

Forex Medium-Term Outlook

29 March 2018

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Forex Department

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Overview of Outlook

USD/JPY continued to fall during March, sinking to the 104 level for the first time since November 2016. The Fed's monetary policy stance is as hawkish as ever, and U.S. interest rate levels remain strong accordingly, but USD/JPY does not seem to follow in the same trend at all. It is safe to say that the simplistic prediction that JPY selling/USD buying would accelerate due to increase in U.S.-Japan interest rate gap, which prevailed in the late last year through early this year, has clearly not worked. Furthermore, now that a rise in interest rates has begun to weighing down the stock markets (and, therefore, to the real economy), I think that a reversal in the USD/JPY trend as a result of an increase in U.S. interest rates will not be that easy. Note that real effective exchange rates (REERs) have a propensity to return to their long-term average levels, and in this connection, currencies such as EUR, GBP, and MXN, which had previously been undervalued, rose strongly over the past year. JPY is the only currency that, despite being severely undervalued, remained that way, so I see the recent appreciation of JPY since February as a one-year overdue adjustment. There seems no reason to believe that the Trump administration will give up on its protectionist stance eventually, and given its compatibility with protectionist trade policies, a weak USD is bound to be seen in a favorable light. Under such circumstances, my basic understanding is that the risk of USD/JPY falling below the 100 level within the first half of the year cannot be ruled out.

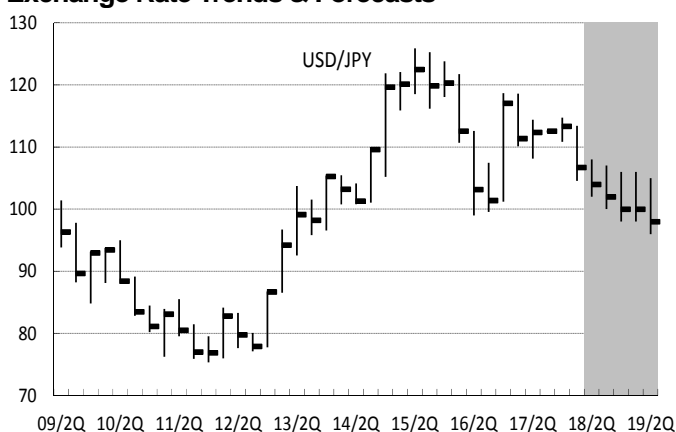
EUR, meanwhile, has been fairly stable. Thanks to USD weakening, EUR/USD has not fallen too dramatically, but with the ECB's dislike for a strong EUR and the volatile political situation in Italy, circumstances are not conducive to EUR appreciation. In terms of REER, the currency has undergone significant adjustment through strengthening over the past year, but further appreciation will require more hawkish policy operation, including the prospect of an eventual exit from the negative interest-rate policy. Actually, going by the ECB's communications, its intention seems to hike the rate by mid-2019. If true, perhaps there is greater hope for an increase in EUR/USD. However, the macroeconomic distortion caused by the one-sided strength of the German economy is some of concern. Real-estate prices in Germany, for instance, are significantly higher than those in the rest of the EU. Looking at monetary policy operation from the perspective of macroprudential regulation, how the ECB evaluates and positions the soaring of asset prices within Germany may be a matter of great importance going forward.

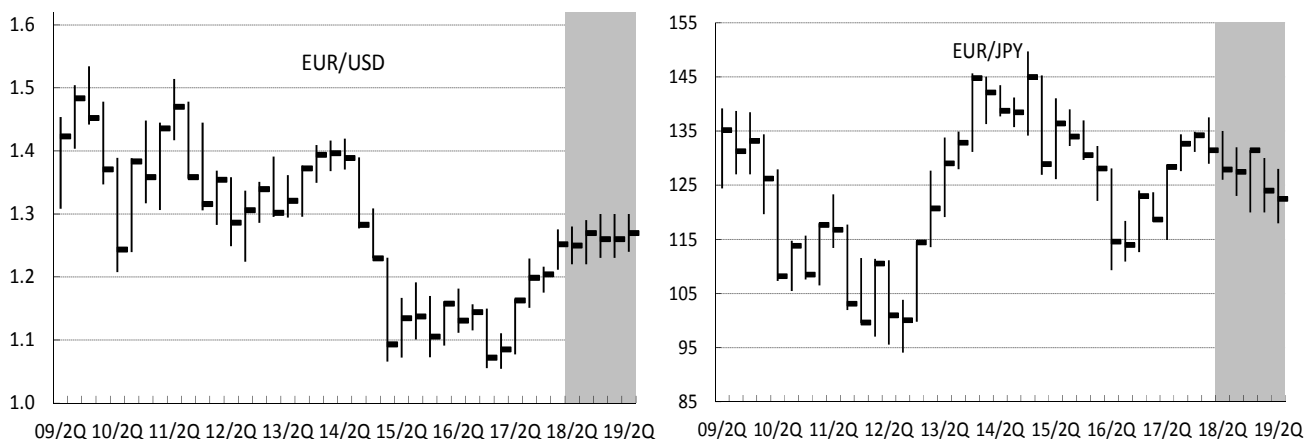
Summary Table of Forecasts

	2018				2019	
	Jan - Mar (actual)	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	104.64 ~ 113.40 (106.85)	102 ~ 108 (104)	100 ~ 107 (102)	98 ~ 106 (100)	98 ~ 106 (100)	96 ~ 105 (98)
EUR/USD	1.1916 ~ 1.2556 (1.2314)	1.20 ~ 1.26 (1.23)	1.20 ~ 1.27 (1.25)	1.21 ~ 1.28 (1.24)	1.21 ~ 1.28 (1.24)	1.22 ~ 1.28 (1.25)
EUR/JPY	128.96 ~ 137.51 (131.56)	126 ~ 135 (128)	123 ~ 132 (128)	120 ~ 130 (124)	120 ~ 130 (124)	118 ~ 128 (123)

(Notes) 1. Actual results released around 10am TKY time on 29 Mar 2018. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





USD/JPY Outlook – JPY an Easy Target

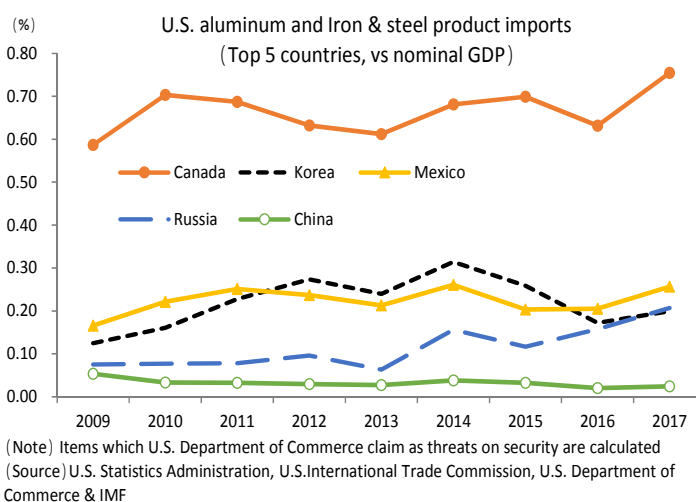
USD/JPY and U.S. Currency and Trade Policies – JPY an Easy Target

Impulsive U.S. Currency and Trade Policies

Since the beginning of March, the phrase “Trade Wars” has been increasingly used. The turn to protectionism in the U.S. trade policies began when emergency import restriction measures (safeguard measures) were adopted against large household washing machines and photovoltaic power generation products on January 23, and gained further impetus when additional tariffs were announced for steel and aluminum imports (25% for steel products, 10% for aluminum products) on February 1. Finally, Gary Cohn, expressing his opposition, resigned as a director of the National Economic Council (NEC) on March 6. With the departure of Mr. Cohn, who was the “control tower” of economic policies, and who had a stable reputation as having the most international outlook among cabinet members, concerns of a further protectionist movement have increased. Some countries have been exempted from the steel and aluminum tariffs, but Japan was denied an exemption despite the government’s entreaties. At any rate, the tense situation caused by impulsive U.S. currency and trade policies seems likely to continue for some time.

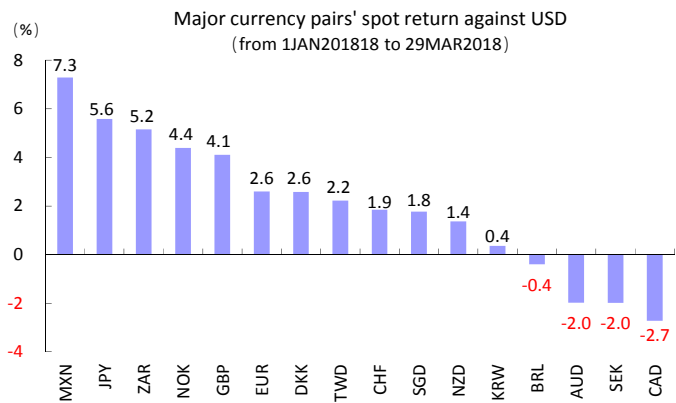
A Trade War with No Winners

If there are many more instances of additional tariffs being imposed on imports using the pretext of “national security,” the possibility of trade wars will become more real. For instance, the U.S. is a huge market for Canadian and Mexican steel and aluminum exports (see graph). These countries have been exempted from the tariffs until May 1, but whether or not the exemptions will be made permanently depends on negotiations going forward. In the event that the exemptions are no longer applied, the exports originally directed to the U.S. are likely to be directed at other regions and countries. This could give the countries at the receiving end of these exports grounds to trigger safeguard measures themselves. As much as USD 50 billion in additional tariffs were imposed on China over violations of intellectual property. All these factors could contribute to a decline in global trade volumes, and result in a stagnation of the global economy. Ultimately, the policies will also come back to affect the US export industries. It is truly a situation with no winners. Incidentally, the EU and China have not bothered to hide their retaliatory intentions against such trade policies by the U.S. One would need to remember that, historically, this kind of division of the countries and regions of the world lead to the war in the past.



Currency Direction Desired by the U.S. Generally Comes True

Taking into account the words and actions of President Trump, who recently said that trade wars “aren’t so bad,” such a scenario cannot be ruled out altogether. If the situation does in fact develop into trade wars, tariffs and non-tariff barriers will act as “weapons,” and so will “currency.” The U.S., which is setting the scene for (or getting dragged into) trade wars, has a strong preference for a weak domestic currency (naturally, given that it can be used as a “weapon”). This is clear also from President Trump’s propensity to pick on trade surplus countries, an attitude he has never bothered to hide. From the standpoint of forex rate prediction, I think it is wise to assume that an across-the-board USD weakening is inevitable if the trade wars are accompanied by an intensification in competitive devaluation.



(Source) Bloomberg

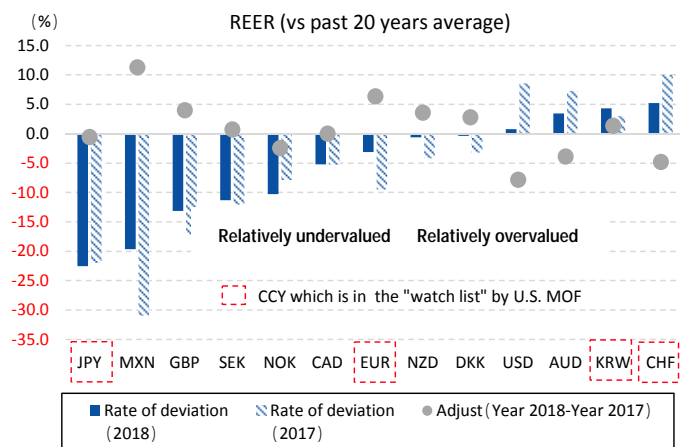
As I have repeatedly stressed in this report, given that USD is the key global currency, U.S. intentions are paramount under a floating exchange rate system, but this is more a question of fact than prediction. In the difficult-to-predict world of forex rates, one unshakable fact is that currency direction desired by the U.S. generally comes true. The fact that USD is the only depreciating currency amid “trade war” is the evidence of this. Perhaps the only exception to the otherwise appreciating list of global currencies is CAD, the currency that is at the vortex of the trade wars and most likely to be affected by NAFTA renegotiations and the imposition of additional tariffs – CAD has depreciated significantly against USD since the beginning of the year (see graph).

Analyzing the Current Situation based on a Fundamental Theory

As phrases such as “trade war” and “competitive devaluation” are frequently cited, USD/JPY continues to weaken, and there is a sudden influx of inquiries from people asking whether such a trend is appropriate in light of JPY’s fundamentals. Frankly speaking, it is difficult to debate the appropriateness or inappropriateness of any forex trend, as no clear “fair value” exists in the world of foreign exchange rates. However, under a floating exchange rate system, one does not, in theory, expect to see one currency being consistent sold (or bought). For instance, it is known that the REER of any currency has the propensity to return to its long-term average level. I will refrain from going into the details, but roughly speaking, assuming free movement of people, things, and money, forex rates would not move constantly in the direction beneficial to the competitiveness of any one country. Rather, it is thought that they would move in such a way as to ultimately realize the law of one price. I would like to analyze the current situation based on this fundamental theory.

JPY Adjustment is Clearly Not Sufficient

The graph to the right is an attempt to evaluate the various currencies using their REERs as published by the Bank for International Settlements (BIS) every month. Although JPY has appreciated considerably since the start of 2018, it continues to be the most undervalued of the major currencies. Comparing currencies based on their misalignment compared with long-term (20-year) averages, we find, as per latest figures (as of February this year), that JPY remains as undervalued now as it was a year ago. Specifically, as of the current time (which indicates February this year unless otherwise specified), this valuation of JPY stands at -22.5% below its long-term average level, the degree of this valuation has even widen from the previous year (February 2017) of -22.0%. While MXN and GBP along with EUR are often cited as undervalued currencies, those currencies have made considerable progress toward their long-term averages over the past year. For instance, EUR, which has dominated forex market news over the past year, has adjusted in the appropriate direction by +6.4 pp over the past year, from a downward misalignment of -9.5% a year ago, to -3.1% at the current time. Similarly, MXN has adjusted from -31.0% to -19.7%, while GBP has adjusted from -17.2% to -13.2%, by +11.3 pp and +4.0 pp, respectively.



(Note) As of FEB 2018 (Source) BIS

On the other hand, CHF and AUD along with USD were currencies appearing to be relatively overvalued last year, but those currencies have been progressing toward lower values during the past year. For instance, USD, which had an upward misalignment of +8.6% a year ago is now down to just +0.8%, having undergone a -7.8 pp adjustment. Similarly, CHF has come down from +10.0% to +5.2%, while AUD has come down from +7.3% to +4.3%, having adjusted by -4.8 pp and -3.9 pp, respectively. Overall, these trends reflect a progressive trend of USD and CHF selling, with the proceeds being shifted to EUR and MXN. Amid those trends, the behavior of JPY – starting out undervalued and becoming even more undervalued – can be said to be rather unusual, and there seems to be an accumulating kind of imbalance or misalignment in the forex market. It is based on this fact that I have frequently been inspired to note in this report that JPY adjustments have been rather lax or un-rigorous.

Awkward Positioning of JPY

As widely known, the U.S. Department of the Treasury publishes a “Monitoring List” as part of its Semiannual Report on International Economic and Exchange Rate Policies (IEERP, published in April and October every year), and the list has five countries including Japan on it at the present time. Based on the REER comparisons discussed in the section above, JPY is the most undervalued of the currencies on the Monitoring List; moreover, it is the only currency that has not made progress in its adjustment during the past year. What is more, the IEERP published in October 2017 said (regarding REER) that “on a 20-year rolling average basis, the yen is more than 20 percent below, and the euro is 4 percent below, its longer-term real effective rate.” However, as we have seen above, EUR has appreciated significantly over the past year while JPY has remained more or less unchanged (rather, it has declined slightly in terms of REER). Of course, REER is one of several traditional tools for evaluating forex rate levels, but given the current JPY forex rates and the intent of U.S. currency and trade policies, it is probably safe to say that JPY is in a particularly awkward position. In another words, JPY is in a position that makes it an easy target. Under this situation, it is better to keep in mind that the latest edition of International Economic and Exchange Rate Policies (IEERP) will be released and US-Japan economic dialogue will be held in April.

Exchange Rates Predicted by Japanese Corporates – the Key Level is 100

The Rate Predicted by Corporates – Level and Volatility

On March 2, the Cabinet Office released the 2017 Annual Survey of Corporate Behavior. The break-even USD/JPY rate for export companies indicated here is 100.6 (average of real numbers presented by all the companies), which is more or less the same as the previous year’s survey (100.5). The forecast JPY rate “one year from now” in the previous year’s survey was 113.1, and given that USD/JPY was, indeed, 113.0 for the month preceding the survey this time, the predictions of export companies can be said to have been mostly accurate (even though the forecasts indicated in this survey tend, essentially, to be similar to current levels), missing by barely -0.1. This is the smallest discrepancy ever seen since records began in 1986. In the context of high stock prices over the past year, their discrepancy with forex rates was often debated, but it is important also to see the stable foreign exchange rates as having contributed to improving the business environment for companies. Looking back, the discrepancy between the rate predicted by companies and the real rate was extremely small during the previous financial peak in 2006-07, when the Nikkei remained consistently strong. While it is important to understand the level of JPY rates (whether they indicate a strong or weak JPY), equally important is the currency’s volatility. Incidentally, 2018 is following the year that has seen the third lowest level of volatility ever, and JPY has tended to be stronger than corporate predictions during years following low-volatility years (2006 being the year of least volatility, followed by 2015). The quiet phase seems unlikely to continue long.

Forecast USDJPY rate after 1 year & break-even USDJPY rate by “Annual Survey of Corporate Behavior”

Survey year	Forecast USDJPY rate after 1 year	Break-even USDJPY rate	USDJPY rate 1 month before survey ()	-	-	-1 year before (Deviation of the forecast)
2000	114.2	107.0	112.2	7.2	5.2	4.6
2001	132.8	115.3	127.4	17.5	12.1	13.2
2002	124.5	114.9	122.3	9.6	7.4	-10.5
2003	109.3	105.9	107.9	3.4	2.0	-16.6
2004	106.4	102.6	103.8	3.8	1.2	-5.5
2005	113.2	104.5	118.6	8.7	14.1	12.2
2006	115.5	106.6	117.3	8.9	10.7	4.1
2007	111.0	104.7	112.3	6.3	7.6	-3.2
2008	97.0	97.3	90.4	-0.3	-6.9	-20.6
2009	95.9	92.9	89.6	3.0	-3.3	-7.4
2010	88.4	86.3	83.4	2.1	-2.9	-12.5
2011	80.3	82.0	77.9	-1.7	-4.1	-10.5
2012	88.4	83.9	83.6	4.5	-0.3	3.3
2013	105.7	92.2	103.5	13.5	11.3	15.1
2014	119.5	99.0	119.4	20.5	20.4	13.7
2015	120.9	103.2	121.8	17.7	18.6	2.3
2016	113.1	100.5	116.0	12.6	15.5	-4.9
2017	114.3	100.6	113.0	13.7	12.4	-0.1

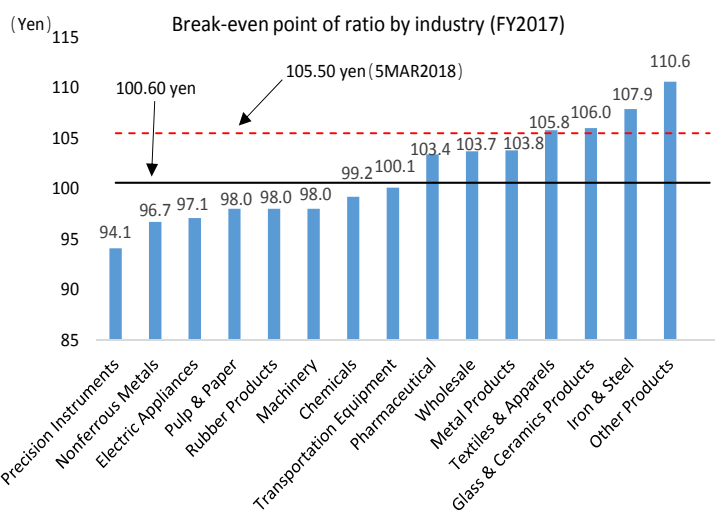
Note 1) Forecast : Class values average Break even rate: real value average Note 2) Break-even rate: exporters only

Note 3) USDJPY rate 1 month before survey: December excluding FY1994 & FY2008 (FY1994 & FY2008: January)

(Source) Cabinet of office, Government of Japan & Bloomberg

The 100 Level is the Most Critical

Looking at the break-even rate for corporates in various industries, it is clear that while industries such as precision instruments (94.1), non-ferrous metals (96.7), and electrical equipment (97.1) are conspicuously resilient to JPY strength, there are other industries like textile products, glass and earthenware products, and steel, for which JPY is already beginning to fall below the break-even rate and is entering levels that can easily be seen as problematic. Somewhat exceptional is the 100.1 break-even rate for the transport equipment industry, which has a big impact on the real economy and would appear to have greater resilience, but seems on the verge of becoming unprofitable. The survey results suggest that most industries are profitable at USD/JPY rates of 110 or above,



(Source) Cabinet of office, Government of Japan

but as the rate approaches 100, many industries including transport equipment will begin to see their financial settlements impacted. In this view, it may be wise to see the 100 level as a critical point, at which there begin to be policy expectations from the government, ruling party, and the BOJ to do something about the rates. However, as I have discussed in the past issues of this report¹, the strengthening of JPY to the 100 level is, in itself, not abnormal in terms of purchasing power parity (PPP). Incidentally, given that the predicted exchange rate for the whole of FY 2017 in the BOJ December Tankan was 110.20, the present 105 to 106 level is positioned somewhere between the predicted rate and the break-even rate. Assuming that some investors, flustered at the bearish market, will rush to let go of USD in exchange for JPY, a rate just below the present rate (105-106) is likely to prove a milestone.

Strong JPY Trend will Last Three Years

Economic indicators released in March revealed a succession of strong performance, including the February Employment Situation Summary report released in early March, and yet USD/JPY showed few signs of recovery (rather, it fell further). As I have already mentioned, despite the Fed maintaining its rather bullish policy stance, neither this stance nor U.S. interest rate trends based on it seem likely to pave the way for a rise in USD/JPY. We are now at a stage where the USD/JPY trend must be seen in a big picture. The table below takes a look at all the weak- and strong-JPY phases since the Plaza Accord in terms of their durations and change in JPY value. I have used my own (admittedly biased) judgment to decide whether JPY was “weak” or “strong” at a given time, but I trust that my

¹ Please see February 12, 2018 Mizuho Market Topic titled “The return to PPP levels finally begins – The ultimately rewarding forex rate prediction is...?”

judgment is not that far from the reality. One of the facts that emerges from a rough appraisal of past trends is that most phases, whether weak or strong JPY, last about three years. More specifically, my impression is that strong-JPY phases have lasted around 3.5 years (41 months) while weak-JPY phases have lasted around 2.5 years (30 months). Incidentally, the rate of change in JPY value during each period (calculated using the rates at the beginning and end of each phase) has been around 35% – specifically, around 33% during strong-JPY phases and around 37% during weak-JPY phases. Most recently, the weak-JPY phase began in November 2012 and peaked in June 2015, but the rate of change in JPY value during this time (a period of 31 months or so, or approx. 2.5 years, as expected) was, in fact, over 50%.

Of course, different conditions may exist during different phases, so one cannot lightly generalize, but going by the past experience, a 3.5-year-long phase, during the course of which JPY gains 30% would not be altogether surprising. In this context, if we take the beginning of the current phase of JPY strength to be July 2015 (with the starting USD/JPY value being 123), the phase is expected to last until January 2019, with USD/JPY falling below 90. Of course, this is an extremely vague argument, and nothing more than a mental exercise, but one would do well to remember that strong-JPY phases, once they have begun, have lasted around 3.5 years and resulted in JPY appreciating by 30%. As of the current time, two years and eight months have passed since July 2015, and JPY has strengthened around 14%. Leaving aside the duration for a moment, the process of strengthening itself has been rather gentle.

JPY strengthening & weakening trend since Plaza accord

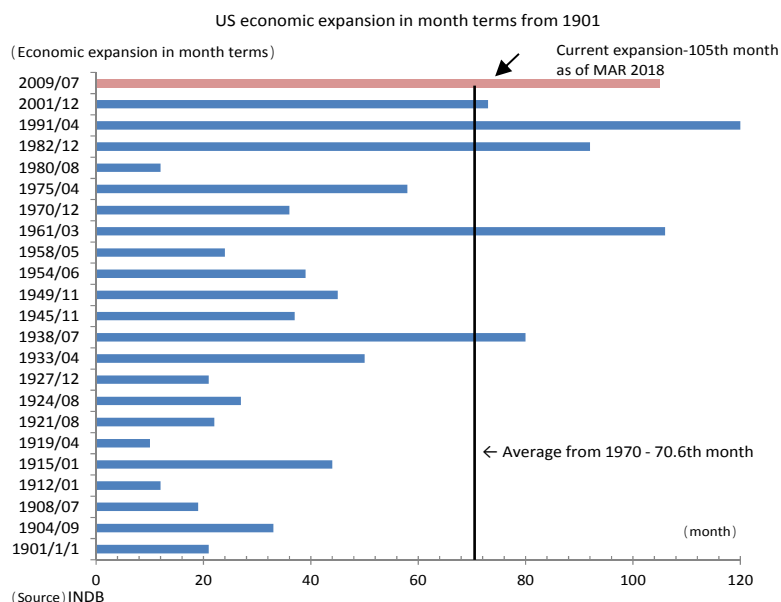
Start	End	Direction	Numbers of days	Numbers of months	Rate of variability	Key phrases (some representative examples)
MAR 1985	DEC 1987	Strong JPY	1005	33.5	-51.7	Plaza Accord
JAN 1988	MAR 1990	Weak JPY	790	26.3	23.5	Japanese Economic Bubble
APR 1990	APR 1995	Strong JPY	1826	60.9	-46.9	Collapse of Japanese Economic Bubble
MAY 1995	JUL 1998	Weak JPY	1157	38.6	71.0	Asian Currency Crisis, Japanese Banking Crisis, "Strong dollar a national advantage" (for the U.S.)
AUG 1998	DEC 1999	Strong JPY	487	16.2	-26.4	Russian financial crisis, Fall of long-term capital management (LTCM)
JAN 2000	JAN 2002	Weak JPY	731	24.4	24.5	Dot-com bubble and its collapse, U.S. September 11, 2001 terrorist attacks
FEB 2002	DEC 2004	Strong JPY	1034	34.5	-23.0	End of Japanese banking crisis, Japanese economic boom surpasses erstwhile Izanagi boom, Phase of U.S. rate cuts
JAN 2005	JUL 2007	Weak JPY	911	30.4	14.4	Financial bubble
AUG 2007	Oct 2012	Strong JPY	1888	62.9	-34.1	Collapse of Lehman Brothers, European debt crisis, U.S. monetary easing
Nov 2012	JUN 2015	Weak JPY	942	31.4	51.0	FRB's normalization process, End of European debt crisis, Abenomics
JUL 2015	?	Strong JPY	?	?	-13.9	Collapse of Chinese economic bubble, Brexit, Donald Trump
Average (overall)			1,077.1	35.9	34.6	
Average (strong JPY)			1,248.0	41.6	-32.7	
Average (weak JPY)			906.2	30.2	36.9	

(Source) Bloomberg (Notes) month=30 days, Classified as either trends exceeds one year.

The "Average (Overall)" for the "Rate of Change" is the average of the absolute values. Strong JPY stage since JUL 2017: preliminary calculation as of end of FEB 2018

Monitoring How Japanese Political Turmoil Affects on Appointment of BOJ Executives

In addition to such past experiences, it is also important to take into account that the U.S. economy's current expansion phase is now in its 105th month (on the verge of surpassing the second-longest economic expansion in its history, which was 106 months long), that the U.S. 10-year interest rate has already reached the Fed's long-term neutral interest rate level, and that stock markets have begun to dislike the rise in interest rates, and additionally, dark clouds have begun to hover even over the Japanese political situation, which had been relatively stable among the advanced nations. Although something that should not be lightly discussed at the current time, if the reappointment of BOJ Governor Haruhiko Kuroda and the appointment of



other BOJ Policy Board members also get embroiled in the political turmoil, the increase in uncertainties could give momentum to move to buyback JPY in the markets. At the very least, the strongly pro-reflationary monetary policies and the Kuroda regime, which has embodied them, are in the same boat as the Abe administration, and cannot avoid being impacted if there is any major change in the government/ruling party establishment. BOJ members have often been used as tools in political fights, and I am watching to see whether the same happens this time too. Apart from the above points, as I have mentioned several times in previous reports, it is important to remember the extremely basic fact that JPY is undervalued in terms of PPP and REER. Taking all this into account, any prediction at the current time that USD/JPY will recover and aim for the 115-120 level can only be described as extremely ambitious.

U.S. Monetary Policy Now and Going Forward Toward a Phase of “Tightening”

Reading Beyond the SEP

At the March 21-22 FOMC meeting, the Committee decided to raise the target range for the federal funds rate by 0.25 percent to 1.50-1.75 percent, as expected by the markets. This is the sixth interest rate hike since the beginning of rate hikes in December 2015. In the Summary of Economic Projections (SEP; see table), the real GDP growth rate projections for 2018, 2019, and 2020 (+2.7% +2.4% +2.0%) were raised by +0.2 pp, +0.3 pp, and +0.1 pp, respectively, compared with the December projections. Naturally, similar revisions were made to the unemployment rate projections (3.8% 3.6% 3.6%), which were lowered

by -0.1 pp, -0.3 pp, and -0.4 pp, respectively. The projections for 2019 and 2020 have been lowered quite significantly, belying recent years' prediction that the rate was already close to full employment. At any rate, the projections suggest that, during the forecasting period under review, both economic growth and job data will continue to be strong compared with long-term projections (+1.9% and 4.5%, respectively), which are considered equilibrium levels. The message is that both rate hikes and compression of assets are, therefore, possible. Amid all this, the core personal consumption expenditure (PCE) deflator projections for 2018, 2019, and 2020 (+1.9% +2.1% +2.1%) stayed constant for 2018, and went to up by +0.1 pp each for 2019 and 2020, respectively, compared with December. In short, going by the real GDP growth rate, unemployment rate, and other indicators, demand is expected to tighten, but the Committee considers that inflation will remain stable, without accelerating. One of the arguments that could be made to explain this is the claim that rate hikes will subdue the rise of the core PCE deflator. However, given that there were concerns of disinflation until very recently, and inflation expectations continue lackluster, is such an argument correct? Fed Chair Jerome Powell pointed out the flattening of the Phillips curve in his press conference, but it remains unclear whether this will turn out to be a transient phenomenon. It seems rather dangerous, therefore, to conduct policy operations based on the assumption that the core PCE deflator will eventually rise.

Policy Normalization to End in 2019; Tightening to Start in 2020

FOMC participants' projections of target level for the Federal Funds (FF) rate (dot plot, midpoint of projections, see table) were also consistent with the strong SEP. The target FF projection for the end of 2018 remained unchanged at 2.1%, with an assumption of three rate hikes overall (two remaining), but the target level for 2019 was raised from 2.7% to 2.9%, and that for 2020 was raised from 3.1% to 3.4%, indicating that three rate hikes for 2019 and two for 2020. The long-term neutral interest rate, important for anticipating future policy trends, was upgraded from 2.75% to 2.90%, so the point of termination of rate hikes seems to have been similarly extended. Going by the recent-most dot plot, the federal funds rate will reach the long-term neutral interest rate level by the end of 2019. In another words, starting from 2020,

FRB Economic Outlook (forecast, %, as of MAR 2018)

	2018	2019	2020	Long term
Real GDP Growth Rate as of DEC	2.6 ~ 3.0 (2.2 ~ 2.6)	2.2 ~ 2.6 (1.9 ~ 2.3)	1.8 ~ 2.1 (1.7 ~ 2.0)	1.8 ~ 2.0 (1.8 ~ 1.9)
Unemployment Rate as of DEC	3.6 ~ 3.8 (3.7 ~ 4.0)	3.4 ~ 3.7 (3.6 ~ 4.0)	3.5 ~ 3.8 (3.6 ~ 4.2)	4.3 ~ 4.7 (4.4 ~ 4.7)
PCE Inflation Rate as of DEC	1.8 ~ 2.0 (1.7 ~ 1.9)	2.0 ~ 2.2 (2.0)	2.1 ~ 2.2 (2.0 ~ 2.1)	2.0 (2.0)
Core PCE Inflation Rate as of DEC	1.8 ~ 2.0 (1.7 ~ 1.9)	2.0 ~ 2.2 (2.0)	2.1 ~ 2.2 (2.0 ~ 2.1)	

(Source) FRB

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

FOMC Date	2018	2019	2020	Longer run
Mar-15	n.a.	n.a.	n.a.	3.750%
Jun-15	n.a.	n.a.	n.a.	3.750%
Sep-15	3.313%	n.a.	n.a.	3.500%
Dec-15	3.250%	n.a.	n.a.	3.500%
Mar-16	3.000%	n.a.	n.a.	3.250%
Jun-16	2.375%	n.a.	n.a.	3.000%
Sep-16	1.875%	2.625%	n.a.	2.875%
Dec-16	2.125%	2.875%	n.a.	3.000%
Mar-17	2.125%	3.000%	n.a.	3.000%
Jun-17	2.125%	2.938%	n.a.	3.000%
Sep-17	2.125%	2.688%	2.875%	2.750%
Dec-17	2.125%	2.688%	3.063%	2.750%
Mar-18	2.125%	2.875%	3.375%	2.875%

(Source) FRB

monetary policy will clearly change from “normalization” to “tightening.”

Considering the situation since February, it will be extremely important to see how the financial markets, especially the stock markets, will assess and respond to such a change in phase. As I repeatedly said in this report, any increase in interest rates is a negative when it comes to stock price valuation. Given that the U.S. economy has been propped up by strong personal consumption spurred by the wealth effect of strong stock prices, it is natural to think that the recent SEP and dot plot should trigger stock selling. On top of this, if the protectionist trade policies that the Trump administration has been emphasizing begin to be implemented, then that will also trigger a cost-push inflation. The significant improvement in the projections of various indicators this time was thanks partially to the tax reforms, which had not been factored in as of December, but such special factors cannot be expected going forward. Also, as mentioned above, one cannot be certain that the flattening Phillips curve will return to a stable sloping state. Mr. Powell’s first battle may have ended well, but one cannot help thinking that many challenges lie in store ahead.

Risks to the Main Scenario – Rising U.S. Interest Rate Presenting a JPY Appreciation Risk

Reflation Theme No Longer Likely to Cause JPY Depreciation

As I do each month, I would like to review the risk factors related to my main forecast scenario. Regarding the listed risk factors (see table), from this month, we have eliminated risk factor -1, which represented a risk of JPY depreciation stemming from the Trump administration’s expansionary fiscal policies. The risk factor causing the greatest concern regarding this article’s JPY appreciation scenario had been that tax reduction measures and large-scale infrastructure investments that would cause a rise in the U.S. interest rates hence promoting USD appreciation. A representative example of this kind of market conditions was

Potential Risks to the Main Scenario

	Risk Factors	Remarks	Direction
US	Economic policy by President Trump	·US currency ·trade policy and tough negotiations about economy between U.S. & Japan.	Strong JPY Weak USD
	Political risk in U.S.	·Domestic turmoil causing unstable international affairs	Strong JPY Weak USD
	FRB monetary policy normalization	·Significant upward revision of neutral interest rate	Weak JPY Strong USD
Japan	Political risk in Japan	·Retrospection of reflation policy by Abe resignation	Strong JPY Weak USD
	Risk-taking by Japanese investors	·From hedged to unhedged position expansion?	Weak JPY Strong USD
	-1 Risk of BOJ monetary policy change	·BOJ might use a reversal rate discussion to begin considering means of reducing its easing	Strong JPY Weak USD
	-2 Risk of BOJ monetary policy change	·Radical easing monetary policy such as purchase foreign bonds, helicopter money & etc	Weak JPY Strong USD
Europe	Political risks in EU	·Negative impact by the extreme right party at Italy general election ·Uncertainty surrounding Catalonia may spread to other places in Euro-zone	Strong JPY Weak USD
Others	Geopolitical risk	·Tension in the Korean Peninsula. War between US & North Korea?	Strong JPY Weak USD?

(Source) Daisuke Karakama, Mizuho Bank

seen for about a month after the U.S. presidential election in November 2016 – when the U.S. 10-year interest rate rose sharply by approximately 90 bps, and USD/JPY also increased by about JPY17. Subsequently, the growth of doubts regarding the Trump administration’s ability to implement its targeted policies emerged and led to the rolling back of those advances in interest rates and USD/JPY, both of which have subsided, but the market has continued to harbor based on vague expectations about when the expansionary fiscal policies might take concrete form. Quite a few observers had been expecting to see a resurgence of the “reflation trade” trend once the details of the large-scale fiscal spending policies became evident. Since this February, however, the mood has clearly changed. Although the rise in U.S. interest rates had been considered a reflection of booming economic conditions and therefore compatible with the rise in stock prices, it has gradually come to be recognized by a growing number of market players as a factor promoting the sell of stocks. As U.S. 10 year interest rates are fluctuating at levels in the vicinity of the neutral interest rate (currently 2.90%), a rise in interest rates going forward might easily come to be considered a sign of monetary policy ‘tightening’ rather than ‘normalization.’ Since it is generally recognized that interest rate rises are a negative factor with respect to stock price valuations, it should be noted that the past two years has been rather unusual in that stock prices have been increasing despite the rise in interest rates. Given these situations, the risk scenario of Trump administration expansionary fiscal policies and hence promoting a rise in USD/JPY has been greatly diminished, and I think the time is now for removing it from the list of plausible risk factors.

JPY Appreciation Risks – U.S. Currency and Trade Policies Clearly the Greatest Risk Factors

Given the above situation, what should we consider to be the greatest remaining risk factors? As this article has argued ever since the Trump administration's inauguration, I believe U.S. currency and trade policies (risk factor) should be considered a factor with considerable potential for causing major disruption. U.S. Treasury Secretary Mnuchin's mention of the benefits of a weaker dollar and the U.S. imposition of safeguard tariffs (on solar panel and washing machine imports) in late-January, the imposition of additional tariffs on steel and aluminum imports and imposition of USD50 billion of tariffs on Chinese products owing to intellectual property right violations in March, and other factors are continuing to provide additional evidence that the indications of a prospective protectionist posture seen immediately before and after the presidential election were not merely bluffs. The tariffs on steel and aluminum imports took effect on March 23, and the Japanese government's request to be exempted from the tariffs has not been approved despite Japan's position as a staunch U.S. ally. The day before the tariffs took effect, Trump said – "I'll talk to Prime Minister Abe of Japan and others – great guy, friend of mine. There will be a little smile on their face. And the smile is, 'I can't believe we've been able to take advantage of the United States for so long.' Those days are over."

There is considerable concern regarding how various events in April – such as the U.S. Treasury Department's Semiannual Report on International Economic and Exchange Rate Policies (IEERP) and the U.S.-Japan economic dialogue meetings – can take place amid such continued tension. The IEERP has long indicated that JPY is undervalued, and U.S. Vice President Mike Pence became the first high-level U.S. official to utter the "Japan - U.S. Free Trade Agreement (FTA)" phrase during the second round of the US-Japan Economic Dialogue (held in Washington D.C. last October), when he expressed a "strong interest" in a bilateral FTA with Japan. At this point, not so many observers are anticipating that bilateral negotiations will begin either sooner or later. In the case that they were actually initiated, however, there is concern about the possibility that an FTA might include forex clauses and that such negotiations might have other JPY appreciation-promoting effects.

In addition, China and the EU have begun showing an inclination to retaliate in response to the U.S. unilateral expressions of intent, and China's ambassador to the United States has begun hinting that China would consider reducing its purchases of U.S. Treasury bonds. The possibility that China might play the "U.S. bond selling" card became a hot topic at one point this past January², but it appears that the controversy at that time was spurred only by 'observation balloon' comments from unknown sources. Because the recent remarks are clearly attributable to China's ambassador to the United States, however, they clearly have a more-tangible element of reality to them. Given the fact that the rise in U.S. interest rates has been inspiring concern about the height of U.S. stock prices since February, it is expected that the playing of this card – depending on its timing – might be reasonably effective, and one of the key issues market players will be focusing on going forward is whether the U.S. attitude will soften when confronted by such Chinese countermeasures. Another U.S.-related situation worth keeping an eye on is the fact that a deepening of internal conflicts has the potential to promote JPY appreciation (risk factor). As a growing number of major cabinet secretaries are replaced by people considered to be President Trump's 'yes-men,' there is concern that it may become increasingly easy to implement the kind of protectionist policies mentioned above. It also bears remembering that the "Russiagate" investigation is ongoing, even though it has not been a hot topic for some time and appears to be somewhat forgotten in general. It seems to be a feature of the Trump administration that external or international initiatives are undertaken on a level considered sufficient to offset the effects of internal disorder, and one gets the impression that it is highly likely that protectionist policies including policies designed to promote USD depreciation will be implemented amid the upcoming mid-term elections.

JPY Appreciation Risk Factors – Japan's Political Situation

While the instability of the U.S. political situation is increasing, the growing instability of the Japanese political situation (risk factor) may be more of a urgent problem, as Prime Minister Abe prepares to run for re-election as the leader of the Liberal Democratic Party (LDP) in the election scheduled for September 2018. The scandal regarding the rewriting of official documents by Japan's Finance Ministry and the possibility of Prime Minister Abe's wife's involvement in that scandal are depressing the level of public support rate for the current cabinet. While it had previously been assumed that Prime Minister Abe was assured of securing a third three-year term as the LDP leader, these developments are causing a new trend of uncertainty to begin to emerge. On the other hand, since the drop in public support for the current cabinet has not been paralleled by a commensurate rise in public support for the opposition parties, there is no expectation that the opposition parties could take over the government even in the case that Prime Minister Abe were to retire. (This reflects another serious problem in Japanese politics – the lack of a realistic alternative.) However, because the term "Abenomics" has become considered virtually synonymous with vigorous reflationary policies, particularly among foreign investors, there is probably a significant risk that the

² Please see the January 11, 2018 edition of Mizuho Market Topic, entitled "Interpreting reports about a deceleration or halt of Chinese purchases of U.S. treasury bonds."

replacement of Prime Minister Abe could be construed as indicating a change regarding the policies themselves.

On March 21, for example, Japan's national public broadcasting organization (NHK) ignited considerable controversy by broadcasting a show entitled – “LDP's Kishida considering “exit strategy” for normalizing monetary policy”. (House of Representatives Member Fumio Kishida is the Chairman of the LDP's Policy Research Council and is considered a strong candidate to succeed Prime Minister Abe.) The troublesome is that, regardless of who is prime minister, there are very few remaining policy options available to the BOJ at this point and, although normalization should be under consideration given the burden of BOJ policies on Japan's financial system, if the accession to office of a new prime minister were to correspond with any kind of change to the yield curve control (YCC) framework, it would inevitably lead to widespread talk about the end of “Abenomics.” (Such a prospective event has come to be referred to by such names as “Abexit.”) Since it is generally believed that the Kuroda-led BOJ has undertaken its policy management under the auspices of the Abe government, a transition to a new prime minister could potentially lead to a replacement of BOJ Governor Kuroda, who may not be positioned to complete his second five-year term owing to his age. While it is not obvious exactly how foreign investors would respond to such destabilizing changes, it is highly likely that they would not respond by increasing their JPY selling and their Japanese stock buying. For the time being, it will be worth keeping a close eye on the Japanese political situation, which should be considered a significant JPY appreciation risk factor.

JPY Appreciation Risk Factors – BOJ Policy Adjustments and Other Political Risks

It is evident from a graph of USD/JPY levels over time that this year's JPY appreciation trend began on January 9. That was the day the forex market was surprised by the unexpected decision by BOJ to reduce the amount of JGB purchases through “Rinban operations.” It would be unreasonable to try to argue that this JGB purchasing reduction alone caused the considerable drop in USD/JPY, but – given the fact that there has been an increase in the number of foreign investors concerned about the BOJ exit strategy since that time – it would also be difficult to argue that significance of the purchasing reduction was minor. Moreover, despite the forex market's intense attention to the JGB purchasing reduction, the BOJ further reduced the amount of its JGB purchasing on February 28. Two days later, on March 2, BOJ Governor Kuroda responded to questions posed by the House of Representatives committee in charge of his reappointment to the BOJ governorship by saying that he was sure there was a high likelihood of attaining the 2% inflation target during fiscal 2019, and that there was no doubt that there would be consideration of an exit strategy sometime around fiscal 2019. JPY showed a surge of appreciation in response to this statement. Naturally, it is likely that the media's headline writers and forex market participants are to a certain extent making a mountain out of a molehill with regard to Governor Kuroda's statement. However, in this light of the nature of the BOJ's information dissemination activities since the start of this year, it seems clear that the BOJ is desiring that its “next policy move” be in the direction of normalization. At a press conference on March 20, the day he became deputy governor, Deputy Governor Masayoshi Amamiya said – “Conceptually and theoretically, we haven't ruled out the possibility of adjusting the yield curve.” Although he also said it was premature to consider such an adjustment at this point, one gets an impression of how such an adjustment might be undertaken in the case of the passage of a two-to-three month period characterized by an increasingly strong risk-off mood. I believe that such a policy management decision is hopelessly difficult to make at a time when USD/JPY has recently descended below 105 and the Nikkei has a realistic chance of falling below the JPY20,000 level, but if the BOJ were able to implement an increase to the long-term interest rate target of its YCC framework, it would be likely to spur a sharp drop in USD/JPY. While I do not think there is a high likelihood of such developments, it would be hard to say the likelihood is zero. Other JPY appreciation risks include the European political situation (risk factor) and geopolitical risks (risk factor). Regarding risk factor , the Italian general elections have taken place without any individual party gaining a controlling number of legislative seats, but there is concern about the possibility that a coalition government may be formed by the two populist parties – the Five Star Movement (Movimento 5 Stelle, M5S) and the Northern League (Lega Nord), the latter of which is advocating withdrawal from euro area. Geopolitical risks appeared to be easing during a period in which the possibility of U.S.-North Korean talks was being brought up, and USD/JPY rose during the period of initial reports about the possibility. It is believed that U.S. Secretary of State Rex Tillerson laid the groundwork for such talks, however, and there is speculation that Tillerson's shocking dismissal from his post may have delayed the timing of the talks from May to sometime in the June-July period. Going forward, it will be worth keeping an eye on whether conditions for the talks will be auspicious or contrary. Tillerson's replacement as U.S. Secretary of State, former CIA Director Mike Pompeo, is generally considered to be a hard-liner with respect to North Korea.

Excessive JPY Depreciation Forecasts

When presenting reports about my fundamental understanding of the forex market and participating in related lecture meetings, study groups, etc., I often hear participants say they have a good understanding of JPY appreciation risks but would like to hear more about JPY depreciation risk factors. Even though I strive to think objectively, I honestly cannot think of much more to say about such JPY depreciation risk factors. Of course, there do exist Japan-related

factors supporting USD/JPY levels, such as Japanese institutional investors' proactive investment in foreign bonds (risk factor) and the potential for the BOJ to introduce radical new easing methods, such as those involved in foreign bond purchasing and helicopter money (risk factor). However, although these are assumed to be continuing to present risks, there is probably a very low likelihood of such risks eventuating. If one absolutely had to forecast JPY depreciation, the only somewhat shaky logical argument that comes to mind for such a forecast is that the FRB's continued normalization process may boost U.S. interest rates and thereby expand the Japan-U.S. interest rate gap, which should prompt JPY selling and USD buying. In fact, from the late last year through early this year, many financial institutions were inclined to use this logic to forecast JPY depreciation. Since last fall, however, the data has been showing that there is no positive correlation between USD/JPY and the size of the Japan-U.S. interest rate gap (regardless of whether the gap measurement focuses on short- or long-term interest rates), in fact there has been an inverse correlation. As the U.S. yield curve has steadily flattened, the key issue that should be focused on is not the widening bilateral Japan-U.S. interest rate differential, but the difference between long- and short-term interest rates within the United States. A textbook interpretation of the yield curve flattening suggests a slowdown in the real economy, and in fact the stock market has shown an aversion to rising interest rates since February. And JPY has progressively appreciated during the risk off mood period. The forecasts of JPY depreciation based on the bilateral interest rate gap expansion are flawed in that they do not give due attention to the disadvantages associated with the rise in U.S. interest rates, so it is natural that it has become necessary to make large downward revisions to forecasts such as those anticipating that USD/JPY would rise into the JPY120-125 range owing to bilateral interest rate gap expansion. This probably does not mean that the fundamentals have changed significantly since the beginning of the year. The facts that President Trump is inclined to support protectionism and that JPY is undervalued in light of real effective exchange rates (REERs) were well known a year ago, and they have been clearly suggesting the need for a downward adjustment to USD/JPY. Given the extreme actions of President Trump, one could logically argue that there is a need to adjust forex forecasts to anticipate even greater JPY appreciation, but there has not emerged any new argument this year that would justify changing the actual direction of the forex forecasts. From my perspective, USD/JPY's movements during February and March have been in line with my expectations about what should be happening. Given the above arguments, my fundamental understanding is that JPY appreciation risks are steadily increasing with regard to USD/JPY during the year from this point in time.

EUR Outlook – Interest Rate Hikes Now Within the Realm of Possibility?

ECB Monetary Policies Now and Going Forward – Reconfirmation of Status Quo and Embryonic Stirrings of Post-Draghi Era

Deletion of “Easing Bias”: a Reconfirmation of the Status Quo

At the March ECB Governing Council meeting, it was decided to keep the interest rate on the main refinancing operations (MRO), the rate on the marginal lending facility (the ceiling of market rates), and the rate on the deposit facility (the floor of market rates) unchanged at 0.00%, 0.25%, and -0.40%, respectively, with the interest rate corridor (difference between the ceiling and the floor) also remaining unchanged at 0.65%. The author of this article argued that – “While text related to the expansion of the Asset Purchase Programme (APP) will be deleted, the text related to the program’s extension will be retained, and the main gist of the meeting is likely to be status quo maintenance regarding the sequence text” – and the meeting turned out just as predicted. The portion of the statement describing non-standard monetary policy measures previously read – “we confirm that our net asset purchases are intended to run until the end of September 2018, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. We stand ready to increase the asset purchase programme (APP) in terms of size and/or duration.” – and the mention of “size” (so-called relaxation bias) has been deleted from this portion of the latest statement (and “the decision was unanimous”). Since there had been almost no anticipation of an increase in size, the new statement can be said to simply reconfirm the status quo. ECB President Draghi also said that – “It’s substantially a backward-looking decision” – and emphasized that the decision does not have significant implications. Some observers are still questioning whether there is some significance to the deletion decision at this particular time, following the retention of the “size” text for so long, and it seems that the main reason may be that, over the course of several revisions of its forecasts, the ECB has come to have increasing confidence in the accuracy of the inflation forecast. It seems that it was judged that the time was ripe for the decision to be made.

Rather than responding to the deletion of the relaxation bias, EUR showed a trend of depreciation in the forex market following the meeting in response to the retention of the ‘duration’ text and to the concurrent release of a staff projection with a downward-revised inflation outlook. Only a minority of observers are interpreting the decision as being hawkish

Likely Extension of APP in June

As was argued in the edition of this article previewing the Governing Council meeting, rather than the deletion of the “size” text, it is the retention of the “duration” text that has many implications. One can assume that there were significant reasons for the retention of the latter of the two easing-related parameters, and it appears that one

ECB staff outlook (March 2018)

	2017	2018	2019	2020
HICP	1.5	1.1 ~ 1.7	0.6 ~ 2.2	0.8 ~ 2.6
(Previous: DEC 2017)	(1.5 ~ 1.5)	(0.9 ~ 1.9)	(0.7 ~ 2.3)	(0.8 ~ 2.6)
Real GDP	2.5	2.1 ~ 2.7	0.9 ~ 2.9	0.7 ~ 2.7
(Previous: DEC 2017)	(2.3 ~ 2.5)	(1.7 ~ 2.9)	(0.9 ~ 2.9)	(0.6 ~ 2.8)

(Source)ECB (Note) EURUSD is assumed to be 1.23 year 2018 and 1.24 year 2019-2020

of those may be the downward revision to the ECB staff projection of the euro area Harmonized Index of Consumer Prices (HICP; see table). It may well be that EUR appreciation in the past year (a rise of just under +6% on a nominal effective basis) has had an inflation-rate-lowering effect that has completely offset the inflation-rate-raising effect of the increase in oil prices from midway through last year. Although there is more than one reason for EUR appreciation, given that it is generally understood that a main reason was a rise in expectations of ECB policy normalization following President Draghi’s speech last June (commonly known as Sintra speech), it is natural for him to judge that there is a need to refrain from disseminating information that might be interpreted as somewhat hawkish. Although it will be necessary to consider whether the APP extension period should be one of 3 months or 6 months, it appears highly likely that a decision to approve an extension will be made at the Governing Council meeting on June 14 this year. At that time, the reason for the decision is likely to be the sluggishness of inflation rates.

Also, although the size-related relaxation bias has been deleted, it should be noted that there has been no commitment to continuing to omit that size-related relaxation bias forever. In the past, the ECB has sometimes (more than once) decided to implement interest rate reductions following its announcements that such reductions had ended. Going forward, in the event of an unexpected decrease in HICP or when the political situation of some member countries (such as Italy) becomes extremely unstable and the bond market becomes turbulent, there is an undeniable possibility that the ECB will consider a ‘size’ expansion regardless of the deletion of the relaxation bias text.

A Question About Whether Any Policymaker Called for a More-Radical Change

At the post-meeting press conference, a reporter posed the question – “You mentioned that the removal of the pledge to increase quantitative easing was unanimous. In the run-up to that unanimous decision, did any policymaker call for a more radical change, perhaps dropping a link between the APP and inflation or taking out the option to extend the duration of the APP?” In response, President Draghi said – “there wasn’t much discussion about other possible changes in monetary policy for the coming months.” He explained that the discussion that did take place was the “usual blend of confidence, persistence and patience.” He mentioned that ‘confidence’ reflected a decrease in risks – “because the latest incoming data on growth reduced the variance of the path of inflation converging to our inflation aim” – but he also noted that “sustainability” and “patience” were considered necessary owing to uncertainty about the evaluation of the unemployment situation. Regarding inflation (see graph), President Draghi said – “we said that basically, inflation, headline inflation, will hover around 1.5% for the remaining part of the year.” – and that for this reason – “victory cannot be declared yet.” His statements suggested that the APP extension option was not eliminated because the ECB retains a cautious view on the economy and inflation. Although the size-related relaxation bias has been deleted, President Draghi noted that – “The picture isn’t much different from last time, really.” – and this suggests he is not inclined to be optimistic.

Embryonic Stirrings of the Post-Draghi Era

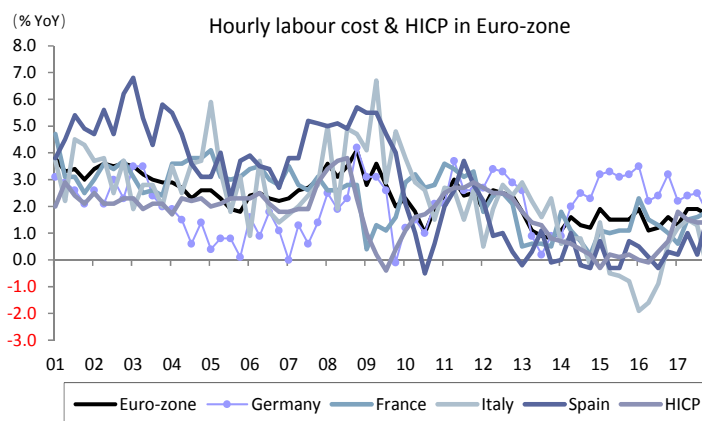
The latest press conference also featured questions relating to President Draghi’s future retirement. For example, a reporter asked – “You are ECB president for more than six years now and member of the Governing Council for even longer [including the period in which Draghi served as the head of Italy’s central bank]. What would you say? What makes a good ECB president? What are the most important skills?” In response, President Draghi said – “Well, the second question is easy to answer: I let others judge, it’s not up to me.” Another reporter asked – “You have been personally credited with a lot of the decisions that the ECB has made over the last seven years. That reflects your ability to set the agenda in Governing Council meetings. How much could a new ECB president with a different set of beliefs about QE, for instance, take the ECB along a different course given your knowledge of how the institution works?” This is a somewhat sensitive question, given the possibility that President Draghi may be succeeded by German Bundesbank Governor Jens Weidmann, who is considerably more hawkish than President Draghi. In response, President Draghi said – “You keep on asking questions as if I’m going to leave tomorrow. I still have quite some time before my mandate expires. I may be willing to answer questions about myself at the date which is closer to the end of my mandate than it is today.” In fact, President Draghi still has more than a year and a half remaining in his term, and it is not surprising that discussions of his retirement should be considered premature.

Nonetheless, as discussed in detail in a previous edition of this article³, the decision next February on who will serve as Chief Economist of the ECB (currently Executive Board Member Peter Praet) is highly likely to narrow down the field of candidates to succeed President Draghi when his term expires on October 31, 2018. (Specifically, attention is being focused on whether the chief economist post will be given to a candidate from Germany or from Ireland.) In addition, if the APP is not discontinued at the end of September this year then, so long as the ECB maintains its commitment to the sequence text in the latest statement, it can be assumed that any interest rate hikes will be delayed to a still-more-distant date. Thus, it can be expected that any return to positive interest rates would be implemented under the direction of the next ECB president. From midway through this year, realistically speaking, the focus of ECB monetary policy-related attention will shift to the question of whether President Draghi will make a sort of ‘parting gift’ by paving the way toward interest rate hikes. Although the date of President Draghi’s retirement is still distant, it is unquestionable that the embryonic stirrings of the post-Draghi era are already making themselves felt, and we have therefore entered a period of preparation for that era.

Starting to Lay Out the Path to Discontinuing the APP?

Regarding policy management going forward, one gets the impression that there are numerous indications that there may be a shift toward increased hawkishness. On March 19, Reuters reported that five sources associated with the ECB had said that dovish members of the ECB GC were beginning to accept the possibility of ending the APP within this year and that, as a result, there was an emerging possibility that interest rate hikes could be initiated by midway through 2019. Not only that, discussions within the Governing Council were said to be already beginning to address the “pace of interest rate hikes”. One of the sources said the sole reasons for extending the APP would be “to preclude expectations of interest rate hikes and to support the yield curve”, but that those objectives could be realized through other policy measures, such as those to further clarify the forward guidance and expand long-term financing operations. It seems likely that the Governing Council’s real view is that discontinuing the APP is possible so long as the markets will accept that interest rate hikes will not be undertaken for the time being. It is not really possible to make a rational judgement about the accuracy of the stories the sources are telling.

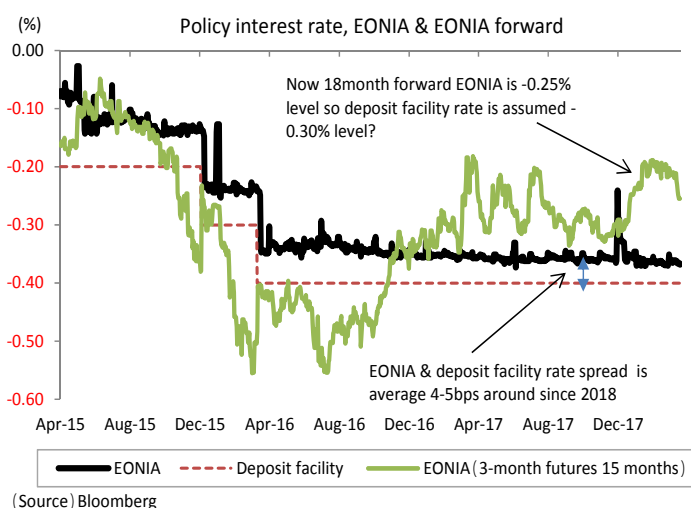
Given the fact that the Governing Council must clearly explain its APP-related policies by July at the latest, however, it does seem possible that measures to smooth the path toward the discontinuation of the APP may have begun to be taken. Frankly speaking, in light of the current inflation and wages situations, it is unclear what the basis for this increased bullishness. The graph on the right shows YoY changes in euro area companies' hourly labor employment costs (labor costs) and in the euro area Harmonized Index of Consumer Prices (HICP). While there are some differences in the trends of individual countries, it cannot be denied that the overall impression is that the rates of growth in those indicators have generally been decreasing since the financial crisis. In recent years there have been times when Germany's figures are conspicuously higher than those of other countries, but the gap between Germany's figures and other countries' had been almost eliminated in the latest time period – the October-December 2017 period.



(Source) Datastream

ECB's Real Intention to Implement an Interest Rate Hike by the June-September 2019 Period?

In light of the levels of the Euro OverNight Index Average (EONIA), EONIA forward contracts, and the deposit facility interest rate (see graph), it appears that, over the upcoming 18 months (through September 2019), there are expectations that EONIA will rise by 10bps above the deposit facility interest rate, and this suggests that the market has factored in its expectations of a single interest rate hike (assumed to be by a margin of 10bps). It is worth noting that only a portion of such an EONIA increase is factored in for the upcoming 15 month period (through June 2019), so the image one gets is very close to that of "a single rate hike during the period from June through September 2019." This situation has been sustained since the start of 2018 and, given the timing with which a series of statements have been reported, it may well be that the Governing Council's real intention is something akin to that of "a single rate hike during the period from June through September 2019." Regarding EUR exchange rates, it also seems reasonable to assume that the EUR/USD122-124 range is based on the factoring in of expectations of "a single rate hike during the period from June through September 2019." On the other hand, if there is a further increase in the hawkishness of ECB policies, it will lead the ECB to adjust its communications regarding normalization.



(Source) Bloomberg

What is the Outlook?

According to the abovementioned report, one of the sources showed concern about the possibility that normalization may cause problems, saying that "given the risks related to trade and exchange rates, there will be a need to respond carefully to interest-hike expectations." The report quotes another source as saying that, to restrain expectations of rapid interest rate hikes, "it will be necessary to firmly fix such expectations before making the first policy decision." Based on consideration of these remarks, it appears that the Governing Council considers the greatest risk to be that market expectations will fall into the "APP discontinuation → rate hike → EUR appreciation" syllogistic pattern, and this suggests that there has been no major change to the ECB's view that EUR appreciation is very intimidating.

Based on this interpretation of the ECB's psychology, what is likely to happen going forward? As has been repeatedly pointed out in previous issues of this article, the ECB's current forward guidance wording appears to require that the APP be discontinued at least a half year before an interest rate hike. A half year prior to September 2019, for which point in time the market has completely factored in a rate hike, would be March 2019, while a half year prior to June 2019, for which point in time the market has partially factored in a rate hike, would be January 2019. This suggests that even the (apparently) most rapid – "June 2019 rate hike" – scenario allows for the APP to be continued throughout (through December of) this year. Thus, if the ECB is really concerned about EUR

appreciation accompanied by downward pressure on HICP, then, rather than having to end the APP in September, it would logically appear to have the additional option of extending the APP three months and ending it within this year. If the extension were announced together with an announcement of a reduction of monthly purchases (EUR30 billion → EUR15 billion), it should be reasonably easy for hawkish Governing Council members to accept. The APP's end-

ECB exit strategy fastest case (2018-2020)

Period	Details	
OCT 2017	Decision of APP extension & reduction	
JAN 2018	APP reduction (60bil 30bil)	Decision
SEP 2018	APP reduction (30bil 15bil)	Forecast
DEC 2018	APP abolition?	
JUN 2019	Deposit facility interest rate hike (0.40% 0.30%)	
SEP 2019	Deposit facility interest rate hike (0.30% 0.20%)	
DEC 2019	Deposit facility interest rate hike (0.10% 0%)	
MAR 2020	Deposit facility interest rate hike (0% +0.10%)	
JUN 2020-2021	Balance sheet reduction	

(Source) Karakama, Mizuho Bank

point may be advanced to three months earlier than I had previously anticipated; however, given the fact that there has been no change to the ECB's fundamental fear of EUR appreciation, there will remain a possibility that the normalization pace may be suddenly forced to slow down once interest rate hikes enter the realm of possibility. Another statement by one of the anonymous sources mentioned above appears to suggest the possibility that the ECB may seek to offset the end of the APP by announcing a coincidental increase to the dovishness of the forward guidance text. However, given that the text already says interest rates will "remain at their present levels for an extended period of time," there seems to be little scope for adjustments designed to restrain expectations of future interest rate hikes. If the ECB strongly desires to restrain expectations of future interest rate hikes, the most effective way to do that would be to delay the end of the APP.

German Economy Now and Going Forward – Should We be Worried About a Bubble?

German Economy Doing Extremely Well

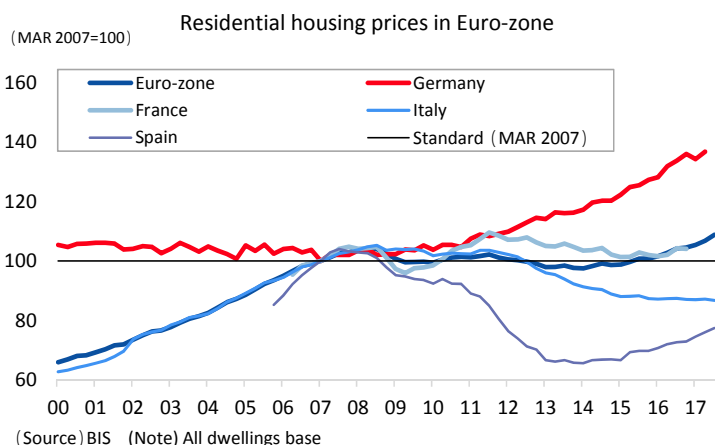
It was reported on March 12 that, asked whether she favored a German becoming the next president of the ECB, German Chancellor Angela Merkel had said, "for all the positions to be filled in the next year ... we will have good candidates." While avoiding a direct answer to the question, she implied the existence of a large number of candidates from her country. As I elaborated in this section of the report last month, Central Bank of Ireland Governor Philip Lane's name has come up as an alternative to extreme right-wing Deutsche Bundesbank President Jens Weidmann as successor to current ECB president Mario Draghi. In any case, most of the rumors suggest that the posts of president and chief economist of the ECB will be divided among these two men one way or the other. Either one of them, regardless of which one is appointed to the post, will make for the youngest president of the ECB so far, and what is more, will be more hawkish than Mr. Draghi as per most assessments. In reality, the German economy has been maintaining the kind of strength that is rarely seen, and one has to wonder if it would be possible for Mr. Weidmann, assuming he becomes president, to manage communications without bias toward his own country's economy. Specifically, checking Germany's 2017 economic indicators, the country reported the world's largest current account surplus for the second consecutive year, while its real GDP growth rate was 2.2% YoY, the highest in six years. This was accompanied by tight employment and wage situations, with unemployment rate renewing the lowest on the record since the unification of the two Germanys, at 5.7% (see graph). It was reported that the largest German labor union, IG Metall (a metalworkers' union) had demanded a 6% annual increase in wages and shortening of working hours given the economy's strength and low unemployment rates.



(Source) Bloomberg

How will the ECB Evaluate German Domestic Asset Prices?

In the context of the improving employment and wage situations in Germany, the success of the Hartz IV unemployment reforms implemented by former German Chancellor Gerhard Schröder during 2003-05 cannot be underestimated. The reforms deregulated employment, thereby increasing businesses' appetites for hiring, and shrank unemployment benefits, thereby increasing the labor force's will to work. Many believe that the Merkel Administration is merely reaping the benefits of these reforms⁴. Having said that, there is no room for doubt that the accommodative monetary conditions created by the ECB and the "perennially weak currency" that exists due



to these conditions are also contributing to Germany's economic recovery. In the past issues of this report, I have argued that the ECB's monetary policy operations, designed to suit the southern European and other weak EU member states, entail the risk of overheating Germany's economic and monetary climate, leading to the formation and collapse of economic bubbles. In fact, German real-estate prices are much higher than anywhere else in Europe (see graph), so my concerns remain quite valid. Looking at monetary policy operation from the perspective of macroprudential regulation, how the ECB evaluates and positions the soaring of asset prices within Germany may be a matter of great importance going forward.

The Post-Merkel Era Begins

On March 14, Ms. Merkel was sworn back in as the Chancellor of Germany, marking the official start of her fourth term in office. The new government was finally established after a six-month-long vacancy following the federal elections in Germany last September. The vacancy was the longest ever, since the end of World War II. However, the decline in Ms. Merkel's unifying ability cannot be denied, given that her coalition barely won the majority (only a total of 364 seats – 355 seats are required to win a majority), with the disaffection of many. Though the German election results did not affect the financial markets, they were perhaps the biggest surprise in 2017, "the year of European politics," when you consider that Ms. Merkel had been seen as certain to win a landslide victory. Ms. Merkel has dubbed the role of the new administration "a new departure for Europe," but the reality is that it is "a new departure for the post-Merkel era." In fact, in forming her Cabinet, Ms. Merkel said that her lineup offered both "experience and new faces," and that "with this team, we can take on the challenges of the future." Ms. Merkel's pick for health minister, for instance, is Jens Spahn (37), one of her administration's most vocal critics in recent years. With the start of her fourth term in office, Ms. Merkel is set to rival the 16-year tenure (the longest of any German chancellor) of Helmut Kohl, who discovered Ms. Merkel as a politician, but the journey has been begun with a strong sense that this will be her last term.

The Cause of Defeat Remains Unchanged

The main cause of the decline in Chancellor Merkel's popularity was her open-door policy on immigration decided in August 2015. However, the status with regards to the immigration problem has not changed much. The tide of fresh immigrants was somewhat stemmed following the March 2016 EU-Turkey statement. However, political relations between Turkey and the EU (especially Germany) are not solid, and their total collapse still remains a matter of concern. If something similar to what happened in summer 2015 were to occur again, that would be the end of the Merkel administration. What is more, as of the current time, immigrants and refugees who have already entered the region, even when they are terrorists, are still walking freely. Ordinarily, one of the responses to the numerous incidents of terror that have taken place would be to call for appropriately sharing information available to the various domestic police authorities within the EU, but there seems no chance of this issue being put on the EU political reform agenda. If terrorist incidents continue to take place now and again, they are likely to be directly associated with the immigration crisis and negatively affect Ms. Merkel's support rating. With the causes remaining unchanged, the reality is that she was only chosen as leader based on the method of elimination.

⁴ Specifically, the reforms expanded the scope of firms to which the (employment) Termination Protection Act did not apply, reduced the period for which unemployment benefits would be available and made the conditions for receiving unemployment benefits more stringent, among other things.

Are There Sufficient Political Resources to Spare for a EU Reform?

Reports suggest that Ms. Merkel's first foreign visit during her fourth term in office will be France. For some time to come, her role is likely to be evaluated from the perspective of how effectively she can combine forces with French President Emmanuel Macron and promote EU reforms. Following Brexit, the remaining 27 EU member states are now faced with the task of considering how to reorganize the EU without the UK, and last May, the European Commission published a chart detailing the reform process to be completed by 2025. Following this, in December last year, the European Council agreed to (1) set up the European Monetary Fund (EMF), the European version of the IMF, and (2) promote the completion of the EU banking union. Final decisions on these are expected to be made in June, following the Euro summit meeting scheduled for this month. The EMF is intended to play the role of a stronger European Stability Mechanism (ESM), i.e., with the inauguration of the EMF, the ESM will be progressively dissolved, and when the funds of the Single Resolution Fund (SRF), which is said to have incomplete funds as of the current time, dry up, the EMF is expected to act as a backstop for it.

Germany has also expressed approval of the reform proposals so far, but the two countries are still far from agreeing on Mr. Macron's ambition of adopting a common budget or having an EU finance minister, and no decision on this seems likely even in June. However, given that the ultra-leftwing party, Alternative for Germany (AfD) has strengthened its presence by becoming the largest opposition party, it is extremely doubtful whether the political resources of a much-weakened Chancellor Merkel can be allocated toward EU reforms. In the German federal parliament, it is customary to give the post of chair of the budget committee, a position that wields great power, to the largest opposition party. With the formation of a "grand coalition" to run the government, the AfD has become the largest opposition party, and one of its legislative members has already been appointed to the post of budget committee chair. Again, as already reported, pro-EU reform leader of the Social Democrats (SPD), Martin Schulz, has resigned after being criticized for the coalition deal. Even if Ms. Merkel wanted to promote EU reforms together with France, it is not clear whether the domestic political situation would permit this.

EU Reforms Beset by Vertical, Horizontal, and Diagonal Ruptures

Incidentally, with regards to Ms. Merkel cooperation with France to promote EU reforms, there is cause for conflict not just within Germany but also elsewhere within the EU. As is commonly known, there is already a vertical North-South split over economic disparity (specifically, between Germany and the southern European nations) and a horizontal East-West split over handling of immigration issues (specifically between Germany and Hungary) in the EU, and recently there has also emerged a diagonal split between coastal EU versus continental EU member states. On March 6, the finance ministers of eight North European member states (Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands, and Sweden) issued a joint statement⁵ regarding EU reforms going forward, remonstrating against a decision-making process driven primarily by Germany and the other large member states. It is very interesting to see the presence of countries like the Netherlands and Finland in that group, given that they have so far tended to go along with Germany on matters of economic and monetary policy. The joint statement makes six points in "a clear voice," one of which is, "The future of the EMU (fiscal, structural, financial, institutional issues etc.) is relevant to all and should therefore be discussed and decided by all." It is clearly intended as a deterrent against the power of a German-French coalition. The statement also notes that "the discussion on the deepening of the EMU should find a consensus on 'need to haves', instead of focusing on 'nice to haves'" and that priority should be given to (1) the completion of the Banking Union, and (2) the transformation of the ESM into an EMF. It also emphasizes that far-reaching transfers of competence to the European level should be avoided, indicating a lack of support for Mr. Macron's ideas of an EU finance ministry and common budget. Even as Germany's political power wanes, a number of EU member states are beginning to call for a temporary halt to a deepening and expansion of integration within the EU. Though not going so far as to predict a collapse or disintegration of the EU, one cannot deny that there seems to be a gradual strengthening of forces pulling the union apart. Under such circumstances, most glances thrown at the fourth Merkel administration seem to be asking a very fundamental question – whether it can last through the entire four-year term.

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⁵Finance ministers from Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands and Sweden underline their shared views and values in the discussion on the architecture of the EMU," March.6.2018

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