

June 30, 2021

## Overview of Outlook

The June USD/JPY trend once again reflected conspicuous JPY weakness. While USD has clearly been depreciating since April, JPY has remained weak too. Spot transaction volumes are also small, revealing the sparse interest in JPY (or rather in Japan). While Europe and the U.S. take strides toward economic and social normalization against the backdrop of high vaccination rates, Japan is alone in aimlessly continuing to impose movement restrictions with no sense of progress. The Fed has already prepared the ground for quantitative easing (QE) tapering and is seen as certain to begin tapering by the end of the year. If things progress smoothly, rate hikes may begin to be discussed by the end of the year. By fall, Japan too is expected to have achieved vaccination rates similar to current rates in the U.S. and Europe. However, by then, the markets will have shifted their focus from vaccination rates to monetary policy gaps. USD depreciation during April-June has been nothing more than a correction warranted by the rapid pace of USD appreciation during January-March and, overall, the correction has been within the scope of what one would expect. Comparing stats at the end of June vs. the beginning of the year, U.S. 10-year interest rates have increased by +60bps, while USD's nominal effective interest rate (NEER) has risen by +1.0%. This report's prediction of a mutually-inspired increase in U.S. interest rates and USD, therefore, remains unshaken. One thing that is of concern are the setbacks recently suffered by some of the most vaccinated countries, such as the UK and Israel. In particular, it must be noted that the October-December and January-March periods, when lower temperatures make it easier for infections to spread, hold significant risks for my main scenario.

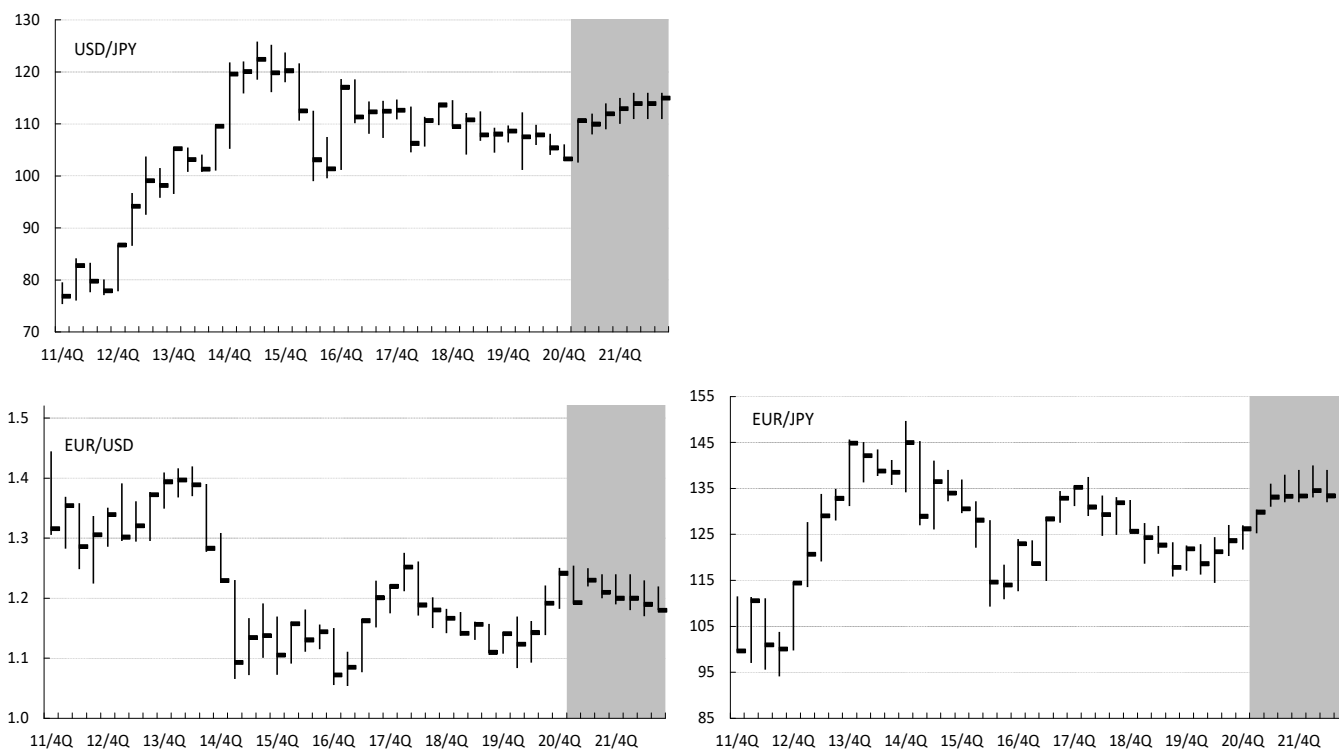
Meanwhile, EUR has been posting small movements. It appears that EUR fluctuations are limited during both USD weakening and USD strengthening phases, perhaps a result of a tug-of-war between the region's deep negative interest rates and its strong current account and trade surpluses (the largest in the world). Given Europe's steady increase in vaccination rates and expectations of higher growth rates, the ECB may begin to discuss tapering before the end of the year even if ending its pandemic emergency purchase programme (PEPP) by the end of March next year is difficult. Despite its late start compared with the U.S., there is no question that Europe is now making steady progress toward a post-COVID era, and while EUR/USD may fall as U.S. interest rates rise, EUR is unlikely to crash, thanks to strong demand for the currency. Meanwhile, given that Europe is expected to achieve social, economic, as well as monetary policy normalization sooner than Japan, EUR/JPY seems likely to rise. As a long-term factor, I would also like to draw attention to the Next Generation EU (NGEU) bonds, which were launched in June. Depending on the performance of these bonds going forward, they could be a milestone for the United States of Europe (perhaps serving as its "Hamilton moment"). Given the dearth of safe assets globally, the potential demand for bonds issued by the European Commission, an organization with the highest credit rating, is bound to be extremely high. We will only know in retrospect whether or not the issue of the NGEU was Europe's "Hamilton moment," but it must be recognized that this is, nevertheless, a historical moment.

### Summary Table of Forecasts

	2021			2022		
	Jan-Jun (actual)	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
<b>USD/JPY</b>	102.60 ~ 111.11 (110.58)	109 ~ 114 (112)	110 ~ 115 (113)	111 ~ 116 (114)	111 ~ 116 (114)	111 ~ 116 (115)
<b>EUR/USD</b>	1.1704 ~ 1.2349 (1.1900)	1.18 ~ 1.22 (1.19)	1.17 ~ 1.22 (1.18)	1.16 ~ 1.22 (1.18)	1.15 ~ 1.21 (1.17)	1.14 ~ 1.20 (1.16)
<b>EUR/JPY</b>	125.10 ~ 134.12 (131.59)	132 ~ 138 (133)	132 ~ 139 (133)	133 ~ 140 (135)	132 ~ 139 (133)	131 ~ 138 (133)

(Notes) 1. Actual results released around 10 am TKY time on 30 June 2021. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels  
3. Forecasts in parentheses are quarter-end levels

### Exchange Rate Trends & Forecasts

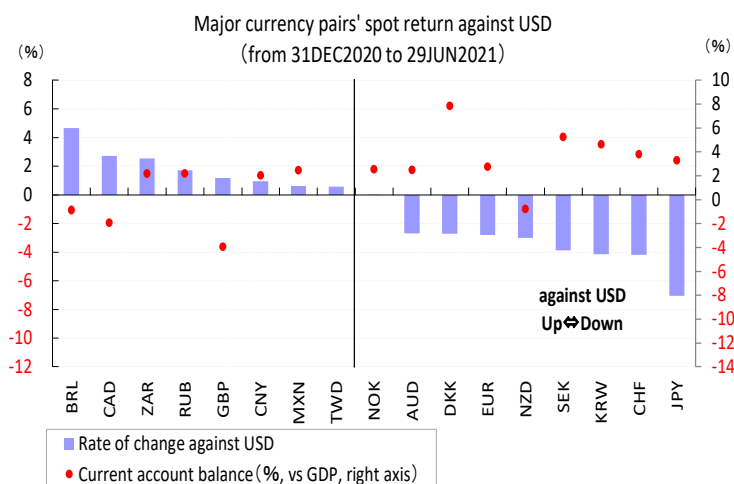


## USD/JPY Outlook – The Exclusion of JPY and Japan

### JPY and Basic JPY Supply-Demand Now and Going Forward – Heightening Sense of JPY and Japan Exclusion

#### JPY Alone Remains Weak

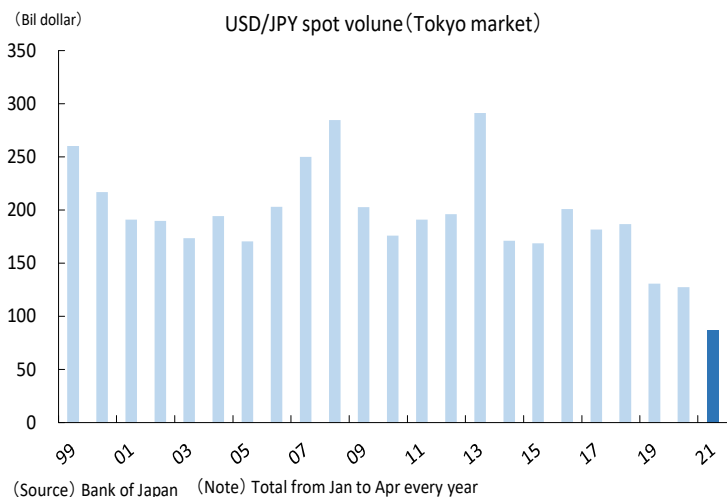
Despite the conspicuous weakening of USD in the forex markets since April, there are still no signs of USD/JPY decreasing, reflecting the isolated weakness of JPY in an otherwise strong market. The figure to the right shows the year-to-date rate of change of various key currencies against USD. JPY is not the only currency that has depreciated against USD, but it certainly is chronically and markedly weaker than USD. Note that all the currencies that have depreciated are backed by current account surpluses worth 2% of GDP or more, revealing that supply and demand are not currently significant currency evaluation factors. Meanwhile, key currencies that have appreciated include CAD and GBP. Canada and the UK both run current account deficits, so it seems likely that their high vaccination rates and economic normalization expectations have contributed to their currencies strengthening (as of June 28, Canada and the UK rank No. 1 and No. 2, respectively, among G7 nations in terms of vaccination rates). The spread of the COVID Delta variant caused the UK to delay its complete easing of lockdown restrictions, which were scheduled for June 21, but the fact is that the country posted zero deaths on June 1 for the first time since last July. The low rate of severe infections or deaths in the current wave is perhaps thanks to the vaccines. The British government, moreover, announced on June 22 that it intended to hold the EURO2020 European Football Championship Final in Wembley Stadium with 60,000 spectators. It is clear that everyday life is gradually returning to normal thanks to the vaccines, and I believe the forex markets are also positively rating currencies based on a straightforward assessment of such developments. Going by the positions of various currencies against USD in IMM currency futures transactions, JPY is the only one that has consistently maintained a short position since March, underscoring the impression that JPY alone is weak in an otherwise strong market.



(Source) Bloomberg & IMF (Notes) Current account : Forecast for 2020  
Taiwan has a surplus of more than 14%

### Lowest Ever Transaction Volumes and Heightening Sense of Exclusion

The fact that JPY has not been bought back against USD, which has been clearly weakening since April, is probably a reflection of the fact that JPY is not worth buying back. Following the BOJ's policy review in March, some even think that the BOJ's "next move" will be to maintain the *status quo* for the rest of Governor Haruhiko Kuroda's term. This has caused JPY interest rates, already quite stable, to become even more so. Again, while other developed countries are beginning to discuss the removal of movement restrictions against the backdrop of high vaccination rates, Japan is alone in repeatedly declaring emergencies, and the country spent nearly the whole of the April-June period in a state of emergency. It seems likely that Japan will be the only one of



these countries to post negative GDP growth for this period. Of course, with the beginning of June, vaccinations have begun to increase in Japan too, which in itself is good news. However, things are evaluated on a relative basis in the financial markets. By the time Japan achieves vaccination rates similar to current U.S. or European rates, vaccination rates will no longer be the main focus of the markets and are unlikely to affect asset prices. Assuming a similar pace of vaccinations as now, the UK and Germany are expected to achieve vaccination rates required for herd immunity (70%) by September, while the U.S. is expected to achieve it by November.<sup>1</sup> Once we get to this level, there will be less interest in vaccination rates, and the focus could shift to the removal of mask mandates, resumption of large-scale events, launch of vaccine passports and other topics. In the world of monetary policy, "expectations" rather than the "actual implementation or not" of tapering and other exit strategies will make the headlines.

Therefore, by the time Japan's vaccination rates improve, the "vaccine market" trend might have expired, but the gaps in terms of economic and financial conditions are unlikely to have been narrowed, so I see no reason to change my JPY forecast scenario. For market participants, JPY lacks topics of interest to begin with, so there is no reason to transact in the currency when there seems a very obvious likelihood of a widening economic gap between Japan and better-performing economies. In this context, it must be pointed out that it is not just reasons to buy JPY that are scarce, but also reasons to sell. As I discussed in last month's edition of this report too, Japan has the largest amount of net assets in the world, an enormous current account surplus to begin with, and a well-established trend of trade surpluses over the past year (for instance, Japan's trade surplus for the one-year period through May 2021 was over +JPY 3 trillion). There is bound to be some hesitation in unilaterally selling a currency backed by the above. Ultimately, therefore, the current position of JPY seems to be that there are neither very good reasons to buy back the currency nor to aggressively sell it off, and this rationale is well reflected in transaction volumes (see figure). The total USD/JPY spot transaction volume for the January-May period was USD 413.7 billion, less than half of the USD 843.7 billion average over the past 10 years. One of the reasons for this may be the protracted state of emergency, which has caused more people to work from home, where they can only place or receive a limited volume of orders, but it cannot be denied that there are few reasons to transact in JPY to begin with. Whatever the reasons may be, one cannot help get the impression from forex market trends overall that JPY is being excluded, and it seems very likely that the USD/JPY rate range will remain very narrow again this year.

<sup>1</sup> Please see online edition of the Nikkei Shimbun, "COVID vaccination rates around the world through charts."

## CNY Rates Now and Going Forward – What it Will Take to Realize USD Appreciation

### Signs of Change in Tolerance for CNY Appreciation

As mentioned above, USD has weakened in the forex markets since April, and the currencies that have conspicuously strengthened against USD are CNY and CAD, which have continued to exert downward pressure on USD's NEER (see chart). Meanwhile, currencies such as EUR, MXN, and JPY have been exerting upward pressure on USD's NEER. Note also that, as of June 28, Canada has surpassed the UK and U.S. in terms of the percentage of its population that has received at least one dose of the vaccine, at 67.8%. Looking back at the beginning of the year, Canada was second only to Japan among G7 nations in terms of vaccine delays, but the gap between these two countries has expanded dramatically over the past six months. In this way, Canada has managed to turn around its economic and financial situation on the back of strong vaccination rates, and has even taken a step toward monetary policy normalization (tapering has already been started), so the recent strengthening of CAD is not difficult to explain.

On the other hand, what about CNY, the other currency contributing to USD weakness? As already reported, the pace of CNY appreciation has not slowed since last year, and the currency has continued to soar this year too. By the end of May, CNY had been purchased so much as to hit a three-year high against USD, and the People's Bank of China (PBoC) set a daily reference rate for CNY soon after this, as though to ratify the development.

However, on May 31, the PBoC set the CNY daily reference rate lower than market expectations, while simultaneously declaring that it would raise the foreign currency reserve requirement ratio for commercial banks by 2pp to 7%. This is the first time since 2007 that the foreign currency reserve requirement has been raised. Subsequently, the PBoC continued to set lower and lower CNY daily reference rates in June. A former PBoC executive (the head of its Financial Survey and Statistics Department) was also reported on May 30 as having said that the recent strong rates of CNY reflected speculative transactions and were not expected to last long, a remark possibly intended to discourage further appreciation of the currency.

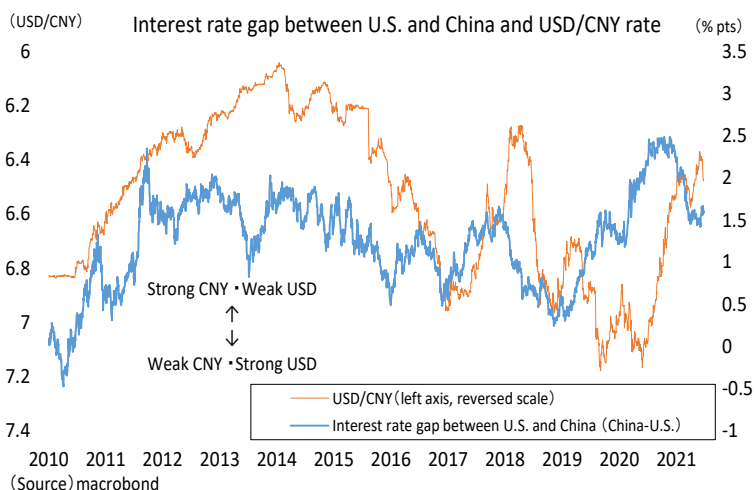
The appreciation of CNY against USD began

almost exactly a year ago, but it seems clear that the currency policy stances of the Chinese government and central bank have begun to change now that CNY has hit a three-year high. Further, the CNY appreciation against USD since last year had been in response to changes in the U.S.-China 10-year interest rate gap, but since April, one gets the strong impression CNY has been soaring without any relation to the interest rate gap (see figure).

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	0.9	-0.2
Euro-zone	17.0	-2.7	0.5
Mexico	13.3	-3.5	0.5
Canada	11.7	2.8	-0.3
Japan	7.1	-6.8	0.5
S.Korea	3.8	-4.3	0.2
Taiwan	2.2	0.6	-0.0
Switzerland	1.7	-3.9	0.1
U.K.	3.2	1.7	-0.1
Russia	0.6	1.3	-0.0
S.Africa	0.4	3.0	-0.0
Turkey	0.5	-6.3	0.0
Argentina	0.3	-13.6	0.0
Other	15.0		-0.1
NEER JAN-JUN2021	-	1.0	1.0

(Source) BIS & Bloomberg. (Notes) NEER: Broad base  
Currency rate of change: from 31DEC2020 to 22JUN2021



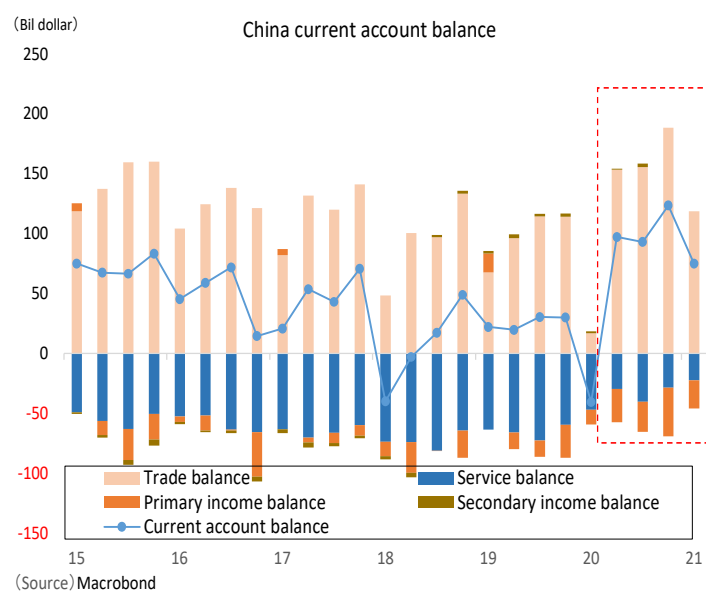
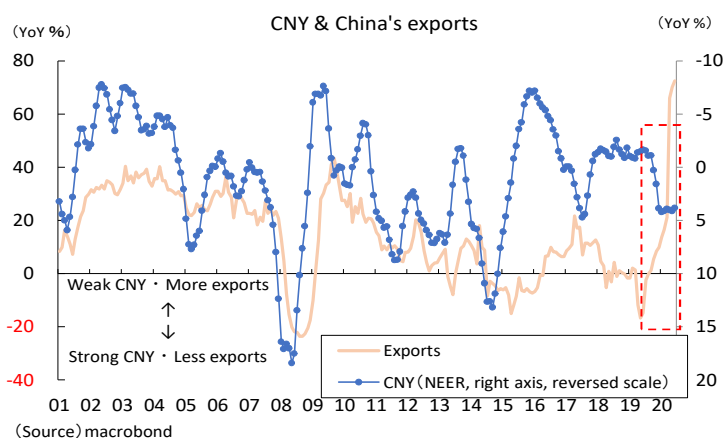
### Exports Remain Robust, but...

In my view, the most important factor that could cause USD to strengthen in 2021 will be Fed policy operation, but also important is the peaking of CNY appreciation, which has driven USD weakness since 2020. The change in the stance of Chinese authorities, which has been apparent since the end of May, underscores my basic understanding. In the February 8, 2021 edition of Market Topics titled “The Test of Dual Circulation – Will CNY Appreciation be Tolerated?” I presented my views on the Chinese government’s new policy of dual circulation, which is aimed at switching to a domestic-demand-driven development model. If the ideas behind the dual circulation strategy were to be taken at face value, there was a possibility that Chinese authorities would not aim for economic growth reliant solely on external demand as before, but rather be somewhat more open to CNY strength too. This assumption seems to be correct, given that CNY has appreciated over +10% against USD in the past year.

On the other hand, since dual circulation assumes the coexistence of both domestic and external demand, export trends would remain an important evaluation factor as before. Specifically, it is thought likely that the PBoC would have to take action to guide CNY somewhat lower if Chinese exports begin to be negatively affected by CNY’s NEER with a time lag of six months to a year, and this in itself could serve as an indirect source of upward pressure on USD. In this context, it must be noted that Chinese exports do not yet show any signs of slowdown despite CNY strength against USD over the past year. Rather, they have accelerated since the beginning of the year. China’s May trade statistics, which were released on June 7, showed that exports had increased +27.9% yoy. Of course, the trade surplus itself had decreased slightly due to an even stronger increase in imports (by +51.1% yoy) thanks to higher resource prices. The fact remains, however, that exports have not slowed, and total exports for the January-May period have posted an increase of +40.2% yoy. While there has been a slowdown in COVID-related special demand for items such as masks and protective medical equipment, which led exports last year, exports to the U.S. and Europe, which are heading toward a post-COVID phase thanks to vaccinations, has remained strong. The special COVID demand that led last year’s exports may have faded, but pent-up demand has been boosting exports in its place this year to the extent that the weight of CNY strength is not being felt. Imports have risen due to the soaring of commodity prices on a global level, but exports have been accelerating even more, with the net result that China continues to post steady trade surpluses, which itself may be one of the factors causing CNY to appreciate. However, though I repeat myself, it can take up to a year for an increase in NEER to affect exports. Chinese exports are not yet being affected thanks to the aforementioned special circumstances, but as things return to normal both in China and elsewhere, there is concern that the impact of CNY’s NEER could begin to be felt. It could be said that the earnestness of the Chinese authorities regarding dual circulation will be tested in the coming time, and in fact, there are signs that the PBoC’s patience is beginning to wear thin.

### The Remaining Options are More Direct

Approaches such as setting the CNY daily reference rate on the lower side and raising the forex reserve requirement are the relatively milder of the few different policy options that are possible to check CNY appreciation. In addition to these, the PBoC abolished the requirement for commercial banks to deposit a forex risk reserve when booking to sell CNY futures (buying foreign currency) in October last year. Before then, commercial banks had to deposit 20% of the amount with the PBoC when booking a forex transaction to purchase foreign currency in exchange for CNY, but this system was fully abolished last October. As a result, the cost of selling CNY decreased, which also contributed to CNY appreciation. Taking into account China’s fundamental stance in recent years, the true desire of the PBoC is probably that it would like to prevent CNY from appreciating rapidly, while at the same time avoiding extreme deviation from market rates. Therefore, it probably hopes to wait and watch if the measures it has taken since the end of May can effectively check CNY appreciation. Recent high commodity prices, which have begun to boost imports, are also likely to make the authorities hesitate to guide CNY to very weak levels.



If any more measures to contain CNY were to emerge in the coming days, they are likely to be more direct, say, encouraging capital outflow or discouraging capital inflow (or both). Measures that encourage outbound securities investment from residents of China are bound to contribute to containing CNY appreciation. Of course, CNY selling/USD buying currency intervention is also considered an effective means of bringing down the rate of CNY, but with U.S.-China relations already quite strained, one conjectures that currency intervention would be preserved as the last resort, literally. Looking at the outlook for the rest of this year, the Fed's normalization process is expected to slowly but steadily progress in the natural course of things, and USD can be expected to recover as U.S. interest rates rise. Unless a slowdown in exports clearly results in a slowdown in real economic performance, the authorities are likely to prefer avoiding an outright currency intervention.

At any rate, given that currencies are always evaluated in pairs in the forex market, CNY trends will always covertly and overtly affect USD trends. CNY appreciation has been the contributing factor behind approximately half the year-to-date fall in USD's NEER. That being the case, the behavior of the Chinese authorities going forward – whether they will continue to tolerate CNY appreciation under their dual circulation strategy, or switch to encouraging CNY weakness in response to a greater-than-expected slowdown in exports – will be an important factor affecting USD trends and, therefore, the forex market as a whole. Going by the current actions of the PBoC and expected policy operation by the Fed from summer onward, I believe that CNY appreciation will undergo a correction and contribute to USD appreciation.

## **BOJ's Monetary Policies Now and Going Forward – How to Interpret the BOJ Finally “Going Green”?**

### *Environmental Policies of Central Banks Hints at Return to Normalcy*

While the BOJ decided to keep its monetary policy unchanged following its June 18 Monetary Policy Meeting, it also revealed that it was considering a new fund-provisioning measure to encourage financial institutions to finance and invest in efforts aimed at addressing climate change. The measure is expected to support, for instance, corporate fixed investment toward decarbonization. Fund-provisioning operations aimed at a specific use of funds are, in themselves, not a new phenomenon – operations targeting expected high-growth areas (Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth) are an example, and fund-supplying operations to support recovery from earthquakes or COVID would also, broadly speaking, fall into this category. One could say that the new measure is no different except that it targets the grand cause of climate action, but it is worth special note in the sense that it signifies the BOJ joining a global trend. The outline of the new measure will be formulated in July, and it is expected to go into operation within the year. Embarking on a decision of this kind hints at a return to normal following the pandemic. A year ago, the BOJ would not have had the leisure to take action focused on climate change. The issue did, however, invite lively discussions before the pandemic struck, during the placid “Goldilocks” phase, so it could be said that this recent action by the Bank hints at a return to normalcy.

### *Climate Action is a European Rather than Euro-American Trend*

How do we interpret the recent actions by the BOJ? The BOJ's climate action may be seen as part of a global trend, but in fact, I have the strong impression that it is a trend originating from Europe. The ECB began frequently referring to climate change after Christine Lagarde took over as president, and climate action is expected to be incorporated into the ECB's new monetary policy strategy, to be announced within the year. In March this year, the Bank of England (BOE) gave itself a new mandate of moving toward zero actual emissions of greenhouse gasses (GHGs) in addition to its original mandate of achieving an inflation target of 2%. In doing so, it became the first central bank in the world to officially declare a climate action target. The Fed has not taken any moves as extreme as the BOE or the ECB. There certainly is a stronger sense under the Biden administration that the central bank should be more involved in addressing disparities and climate change, and in March, Fed Governor Lael Brainard revealed plans to make climate action a major part of the Fed's Wall Street oversight. However, this is no more than a part of the Fed's bank oversight, and is in a different league than monetary policy. It would be more accurate to say, therefore, that the recent move by the BOJ is an effort to join the European trend rather than a Euro-American trend.

### *Jens Weidmann's Defection Makes Climate Action Europe-Wide Trend*

For sure, this “European trend” seems difficult to ignore. As some media reports are already pointing out, Jens Weidmann, president of Deutsche Bundesbank who also serves as the chairman of the board of the Bank for International Settlements (BIS), conspicuously abandoned his original position at Green Swan 2021, an online conference organized by the BIS and other organizations from June 2 to June 4.<sup>2</sup> Previously, Mr. Weidmann had been the leader of the faction of central bankers who believed that central banks must stay away from climate-related policies, based on the opinion that climate legislation was a job for democratically elected governments and that there could be no democratic justification for unelected central bankers promoting climate policies. At his speech during the recent meeting, Mr. Weidmann once again began by saying, “The lines of responsibility separating central banks and politicians should not be blurred. We need to be clear about what central banks can and cannot do.” But this turned out to simply be the prologue, which he followed up by saying, “However, climate change and climate action can affect inflation, output and interest rates,” and went on to

<sup>2</sup> Please see Jens Weidmann “Climate risks, financial markets and central banks’ risk management Speech at the Green Swan 2021 Global Virtual Conference” 3 June 2021

express views that can be summed up as, “there are things the central bank can do to help.” As it is rare for Mr. Weidmann to compromise on his principles, I thought it important to excerpt from his speech below. Quite a few segments have been excerpted, but all of them are important and interesting. (I have also included my interpretations of his words in parentheses in some places):

- **Central banks have to understand the implications (of climate change) for price stability and monetary policy and have to expand their analytical toolkit accordingly. Moreover, central banks can play an important part in supporting the greening of the financial system. In their role as supervisors and guardians of financial stability, central banks can help to ensure that financial institutions adequately incorporate climate-related financial risks into their risk management.**
- **But that is not enough. Just like the portfolios of private financial institutions, climate-related financial risks can affect the asset holdings of central banks, too. Their balance sheets – and thus their ability to maintain price stability – might be impaired. Central banks’ risk management should therefore incorporate climate-related financial risks adequately, including those arising from monetary policy operations like corporate bond purchases.**
- **Therefore, the Eurosystem (equivalent to the ECB) has a legitimate interest in making climate-related risks more transparent. That is why I have recommended that, in future, the Eurosystem should only purchase securities or accept them as collateral if their issuers meet certain climate-related reporting obligations. Moreover, we should only use ratings that adequately and transparently reflect climate-related financial risks.**
- **These two measures could change the composition of our monetary policy portfolios (...) But the measures cannot be introduced immediately (...). rating agencies may struggle with the multi-decade time horizon of climate-related risks that reach beyond their standard time horizons. If no adequate solution can be found here, the Eurosystem would have to adopt alternative measures to properly incorporate climate-related financial risks into its risk management, for example by limiting the maturities or the amount of corporate bonds of certain sectors and issuers in the Eurosystem’s monetary policy portfolio. Such risk-oriented tilting should not be confused with suggestions to steer the behaviour of companies and financial institutions for political reasons. And, (...) we would still need an appropriate and transparent yardstick for climate-related financial risks.**

One has to say that this is a significant shift in Mr. Weidmann’s views going by his previous remarks on this matter. It is not surprising, therefore, that the BOJ would see such a move as an indication of how deep-rooted a European trend climate action has become.

#### *Another Interpretation: Role as BIS Chairman*

Having said the above, one gets the impression that Mr. Weidmann still has doubts, as he ended his speech by saying, “We would also help to enhance the market transparency of climate-related risks, thereby acting as a catalyst for other initiatives and the greening of the financial system. This would contribute to the fight against climate change without overstretching the Eurosystem’s mandate. Yet this contribution can be no substitute for ambitious and urgent action from policymakers and standard setters.” In other words, his position is that the central bank can serve merely as a “catalyst” for encouraging change, rather than being a main actor. Also, his deliberate inclusion of the phrase “without overstretching the Eurosystem’s mandate” could mean that he is opposed to the currently being considered revisions to monetary policy strategy, which will clearly outline climate action. Further, as seen in the excerpts above, he also makes it a point to warn, “Such risk-oriented tilting should not be confused with suggestions to steer the behaviour of companies and financial institutions for political reasons.” Moreover, he appears still uncertain about the means by which to achieve any of this and appears to caution against the dangers of overstepping the bounds. He mentions at one point that, when economic and financial conditions begin to normalize, the central bank’s policy measures would include “scaling back our asset purchases or portfolios for monetary policy purposes, whereas the political need to promote the transition to net-zero will not simply vanish.” In other words, climate change being such a widespread concern, it is inconceivable that efforts contributing to climate action would end with QE. It would appear that Mr. Weidmann is not a supporter of “Green QE.” One interpretation is that perhaps Mr. Weidmann, as chairman of the BIS, found it difficult to bluntly state at an environment-themed conference organized by the BIS (a forum much like a “salon” for central banks) that there was nothing central banks could do. Perhaps one could give him the benefit of the doubt by assuming that, after mulling over the issue, he said what he had to say, not as president of the Bundesbank, but as chairman of the BIS.

#### *Practical Reason Behind Climate Operation*

However, the BOJ has now ended up getting on the bandwagon of climate-change action. This raises the question – how must we see moves by the central bank to become involved in climate action? As a number of market participants are aware, the background to the recent decision is that the Bank needs a scheme that will allow it to continue with its current Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel

Coronavirus, which is due to expire at the end of March next year. To summarize, the climate operation was chosen as an alternative measure to help financial institutions (especially regional ones) maintain their revenues. The BOJ's Interest Scheme to Promote Lending, which was established in March, would collapse if the balance of the Coronavirus Operation, which offered up to +0.2% interest rates, were to vanish altogether. The climate operation, which can be touted as something required to match global standards, is bound to have come as a lifesaver for the BOJ.

### *Two Reasons why Climate Action by Central Banks Seems Inappropriate*

Whatever the practical reasons behind the BOJ embarking on climate action, we must first debate the more fundamental question of the appropriateness or otherwise of central banks becoming involved in climate action. As one can see from Mr. Weidmann's shifting understanding of the matter, common sense is certainly something that evolves constantly, but I remain unconvinced that central banks can make meaningful policies to address climate change. I will explain my position by addressing two questions, namely (1) whether addressing climate change is an appropriate role for a central bank, and (2) whether there is anything the central bank can do in the first place. Of course, increased climate action is an inevitable trend, but one must also ask oneself whether it is something the central bank should be involved in. Or perhaps the question can be rephrased – what use is it for the central bank to be involved in climate action? In the current Europe-led global mood related to this issue, one may have no choice but to go along with the idea that it is meaningful for the central bank to be involved in climate action without questioning it. However, I feel that this atmosphere of indiscriminately requiring contribution to climate action from all economic entities is reckless. For one, if an entity being asked to contribute to climate action does not have the capability to do so, the only result would be a waste of resources (relates to point (2)). For another, there are some cases in which it is actually inappropriate for a given entity to be involved in this matter (relates to point (1)). Precisely because this issue is of such great importance, what we need is the ability to formulate meaningful policy, not just a show of doing something.

### *Involvement in Climate Action Compromises Central Bank Neutrality*

Taking a look at point (1) first, as mentioned by Mr. Weidmann in his speech, the lines of responsibility separating central banks and politicians should not be blurred. The main policies to address climate change include taxation, regulation, and subsidies determined by the government. In the private sector, climate action is something private companies should voluntarily implement in the cause of social contribution. Naturally, voluntary social contribution efforts by private companies are not a problem, nor is government legislation, because such legislation is conducted by democratically elected politicians.

The central bank, however, is different. Central bank policymakers are not democratically elected officials. Rather, they work in those capacities because of their expertise and experience in the field. The responsibilities of central bankers, therefore, should be limited to “stabilizing prices” or similar mandates that are universally and ubiquitously considered to be for the public benefit. However, for the central bank to contribute to climate action, it would have to interfere in economic activities much more than it previously has. It is being whispered that, with its involvement in climate action, the central bank, in accepting collateral from private banks, would give preferential treatment based on the weight of “green bonds” (i.e., corporate bonds from companies with a higher level of environmental consciousness), or that it would specifically target green bonds for quantitative easing (green QE). Such policies amount to the central bank meddling in the corporate sector's decisions related to resource allocation. To take the argument further, private banks may have to proactively retract credit from companies that are not very environmentally conscious if they want support from the central bank, thereby endangering the business of some companies. The question is – does the central bank really have the right to be involved to that extent? If the answer is yes, then this gives rise to the need for a quantitative method for assessing the level of corporate environmental consciousness, and as Mr. Weidmann himself acknowledged, we do not have a solution for this fundamental problem.

Incidentally, the “green QE” approach is one that is frequently brought up as a way for the central bank to contribute to climate action, but one must remember that QE is a measure undertaken mainly during a recession. So, could it be that those arguing for “green QE” think that once the economy recovers and QE is no longer needed, contribution to climate action is also no longer required. That would be flawed logic. Perhaps the intention is to implement “green QE” continuously, regardless of weak or strong economic performance. However, this would conflict with the price stability target of central banks. It is precisely in order to save it from becoming embroiled in inconvenient political decisions that the central bank is given autonomy and the mandate to pursue price stability. Therefore, rather than meddling in political matters in its spare time and inviting skepticism regarding its neutrality, it may be better for the central bank not to be involved in them at all.

### *What Can the Central Bank Do?*

Moving on to the second question of what the central bank could do in the first place, perhaps the question could be rephrased as – is there anything the central bank can do in this regard that is meaningful? Considering how difficult it is for the central bank to control near-term prices and economic cycles, is it reasonable to expect that it can control climate change? There is always a time lag between monetary policy implementation and effectiveness, and although a variety of attempts are constantly made to measure the effect of monetary policy, it has always been very difficult to come to any clear conclusions. Are we to believe, then, that we can gauge the impact of central bank policies on climate change? If dynamic economic activity is the real cause behind global warming, then perhaps the easiest way to tackle this problem would be to raise interest rates so as to dampen consumption and investment appetite, thereby effectively throttling the real economy. It is, in fact, true that the COVID-led recession significantly



reduced atmospheric pollution, causing distant mountains or starry skies that had previously been hidden by the pollution to become visible again. Naturally, I am half joking when I say this. However, attempting to target economic stability while simultaneously promoting climate action seems unrealistic to me. If the central bank focuses on climate action, this could lead to recession and disinflationary pressures in the short term. Of course, I will reserve judgment on the BOJ's recently announced framework, as its specifications are still unclear. However, unless the scope and criteria related to the climate operation are somewhat loosely defined, it will not be utilized, and if it is not utilized, it will not contribute to the revenues of financial institutions, the possible practical reason behind the BOJ's decision as mentioned at the start. Having said that, focusing on the "looseness" of the operation will lead to universal criticism of the operation as being no more than thinly veiled subsidies to financial institutions, thereby leading us to the conclusion that that perhaps there is nothing the central bank can do in terms of climate action. Although I repeat myself, in order not to become embroiled in such troublesome debates, the central bank would probably do well to stay away from the subject of climate change, but it seems likely that such a line of reasoning will gradually become obsolete.

## U.S. Monetary Policies Now and Going Forward – Fiscal Tapering Likely to Take Place First

### Strategy Declared in March Speech has been Realized

The Fed decided to keep its monetary policy unchanged following the June 15-16 FOMC meeting. The statement released following the meeting noted that "Progress on vaccinations will likely continue to reduce the effects of the public health crisis on the economy" in place of the previous "The ongoing public health crisis continues to weigh on the economy." The revision is natural, given that things are more or less back to normal in the U.S. There is no change in the understanding that the rise in inflation reflects transitory factors, but the revision to the dot plot, which shows committee members' projections of the Federal Funds (FF) rate, clearly reflected an improvement in the economic forecast (details later). Incidentally, ever since U.S. President Joe Biden's speech in March, when he promised that the U.S. would be free from the coronavirus by the Fourth of July (U.S. Independence Day) and that movement restrictions would be eased accordingly, I have predicted in this report that the phrase related to the pandemic would no longer feature in the FOMC statement starting June, and that this would be accompanied by a shift toward a more hawkish monetary policy stance. Neither infectious diseases nor financial markets are easy to control, but the U.S. has truly managed to tame them both and achieve the promised result. This was made possible, despite the many sacrifices that had to be made along the way, by a combination of the right strategies and tactics, and one feels that it must be applauded whole-heartedly.

### Wariness Related to August Fades with "Talking-About-Talking-About Meeting" Remark

As in the case of the FOMC statement, the dot plot was also upwardly revised. The dot plot consensus that "zero interest rates would continue until the end of 2023" was formed at the most desperate time during the pandemic, when there were no vaccines and lockdowns were the only way to keep down infections. Also, given that the dot plot projections themselves are not policy promises to begin with, it seems inevitable that they would be upwardly revised at this time. The markets

Policy interest rate outlook as of each year end (median estimate)

FOMC Date	2021	2022	2023	Longer run
Jun-20	0.125%	0.125%	n.a.	2.500%
Sep-20	0.125%	0.125%	0.125%	2.500%
Dec-20	0.125%	0.125%	0.125%	2.500%
Mar-21	0.125%	0.125%	0.125%	2.500%
Jun-21	0.125%	0.125%	0.625%	2.500%

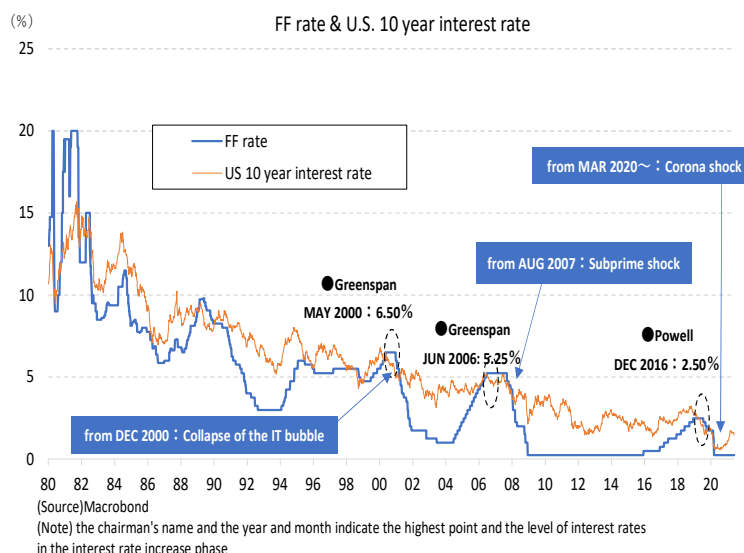
(Source) FRB

expected that the dot plot would be revised from "zero interest rates through the end of 2023" to "start of rate hikes sometime in 2023," but in fact, the median of projections in the recent dot plot suggests two rate hikes in 2023. Again, though not a big deal since they are not the median of projections, the number of members who predict one rate hike in 2022 has increased from three to five, while the number of members who predict two rate hikes in 2022 has increased from one to two. This is a more hawkish shift than financial market participants had expected, and was a big reason for share prices falling soon after the meeting.

At any rate, things are progressing at a somewhat faster pace than the markets expected, namely that tapering would be hinted at during the August Jackson Hole Symposium, decided in September, and begin to be implemented during the October-December quarter. At his press conference, Fed Chair Jerome Powell said regarding whether tapering had been discussed at the recent meeting, "You can think of this meeting as the talking-about-talking-about meeting, if you like." In other words, it would seem that the recent meeting has already prepared the ground for tapering, something that was expected to be done at the Jackson Hole Symposium. Having already put this out, the Fed can hope to avoid any significant market turmoil even if it makes a more earnest move at Jackson Hole in August. In fact, given that there is still the July FOMC meeting to go before Jackson Hole, the Fed may do well to consider offering additional hints as to rate hike prospects, and it would be a pity to miss the opportunity.

### Highest Point for Neutral Interest Rates and Rate Hikes

The problem going forward is policy operation when nominal interest rates begin to rise again, and in this report, I have believed that there is a high possibility of this happening within the year. Of course, over the longer term, the long-term interest rate is unlikely to increase much. Even looking at the dot plot, even though the progression of the FF rate has been upwardly revised, the neutral interest rate, which is also the end point for rate hikes, remains unchanged at 2.50%. History shows (see figure) that the highest target for rate hikes (i.e., the end point of rate hikes) has gradually declined with each major shock. The FF rate, which was lowered to zero percent following the subprime mortgage crisis and the collapse of Lehman Brothers, had recovered only to 2.50% as of December 2018 (2.50% is the currently assumed neutral interest rate). To be very honest, therefore, the end point of the next phase of rate hikes will also be 2.50% at best, but quite possibly even lower.



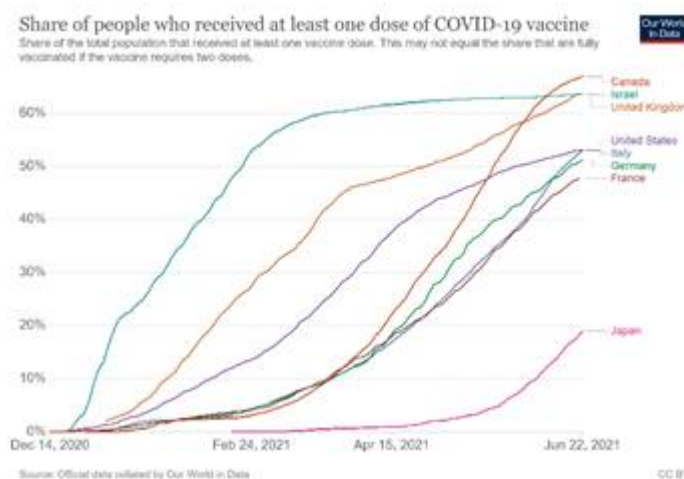
The end point of rate hikes has also more or less coincided with the upper bound of 10-year interest rates. Taking this into account, one gets the impression that the upper bound of 10-year interest rates over the next couple of years will be around +100bps from its current level. However, if JPY interest rates remain unmoving, this will imply a 100bp expansion in the U.S.-Japan interest rate gap. I think it would, therefore, be appropriate to predict the direction or level of USD/JPY to be consistent with this. This report's forecast scenario of USD/JPY shooting past 115 over the next year is based on the above assumption.

At any rate, starting 2H of the year, it seems almost certain that the gap between Japanese and not just U.S. but also European economic and financial conditions will widen, so it would not be very surprising to see JPY fall by around -5% in terms of its real effective exchange rate. As I repeatedly say in this report, one risk factor that could cause my scenario to crumble would be a strengthening of the virus in a way that makes the vaccines ineffective, thereby intensifying the risk-off mood again. This is a scenario I will discuss in the next section.

### Risks to My Main Scenario – Fearsome Potential for Setbacks in Countries with High Vaccination Rates

#### “Vaccine Market” Trend to Begin Fading from this Autumn?

Since last year this article has been forecasting a scenario – based on the assumption that vaccination programs will enable sharp improvements in the economic and financial conditions of the United States and other overseas countries – in which a widening gap between Japanese and overseas interest rates promotes JPY selling and USD buying. The pace of U.S. interest rate increases and USD appreciation during the January-March quarter was more rapid than anticipated in this article's basic forecast scenario, and I attribute the more-restrained movement of USD/JPY during the April-June quarter to that unexpected first quarter acceleration. Practically speaking, the vaccination program-based pandemic exit strategy is the only feasible pandemic exit strategy, so it is not surprising to see financial markets give relatively high evaluations to the economic conditions and currencies of countries



with relatively advanced vaccination programs; in fact countries with more-advanced vaccination programs appear to have been earning such relatively high evaluations during the last six months. This can be called the “vaccine market” trend, and it is apparent that this trend has been a key determinant of global economic and financial trends during the first half of 2021. Similarly, the weakness of the Japanese economy and JPY can probably to a certain extent be considered reflections of the relative slowness of Japan's vaccination program.

However, the “vaccine market” trend cannot be expected to persist forever. Regarding both stock prices and forex rates, the “vaccine market” trend is exerting an impact owing to inter-country disparities in vaccination rates and in the degree of behavioral restriction relaxation associated with those rates. Only about 20% of Japan's population has been vaccinated at this point, and that is by far the lowest vaccination rate among G7 countries. I believe the forecast scenario of increasingly disparate economic conditions and interest rate levels in Japan and the United States promoting JPY selling and USD buying is still convincing. However, Japan's government has indicated that all Japan residents seeking vaccinations will be vaccinated by some time in the October-November period. Looking at trends in

the United States and in European countries with high vaccination rates, however, one may note that the pace of vaccinations tends to slow when vaccination rates reach levels in the 40-60% range. It appears that vaccination rates in Western countries are approaching their peak levels, although it is not yet clear when those levels will be attained. As a result, the vaccination rate gap between Japan and other countries can be expected to progressively narrow, and logical basis of the “vaccine market” trend seems highly likely to become undermined by some time this autumn. However, by moving ahead with vaccination programs in tandem with economic and financial normalization measures, the United States and in European countries are positioning themselves to undertake various normalization measures as soon as possible. Given the current pace of vaccinations, it is expected that herd immunity may be attained by the United Kingdom and Germany in September and by the United States in November. As major Western countries come close to attaining herd immunity, attention will be focused on how quickly behavioral restrictions can be eliminated – enabling events with large numbers of participants and the discontinuation of mask-wearing obligations – and it seems likely that there will be a parallel movement in monetary policy toward tapering and the hiking of interest rates. It seems possible that the Fed’s Jackson Hole Economic Policy Symposium in August will focus more on the “path to interest rate hikes” theme than on the “opportunities for tapering” theme. Amid such developments, even if the “vaccine market” trend’s basis is undermined by some time this autumn, it is quite possible that that trend may be quickly succeeded by a USD appreciation trend based on the U.S.-Japan monetary policy gap. There appear to be very reasonable grounds for anticipating JPY depreciation against USD over the next year.

#### *Potential Setbacks in Countries with High Vaccination Rates*

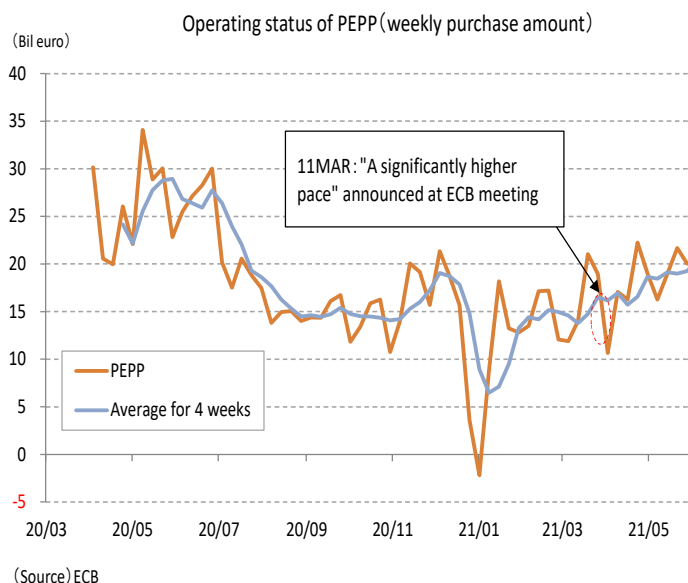
One related issue that frequently comes up during my online study sessions and webinars is – “What if the JPY depreciation/USD appreciation scenario collapses?” It seems that some people feel uncomfortable about the potential for a situation in which JPY appreciation hardly progresses despite the weakening of USD. My view is that such a situation would become possible in the case that current covid-19 vaccines were clearly shown to be insufficiently effective. JPY appreciation trends tend to be reinforced by consciousness of associated supply-demand trends. Supply-demand-trend-based forex trends are promoted by market participants’ confidence in reliable clues about supply-demand trends, and they are often characterized by a generally pessimistic mood. Moreover, at times when inter-country interest rate differentials almost disappear – as was the case last year – market players are likely to give greater attention to supply-demand trends simply because of a lack of alternative trends to focus on. I do not think it was a coincidence that RMB, EUR, and JPY appreciated last year immediately following the pandemic’s emergence – these are the currencies of the countries with the world’s largest current account surpluses. There are several potential situations that merit careful monitoring as they could possibly intensify the generally pessimistic mood. The spread of the Delta mutant covid-19 strain discovered in India is cause for strong concern, as it has prompted Israel (the world leader regarding vaccination rates) to renew mask-wearing obligations and led the United Kingdom to postpone its plan to relax behavioral restrictions. At this point, in both Israel and the United Kingdom, it appears that the situation is that it is largely nonvaccinated people who have been becoming infected with the Delta strain, and the number of severe cases and deaths associated with those infections is not high. (Of course, it would be prudent to await further information before drawing firm conclusions about this.) However, most market participants are not factoring in the potential for more such setbacks in countries with high vaccination rates in their main forecast scenarios for this year. This could be a particular problem starting from the October-December period, when the onset of winter weather can be expected to promote the spread of infectious diseases, and I consider it to be a serious risk for the January-March quarter also. If the United States were to re-impose lockdowns this winter, for example, it would be difficult for the financial markets to calmly respond to that. Since the “vaccine market” trend in the first half of this year has been based on expectations of economic revivals in countries with high vaccination rates, a discovery that the current vaccines are not effective would prompt diametrically opposite financial market trends (U.S. interest rate declines and USD depreciation). Although this constitutes an extremely large risk with respect to this article’s main forecast scenario, I recognize that this nature of the risk is outside the scope of my expertise as an economist, so I will limit myself to noting that this appears to be the worst of the various possible downside risk factors.

## EUR Outlook – Noteworthy Creation of New “Safe Assets”

### EUR Area Monetary Policies Now and Going Forward – Looking beyond PEPP

#### PEPP Purchases Still Accelerating

The ECB Governing Council meeting in June decided to maintain the policy status quo. The March Governing Council meeting's statement noted that the “significantly higher pace” of purchases under the pandemic emergency purchase programme (PEPP) would be reevaluated on a quarterly basis, and that statement's wording was retained unchanged in the latest statement. This is not a surprise, as it was suggested by statements made by high-ranking ECB officials prior to the meeting. 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[.]” ECB President Christine Lagarde had also said that it was too early to discuss adjusting the purchasing pace, and it seems likely that the ECB Executive Board members had agreed on maintaining a “significantly higher pace” prior to the June Governing Council meeting. Moreover, the latest purchasing figures indicate that the pace of purchases has continued to accelerate (see graph). Since early June, the average weekly purchases level has risen to EUR20 billion, the highest such level in a year. Given all the momentum behind the acceleration of purchases, it has not seemed likely that the ECB would suddenly decelerate them.



#### Discrepancy between Higher GDP Growth Forecasts and Purchase Pace Maintenance

In light of high-ranking ECB officials' recent statements, it is not surprising that the ECB would decide to sustain its acceleration of PEPP purchases, but it is still reasonable to question the logic of that decision. The latest Eurosystem staff macroeconomic projections, have significantly increased the euro area real GDP growth rate forecasts – from +4.0% to +4.6% for 2021, and from +4.1% to +4.7% for 2022. In line with this, the euro area consumer price index (HICP) growth forecast has also been raised – from +1.5% to +1.9% for 2021, and from +1.2% to +1.5% for 2022. The staff projections anticipate that the euro area economy will be supported by monetary policy easing, fiscal stimulus policies, and the Next Generation EU recovery fund (NGEU) as well as that the acceleration of vaccination programs will quickly lead to the removal of behavioral restrictions and fading away of concerns about uncertainties. However, these increasingly optimistic forecasts do not seem in harmony with the policy of maintaining the PEPP's “significantly higher pace”. President Lagarde said she was concerned about the euro area's job market and consumer behavior along with the potential scarring effect the pandemic may have on global supply chains. She noted that while the official unemployment rate was currently 8%, the share of people not currently working was effectively 15% after considering the number of people under furlough schemes, and that she therefore anticipated that upward movement in wages and prices would be restrained. It can be understood that the ECB's desire to continue accelerating PEPP purchases reflects its basic stance of putting safety first. However, when the “significantly higher pace” wording was inserted in March, there were concerns about possibility of further pandemic expansion, and lockdown measures were being implemented in various euro area countries. There has been clear improvement in the real economy since time, and it seems that that improvement has been perceptible enough to exert a significant effect on the outcome of local elections in Germany. In light of the changing circumstances, it seems a bit peculiar to maintain without adjustment a policy adopted in March. President Lagarde admitted that there was some debate about the pace of purchases and that there were “a couple of diverging views and not unanimous consent across the board”, and this suggests that some Governing Council members (perhaps led by the German members) may have doubts about the decision to maintain the pace.

President Lagarde clearly stated the significantly higher pace of PEPP purchases would be maintained going forward, saying – “we are going to do that [maintain the significantly higher pace] in the next three months according to market conditions, which clearly include seasonality. And we will do that with the core attribute of PEPP, which is flexibility across asset classes, flexibility across time, flexibility across geography, as you know well. That's really what we will be doing.” Given that the ECB defines “significantly higher pace” in comparison to the pace “during the first months of the year”, and that the average weekly purchase level of EUR20 billion at the time of the June meeting was already roughly double the pace in the January-February period, the ECB actually has leeway to decelerate its purchases from the current pace. It would seem that there should be a high likelihood of such deceleration in light of the currently anticipated improvement in the euro area economy. It is worth noting that the “seasonality” mentioned by President Lagarde refers to practice of reducing purchases

during Europe's summer vacation period every year – such a summer reduction is normal, but that reduction is ordinarily offset by a September increase of roughly the same magnitude. Consequently, it may be worth keeping a close eye on the pace of purchases in September.

#### *Future Policy Management — Post-PEPP Utilization of APP*

The PEPP's official expiration date is the end of March 2022. It seems that the ECB has not yet begun discussing how the PEPP will be wound down, but the subject is sure to be a major focus of the ECB's deliberations later this year. Frankly, it seems quite difficult to completely discontinue such a large QE program in only nine months, particularly given that there has not even been a mention of tapering at this point. If we assume that the Fed would not begin tapering until September at the earliest, and we note that it took the Fed 10 months to complete its previous tapering (December 2013 through October 2014), then we may anticipate a likelihood that the Fed will still be tapering in March 2022. Given that the euro area has been lagging behind the United States in the attainment of herd immunity, it is unlikely that the ECB would discontinue quantitative easing before the Fed.

However, it is questionable whether there is a need to continue purchasing assets within the PEPP framework. While the PEPP is a special program designed to respond to the pandemic, the ECB has its regular asset purchase programme (APP), which is continuing to make monthly purchases of about EUR20 billion. As its name suggests, the pandemic emergency purchase programme (PEPP) has an "emergency" program status that makes it exempt from various standard restrictions (such as rules limiting the share of individual bond issues that can be purchased and requiring that purchased assets have specified creditworthiness ratings), and enables the ECB to use it more-freely than the APP. There should be some debate about whether such provisions for exemption from restrictions will still be necessary in 2022 and subsequently. It may be possible to discontinue the PEPP and allocate all or a portion of the PEPP purchasing envelope to the APP. If due consideration is given to the eligibility of assets to be purchased and optimal monthly purchase amounts going forward, expanding the APP may be an attractive means of moving toward an exit strategy. It would seem to be highly appropriate and timely for the ECB to prepare to discontinue the PEPP while mapping out what will replace it as a part of its monetary policy strategy review

### **Creation of and Outlook for EU Recovery Fund – Emergence of a New "Safe Asset"?**

#### *Accelerating Toward the EU's Hamilton moment*

The EU's recovery fund, which has been a hot topic among financial market players since a year ago, has finally started operating. On June 15<sup>th</sup> that the recovery fund began raising funds through its first bond issuance (10-year bonds maturing in July 2031), and while EUR20 billion of bonds were offered, final investor demand for the bonds amounted to seven times that much, at EUR142 billion. The European Commission plans to issue EUR80 billion of such bonds by the end of 2021 and EUR800 billion by the end of 2026 (maturing at dates through 2058). The recovery fund's official name is "Next Generation EU (NGEU)", and it is positioned as a financial resource for promoting the EU's post-pandemic development. The NGEU's EUR750 billion will supplement the EU's multi-year budget (2021-2027) of EUR1,074.3 billion, and plans call for the resulting large-scale budget of EUR1,824.3 billion to be invested such high-priority fields as environmental protection and the promotion of digitization.

Looking back on the measures enabling this scheme, one finds that the EU Economic and Financial Affairs Council (ECOFIN) completed the ratification of NGEU's financial resources on May 31, and that ratification came into effect on June 1. This has made it legally possible to raise funds through the joint issuance of bonds (NGEU bonds) with a total value of EUR750 billion. Plans call for the EUR750 billion to be distributed through EUR390 billion of subsidy grants and EUR360 billion of low-interest loans. The above-mentioned EUR800 billion value of the EC's procurement plan is roughly equivalent to the EUR750 billion figure after future price increases are taken into consideration. These funds are allocated into several categories within the NGEU, the core category being the EU Recovery and Resilience Facility (RRF), which accounts for EUR672.5 billion of the total EUR750 billion figure. EU member states will have to submit national Recovery and Resilience Plans (RRP) detailing their targets, milestones, and estimated costs, and the EC will distribute funds after approving the RRP's based on qualified majority votes. It can be expected that there will soon be demands for the EU to accelerate this approval process.

The United States' first Treasury Secretary, Alexander Hamilton, is famous for his efforts to consolidate the debt of individual U.S. states (financial integration) in the form of federal debt, laying the basis for what the USD has become today. Going forward, NGEU bond issuance may be recognized as being a historic "Hamilton Moment" with respect to EU members' financial integration. It is not yet clear whether NGEU bond issuance represents a true Hamilton Moment, but from a long-term perspective this issue can be expected to be a major theme among financial market participants.

#### *Move toward Alleviating Global Shortage of Safe Assets*

In fact, there is a global shortage of safe assets (promoting the global disappearance of interest rates). It would not be an exaggeration to say that NGEU bonds boast the highest possible credit rating, and it appears that they have the potential to become a "new safe asset" on a par with U.S. Treasuries. The above-mentioned strong demand for the first NGEU bond issue reflects the high level of attention NGEU bonds are attracting as they are an initial move to expand the safe asset market. The European Commission has already issued EUR90 billion of SURE bonds to fund the "temporary Support to mitigate Unemployment Risks in an Emergency (SURE)" program aimed at helping maintain employment levels during the pandemic. The SURE bonds have been highly evaluated owing to their being

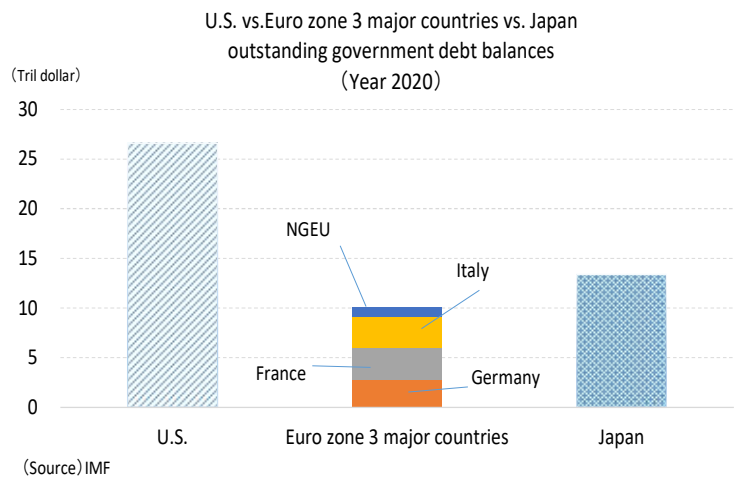
issued by the European Commission, and they are also considered a good example of the trend toward establishing funds for addressing societal problems.

Plans call for the issuance of NGEU bonds with a total value eight times that of SURE bonds (EUR100 billion), and NGEU bonds feature long maturities. EUR250 billion of the NGEU bonds (about 30% of the total issuance amount) will be issued as environmental bonds (green bonds), and this reflects the European Commission's sustainable finance strategy, which calls for it to issue "social bonds". (These include such subcategories as green bonds, ESG (environment, society, governance) bonds, and sustainable bonds.) It is noteworthy that the sustainable finance strategy is an important means for the EU to take various initiatives in the environmental protection field and establish related norms. The social bond concept has attracted considerable amounts of both praise and criticism, but it does seem likely that there will be abundant demand for social bonds.

#### *Still Less than Half the Scale of the U.S. Treasury Market*

Of course, it's too early to start comparing the newborn NGEU bonds with U.S. Treasuries – the world's most liquid and high-rated sovereign bonds. Looking at individual EU countries' outstanding government debt balances (2020, IMF) as a rough indication of the scale of the EU government bond market, one finds the total debt of three major EU countries (Germany, France and Italy) plus the amount of NGEU bonds to be issued (EUR800 billion ≈ USD966 billion; (EUR1 = USD1.22)) adds up to about USD10 trillion. This is less than half the value of outstanding U.S. government bonds, which is less than the value of outstanding Japanese government bonds. However, it corresponds to about 70% of euro area GDP, so it would slightly deviate from the Maastricht Treaty standard, which limits euro area members' public debt levels to 60% of GDP.

There are strong arguments that such fiscal stimulus constraints as the EU's Stability and Growth Pact are hindering the development of the euro area economy and its common currency, and many such arguments are quite reasonable. Moreover, even German government bonds (not to mention Italian government bonds) do not boast the highest credit rating, and EUR-denominated "safe assets" are essentially limited to German government bonds. This reflects the reality that the disparate credit ratings of individual EU members makes it difficult for investors to manage funds in EUR-denominated assets. Regardless of whether the goal is grandiosely expressed as creating a "second key currency" or not, if the European Commission wants to further encourage the use of EUR and the holding and management of EUR within countries' foreign exchange reserves, it should recognize that one way to achieve that would be to continue issuing NGEU bonds and promote the progressive diversification of NGEU bond holders. In fact, besides U.S. Treasuries, the only other true safe haven bonds likely to emerge going forward would be NGEU bonds. The trend toward increased diversification of foreign currency reserves has been ongoing for a quarter century, and it can be expected that many countries' financial authorities will be interested in NGEU bonds. In addition, the existence of NGEU bonds could possibly facilitate the ECB's monetary policy management, as the ECB often faces situations in which there are no appropriate assets for it to purchase. (This is leaving aside, for the time being, the issue of whether it is appropriate for the ECB to purchase bonds issued by the European Commission).



#### *Outlook for a Protracted Debate about Whether to Make Changes Permanent*

Of course, NGEU is only provided for in the EU's current multi-year budget and the program's framework is time-limited. Some argue that the reconstruction fund's establishment is not a Hamilton moment since NGEU bonds are also a time-limited financing method. It is worth noting, however, that the EU's current European Stability Mechanism (ESM) crisis response fund was initially established during the debt crisis in a time-limited form as the European Financial Stability Facility (EFSF) and only subsequently became permanent. Crises have prompted permanent structural changes in the past, and it is unlikely that the NGEU bond concept would have been realized if it were not for the current pandemic crisis. The question of whether this time is a Hamilton moment or not will only be answerable after some time has passed – it is not necessary to seek a final answer at this point.

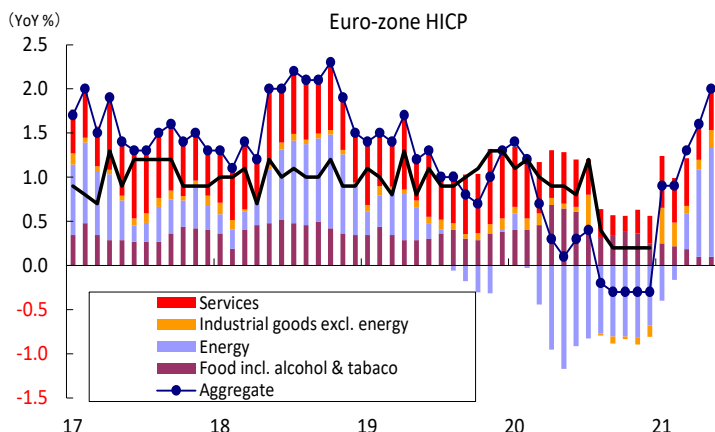
After the EU's current multi-year budget period (2021-2027), the issue of jointly issued debt will be formally discussed during deliberations regarding the subsequent multi-year budget (2028-2034). I think that the expansion of the jointly issued EUR bond market will eventually increase EUR's global presence and promote the stabilization of EUR value, but it can naturally be expected that those results will be attained only after the surmounting of numerous challenges and arrangement of compromises. But it cannot be said with certainty that the path to those results will be successfully traversed. Realistically, one should be prepared to observe attempts to create a common EU finance ministry and unify the EU's fiscal policies under a common budget with a very-long-term perspective, considering such questions as what may be possible within this century.

## The Euro Area Economy Now and Going Forward – Steady Progress of Japanification

### Record-Low Pace of Wage Growth

In May, the euro area Consumer Price Index (HICP) was up 2.0% yoy, the fastest yoy growth seen in 2 years and 7 months (since October 2018). Most of that increase reflected the base effect of energy prices, however, and on a core basis (excluding energy, food, alcoholic beverages, and tobacco) May HICP growth was only +0.9% yoy. Just as in the United States, demand is recovering owing to the lifting of pandemic-related behavioral restrictions while supply constraints in the real economy remain, and this is generally pushing up prices in sectors other than services and energy, such as mining and manufacturing goods. As shown in the graph on the right shows, however, the comprehensive-basis and core-basis HICP movements are quite far apart, and the euro region's inflation pressure can be considered to remain weak. During the four years from January 2009 through December 2012 (when the European debt crisis occurred immediately after the Lehman shock), yoy growth in service prices (which largely reflect wage levels) averaged around +1.7%. During the period from January 2020 to May 2021, this average level dropped to about +1.0%. In fact, it was not until 2021 that it returned to the +1.0% level, and levels below +1.0% were the norm last year. This is the first time since EUR's launch that service prices have been so sluggish.

The ECB surveys and analyzes movements in euro area wages on a quarterly basis, and in the January-March 2021 period, the wage level rose +1.36% yoy, the lowest such growth rate recorded since the euro area's establishment (see graph). Of course, the employment and wage situation is a lagging indicator of economic conditions, and the January-March wage growth figure strongly reflects the extreme pessimism of 2020. In light of Japan's experience, however, it seems that once wage growth is decelerated it is quite uncertain whether it will easily re-accelerate back up to its previous pace. The graph shows that the Lehman shock has triggered a gradual slowdown in euro area wage growth, and it is thought that wages have a large impact on service prices, which account for 40% of HICP.



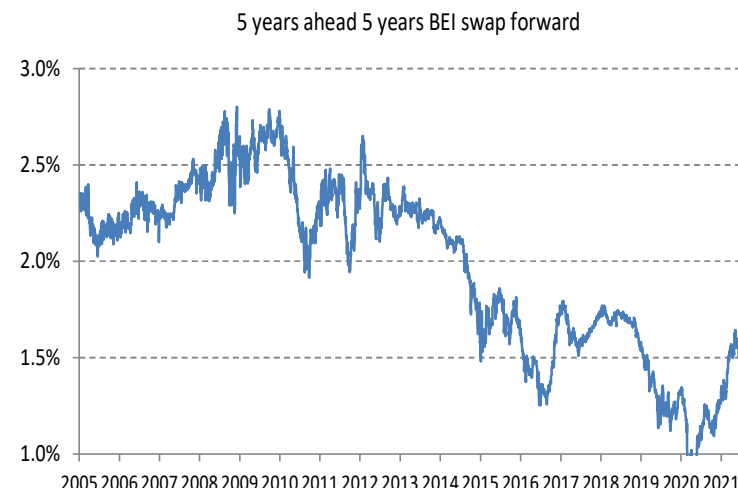
(Source) Datastream  
(Note) Core excl. energy, food, alcohol & tobacco



(Source) Macrobond  
(Note) There are also non-agreed wages. therefore differ from actual labor cost

### Steady Decline in Inflation Expectations

The trend in inflation expectations is reversing in line with the trend in actual inflation. The ECB has a strong focus on the five-year in five years inflation swap break-even inflation (BEI) rate, and while this rate fell to below 1% a year ago, it has recovered to levels comparable with pre-pandemic levels. Just as service prices and wages have restrained HICP growth, however, inflation expectations have fallen steadily in the wake of the Lehman shock and the European debt crisis. Inflation expectations were above 2.0% through 2014, then fluctuated in the 1.5%-to-1.7% range prior to the pandemic. It will be worth paying close attention to the question of whether – from next year when the post-pandemic situation become more clear – inflation expectations will again stabilize in the 1.5%-to-1.7% range or will shift to a lower range suggested by increasing weakness of wages. It seems unlikely that the ECB would move ahead with a clear-cut normalization process unless the inflation expectation situation becomes more clear.



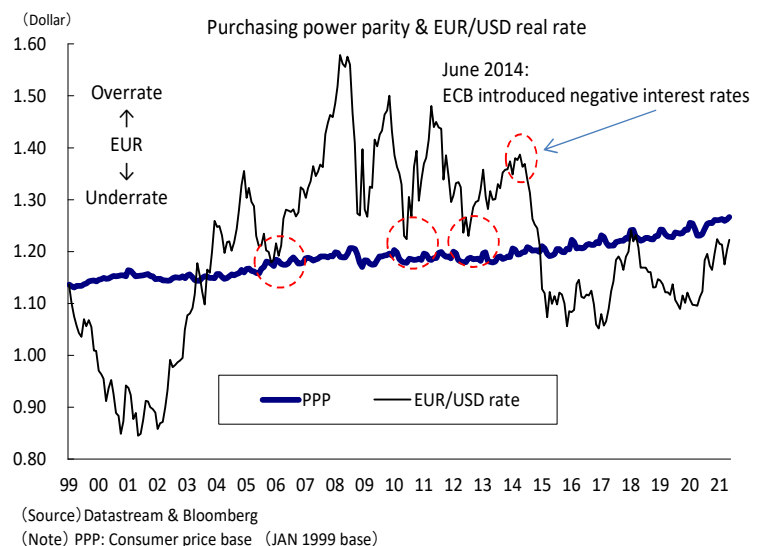
(Source) Bloomberg

### EUR Appreciation Trend Paralleling JPY Appreciation History

It should be noted that the current situation is confirming the stickiness of deflationary trends in the euro area and that those deflationary trends have not been effectively countervailed despite the proactive monetary policy management of the ECB, which has come to boast the world's largest balance sheet. This is an important situation to keep in mind when considering the outlook for EUR. As the history of the Japanese economy and JPY have demonstrated, the history of USD/JPY was a history of JPY appreciation, and the history of JPY appreciation was a history of deflationary trends. The euro area has not experienced actual deflation, but if disinflationary trends that prevent prices from rising become the norm, they can theoretically be expected to increase EUR's purchasing power. Looking at EUR/USD, for example, one can see that EUR's purchasing power parity (PPP) level is gradually rising (see graph). Although prevailing

forex market levels have not stayed close to the PPP level for a long time, there is a valid theoretical basis for anticipating that the market levels will have a tendency to converge towards PPP levels.

In 2014 I published a book – “Ready for the Japanization of Eurozone, Euro and ECB” (Toyo Keizai Shinposha) – that explained the euro area's tendency toward disinflation and the associated possibility of an undesired EUR appreciation trend. Seven years have passed since then, and I feel that the possibilities I was concerned about in 2014 are now clearly becoming real. That is the “big picture” framework within which I am analyzing economic and financial trends in the euro area and in EUR.



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