

January 31, 2022

Overview of Outlook

USD/JPY remained strong in January. The financial markets are beset by any number of risk factors – the spread of infections from the omicron variant, persistently high resource prices, the sharp hawkish turn in the Fed’s monetary policy stance, and heightening geopolitical risks, among others – but there are no signs of JPY buying triggered by risk aversion. When USD/JPY hit the 116-level early in the new year, USD was depreciating in terms of its real-effective exchange rate rather than appreciating in the forex markets. In other words, JPY was also being sold at the same time as USD. As I have repeatedly argued in this report, the recent weakness of JPY reflects the weakness of Japan to some extent, making it difficult for JPY to appreciate simply because of a slowdown in the U.S. or European economies. Choosing the easy option of movement restrictions as its main countermeasure against the pandemic has resulted in a widening of the gap between its domestic and overseas economies for Japan, and this situation seems likely to continue in 2022. Although some in the Kishida administration seem to believe that strict movement restrictions correlate directly with public approval rate, share and forex market trends indicate no notable increase in support for the administration. In the U.S., even before rate hikes begin, there is already a pervasive sense that the Fed is being excessively zealous in its monetary policy stance. I disagree with the current view that four or five rate hikes seem par for the course. Even assuming that a rate hike will be implemented as planned in March, the brakes may be applied on the process starting around June despite inflation peaking. Again, though the Fed insists it does not take share prices into account, there are limits to how long it can maintain a hawkish policy stance amid the negative wealth effect on household budgets and the impact on housing investment, and the level of caution in the financial markets seems to be at its peak. At any rate, with Japan avoidance still being a theme, if U.S. interest rates also increase, it seems likely that the trend of JPY depreciation against USD will continue strong.

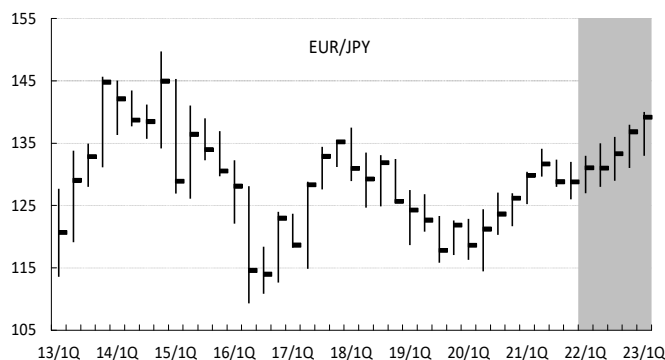
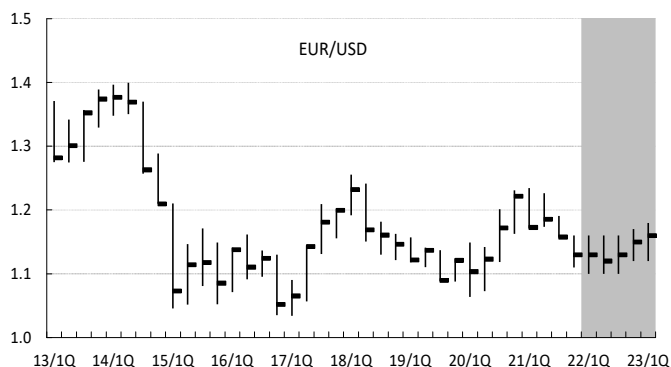
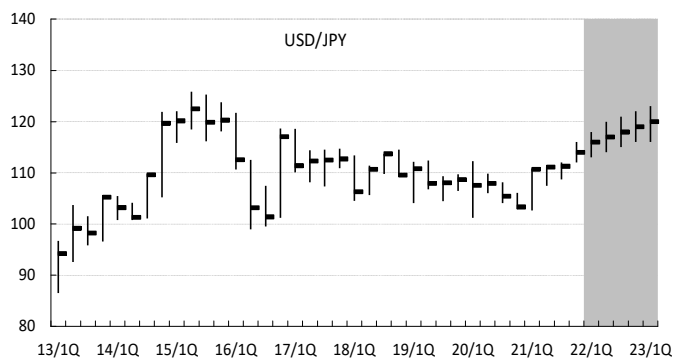
Meanwhile, EUR weakened in the forex markets in January. The scope for factoring in a shift toward a more hawkish monetary policy stance on the part of the ECB, which has until recently maintained that there will be no rate hikes this year, seems to be expanding, and this may promote EUR buying going forward, given that the Fed’s hawkish stance has already been fully factored in. As of now, the ECB seems committed to continuing the expanded asset purchase programme (APP) with a temporary increase in bond purchases until the end of the year, but it is worth keeping in mind that an early termination is not impossible. On the demand side, the euro area’s current account and trade surpluses (the largest in the world) are also bound to support EUR. However, geopolitical risk factors could very well weigh EUR down going forward, as the EU is a directly concerned party when it comes to the recent Russian invasion of Ukraine. However, the majority view seems to be that a military confrontation might be avoided. If this is the case, and the ECB’s policy normalization process also gains speed, EUR may recover during the second half of the current forecasting period. Moreover, despite some sluggishness, the euro area’s economic and financial performance is much better than Japan’s, so EUR/JPY is bound to remain strong.

Summary Table of Forecasts

	2022					2023
	Jan (actual)	Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
USD/JPY	113.47 ~ 116.35 (115.45)	113 ~ 118 (116)	114 ~ 120 (117)	115 ~ 121 (118)	116 ~ 122 (119)	116 ~ 123 (120)
EUR/USD	1.1122 ~ 1.1483 (1.1149)	1.10 ~ 1.16 (1.13)	1.10 ~ 1.16 (1.12)	1.10 ~ 1.16 (1.13)	1.12 ~ 1.17 (1.15)	1.12 ~ 1.18 (1.16)
EUR/JPY	128.25 ~ 131.60 (128.68)	127 ~ 133 (131)	128 ~ 135 (131)	129 ~ 136 (133)	131 ~ 138 (137)	133 ~ 140 (139)

(Notes) 1. Actual results released around 10am TKY time on 31 JAN 2022. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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Exchange Rate Trends & Forecasts



USD/JPY Outlook – JPY May Remain Weak Despite USD Weakness

World Economy Now and Going Forward – JPY Avoidance Situation May be Repeated

A Large Number of Risk Factors

The International Monetary Fund (IMF) published a revised version of its World Economic Outlook (WEO) on January 25, enumerating all the ongoing problems in its subtitle “Rising Caseloads, A Disrupted Recovery, and Higher Inflation.” Comparing the revised report’s 2022 real GDP growth rate forecast with that of the previous report (dated October 2021), the outlook for the world economy has been downgraded by -0.5 pp to +4.4. Nearly all of the 0.5 pp reduction is attributable to the U.S. and Chinese economic outlooks. The former was lowered by -1.2 pp in light of soaring inflation in the U.S., while the latter was lowered by -0.8 pp in view of China’s stubborn adherence to a zero-COVID policy. Apart from the above, the economic outlook for Germany, which saw an early resurgence of infections, was also lowered conspicuously by -0.8 pp. As a result, the balance of risks has shifted further downward due to a host of factors, including the emergence of new variants, continuing supply chain disruptions, volatile energy prices, rise in wages, and insecurities arising from the rise in interest rates in developed economies (which could lead to a capital drain from emerging economies). The report also mentions a rise in geopolitical tensions but avoids mentioning the names of specific countries (Russia, Ukraine, and Taiwan, for instance).

G7 & China growth ratio trajectory from 2020 to 2023 (YoY%)

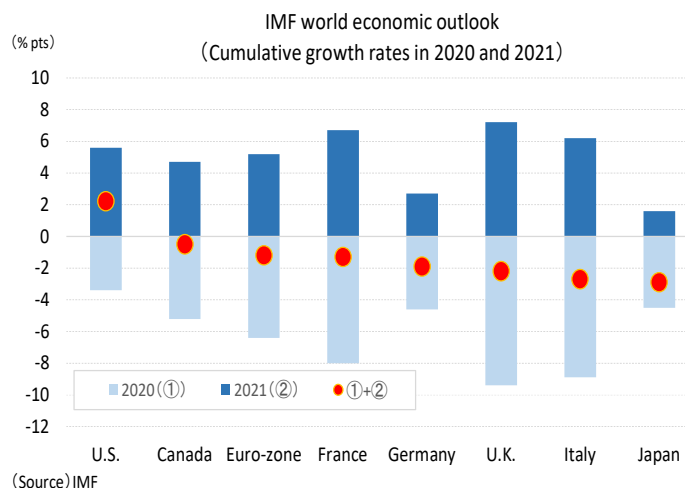
	2020	2021	2022		2023	
	Actual	Estimate	as of OCT	as of JAN	as of OCT	as of JAN
U.S.	-3.4	5.6	5.2	4.0	2.2	2.6
Euro-zone	-6.4	5.2	4.3	3.9	2.0	2.5
Germany	-4.6	2.7	4.6	3.8	1.6	2.5
France	-8.0	6.7	3.9	3.5	1.8	1.8
Italy	-8.9	6.2	4.2	3.8	1.6	2.2
Japan	-4.5	1.6	3.2	3.3	1.4	1.8
Canada	-5.2	4.7	4.9	4.1	2.6	2.8
U.K.	-9.4	7.2	5.0	4.7	1.9	2.3
China	2.3	8.1	5.6	4.8	5.3	5.2

(Source)IMF “World Economic Outlook”(JAN 2022)

In sum, the world economy is beset by troubles in a variety of areas, including economic, financial, and diplomatic (security related). Under such circumstances, it is unsurprising to see high-risk assets, such as equities and cryptocurrency, being dumped. During such phases of decline in risk appetite, resource prices usually undergo correction amid lower demand, but the problem is that there is no sign of such a correction this time. It appears that the world economy is slowing down, but demand remains strong amid a failure of recovery in supply capacity. At any rate, there are a large number of risk factors that must be overcome before the world economy can regain stability.

Upward Revision of Japan Outlook Only Natural

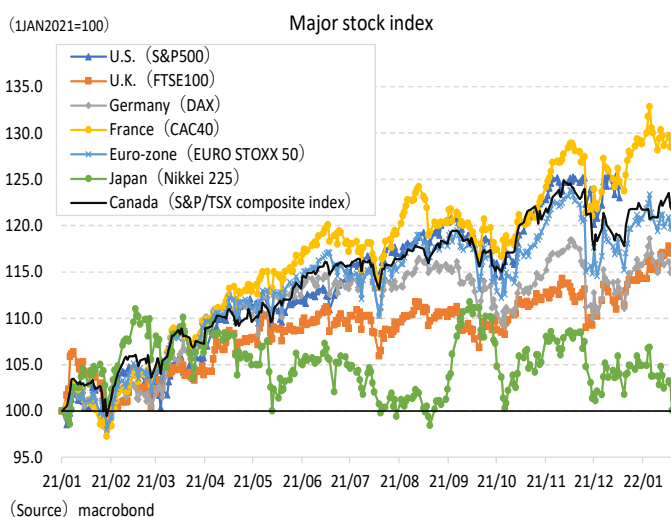
In this midst, the economic outlook for Japan, which was downwardly revised several times last year, has been upwardly revised for both 2022 and 2023. Japan was the only one among G7 countries to see an upward revision, but this is no more than in reaction to the extremely low growth rates Japan saw in 2021, thanks to protracted periods of movement restriction. Naturally, the weaker the starting point, the stronger the rate of change. Let us see how by comparing growth rates for 2020 through 2021 (actual results for the former, estimated results for the latter; see figure) for various countries. In terms of cumulative growth rate (the sum of the 2020 and 2021 growth rates) under the pandemic, the Japanese economy clearly has the most lackluster performance of the countries shown. Meanwhile, the U.S. and European economies have already recovered pre-pandemic (October-December 2019) growth levels, so it is only natural that these economies, which have been quite volatile, should slow down and return to cruising speeds. While they have had their ups and downs, these economies are far ahead of Japan, which has still not managed to recover pre-pandemic growth levels. The reason for this is obvious when one looks at the gap between the monetary policies of Japan and the other nations.



Incidentally, the IMF's January 2021 WEO also indicated an upward revision for the Japanese economic outlook. Subsequently, however, the outlook was repeatedly revised downward, in April, July, and October, in contrast to the outlook for the world economy. Needless to say, this was the result of Japan's emergency declarations and measures for preventing the spread of infections. The recent IMF report does not take into account the measures for preventing the spread of infections currently in place for Tokyo and 34 other prefectures. Therefore, the current forecast of +3.3% growth for 2022 already requires downward revision, and if the measures stay in place beyond their current deadline of February 13, an even bigger downward revision is likely. Looking back at 2021, U.S. and European economic growth began to recover after movement restrictions were relaxed in early spring, but Japanese growth sank as a result of Japan's unwillingness to lift the restrictions. The results of this are obvious from the stock index trends of key countries (see figure). Japan is now consistently the weakest among developed nations, but the Japanese stock index was not performing any worse than the stock indices of other developed countries until April last year. However, once the U.S. and Europe began to lift movement restrictions, the gap between Japanese and other stock indices began to widen conspicuously. At the present time, stock prices are undergoing significant corrections all over the world, but the Japanese stock index is the only one that is lower now than it was a year ago. I have repeatedly asserted in this report that the weakness of the Japanese economy cannot be obscured by the failures of other countries, and share prices seem to be underscoring this reality.

Last Year too, the Outlook was Fine Through January

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Some in the Kishida administration seem to be under the impression that strict movement restrictions correlate directly with public approval, and the administration seems to be in a desperate risk-avoidance mode in preparation for the upcoming election of the House of Councilors. It would be good to see their calculation fail. Unfortunately, going by the current domestic and international economic climates, 2022 may repeat the mistakes of 2021. I, therefore, do not see either Japanese stocks or JPY as desirable investment options for international investors.

Japanese Economy Now and Going Forward – Will the Political Establishment Heed the Markets? Risk of Ignoring the Undesirable Weak-JPY Trend

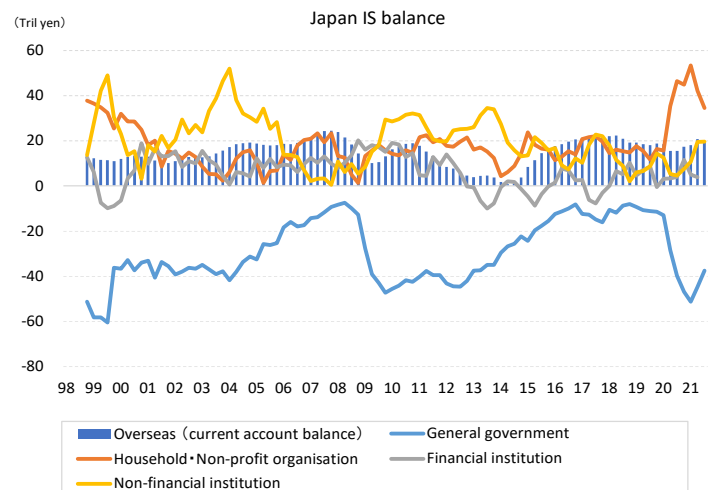
Desire for Higher Approval Rate Could Result in Renewed Movement Restrictions

In January, the Japanese government decided to implement measures to prevent the spread of infections in Tokyo and 34 other prefectures. It seems fairly obvious that, so long as the increase in new cases does not result in a similar increase in severe cases or deaths, and so long as the medical system is able to handle the load, economic activity should not be curtailed. Yet, the Japanese administration remains excessively focused on new cases, and the will of the Japanese people is yielding to this. When the Kishida administration first came to power, there was hope that it would formulate measures against COVID that do not depend on movement restrictions, given that Japan's vaccination rate was already quite high. Especially considering that the omicron variant's symptoms are nearly indistinguishable from those of a common cold, there should have been scope for testing out a new approach to dealing with the pandemic, but as clearly revealed by Prime Minister Kishida's words that being "too cautious" was the better option, the administration's stance seems to be in favor of stricter movement restrictions.

Calling for movement restrictions despite doubts about their effectiveness and continuing to impose travel (entry) restrictions despite the confirmation of community spread – perhaps such measures are being taken because they clearly contribute to a higher approval rate. According to an opinion survey conducted by JIJI Press, Ltd., in January, the approval rate for the Kishida administration is 51.7%, the highest ever recorded. The administration has accomplished nothing significant in its three months in power (rather, delays have been more conspicuous), so putting COVID countermeasures ahead of economic normalization, as emphasized by Kishida in his policy speech, may be the main reason for its high approval rate. Some local governments have recently declared their intention not to seek the implementation of movement restrictions given their dubious effectiveness, and I agree with them, but under current social conditions, their moves may be seen as rather bold.

Circumstances Continue to Compel Excessive Saving

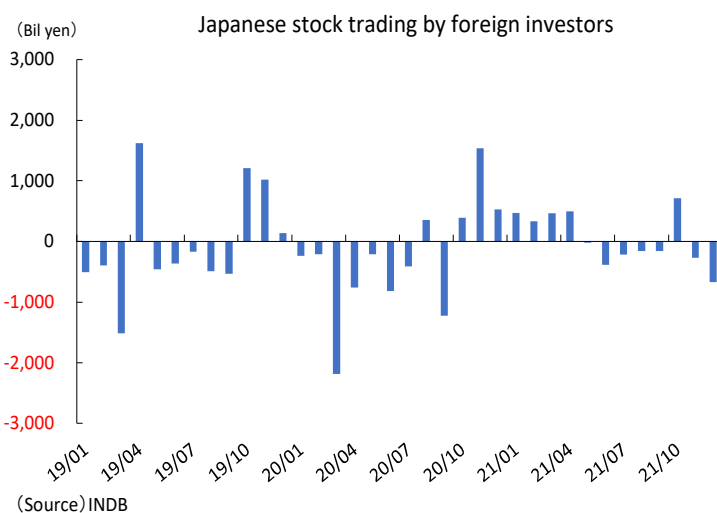
Several times in this report last year, I discussed how Japan was alone among developed nations in consistently posting negative growth as well as weak share and forex market performances. This was to be expected, given that the country endured movement restrictions through most of the year starting spring. Growth rates directly affected inflation and, therefore, monetary policy, weakening JPY both in real and nominal terms. A weak JPY against the background of soaring resource prices will, naturally, expand Japan's trade losses. In practice, the expansion of trade losses means lower real wages for households, so a steady deterioration in real living standards for households is to be expected. Meanwhile, Japan is increasingly cheap for foreign visitors, as one might know from the numerous special reports on this issue in the media last year.



Even if public opinion favors stricter movement restrictions, the government must realize that such restrictions are damaging economic growth and indirectly resulting in a "cheap Japan," and accordingly disseminate information. As of now, though, the Japanese economy seems to be continuing on the same path as it was last year, which could result in a further weakening of the already weak JPY, which is at a 50-year low. The Japanese economy's savings-investment (IS) balance for the household and corporate sectors (i.e., the private sector) is at its highest level ever recorded, and is barely being balanced out by government sector consumption and investment (see figure). Without an increase in private sector consumption and investment, inflation is unlikely to increase, and monetary policy will have to remain unchanged. If the gap between Japanese monetary policy and the monetary policies of countries where rising inflation rates provide greater opportunities for policy normalization keeps expanding, it will be that much easier for JPY (especially in real effective terms) to weaken. As a policy, movement restrictions force the private sector to save, so the trend of higher savings in the private sector will strengthen during the January-March quarter.

Timing of Removal of Restrictions is the Bigger Concern; Will the Political Establishment Heed the Markets?

The aforementioned developments have already taken place, so there is no use lamenting over them. Risks going forward are the ones worth worrying about. Going by past experience, rather than announcement of restrictions, it is the timing of their removal that is the bigger cause for concern. Amid relief at the removal of restrictions people forget to take note of the fact that the damage can be limited so long as decisions to remove restrictions are made swiftly following their imposition. Japan's vaccination rate rose at a rapid pace last year and went on to surpass the U.S. vaccination rate, but despite this, Japan repeatedly and aimlessly extended its state of emergency. Of course, before the summer, one could have argued against relaxing restrictions ahead of the Tokyo Olympic Games (but the restrictions were not relaxed even during the Games).



This year, with the Upper House elections scheduled for July, there is no political incentive to lift restrictions early, given that public opinion seems to favor keeping the restrictions in place. This time, however, the Tokyo Metropolitan Government has given an advance indication of the criteria for introducing measures to prevent the spread of the pandemic (hospital bed occupancy rate of 20% or more) and for declaration of an emergency (hospital bed occupancy of 50% or more). If these criteria are mechanically applied also when it comes to removing the restrictions, we may be able to avoid the pattern of incremental extension of restrictions seen during previous waves, which would make it easier to formulate forecasts. However, looking back at the illogical attitude to decision-making seen over the past couple of years, the authorities may well use vague phrases like “taking a comprehensive view of things” or “owing to circumstances” to extend the restrictions. I repeat myself, but the authorities are quite susceptible to adopting this path if this is what will win them public approval.

However, unlike public opinion, the financial markets are not in favor of this political stance of putting anti-pandemic measures ahead of economic normalization. There are few reasons to invest in the Japanese economy, plagued as it is by excessive saving and barely rational movement restrictions. In fact, not many foreign investors have invested in Japanese stocks since last April, when movement restrictions became protracted in Japan. This trend in equity investment may also be one of the reasons why JPY fails to appreciate even in phases when USD is depreciating. Will Kishida, who prides himself on being able to “listen,” heed what the markets are trying to tell him? If the damage to the Japanese economy from the stock and forex market trends comes into clearer focus, there may arise some scope for revising the current stance in favor of being “too cautious.” If not, the Japanese economy will continue to sink, and JPY will weaken both in real and nominal terms along with it. Going by the current social and political climate, one cannot rule out the possibility of JPY weakening even more than assumed as part of this report’s forecast scenario.

BOJ Monetary Policy Now and Going Forward – Handling “Undesirable JPY Weakness”*Inflation may be Temporary*

At the January 18 BOJ Monetary Policy Meeting, monetary policy was kept unchanged. Barely a few days earlier, on January 14, Reuters ran an article in English titled “BOJ debates messaging on eventual rate hike as inflation perks up,” stirring up rumors of a potential end to negative interest rates (i.e., rate hikes) before the consumer price index (CPI) had reached 2%. On the same day, USD/JPY fell sharply. Significantly, the Japanese language media did not pursue the story, and USD/JPY recovered in the days leading up to the meeting. Rumors about policy normalization, therefore, may have been just a flash in the pan.

In the Outlook Report, the core CPI outlook was raised by +0.2 pp from 0.9% to 1.1% for FY 2022, while that for FY 2023 was raised by +0.1 pp from +1.0% to +1.1%. In other words, inflation growth is not expected to accelerate from FY22 to FY23, but rather end as a temporary phenomenon arising from JPY depreciation and resource price appreciation. Although the forecast for risk to prices was raised to a neutral level for the first time since October 2014, to “generally balanced,” the discussion is unlikely to progress to ending monetary accommodation unless the core CPI outlook improves.

No Promises Regarding Interest Rate Levels

Although the Reuters report speculation appears to have been put to rest, other speculations will continue to emerge regarding the BOJ's policy normalization process going forward. The current BOJ administration will end at the end of March, 2023, and the Kishida government, which is somewhat removed from Abenomics policies, will likely be in charge of selecting members of the new administration, so monetary policy may slowly but steadily shift away from its current path. However, since abruptly embarking on policy normalization in April 2023 would throw the markets into turmoil, efforts to lay the ground may be gently begun during FY 2022. Thanks to the Reuters report, it is now widely known that the current monetary policy framework permits raising interest rates while insisting that it enhances monetary accommodation in real terms. This has to do with previous criticisms of negative interest rates as being "reversal rates" (details below).

As the recent Statement on Monetary Policy notes, the BOJ will merely "continue with Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control (YCC), aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed consumer price index (CPI, all items less fresh food) exceeds 2 percent and stays above the target in a stable manner." In other words, the Bank promises to continue expanding the monetary base but makes no commitment to maintain stably low interest rates, leave alone negative interest rates. Under this framework, the BOJ can use YCC to ensure a monetary easing effect by guiding the actual yield curve lower than the average level as estimated by the BOJ. However, the average yield curve naturally rises and falls depending on economic and financial conditions, so that the actual yield curve could be accordingly raised or lowered to maintain the same level of monetary accommodation as before, with the question of whether this results in a positive or negative interest rate being a secondary argument.

Policy Normalization a Natural Solution to Concerns of Undesirable JPY Weakness

Concern over JPY appreciation will understandably persist as a result of past traumas, but then the scope for JPY appreciation at the present time may be limited, given the disappearance of trade surpluses and the dramatic expansion of the gap between domestic and international economic/financial conditions. It is also possible that JPY appreciation would be tolerated to some extent in the current climate, given that high resource prices seem poised to turn the undesirable weakness of JPY into a social problem. Should the authorities want to correct this weak JPY trend, increasing the interest rates seems the natural way to do it. After all, worrying about a weak currency while keeping interest rates negative is like a bad joke. Of course, the BOJ may not be able to singlehandedly reverse a trend stemming from the floating exchange rate system, but eliminating negative interest rates would be the natural step for the BOJ to take if it truly wanted to check JPY depreciation. BOJ Governor Haruhiko Kuroda, however, dismissed the idea, stating that the Bank had neither discussed nor was considering any rate hike or other change in its present accommodative monetary policy. However, given that Kuroda had also outright dismissed the idea of negative interest rates right until the eve of implementing them in January 2016, it may be risky to take his words at face value.

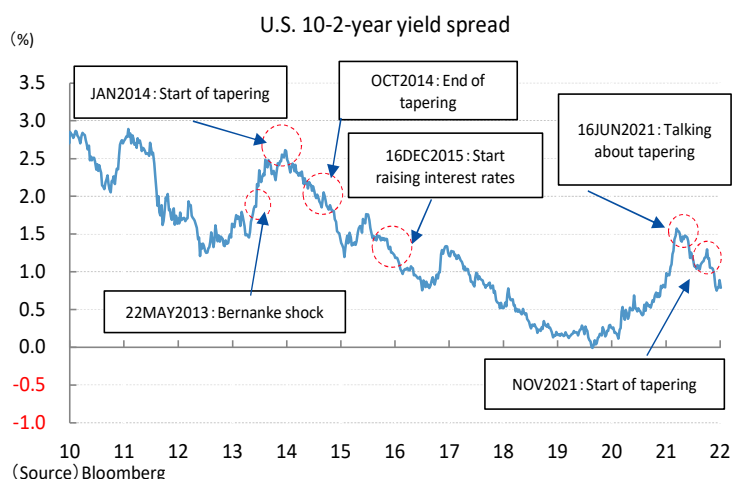
In the event that the BOJ does consider some sort of policy normalization, this may be the best time for it, given the Fed's swing to an extremely hawkish stance, although there are already concerns that the Fed's stance may be overzealous. Rationally speaking, therefore, the BOJ may have a one-in-a-million chance to gradually expand its discussion of the policy normalization process this year. While it is still too early to start considering specific steps, one assumes that, rather than abruptly implementing a rate hike, the initial step will be to steepen the yield curve by shifting the YCC target from the current 10-year to five-year bond yields. Whenever the president of any central bank retires, there is always talk of one last rate hike to mark the end of his or her term in office, but in the case of the BOJ, elimination of negative interest rates (i.e., a rate hike) may serve rather as a banner for the new (incoming) administration.

As mentioned above, under the YCC framework, revising the interest rate level itself does not equate to a revision of the accommodative monetary stance. Especially given the harsh criticism of the BOJ's negative interest rates as damaging to Japan's economic and financial health (reversal rate), it would not be impossible for the BOJ to present the elimination of negative interest rates and the shift in the YCC target to shorter maturities as a form of "additional monetary easing." Also, in light of the fact that Bank has introduced schemes such as the Special Deposit Facility to soften the damage to financial institutions from negative interest rates, it makes logical sense to fundamentally eliminate negative interest rates. At any rate, discussions surrounding policy normalization in anticipation of the post-Kuroda regime are likely to be an interesting issue for the Japanese markets this year.

U.S. Monetary Policy Now and Going Forward – How Long Can Share Prices be Ignored?

No Weakening of Hawkish Stance

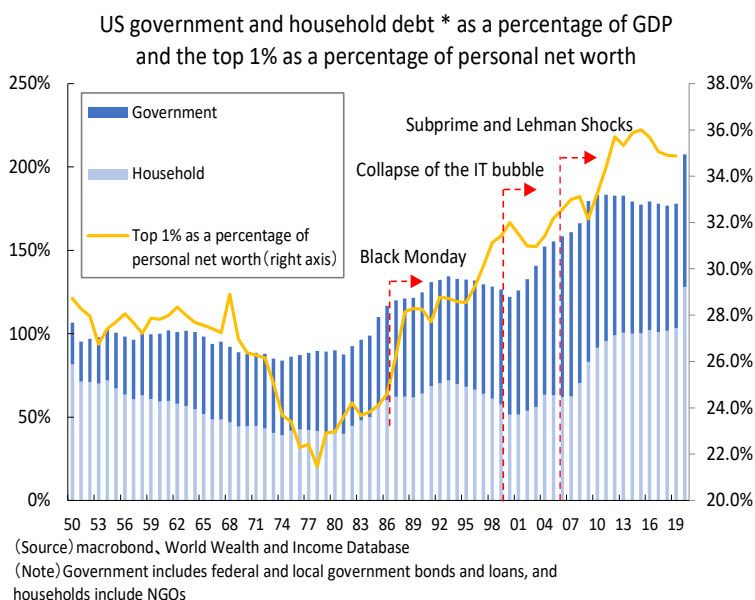
The January FOMC statement noted that “it will soon be appropriate to raise the target range for the federal funds rate,” serving as a preliminary announcement of a rate hike in March. Fed Chair Jerome Powell also clearly stated in his press conference, “the Committee is of a mind to raise the federal funds rate at the March meeting, assuming that conditions are appropriate for doing so.” However, the markets are more interested in the margin by which the FF rates will be increased, not in whether or not they will be raised. In this connection, a reporter asked specifically whether the rate could be increased by 50 bps rather than 25 bps, to which Powell responded “We have not made these decisions,” explaining that, compared with the previous phase of rate hikes, inflation was substantially higher and the labor market was very tight. Most market participants interpreted his comments to mean that a 50-bp rate hike was not ruled out. Powell expressed concern about soaring wages and inflation in his response to other questions as well, giving the impression of hawkishness and prompting a fall in share prices. He also clearly stated that more detailed discussions on shrinking the balance sheet (quantitative tightening) will take place at the next meeting. If things proceed smoothly, the odds of a decision being made at the June or July FOMC meeting are high.



Meanwhile, there was no special consideration given to share market trends, which have recently been very turbulent. Overall, there seemed no weakening of the hawkish stance, and U.S. 10-year interest rates rose to the level of 1.9%, progressively flattening the yield curve. In the forex markets, USD strengthened in line with the increase in interest rates. The 10- to 2-year Treasury yield spread is less than 70 bps, which is similar to the average spread seen during October-December 2017, when the Fed had already implemented four rate hikes as part of its previous rate-hike phase. This time, though, the financial markets are much more on edge over what seems like an overzealous attitude on the part of the Fed (see figure).

How much Longer can Share Prices be Ignored?

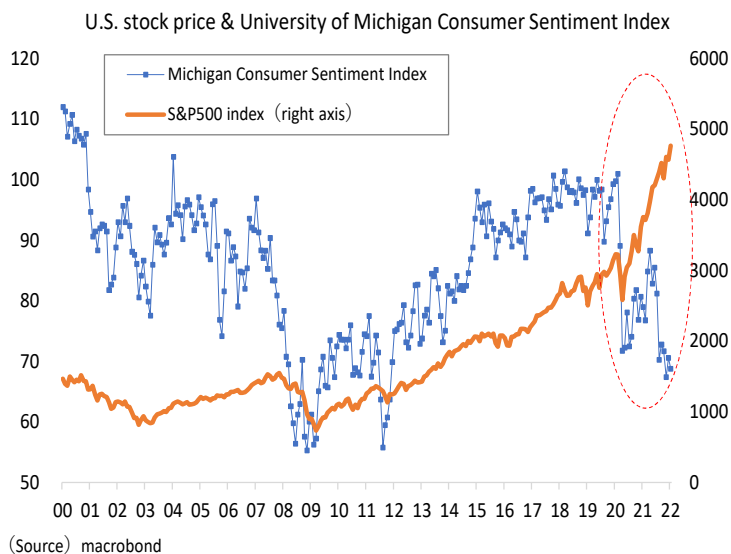
On January 24, White House Press Secretary Jen Psaki made the headlines for remarks that came across as flippant toward market participants: “(President Joe Biden focuses) on the trends in the economy, not any one day and any single indicator. (...) Unlike his predecessor (former President Donald Trump), the president does not look at the stock market as a means by which to judge the economy.” Many people, rightly or wrongly, seem to think that Powell agreed to fight inflation in return for renomination as Fed Chair. Going by the timing of his renomination (mid-November) and the timing of the sudden change in the tone of his statements (late November), they could be right. If this sudden switch to a more hawkish stance is owing to political pressure, one could assume that Powell’s attitude to share prices would be similar to that of Biden as reported in the media. There is, however, bound to be a limit to how long share prices can be ignored.



It is true that strong share prices during the pandemic have been criticized as resulting in a highly uneven distribution of wealth, and perhaps this is the focus of the Biden administration’s concerns. This structural tendency of wealth distribution, however, is not new to the recent crisis. It has been strengthening with each new crisis (see figure to the right, top). The Biden administration, which came to power promising to raise taxes on the wealthy and narrow the income gap, clearly sees the use monetary tightening to suppress share prices and inflation as a just cause.

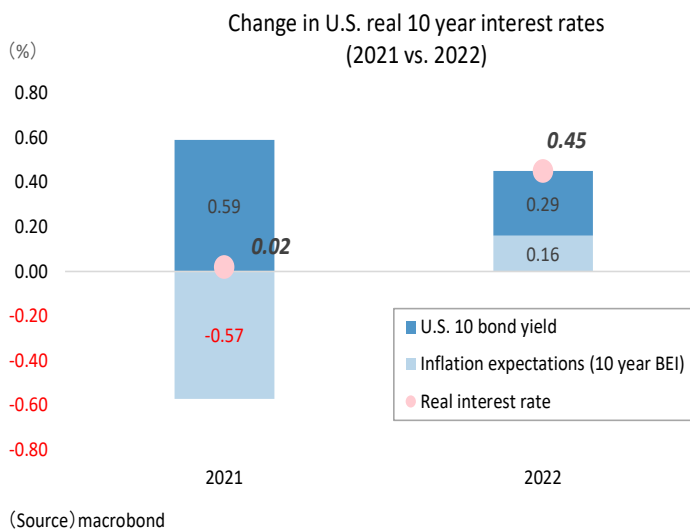
However, given that equities comprise 40% of U.S. households' financial assets (the total value of equities directly and indirectly held by households during July-September 2021), it will be difficult to continue ignoring the negative wealth effect from the decline in share prices. So far, the U.S. consumer sentiment index has not been in sync with share prices (see figure to the right, bottom), rather deteriorating with an increase in inflation, but going forward, they could begin to be affected by the fall in share prices also. It would not be wise to underestimate the direct correlation, historically speaking, between consumer sentiment and share prices.

It is unclear how far share prices have to fall before they begin to draw attention, but the more important point is the shape of the yield curve. The FOMC does not seem to be paying particular attention to share price levels, but going by its meeting minutes, it is keeping track of the shape of the yield curve. As of the writing of this report, the number of rate hikes factored in for this year is approaching five, but if things go that far, the markets are very likely to be abuzz with rumors of an inverted yield curve within the year. It seems unlikely that FOMC members can unanimously retain their hawkish stance even under those circumstances, as more market participants call out the excessive zealotry. Moreover, there is no guarantee that Biden-Powell joint forces can solve the problem of inflation. In any case, as of the present time, I disagree with the current view that four or five rate hikes seem par for the course. For instance, will the FOMC maintain its pro-rate-hike stance even after the mid-term elections in December? My prediction in this report is still for only three rate hikes this year, and I would like to base my forex outlook on this prediction.



Marked Increase in U.S. Real Interest Rates

Expectations of policy normalization by the Fed are beginning to change the landscape of U.S. interest rates. U.S. interest rates were on a rise exactly one year ago too, but at that time, the rise in interest rates was nominal, accompanied by an increase in inflation expectations, and real interest rates (nominal interest rates minus inflation expectations) showed only a modest rise. For instance, both the U.S. 10-year bond yield (hereafter: nominal 10-year interest rate) and 10-year break-even inflation rate (hereafter: inflation expectations) rose by around +0.60 pp through 2021, but the real 10-year interest rate rose only by +0.02 pp, remaining more or less level (see figure on next page). However, in the first month of 2022, there has been an approximately -0.16 pp decline in inflation expectations and a +0.45 pp increase in the real 10-year interest rate

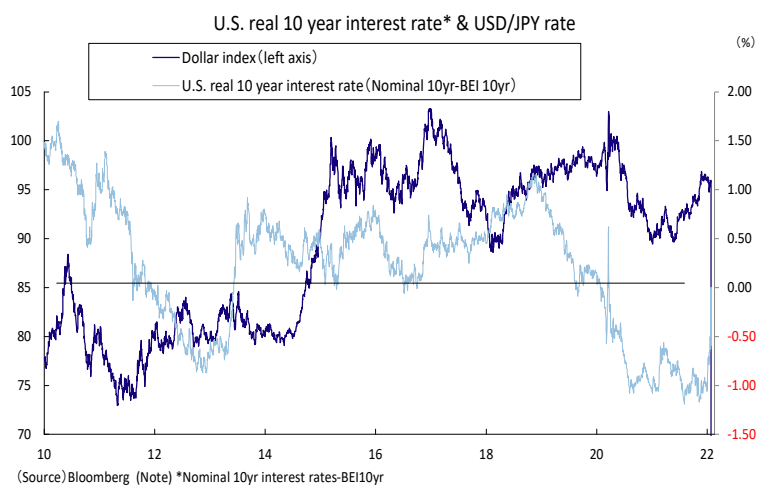
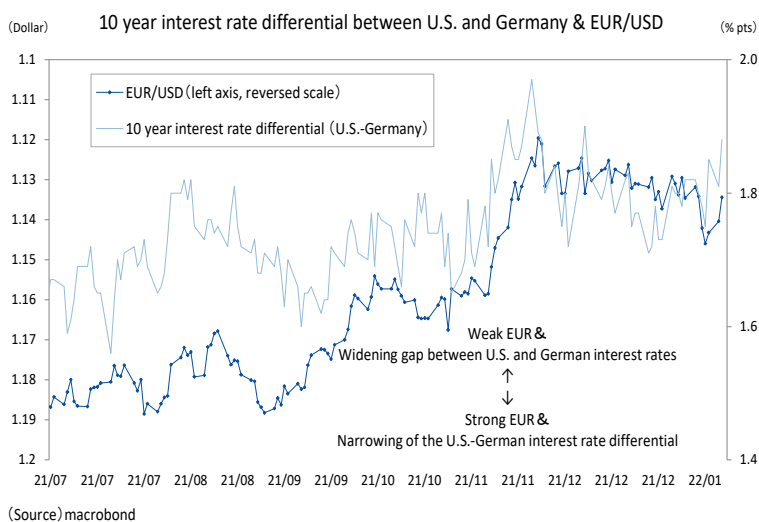


accompanying an approximately +0.29 pp increase in the nominal 10-year interest rate. The nominal 2-year interest rate, which is strongly influenced by monetary policy, has also risen to the 1.00% level for the first time in two years, indicating the extent to which U.S. bond markets have factored in rate hikes.

Given that strong U.S. share prices were one of the major reasons given to explain the consistently low real interest rates, one begins to understand the recent volatility in share prices. The reason inflation expectations are not keeping up with the increase in nominal interest rates is because many market participants fear a monetary policy overkill, i.e., that real economic performance will lose steam as a result of the Fed's overzealous rate hikes. Naturally, this is dampening share prices, which are a leading economic indicator. Going forward, the most important point to watch out for from early spring onward, as inflation rates probably peak out over the next three months, is whether or not the Fed's normalization process comes to a halt as a consequence of the aforementioned market concerns. I believe there is a good possibility of it.

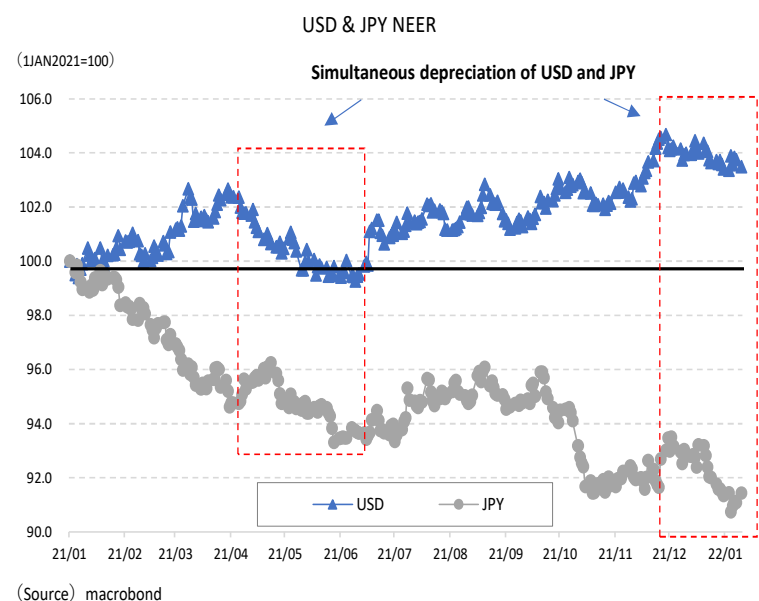
Global Trend of Rising Interest Rates; German 10-Year Interest Rates Positive for First Time in Three Years

What impact will such interest rate and inflation expectation trends in the U.S. have on the forex outlook? USD (dollar index used here) itself has not appreciated as strongly as warranted by the strong increase in U.S. nominal interest rates since the beginning of the year. It may be that, with four rate hikes already factored in, there is not that much more scope for an interest-rate-driven USD appreciation. Another reason USD appreciation is not as strong as one might expect from the rise in real and nominal interest rates may be that the rise in interest rates itself is an increasingly global trend. For instance, in the euro area, German 10-year interest rates became positive this January for the first time since May 2019. Although they have somewhat weakened again since then, EUR/USD, which maintains a stable correlation with the U.S.-German 10-year interest rate gap, has been strong since early this year. This may be partly responsible for weighing down the upper bound of USD in real effective terms. The euro area, however, is a directly affected party when it comes to the rise in geopolitical tensions as a result of the Russian invasion of Ukraine, so EUR may not be all that attractive for investors merely based on an increase in interest rates for some time to come. Historically, the relation between real interest rates and USD has not always been stable, but the two do tend to be in direct correlated to each other (see figure, bottom). So long as real interest rates rise, it is fundamentally unlikely that USD will crash.



USD/JPY a Different Matter

What about USD/JPY? The Japanese 10-year interest rate is also on the rise, but given that it has been capped at 0.20% as a YCC target maturity, the relationship between the U.S.-Japan interest rate gap and USD/JPY is not quite the same as that between the U.S.-German interest rate gap and EUR/USD. Going by forex market trends since last year, even an across-the-board weakening of USD in financial markets has not always led to JPY buying. Given the decline in Japanese political and economic conditions in recent months, it is quite possible that JPY will continue to be sold off even during phases when USD is being sold off. This has, in fact, been witnessed off and on in the forex markets since last year. For instance, since USD/JPY has been mostly strong since December 2021, many in Japan may be under the impression that USD has been appreciating. In reality, though, nominal effective USD rates have been gently declining. In other words, USD is being sold off, but so is JPY (see figure).

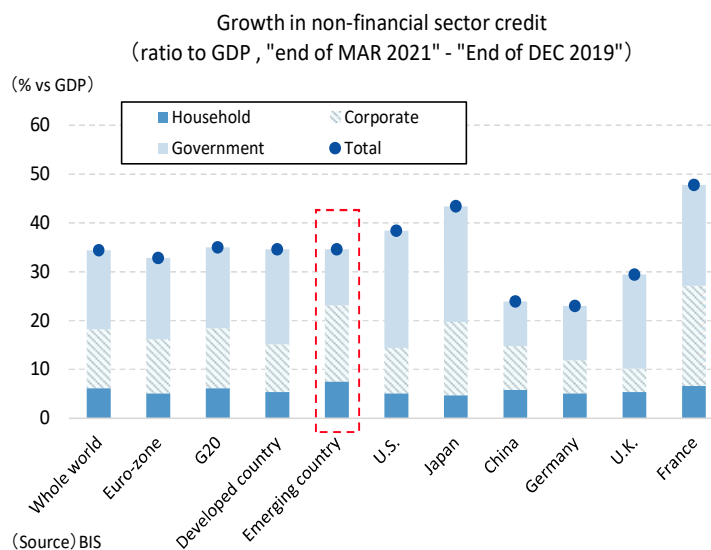


As I have argued many times before, the recent weakness of JPY reflects the weakness of Japan itself to some extent, and the contrast between Japan, which is once again imposing movement restrictions, and the U.S. and Europe, which are moving to lift them, will once again draw attention. The recent marked increase in U.S. real interest rates is cause for concern for the prices of risky assets, but they do not warrant a revision of my USD/JPY outlook.

Risks to My Main Scenario – Can Emerging Countries Overcome Normalization-Related Challenges?

Emerging Countries' Economic Outlooks "More Uncertain" in 2022

On January 10th, the IMFBlog website (<https://blogs.imf.org/>) posted an article entitled "Emerging Economies Must Prepare for Fed Policy Tightening", which warns that the policy normalization processes of the Fed and other developed countries' central banks may encourage capital outflows from emerging economies accompanied by currency depreciation, inflation, and economic stagnation (stemming from unwanted interest rate hikes) in those countries. These problems have been repeatedly discussed in previous editions of Mizuho's "Medium-Term Forex Outlook.", which described the problems as "growing pains" that naturally tend to occur when the world moves toward monetary policy normalization. It is expected that 2022 will be a year in which financial market participants will have to focus on the Fed's prospective moves to hike interest rates and shrink its balance sheet (so-called quantitative tightening, or QT). In light of the size and volatility of international capital movements in the world today, however, there are concerns about how the Fed's normalization process (by raising the global cost of capital) may impact vulnerable emerging economies, particularly the international sectors of those economies.



The IMFBlog article states that the moves toward monetary policy normalization have made the outlook for emerging economies "more uncertain", and this is not an exaggeration. The article notes that many emerging economies are facing high levels of inflation rates and public debt, stating that "Average gross government debt in emerging markets is up by almost 10 percentage points since 2019 reaching an estimated 64 percent of GDP by end 2021, with large variations across countries." The surge in the government sector debt burden is not limited to emerging countries, however, but can also be seen in the case of developed countries (see graph). The problem for emerging countries is that their real economic growth rates are not being pushed upward in exchange for the rising government sector debt burden – compared to the United States and other developed countries, their economies and labor markets are lacking resilience and upward momentum. It is thought that emerging countries' inferior growth rates reflect the weakness of their medical systems compared to those of developed countries – emerging countries' have lagged behind regarding vaccine procurement, vaccine injection programs, and other epidemic countermeasures. As the graph shows, Japan is one of the world's top countries with respect to the size of its recent government sector debt rise (+24 percentage points as a percentage of GDP). Japan faces challenges similar to those confronted by emerging economies in the sense that its economy has not grown enough to help offset the rising government sector debt burden, and I suspect this is one of the factors promoting the recent trend of JPY depreciation.

Returning to the subject of emerging countries, since the Fed's rate hikes haven't yet started, most countries are still able to procure dollar funding at low and stable cost levels. However, some countries, such as Brazil, Russia, and South Africa, have already decided to raise their interest rates because they fear that inflation and the depreciation of their own currencies will hinder their foreign currency procurement in the future. These interest rate hikes are being undertaken as self-defense measures, but because of the negative effects such hikes will have on their economies, the hikes clearly cannot be sustained over long time periods.

Vulnerability of "BEAST" Countries

The IMF Blog article's main forecast scenario is a soft landing. It anticipates that inflation rates will become more moderate, as supply constraints are expected to ease toward the latter half of the year and the rolling back of expansionary fiscal policies is expected to curb demand in each country. The IMF argues that, while the Fed's rate hikes will push up funding costs, "should [...] inflation moderate as expected, history shows that the effects for emerging markets are likely benign if tightening is gradual, well telegraphed, and in response to a strengthening recovery." Although a rise in U.S. interest rates may make emerging countries' currency depreciation inevitable, the IMF points out that those countries' economic slowdowns will be eased by the currency depreciation's promotion of improved international competitiveness and stronger external demand.

However, the IMF Blog article also notes the existence of risks. The outlook for the moderation of inflation is acknowledged to be uncertain in that such a moderation trend would require the expeditious elimination of supply constraints along with the prospect of a timely amelioration of the pandemic situation. The Fed's "dialog with the market" process is currently proceeding smoothly, and if interest rates are hiked at a rate of three to four times a year in line with that dialog, the negative impacts of the hikes are expected to be limited. However, this may not be the case if a faster rate of hikes is required. The article presents the graph on the right to emphasize that there is a stable relationship between U.S. interest rate rises accompanied by USD appreciation and capital outflows from emerging countries. At times of U.S. interest rate hikes, countries with large government debt balances and current account deficits along with political instability are relatively susceptible to capital outflows, so the BEAST countries (Brazil, Egypt, Argentina, South Africa, and Turkey) are likely to be particularly vulnerable. In fact, these countries' currencies have often shown significant fluctuations during monetary policy normalization periods in the past.

"Potential Bouts of Economic Turbulence"

Of course, emerging countries suffering from capital outflows along with currency depreciation and associated inflation are expected to take countermeasures, such as those to raise interest rates, intervene in the forex market through sales of its own currency, and reduce fiscal spending. Such fiscal and monetary policy tightening measures can help curb currency depreciation and inflation trends, but they also slow down domestic demand. In the end, regarding the turmoil that accompanies the Fed's normalization, emerging countries may have to acknowledge "difficult tradeoffs" – recognizing that the turmoil will burden them with considerable costs regardless of whether they try to counter it or simply let it take its course. The IMF Blog article emphasizes the importance of dialogue in managing these trade-offs, saying – "For central banks tightening to contain inflation pressures, clear and consistent communication of policy plans can enhance the public's understanding of the need to pursue price stability." – but, realistically speaking, in the case that the Fed accelerates its normalization to an unexpected degree, it is highly likely that emerging country central banks' information dissemination activities will not make much of an impression on financial markets.

The IMF Blog article also recommends such more-specific countermeasures, such as the hedging of foreign currency-denominated debt and extending the maturities of debt to decrease rollover risks, and it can be said that such responses are more likely to have positive results. In addition, the article notes that emerging countries that had high levels of corporate sector debt and non-performing loan balances even before the pandemic should ready bankruptcy resolution frameworks in preparation for needs likely to arise amid severe funding conditions in the future. In fact, emerging market currency depreciation and other forex market-induced shocks are liable to be sudden and intense, and it seems clear that starting the steady implementation of countermeasures now will ultimately prove to be beneficial overall.

As the period prior to Fed interest rate hikes could be considered a calm before a storm, the IMF Blog article notes in its last sentence that "emerging economies should prepare for potential bouts of economic turbulence". The gist of this message is quite clearly articulated. Of course, if the "FRB normalization process → turmoil in emerging countries" situation intensifies sufficiently, there remains a possibility that the Fed normalization process might be somewhat delayed or decelerated. It is probably safe to say that both emerging and developed countries will need to be very attentive to the possibility of such a development.

Foreign-exchange complications

Capital flows to emerging economies historically have weakened when the US dollar appreciated relative to other major currencies.

(Dollar Index, investment flows to emerging markets in billion \$US)



Source: Datastream and IMF staff calculations.
Note: Federal Reserve Nominal Broad Dollar Index, average of daily values (Jan 2006 = 100). Higher values signal appreciation.

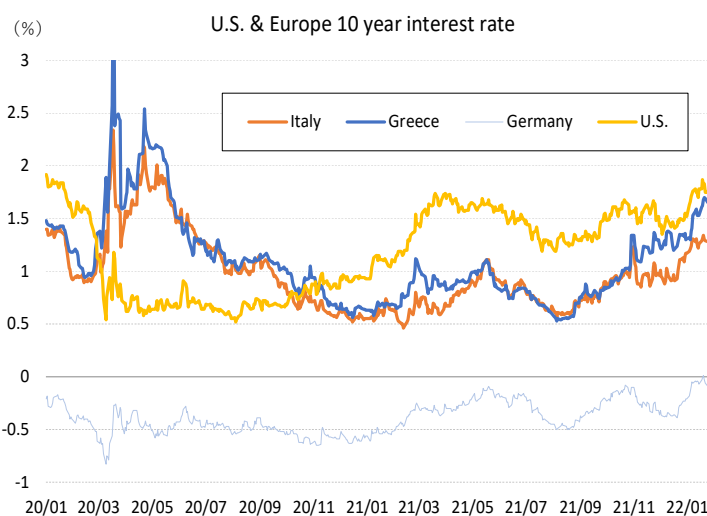
IMF

EUR Outlook – Revision of the “No Interest Rate Hike in 2022” Outlook?

EUR Area Monetary Policies Now and Going Forward – Likelihood that Inflation May Require ECB Policy Adjustments

Steady Rise in Euro Area Interest Rates

Although there was no ECB Governing Council meeting in January, there were some signs of shakiness regarding the presumption of a “no rate hike in 2022” outlook. As U.S. interest rates rise on nominal and real bases and prices of stock and other risk asset prices continue to fluctuate, there are increasing grounds for doubting whether Europe can remain aloof from such trends. In mid-January, the German 10-year interest rate’s return to positive figures for the first time in about three years attracted considerable attention, but it should be noted that interest rates both in Germany and other parts of the euro area have risen to their pre-pandemic levels, and this appears to have restrained the expansion of U.S.-euro area interest rate differentials and contributed to the firmness of EUR against USD. Germany’s December Producer Price Index (PPI; announced on January 16) was +24.2% yoy – well above the median of market forecasts (+19.4% yoy) and the highest rate of increase in this indicator on record. While many people still believe the surge in euro area inflation rates is “temporary and led by energy prices”, crude oil prices remain high, and it is gradually becoming more difficult to argue that the inflation surge is transient.



(Source) macrobond

ECB President Lagarde Hints at Possibility of Revising “No Interest Rate Hike This Year” Posture

Released on January 20, the Account of the December 16 Governing Council meeting indicates that, with respect to ECB plans to increase the amount of asset purchases under the asset purchase programme (APP) from April, some Governing Council members believed that, depending on inflation trends, consideration should be given to decreasing asset purchases and/or the accelerated discontinuance of asset purchases. The Account also shows that some Governing Council members argued that the ECB should avoid making such commitments as a promise to sustain asset purchases throughout 2022. ECB President Christine Lagarde was interviewed by a French radio station on the day of the Account’s release. During the interview, she emphasized that the ECB need not emulate the Fed’s shift toward hawkishness because the situation in the United States is quite different from that in the euro area, but it is worth noting that the Eurosystem staff projections revised last December anticipate that the Eurozone Consumer Price Index (HICP) will exceed +2% on average during the three years through 2024 (see table).

ECB staff outlook (DEC2021)

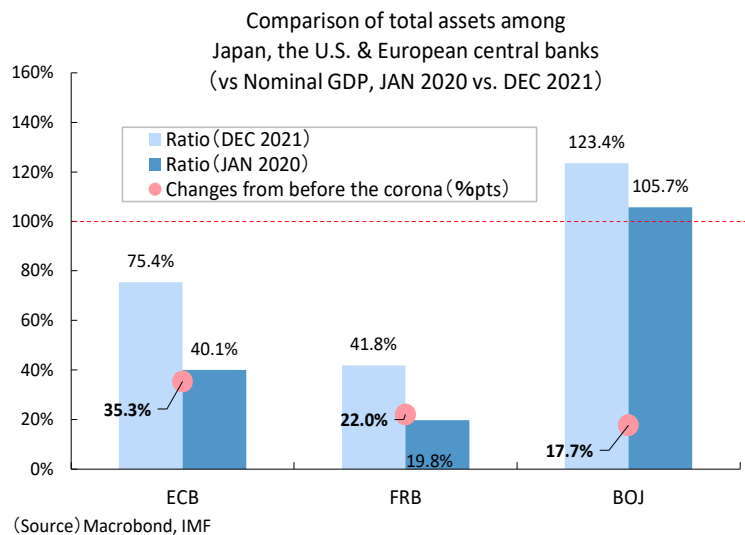
	2021	2022	2023	2024
HICP	2.6	3.2	1.8	1.8
(Previous : SEP 2021)	2.2	1.7	1.5	—
Real GDP	5.1	4.2	2.9	1.6
(Previous : SEP 2021)	5.0	4.6	2.1	-

(Source)ECB (Note) EURUSD is assumed to be 1.13 year 2022 - 2024

While that outlook can be assessed in various ways, it should be understood that the staff projections do appear to acknowledge the attainment of the ECB’s price stability (inflation) target, so it cannot be said that there is no possibility that the ECB could undertake monetary tightening measures. In fact, President Lagarde also said that the ECB is ready to respond with whatever monetary policy measures are deemed necessary based on consideration of incoming data, and this gives the impression that there may be some wiggle room with respect to previous indications that the ECB would stolidly maintain a “no interest rate hike this year” posture.

February Governing Council Meeting Likely to Emphasize a Wait-and-See Posture

Under these circumstances, what is the ECB Governing Council likely to do this year? While the Fed has made monetary tightening its default route, the ECB appears to have a lot of leeway for adjusting its policies, and there seems to be a need to give considerable thought to the question of how it might undertake such adjustment. As President Lagarde indicated in her abovementioned interview, the ECB's basic view at this point is that "the surge in inflation is temporary" and "there is no reason to adjust policies in line with the Fed's adjustments", and this view suggests that the ECB does not intend to accelerate movement toward policy normalization. With the December Governing Council meeting's decisions to discontinue the pandemic emergency purchase programme (PEPP) in March and increase asset purchases under the APP from April, the ECB can probably be considered to have made the necessary basic adjustments. In light of the continued acceleration of inflation rates throughout the world, however, the sustenance of quantitative monetary easing is becoming anachronistic. Plans call for the APP to continue operating this year, and the ECB has promised that the APP will temporarily accelerate its asset purchases from the second quarter, but it is somewhat questionable whether that temporary acceleration will be realized. The discussions described in the Account of December 16 Governing Council meeting mentioned in the previous section of this article suggest a possibility that the temporary acceleration could be adjusted. In light of the ECB's current forward guidance text – "We expect net purchases to end shortly before we start raising the key ECB interest rates." – the ECB will be hesitant to discontinue the APP as it would arouse expectations regarding interest rate hikes. However, the ECB might consider restraining APP purchases to a steady monthly pace of EUR20 billion to be a sufficient policy adjustment. As the ECB would like to secure greater lead time prior to initiating interest rate hikes, its "next move" might well be one to continue suggesting the prospect of a future APP termination move while also stating that interest rates will remain unchanged for a vaguely defined period (for example, for "some time") after the end of quantitative expansion.



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Given the increasing difficulty of placating financial markets with formulaic reiterations of an "inflation is temporary (so status quo maintenance is justified)" mantra, it seems that the ECB may feel pressured to shift its information dissemination content a bit more in the direction of hawkishness at the time of the February Governing Council meeting. If the ECB does not do that in February, it may come under pressure from an acceleration of increases in government bond yields, and there may emerge a risk of damage to the real economy. The ECB is the central bank that has undertaken the greatest amount of quantitative easing during the pandemic, both on an amount basis and on a GDP ratio basis (see graph). Even if the flow aspect of monthly asset purchases were to be discontinued, the ECB can argue that the stock aspect of its large balance sheet is sufficient to allow for a moderate shift toward hawkishness, and it is quite conceivable that the ECB will move toward this kind of posture going forward.

Appendix: The Scholz Government Now and Going Forward – Germany's Conspicuous Straying and Isolation

Scholz Government Shows "Evasiveness"

Besides concerns about the Fed's normalization process, the financial markets are facing serious geopolitical risks related to the possibility that Russia might invade Ukraine. The Ukraine situation seems to be potentially explosive, and the United States has announced it will dispatch some troops to reinforce North Atlantic Treaty Organization (NATO) troops the Eastern European region near Ukraine.

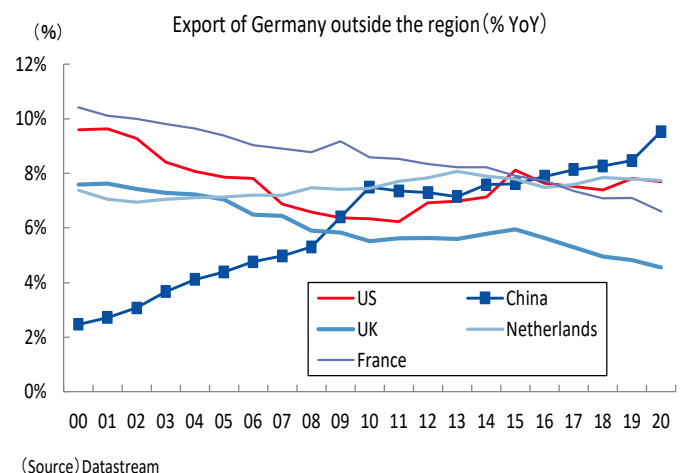
These circumstances put Germany and its new chancellor, Olaf Scholz, in a difficult position. As this article has discussed in the past, the Scholz government has from its inception emphasized a policy of distancing Germany from such countries as China and Russia as a means of emphasizing how its posture differs from that of the Merkel governments that ruled Germany during the previous 16-year period. In fact, however, the United States and most of Germany's NATO allies have been increasing their support for Ukraine in light of the potential for a Russian invasion, while Germany's relatively Russia-friendly posture has been widely criticized. For example, on January 24, a U.S. newspaper, the Wall Street Journal, published an editorial article entitled – "Is Germany a Reliable American Ally? Nein Berlin goes its own way, prizing cheap gas, car exports to China, and keeping Putin calm." – and it is generally believed that the title is a fairly accurate reflection of the U.S. government's perspective.

There appears to be a solid basis for this kind of criticism. Germany has refused to provide Ukraine with weapons, and the Ukrainian government has criticized it for that. It is also noteworthy that when Britain airlifted weapons to Ukraine, its planes took a roundabout route to avoid passing through German airspace. The UK Ministry of Defense has stated that its aircraft were not refused access to German airspace but admitted that it had decided not to ask Germany for the additional clearance required for flights with dangerous cargo. It appears that the UK Ministry of Defense avoided German airspace in deference to political sensitivities in Germany – while may not be considered a very important issue, one can presume that a public application for additional clearance might possibly have had uncomfortable political ramifications in Germany. It seems obvious that the German government would have been uncomfortable if it had been forced to either approve or disapprove the flights, and it also seems clear that the reason for this is that the German government is seeking to cater to Russian sensitivities. Currently, the Scholz government is stating that it will not approve the use of the newly completed “Nord Stream 2” natural gas pipeline until it confirms the legal compliance standards of related companies, and this delay is causing Germany-Russia relations to deteriorate. Partly owing to the tightness of Germany’s domestic electric power situation, it appears that the Scholz government strongly wants to avoid creating additional Germany-Russia frictions. While its domestic electric power prices are already said to have risen by more than 60% yoy in 2022, Germany has been opting to close down its coal-fired and nuclear power generation plants, so obtaining additional natural gas via Nord Stream 2 would make an important contribution to the reinforcement of the country’s electric power generation capabilities.

However, the sovereign security risks associated with Germany’s resolute implementation of its “clean energy” policy are becoming quite apparent, and the United States has been expressing concerns about these security risks for some time. The Scholz government appears to be acting “evasively” during the current emergency, and this evasiveness seems to be damaging its credibility from the perspective of its allies (and prompting such media articles as the abovementioned Wall Street Journal editorial). The Scholz government seems to be embodying the truism that – “It takes years to build trust and minutes to lose it”. It is noteworthy that on January 21, the chief of the German navy, Vice Admiral Kay-Achim Schönbach, gave a talk (posted on YouTube) in which he made such Russia-friendly remarks as – “What [Russian President Putin] really wants is respect. [...] It is easy to give him the respect he really demands; and probably also deserves.” Regarding the Crimean Peninsula, which Russia annexed in 2014, he said, “the Crimea Peninsula is gone: It will never come back; this is a fact.” These remarks appear to confirm what many other countries suspect is Germany’s true view of Russia. Not surprisingly, Ukraine has protested Vice Admiral Schönbach’s statements, and he has resigned from his post at the head of the navy.

Germany Unable to Support Neighbor

The Scholz government is behaving dangerously not only with respect to Russia but also in its relations with China, and the government’s initial positive momentum seems to be diminishing. It is well known that the Scholz government’s policy platform calls for maintaining a strict stance toward tyrannical actions on the part of China and thereby breaking away from former chancellor Merkel’s major legacy of strongly pro-Chinese policies. Reflecting this stance, Germany’s current foreign minister, Annalena Baerbock, stated early on that she would not attend the 2022 Winter Olympics in Beijing. Aside from political and diplomatic remarks, however, one wonders how easy it will be for Germany to scale down its economic relations with China given that China’s share of Germany’s international trade more than doubled during the Merkel era, to about 10% (see graph). The difficulty of a putative scaling down of Germany-China economic relations has been apparent since the beginning, but the significance of this does not appear to have been fully appreciated.



The fact that Germany is not able to sustain strict political and diplomatic policies regarding China owing to the closeness of Germany-China economic relations is intermittently becoming quite evident. Currently, the issue of Lithuania is attracting attention. There have been many reports since last year about how Lithuania (one of the three small Baltic states in the euro area) has been diplomatically distancing itself from China and cultivating closer ties with Taiwan. There are various situations in the background of Lithuania’s anti-China stance, but it is most often pointed out that, given Lithuania’s history of oppression within the former Soviet Union, the country feels unable to countenance China’s stances regarding human rights and democracy. In July 2021, Lithuania allowed the establishment of a de facto embassy called the “Taiwanese Representative Office in Lithuania”. China has long been forcefully promoting a “one China” policy (based on the concept that Taiwan is one of its provinces rather than being an independent country) that requires Taiwan-related institutions to use the name “Taipei” (a city) instead of “Taiwan”, and the naming of the de facto embassy is clearly not compliant with the policy. This overt non-compliance dealt a decisive blow to Lithuania-China relations – China reacted ferociously and has been harassing Lithuania with regard to diverse kinds of economic transactions. Lithuania is a quite small country that is a clear underdog in its confrontation with China, and many observers are sympathetically supporting its resolute determination to avoid giving in to Chinese threats.

However, Germany's determination to maintain an anti-China policy is becoming shaky. It was reported last December that had China demanded that a major German auto parts company stop using components manufactured in Lithuania. China is seeking to use Germany as a lever to force Lithuania to knuckle under. Since the scope of China's strategy is not limited to goods imported directly from Lithuania but includes all goods with materials or components from Lithuania, its impact extends to Germany and all other EU member countries. Given the Scholz government's ostensible anti-China policy, one might have thought that Germany would be supporting Lithuania in this struggle, but that has not proved to be the case. According to various reports, German industries have generally turned their backs on Foreign Minister Baerbock (the leader of the Green Party) and her anti-Chinese policy and are making increasingly loud calls for Lithuania to improve its relations with China. The Scholz government's policy platform calls for German companies to formulate management strategies that reduce their dependence on China, but as the government itself has been unable to muster up a resolute anti-China attitude, German companies are emphasizing that they are not in a position to take the initiative versus China.

It is worth recalling an event in September 2007, when then-Chancellor Merkel invited the Dalai Lama to her office in Berlin for talks and thereby triggered a strong negative reaction from China. Partly owing to protests from industries strongly impacted by the Chinese reaction, the Merkel government was forced to make efforts to improve its relations with China. Then-Chancellor Merkel never again met with the Dalai Lama, and she was subjected to a certain amount of teasing for having suddenly become so abjectly Sinophilic. The key question at this time is whether or not the Scholz government will succumb to the powerful pressures emanating from China in a similar manner. If it takes the attitude – based on an emphasis on business profits – of favoring a despotic but large distant country over a democratic but small neighbor, it could be considered to be perpetuating the Merkel-era policy.

EV Promotion Target also Scaled-Down

Straying from the policy platform has also been noticeable regarding the Scholz government's energy policy, a high-profile and highly emphasized policy. As explained at the start of 2022 in a Mizuho Market Topic article entitled "European Commission's Natural Gas 'Green' Classification a Blatant Compromise – Decision-Making Time for Japan, if it Seeks Decarbonization", the EU recently classified energy from nuclear and natural gas as "green" on its taxonomy list. As it has inherited the Merkel administration's policy of abolishing nuclear power, the Scholz government opposed this decision, but only a minority of EU countries oppose nuclear power at this point, so there is no prospect of the European Commission's decision to greenify nuclear power being overturned. If the Scholz government hopes to differentiate itself from the previous Merkel government, it would seem wiser for it to have countered the sharp energy price rises that are plaguing Germany's household sector by ending the Merkel government policy of completely eliminating nuclear power plants, but it appears that such a differentiation policy is not feasible so long as Green Party assistance is required to maintain a ruling coalition. Although the European Commission's decision seems to have presented an excellent opportunity to rescind the policy of abolishing nuclear power, the Scholz government has reiterated its opposition to nuclear power in a statement reading – "As the federal government, we have once again clearly expressed our rejection of the inclusion of nuclear energy. It is risky and expensive." It is hard not to regard this as an expression of masochistic idealism.

In addition, on January 17, Reuters published an article entitled "German transport minister reverses from 15 mln electric vehicles goal" that quotes Transport Minister Volker Wissing discussing an important adjustment to the country's electric vehicle (EV) promotion target. Essentially, the Scholz government replaced the Merkel government's goal of having Germany utilize 7 to 10 million EVs including plug-in hybrid vehicles (PHVs) by 2030 with a considerably-more-ambitious goal of putting 15 million pure EVs (not including PHVs) on German roads by 2030. According to the above report, however, Minister of Transport Wissing said at a meeting hosted by the German Handelsblatt newspaper that PHVs will now be counted toward the 15 million EV target.

Repeatedly Boasting and Backing Down

There are many other developments suggesting the Scholz government may not be a paragon of stability going forward, but the above-mentioned examples – efforts to adopt unrealistically strict postures toward Russia and China and to implement an energy policy blindly focused on unrealistic decarbonization targets – can be said to reflect what appears to be a characteristic habit of boasting about non-feasible ambitions. Less than two months after the government's inauguration, one cannot help but perceive the danger that this characteristic attitude will continue generating serious problems regarding major issues. Of course, one considers the complexities of the challenges the Scholz government faces, one will note that many of those challenges relate to problems left unresolved by the Merkel government, and one should also have sympathy for the Scholz government's misfortune of being impacted by such unpredictable situations as the sharp rises in resource prices and Russia's putative preparations to invade Ukraine. However, one still gets the impression that the Scholz government has been unable to maintain a realistic perspective largely because of its excessive emphasis on breaking away from the policies of the Merkel government. It is also quite possible that the Scholz government is simply trying to achieve too much with excessive haste.

At present, Germany has become conspicuously isolated both inside and outside the EU, and its relationship with China – previously one of its few “close friends” – is in a deplorable state. However, Germany has been facing a difficult external environment for the past 16 years, yet former Chancellor Merkel was generally able to successfully manage German interests despite the difficulties. Germany has been proud of its outstanding stability but now has been confronted with a very unstable environment. As it struggles to cope with that environment going forward, it seems likely that Germans and other people throughout the world will have many occasions to wistfully remember the formidable talents and global presence of former Chancellor Merkel.

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