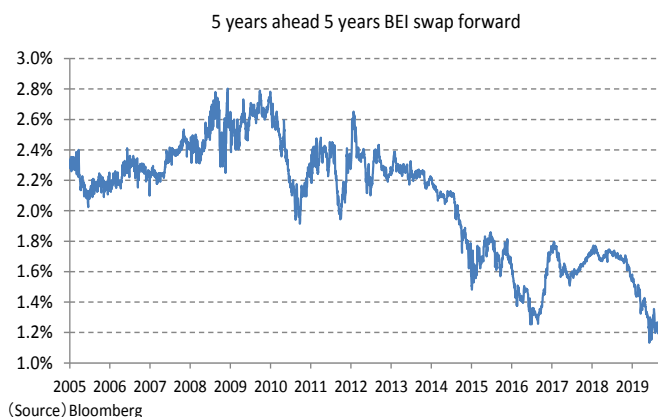
End of the Draghi-Led-ECB Style?

It was the Draghi-led ECB that pioneered the ECB's first non-traditional policies, including negative interest rates and government bond purchases. While the previous ECB president, Claude Trichet, always used a code of 'hint phrases' to refer to the "next move" and emphasized consensus decisions, the Draghi-led ECB seems to have been characterized by a more-aggressive approach focused on flexibility and efforts to break through impasses via majority decisions. That is why the Draghi-led ECB decided to overcome considerable opposition at the September Governing Council meeting to revive quantitative easing (QE, strictly speaking, the expanded asset purchase programme (APP)), and it can be said that President Draghi's decision to retire while leaving behind an unprecedented division within in the Governing Council was his last action in the 'Draghi-led ECB style'. At the latest post-Governing Council meeting press conference a reporter posed a question to President Draghi about – "your legacy and whether you feel it's been tarnished by the recent discussions, which were unusually public, about the rift in the Governing Council and the disagreement about the policy action taken?" Of course, President Draghi responded that – "the answer is no." – and emphasized that the 'rift' was merely a difference of opinion after a discussion and that this is not the first time that such disagreements have been made public. He then noted regarding his opponents at the September Governing Council meeting that – "one of the dissenters called for unity and the full implementation of the policy package. Another dissenter said, "Bygones are bygones." While his report may well be accurate, it should be recognized that ECB presidents are constrained from openly recognizing internal

Governing Council divisiveness at post-Governing Council meeting press conferences and that, to a certain extent, President Draghi's answer reflects the way he would like to portray the divisiveness.

Retrospective on Service – Pride and Regret

The latest post-Governing Council meeting press conference featured a conspicuously large number of questions about President Draghi's retrospective assessment of his term in office. For example, questions were posed about what he regretted and what he was proud of with respect to policy management during his term. President Draghi quickly disposed of the query about his regrets, saying – "I always focus on things that can be done, not things that you can't change." – but another reporter then asked him about a statement by Peter Praet (the ECB's chief economist, who retired at the end of May 2019) expressing his regret about not being to "have monetary policy back to a



kind of normality" before retiring, President Draghi's lengthy response to that question did seem to be somewhat regretful, although he described the shift away from normalization as being dictated by changing conditions and the ECB's mandate. It may be recalled that the ECB began moving toward normalization in 2017 but had to revise its plans due to sudden changes in the economic and financial situations. Ultimately, except for the somewhat exceptional 2017-2018 period, President Draghi was compelled to maintain a crisis-response posture throughout his entire term in office, from November 2011 through his retirement.

His policy posture also created a gap of estrangement with Germany that did not seem necessary to mitigate, so that over 8 years the gap became increasingly deep and wide. Looking back, one finds that three senior-level ECB officials from Germany – former-Bundesbank-president Axel Weber and the former ECB executive board members Jürgen Stark and Sabine Lautenschläger – resigned from their positions over the past decade, and it said that their resignations were in protest of the Draghi-led ECB's easing policies. Although the financial markets did not make a fuss about the resignations, it was peculiar to see so many such resignations during President Draghi's 8-year term, and the resignations reflected the fact that the relationships between President Draghi and senior German officials were often strained and in danger of additional deterioration. At the latest post-Governing Council meeting press conference a reporter asked – "Really how glad are you to finally leave Germany [Frankfurt] and all those fierce critics behind you? Is there maybe one last thing you want to tell them, especially here, but maybe also with a view to those former ECB Council members who recently published a very negative memorandum on ECB policies?" However, it may just be that President Draghi was unlucky to have served during a particularly challenging time period. No matter who its president might have been, the ECB would hardly have been able to resolutely face down the large number of countries – particularly in Southern Europe – that were seeking financial and monetary policy relief. Although President Draghi would never admit it aloud, it is almost certain that he feels regret that the market-based inflation expectations the ECB has emphasized have fallen considerably despite the ECB's sustained extraordinary monetary easing efforts (see graph).

On the other hand, when asked – "You have been asked about something that you regret, with no answer. Maybe you could tell us one thing that you are proud of." – President Draghi enthusiastically responded that – "there isn't anything specific. . . . Actually if there is one general thing I'm proud of, it's the way in which the Governing Council and myself have constantly pursued our mandate. This is something we collectively should be very, very proud. Now, we can talk about legacy and all this later, but in a sense this is part of our legacy: never give up." Major media outlets' articles about the latest Governing Council meeting prominently featured the "never give up" phrase in their headlines, and this phrase might be considered the highlight of President Draghi's final press conference. It is worth noting that the ECB's incoming president, Christine Lagarde, attended the Governing Council meeting, although she did not participate in the meeting's discussions. A reporter at the press conference asked President Draghi whether he had any advice for the incoming president, particularly about addressing German criticisms (in a way that President Draghi did not). President Draghi responded that – "No, I have no advice for Christine; as I said, she knows better than anybody else what to do and what to say."

"Just Ask my Wife." – A Draghi-esque Scene

Several questions were asked at the press conference about the President Draghi's post-retirement plans. This is naturally an interesting issue in light of President Draghi's achievements and talents, and there had even been speculation that that President Draghi and Ms. Lagarde might exchange their positions (Ms. Lagarde would take the ECB presidency while President Draghi would become the IMF Managing Director). Asked about his post-retirement plans, the previous ECB president, Claude Trichet, said he would take care of his four children and read poetry, and

when Ms. Lagarde was preparing to leave her IMF managing director position, she said – “I will be a grandmother.” – so it is natural that similar questions would be posed to President Draghi. In fact, it is rumored that Draghi could become the president of Italy or be appointed to some other political post in his home country. However, President Draghi’s response to a query about his post-retirement plans was – “I don’t have any set idea about that, but if you want more information, just ask my wife. She would know. I hope she does.” President Draghi has always been known for interspersing wry humor in his press conference utterances, and this comment made it clear that he would maintain his characteristic style to the very end.

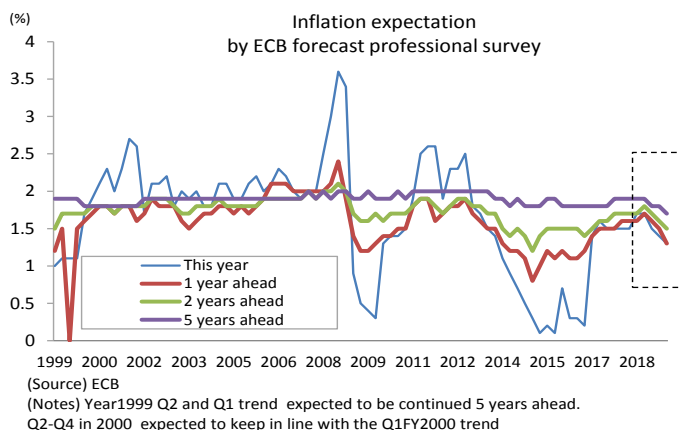
It will in any case be hard to fill the shoes of President Draghi, who is witty and has boldly confronted market expectations, but considerable attention will be focused on how President Lagarde will go about shrinking the large gap of estrangement with Germany that President Draghi’s policy management has created. It seems that President Lagarde’s accession to the presidency may be particularly well timed in light of her renowned coordination abilities. As mentioned above, having been the head of the IMF, Ms. Lagarde is one of the leading policymakers who have survived the European crisis – along with President Draghi and German Chancellor Merkel – and in that sense she can be viewed as someone of the same rank as President Draghi, and I will discuss the key issues of her upcoming ECB presidency in the following sections of this article. Anyway, since the euro area had no crisis response framework in place, Draghi initially had to face the financial crisis and debt crisis with his empty or bare hands – he had to take a zero-based approach to everything. Given that history, I felt that his citation of the “don’t give up” phrase during the press conference was quite dramatic, and it could even be considered a kind of yell of encouragement in the direction of Ms. Lagarde. To President Draghi, I feel like saying “thank you very much for your hard work”.

Three Issues Regarding the Lagarde-Led ECB

On the occasion of Ms. Lagarde’s accession to the ECB presidency, I would like to discuss three issues regarding the ECB that are likely to become important topics going forward. Roughly speaking, the issues are (1) the need to reassess the ECB’s target setting, (2) the question of what “the next move” should be, and (3) whether internal divisions can be alleviated. The first issue regarding reassessing the ECB’s target setting is very important, and it is likely to be the first major project launched by the Lagarde-led ECB. The ECB’s current definition of price stability is – “below, but close to, 2% over the medium term” – and this phrase is quite well known among financial market participants. This is a target that can be interpreted in many ways, but a key point is that it is somewhat more conservative than a simple 2% target. Conceived during the pre-financial-crisis era, when inflation was of greater concern than deflation, the target may be considered inappropriate for the current era, in which the focus of concern – particularly in developed countries – has shifted to the question of why inflation rates stubbornly refuse to rise. It is hard to argue that the “below, but close to, 2% over the medium term” phrase is in accord with the current era.

During the past five years, concerns about the “Japanization of the euro area” trend have grown and the euro area’s stubbornly low inflation rate has become a major topic of discussion. Trends in actual inflation rates have continued to be discouraging, but trends in inflation expectations have been even more disastrous. The ECB has traditionally focused on five-year in five years inflation swap break-even inflation (5-year, 5-year forward BEI) movements, but this index has obstinately refrained from rising despite the implementation of numerous monetary easing policies. Although the ECB tries to avoid such characterizations, it is probably safe to say that inflation expectations have been plunging or collapsing. By the way, the downtrend is now seen not only in market-based inflation expectations but also in survey-based inflation expectations, and this is presenting the ECB with a problem (President Draghi mentioned this point several times in the press conference). According to the ECB’s quarterly Survey of Professional Forecasters (SPF), while 5-year-forward inflation expectations had been relatively stable since 2013, there is now a clear trend of decline in inflation expectations for all periods including the 5-year-forward period (see graph). The magnitude of sustained fluctuation in the 5-year-forward inflation expectations seen recently is greater than that seen since the 2007-2010 period of peak tensions regarding the financial crisis and European debt crisis.

The ECB’s “below, but close to, 2%” description of its medium-term price target has been conducive to a market expectations that if the inflation rate were to rise above 2%, the ECB would shift to monetary policy tightening. It has also possibly fostered the impression that inflation rate levels below 2% may be acceptable from the ECB’s perspective. One of the issues that the ECB has been most concerned about beginning this year is that this asymmetry between the treatment of upward and downward deviation from the 2% target may one of the factors contributing to the decrease of inflation expectations in the euro area. In this regard, President Draghi emphasized the importance of “clarifying the symmetry of our aim” at the annual ECB Forum on Central Banking this June, and



efforts have been made at subsequent Governing Council meetings to further emphasize that the ECB views its inflation target in a symmetrical manner. The essential “below, but close to, 2%” price stability target definition has been retained, however, creating a situation in which the ECB’s communications appear to be inconsistent.

In light of this situation, there is a possibility that the Lagarde-led ECB may finally begin work to adjust the “below, but close to, 2%” price stability target definition. The “below, but close to, 2% over the medium term” phrase was drafted after “a thorough evaluation” of monetary policy strategy at the May 8, 2003, monetary policy meeting, so it would be natural to think that modifying the phrase will entail a considerable amount of work. Since the exact meaning of the definition is an important issue directly related to the nature of the ECB organization’s mission, associated decisions should ideally be made only after thoroughgoing discussions. That is why it is thought that the Draghi-led ECB, approaching the end of President Draghi’s term, chose to temporarily employ language that appeared to adjust the definition but decided to entrust the actual revision of the definition to the Lagarde-led ECB. I see this revision project as one of the most important tasks awaiting President Lagarde.

(2) What is “the Next Move”?

The first issue discussed above is a medium-to-long-term issue, while the remaining two are short-term issues. Issue (2) is the question of what “the next move” should be, and market participants are especially interested in this. In particular, attention is focused on the future directions of policy interest rates and quantitative easing (QE) programs. I will first discuss the policy rates. At the time this article was written, the ECB’s main policy interest rate, the deposit facility interest rate, had been reduced to -0.50%. At the same time, the ECB had introduced a tiered system that excludes the application of negative interest rates to “balances up to six times the required reserve level” as a means of reducing the side effects of negative interest rates on the banking sector. Many have commented that the introduction of this tiered system has given the ECB greater leeway for additional interest rate cuts, and some are actually expecting such additional rate cuts. Frankly speaking, I do not see the benefit (other than promoting currency depreciation) of policies to “decrease interest rates while moderating the impact of interest rate cuts”, but the trend toward such policies is apparently becoming global, as Switzerland appears to be moving toward a similar policy. In addition, there is a possibility that such policies will continue to be adopted without facing resistance in such European countries as Denmark and Sweden, which have been leaders regarding the employment of negative interest rates.

On the other hand, the September 12 Governing Council meeting defied general expectations by deciding to revive the expanded asset purchase programme (APP). (As explained below, this decision has caused an unprecedented internal division within the Governing Council .) At the time this article was written, plans call for the APP to make asset purchases at a rate of EUR20 billion per month from November 1 until just before the next interest rate hike. The APP was restarted just 11 months after its termination in December 2018. As yields on many of the euro area countries’ government bonds are in the negative range, the ECB will have to fundamentally reassess its asset purchasing rules in order to continue pursuing quantitative expansion. The same day, besides restarting the APP, the Governing Council played many of its cards by approving an “all out” package including such elements as an additional interest rate cut, the introduction of a tiered system, and a fundamental relaxation of the terms of a third series of targeted longer-term refinancing operations (TLTRO3). There are many people inclined to assume that the Governing Council ’s recent decisions were “made in advance” to position the Lagarde-led ECB to freely continue implementing easing policies. Market participants are generally aware of this, and it is assumed by many that the ECB has now exhausted its policy options. Consequently, one gets the impression it is not really necessary to speculate about what the “next move” of Lagarde-led ECB may be, and it seems that this is owing to a somewhat over-protective preparations undertaken by the Draghi-led ECB.

(3) Repairing Internal Divisions

Because the overprotective preparations have created a serious internal division within the ECB, President Lagarde must immediately begin her policy management while dealing with internal discord within the Governing Council . On September 25, the ECB announced that the German Governing Council member Sabine Lautenschläger would retire at the end of this October in advance of the expiration of her term in January 2022. While the reason for her premature retirement has not been explained, many people interpret it as being a protest resignation to express opposition to the railroading of the decision to re-start the APP. This was the third such ‘German rebellion’ resignation in the last 10 years, following the September 2011 resignation of ECB executive board member Jürgen Stark to protest the re-commencement of the securities market program (SMP) and the February 2011 resignation of then-Bundesbank-president Axel Weber for the same reason.

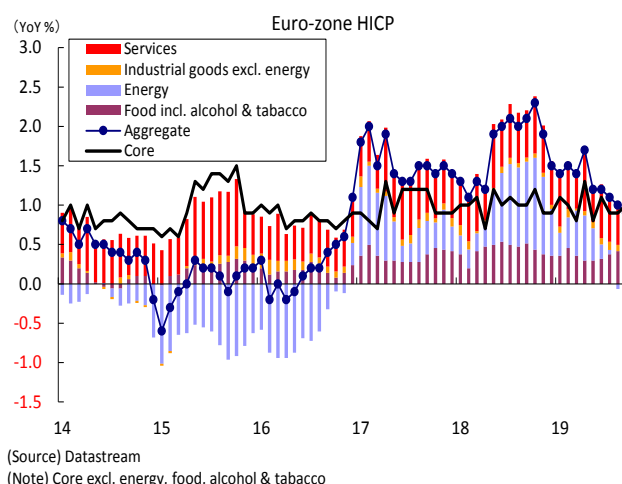
While it may not influence future monetary policy management the impact of Governing Council member Lautenschläger’s resignation is not minor. It is true that there was no significant impact on policy management from the 2011 resignation of executive board member Stark and nor from the February 2011 resignation of then-Bundesbank-president Weber. However, that is only because Germany was isolated during the European debt crisis. If protestors have no followers, their impact is small. However, it is now said that Governing Council members from such countries as France, the Netherlands, Austria, and Estonia are in opposition to the current situation. The

dissenters are still inferior in number to their opponents from countries centered on Southern Europe, but it is highly likely that the situation is closer to being a crisis than the previous division, in which Germany was isolated in its dissent. Accordingly, it is expected that President Lagarde will find it more-difficult to manage monetary policies in the Draghi-style, which centered on promoting majority decisions with an emphasis on speed. For the time being, it is highly probable that the Lagarde-led ECB will avoid flashy initiatives designed to manipulate market psychology. However, President Lagarde played a role in overcoming the European debt crisis in her IMF managing director position, and many people consider her to have outstanding coordination skills. In that sense, it may be that she is exactly the person that the ECB needs at a time when the divisiveness within the Governing Council is expected to become increasingly problematic. First of all, I am looking forward to President Lagarde's debut appearance at the December 12 post-Governing Council meeting press conference.

Euro Area Inflation Situation Now and Going Forward – Japanization Transition Period?

Euro Area Worried about Inflation

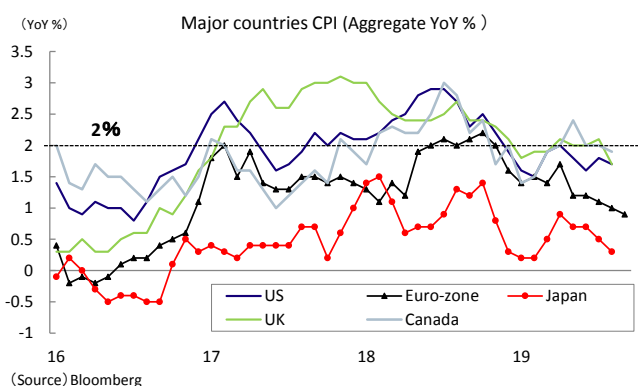
While the deterioration of U.S. economic indicators attracted attention in September, some European figures have been announced that require close attention. Of particular importance is the euro area inflation situation, which is a key determinant of the ECB's "next move" and is also a central basis for intermittent controversies regarding the possibility that the euro area is undergoing a Japanization process. The preliminary euro-zone Harmonized Index of Consumer Prices (HICP) figures for September have been released. On a comprehensive basis, the change was +0.9% yoy, and on a core basis (excluding energy, food, alcoholic beverages, and tobacco) the change was +1.0%. These changes were almost in line with market expectations, and the fact that the core basis rise exceeded the comprehensive basis rise reflects the considerable impact of energy prices. It is also noteworthy that the comprehensive basis growth rate was at the lowest level seen in about three years, since November 2016. Nonetheless, it appears that price hikes have been more-successfully implemented since 2017 than in the 2014-2016 period, when discussions of the euro area's possible Japanization were particularly active. It is also worth noting that the core basis rate of inflation has been stable at around +1.0% throughout the two time periods. As explained above, there is growing concern over internal divisions within the ECB owing to the restart of the APP, and it certainly cannot be said that the restarting of the APP could have been justified merely on the basis of the actual inflation situation. (The APP was inaugurated in January 2015 with the goal of alleviating concerns about the possibility of deflation.)



(Source) Datastream
(Note) Core excl. energy, food, alcohol & tobacco

Gap between Actual Inflation and Inflation Expectations

In light of Japan's experience, however, it is understood that when the inflation expectations of such economic agents as companies and households collapse, the persistent "stickiness" of those lowered expectations can be extremely problematic. As mentioned previously, the euro area is facing a quite-dangerous inflation situation owing to the downtrend in inflation expectations. If this situation is pessimistically assessed (expecting the falling expectations to lead directly to future deflation), then the reasoning behind the decision to revive the APP is apparent. It is clear that there is a gap between the euro area's actual inflation and inflation expectations. Although concerns about deflation may have diminished, however, there is no doubt that the actual inflation trend is disinflationary. Given that actual inflation rate is about half the ECB's targeted +2% yoy level, the ECB's consideration of additional easing measures is not difficult to understand.



(Source) Bloomberg

As is well known, inflation rates have become restrained throughout the world, and countries and regions where the consumer price index (CPI, comprehensive basis) persistently exceeds +2% yoy have become relatively rare. As mentioned above, the euro area HICP has not actually collapsed, and it cannot be said that the euro area is currently undergoing Japanization. However, as can be seen from the graph on the previous page, the world's leading economies can be roughly divided into three inflation trend groups – (1) The United Kingdom and the United States; trending at less than but close to 2%, (2) “Japan; continuously at less than 0.5%”, and (3) the euro area; trending in the vicinity of 1%. Given that only groups (1) and (2) existed prior to the crisis, it is possible at this point to view the euro area as being in a period of “transition to Japanization”.

The August 8, 2019 edition of Mizuho Market Topic, entitled “Germany Undermining Euro Area Growth”, points out that the euro area’s Phillips curve is gradually but surely shifting downwards (unemployment improving but inflation sluggish), and this reflects the fact that the euro area’s HICP levels are beginning to become conspicuously lower than those of other leading economies in the world. In any case, although the euro area’s actual inflation rates have not fallen as much as those of Japan, there appears to be noteworthy progress in the collapse of the euro area’s inflation expectations, which are becoming clearly lower than those of the United States and the United Kingdom, and this is an important situation that merits consideration when forecasting trends in the euro area economy.

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