

May 31, 2021

Overview of Outlook

USD/JPY in May remained rudderless. In last month's report, I stated that I did not feel the need to revise my forecast of USD appreciation against JPY despite the corrective trend seen in April, and my opinion remains unchanged this month. It is true that the USD appreciation trend has reversed, but it seems safe to say that this is mainly due to the excessively rapid pace of U.S. interest rate & USD appreciation during the January-March period. Currency exchange rates in the forex market continue to be dictated by vaccination rates, which means that JPY remains unlikely to be valued by investors. In fact, JPY has not strengthened much even against the weakening USD since April. The state of emergency in Japan, which was introduced as an "intensive short-term" measure, has now been continuing for nearly half a year, while vaccination rates remain dismal and at par with African nations. There is, obviously, too much of a gap between the future outlooks of Japan and the U.S., which is drawing up a blueprint for normalization from July. Going forward, U.S. interest rates and USD are likely to resume a mutually correlated appreciation in anticipation of "further vaccine rollouts → fewer infections → normalization of economic activity → normalization of monetary policy," and when that happens, the gap between the U.S. and Japan will expand even further. As of the end of May, the power dynamics between G7 currencies shows $CAD > GBP > USD \geq EUR > JPY$, and this structure is expected to continue more or less unchanged for the rest of the year. Vaccination delays, low interest rates, the lack of resources, and the inability to even post a positive growth rate make JPY an unattractive currency for investors as of the moment. It does still tend to be bought as a "safe haven" currency during pessimistic phases, but the world is not currently in a pessimistic phase even if Japan may be in one. The situation is not conducive to forecasting JPY appreciation for the time being.

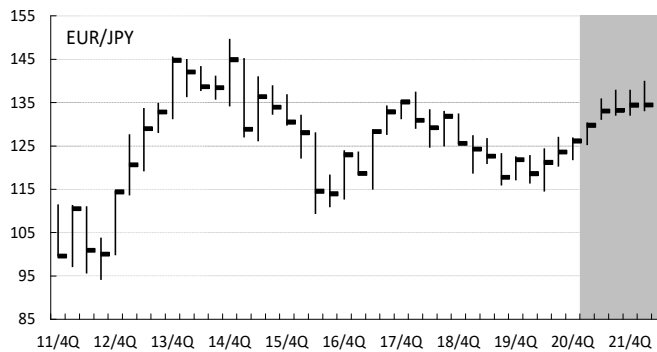
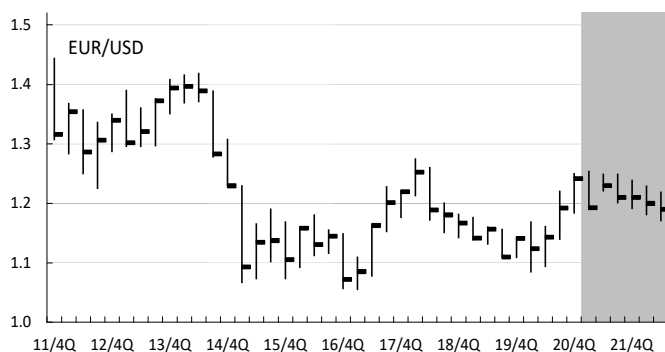
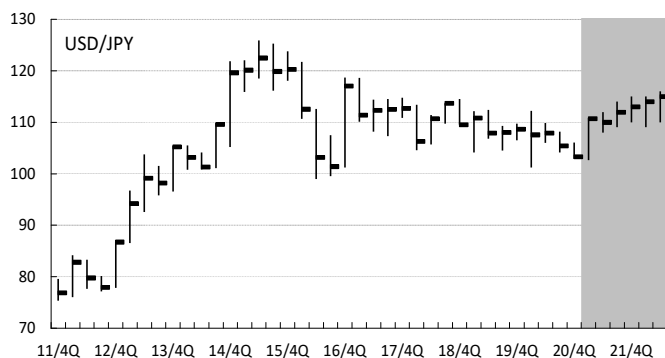
Meanwhile, EUR remains strong. The ECB's balance sheet during the current forecasting period looks set to balloon to an unprecedented level of USD 10 trillion or so, but despite dangling the prospect of quantitative easing (QE) on such a massive scale, EUR, which is backed by the world's largest current account and trade surpluses, shows no sign of caving in. The currency is once again trending at its highest ever level in real effective terms, making it difficult for the ECB to implement tapering. Having said that, movement restrictions have progressively been lifted in various parts of continental Europe since April, and a return to positive economic growth starting the April-June quarter seems likely. Despite lagging behind the U.S., the euro area is also now heading toward a post-COVID phase. Reports suggest that leading member state, Germany, will achieve full vaccination by mid-July. Even without the ECB's tapering, investors are likely to want to buy EUR in hopes of the region's economic growth. With regard to EUR/USD, I predict the possibility of a weakening to around 1.15 because U.S. interest rates look set to increase quite a bit. Meanwhile, I predict EUR/JPY to increase to around 140 or so, taking into account the gap between the real economic performance of the euro area and Japan. Additionally, as the COVID crisis comes to an end, the Scottish independence issue could become a factor influencing forex rates starting early next year.

Summary Table of Forecasts

	2021				2022	
	Jan -May (actual)	Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	102.60 ~ 110.85 (109.78)	108 ~ 112 (110)	109 ~ 114 (112)	110 ~ 115 (113)	109 ~ 115 (114)	110 ~ 116 (115)
EUR/USD	1.1704 ~ 1.2349 (1.2190)	1.20 ~ 1.23 (1.21)	1.18 ~ 1.23 (1.19)	1.17 ~ 1.22 (1.19)	1.16 ~ 1.21 (1.18)	1.15 ~ 1.20 (1.17)
EUR/JPY	125.10 ~ 134.04 (133.83)	131 ~ 136 (133)	132 ~ 138 (133)	132 ~ 138 (134)	133 ~ 140 (135)	134 ~ 141 (135)

(Notes) 1. Actual results released around 10 am TKY time on 31 May 2021. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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Exchange Rate Trends & Forecasts



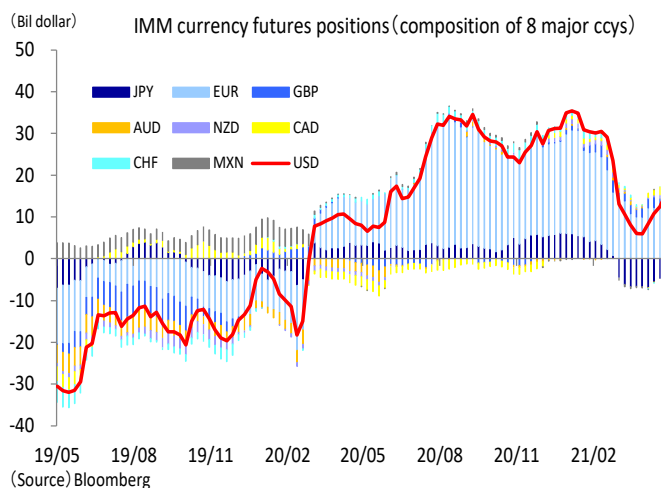
USD/JPY Outlook – Decline in Interest in JPY; Vaccination Rates Continue to Influence Forex Rates

Current State and Future Outlook of Forex Markets – Clear Decline in Interest in JPY

JPY Unaffected by Correction of Strong USD Trend

USD has weakened conspicuously in the forex markets overall, but no major change is obvious against JPY. The figure to the right shows the composite position of eight key currencies against USD as seen from IMM trading in currency futures. The USD short position as of May 25 was USD 15.44 billion, the highest in 11 weeks since March 9. The same data shows a gradual increase in USD selling since April 6. Real interest rates in the U.S. began to decline conspicuously starting early April, and this is what has been driving the sell-off of USD. However, the momentum of USD selling differs by currency. For instance, the currency that has seen the greatest expansion in buying against USD since April is EUR, which has posted a net buying worth +USD 5.9 billion. Presumably this is due to the gradual lifting of movement restrictions in Europe since April and expectations of positive economic growth for the current (April-June) quarter as a result. The next most bought currency is CAD, which has posted an increase in its long position worth +USD 3.5 billion (see figure). In recent months, thanks to steady vaccine rollouts, Canada's economic and financial outlooks have improved vastly, and the Bank of Canada (BOC) took the major step of embarking on a phased reduction of QE (tapering). These developments appear to be reflected in a straightforward manner in speculative trade trends.

As for JPY, it remains characterized by a net short position worth -USD 5.76 billion despite posting an increase in buying worth +USD 840 million. The desire to sell JPY seems quite persistent in the forex markets. Over the past month, the USD rate trend has changed direction from appreciation to depreciation in line with the peaking of U.S. 10-year interest rates at their year-to-date peak of 1.8% attained around late-March to early-April. I do believe that this is merely a corrective phase in the larger USD appreciation trend, which I expect will continue going forward. The important thing to note, here, is that JPY continued to be sold off even during this corrective phase.



USD Weakness Must be Viewed Against CAD and CNY Trends

There are other ways of confirming forex market participants' persistent desire to sell JPY. The figure plots the contributions of the individual currencies that comprise the USD basket of currencies to the rise and fall of USD's nominal effective exchange rate (NEER; as of May 17). USD's NEER increased until the end of March but has since declined by -1.1% as of May 25. Within this, CAD has contributed to a -0.6pp decline and CNY has contributed to a -0.3pp decline. Meanwhile, JPY has bucked the trend and contributed to a +0.4pp increase. In other words, JPY's depreciation appears to be breaking USD's fall. At any rate, it is interesting to note that JPY stands alone in not riding the wave of the USD sell-off (correction of the USD appreciation trend) since April.

Marked Decline in USD/JPY Transaction Volume

Given the sharp rate of USD appreciation seen for a few months starting early this year, the fall in share prices starting March, the decline in interest rates, and the USD depreciation in response to these are healthy corrections and, I believe, necessary for progressing to the next step. However, as mentioned above, there was no buy-back of JPY even during this corrective phase.

As I have stated several times in this report, the pace of vaccine rollout in Japan is at par with the African continent, and the country is continuing with aimless restrictions on movement in the name of an emergency, so (though I will refrain from arguing about the merits or demerits of Japan's pandemic control measures here) it is natural that financial markets are finding it hard to be interested in the country. As I have already mentioned, CAD has been received positively in the markets since the beginning of the year, the reason for this being that Canada not only made good progress on vaccine rollouts within a short period, surpassing vaccination rates in continental Europe, it also went on to begin monetary policy normalization. Meanwhile, EUR also recently recovered its strength. This is partly bound to be because of the markets' positive response to movement restrictions being progressively lifted starting the end of April and the EU-wide vaccine procurement strategy beginning to succeed. In the world of forex markets, the direction and margin of change are most easily evaluated, so it is natural that not much attention is paid to JPY and Japan, where the casualty figures may be low, but low economic growth continues amid aimless restrictions on movement.

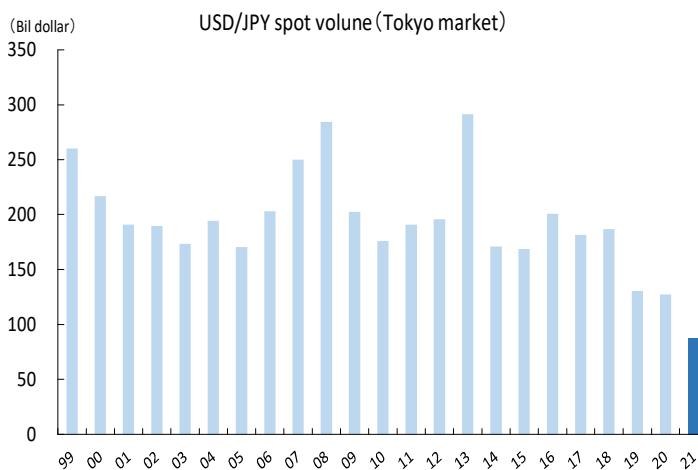
The lack of interest in USD/JPY is evident in the trading volume. The total USD/JPY spot trading volume for January-April was USD 87.4 billion, which is markedly lower than the average volume for past five years (USD 165.4 billion), past 10 years (USD 184.5 billion), and the past 20 years (USD 194 billion) – see figure. Of course, the Tokyo metropolitan area and other areas have been in a state of emergency most of the time since the beginning of the year so far, so some of the fall in trading volume may be attributed to market participants working from home. However, most market participants probably feel that USD/JPY lacks a theme to begin with. The main attraction in forex markets is to trade based on speculation of the “next move” by a central bank. In the case of the BOJ, however, since the release of the Policy Review in March, the default policy operation path under Governor Haruhiko Kuroda seems to maintain the *status quo*. JPY interest rates rarely ever move, so there is no real need to buy back JPY while U.S. and European interest rates are moving.

Going forward, if the risk-off mood intensifies and supply and demand factors such as being the world's largest net external creditor once again begin to influence forex trade, there may be a revival of interest in JPY, but this is a far-fetched scenario at the current time, as the world looks forward to a post-COVID phase. It has to be said that there is very little reason for investors to proactively buy a currency that seems to have missed the normalization wave. If any movement can be expected in the USD/JPY rate trend, it will probably be due to a JPY sell-off, so I believe the risk has expanded in the direction of a weak JPY.

USD NEER rate of change & contribution since the beginning of the year

Country	Share (%)	USD from the beginning of the year vs. each currency (%)	Contribution (%pts)
China	23.3	1.8	-0.4
Euro-zone	17.0	0.3	-0.0
Mexico	13.3	0.1	-0.0
Canada	11.7	5.5	-0.6
Japan	7.1	-5.1	0.4
S.Korea	3.8	-3.2	0.1
Taiwan	2.2	1.6	-0.0
Switzerland	1.7	-1.2	0.0
U.K.	3.2	3.5	-0.1
Russia	0.6	1.2	-0.0
S.Africa	0.4	6.0	-0.0
Turkey	0.5	-12.1	0.1
Argentina	0.3	-10.8	0.0
Other	15.0	-	-0.4
NEER JAN-DEC2020	-	-1.1	-1.1

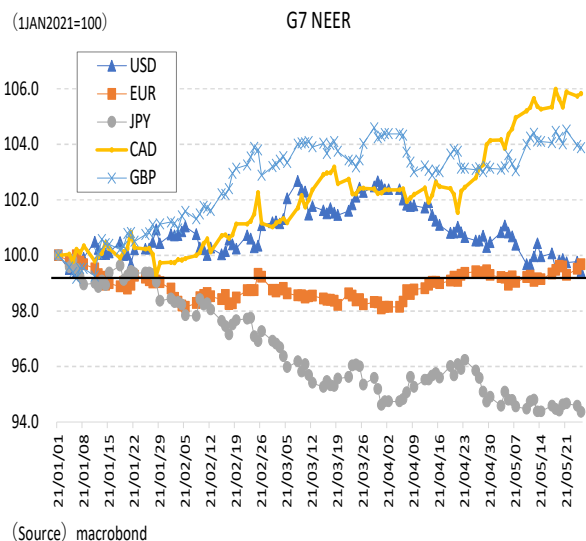
(Source) BIS & Bloomberg. (Notes) NEER: Broad base Currency rate of change : from 31DEC2019 to 25MAY2020



(Source) Bank of Japan (Note) Total from Jan to Apr every year

Vaccination Strategy Continues to Hold the Key to Forex Rates in May and Onward

My perception of rate trends has not changed at all. The figure to the right (top) shows the NEER of G7 countries since the beginning of the year. In terms of year-to-date rate of change, CAD and GBP have increased significantly, and USD and EUR have remained level, while JPY has decreased significantly. As I have been pointing out, the currencies that have appreciated belong to countries with the highest vaccination rates among developed nations (see chart). Steady progress in vaccine rollout makes it easy to draw up a roadmap for economic normalization, which raises expectations and market interest rates, which in turn enables market participants to evaluate the currency positively. As the figure shows, CAD and GBP have risen significantly more than the other currencies, and it is noteworthy that both their central banks have begun showing an interest in starting policy normalization. For instance, the BOC decided on April 21 to cut back on the scale of its QE program. In response, the market brought forward its expected timing for the start of rate hikes from 2023 to 2H of 2022. Meanwhile, the Bank of England (BOE) decoded on May 6 to cut the amount of its weekly asset purchases from GBP 4.4 billion/week to GBP 3.4 billion/week. However, the total amount of government bond purchases until the end of the year will remain unchanged (GBP 895 billion). In other words, there is no change in monetary policy as a whole, and the decision is unlikely to attract much attention in the markets. Some members of the Monetary Policy Committee, however, are said to have insisted that the target balance of asset purchases itself must be lowered, which does suggest that the next move by the BOE could be to begin the normalization process. Perhaps this is contributing to GBP's strong performance. As for USD, the fact that it is the world's key currency makes it imperative for U.S. monetary authorities to be extremely cautious in their policy operations, and this special characteristic could be contributing to USD's weakness.



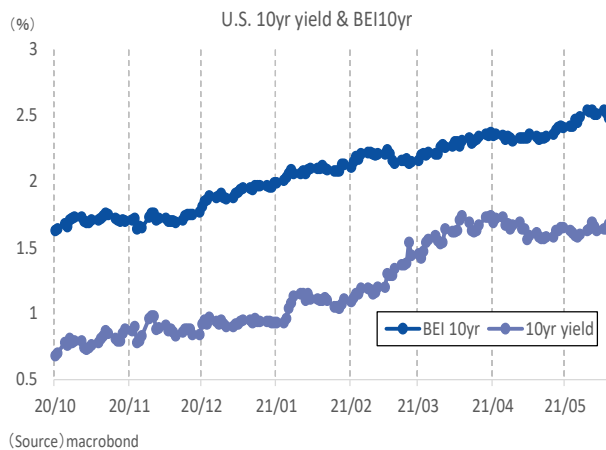
Percentage of people vaccinated at least once

Country	%
UK	54.48
US	47.59
Canada	47.58
Germany	37.88
Italy	32.94
France	31.28
EU	27.74
Japan	4.14

(Source) Our World in Data as of 19 May, Japan as of 6 May, UK, Germany & France as of 7 May

U.S. and Europe Even Further Ahead by Autumn

Given that vaccination is the only exit strategy available to us from this pandemic, the aforementioned status of forex rates was easy to predict. Of course, by Autumn, Japan is likely to have made considerable progress with vaccine rollouts too. However, by then, it is quite likely that following on from the BOC and the BOE, the Fed's start of tapering will have captured the market's attention, leaving Japan even further behind. It would not be surprising if the dot plot consensus among FOMC members ("zero percent interest rates through 2023" since last year) has been revised by Autumn. As the figure on the previous page shows, U.S. 10-year interest rates have recently been peaking out, but inflation expectations are beginning to rise again. Assuming a Fisher Effect, nominal interest rates will follow in the trend of inflation expectations. If the trends seen from November 2020 through March 2021 are any indication, nominal interest rates follow inflation expectations with a delay of a month or two. The "July 4" turning point for normalization, frequently referred to by U.S. President Joe Biden must also be taken into account. If the second half of the year brings about a change in the U.S. economic and financial scenarios, it would be irrational to continue hanging on to the "zero percent interest rates through 2023" commitment made during an emergency. Of course, taking into account their current pace of vaccinations, "resumption of economic activities" is quite likely to be the main theme during the second half of the year in the UK, Canada, and continental Europe too.



In other words, by Autumn, when vaccinations are being rolled out in a routine manner in Japan, the other major world economies are expected to already be considering exit strategies from their unprecedented economic and financial responses to the crisis. The gap between their situations and Japan's will undoubtedly be reflected in interest rate gaps and form the basis for determining currency-related power dynamics. In other words, the situation we have seen since the beginning of the year is likely to continue unchanged during the second half of the year. Right now, the emergency declared in Japan in April is looking likely to be extended through June 20. During the January-March period, the strength of the U.S. economy was conspicuous, but in the April-June period, the euro area is also expected

to recover positive growth. Japan, meanwhile, is certain to post conspicuously weak growth on a global level. If, as the soft light of a post-COVID phase shines on the American and European economies, Japan stands apart as an economy in technical recession, having posted two consecutive quarters of negative growth, this would be a rare development, given the increasing connectedness of the global economy in recent years. Naturally, the financial markets would also be affected by such a scenario.

Under such circumstances, with signs of normalization beginning to be evident around the world except in Japan, my basic understanding is that the balance of risks for USD/JPY is increasingly on the upper side. Without becoming too caught up in recent developments, I would like to predict a bigger picture of USD ≥ GBP ≥ CAD > EUR >> JPY for G7 countries overall.

Basic JPY Supply-Demand Balance Now and Going Forward – Trade Surplus Expanding in the Background

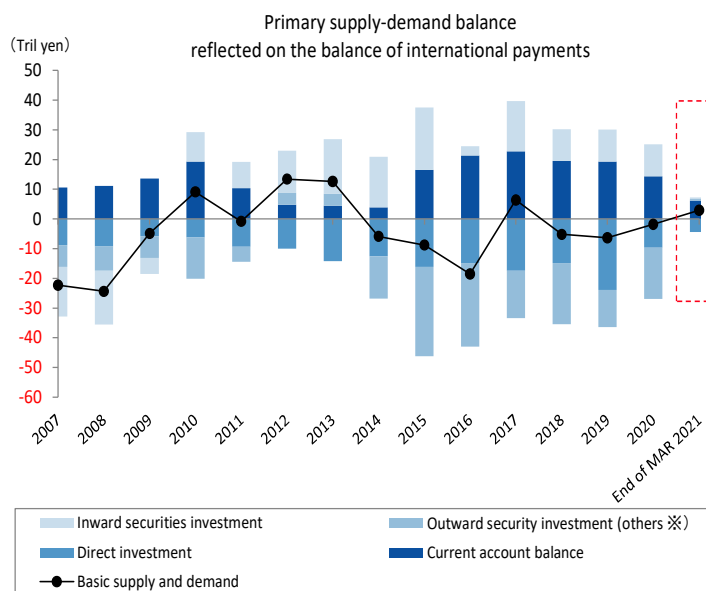
Net Buying of JPY Amid Expanding Trade Surplus?

USD/JPY continues to post small movements. Thanks to smoldering inflation expectations in the U.S. and the accompanying increase in interest rates, it is easy for USD to be chosen in the markets. However, given the exceptional delay in vaccine rollouts in Japan among developed economies and the inevitably poorer performance of the Japanese economy, one gets the impression that the upper bound of USD/JPY is being surprisingly weighed down. Of course, inflation concerns have invited a correction in U.S. share prices, and that itself is prompting a risk-off JPY buying, but that is not the only factor.

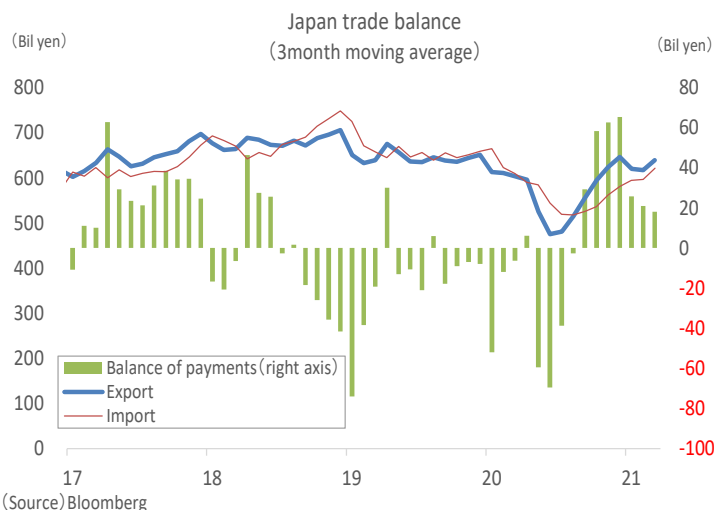
Another possible factor is the supply-demand situation. In May, Japan's March Balance of Payments were released, so I would like to take stock of JPY's supply-demand balance for the January-March quarter. As the figure shows, as of the end of the January-March quarter, the JPY supply-demand balance amounted to a net buying of JPY worth +JPY 2.9 trillion. Albeit gradual, the trend is clearly beginning to shift from a net selling of JPY to a net buying. There are mainly two reasons for this. One is that, as Japan's trade surplus increases, its current account surplus is also expanding. The other reason is the net sale of portfolio investment assets. Both factors can provide strong arguments, but the former is more immediately effective when it comes to explaining the strength of JPY. The building up of the current account surplus is, strictly speaking, due to the accumulation of a trade surplus.

As the figure to the right shows, the trade surplus has been recovering sharply since 2H of last year. Part of this is attributable to the normalization of corporate activity and the accompanying recovery in exports, but had it been just that, things would have recovered merely to the pre-COVID neutral trade balance level. The reason for an expansion in trade surplus is that, while exports have recovered to pre-COVID levels, imports have not. Looking at the state of affairs in Japan, it is clear that in addition to long-term movement restrictions, inconsistent measures to deal with the pandemic have been continuing, with the result that there are no signs of a revival in consumption or investment appetite in the domestic economy. This is different from exports, which are driven by strong overseas economic performance.

Ultimately, then, the trade surplus is the result of the economic gap between the domestic and overseas economic situations. Ideally speaking, both imports and exports would increase, with exports recovering to pre-COVID levels, but that is not what is happening. As a trade surplus results in an outright buying of JPY/selling of USD, an increase in the trade surplus is, naturally, a direct factor weighing down USD/JPY. However, despite being a whole lap behind, Japan is also expected to see progress in vaccine rollout going forward, which will lead to movement restrictions being lifted and economic growth re-emerging. When that happens, it seems quite likely that the trade surplus, which is on the rise due to the gap between domestic and overseas economic performance, will automatically shrink again.



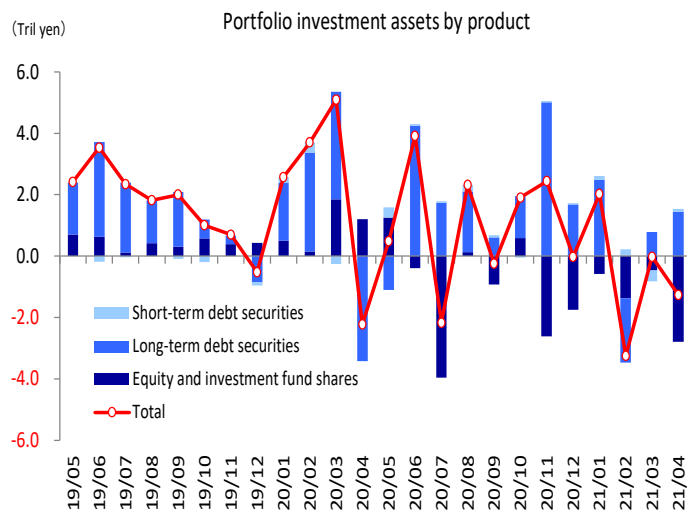
(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government



(Source) Bloomberg

Net Buying Continuing Only for Long-Term Debt Securities

Meanwhile, the continuing net selling of portfolio investment assets is conspicuous. Specifically, a net selling of portfolio investment assets worth -JPY 460.2 billion was posted for the January-March period. The figure to the right shows the international transactions in securities (based on reports from designated major investors) for a year through April 2021 (the latest release), and as is evident from a glance, the net buying trend has turned into a net selling trend since the beginning of the year (N.B. a net buying of portfolio investment assets amounts to a buyback of JPY or an inflow of capital, which contributes to a net buying of JPY, while a net selling is the opposite). However, if we look only at long-term debt securities, we see a net buying worth +JPY 2.6 trillion in total for the January-April period. This seems to show that the investment appetite of institutional investors targeting the U.S.-Japan interest rate differential remains fairly strong amid a general waning of investment appetite in foreign equity. If we assume that the U.S. employment and wage situations will post marked improvement starting summer, as restrictions are lifted, speculations are likely to focus on “when” rather than “whether” the Fed will begin tapering. Naturally, such developments would be reflected in the U.S.-Japan interest rate differential, and if that happens, the net JPY selling trend is unlikely to weaken for the time being even if it does not strengthen, propped up by net buying of long-term debt securities and other portfolio investment assets.



(Source) INDB

To summarize the above points, the current structure (if one such can be acknowledged) of JPY net buying due to an expansion in the trade surplus and a net selling of portfolio investment assets, which is weighing down USD/JPY, is transient and seems quite likely to fade away as we approach the second half of the year.

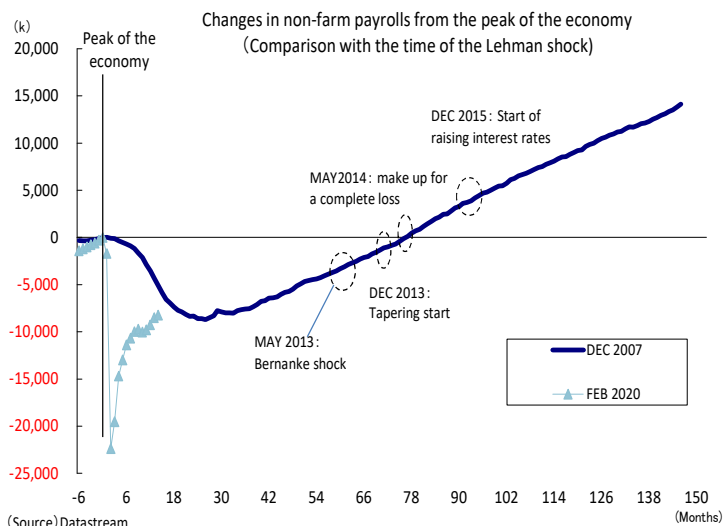
U.S. Monetary Policy Now and Going Forward – Fiscal Policy May be Tapered First

Start of Policy Normalization in Sight

The minutes of the FOMC meeting of April 27-28 were published on May 19. As reported earlier, the tone throughout the meeting strongly suggested that it was too early to begin a phased tapering of QE, but the line “A number of participants suggested that if the economy continued to make rapid progress toward the Committee's goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases” in the minutes drew some attention. It suggests that tapering is now within sight as the next move, and efforts have begun to consolidate opinions on when would be an opportune time to begin it. This is a dramatic change in mood compared with what existed until the end of last year, when even the mention of tapering was taboo. Again, since December last year, the forward guidance for asset purchases has used the language “until substantial further progress has been made toward the Committee's maximum employment and price stability goals.” However, even though “various participants” noted that “it would likely be some time” before the economy had made this “further progress,” the minutes also noted that “Many participants highlighted the importance of the Committee clearly communicating its assessment of progress toward its longer-run goals.” Though it is still too early, there are glimpses of the sentiment that a discussion on the subject will become necessary in the near future. Further, the minutes noted that “a couple of participants commented on the risks of inflation pressures building up to unwelcome levels before they become sufficiently evident to induce a policy reaction.” Incidentally, the minutes also mentioned a survey, according to which, “the Federal Reserve's net purchases of Treasury and agency securities were expected to end three quarters after the first reduction in the pace of asset purchases, and the first increase in the target range for the federal funds rate was expected to occur three quarters after that.” This is more evidence of a discussion based on the anticipation of policy normalization.

Employment Situation Still Devastated

The Fed's two mandates are to stabilize prices and maximize employment. The former, what with inflation concerns surfacing, appears to suggest the need for monetary tightening (details later), but the latter needs to be evaluated more cautiously. While employment and wages are on the mend, they remain quite devastated. As I have mentioned before, although unemployment had fallen to 3.5% and near-full employment had been realized, inflation never accelerated during the second half of President Donald Trump's term. As the figure below shows, the CPI core never reached +2.5% even when the employment market was at its tightest in 2019. So, as before, it seems premature to warn about runaway inflation rates with unemployment being close to 6%. The figure plots the rise and fall of employment starting from its peak. In the previous cycle, December 2007 was the economic peak preceding the recessionary phase caused by the 2008 global financial crisis. 26 months later (February 2010), was the lowest point, with around 8.7 million jobs lost. 77 months since the peak (May 2014), the lost jobs were fully recovered. This time, February 2020 was the peak, and 14 months later (April 2021), 8.2 million jobs have been lost. In other words, merely looking at the number of jobs lost, the current situation is not much different from the worst part of the global financial crisis.



Realistic to Expect that Monetary Policy will be Revised After Employment Recovers in Summer

What can we conclude regarding the current state and future outlook of monetary policy taking into account this recovery in employment? Looking back at the previous policy normalization phase, in May 2013, a year before the lost jobs were fully recovered, former Fed Chair Ben Bernanke mentioned a phased tapering at his Congressional testimony. Tapering was then actually begun in December the same year. In other words, the Fed began considering as well as implementing tapering without waiting for jobs to be fully recovered. However, the lost jobs were down to 2.3 million at the time of what later came to be known as the “Bernanke Shock.” That is to say, the Fed began to discuss an exit strategy after it had recovered over 70% of the 8.7 million jobs that had been lost by the lowest point. It is also worth noting that the CPI core was unvaryingly below +2% at that time. Long story short, it can be said that the Fed embarked on policy normalization after confirming that the employment status and its future prospects were forward-looking, rather than focusing on whether inflation was above 2% or not. That being the case, it seems rather unlikely that the Fed would embark on policy revision this time based on a transient increase in inflation expectations, while the employment situation remains devastated. Of course, given that the pace of job loss/recovery this time is completely different from historical precedent, it is quite possible that by summer, when movement restrictions are more or less fully lifted, the net jobs lost will have shrunk significantly. If so, the Fed may take this development into account and finally begin discussing (not implementing) the possibility of tapering from the second half of the year onward – this is a relatively realistic scenario.

Tightening Labor Market

As mentioned above, a total of 8.2 million jobs (nonfarm payrolls) have been lost since the peak in February 2020, but 6.2 million of these jobs have been in the service sector (see chart). Within the service sector, the accommodation and food services industry sectors, which are directed affected by movement restrictions, have lost 2.23 million jobs, while closures of schools, childcare centers, etc., have resulted in a total of 830K jobs being lost in the education and health care sectors. These are the main industry sectors preventing a recovery in non-farm payrolls. However, according to the March Job Openings and Labor Turnover Survey (JOLTS), the number of job openings rose by 597K mom to 8.123 million, the highest ever since the survey was started in December 2000. This strong demand for labor is the reason why, despite the April job data falling short of expectations, the markets are concerned about inflation rather than deflation. On May 13, a major U.S. fast food chain announced an increase in hourly wages in an effort to retain workers.¹ There are signs that restrictions on labor supply are beginning to invite higher wages.

U.S. Employment Statistics over the past 12 months

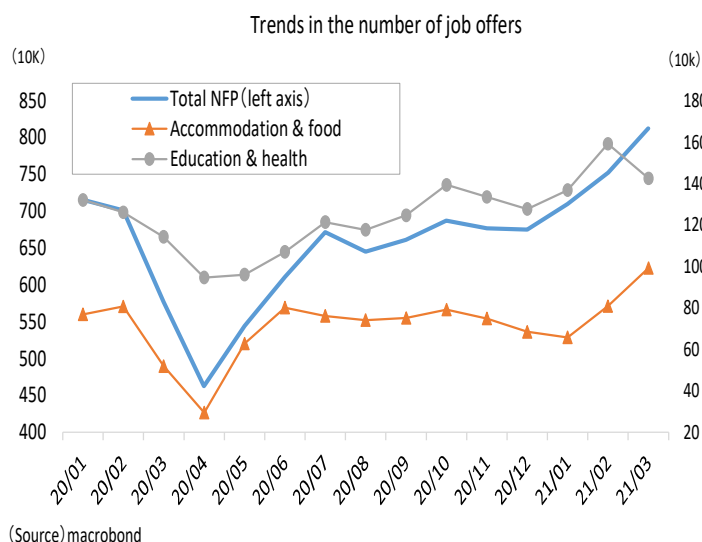
	Restoration rate	Employment loss (10k)
Total (NFP)	63.3%	-821.5
Goods	69.4%	-78.6
Motor vehicles & parts	70.1%	-10.8
Service	67.1%	-618.5
Transportation & warehousing	75.3%	-14.2
Retail	83.2%	-40.0
Temporary help	70.3%	-29.6
Education & health	64.3%	-82.8
Accommodation & food	67.6%	-223.4
Government	-	-124.4

(Source) macrobond (Note) From March 20 to April 21

¹ See May 13, 2021 Bloomberg article titled “McDonald’s Boosting Average U.S. Wages to Over \$13 an Hour.”

Fiscal Policies are What Require Tapering

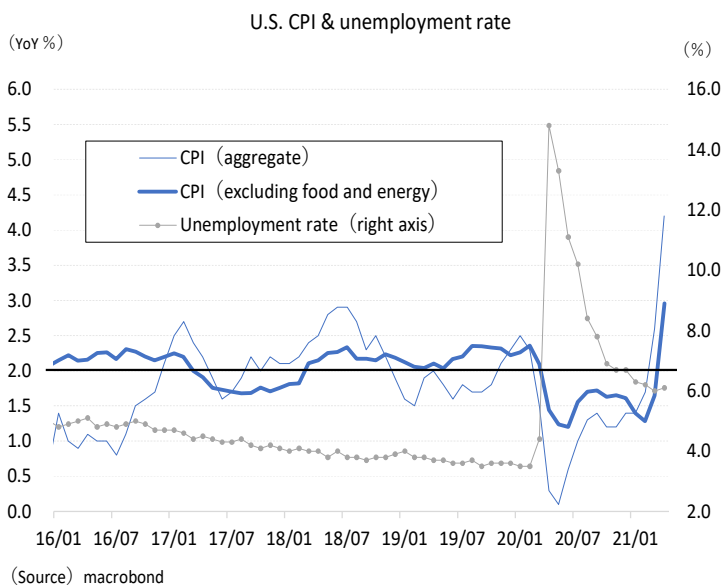
Some of the reasons jobs are not recovering despite this strong demand for labor include (1) hefty unemployment benefits, (2) fear of infections spreading, and (3) a weakening desire to work, of which reason (1) is drawing the greatest attention at this time. In its statement dated May 7,² the U.S. Chamber of Commerce pointed out that the “the \$300 benefit results in approximately one in four recipients taking home more in unemployment than they earned working,” and that ending these unemployment benefits would contribute to addressing the labor shortages. The JOLTS survey results (see figure) also show that job openings are strong in accommodation and food services, education and health care, and other industries that suffered hefty job losses. Although one cannot expect that all those who lost their employment as a result of the pandemic would return to the workplaces or industries they were originally affiliated with, the fact that so few workers are available despite so many job openings points to the problem that going back to work has become less profitable for workers.



If this situation continues, it is natural that wages (which equate to job quality) will increase, and that itself would hint at the need for monetary policy normalization, but it seems unlikely that the Fed would make that decision. The recent FOMC meeting minutes noted that “A number of participants remarked that supply chain bottlenecks and input shortages may not be resolved quickly” and that cost-push factors related to both labor and commodity supply bottlenecks “could put upward pressure on prices beyond this year.” However, such constraints are unlikely to continue very long, so despite the expression of concerns over them, they may not be used as a reason for policy normalization. The Chamber of Commerce statement noted that “a comprehensive approach to dealing with our workforce issues” was needed, so taking everything into account, it seems that a part of fiscal policy should be prioritized for tapering rather than monetary policy. At the very least, such a step would relieve the inflationary pressures on labor (and, therefore, also on commodity prices down the line).

Rise in Inflation a Topic of Concern, but...

Starting early May, the rise in inflation has been a topic of concern. This was seen as a factor that could cause the Fed to become more hawkish in its policy operations in view of its “price stabilization” mandate. Symbolically, the U.S. April CPI Aggregate made the headlines when it increased by +4.2% yoy, the largest increase in 12 years and 7 months since September 2008. The CPI Core (which excludes food and energy) also increased by +3.2% mom, the largest increase in 25 years and 6 months, since October 1995. This news caused U.S. 10-year interest rates to shoot up to the neighborhood of 1.70% and share prices to tumble. As mentioned above, inflation expectations have already been rising and an accompanying increase in nominal interest rates is a matter of concern, so similar developments may be seen again in the coming months. Though it is true, as the Fed has been consistently saying, that the recent rise in prices is transient, such a strong increase in the CPI was bound to cause interest rates to shoot up. The development is a significant headwind for share prices and a tailwind for USD.



As predicted in advance, the reason for the increase in CPI is mainly an increase in energy prices (+25.1% yoy), but apart from that, car sales, especially used car sales, contributed significantly at +21.0% yoy. The rise in prices reflecting semiconductor-related supply constraints, which has contributed significantly to the rise in Core CPI, is also pointed out. Further, the aforementioned labor shortages are also likely to be pushing up the prices of various goods and services.

² U.S. Chamber of Commerce “U.S. Chamber Calls for Ending \$300 Weekly Supplemental Unemployment Benefits to Address Labor Shortages” May 7, 2021

Risks to My Main Scenario – “World’s Largest Net External Asset Balance” Status and UK-Related Risks

World’s Highest Net External Asset Level for 30 Consecutive Years

As I have previously discussed, my basic understanding of this year’s exchange rate outlook is that USD will become stronger due to the normalization of the U.S. economy and an accompanying rise in U.S. interest rates. On the other hand, in a world where the degree of influence of such interest rate movements on forex rate movements cannot be taken for granted – the so-called “world without interest rates” – it has been increasingly apparent that analyses focused on such supply-demand situations as countries’ balance of payments trends and associated trends in countries’ net external asset structures will become more important. If COVID-19 continues generating new mutant forms and existing vaccines become ineffective, for example, supply-demand factors can be expected to again attract growing attention. This situation is just as it was last year.

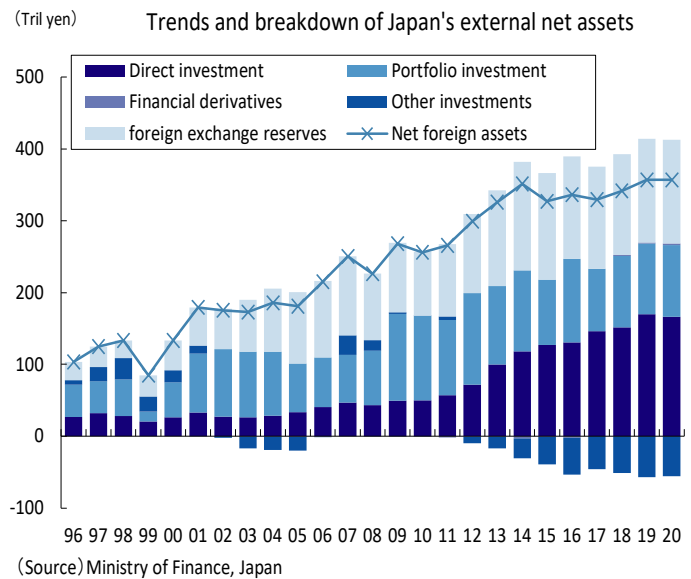
In this regard, the “Japan’s External Assets and Liabilities Report (2020 year-end)” released by the Ministry of Finance in May indicates that JPY is likely to

continue being considered a safe asset at times of strengthening risk-aversion moods. As explained below, countries’ accumulation of huge net external asset balances is not necessarily a positive situation, as such net external asset balances may reflect a lack of (attractive) domestic investment opportunities. However, it is worth noting that Japan’s huge net external asset balance is the most significant basis for considering JPY to be a safe asset despite Japan’s current trends of political and economic weakening.

The report indicates that Japan’s net balance of external assets and liabilities at the end of 2020 was JPY356.970 trillion, down JPY45.0 billion yoy (the third consecutive year of decrease) but that Japan maintained its status as the country with the world’s highest level of net external assets for a 30th consecutive year. Although Japan’s net balance of external assets and liabilities decreased from the previous year in JPY terms, it can be considered to be roughly stable in USD terms given that USD/JPY declined by about 5% during 2020. The net external asset level at the end of 2019 was JPY357 trillion, and 5% of that amounts to JPY17.9 trillion. This is approximately equivalent to Japan’s 2020 current account surplus (+JPY17.5 trillion), which was previously expected to increase the 2020 year-end net balance of external assets. In short, the price effect of exchange rate fluctuations has stabilized the net external assets level in USD terms, and there has been no change to Japan’s fundamental trend of accumulating net external assets.

Looking at changes in external assets and external liabilities separately, one finds that both increased by almost the same amount, approximately JPY55.6 trillion yoy. There are three main factors causing fluctuations in external assets and liabilities: ① transaction flows, ② exchange rates, and ③ other adjustments (≈ fluctuations in asset prices).

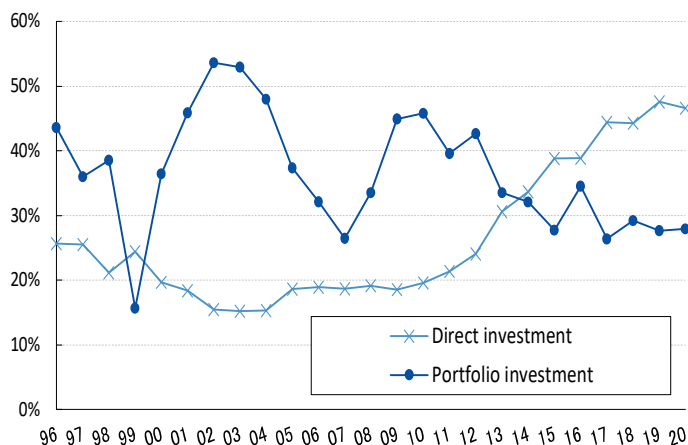
Regarding external assets the effects were ① -JPY13.2 trillion, ② -JPY31.8 trillion, and ③ +JPY100.6 trillion. While the asset balance was decreased by the sale of the assets themselves (factor ①) and the valuation loss due to JPY appreciation (factor ②), those effects were fully offset by a rise in the prices of financial products (factor ③). It is easy to understand factor ③ given the tremendous surge in risk asset prices last year. Furthermore, examining this financial product price increase factor by financial product type, one finds the change for stocks and investment fund equity was +JPY17.9 trillion and that for bonds was +JPY10.7 trillion, so the traditional financial product categories alone do not come close to explaining the +JPY100.6 trillion figure. The largest contribution to that figure was from the category including financial derivatives, which amounted to +JPY77.5 trillion. Regarding external liabilities, the scales of the three factors were similar, at ① -JPY28.6 trillion, ② -JPY8.9 trillion, and ③ +JPY93.1 trillion. Thus, it is evident that the balances of assets and liabilities increased not because of the “quantity” factor associated with transactions but because of the “price” factor that reflects valuation gains.



Direct Investment Diminishes “Risk-Off-Mood JPY Buying”

In recent years, I have been writing about changes in Japan’s net external asset structure and expressing my view that those changes are diminishing the power of “risk-off-mood JPY buying”. Looking at changes in Japan’s net external asset structure over the past 10 years, one finds that of Japanese companies’ overseas assets, the share in the form of foreign direct investment (≈ acquired companies) has grown to become considerably greater than the share in the form of investment in foreign securities. As the graph on the right shows, the share of direct investment surpassed that of securities investment around 2014 and has subsequently continued to increase. My hypothesis is that this change may one of the factors causing the power of “risk-off JPY buying” to decline in recent years. Even when risk aversion moods intensify, it is still unlikely that Japanese companies will relinquish their ownership of overseas companies, but they are probably more inclined to sell their liquid foreign securities and convert them into JPY. In light of this, I believe growth of overseas corporate acquisitions will slow the momentum of “risk-off-mood JPY buying.”

Direct investment & portfolio investment ratio in net foreign assets



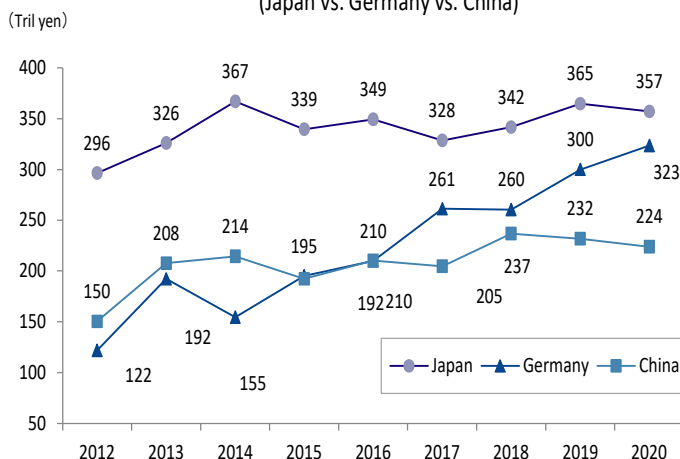
(Source) Ministry of Finance, Japan

In 2020, the pandemic’s impact caused a JPY3.5 trillion yoy decrease in direct investment within net external assets (the first such decrease in 12 years), but this was an inevitable consequence of the extraordinary situation last year. Given that the rate of returns on direct investment is clearly superior to that on securities investment, the continued shift away from securities investment and toward direct investment can be considered rational. However, it bears repeating that being the country with world’s highest net external asset level is not actually as positive a situation as it may seem. The rise in net external assets results from the accumulation of annual current account surpluses and, theoretically, the current account surpluses result from a glut of domestic savings glut (savings > investment). The vigorous rise of Japan’s foreign securities investment and direct investment reflects the fact that there are insufficient domestic investment opportunities. Regarding the increase in direct investment, it can probably said that it stems from the Japanese companies’ judgment that acquisitions of and investments in overseas companies are more likely to promote their medium-to-long-term growth than investments in the ever-shrinking domestic market. Japan’s history since 1990 has often been referred to as the “lost 20 years” and now the “lost 30 years”, and the country’s attainment of the world’s highest net external asset level should be understood to be a by-product of that “lost” era.

Germany’s Approach from Behind – Fearsome Prospect of Losing “World’s Largest Net External Asset Balance” Status

Japan’s status as the country with the world’s largest net external asset balance is clearly one of the most important factors to take into account when considering the value of JPY – that status being a factor promoting JPY appreciation. As mentioned above, however, JPY used to acquire overseas companies tends to be “JPY that is sold but does not return.” The current trend of increase in the proportion of direct investment within Japan’s net external assets is slowly but surely undermining a basis for JPY appreciation. Japan is still more strongly inclined to worry about the potential for extreme JPY appreciation, but since Japan is a resource-importing country, the possibility of extreme JPY depreciation is also certainly something worth worrying about. It is theoretically possible (leaving aside the question of political feasibility) for a country to countervail its currency’s appreciation by infinitely undertaking the selling of its own currency and buying of foreign currency, but the scale of that country’s foreign currency selling and own currency buying is limited by the amount of its foreign currency reserves. In other words, Japan has a finite quantity of ammunition for fighting against extreme JPY depreciation. When considering the potential for out-of-control extreme JPY depreciation or extreme JPY appreciation scenarios, one should recognize that it is the out-of-control extreme JPY depreciation scenario that is much more intimidating.

Net external assets (Japan vs. Germany vs. China)



(Source) Ministry of Finance, Japan

In light of this, when envisaging possible future trends in Japan’s economy and in JPY exchange rates, it is becoming important to also consider scenarios in which JPY loses its attractiveness as a safe haven asset, raising the prospect of extreme JPY depreciation trends. It is precisely because JPY has maintained its attractiveness as a safe haven

asset for 30 years that the loss of that attractiveness would have the potential to create considerable turmoil in foreign exchange markets. In this regard, I am concerned about comparisons of Japan with other countries, particularly Germany. As the graph shows, Germany continues to leverage the perennially undervalued currency Germany utilizes as a euro area member to generate huge trade surpluses and maintain its status as the country with the world's largest current account surplus. (Special pandemic-related demand factors enabled China to usurp that world's largest current account surplus status by a thin margin in 2020, but its current account surplus for 2020 was almost the same as that of second-place Germany.) No matter how large Germany's trade and current account surpluses become, EUR will not appreciate enough to undermine the country's competitiveness, so it can be expected that Germany will sustain the pace of its net external asset accumulation seen in recent years. As of the end of 2020, the gap between the net external assets of Japan and Germany had narrowed to a record low of JPY34 trillion. At this point, depending on forex market price trends, it would not be surprising to see Japan lose its status as the country with the world's largest current account surplus at any time. As Germany is maintaining stable high levels of trade and current account surpluses, Japan could lose that status at the end of 2021 in the absence of a surge in its trade surplus this year. At such a time, can the forex market be expected to react calmly with respect to JPY exchange rates? It seems undeniable that the reaction might be one in the direction of extreme JPY depreciation. The "Japan's External Assets and Liabilities Report" is considered newsworthy each year even if it has not recently been considered a material market-moving factor, but I think it is worth paying close attention, with a certain amount of anticipatory tension, to the figures in the next edition of that report when it is released in May 2022, which is in the latter half of the forecast period.

Considering UK-Related Risks

The above-mentioned issues are ones that one should be closely monitoring from a medium-to-long-term perspective, but the situation in the UK suggests the financial markets are facing a risk that may eventuate in the near future. As we have noted, the financial markets have basically come to view vaccination programs as the only absolute pandemic exit strategy, and the progress of those programs has come to be a major basis for projecting economic and financial trends. The flip side of this situation is that, if vaccination programs in the UK, the United States, Canada and other countries prove ineffective means of ending the pandemic, it may undermine such projections and thereby cause turmoil in financial markets. In this regard, it will be worth noting whether the UK – which has not had a large increase in infections but is said to be facing a threat from the increasing presence of Indian mutant covid-19 strains – will find it possible to completely discontinue its lockdowns on June 21. The deadline for finalizing the lockdown discontinuation plan is June 14, and British Prime Minister Johnson has said, while he has not yet seen data that would dictate a further delay, he still would have to wait a bit more before making the final decision. The decision is momentous, as mutant strains will inevitably spread worldwide, and it is quite possible that the UK's policy example may be an important indicator of what kinds of trends can be expected in world economy during the latter half of the year. While the possibility of a delay in the UK's complete discontinuation of pandemic-related restrictions is worrisome, the biggest risk the financial markets are currently facing is that the restrictions might be re-tightened in light of the threat from Indian mutant covid-19 strains. This would greatly undermine confidence in the vaccination program-based pandemic exit strategy, and there are grounds for fearing that the financial markets might panic in response to that. I am deeply concerned that such developments are taking shape soon after the BOE's hints of interest rate hikes in the near future.

EUR Outlook – Possibility of Tapering and a Return to EUR Appreciation

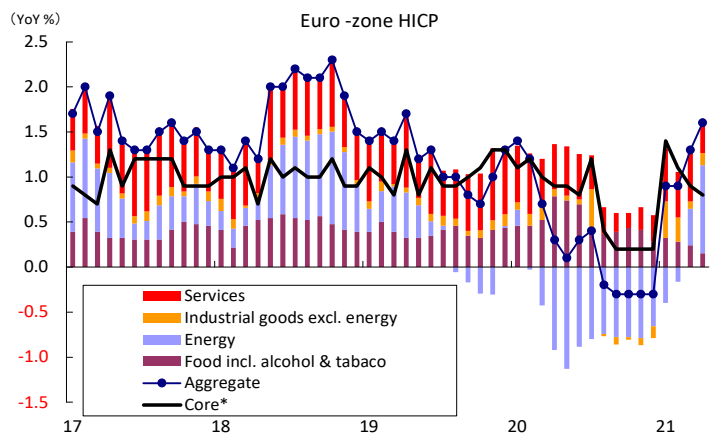
EUR Area Monetary Policies Now and Going Forward – Possibility of ECB Tapering

Euro Area Economy Preparing for Second Quarter Surge

During April and May, Japan, the United States, and the euro area announced their first-quarter GDP figures. Japan's real first-quarter GDP was down by an annualized rate of 5.1% qoq, the first negative qoq figure in three quarters and Japan's largest qoq GDP decrease in the post-war era. As the margin of decline was considerably larger than the 2020 drop of 4.6% yoy and the post-Lehman-shock 2008 decrease of 3.6% yoy, it became a hot topic in financial markets. GDP growth in the euro area also fell further behind the United States, with an annualized rate of -2.5% qoq, although it bears remembering that continental European behavioral restrictions have been relaxed since April and that the EU's vaccine procurement strategy has showing signs of success. While Germany was late to begin vaccinations, it has been reported that all those seeking vaccinations will be vaccinated by the end of July. Although the euro area has given Japan some companionship in recording negative GDP growth figures, it appears that it may now be ready for economic acceleration.

ECB's Official Perspective on Tapering

In light of these circumstances, the ECB is increasingly being asked whether it is finally in a position to undertake tapering (to gradually discontinue its quantitative easing measures). Given recent reports of statements by high-ranking ECB officials, it seems unlikely that an official decision on tapering will be made in the near future (although there may be some unofficial indications of prospective decisions, as is discussed below). For example, ECB President Lagarde is reported to have said on May 18 that – "It's essential that monetary and fiscal support are not withdrawn too soon. As far as the ECB is concerned we will stand by our commitment [...] to protect Europe's economy." That same day, Banque de France Governor Francois Villeroy de Galhau was even more clear, saying – "As of today, there is no risk of a durable return of inflation in the euro zone and therefore, it goes without saying, there is no doubt that the monetary policy of the ECB will remain very accommodative." Just as the rise in the U.S. consumer price index (CPI) has inspired widespread discussions, the euro area consumer price index (HICP) has shown significant upward movement recently that has attracted considerable attention (see graph). However, 60% of the most recent rise (1.0 percentage point of the April 1.6% yoy increase) is a temporary movement reflecting the effect of energy prices. Service prices, which are considered to roughly reflect wage levels, are still relatively sluggish at (+0.9%), so it is probably unlikely that the ECB will consider tapering because of inflation-related trends.



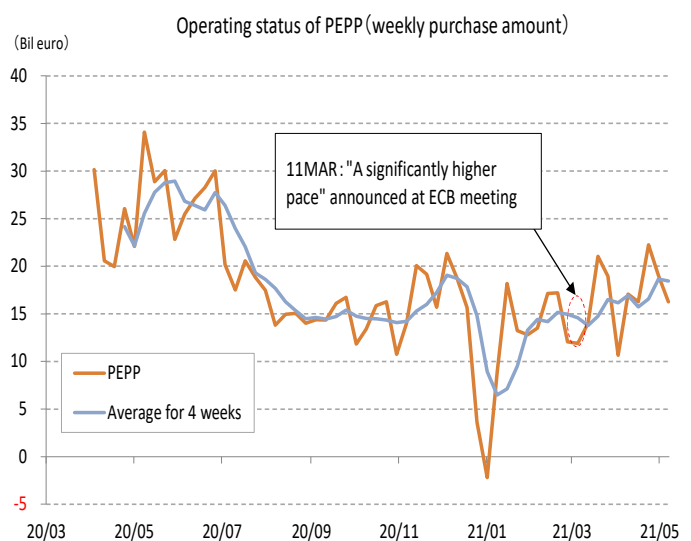
(Source) Datastream

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

Possibility of Tapering Suspicions

While it is unlikely that an official decision on tapering will be made soon, there is still a possibility that there may be unofficial hints giving grounds for suspecting the nature of such a decision in the future. This is because President Lagarde stated at the March ECB Governing Council meeting that the pace of asset purchases under the Pandemic Emergency Purchase Program (PEPP) will be reviewed quarterly, when the Eurosystem staff macroeconomic projections are revised. The ECB's current policy making sequence is essentially to first "determine the level of risk-free policy interest rates → determine the yield of government bonds → determine the yield of corporate bonds and bank loans", and then manage policies in light of this series of flows. President Lagarde has repeatedly stated that it is important for the ECB to maintain a multifaceted perspective that holistically considers multiple indicators. Regarding PEPP management, the ECB first considers the financing environment in view of the current economic and inflation outlook, and if

government bond yields appear too high (too low), the ECB will step on the PEPP's accelerator (brake). The optimal time to review the PEPP management decisions is when the staff projections are revised.



(Source) ECB

My perception is that the introduction of this quarterly review system may impair one of the PEPP's advantageous characteristics – that it gives the ECB a great deal of discretion to accelerate or decelerate associated asset purchases at any time – and it is because of this that the ECB is expected to be subjected to some external pressures at the time of the June Governing Council meeting. Compared to March staff projections, the staff projections released in June are likely to factor in the positive effects of progress made in vaccination programs and the easing of behavioral restrictions. Since the ECB stepped on the accelerator with “a significantly higher pace” of purchases in light of the March situation and outlook, if the June projections are more positive, it might be considered logical for the ECB to step on the brake with statements indicating “a slightly slower pace” of purchases. The PEPP's average weekly purchasing level was EUR14.5 billion during month immediately preceding the March Governing Council meeting and has now been raised to EUR16.7 billion. So the purchasing pace has been accelerated by about 15% but, given that euro area bond yields are showing signs of stabilizing, it has been expected that there is a possibility that the pace may be somewhat reduced. However, ECB board member Fabio Panetta said in a May 26 interview with Nihon Keizai Shimbun that – “The conditions that we see today do not justify reducing the pace of [PEPP purchases.]” I do not think the view of a single ECB board member can be considered definitive, but as discussed below, given that EUR is slowly appreciating, it seems that the possibility of a June Governing Council meeting status quo maintenance decision is also rising.

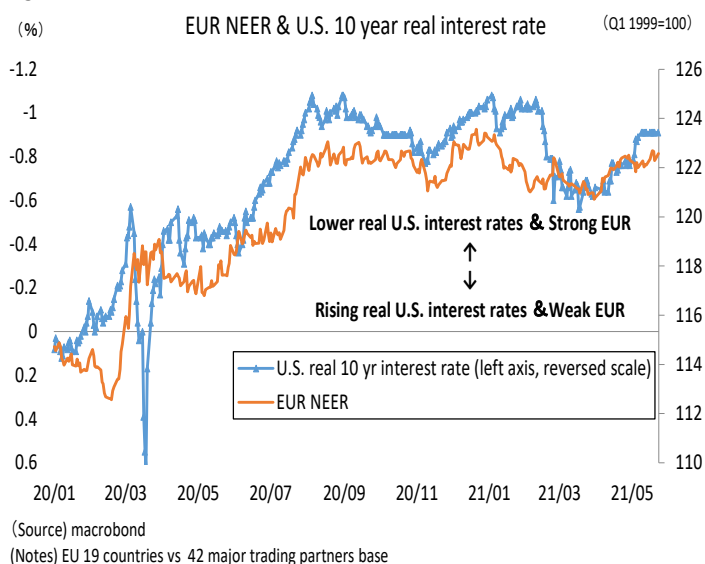
The ECB's basic view is that the PEPP's purpose is to curb euro area interest rates and thereby maintain a favorable financing environment, and PEPP purchasing volumes merely reflect the levels deemed appropriate for that purpose, so, in theory, it would not be surprising to see a June decision to reduce the purchasing volume. However, if the ECB decelerates PEPP purchases while financial markets seem to want to undertake transactions based on a “problematic rise in inflation rate” theme, there is a risk that the ECB's move will be interpreted as a sign that it is effectively showing signs of moving toward tapering. As discussed below, EUR has such underlying strength at this time that such a development would have the potential to magnify that strength. Currently, the PEPP's official expiration date is the end of March 2022, and it is probably necessary to gradually decelerate PEPP purchasing (taper) so as to reduce purchases to zero by that time and realize a “soft landing” for the program. The PEPP does not specify a fixed level of monthly purchases as previous programs have but offers a framework that allows the ECB to freely adjust weekly purchase amounts, so if the ECB undertakes small decelerations every week from this fall, it should have plenty of time to gradually wind the program down by the end of March 2022. The ECB's new monetary policy strategy review (which has been postponed) should have been completed by that time. Announcing new monetary policy strategy review at the same time as it announces its PEPP termination policy would seem to be the optimal way for the ECB to present its forward-looking posture.

EUR Now and Going Forward – Return to EUR Appreciation?

EUR Effective Exchange Rate Returns to Record High Range

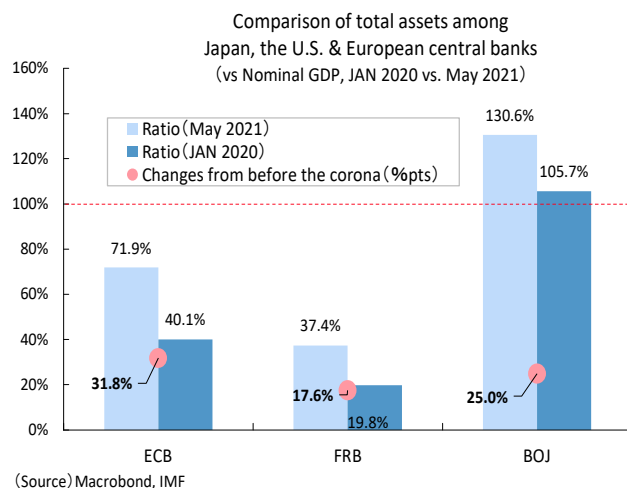
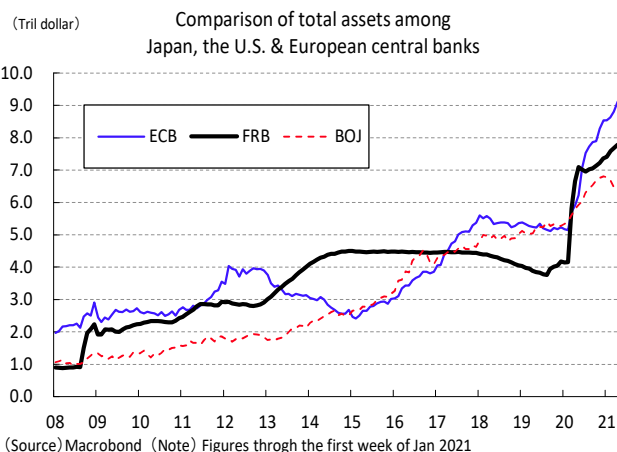
EUR continues to be strong. The EUR nominal effective exchange rate (NEER) announced by the ECB bottomed out around the end of March and has subsequently begun rising again, reaching record high levels. A statement last October 29 – “the Governing Council will carefully assess the incoming information, including the dynamics of the pandemic, prospects for a rollout of vaccines and developments in the exchange rate.” – was the ECB's first listing of EUR appreciation alongside the pandemic as a risk factor, but the significance of the EUR appreciation risk factor may be greater now than it was then. More recent ECB statements have included the sentence – “We will also continue to monitor developments in the exchange rate with regard to their possible implications for the medium-term inflation outlook” – indicating the ECB's continued concern about EUR appreciation, and the possibility that the ECB may cite EUR appreciation as a justification for further strengthening its easing stance cannot be ruled out.

The ECB's basic view is that USD is depreciating – as U.S. real interest rates are being depressed by the peaking out of U.S. nominal interest rate and rising inflation expectations – and that EUR appreciation is the result of that USD depreciation (see graph). As I have repeatedly stated in this column, however, it appears that, in a world of negligible interest rates, the euro area's world-leading trade surplus is becoming more likely to exert its power as a factor supporting EUR appreciation. In fact, EUR did not weaken as much as JPY during the January-March quarter when USD was particularly strong. While this may be partially explained by progress made in vaccination programs and associated rise in infection prevention, I suspect that it also reflected the strength of real demand for EUR, which countervailed the EUR depreciation pressure.



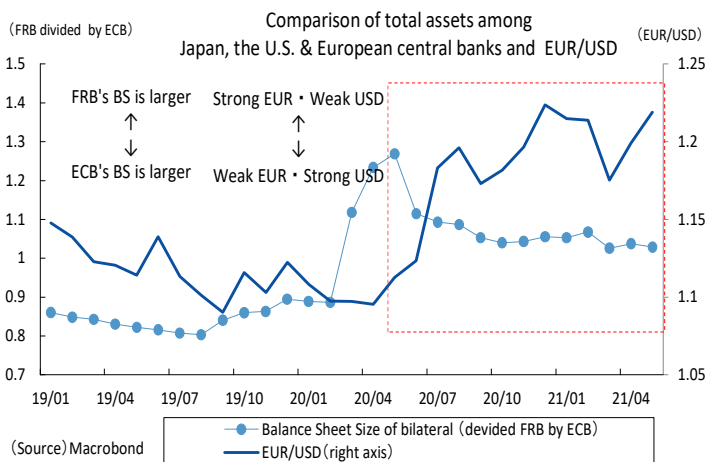
More than Double the Draghi-Era Quantitative Easing Level in Just One and a Half Years

The euro area HICP is currently gaining upward momentum, but it can be expected to slow as upward pressure from energy prices diminishes going forward. The rise in the EUR NEER should promote this trend. Moreover, given that the euro area economy is highly dependent on exports, it seems likely that the deceleration of PEPP purchases expected in June may also countervail EUR appreciation. As of mid-May, the ECB's balance sheet had surpassed USD9 trillion, considerably higher than that of the Fed (USD7.8 trillion). The Fed had the fastest pace of asset purchases after announcing a policy of purchasing an unlimited amount of government bonds last March, but the ECB's asset purchases give the impression of being close to matching that pace throughout the past year (see graph on upper right). Even if the ECB gradually reduces (tapers) its purchases from June, it is certain that its balance sheet will reach the unprecedented level of USD10 trillion by the end of next March. The ECB's balance sheet as a percentage of GDP has risen to 72%, up 32 percentage points since January 2020. This is nearly double the pace of the rise in the Fed's balance sheet as a percentage of GDP. It is worth noting that former ECB President Mario Draghi expanded the ECB balance sheet by about USD1.9 trillion (≈EUR2.2 trillion) during his eight-year term (November 2011-October 2019), but ECB President Lagarde has expanded the ECB balance sheet by about USD4.1 trillion (≈EUR2.9 trillion) in the year and a half since she took her post in November 2019. While the amount of quantitative easing during the Draghi era was significantly impactful, the Lagarde-led ECB has undertaken more than double that level in a time period only one-fifth as long as the Draghi era.



Quantitative Easing Unable to Countervail Currency Appreciation

As of May 21, EUR780 billion of the PEPP's EUR1.85 trillion envelope remained unused. The average monthly purchase pace from January through April was EUR66.6 billion (EUR16.7 billion per week). Since the remaining balance of the envelope is quite sufficient to sustain purchases at this pace through the end of next March, I think there is a possibility that the purchase pace will remain unchanged in June. The PEPP is intended to stabilize government bond yields at low levels and thereby maintain favorable funding environment conditions, and in that sense, it can be said that it has achieved the desired effect. As mentioned above, however, the associated quantitative easing has not effectively countervailed the trend of EUR appreciation. As the graph shows, the ECB's balance sheet size relative to that of the



Fed has expanded steadily over the past year, yet EUR has steadily appreciated against USD. It can be said that the ECB has itself demonstrated that the size of a central bank's balance sheet does not have a decisive effect on the value of the currency under its jurisdiction. This article forecasts that USD will again be appreciating against other currencies during the upcoming year, but I think that USD's strongest level against EUR will be around EUR/USD1.15. As a result, EUR/JPY may reach a high of roughly 140 next year.

Appendix: Q&A Regarding Scottish Independence – Current and Prospective Issues

Q&A Regarding Scottish Independence

A little less than seven years have passed since the last referendum on the issue of Scottish independence, but the issue is once again in the spotlight. In the Scottish Parliamentary elections held on May 6, the ruling Scottish National Party (SNP), which favors Scottish independence, recorded an overwhelming victory, winning 64 seats, one less than an independent majority (65 seats) of all seats (129 seats). The Scottish Green Party, which also favors Scottish independence, won eight seats, so the two parties together represent a parliamentary majority in favor of Scottish independence. There have been significant concerns about the possibility of Scotland becoming independent (≈ division of the UK) since the UK's June 2016 Brexit referendum, and such concerns are now steadily intensifying. Since I have received a growing number of inquiries on this subject, I would like to take this opportunity to summarize the current situation using the Q&A format (there were numerous requests for Q&A format).

Q1: Wasn't independence already rejected in 2014?

A: In September 2014, a referendum was held within Scotland asking whether Scotland should become independent from the United Kingdom. The result was that 55% of the voters voted against independence. The referendum was organized after the SNP, whose manifesto favored the holding of a referendum, won a majority of seats in the May 2011 Scottish Parliamentary elections. It is understood that the results of the 2014 referendum indicated a desire to maintain the status quo of inclusion within the United Kingdom, which was an EU member at that time, in light of numerous policy issues (discussed below) that would arise upon independence. But the United Kingdom is no longer a member of the EU. Given that a majority of Scottish people supported remaining within the EU and that the United Kingdom has left the EU, organizing another independence referendum makes sense despite the previous results, since the EU-related situation has changed.

Q2: What is behind the desire for independence in the first place?

A: Scotland has been given limited autonomy under the Scottish Government with respect to fields including education and medical care, but overall economic policy, including tax policy, is under the jurisdiction of the UK government. Since Scottish MPs constitute a small minority of members in the UK Parliament, there is a structural problem in that Scottish MPs' voices are easily overwhelmed. The Scottish public generally has a perception that UK policy management continues to overly favor England's interests, and this is considered to be a main factor motivating those supporting independence. At the time of the September 2014 referendum, the number of those supporting remaining in the UK was greater than that of those supporting independence, but support for independence has increased since the June 2016 Brexit referendum provided for the UK to leave the EU, and it now appears that support for independence is gradually becoming greater than that for remaining. It is natural that the UK's withdrawal from the EU will cause changes in Scottish public sentiment. There are several possible problems associated with Scottish independence, such as independence's potentially negative impact on Scottish exports. It has been reported that the value of UK seafood exports to the EU this January was down 80% yoy, and there are concerns about the adverse effects of this trend on Scotland, which is known for its strong fishing industry. With regard to other industries also, there are certainly grounds for concern that the post-Brexit business environment has put Scotland in a weaker position to export to the huge continental European market. However, only about 20% of Scotland's trade involves transactions with the EU, and the roughly 60% of Scotland's trade involving England is far more important. In that sense, if Scotland were to become independent and have an international border separating it from the rest of the UK, it is likely that net effect of associated trade barriers would be negative. As in the case of Ireland, there are industries achieving greater growth in exports to the United States than to the UK, however, and there are also industries for which continental European markets can be expected to grow in importance as a major export destination, so it is possible that Scotland might want to choose independence based on an emphasis on longer-term benefits even if it were to suffer disadvantages in the shorter term.

Q3: Is a referendum likely to be held soon?

A: As top priority is currently being given to pandemic response measures, it does not appear likely that a referendum would be held soon. However, the SNP published a manifesto prior to the May 6 Scottish Parliament election declaring that if it won a majority of seats, a referendum on independence would be held by the end of 2023. They are planning to have the Scottish Parliament vote on organizing the referendum during the first half of the 5-year parliamentary term (2021 to 2026). After the SNP won the May 6 election, SNP leader and Scottish government First Minister Nicola Sturgeon said that conducting a referendum on independence is "a fundamental issue of democracy." When the end of the pandemic comes into sight, the SNP plans to pass legislation creating a legal framework for the referendum, thereby paving the path to an actual vote.

Given that vaccination programs have proceeded more quickly in the UK than in other industrialized countries, it seems realistic to expect this topic to be seriously addressed some time after the start of 2022. It appears possible that if the UK government continues resisting the possibility of a Scottish independence referendum, that resistance itself may increase support for independence. So while the Scottish independence issue may remain dormant during 2021, it is possible that it may become a significant market-moving theme soon after the start of 2022. To repeat, since the 2014 referendum on Scottish independence took place when the UK was a member of the EU, it is objectively speaking quite difficult for the UK government to argue that another such referendum is unnecessary since the 2014 referendum was held quite recently. The previous referendum took place under significantly different circumstances.

Q4: Can it be done without the UK Government's approval?

A: The current situation is not clear. If approval for a binding referendum is not forthcoming, SNP leader Sturgeon has indicated that she will not insist on holding an informal, non-binding referendum that the UK government does not recognize. Of course, it would be possible to implement an advisory referendum without UK government consent, but there are doubts about how high a voter participation rate could be achieved for a non-binding referendum. However, an Ipsos MORI poll conducted during the April 1-7 period on the question – “If the Scottish National Party wins a majority of seats in the 2021 Scottish Parliament elections, do you think the UK Government should or should not allow them to hold another independence referendum within the next five years?” – found that, of UK respondents, 51% said UK Government should allow the referendum and 40% said it should not. Support for the referendum was even higher among Scottish respondents, of which 56% said UK Government should allow the referendum and 41% said it should not.

As mentioned above, if the UK government continues refusing to allow a referendum, it could further increase support for Scottish independence and eventually have a negative impact on support for Boris Johnson's government administration. In addition, if it were to become difficult to establish a UK government following the next general election (June 2022) without the assistance of the SNP, it might become necessary to approve the referendum at that point. So, it is unlikely that the UK government will allow a binding referendum in the near future, but it is quite possible that the situation will considerably change over the next year.

Q5: Does the Scottish Government have a post-independence blueprint?

A: At this time, it is not apparent that it has such a blueprint. Following the September 2014 referendum, observers concluded that it was the magnitude of uncertainties about what might happen after independence that generated the majority support for remaining in the UK. If another referendum were to be held, it cannot at this point be said with confidence whether the impact of such uncertainties would be less than in 2014. For example, at the time of the 2014 referendum, it was pointed out that a post-independence Scotland could not continue using GBP, since GBP is issued by the Bank of England. Of course, a post-independence Scotland would aim to join the EU and may want to circulate EUR in the future, but joining the EU and introducing EUR are both processes that take years to implement, so there remains the question of what monetary system a post-independence Scotland would employ during the transition period. It would be convenient if it were possible for a post-independence Scotland to use GBP only during the transition period, but it seems that that also would be somewhat difficult. If it were not possible to use GBP during the transition period, it might be possible to issue a new currency (Scottish pound), but preparations for making such a move would also be complex and challenging.

Also, as mentioned above, if Scotland were to independently join the EU, it would probably be forced to establish barriers to trade with the UK, which is its largest trade partner. Although it is possible to argue that the medium-to-long-term trade-related benefits of independence would be great, it is impossible to deny that the short-term damage to trade would also be substantial. In light of the contentious nature of UK-EU trade negotiations during recent years, it is obvious that reaching agreements regarding the allocation of advantages and disadvantages in Scotland-UK trade relations would be difficult.

And there are numerous other very large uncertainty factors. Regarding outstanding UK government debt, for example, there may be a need to devise a system for proportionately allocating a portion of the debt burden through such means as the transfer to Scotland of responsibility for the repayment of a portion of existing UK bonds. It is not clear exactly how this might be done. Moreover, the government bond market would be likely to demand a risk premium on bonds issued by an independent Scotland bereft of UK backing. While North Sea oil fields would be among an independent Scotland's most valuable resources, it should be noted that the reserves of those oil fields are being depleted and it would be dangerous to count on great benefits from them over the longer term. The momentum of popular sentiment currently seems to be in favor of Scottish independence supporters, but anxieties about potential post-independence challenges remain large albeit nebulous, and it is quite possible that (as was the case in 2014) such anxieties may become a factor providing more-powerful support for remaining in the UK if a binding referendum were actually to be implemented.

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