

Forex Medium-Term Outlook

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Forex Department

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Overview of Outlook

USD/JPY bounded back in April. US Treasury yields continue to rise on the back of the Fed's hawkish stance, the rise of crude oil, and the concerns over Treasury supply, and in short term, there are signs of USD/JPY moving higher with such trend. Considering the ultra-low yields of JGB, it seems reasonable that demand for USD will gain momentum at some point if U.S. interest rates continue to rise. However, how should one assess this increase in U.S. interest rates under still relatively subdued inflation? If the coming supply of U.S. government bond is the real reason behind the interest rate increase, then this will cause the real economy to slow down (as a result of "crowding out"). Of course, if the Fed's policy normalization process is behind the curve, and if inflation is expected to rise sharply going forward, then the 3% yield of 10-year U.S. Treasury will be no more than a transit point. However, given the increasing tendency of the U.S. yield curve to flatten, the bond markets are actually getting more concerned about the possibility of Fed going too tight on its monetary policy. Few indicators in the past have accurately predicted U.S. economic slowdown/recession based on the flattening (or eventually inversion) of the yield curve. Going by such alarms raised by the markets, I still think it is wise to remain prepared for a deviation of the Fed's policy normalization process as the U.S. economy slows down. This will eventually result in lower interest rates and USD depreciation (i.e. JPY appreciation).

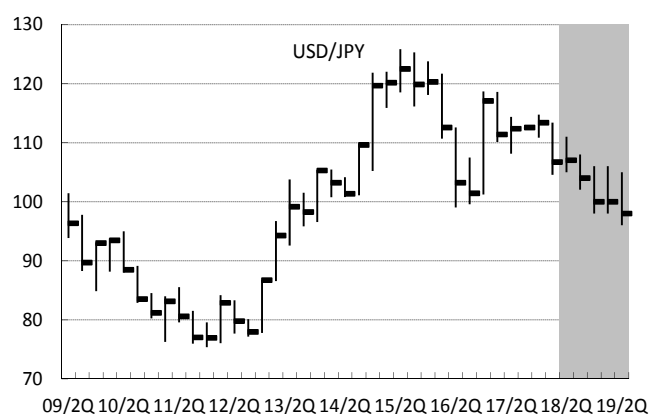
Meanwhile, EUR weakened during April. This was mainly the result of USD recovering amid an increase in U.S. interest rates, but to some extent, it was probably also due to the increasing uncertainty prospects of the ECB's policy normalization process amid concerns that the Euro area's economy may be peaking. Leaving aside the timing of it, the termination of the asset purchase programme (APP) itself is quite certain, so the ECB's final decision in this regard is unlikely to trigger EUR appreciation. The main issue is whether or not interest rates will be raised following the termination of the APP, which depends on the resulting state of the regional real economy and EUR levels at that time. At the very least, EUR will rise sharply, as it has over the past year, so long as the ECB officially admits that it is considering rate hikes. However, given that EUR appreciation is seen as "the source of uncertainty" even at the present time, rate hikes are bound to be a battle against EUR appreciation. My basic understanding is that EUR will recover as USD weakens during the second half of the forecasting period, but the speculative EUR long position is now larger than it has ever been before, and given reports of political instability in Italy, the currency is likely to have a heavy upside for some time to come.

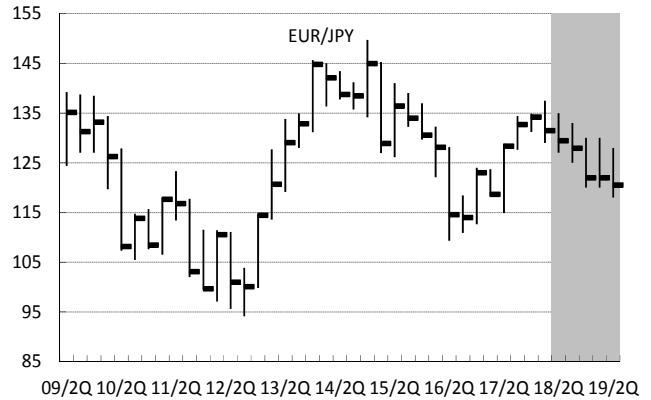
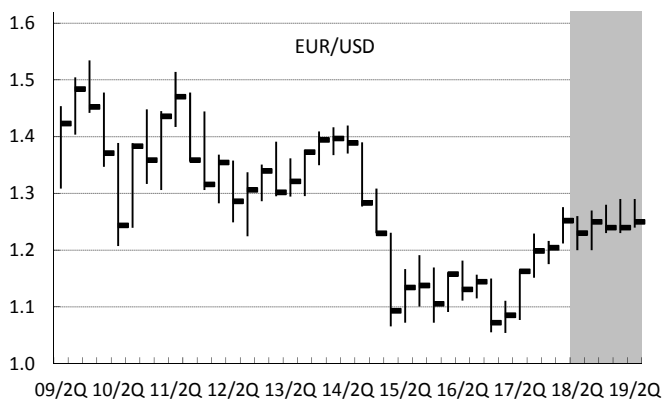
Summary Table of Forecasts

	2018				2019	
	Jan - Apr (actual)	May-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	104.64 ~ 113.40 (108.91)	105 ~ 111 (107)	102 ~ 108 (104)	98 ~ 106 (100)	98 ~ 106 (100)	96 ~ 105 (98)
EUR/USD	1.1911 ~ 1.2556 (1.1968)	1.18 ~ 1.24 (1.21)	1.18 ~ 1.25 (1.23)	1.21 ~ 1.26 (1.22)	1.21 ~ 1.27 (1.22)	1.22 ~ 1.27 (1.23)
EUR/JPY	128.96 ~ 137.51 (130.36)	127 ~ 135 (129)	125 ~ 133 (128)	120 ~ 130 (122)	120 ~ 130 (122)	118 ~ 128 (121)

(Notes) 1. Actual results released around 10am TKY time on 7 May 2018. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





USD/JPY Outlook – Interpreting the U.S. 3% Long-term Treasury Yield

USD/JPY and U.S. Currency and Trade Policies

– JPY Appreciation Inevitable with the Start of U.S.-Japan Trade Talks

Japan, Sadly, an Original Member of the List

In the Semiannual Report on International Economic and Exchange Rate Policies (the Report) published on April 13 by the U.S. Department of the Treasury, in addition to countries like China, Japan, South Korea, Germany, and Switzerland, which have been on the Monitoring List for a while now, a sixth country was added – India (see chart below). Although inclusion on the Monitoring List does not accompany specific sanctions or other measures, it is aimed at encouraging the country in question to eliminate its trade surplus with the U.S. and deterring it from currency devaluation. As I will discuss in detail again later, the Report says regarding Japan that “Treasury remains concerned by the persistence of this large bilateral trade imbalance between the United States and Japan,” giving a sense of ominous things to follow. The Monitoring List was started in April 2016, and while countries on the list come and go, China, Japan, South Korea, and Germany are, sadly, the four original countries that have remained on it throughout. Let me once again summarize the criteria for being placed on the list – (1) bilateral trade surplus with the United States (of at least USD 20 billion), (2) a material current account surplus (of at least 3 percent of gross domestic product (GDP)), and (3) persistent, one-sided intervention in terms of net purchases of foreign currency (at least 2 percent of an economy’s GDP over a 12-month period). If any two of the above three are true, the country is placed on the Monitoring List, and if all three are true, then it is declared a “currency manipulator.” Even if a country does not meet two of the three criteria, it could be placed on the Monitoring List if it “accounts for a large and disproportionate share of the overall U.S. trade deficit.” This condition seems to be designed specifically for China, which only meets criteria (1) above. As widely known, the axis of evaluation for the Trump administration’s currency and trade policies is the size of a country’s trade surplus with the U.S. It is not difficult to imagine, therefore, that criteria (1) to (3) above are not weighted equally, but that (1) is significantly more important than the other two. Of China, Japan, South Korea, and Germany, the countries on the Monitoring List that the U.S. is especially concerned about, South Korea was just dealt a blow through the recent free trade agreement (FTA) talks, and tense talks with China are continuing on matters apart from foreign exchange (including not just trade talks but also diplomatic relations). Assuming that the administration may be looking for something currency related to seduce voters ahead of the midterm elections (and with a reelection in 2020 in mind in the medium to long term), Japan and Germany could well be the next targets, going by the elimination method.

Monitoring list 3 conditions (Highlighted countries are on the monitoring list as of APR 2018)

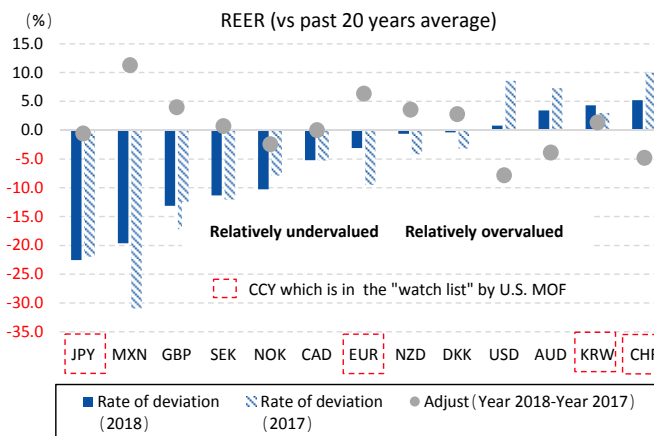
	Trade surplus vis-à-vis the U.S. (Bil dollar)	Current balance			Buying USD & selling own ccy intervention
		vs GDP (% , 2015)	Change in last 3 yrs (% pts)	Amount (Bil dollar)	vs GDP
China	375	1.4%	-0.9%	168	-0.6%
Mexico	71	-1.6%	0.2%	-18	-0.2%
Japan	69	4.0%	3.3%	197	0.0%
Germany	64	8.1%	0.6%	299	-
Italy	32	2.8%	0.9%	54	-
India	23	-1.5%	-0.2%	-39	2.2%
S.Korea	23	5.1%	-0.9%	78	0.6%
Canada	18	-3.0%	-0.6%	-49	0.0%
Taiwan	17	14.6%	3.1%	84	1.3%
France	15	-0.6%	0.4%	-15	-
Switzerland	14	9.8%	1.4%	67	6.6%
U.K.	-3	-4.1%	1.3%	-107	0.0%
Brazil	-8	-0.5%	3.8%	-9	0.1%
Euro-zone ()	133	3.5%	1.0%	440	0.0%

(Source) U.S. Ministry of Finance (Note) Euro-zone: estimation by U.S. Ministry of Finance. Trade surplus vis-à-vis the U.S., current balance & intervention amount counting from DEC 2017 for a year.

Awkward Atmosphere for Japan

What did the Report specifically say about Japan? It pointed out that in nominal terms, JPY remained somewhat strong against USD throughout 2017 and has strengthened even more since the start of 2018, but that on a real effective exchange rate (REER) basis, it actually depreciated by 2.4% from the start of 2017 through February this year. The assessment of the current state of affairs was clearly worded: “This brought the real effective exchange rate to nearly 25 percent below its 20-year average.” The Report also noted that “the nominal exchange rate has been weaker than historical average levels since the first half of 2013,” suggesting that U.S. authorities were unhappy with both the real and nominal exchange rates of JPY.

It is a fact that JPY, which was already greatly undervalued on a REER basis a year ago, has undergone a further slight depreciation. As the graph to the right shows, among currencies of countries on the Monitoring List, JPY is the only one that is not moving in the direction it naturally should move in in relation to its long-term average – i.e., weaken if it is stronger than the long-term average, or strengthen if it is weaker than the long-term average. What is more, the size of Japan’s current account surplus and its trade surplus with the U.S. (as percentage of GDP) have not changed very much since a year ago (the Report says regarding Japan’s trade surplus that it “has been roughly steady for the past four years”). In another words, the fact is that the USD/JPY



(Note) As of FEB 2018 (Source) BIS

exchange rate has not undergone adjustments to the satisfaction of the Treasury Department, and Japan has shown almost no improvement in terms of the other criteria that earned it a place on the Monitoring List either. It seems inevitable, therefore, that bilateral trade talks will have to begin in a rather awkward atmosphere for Japan.

Intentions Regarding Monetary Policy Also of Concern

Incidentally, there was another point of some concern in the Report. The previous (October) issue of the Report noted that “Japan should take advantage of the current window of above-potential economic growth, underpinned by accommodative monetary policy and flexible fiscal policy, to enact critical structural reforms.” Looking through the ten issues of the Report that have been published since Japanese Prime Minister Shinzo Abe took office (starting April 2013), the message that “Japan should complement fiscal, monetary, structural and other policies skillfully to support its economy” has remained more or less the same, even if it may have been phrased in various ways. This time, however, the Report said, “Japan should take advantage of the current window of steady growth to enact critical

structural reforms that can support sustained faster expansion of domestic activity,” avoiding any mention of accommodative monetary or fiscal policies underpinning real economic growth. Could this be intended as a message to Japan to stop relying on discretionary fiscal and monetary policies to underpin “steady growth” and get on with structural reforms?

Of course, there is such a thing as reading too much into casual statements but, given the Trump administration’s rough-and-ready approach to currency and trade policies, one cannot rule out the possibility of objections being raised in monetary policy matters too. Of course, a country’s monetary policies are determined by its internal conditions and do not warrant interference by other countries, but if we take it that U.S. authorities are not comfortable with Japan’s accommodative monetary policies, it may be necessary to watch out for attempts to deter actions by the BOJ during strong JPY phases.

Cannot Afford to Go by Just the First Reaction or Lack Therein

The markets did not react much to the rather harsh Report this time, but it would be dangerous to get distracted by the first reaction or lack of it and underestimate U.S. currency and trade policies. Even in the past, despite the contents of the Report being eagerly awaited, the markets have usually shown no major reaction immediately after its publication. However, this does not mean that the contents or suggestions contained in the Report have been of no significance.

For instance, the Report has assessed JPY as being 20% undervalued on a REER basis for a year now. And in fact, a year ago, the markets’ first reaction, while being distracted by U.S. attack on Syria, was relief that no country had been declared a “currency manipulator.” But it is important to take note of what has happened to USD in the year since then. The currency has weakened across the board amid the radically protectionist stance of the U.S., and JPY has also appreciated against it. The Trump administration’s trade policy actions, which have drawn a great deal of attention since early this year, could have been predicted to some extent from Mr. Trump’s election campaign. The main reason behind President Trump’s victory in the election were his anti-liberal arguments, and it is merely coincidental that his initial assertions have been translated into specific policies only this year. So long as President Trump hopes to be reelected in 2020, there is no reason for him to withdraw from this policy line, and the tone of the Report is more or less consistent with Mr. Trump’s own thoughts on the matter.

To begin with, even though this is an exchange rate policy report, the U.S., being a key G7 nation, cannot openly declare a desire to “weaken USD.” Even if it is driven by strong feelings, the Report itself essentially discusses issues based on indicators, and substantial quantitative evidence is necessary before a country can be declared a “currency manipulator” and specific sanctions imposed on it. Being placed on the Monitoring List is, at worst, like being given a verbal warning. There is no reason, therefore, to expect the Report to contain anything radical enough to evoke a response from the forex markets. In formulating my forex outlook, therefore, I think it is important to take such facts into consideration, look beyond the presence or absence of a first reaction from the markets, and make an attempt to read between the lines of the Report in gauging the true intent of the Treasury Department and, thereby, the administration in power. This is not normally a simple task, but one of the small mercies of the Trump administration is that its intent in trade policies, and the accompanying currency policies, is clear as day.

As I have said in past issues of this report, even in the area of foreign exchange, where it is difficult to make predictions with any degree of certainty, it is prudent to assume that the U.S. government’s desires in terms of currency policy direction generally come true. All the more reason why one cannot afford to take it lightly when the currency authorities of the country (with the key global currency) attempting to hold bilateral talks with your own country point out the fact that “your currency is too undervalued.”

JPY Supply-Demand Balance – Net Buying of JPY for the First Time in Four Years

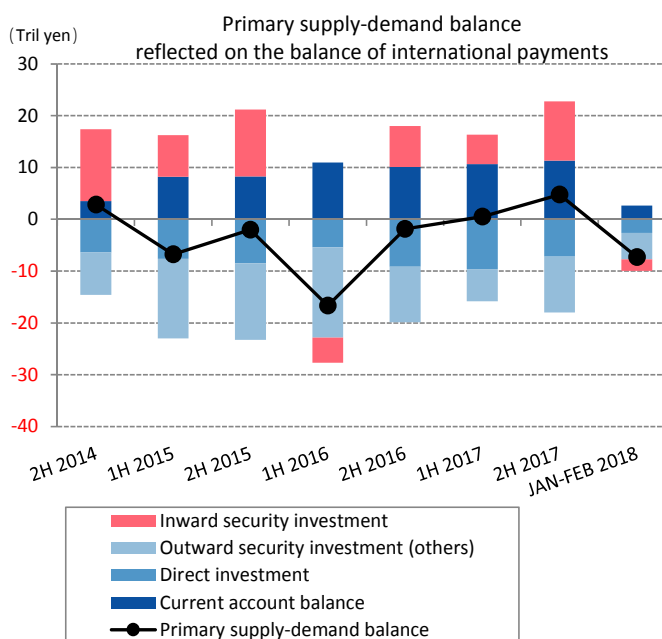
An Overview of the JPY Supply-Demand Balance

Ever since March, the markets have been in turmoil over concerns about trade wars, and it is precisely because of this that it is important to attempt to discuss the situation calmly. In April, Japan's February Balance of Payments were published, so I would like to summarize the supply-demand balance of JPY (which I use as a pointer for my forecasts in this report) two months into 2018. The JPY supply-demand balance amounted to a net selling of approx. -JPY 865.7 billion for February and approx. -JPY 7.2871 trillion for January and February put together (see graph). In other words, the large portion of the net selling took place in January, led by outward securities investment worth nearly -JPY 4 trillion during that month. Given that the supply-demand balance for the same period (total for January-February) last year was +JPY 4.1231 trillion, it would seem that the balance has undergone a complete reversal. However, it is difficult to make a simple comparison as this period last year was affected by a special factor – the accelerated disposition of U.S. bonds by Japanese institutional investors, whose portfolios had been negatively impacted by the Trump rally during November-December 2016.

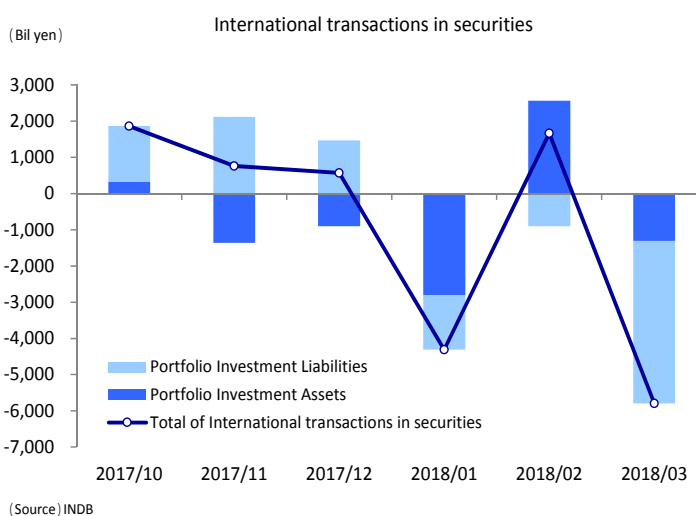
Moreover, the supply-demand balance for January-February this year was also affected by the fact that the substantial net buying in inward securities investment since last year turned into a net selling starting early this year. Looking at the March International Transactions in Securities (based on reports from designated major investors), which was released along with the February Balance of Payments, outward securities investment continued to post substantial net buying at -JPY 1.3035 trillion, while inward securities investment posted a conspicuously large net selling (see graph). This was mainly due to an approx. -JPY 4 trillion net selling of equity and investment fund shares. At any rate, going by these indicators, it seems almost certain (without having to wait for the May Balance of Payments) that the cumulative supply-demand balance for the January-March period will amount to a substantial net selling of JPY.

Outward Securities Investment Cannot Rely on the Increase in U.S. Interest Rates

Notwithstanding the above, the January-March period tends to be dominated by irregular flows pertaining to the end of the fiscal year, so it would be inappropriate to make predictions for the entire year based on the trend during this period. Future trends in outward securities investment are predicted based on the current status and future prospects of the Fed's normalization process, so the markets tend to focus on the U.S.-Japan interest rate gap is a direct indicator. However, taking into account the lower consumption and investment appetite brought about by an increase in U.S. interest rates, rather than focusing solely on the economic recovery it suggests, perhaps one should not rely too much on a simple positive correlation. Evidence of this can be seen in the fact that "the rise in U.S. interest rates" and "concerns over the Fed accelerating the pace of its rate hikes" are often cited in connection with stock market crashes.

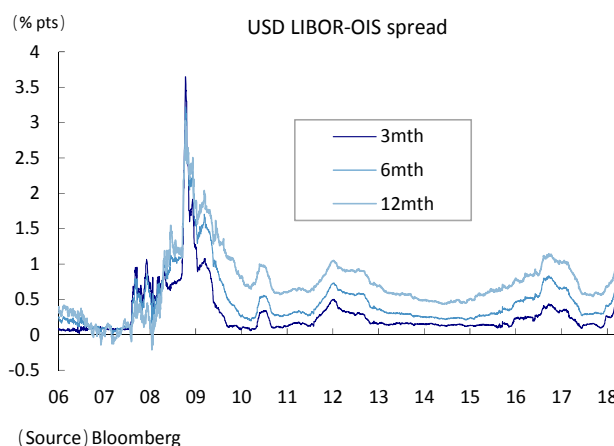


(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government



(Source) INDB

Of course, it also seems very unlikely that USD/JPY will not rise despite the expansion of the interest rate gap. In fact, USD/JPY did rise after the U.S. 10-year Treasury yield hit the 3% milestone in late April. Given that Japanese institutional investors are having to endure a miserable JPY interest rate environment, there is bound to come a critical point at which outward securities investment will begin to rise. However, going by the current state of affairs, my feeling is that the U.S. economic and finance conditions will protest this increase in interest rates before that critical point is reached. The true cause behind the widening of the LIBOR-OIS spread, which has accelerated since mid-March (see graph), is



(Source) Bloomberg

unclear, but some suspect that it may be a sign of “crowding out” as a result of President Trump’s fiscal stimulus package. If this is true, then outward securities investment by Japanese investors is unlikely to grow much (it is growing right now, but the sustainability of this growth is doubtful) despite current U.S. short-term financial markets suggesting tight demand conditions (in interest rate terms, rising USD LIBOR interest rates).

Ordinarily, the reason Japanese investors react to an increase in U.S. interest rates with a net buying of foreign securities (and other USD-denominated assets) is because they feel confident of the future prospects of the U.S. economy. However, if the rising US Treasury Yield is due to the concern over the US fiscal situation, then the story is different, and we should not expect outward securities investment by Japanese investors. It is rather difficult to make a strong case based on a development that is barely two months old, but I find simple scenarios relying on U.S. interest rate increases such as, “outward securities investment by Japanese will increase in response to the U.S.-Japan interest rate gap expansion, pushing up USD/JPY” rather unconvincing. Rather, I would like to warn of the possibility that the FOMC meetings will begin to show glimpses of dovish tendencies sometime mid-year, causing the U.S. interest rate increases to cool off, thereby shrinking the size of net investment in foreign securities by Japanese investors and tilting the JPY supply-demand balance toward JPY buying.

BOJ Monetary Policies Now and Going Forward – Have the Markets Been Misunderstanding?

Two Key Points

At its April 26-27 Monetary Policy Meeting, the BOJ decided by a majority vote to keep monetary policy unchanged. The guidelines for market operations will continue as they were before: short-term policy interest rate to remain at -0.1%, and operations to be conducted with a view to keeping the 10-year JGB yields at around zero percent. The two key points in the recent meeting were that, in the Outlook for Economic Activity and Prices (Outlook Report), (1) the time frame for achieving the 2% price stability target, which had previously been “around fiscal 2019,” was abandoned, and (2) the risk balance, which had previously been described as being “generally balanced,” was changed to “skewed to the downside for fiscal 2019 onward.”

Naturally, (1) is the more attention-grabbing of the two developments, given that the Kuroda regime, ever since its inauguration, has been obstinately pushing “2” as some kind of magic number. Although the target had already become devoid of substance, continuing to clearly mention a time frame was only drawing attention to the BOJ’s failure in achieving the target, not to mention inviting idle speculation about additional monetary easing. In this sense, it had turned into a situation of “all pain, no gain.” Governor Kuroda said in this connection, that the Bank had decided to rephrase in order to make it clear that the time frame was not a binding deadline but simply a forecast, as there were concerns of the markets misunderstanding that the time frame is tied to monetary policy action. In other words, the change was explained as a measure to deal with the markets “misunderstanding” a forecast to be a deadline.

Were the Markets Misunderstanding?

However, it is rather harsh to say that the markets have so far been “misunderstanding.” When Quantitative and Qualitative Easing (QQE) was introduced in April 2013, the logic behind setting a clear two-year time frame was to indicate a commensurate level of resolve in conducting the unprecedented monetary easing necessary to rid Japan of its persistent deflation. It was precisely because a short, decisive battle was assumed that Mr. Kuroda’s famous line “there will be no sequential escalation of force” arose. At that time, the two-year deadline existed without a doubt. And it was not just in the initial days of the policy that this deadline existed. In a lecture given in December 2016, for instance, then BOJ Deputy Governor Kikuo Iwata said, “Saying ‘as early as possible’ does not make it clear whether it is five years, 10 years, or 15 years. In general, other countries have been able to achieve a 2% price stability target in two years. Taking this into account, we thought it important to take a bold step in setting a clear-cut two-year time

frame to indicate the Bank's resolve, so as to be evaluated positively by the markets." Since one of the deputy governors of the BOJ himself has stated that the "clear-cut two-year time frame" indicated "the Bank's resolve," one cannot but see the indicated time frame as a deadline. I believe that the markets had not been misunderstanding at all; their understanding was quite correct. What is more, the claim that "None of the central banks in the West ever specify a deadline for achieving their price stability target (therefore, it is not strange for the BOJ to have removed its time frame)" is completely unreasonable given the original claim that "Our price environment is entirely different from anything seen in the West, and that is why we need to set a time frame and formulate an unprecedented monetary easing." The fact is that the Kuroda BOJ has never, since its first launch, considered it right to walk in step with its Western counterparts.

As I mentioned above, probably the main reason for deleting the time frame this time was to do away with the idea that there may be a connection between "the deadline not having been achieved" and "additional monetary easing." The BOJ probably wanted to avoid the sense of futility in postponing the deadline for the umpteenth time (the recent-most was the seventh time, by the way) with every downward revision of the outlook for prices in the Outlook Report, and perhaps it decided to make a fresh start in time for the start of a new regime. The revision itself is quite constructive, no matter which way one looks at it, and deserves to be appreciated. Apart from that, internal circumstances may also have existed – i.e., the decision may have been intended to deter moves by Policy Board Member Kataoka to push for further monetary easing in pursuit of a pure price stability target. Mr. Kataoka did, indeed, vote against the action to remove the time frame this time. Again, now that the link between prices and additional easing is broken, one could assume that the BOJ can raise interest rates despite being nowhere near achieving the 2% target, but going by the balance of risks as explained below, I do not think this is likely. As a digression, the aspect of the BOJ's currency policy operation that most invites misunderstanding is its "80 trillion yen" target for the annual pace of increasing its monetary base. I think that ought to have been revised, but for some reason, it was left unchanged.

The "Next Move" Will be an Additional Easing After All

Regardless of how one interprets it, given that "achieving the 2% target within a short time" was the main point of the BOJ's strategy under Mr. Kuroda, the breaking away from this commitment at this point is a major development. However, perhaps (2) the downward revision of the risk balance is the more important point when it comes to understanding policy operation going forward (come to think of it, (1) was nothing more than an acknowledgement of the current state of affairs). Specifically, the latest Outlook Report, while saying that in fiscal 2018, "upside and downside risks to economic activity are generally balanced," noted that for fiscal 2019, "risks are skewed to the downside." Perhaps the ripple effect from the protectionist stance of the U.S. government was taken into account, but the "effects of the scheduled consumption tax hike" were also mentioned for the first time. It is not clear why something that is already known was clearly included in the report at this time, but perhaps there is no need to read too deeply into the timing, given that the removal of the time frame for achieving the price stability target itself may have been simply a way of making a fresh start in time for the launch of a new regime. There is one question that needs to be asked, though. Given that the risk balance was deliberately downwardly revised at the recent meeting, does this make it more likely that the next move will be an additional easing rather than a tightening of monetary policy? Speculation about policy normalization has been rife since last year, but following the actions taken this time, the minority forecast of an additional easing coming up may begin to gradually gain currency (according to a survey of 47 economists by Bloomberg conducted between 16 and 18 April, only four including myself responded that the next move would be an additional easing). And if an additional easing is indeed implemented, it would obviously be at a time when JPY appreciation has progressed considerably.

U.S. Monetary Policies Now and Going Forward Interpreting the 3% Treasury Yield

The Concept of "Symmetry" Has Always Existed

Monetary policy was kept unchanged at the May 1-2 FOMC meeting, but in the statement issued following the meeting, the phrase "stabilize around the Committee's 2 percent objective over the medium term" had been changed to "run near the Committee's symmetric 2 percent objective over the medium term." This change was interpreted as a hawkish move and increased the sense of certainty regarding a rate hike in June. Specifically, the "run near the Committee's symmetric 2 percent objective" phrase led to a strengthening of the interpretation that the Fed does not intend to stop rate hikes even after the 2% objective has been surpassed, causing stock prices to fall and USD to appreciate across the board immediately after the statement was released.

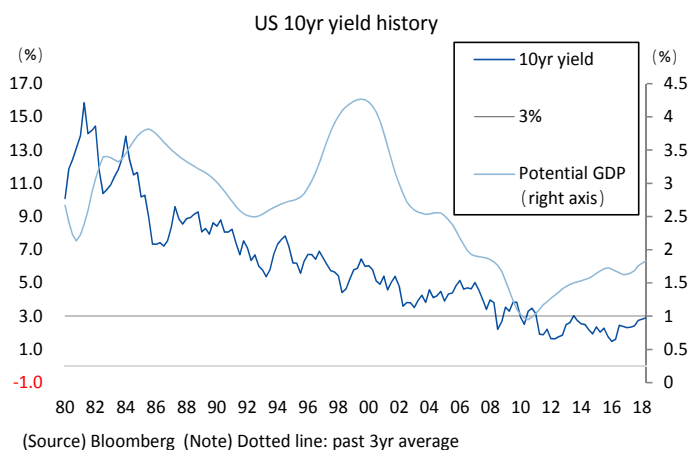
However, the FOMC's inflation objective has always been "symmetric" around 2%, and this is not a newly introduced concept. Rather, some had expressed the opinion that pushing policy normalization while inflation was running far below the 2% objective (as it had been doing so far) went against the Committee's concept of symmetry. In other words, if inflation close to 2% on either side is acceptable, then it would be a mere gamble to begin monetary tightening when the inflation rate was substantially below 2% unless the Committee was convinced of a surge in

inflation going forward. As both 1.5% yoy and 2.5% yoy are similar in that they are both 0.5% away from the 2% objective, beginning a rate hike policy when inflation is at 1.5% based on the assumption that it will eventually strengthen shows a very strong conviction regarding the inflation outlook on the part of the policymakers. Based on the fact that there is limited policy space for monetary easing should the economy fall into a recession as a result of the Fed's over-enthusiasm, there was some criticism by those who said it would be reasonable in terms of risk management to retain an accommodative monetary policy until inflation began to run substantially higher than 2%. This was the criticism Minneapolis Fed President Neel Kashkari, who had voting rights until 2017, gave each time he cast a dissenting vote.

As of the present, both the aggregate and the core personal consumption expenditure (PCE) deflator are steadily rising, so the Fed's judgment that inflation would eventually rise appears to have been correct. The question now is – will inflation growth remain stable at over 2% going forward? If it does, the interpretation that the “Fed will not stop rate hikes even at an inflation rate of over 2%” will gain significance.

U.S. 10-year Treasury Yield and Potential Growth Rate

The development that drew the most attention in April was perhaps the U.S. 10-year Treasury yield hitting 3%, and USD/JPY also rising as a direct result of it. Expectations of future price rises as a result of crude oil price increase, expectations of rate hikes by the Fed in line with this, and already existing concerns over the increased issue of Treasury bonds – these were pointed out as some of the main reasons behind the Treasury yield rise. Perhaps North Korea's announcement that it would suspend nuclear testing, which ameliorated geopolitical risks, also weakened the demand for bonds. Of the above, the waning of geopolitical risks is no doubt a good thing, but the other factors all have strongly negative aspects. Because it does not reflect overall strength of the economy and inflation growth, the current increase in interest rates is essentially an “undesirable” one. If an increase in rates is in response to true underlying economic strength, it is unlikely to be accompanied by a fluctuation in stock prices.

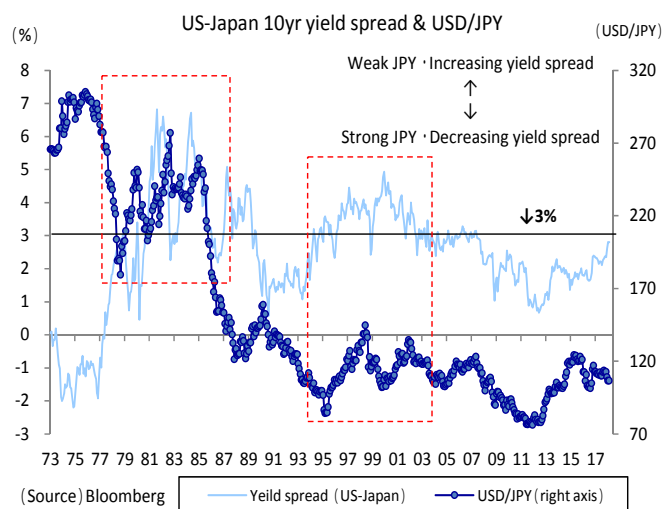


The 3% 10-year Treasury yield level has been the highest since the financial crisis of 2007, and yields hit that level briefly before tumbling back again at one point in January 2014 (see graph). At that time, rate hikes by the Fed were still seen as a distant event, and USD had not yet begun to appreciate either, but QE tapering had just begun in December 2013, and there was a sense of elation that U.S. bond yields were on the rise. However, the current rise in yield levels is different from that seen in January 2014 in that it is not in response to expectations of rate hikes by the Fed, but rather largely due to the various negative factors mentioned above. To be sure, according to estimates by the Congressional Budget Office (CBO), the U.S. economy's potential growth rate bottomed out in 2010, so in theory, it is not surprising that long-term yields should rise in line with the potential growth rate. However, it is also a fact that the potential growth rate estimated by the CBO continued to rise even when long-term yields were falling from 2014 onward, so one needs to be cautious in advancing arguments that link the potential growth rate to Treasury yields. Intuitively speaking, the scope of further growth in emerging economies including China is now smaller than it was a few years ago, and the global economy's potential growth rate has also probably declined compared with before the crisis. Some, therefore, estimate that a 3% 10-year Treasury yield at this time will have a more severe impact on the global economy. The question is whether such concerns are overblown.

Focus on 3-Percentage-Point Japan-U.S. Interest Rate Gap

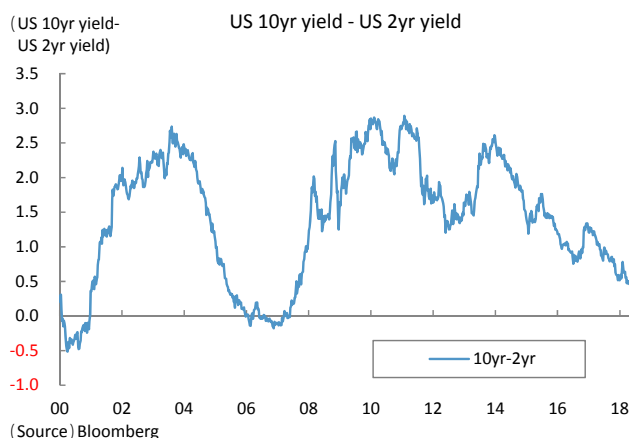
The rise in the 10-year U.S. interest rate has focused increasing attention on the 3-percentage-point level of the Japan-U.S. interest rate gap, particularly as it relates to USD/JPY. In late March, Japanese Finance Minister Taro Aso also attracted considerable attention when he referred to a historical rule of thumb associated with this situation saying – “Looking at several decades of history, one finds that if the [Japan-U.S.] interest rate gap is 3 percentage points, USD will appreciate against JPY” (Reuters, March 29). The graph confirms that, since the shift to the floating exchange rate system, USD/JPY has indeed shown a pronounced tendency to move upward during two periods when the Japan-U.S. 10-year interest rate gap surpassed 3 percentage points. However, it bears repeating that, given differences between the underlying strength of the two countries' economies, the meaning of a 3-percentage-point gap currently may well differ from the meaning of such a gap in the past.

In June 2013, for example, the Fed was assuming that the neutral interest rate was 4.00%, but the assumed rate had been adjusted downward to 2.90% as of the end of this past March. The neutral interest rate level – considered “exactly the right level” for the U.S. economy – has been lowered by 110 bps over roughly the past five years, which can be interpreted as indicating that the country’s potential growth rate has declined. (This point is not in line with the CBO appraisal.) And about 5 years ago, the U.S. 10-year interest rate was less than 2.5%. Compared to that time, the assumed neutral interest rate is now 110 bps lower, but the U.S. 10-year interest rate is about 50 bps higher. In light of this, it seems quite natural to have doubts about the U.S. economy’s ability to cope with a repeated raising of interest rates going forward. After all, there is no guarantee that the U.S. economy can maintain the kind of robustness it showed during the period when U.S. 10-year interest rates rose to create the 3-percentage-point Japan-U.S. interest rate gap, and the U.S. stock market’s intermittent bouts of weakening may well reflect increasing recognition of this. During periods when the U.S. stock market is reacting negatively, USD/JPY ordinarily has a heavy upside.



Not Behind the Curve, but Overkill

Of course, the Fed’s current policy normalization process is completely behind the curve, and if inflation is expected to rise sharply going forward, then the 3% yield of 10-year U.S. bonds will be no more than a transit point. In fact, the Fed’s clarification that it is aiming at a “symmetric” inflation target straddling the 2% level can probably be considered to reflect a recognition of the possibility of such a future scenario. In that case, the U.S. 10-year yield target may be 3.5% or 4% rather than 3%. However, the bond market is concerned about a diametrically opposite situation. As the graph shows, the U.S. yield curve flattening trend seen last year has been further intensifying this year. Although there seemed to be a trend of improvement associated with the February interest rate hike, the trend of further flattening resumed in March. In short, the bond market is less concerned about the Fed being behind the curve than that its monetary policy may be overkill. In the past, few indicators have been more-accurate bases for predicting U.S. economic slowdowns and recessions than the flattening (or ultimately inversion) of the yield curve. In light of the alarm being expressed by the U.S. bond market – the world’s top bond market in terms of diversity and the quantity of funds – it is my fundamental understanding that it is reasonable to anticipate that a U.S. economic slowdown will be accompanied by a derailment of the Fed’s policy normalization, ultimately leading to across-the-board USD depreciation.



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Risks to the Main Scenario – Emergence of Commerce Policy Risks

Recession of Geopolitical Risks and Emergence of Commerce Policy Risks

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), the most important change probably relates to geopolitical risks. During the past month (mostly in late April), North Korea announced a halt to nuclear testing, adopted a joint declaration at a summit meeting with South Korea, and approved momentous plans to denuclearize the Korean Peninsula as well as to finalize the end of the war on the peninsula by the end of this year. While geopolitical risks (particularly the tense situation regarding North Korea) have been included among the important JPY appreciation risk factors, it is probably safe to assume that such risk factors have become considerably less threatening. Of course, in light of North Korea’s past behavior, one must recognize a significant possibility that the momentous plans will somehow become frustrated, so it cannot yet be said that the grounds for concern have been eradicated. Nonetheless, there does appear to have been a considerable decrease in the need to focus on that particular concern in the context of forecasting exchange rates over the next year, and I have therefore removed geopolitical risks from the table of

principle risk factors.

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	· Retrogression 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 measures	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	· Political instability in Italy Conflict intensified about Brexit negotiation	Strong JPY Weak USD

(Source) Daisuke Karakama, Mizuho Bank

While there have not been major changes concerning the principle risk factors, there have been some new developments with respect to each of the factors. I have long felt uneasy about risk factor , for example, and that risk factor currently appears sure to be among the biggest forex-related themes during 2018. Of course, there are many voices saying that the Trump administration is merely bluffing with respect to many of its policy proposals, including its trade policy proposals. Since the IMF and ECB (and, although not explicitly, the BOJ) have made reference to President Trump's trade policies in their risk scenarios, however, I believe it would be unwise to discount the associated risks and consider the policy proposals to be bluffs. Additional tariffs on steel and aluminum are being implemented and, as a means of shielding its exports from those tariffs, Korea has been forced to engage in disadvantageous negotiations regarding the revision of FTA provisions. The steps to exclude Canada and Mexico from the scope of the tariffs are just temporary measures conditional on those countries' consent to renegotiate the North American Free Trade Agreement (NAFTA), and the outcome of such a renegotiation remains to be seen. It is not yet apparent how serious the situation may become but, in light of the actual damage that has already occurred, it would clearly be inappropriate to optimistically characterize the policy proposals as being merely bluffs. As a result of the Japan-U.S. summit meeting in April, Japan and the United States have a new platform linked to the U.S.-Japan economic dialogue meetings. Although it is uncertain how the countries' bilateral trade negotiations might change, there is surely an associated JPY appreciation risk. There seem too many opinions about means of avoiding bilateral trade negotiation problems, but even though the aversion of such problems could eliminate a JPY appreciation risk factor, it would not promote JPY depreciation. It should be recognized that the downside risks associated with Trump administration's economic policies remain significant.

Overkill Risk Merits Keen Attention

Regarding the Trump administration's economic policies, aside from trade policies, there are numerous observers who believe the administration's fiscal policies continue to be a disruptive factor. Some observers believe the U.S. economy should be able to overcome the challenges of rising interest rates because expansionary fiscal policies will promote economic overheating, but I disagree. As this article has repeatedly argued in the past, interest rate increases unaccompanied by domestic inflation are "bad interest rate increases". Given concerns that the current interest rate rise is exerting a crowding out effect, it would seem appropriate to consider an interest rate rise accompanying expansionary fiscal policies to be a JPY appreciation risk owing to its indirect effect of promoting U.S. economic deceleration. The fact that the U.S. 10-year yield has surpassed and been sustained for a considerable time above the 3% milestone level has almost certainly played a role in making stock and forex markets become increasingly insensitive to this view.

However, this should definitely not be construed to suggest that the 3% interest rate level is appropriate for the U.S. economy. The time frames of financial markets and the real economy are completely different, and it is said that the effects of monetary policies will emerge only after a lag of about one year. Eventually, it will prove fundamentally

impossible for the real economy to continue accelerating amid a sustained rise in interest rates. In the case that the current rise in interest rates is already showing signs of causing a crowding out effect, then overlaying expansionary fiscal policies atop that situation should theoretically further increase the risk of monetary policy overkill. The likelihood that that situation will become a JPY appreciation risk factor appears quite high.

Continued Abexit Risk

As Prime Minister Abe prepares to run for reelection as the leader of the Liberal Democratic Party (LDP) in the election scheduled for September 2018, there is cause for concern about the growing instability of the Japanese political situation (risk factor). 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. There has been little change in this situation even through April, and a growing number of observers believe that it is becoming increasingly difficult for Prime Minister Abe to win reelection for his third term as the LDP leader. 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 replacement of Prime Minister Abe could be construed as indicating a change regarding the policies themselves. As noted in last month's edition of this article, 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" on March 21. (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.) Moreover, the Minister for Internal Affairs and Communications Seiko Noda has expressed interest in running against Prime Minister Abe for the LDP leadership and, in April, she said – "We must seriously consider the side effects of the unprincipled continuation of unprecedented policies" – and made other remarks calling for eliminating the 2% inflation target. 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. There also remains the possibility that the BOJ might shift toward policy normalization, provoking JPY appreciation (risk factor -1). As the April Outlook Report revised downward the level of the fiscal 2019 economy-related risk balance, the possibility of such a shift is believed to have become lower but, precisely because the link between inflation trends and policy management has become more tenuous, some voices are asserting that normalization has become easier to undertake, and this situation is worth keeping an eye on. Other JPY appreciation risks include the European political situation (risk factor), and this also merits close monitoring. The hung parliament situation seen in Italy since that country's general election is continuing, and coalition talks have not yet led to agreements. The possibility of another election in June is emerging, and there is a risk that that could foster a risk off mood (≈ JPY appreciation). Among other Europe-related concerns, the U.K. withdrawal from the EU (Brexit) process seems likely to be accompanied by some turmoil.

Foreign Securities Investment As a JPY-Appreciation-Restraint Risk Factor

On the other hand, are there no JPY depreciation risks? While they appear scanty from an objective perspective, it is probably worth noting such risks as those associated with 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 involving foreign bond purchasing and helicopter money (risk factor -2). Particularly regarding risk factor , when USD/JPY fell below JPY105 in March, some observers ascribed the firmness of USD/JPY to an increase in Japanese investment in foreign securities. In fact, this interpretation has some basis, given that net buying has been sustained in Japanese investment in foreign securities since the start of 2018. The new-fiscal-year fund management plans announced by major Japanese life insurance companies since the start of April also demonstrate the strength of Japanese desire to undertake foreign bond investment accompanied by JPY selling and USD buying (open foreign bond investment). Rather than constituting JPY depreciation risks capable of pushing USD/JPY up to new record high levels, these are largely risks that this article assumes may have the potential to restrain JPY appreciation, but they can still be roughly classified as JPY depreciation risk factors.

As mentioned above, while it had been widely thought that the Trump administration's expansionary fiscal policies and the rise of U.S. interest rates would cause USD to appreciate sharply against JPY, it appears that those factors may actually handicap the U.S. real economy, and that possibility seems to be intermittently reflected in the form of U.S. stock price fluctuations. My fundamental understanding regarding this can be boiled down to a simple question – "Is it possible for the economy to avoid deceleration etc. despite its central bank's sustained tightening of monetary policies?" I think it reasonable to assume an impending economic slowdown, and my forex forecast is based on this assumption. The yield curve flattening in the U.S. Treasury market can be considered to accord with this simple argument. My objective here is to focus on the individual risk factors relevant to my forecast without being distracted by the general mood of the moment.

EUR Outlook – Interest Rate Hikes To Entail a Battle Against EUR Appreciation

ECB Monetary Policies Now and Going Forward – Concern About the Possibility of EUR Area Economic Deceleration

Economic Deceleration “Quite Clear”

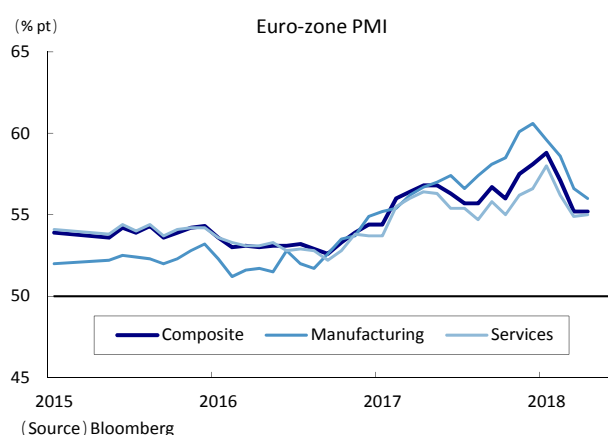
At the April 26 ECB Governing Council meeting, it was decided to keep the interest rate on the main refinancing operations (MRO), the rate on the marginal lending facility (the ceiling of market rates), and the rate on the deposit facility (the floor of market rates) unchanged at 0.00%, 0.25%, and -0.40%, respectively, with the interest rate corridor (difference between the ceiling and the floor) also remaining unchanged at 0.65 pp. As reflected in ECB President Draghi’s statement – “the interesting thing is that we didn’t discuss monetary policy per se.” – the meeting provided almost no hints about the ECB’s policy management going forward. Although the policies themselves were not discussed, it appeared that the ECB’s confidence in the euro area’s real economy is

becoming shakier, and that caused a perception that there is a possibility that there may be a change to the timing of the termination of the asset purchase programme (APP). In addition, since the meeting was the last at which Vítor Constâncio served as ECB vice-president, the post-meeting press conference featured some unusual questions regarding the past eight years of ECB operations as well as the future ramifications of the ongoing generation change in the ECB’s leadership. (Although the discussion of such ramifications did not actually provide hints about policy management going forward.)

President Draghi reported that, rather than addressing monetary policies, each Governing Council member reported on the situation of their own country’s economic situation, and he went on to say – “It’s quite clear that since our last meeting, broadly all countries experienced, to different extents of course, some moderation in growth or some loss of momentum.” He then discussed trends in the Purchasing Managers’ Index (PMI) as a reflection of the economic trends, and indeed there has been a clear-cut peaking-out of euro area PMI indices since the start of 2018 (see graph). He noted that the extent of some of the declines was “unexpected,” and it can be assumed that this is a very unpleasant situation from the perspective of those seeking to draft a road map for the path to policy normalization. He also mentioned that the basic inflation trend was currently weak and, overall, one gets a strong impression that the ECB has a negative appraisal of the euro area’s economic and inflation situations. On the other hand, he also explained that, given the decreased level of exchange rate volatility, the issue of such volatility was not discussed at the meeting.

Analysis of the Current Situation not Yet Complete

However, the – “we didn’t discuss monetary policy per se” – statement seemed a bit abrupt following a meeting designed to be a forum for discussing monetary policy, and one of the reporters actually said – “to be honest I’m a little bit surprised” – in a follow-up question about that lack of discussion. That same reporter expressed concern about the lack of discussion of the monetary policy outlook and a roadmap since decisions on such issues as the termination of the APP will have to be made soon, asking – “Isn’t it already high time to discuss such things given that these are decisions that will not be taken within a couple of weeks only?” President Draghi received the query gracefully, saying – “It is actually a very, I would say, legitimate question and a proper one.” – and then stated that – “the reading of the current developments since the beginning of the year is actually very important in deciding the next steps.” – and followed up by specifying that the first thing the ECB has to do is to understand exactly whether the current situation (an economic downturn) is – “temporary or permanent [...] more supply or more demand.” In fact, given that the euro area’s current expansion period can be said to be the longest such period in history, one might say that it is quite natural to see economic deceleration at this point, but President Draghi explained that the ECB wanted to be sure it was not – “the beginning of a more significant decline.” In short, it appears that President Draghi is saying that the ECB has not analyzed the current situation sufficiently to make some important decisions. Based on this, there seems to be a high likelihood that the decision about whether to extend the APP or not will be delayed until the July meeting.



After the meeting, Bloomberg reported that Ewald Nowotny, governor of Austria's central bank, had urged that participants discuss the nature of policy management from this September onward, but the majority of Governing Council members disagreed (although several members did agree). Since Governor Nowotny has frequently called for the APP to be terminated within this year, one can surmise that his analysis of the current situation is already complete and that he would like to quickly begin preparing to act based on that analysis. It can also be presumed that the several Governing Council members who agreed with him are representatives of such countries as Germany, the Netherlands, and Finland.

Increasing Concern About a Trade War

In addition, there was a slight change to the risk assessment portion of the latest Governing Council meeting's statement. The risk assessment text states – "The risks surrounding the euro area growth outlook remain broadly balanced. However, risks related to global factors, including the threat of increased protectionism, have become more prominent." Despite the description of the risks as 'balanced,' it is only the downside risk of protectionism that is specifically mentioned. So it can be considered natural that one of the reporters posed a question about how an escalation of the trade dispute might affect the ECB's monetary policy. The gist of President Draghi's response was that, while there may be due cause for concern, he cannot currently appraise the potential effects because – "we don't know the extent of the [EU] retaliation [to U.S. tariffs] yet." But he went on explain the downside risk, saying – "What is certainly known" – is that trade disputes impact business confidence, which can affect the growth outlook." Since, as mentioned, there is an increasing perception that the euro area economy is peaking out, it seems apparent that such external shocks as trade disputes are certainly capable of exerting a large impact on euro area economic conditions at this time.

Interest Rate Hikes to Entail a Battle Against EUR Appreciation

In any case, Governing Council is continuing to progress in consolidating support for moving toward the termination of the APP, but it is currently only at the stage of considering approaches toward that objective. In other words, "strategies" for the normalization process are being implemented, but the Governing Council is still at the stage of working out the requisite "tactics." Actually, since the fact that the APP is slated for shrinkage or termination is becoming generally accepted in the financial markets, it should not be extremely difficult to shrink or terminate the program. The problem lies in the question of when to announce that interest rate hikes are being considered. Currently, the ECB is disseminating very little information on prospective interest rate hikes. As mentioned, National Bank of Austria President Nowotny is seeking to promote the early termination of the APP, but he has expressed the view that it is still too early to announce the timing of interest rate hikes. (It is not clear whether he still held that view at the time of the latest Governing Council meeting.) In a rare example of ECB loose lips regarding the timing of interest rate hikes, German Bundesbank Governor Jens Weidmann said in late February this year that expectations of a hike in mid-2019 are "not completely unrealistic," but it seems unlikely that his statement reflected a consensus of the Governing Council. Frankly speaking, Governor Weidmann's perspective is probably the most hawkish of all the Governing Council members. Certainly, if APP is terminated by the end of this year, it will be then possible to consider a June 2019 interest rate hike consistent with the ECB's forward guidance statement that interest rates will remain at their present levels "well past the horizon of our net asset purchases," since there would be a half-year interval between the horizon and the hike. Given that the euro area's cyclical expansionary period is likely to run out of steam over time, it seems reasonable to target June 2019 as the earliest date that can be said to be consistent with the ECB's forward guidance statement (see chart on previous page). However, once the interest rate hike outlook becomes realistic, it is likely that EUR will show a surge of appreciation as it did 2017. It has been argued in the past that EUR appreciation is "a source of uncertainty" and an obstacle to attaining the inflation target, and it is questionable whether the ECB's capacity for tolerating EUR appreciation has subsequently increased. It seems likely that the upcoming interest rate hike will entail a battle against EUR appreciation.

ECB exit strategy fastest case (2018-2020)

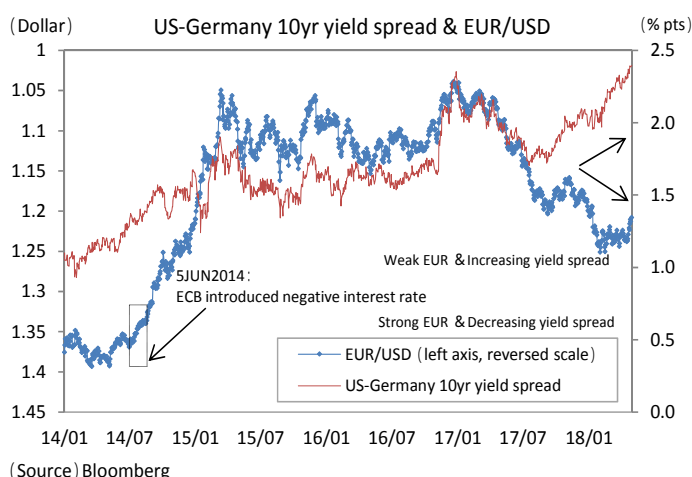
Period	Details	
OCT 2017	Decision of APP extension & reduction	
JAN 2018	APP reduction (60bil 30bil)	Decision
SEP 2018	APP reduction (30bil 15bil)	Forecast
DEC 2018	APP abolition?	
JUN 2019	Deposit facility interest rate hike (0.40% 0.30%)	
SEP 2019	Deposit facility interest rate hike (0.30% 0.20%)	
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

EUR Now and Going Forward – What Can and Cannot be Said Based on Interest Rate Gaps

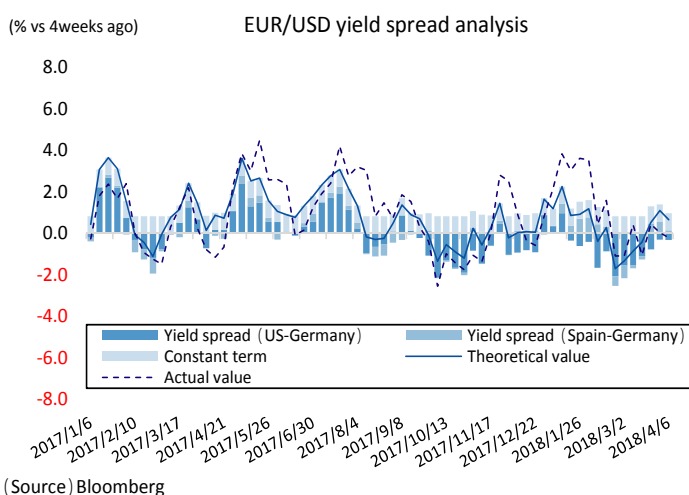
Reanalysis of EUR/USD Movements

EUR exchange rate movements were a prominent feature of the forex market throughout 2017 but have become relatively stable and inconspicuous since the start of this year. It is natural that such large-scale price movements as those seen last year will not persist forever, but now that the movements have stabilized, I think it is an opportune time to look back at the factors driving last year's movements once again and provide a simple assessment of the current and prospective situations. It has often been mentioned in this article that there are many theories about the relationship between movements in EUR/USD and in the U.S.-Germany 10-year interest rate gap, and it is worth noting that the ECB also from time to time employs such theories. As the graph shows, since the middle of last year, the rise of EUR/USD has continued despite the considerable widening of the US-Germany 10-year interest rate gap (U.S. - Germany), and the ECB has noted the incongruity of this divergence. However, the high level of autocorrelation in the forex market regularly leads to overshooting, and forex rate movements that are not theoretically justified are frequently encountered. Regarding the divergence seen since last year, it seems likely that this – to a considerable degree – may reflect a sudden release of previously restrained latent demand for EUR amid the general evaluation of the novel phenomenon of the ECB's fledgling efforts toward normalization. Although EUR is the world's second largest currency after USD, since the financial crisis, more than a few observers believe that excessive priority has been given to unilateral moves to weaken EUR.



The Interest Rate Gap as a Determinant of EUR Investment Appeal

However, if one performs regression analyses of rates of change in EUR/USD and various interest rate gaps, the results do not indicate much of a persistent incongruity. The graph on the next page shows the results of regressing rates of change (compared to four weeks before) in EUR/USD on the rate of change in the U.S.-Germany 10-year interest rate gap and on the rate of change in the Spain-Germany 10-year interest rate gap (10-year Spanish interest rate - 10-year German interest rate) during 2017¹. The U.S.-Germany 10-year interest rate gap is an explanatory variable for measuring the investment appeal of EUR compared with USD, and the 10-year Spain-German interest rate gap is added as an explanatory variable to measure the perception of sovereign risk associated with peripheral euro area countries. The assumed relationship is that interest gap expansion will promote EUR selling/USD buying (a decline in EUR/USD). The graph shows that the EUR/USD rise seen around July last year appears to have been contributed to by the relative rise in Germany's 10-year interest rate compared to that in the U.S. 10-year interest rate.



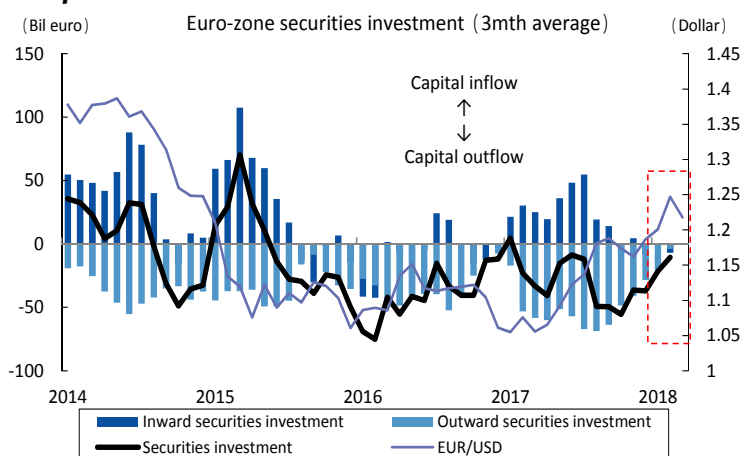
On the other hand, from August through the end of 2017 the U.S.-Germany 10-year interest rate gap placed downward pressure on EUR/USD – in fact, the rise stopped and the rate then remained roughly flat. Subsequently, the sharp surge in EUR/USD seen from the start of 2018 (the time span defined by red dotted lines) greatly exceeded the theoretical value, and it is this time period that seems incongruous compared to the other time periods covered by the graph. In brief, it appears that EUR buying was promoted by the fact that the decrease in the Spanish

¹ This section of this article was undertaken with reference to "The dollar-euro exchange rate, 2016-2018," an article written by Stefan Gerlach and posted on April 4 on the Center for Economic Policy Research (CEPR) website (<https://voxeu.org/article/dollar-euro-exchange-rate-2016-2018>). That article performed analysis focusing on changes in monthly data, while this section of this article tried performing a similar analysis focusing on changes in weekly data compared to four weeks before. One of Europe's leading policy think tanks, CEPR operates the VoxEU.org website, on which it posts articles and other information regarding its work. Japan's Research Institute of Economy, Trade and Industry (RIETI) also participates as a partner in operating the website.

10-year interest rate was larger than that in the 10-year German interest rate during the period in question (interpreted as reflecting a fall in the sovereign risk premium as the euro area's real economy recovers), but it is also likely that the market's consciousness of factors other than interest rate gaps played a major role in causing the anomaly. For example, given that expectations that the ECB might announce an interest rate hike in the near future had been burgeoning since the beginning of the year, there is a possibility that exuberant anticipation of ECB normalization moves contributed to the anomaly. Since February 2018, EUR/USD has softened. For this period, the graph also confirms that this trend reflects the fact that the sudden rise in U.S. interest rates reduced the appeal of EUR investments relative to USD investments. The U.S.-Germany 10-year interest rate gap appears to have consistently had the effect of depressing EUR/USD since February, and since early March, the actual level of EUR/USD has remained unable to realize the degree of increase suggested by the theoretical value.

Capital Flows Also in Line With the Interest Rate Gap

The above kind of relationship between EUR/USD and internal/external interest rate gap trends is also seen between EUR/USD and capital flows. The graph facilitates a comparison of movements in the euro area's inward/outward securities investment and in EUR/USD. During the first half of 2017, it appears that there was a surge in the region's inward securities investment from outside the region. As noted above, this was a period when the German 10-year interest rate increased more than the U.S. 10-year interest rate, making it a period when the appeal of investment in EUR-denominated assets was increasing, so the actual securities investment trends accord with what one would expect to happen theoretically. On the other



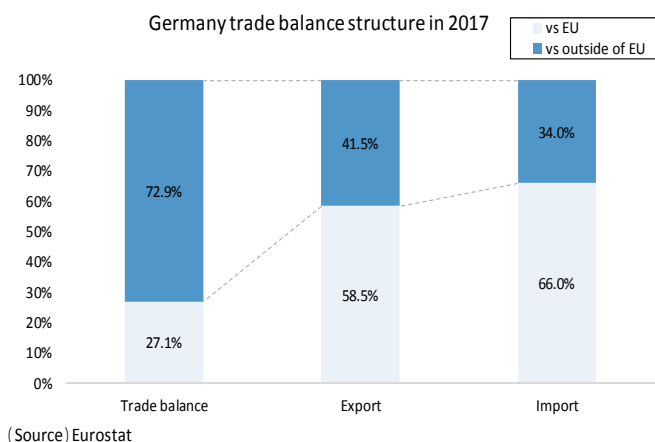
(Source) Datastream

hand, inward securities investment gradually decreased in the second half of the year and has completely stopped since the start of 2018 – the timing of this corresponds with the peaking out of EUR/USD. Looking at the movement of EUR/USD during the past year, one finds that capital flows are generally influenced by the relative height of German and U.S. interest rates, and one gets the impression that the directionality of movements in EUR/USD is also determined by those capital flows. Given this, as has been repeatedly argued in this article, it seems that consideration of a discontinuation of negative interest rates is a prerequisite for a full-scale reversal of the trend in EUR/USD. Since the first ECB rate hike is expected to be in or after mid-2019, I am maintaining my view that it would be difficult for EUR/USD to attain the 1.30 level for the time being.

Europe-U.S. Trade Frictions Now and Going Forward – Is Germany Blameless?

German Trade Surplus Originates Outside the EU

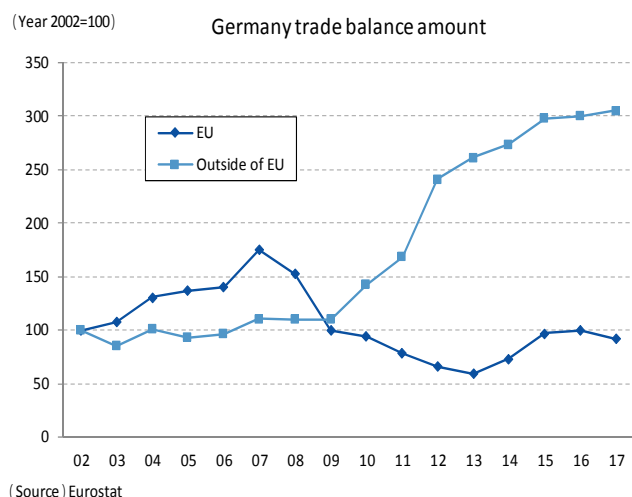
Since March, the war of words between the United States and the EU, including Germany, has intensified and expanded, and both sides have indicated that they will not refrain from retaliatory battles. In March, the EC officially announced a policy of taking retaliatory measures against U.S. steel and aluminum tariffs, and also presented a retaliatory tariff list totaling EUR 6.4 billion of tariffs on such U.S. products as motorcycles and bourbon whiskey. President Trump responded in kind, Tweeting, – “If the E.U. wants to further increase their already massive tariffs and barriers on U.S. companies doing business there, we will simply apply a tax on their cars which freely pour into the U.S.” It is not hard to imagine the great magnitude of the potential impact if



(Source) Eurostat

a full-scale trade war were to break out between the United States and the EU, which has a population larger than that of the United States. The cause for concern about the escalating trade frictions is even more serious when one notes that, among developed country leaders, the personalities of President Trump and German Chancellor Angela Merkel appear to be the least compatible.

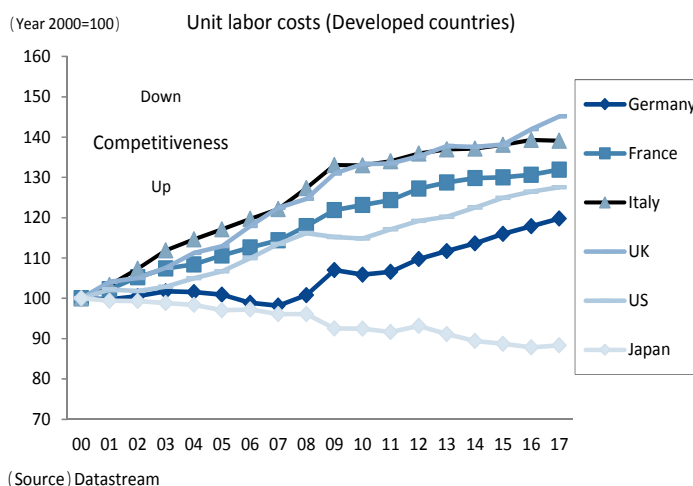
The intensification of U.S. protectionist policies may be fundamentally attributable to President Trump's headstrong willfulness, but can it truly be said that the EU (particularly Germany) is blameless? In this regard, the facts imply that there is considerable room for argument. In 2017, Germany's trade surplus was approximately EUR250 billion, of which more than 70% was in trade with countries outside the EU and only 30% in trade with fellow EU countries. While roughly 60%-to-70% of Germany's exports and imports are with EU countries, an overwhelming share of Germany's trade surplus stems from trade with non-EU countries (see graph on upper right). The pattern of greater German trade surpluses in trade with non-EU countries than in trade with EU countries is relatively recent, dating back only to 2009 (see graph on lower right). Since 2009, the size of Germany's trade surplus within the EU has been roughly stable, and the 2017 level is almost unchanged from 2002. (Specifically, it was EUR73.4 billion in 2002 and decreased to EUR67.6 billion in 2017.) In trade with non-EU countries, however, Germany's surplus has surged since 2009, and the 2017 surplus is three times the size of the 2002 surplus. (Specifically, it was EUR59.4 billion in 2002 and increased to EUR181.4 billion in 2017.) Most of the German trade surplus accumulated outside the Economic and Monetary Union (EMU) rather than within it. Given this, Germany is definitely responsible for a portion of the world's external balance imbalance and – aside from the issue of the virtues and flaws of the Trump administration's trade policies – this situation is clearly not salutary. The fact that Germany's trade surpluses are too large has been pointed out by the EC, despite Germany's affiliation with the EC.



Background of German Trade Surpluses

What is the background of the surge in Germany's trade surplus with non-EU countries since the financial crisis? Three plausible reasons for the trade surplus surge include (1) productivity improvements accompanied by cost control (improving competitiveness), (2) currency depreciation, and (3) a sharp drop in German imports due to domestic economic recession. In short, it seems that factors (1) and (2) have expanded Germany's trade surplus. First of all, it is easy to understand factor (2). As is generally known, EUR depreciated 13.95% on a real effective basis during the first five years after the financial crisis (from March 2008 through March 2013). In the same period, EUR/USD decreased from slightly below USD1.60 to slightly below USD 1.30, and EUR/JPY fell from slightly below JPY160 yen to slightly above JPY120. It is hard to imagine that this degree of currency depreciation did not contribute to EU export growth – it appears to have been a large tailwind factor, particularly for Germany's export industries. However, observers have consistently noted that factor (1) is a significant contributor to Germany's economic revival and the expansion of its trade surplus in recent years, particularly the labor regulation reforms (the Hartz reforms) instituted by the government of Prime Minister Gerhard Schröder in the first half of the 2000s, which have been bearing fruit during the Merkel governments' terms. Although this article is too short to describe the reforms in detail, it is worth noting that they facilitated flexible labor management methods based on a newly introduced work time savings account system and included a series of Harz reforms – such as those to relax dismissal regulations, increase the number of low-wage workers, and reduce unemployment benefits – and there are many analyses that conclude that the creation of a large amount of “inexpensive labor” has led to significant improvement in Germany's international competitiveness.

In fact, looking back at the past few decades, one finds that increases in Germany's unit labor cost (ULC) have clearly been restrained to a greater degree than those of other developed countries. (Deflationary trends in Japan have caused a trend of decline in Japanese ULC.) The approach of maintaining export competitiveness by increasing employment system flexibility has earned kudos, particularly in comparison with the situation in Japan, where workers' reliance on irregular employment to get through periods of economic downturn has prevented human capital accumulation (and has depressed the potential growth rate from a macroeconomic perspective).

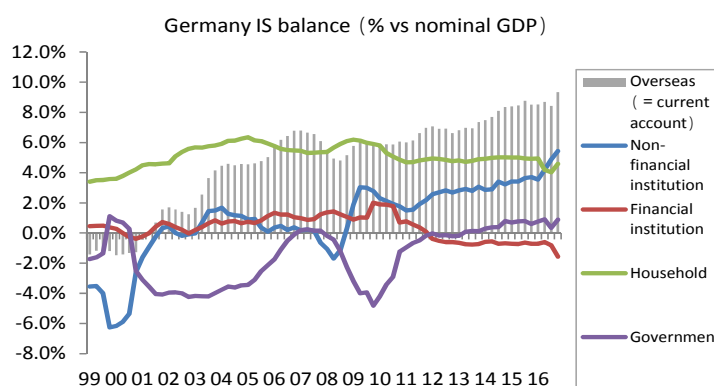


For example, it has been pointed out that the existence of a work time savings system obviates the need to use forceful workforce adjustment methods that shift workers to irregular employment and also restrains companies' restructuring costs.

Although the Harz reforms have not been a panacea, one gets a clear impression that they have led to a considerable magnification of the difference between the economic structures of Germany and Japan, which at one point were considered to have quite similar economic structures. Comparing Germany and Japan in terms of real GDP growth, one finds that the average levels were "1.37% vs. 0.93%" over past 10 years, "1.59% vs. 1.20%" over the past five years, and "1.80% vs. 1.22%" over the past three years – Japan's level of growth has been consistently lower.

Germany's IS Balance Helps Create a "Peculiar Economy"

If Germany's trade surplus was solely attributable to factor (1) as described above, it would be difficult to criticize it. However, it is undeniable and well known that Germany is also enjoying the benefits of EUR, the "perennially undervalued currency", and it seems likely that this situation is greatly increasing the Trump administration's confidence in the justice of their arguments. Of course, the common tariffs adopted by the EU also can be considered somewhat aggressive. Regarding automobile imports, for example, the EU's common tariff is 10%, while the U.S. tariff is only 2.5%. When focusing on Germany alone, however, one inexorably senses that the key problem is "a currency that is excessively undervalued in light of the country's economic power."



(Source) Eurostat (Note) Household including non-profit organizations

In fact, high-level German officials have begun to recognize the effects of EUR's weakness. In February last year, for example, (then) German Federal Minister of Finance Wolfgang Schäuble said – a "The euro exchange rate is, strictly speaking, too low for the German economy's competitive position. When ECB chief Mario Draghi embarked on the expansive monetary policy, I told him he would drive up Germany's export surplus." – (Reuters, February 5, 2017). It seems that even Germany's politicians are beginning to note the incongruity of the coexistence of EUR depreciation and Germany's large trade surpluses.

Several situations – the world's largest trade surplus in terms of share of GDP (the world's second largest in terms of monetary value), the benefits of the "perennially undervalued currency", and the monetary policy featuring the deepest negative interest rate among developed countries – put Germany in an "awkward" position on the stage of trade war-related arguments. In terms of current account surplus magnitude, Germany surpasses China even on a monetary value basis, and it is indeed in a very large imbalance, corresponding to about 8% of GDP. The graph shows Germany's current account surplus from the perspective of the country's savings and investment (IS) balance. It shows that all the country's sectors – corporate, household, and government – are in an abnormal situation of recording net savings surpluses. (The financial corporate sector has a savings deficit, but the financial and non-financial corporate sector as a whole has a savings surplus.) In short, Germany's economic structure is relying entirely on foreign economies' saving deficit (≈ current account surplus, external demand) to offset the weakness of its domestic demand.

In recent years, moreover, it is surprising to find that Germany's excess savings trend is most pronounced in the government sector. From the perspective of Japan, it is difficult to conceive of how a country can have such an uptrend in its fiscal surplus. Even from the perspective of the United States, it seems quite incongruous that government sector consumption and investment could be restrained in this way at a time when overall domestic demand is weak. Indeed, in recent years, Germany has attained a full-employment situation, motivating its non-financial corporations to increase their consumption and investment activities (decreasing their savings surplus), and the current account surplus has accordingly begun to peak out, and yet it is not expected that there will be a change to the country's dogmatic adherence to austerity policies in the near future. Moreover, since Germany tends to position itself as a moral authority and recommend austerity policies to other EU states as being "right," it may well cause its own problems to proliferate throughout the EU. That would be a very dangerous development in light of the current situation regarding the incipient trade war with the United States.

There is no doubt that Germany has a "peculiar economy", and it should also be recognized that it has many characteristics that are likely to become "weaknesses" in the context of a trade war. The fact that Germany's current account surplus has risen to an unprecedented level while the country refrains from expansionary fiscal policies in its domestic market and is averse to the concept of fiscal transfers to other EU countries would be likely to elicit considerable consternation even in the absence of President Trump, and if cogent and well-reasoned critiques of

Germany were to be articulated by such means as the U.S. Treasury Department's Semiannual Report on International Economic and Exchange Rate Policies (IEERP), it would be quite difficult for Germany to find rational arguments to defend itself. While U.S.-China trade frictions tend to dominate media headlines, we should also be closely monitoring developments regarding U.S.-EU trade frictions.

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