

# Forex Medium-Term Outlook

1 November 2018

Mizuho Bank, Ltd.  
Forex Department

## 【Contents】

Overview of Outlook . . . . . P. 2

### USD/JPY Outlook – “Buying JPY as a Safe Asset” Dormant for the Time Being

Why “Buying JPY as a Safe Asset” Lacks Momentum – Short-Term and Medium/Long-Term Factors . . . . . P. 3

U.S. Currency and Trade Policies vs. Forex Rates – Heightening Wariness of China and Calls for a Currency Provision . . . . . P. 4

U.S. Monetary Policies Now and Going Forward – Dangers of the Fed Being Drunk at the Sight of Its Own Reflection . . . . . P. 8

Risks to the Main Scenario – Warning Bells Sounded by Volatility at Higher Levels . . . . . P. 9

### EUR Outlook – The ECB’s Tenuous Bullishness

ECB Monetary Policies Now and Going Forward – ECB Bullishness Subjected to Skepticism . P. 13

EUR Exchange Rate and Capital Flow Situation – Importance of Capital Flows as an Indicator . . . . . P. 14

The Euro Area Economy Now and Going Forward – Euro Area’s Germanization . . . . . P. 15

## Overview of Outlook

USD/JPY had a bullish momentum in September, but it lost its momentum in October. Similar to February, the rise in U.S. yields forced stock prices to undergo a major adjustment in October. The volatility of stock markets has been at an elevated level – a typical symptom observed toward the end of bubbles – suggesting that a change in phase is not-so-distant in the future. The frequent instability in emerging markets since this year seems to prove that the global economy is unable to withstand the Fed's rate hikes. A reversal in the rate hike policy path will be a major change that could completely change the market climate of the past five years, and I think it is important to formulate market forecasts accordingly. My prediction of a strong-JPY trend in this report has not yet come true mainly because I underestimated the underlying strength of the U.S. economy, especially the labor market. For the Fed and others who are bullish about the U.S. economy, this is no more than a happy miscalculation (the Fed had originally assumed an even higher natural unemployment rate). It would be risky to formulate future forecasts based on the assumption that the “happy miscalculation” will continue. Further, some point out that there has been a decline in the “buying of JPY as a safe asset,” but that is because this is not a truly risk-off phase. Rather, I would like to draw attention to the fact that USD is not appreciating all that much despite U.S. yields heading higher as much as they have. Perhaps this is because there is a shift to a more bearish market sentiment?

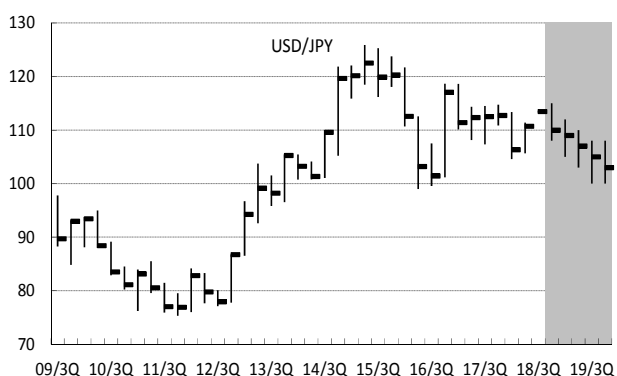
EUR, meanwhile, weakened in October. As of the time of writing this report, the dispute between Italy and the European Commission over Italy's budget bill for the new fiscal year has not yet been resolved. On top of that, German Chancellor Angela Merkel has announced her decision to step down as the leader of her party. Politically, therefore, there are several factors weighing down EUR, which is quite a familiar scenario. One also gets the impression that an increasing number of market participants are responding to the ECB's monetary policies by selling off EUR. At the October Governing Council meeting, ECB President Mario Draghi reaffirmed the continuation of the policy normalization process and maintained a hawkish stance. But amid rumors of political turmoil and clear signs of a slowdown in the real economy, many are beginning to question the justification for such a policy. EUR was sold off despite the hawkish tone of the October meeting probably because of a growing sense of the dangers of such policy operation – in other words, market participants were factoring in a deterioration in the euro area economy and financial situations. However, going by the main forecast scenario of this report (which is predicated on the belief that the Fed's normalization process will break down), one can see EUR maintaining its strength due to the weakness of the USD.

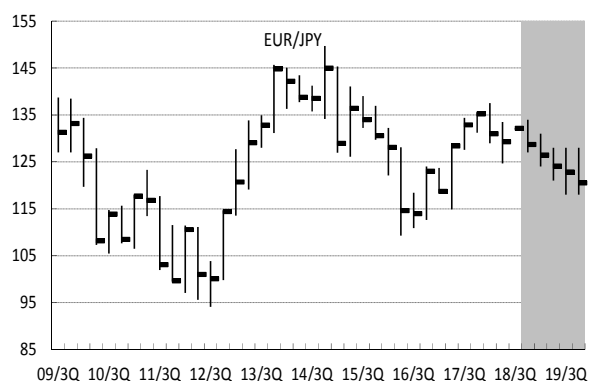
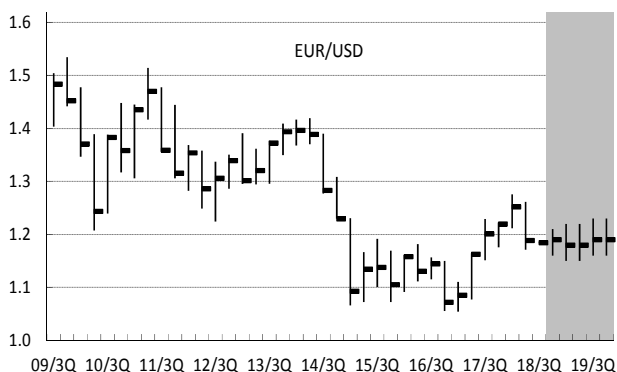
### Summary Table of Forecasts

	2018 Jan - Oct	Nov - Dec	2019 Jan - Mar	Apr - Jun	Jul - Sep	Oct - Dec
<b>USD/JPY</b>	104.64 ~ 114.55 (112.78)	108 ~ 115 (110)	105 ~ 112 (109)	103 ~ 110 (107)	100 ~ 108 (105)	100 ~ 108 (103)
<b>EUR/USD</b>	1.1300 ~ 1.2556 (1.1328)	1.12 ~ 1.17 (1.15)	1.13 ~ 1.18 (1.16)	1.13 ~ 1.20 (1.16)	1.14 ~ 1.21 (1.17)	1.14 ~ 1.21 (1.17)
<b>EUR/JPY</b>	124.62 ~ 137.51 (127.73)	126 ~ 133 (127)	124 ~ 131 (126)	121 ~ 128 (124)	118 ~ 128 (123)	118 ~ 128 (121)

forecasts in parantheses are quarter-end levels

### Exchange Rate Trends & Forecasts





## USD/JPY Outlook – “Buying JPY as a Safe Asset” Dormant for the Time Being

### Why “Buying JPY as a Safe Asset” Lacks Momentum – Short-Term and Medium/Long-Term Factors

#### ***Should We Still Believe in the Trend of “Buying JPY as a Safe Asset”?***

In October, global stock markets led by the U.S. stock markets saw many major phases of correction, but USD/JPY decline was limited. In recent years, we have often heard it said that the trends of “buying JPY to reduce risk” and “buying JPY as a safe asset” are no longer as robust as they once were, and USD/JPY movements this October appear to have proven that theory right. In October, I visited South Korea and had meetings with the monetary authorities there, and I got the impression that they were very interested in this theory. Many market participants share the view that the U.S. economy is approaching its peak, and their big question now is whether or not to believe in “JPY as a safe asset” when considering transaction strategies post the peaking of the U.S. economy.

Going forward, if JPY is not investors’ preferred currency after the U.S. economy slows down and stock markets enter proper correction as a result of the Fed’s rate hikes, then greater interest will be directed at European currencies such as EUR or GBP as alternatives to JPY. Oversold emerging currencies could also similarly draw attention. I think the reason so much attention is being focused on the question of whether or not to believe in JPY as a safe asset is because this is the “off season” for the economy.

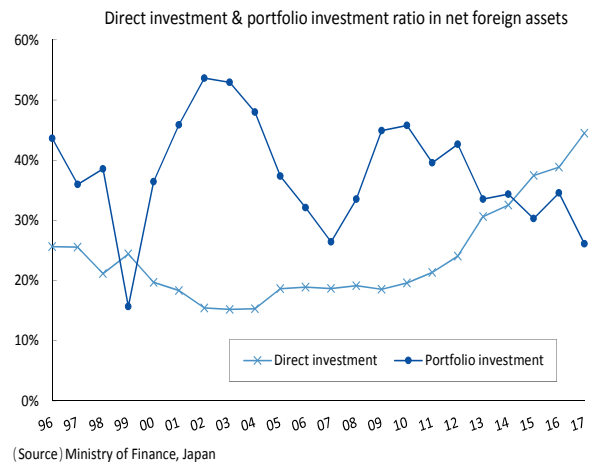
#### ***Two Reasons Why “Buying JPY as a Safe Asset” is Lacking Vigor***

To begin with the answer, I still think “buying JPY as a safe asset” is a valid move. The reason this trend is not currently vigorous is because the situation does not yet warrant it, not because of any change in JPY’s strong fundamentals (Japan has world’s largest net external assets and a unique fund-flow structure supporting the issue of government bonds as domestic loans). Two short- and medium/long-term reasons can be thought of why JPY buying is currently lacking vigor. The latter is both medium/long-term as well as structural.

The short-term reason is that a significant number of market participants feel that they cannot aggressively sell a currency for which rate hikes have been announced (USD). One of my clients said to me, “I understand the logic behind JPY eventually appreciating against USD, but one needs courage to sell a currency for which rate hikes have clearly been announced.” I fully understand the sentiment. As of the present time, USD is the only key currency that offers an interest rate, and given the difficult global investment climate, investors cannot afford to ignore USD. On the other hand, the moment the FOMC statement (or Fed Chair Jerome Powell at his press conference) hints at the possibility that the “next move” may not be a rate hike, forex rates will make an about turn. This is a point I have repeatedly explained in this report. Triggers for such a hint to emerge could include turmoil resulting from the flight of funds from an emerging market, a major U.S. stock market correction as a result of a rate hike, or the U.S. economy itself slowing down – at the current time, it is simply that none of these factors are severe enough to compel the Fed to change its basic stance. The reason USD/JPY has not risen much despite the major stock market correction is because many market participants assume that stock prices will eventually bounce back, and this has, in fact, happened. However, it is logically impossible to assume that the economic and financial situations will remain robust despite an increase in the federal funds (FF) rate. The short-term reason is, naturally, “short term” and does not negate the status of JPY as a safe asset.

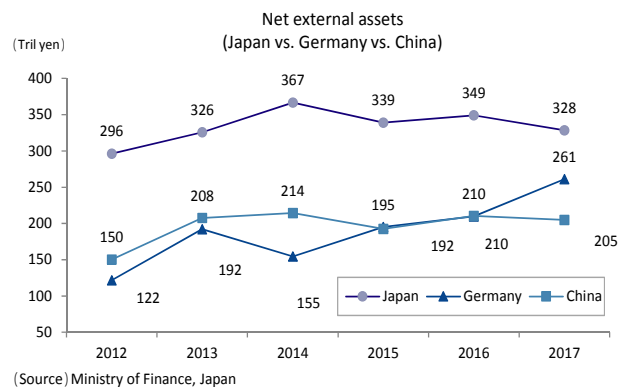
### Gradually Changing Asset Structure of the “World’s Largest Net External Creditor”

On the other hand, there is also a medium/long-term plus structural factor that may make it progressively more difficult to buy JPY. I have discussed this point also in this report before, but the fact that Japan’s external credit structure is changing is also important when considering forex supply and demand. As you may know, the main reason JPY is considered a safe asset is because of Japan’s status as the world’s largest net external creditor – a status it retained for the 27<sup>th</sup> year in a row at the end of 2017. Buying JPY as a safe asset is predicated on the assumption that in a crisis, (a portion of) the enormous external assets can be repatriated to Japan, leaving aside the question of whether such a situation would actually occur. This was a logical assumption at one time, when securities were the largest component of Japan’s net external assets. The idea is that during phases of an increase in risk, there are moves to curb forex risk exposure, which results in JPY appreciation.



However, as the graph shows, the largest component of Japan’s net assets now is no longer securities but direct investment – more specifically, the acquisition of foreign corporations by Japanese companies through cross-border M&A. When securities were the largest external assets, it was easy to imagine that the funds would be repatriated in a crisis, and this was something that was quite possible in reality too. However, it would not be quite as easy in the case of direct investments. Not that many Japanese companies would be willing to sell off the foreign companies they have acquired simply because of the intensification of a risk-reduction stance. To put it bluntly, the ratio of “outright sold-off JPY” may be increasing within Japan’s net external assets, and one estimates an increase in assets that are retained in the form of foreign currency without being converted to JPY. My theory is that this structural change in external credit may be dampening the buying of JPY as a safe asset.

There is one other fact worth noting with regard to Japan’s external credit structure. It is the fact that Japan’s net external assets are no longer far larger than every other country’s net external assets as they once had been. As the graph shows, Japan is still the world’s largest net external creditor, but Germany has been slowly yet steadily catching up. Given that Germany is blessed with a perennially undervalued currency and continues to add to its current account surplus, it seems inevitable that Japan will lose its “world’s largest net external creditor” status to Germany in the not-so-distant future. When this happens, it will be an important change in the climate affecting JPY outlook discussions. Having said that, the loss of its status as the world’s “largest” net external creditor will not change the fact of Japan’s enormous net external assets, so it is farfetched to suggest that losing the status would undermine the buying of JPY as a safe asset. i



### Inability to Respond to U.S.-Japan Interest Rate Gap is a Problem

I would like, rather, to focus on the fact that a continued rise in USD/JPY seems difficult despite the ongoing unilateral expansion of the U.S.-Japan interest rate gap. This may be indicating that a large number of market participants are conscious of the impending “turning point” and feel unsafe buying into optimistic scenarios behind the Fed interest rate hikes and rising U.S. Treasury yields. My belief is that the “buying JPY as a safe asset” trend is merely dormant at the moment in preparation for what lies ahead. To say that it has expired as a phenomenon is going too far.

## U.S. Currency and Trade Policies vs. Forex Rates – Heightening Wariness of China and Calls for a Currency Provision

### China Singled Out Among Countries on the Monitoring List

On October 17, the U.S. Department of the Treasury published its semiannual “Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States” report (hereafter: “Macroeconomic and Forex Report” or “Report”). Once again, no country was declared a “currency manipulator,” but as before, six countries were on the list – China, followed by Japan, South Korea, India, Germany, and Switzerland (see chart below). Simply being put on the list does not signify sanctions against a country, but it means that the country will be targeted for examination again over the next six months. Of the six countries, Japan and Germany (euro area) will also have to face trade negotiations. China, Japan, South Korea, and Germany are the four original members who have been on the Monitoring List ever since

it was started in April 2016, and these four countries also tend to consistently be targeted for criticism by the administration of U.S. President Donald Trump. To be included in the list, a country has to meet at least two of the following three criteria: (1) a significant bilateral trade surplus (of at least USD20 billion) with the United States, (2) a material current account surplus (at least 3% of GDP), and (3) persistent, one-sided intervention in which net purchases of foreign currency are conducted repeatedly (and total at least 2 percent of an economy's GDP over a 12-month period). If all three conditions are met, the country is declared a "currency manipulator."

Note that China only meets condition (1), but has been placed on the list because it "accounts for a large and disproportionate share of the overall U.S. trade deficit." This was a move backed by the Trump administration's evaluating axis for currency and trade policies, namely the size of a country's trade surplus with the U.S. One gets the impression that the structure of the latest Macroeconomic and Forex Report has been changed to take more clear aim at China. Until last time, assessments of China, Japan, Germany and other countries on the list had been outlined in the "Treasury Assessments of Major Trading Partners" subsection within the "Executive Summary" section. This time, the "Executive Summary" section included two separate subsections, one titled "Treasury Conclusions Related to China" and the other titled "Treasury Conclusions Related to Other Major Trading Partners," singling out China for special treatment even among the countries placed on the list. This change in the structure of the report comes as no surprise given reports that President Trump had insisted right up to the publication of the report that China be declared a "currency manipulator" (in fact, some conjecture that this was what caused the delay in the report's release this time). Being included on the Monitoring List is the step before being declared a currency manipulator, but singling out China seems to indicate that China stands out even among the countries on the list.

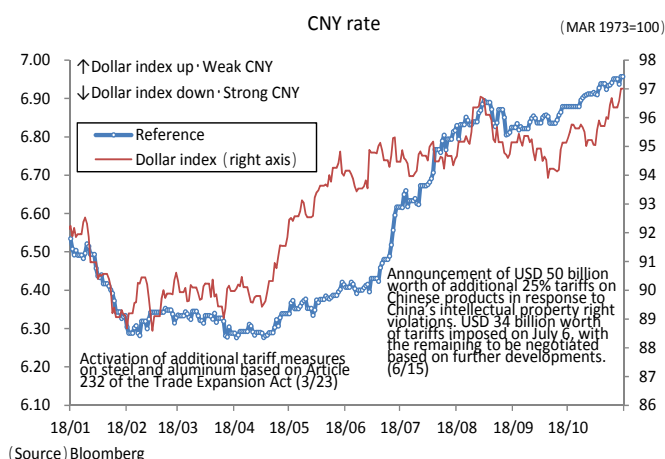
Monitoring list 3 conditions (Highlighted countries are on the monitoring list as of OCT 2018)

	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	390	0.5%	-2.3%	68	0.0%
Mexico	73	-1.6%	0.3%	-20	0.0%
Japan	70	4.0%	1.8%	198	0.0%
Germany	67	8.2%	0.0%	329	-
Italy	32	2.8%	1.0%	57	-
India	23	-1.9%	-0.6%	-50	0.2%
S.Korea	21	4.6%	-2.3%	73	0.3%
Taiwan	17	14.3%	1.4%	85	1.2%
Switzerland	17	10.2%	0.0%	72	2.4%
France	16	-0.6%	-0.2%	-16	-
Canada	15	-3.1%	0.0%	-53	-
U.K.	-7	-3.5%	1.5%	-98	-
Brazil	-9	-0.7%	3.5%	-14	-2.0%
<b>Euro-zone ( )</b>	<b>143</b>	<b>3.6%</b>	<b>0.7%</b>	<b>486</b>	<b>0.0%</b>

(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 JUN 2018 for a year.

### Angered by RMB Depreciation

Let us take a look at what the "Treasury Conclusions Related to China" says specifically. Until last time, the Report mentioned a "major trading partner that accounts for a large and disproportionate share of the overall U.S. trade deficit," a phrase clearly directed at China (even though the country was not overtly mentioned by name). The latest report retains this phrase but additionally includes language such as, "China continues to warrant placement on the Monitoring List of economies that merit close attention to their currency practices," and "Treasury is concerned about the depreciation of the RMB and will carefully monitor and review this determination over the following 6-month period, including through ongoing discussions with the PBOC." This is followed by criticism of China's trade surplus with the U.S., which amounts to as much as USD 390 billion (for the one-year period through June this year). It is obvious that the U.S. administration is finding it



(Source) Bloomberg

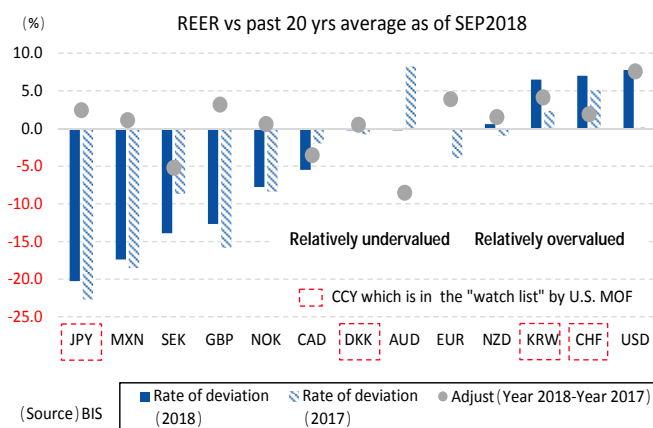
quite hard to palate the depreciation of RMB since June this year. RMB's depreciation may partly be a reflection of China's fundamentals, but given that the currency began to weaken steeply starting mid-June, coinciding exactly with the Trump administration's announcement of additional trade sanctions against China for violating intellectual property rights based on Section 301 of the U.S. Trade Act, circumstantial evidence suggests that willful currency manipulation cannot be completely ruled out. By and large, it looks as though USD has appreciated against RMB during the period from July through September (see graph), so it is not surprising that the Treasury Department feels that China has used currency devaluation as a card in its trade war with the U.S.

### JPY Still Seen as Undervalued Despite no Explicit Mention

In connection with JPY, there was no mention this time of the fact that JPY's "real-effective rate is nearly 25 percent below its 20-year average," a phrase that had been present until the previous report. Considering that EUR is clearly stated to be "about 1 percent below its 20-year average in real effective terms and around 4 percent weaker on a nominal bilateral basis against the dollar versus its 20-year average," it is somewhat disconcerting that JPY's significantly larger and persistent divergence from the average would be deleted from the report.

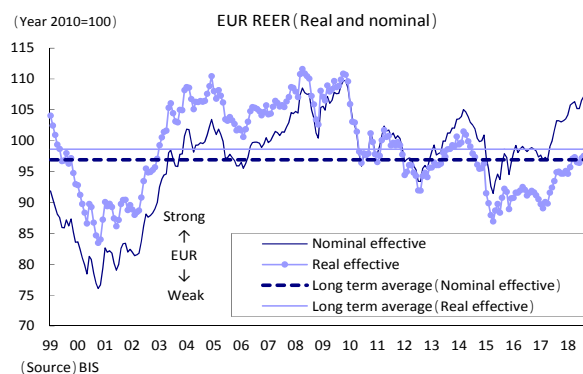
However, this is not to be interpreted as a change in U.S. authorities' understanding of JPY's undervaluation, because the "Foreign Exchange Markets" section at the beginning of the report mentions that "the IMF judges that the dollar is moderately overvalued on a real effective

basis" and clearly states that "real effective exchange rates across the United States' major trading partners have generally not moved in a direction that corrects for pre-existing misalignments" (note that a similar statement was found in the previous report too). In the context of "pre-existing misalignments," there is no room for doubt that JPY is a seriously undervalued currency (see graph on previous page), and there has been no change in this situation over the past year. As of September this year, JPY's REER is approximately 20% weaker than its 20-year average.



### Strong Feelings Regarding the Euro Area and Germany

Incidentally, the Foreign Exchange Markets section also acknowledges that EUR "has risen on a real-effective basis" due to its appreciation against TRY and other Eastern European currencies. This is something I have discussed in past issues of this report and also a matter of interest at ECB Governing Council meetings. As the graph to the right shows, contrary to the impression created by the decline in EUR/USD, EUR has continued to appreciate on a real effective basis this year, and has achieved a significant upward divergence in nominal effective terms. Having said that, EUR has weakened against USD, and given that the euro area and Germany also have the world's largest current account surplus, they are unlikely to be dropped off the Trump administration's radar. In fact, the euro area and Germany are at the receiving end of some fairly blunt criticism in the country/region-wise assessments.



The Report notes that growth varies widely across member countries and points out that "the euro's exchange rate appears undervalued for some of the strongest-performing individual member countries in the currency union (e.g., Germany)" due to this. The IMF External Sector Report has been quoted in several places in the Report, noting that "the IMF estimates that Germany's external position remains substantially stronger than implied by economic fundamentals, and Germany's real effective exchange rate undervalued by 10-20 percent." The 2018 External Sector Report indicates that an appropriate current account surplus for Germany would be around +5.0% of GDP, but in reality, it is as high as +8.0%, giving it an overall assessment of "substantially stronger." Led by the German current account surplus, the current account surplus of the euro area as a whole is also increasing, so, as the Macroeconomic and Forex Report points, the IMF has, "for the first time," upgraded its overall assessment of the euro area's external position from "broadly consistent" to "moderately stronger."

However, as is widely known, a large part of the German economy's strength is due to the euro area's structural defects, so Germany cannot be held fully responsible either. The Report does mention in this regard that "Treasury recognizes that Germany does not exercise its own monetary policy and that the German economy continues to experience strong gains in employment (rather than simply benefiting from external demand)." But it goes on to say, "Nevertheless, Germany has a responsibility as the fourth-largest economy globally to contribute to more balanced demand growth and to more balanced trade flows," which is a somewhat painful argument. Given that Germany has a robust domestic economy and a weak domestic currency through omission rather than commission, there seems no justification for criticism. It is fully the ECB's

decision to keep EUR weak, and there is no justification for criticizing Germany given that the country actually wants monetary tightening. Until recently, German domestic demand was weak and this was often used as a reason for criticism, but at the moment, there appears to be a domestic asset market bubble in Germany, so at the very least, there seems no scope for further improvement in the employment market.

Under such circumstances, all the U.S. can ask Germany to do is to agree to the issue of Eurobonds or the establishment of a euro area finance ministry, both of which are grand and large-scale ideas that have been around for some time, in order to promote a smooth income transfer within the region. From the Report this time, one gets a strong sense that the U.S. is at a loss how to deal with Germany – the impression that Germany will remain invincible as long as it remains in the euro area was strengthened.

### ***Calls for a Currency Provision as per the Script***

Incidentally, following the October 13 G20 Meeting of Finance Ministers and Central Bank Governors held in Bali, Indonesia, U.S. Secretary of the Treasury Steven Mnuchin told the press that one of the objectives of the new Trade Agreement on Goods (TAG) negotiations with Japan would be to bring up currency issues, making it clear that the U.S. intends to include a provision to deter currency manipulation in its agreement with Japan as well. The vagaries of U.S.-Japan trade talks have consistently been the focus of market attention since the inauguration of the Trump administration – this is because of the expectation that currency issues would at some point be brought to the negotiating table.

A provision to deter currency manipulation by implementing retaliatory tariffs and other countermeasures in response to currency devaluation attempts aimed at improving export competitiveness by a trading partner has been clearly included in the text of the United States-Mexico-Canada Agreement (USMCA), which is the new version of the NAFTA deal. As per the deal, if any of the parties to the agreement suspects another party of currency devaluation, unless the situation is resolved through mutual discussion within 60 days, the matter will reportedly be referred to a panel for a hearing. If the panel acknowledges that currency manipulation has taken place, retaliatory tariffs and other measures will be approved.

Meanwhile, the revised U.S.-Korea Free Trade Agreement was signed by the heads of both states on September 24, but the currency provisions included in this agreement are still being disputed. The White House statement issued on the occasion of the signing stated that “Outside the context of KORUS, the Treasury Department has an understanding with South Korea to avoid competitive devaluation and practices that provide an unfair competitive advantage.” The South Korean government, meanwhile, expressed the view that the currency provision was a separate matter from the U.S.-Korea FTA and denied that there had been any new agreements on the currency issue. We heard in March this year that the currency provision would be an ancillary agreement without legal binding force, and as of the current time, the official document for this ancillary agreement has not yet been published. Unlike for Canada and Mexico, a decline in export competitiveness as a result of currency appreciation could become a matter of life or death for the South Korean economy, so the dispute surrounding the currency provision is unlikely to be resolved easily.

Going by South Korea’s experience of apparently having an agreement imposed on it unilaterally, it is not surprising that a call for the inclusion of a currency provision was made in connection with the U.S.-Japan TAG negotiations. Japan’s Minister for Economy, Trade and Industry and for Economic Revitalization, Toshihiko Motegi, categorically denied that any demands for a currency provision had been made in the joint statement related to the TAG negotiations put together at the September U.S.-Japan summit meeting, but then the same was true of the U.S.-Korea FTA too.

Mr. Mnuchin emphasized in his press statement that “We’d like to include (currency provisions) in future trade agreements. With everybody. I’m not singling out Japan on that.” In a way, it sounds like an admonition of Japan, but then one could also say that the U.S. is acting as per the script, i.e., not singling out Japan. This is simply one of the basic actions of the Trump administration. Of course, it is quite exceptional for a country to openly intervene in the currency policies of a sovereign with a floating exchange rate system, but one has to admit that this is something that feels it was bound to happen.

### ***A Currency Provision by Itself is not a Problem***

Similar to the processes outlined in the USMCA, even in cases where sanctions based on the currency provision are warranted, several hurdles are likely to be put in place before they can be brought into effect. However, going by President Trump’s words and actions leading to this turn of events, one is concerned that groundless claims of unfair currency manipulation could be used to arrive at the decision to impose punitive tariffs or to compel the currency in question to appreciate to levels deemed acceptable. There is absolutely nothing unjust about the objective of the currency provision, namely to prevent currency intervention and other forms of competitive currency devaluation, so one has no grounds for objecting to the provision itself. The problem is with the character of the administrators who invoke the provision, and in this respect, it would be correct to assume that the Trump administration has a lot to be anxious about.

In this context, one must not forget that the Treasury Department had been taking a rather strict view of JPY even before the Trump presidency, and the view that JPY’s REER is about 20% weaker than its long-term (20-year) average has remained unchanged since Mr. Trump took office. As I mentioned in connection with a previous graph, JPY’s REER is indeed about 20% weaker than its long-term average. That this was not overtly mentioned in the October Macroeconomic and Forex Report does not change the facts, so it seems natural to expect U.S. authorities to express their dissatisfaction with JPY rates at the upcoming TAG negotiations.

What is worse, of the three key global economies (the U.S., Europe, and Japan), Japan is much further behind the other two in its monetary normalization efforts. Therefore, it is important to keep in mind that any criticism of JPY weakness could immediately segue into a criticism of Japan’s monetary policy. Once monetary policy becomes involved, the forex markets are certain to respond impulsively (JPY will appreciate as market participants anticipate a shrinking of monetary



accommodation). From Japan's perspective, this is probably one thing that should be avoided if at all possible.

### ***The More Defensive One Is, the More Obvious One's Weakness***

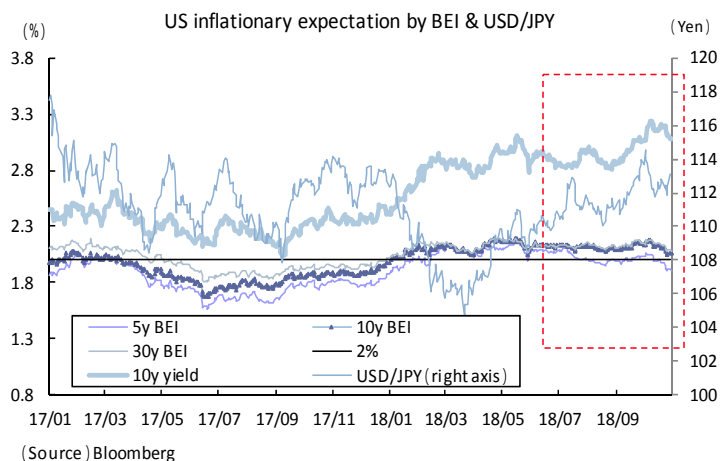
However, the Trump administration's real goal may be to make some practical trade-related gains by dangling the treat of a currency provision rather than introducing the provision itself. The idea that Japan does not have any trade-related concessions to offer the U.S. thanks to the history of trade friction between the two countries is nothing more than hearsay. It is precisely because the Trump administration knows this that it had to come up with a card it could play that would be painful enough for Japan to compel it to make concessions at the TAG negotiations when threatened with it. Specifically, the U.S. has many concessions it would like Japan to make, including greater imports of agricultural products and defense equipment from the U.S., the regulation of Japanese car exports to the U.S., and the abolition of non-tariff trade barriers, and U.S. authorities are well aware that "currency" is the most effective card they can play in order to get these concessions. As is widely known, Japan has frantically tried to keep the "trade" and "currency" issues separate right from the start, and many market participants including myself have accepted without question that this is the best strategy. However, it is also true that the more defensive one is about something, the more obvious it becomes that that is one's weakness, giving one's opponent an easy target for attacks. One could say that this is a turn of events that Japan has invited through its unusual attachment to currency policies among the developed economies.

Of course, even if the currency provision is enforced, it would not necessarily impact JPY rates right away. The provision is simply a card for the U.S. to ensure that the TAG negotiations turn out to its advantage, so it would be inappropriate to make a big hue and cry simply based on the introduction of the provision. However, it is important to keep in mind as a potential risk-off factor that, depending on how things go, monetary policy may also be impacted.

## **U.S. Monetary Policies Now and Going Forward – Dangers of the Fed Being Drunk at the Sight of Its Own Reflection**

### ***Fed Drunk at the Sight of Its Own Reflection***

Despite stock prices becoming volatile at higher levels and undisguised interference from President Trump, the Fed shows now sign of suspending its rate hikes. Far from suspending them, going by the minutes of the FOMC meeting (of September 25-26) published in October, one actually gets the impression that the Fed may be aiming for an even higher rate hike goal. The gist of the minutes was the following: "estimates of the level of the neutral federal funds rate would be only one among many factors that the Committee would consider in making its policy decisions," and, as already mentioned, this caused U.S. interest rates to go up. The U.S. 10-year Treasury yield has surpassed 3% and jumped to the 3.2% level since late September due to increasing number of market participants believing the Fed to



(Source) Bloomberg

raise interest rates beyond the neutral rate level, and share prices have become volatile in this process accordingly. As I have repeatedly said in this report, in the past phases of rate hikes, the ceiling of 10-year Treasury yields has been the presumed "end point of rate hikes." In the current rate-hike phase, many had assumed that the neutral interest rate outlook (median value) of 3.00% would serve as the end point of rate hikes.

However, once the Fed declared that the neutral FF rate level was merely "one among many factors" it would consider, there was no reason for the 10-year Treasury yield to stop at 3.00%. Some are even beginning to suggest the revival of "term premiums," which had disappeared during the long phase of monetary accommodation, so it seems the U.S. financial markets are preparing to accept the rise in U.S. interest rates. Under such circumstances, leaving aside the question of whether such a policy is good for the U.S. and ultimately the global economic and financial situations, the plain fact of the matter is that U.S. interest rates will rise toward a new end point that is different from the neutral interest rate level. As I have discussed in this report in the past, the recent increase in U.S. interest rates is undeniably attributable at least in part to what the Fed has been saying, not because of an acceleration in inflation expectations (see graph). Perhaps the Fed looks at market interest rate trends and congratulates itself on its communication strategy, but the trend it is seeing are merely a reflection of its own actions, not the state of the actual economy. Of course, if the current state and future outlook of the economy as assumed by the FOMC were to be completely accurate, "seeing a reflection of its own actions" is not a bad thing, but in reality, things are never that simple. Ideally, therefore, the Fed would take the markets' feedback (response) into consideration while regarding its own view of the economy with a measure of skepticism. In this sense, there is equally a problem with the markets blindly accepting the Fed's communications as true, but perhaps because the economic and financial situations continue to be relatively good, no particular need for suspicion is currently felt. However, the effects of monetary policies tend to be manifested with a time lag, so it is rather irrelevant how good or bad the current situation is.

### ***Skillful Adjustment of Asset Prices not Guaranteed***

If the Fed persists with rate hikes based on the reflection of its own actions in market trends, one of the things to worry about, naturally, is an overkill. The September FOMC meeting minutes clearly state that “in their discussion of developments in financial markets, a number of participants noted that financial conditions remained accommodative.” The minutes indicate these participants’ understanding that “the rise in interest rates and appreciation of the dollar over the intermeeting period had been offset by increases in equity prices.” Based on this, the minutes note regarding future policy operation that “further gradual increases in the target range for the federal funds rate would most likely be consistent with a sustained economic expansion, strong labor market conditions, and inflation near 2 percent,” appearing to emphasize projections of one more rate hike within the year, three rate hikes next year, and one rate hike the year after next. The current “gradual approach” is stated to balance “the risk of tightening monetary policy too quickly” against the “the risk of moving too slowly,” and thought to contribute to preventing “a buildup of financial imbalances.” Essentially, one gets the impression that the Fed has no intention of discontinuing its rate hikes.

The above discussion merely looks at the key points in the minutes, but one feels that there is a partial contradiction between the Fed's view that strong share prices are offsetting the negative effects of the rise in interest rates and USD appreciation caused by its rate hikes, and its view that it must conduct further gradual rate hikes in order to prevent a buildup of financial imbalances.

This “financial imbalances” refers to a situation where asset prices rise to levels requiring sudden sharp adjustments, i.e., a bubble. In other words, one of the significant aims of the present rate hike policy is to reign in soaring asset prices. However, if the rise in asset prices plays the role of offsetting the negative effects of the rise in interest rates and USD appreciation as per the Fed’s own view, then continuing with rate hikes would amount to sabotaging that advantage deliberately. Of course, that need not be so if asset prices could be adjusted precisely to just the right levels, but historically, it has often happened that central bank policies aimed at fine-tuning asset prices do not go well. The end of the current phase is predicted to begin with the plummeting of stock prices due to rate hike concerns, and some believe that the Fed would not mind that happening.

## **Risks to My Main Scenario – Warning Bells Sounded by Volatility at Higher Levels**

### ***Volatility at Higher Levels Warning of Overkill***

At this point, I would like to review the risk factors related to my main forecast scenario. Despite the intermittent incidence of considerable financial asset price adjustments centered on stock prices during October, the financial markets have retained faith in their major assumption that the Fed’s normalization process will gradually continue, so the price adjustments had no impact on most of the assumed risk factors (see table). However, the strengthening of the ‘volatility at higher levels’ trend seen since the beginning of October in the U.S. stock market as well as other stock markets throughout the world does appear to reflect a basis for concern about policy overkill on the part of the Fed (risk factor ). Many observers are inclined to point out the similarities of the current trends to those associated with the ‘VIX shock’ in February, but in light of the progressive adjustment of price-earnings ratios at this point, it seems more correct to conclude that the situation may be one that purely reflects the effect of excessive interest rate hikes in forcing the adjustment of asset prices.

In addition, risks related to Europe (risk factor ) have been further increasing in their prominence and are cause for concern. At this point, it is generally understood that the Brexit scenario in which the U.K. leaves the EU without an agreement (a ‘no deal’ scenario associated with ‘cliff-edge’ risk) is no longer merely a ‘tail risk’ but must be assumed to be a realistic possibility, and I have been receiving a growing number of inquiries about what will happen in the case of such a ‘no deal’ scenario. Although, in realistic terms, the reaching of a mutual agreement seems the most likely and the possibility of extending the negotiation period seems second most likely (obtaining the agreement of all the member countries would be necessary to extend the negotiations), as the deadline approaches, the ‘cliff-edge’ risk cannot be disregarded when considering the overall risk scenario. In addition, at the time this article was written, the determination of Italy’s new populist government to create an expansionary budget for the upcoming fiscal year remained undiminished. It is technically possible for Italy to insist on passing its budget bill while disregarding the advice of the European Commission (EC), which could have a devastating impact on the EC’s authority as the EU’s executive branch. It is probably inevitable that any scenario of this nature will augment anxieties in a manner that promotes EUR depreciation. Risk factors and seem to have nearly become realized during October, but as already discussed, the situation has not caused a trend of progressive JPY appreciation in the forex market. It appears that this is because the situation is not considered sufficient to induce a change in the Fed’s fundamental posture.

## Potential Risks to the Main Scenario

		Risk Factors	Remarks	Direction
US		Economic policy by President Trump	· Political intervention in monetary policy and sharpening of protectionism, especially complication of TAG negotiation between US &	Strong JPY Weak USD
		Continual excessive monetary tightening by FRB	· Impact by tightening to inside & outside US, in short, fear of stock prices plunge	Strong JPY Weak USD
		Stronger-than-expected US economy	· Surprisingly Goldilocks continue	Weak JPY Strong USD
Japan		FX risk-taking by Japanese investors	· From hedged to unhedged position expansion? · Increasing cross border M&A continuously	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	· Conflict intensified between Italy and European Commission · Conflict intensified about Brexit negotiation · Fluidization of political situation due to Chancellor Merkel's resignation	Strong JPY Weak USD

(Source) Daisuke Karakama, Mizuho Bank

### **Continued Presence of Trump-Related JPY Appreciation Risk**

Of course, in addition to U.S.-China trade frictions, there are strong risk factors associated with other elements of President Trump's economic policy, such as the president's blatant political intervention in monetary policy (risk factor ). The significance of the fact that half of U.S. imports from China have been subject to additional tariffs since late September should not be underestimated. The reason this does not yet appear to have had a major impact on the real economy can be explained in terms of two factors – (1) not much time has passed yet and (2) there has been a remarkable trend of RMB depreciation against USD. Owing to market participants' hedging activities and other situations, one can anticipate that there will be a time lag between the emergence of forex and tariff factors (as well as non-tariff trade barrier factors) and the full impact of such factors. While the IMF and individual countries' financial authorities have unanimously indicated that a trade war is the biggest economic risk factor at this point and have been seeking to calculate the potential impact, the markets' reaction has been limited to an evaluation that a US-China trade war will not be particularly harmful – my basic understanding of this is that the markets are simply overconfident and thus not giving sufficient attention to the situation. Going forward, the United States has plans for additional trade restriction measures including the imposition of supplementary tariffs on USD267 billion of Chinese exports and the imposition of 25% tariffs on imported cars, including those from China. If all these measures were to be implemented, it will be impossible to consider their impact on the real economy to be small.

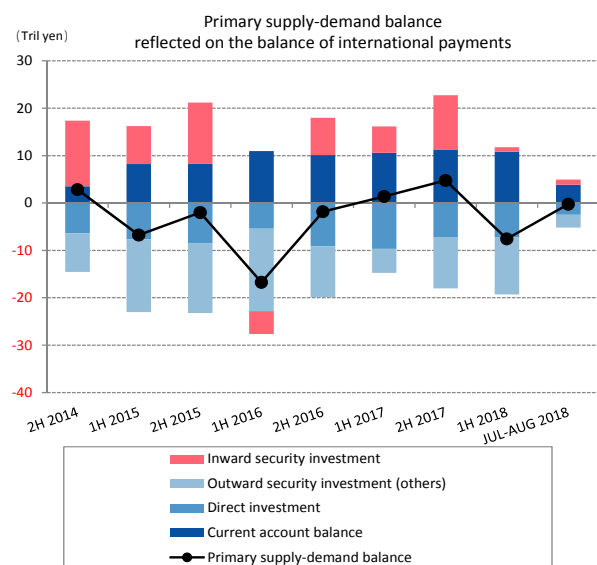
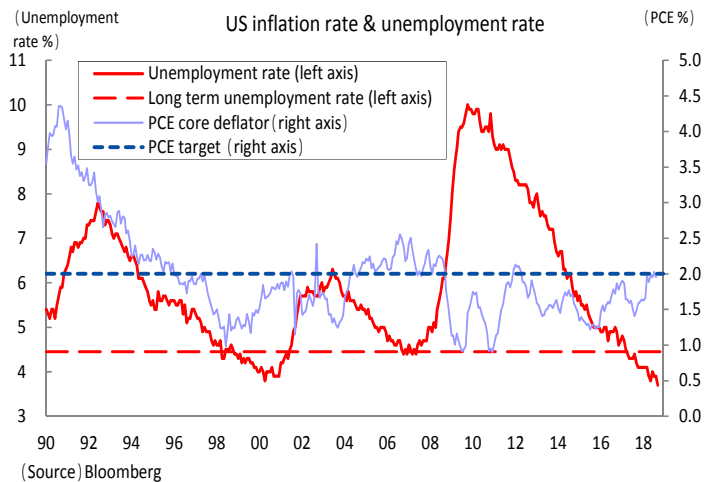
In addition, President Trump has since late July clearly expressed his dissatisfaction with the Fed's policy management, which has become normalized since early October. The troublesome thing is that the recently repeated bouts of stock price adjustments are strengthening the legitimacy of statements in opposition to further interest rate hikes. Although this is unlikely to affect the Fed's behavior, it is worth noting as an extremely minor risk factor that might possibly eventuate in the unlikely event that it could exert an impact by means of such situations as Fed-related personnel decisions. It is currently being reported that president Trump's stance is that he would not move to dismiss a Fed governor simply because he is disappointed in his or her performance, but if the Fed were to continue on its current route despite protracted stock price adjustments, it would be unrealistic to completely deny the possibility that the president might consider the situation to have attained a new phase that justifies a different stance. Although economic indicators continue to be strong, it can be said that the Fed's policy environment is becoming cramped from both monetary and political perspectives. As another ramification of President Trump's currency and commerce policies, it goes without saying that the direction of Japan-U.S. "free, fair and reciprocal" (FFR) trade dialogue meetings will continue to draw great attention, particularly regarding their potential impact on USD/JPY. As noted above with respect to the Trade Agreement on Goods (TAG) negotiations, U.S. Treasury Secretary Steven Mnuchin has articulated his fundamental position that there is a need for a TAG provision to deter currency manipulation. To the extent discernable based on recent information leaks, the Japanese side is not at all inclined to accept this position, which gives the impression that the distance between the two sides' views is not small, so there is undoubtedly a possibility that the negotiations will become quite arduous when they are begun.

## JPY Depreciation Risk Stemming from Surprising Level of U.S. Economic Resilience

In any case, since this article's JPY appreciation scenario forecast has not yet been realized, there is a need to seriously consider the potentially countervailing risk factors that could promote JPY depreciation. In line with the chart of risk factors shown above, this means examining risk factor . This is because the biggest factor impeding the JPY appreciation scenario anticipated by this article boils down to a mistaken assumption about the U.S. economy's resilience. In particular, I must admit that I previously had not thought it possible that the U.S. unemployment rate could fall to the level that it has. Just after the Bernanke shock, in June 2013, the long-term unemployment rate assumed by the Fed was 5.6%. The actual unemployment rate has now declined to 3.7%, and although the Fed has not articulated its perspective on this trend, I imagine that the Fed considers its overestimation of the long-term unemployment rate to be a "happy miscalculation". However, this particular misunderstanding of the U.S. economy has probably had only positive consequences, as this misunderstanding combined with the Fed's own desire to begin policy normalization to facilitate the normalization measures undertaken during the past 5 years (see graph on previous page). If the unemployment rate were to fall from 3.7% to below 3.5% and approach the 3.0% level, it can be expected that average hourly wage growth will steadily accelerate to above 3% yoy, and it can be anticipated that this will support a similar rise in the PCE deflator. In such a case, it will be necessary to prepare for the possibility that the U.S. 10-year interest rate will surpass the 3.5% level.

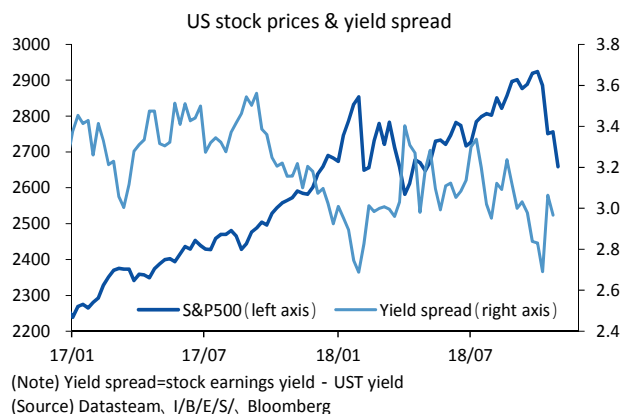
The emergence since early October of revised forex forecasts anticipating USD/JPY levels surpassing JPY120 is probably attributable to the rise of the benchmark 10-year Treasury note yield to above the 3.2% mark. In short, the level of JPY depreciation risk is largely determined by the degree of the U.S. economy's tenaciousness. Given that unemployment has already descended considerably below the natural unemployment rate level, however, I am quite resistant to expectations of a further decline in unemployment, and I believe the rational basis for such expectations is weak. But aside from analyses based on economic and financial indicators, one must keep in mind that, if the Republicans maintain control of both the Senate and the House of Representatives after the interim elections, there is a possibility of market trends similar to those seen following President Trump's inauguration. If the 'reflation trade' trend were to promote concurrent growth in stock prices, interest rates, and USD, one probably could not deny the possibility that USD/JPY might approach JPY120.

If such a belief in the U.S. economy's sustained resilience takes shape, it will become necessary to give additional attention to such a belief's potential for promoting Japanese institutional investors' risk-taking along with JPY depreciation (risk factor ). In fact, the JPY supply-demand environment continues to be characterized by net JPY selling and is therefore not supportive of JPY appreciation (see graph). Looking at the JPY supply-demand balance calculated based on international balance of payment figures during the first eight months of 2018, one finds that net JPY selling amounted to about -JPY7,812.0 billion. The concept that such a supply-demand environment is countervailing JPY appreciation is probably true to a certain extent. Despite being "a factor countervailing JPY appreciation", however, supply-demand cannot be considered powerful enough to be a "factor actually inducing JPY depreciation", and I do not believe it reasonable to create a JPY depreciation forecast scenario centered on this factor alone. In fact, when looking at foreign bond investments, the height of hedging costs relative to current interest-rate differentials may encourage some Japanese institutions to be open to the possibility of undertaking open (unhedged) investments, but it appears that most such institutions are averse to such risk taking and, as somewhat of a gradient is beginning to return to the JPY yield curve (and many forecasts anticipate a gradient restoration going forward), most Japanese investors are likely to be increasingly focused on JPY interest rates.



### ***Environment Not Conducive to a Global Rise in Stock Prices and Interest Rates***

In light of circumstances so far, I am maintaining my JPY appreciation scenario but consider the main risk facing that scenario to be risk factor \_\_\_\_\_. The United States' current protracted period of economic expansion will become the longest in U.S. macroeconomic history if it continues into next year and, given that the term employment/wage situation has already been considered to constitute a full-employment situation for quite some time, it does not appear advisable to create a forecast scenario based on anticipation of still more economic expansion. There is of course a possibility that such a continued growth scenario may actually be realized. The problem is that there is almost no basis at this time for rationally forecasting such a scenario. In both February and October, we have seen



stock price plunges occurring following surges in U.S. interest rates. Stock price adjustments appear to have been induced by U.S. 10-year interest rates' clear-cut surmounting of the 3% level in February and the 3.2% level in October. The possibility that interest rate rises forced stock price adjustments seems to be evident from an examination of movements in such indicators as the yield spread (see graph).

From November going forward, it appears likely that there will be numerous situations that reconfirm the very basic fact that "interest rate rises have a negative effect on stock price valuations," and my main scenario anticipates that the political, economic, and financial ramifications of those situations will effectively pressure the Fed to adjust its hawkish policies. My main scenario's fundamental assumption can probably be considered a very orthodox one. Moreover, the turmoil in emerging countries that has become serious since midway through this year is evidence that the world economy is unable to cope with the rise in U.S. interest rates. I would like to think that the Fed will have to give due attention to these issues during the forecast period.

On top of that, the Trump administration's currency and trade policies, which have long been cause for concern, can be expected to impede global economic expansion, and it is anticipated that political risk factors will sporadically elicit market shocks in such countries as Italy, the United Kingdom, and Germany. My basic understanding is that the upcoming environment is not one in which it is reasonable to expect a global trend of increase in stock prices and interest rates. This is a point that I have already been emphasizing for some time. At this point, however, when one takes into account that the FF interest rate has come to represent the cost of capital for not only the United States but for much of the rest of the world and that private-sector debt has expanded to an unprecedented level, it is difficult to avoid concluding that we are now experiencing a shift toward an extremely risky market environment. Based on recognition of this, I continue to believe that the scenario with the highest degree of likelihood during the upcoming year is that factors within and outside the United States will gradually make it increasingly difficult to justify further interest rate hikes, the FOMC will adjust its stance to become more neutral, and trends in U.S. interest rates and USD will become reversed. Consequently, it should not be very surprising to see an adjustment of USD/JPY downward to around the JPY100 level.

## EUR Outlook – The ECB’s Tenuous Bullishness

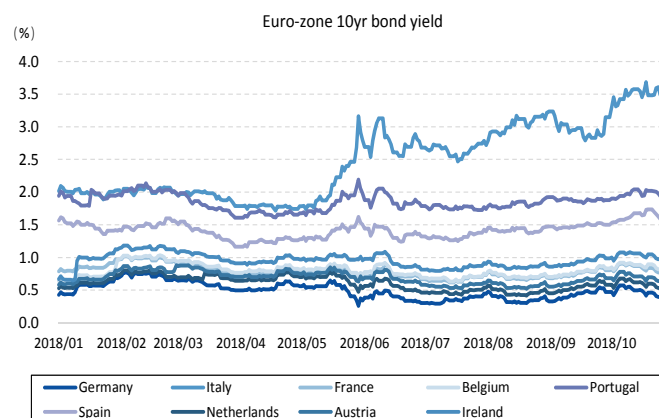
### ECB Monetary Policies Now and Going Forward – ECB Bullishness Subjected to Skepticism

#### **Markets No Longer Willing to Accept ECB’s Bullish Stance**

At the September ECB Governing Council meeting, it was decided to keep the interest rates on the main refinancing operations (MROs), the marginal lending facility (which is the ceiling of market interest rates), and the deposit facility (which is the floor of market interest rates) unchanged at 0.00%, 0.25%, and -0.40% respectively, thereby also maintaining the interest rate corridor (the difference between the ceiling and the floor) unchanged at 0.65pp. It was also confirmed that the expanded Asset Purchase Programme (APP) would continue at a pace of EUR 15 billion/month for the rest of this year and be discontinued at the end of the year. The ECB also seems determined to proceed toward implementing rate hikes from next summer onward – essentially, the Governing Council appears to have no intention to apply the brakes on its policy normalization process. What was interesting about yesterday’s meeting, however, was the reaction of the forex markets, which responded clearly to the ECB’s continued bullishness in word and action. The forex markets’ response pattern is the opposite of what it has been so far and seems to strongly resemble the response pattern seen during the European sovereign debt crisis period – signs of hawkishness in ECB stance cause insecurity and prompt EUR selling, while signs of dovishness invite a sense of security and prompt EUR buying. Simply speaking, the markets are no longer willing to accept a bullish stance on the part of the ECB, which makes it more difficult for the ECB to implement rate hikes or discontinue reinvestments. Some are interpreting the EUR selling as a reaction to the mention of “weaker” incoming information, but as we will see below, the ECB’s core message in yesterday’s press conference seems to have been that it has no intention of changing its fundamental policy stance despite the weakness of the incoming information.

#### **Hawkish Stance Met with Skepticism Even at Press Conference**

Questions at the press conference naturally focused on Italy. Given the rise in interest rates in southern European countries such as Spain and Portugal, there were questions about a possible risk of contagion or spillover. ECB President Mario Draghi’s response was that there were country-specific “idiosyncratic phenomena, facts, events” responsible for the rise in interest rates, and that the contagion was not to indiscriminate as seen during the sovereign debt crisis. To be sure, not just Italy, but Spain and Portugal are also battling their own political instabilities, making the current situation quite different from last time, when insecurities regarding the Euro system were the driving force (see graph).



(Source) Bloomberg

Having said that, the question here is whether it was

necessary for the ECB to deliberately reaffirm its hawkish stance given such circumstances, and it is important to note that skepticism regarding this among an extremely large number of market participants was what weighed down EUR. Another reporter asked, “There have been some concerns that weaker Italian banks could become capital impaired if the spread with German bonds reaches 400 basis points. Do you think that this could compromise the monetary transmission mechanism? If so, what tools do you see available for repairing that?” Mr. Draghi refused to entertain the question, responding, “I don’t have a crystal ball; I don’t have any idea whether (such a situation will occur when the spread reaches) 300 or 400 or whatever.” However, perhaps the reporter’s intention was to draw out a response regarding the continuation (increase in amount) of sovereign bond purchases. Since early October, the political situation in Italy has remained volatile, and this is undoubtedly the reason behind the rise in Italian interest rates, but one cannot ignore the fact that the ECB’s monthly purchases of government bonds halved (from EUR 30 billion to EUR 15 billion) starting around the same time. It appears that in addition to the forex markets, reporters are also beginning to be skeptical about the ECB’s stance.

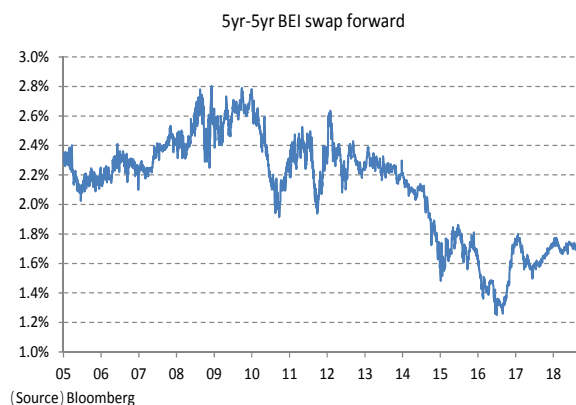
Incidentally, I have repeatedly criticized the European Commission’s unyielding and doctrinaire attitude regarding the Italian problem for distorting the situation. In this connection, one of the reporters asked “Do you sympathise at all with what Italy’s argument is; that it needs more budget flexibility, given also that its budget deficit is still planned to be below 3%?” Mr. Draghi’s response to this was, “I don’t know what to respond with that. We have the Commission; the Commission is the ultimate guardian of the Stability and Growth Pact, not the ECB.” However, it seems clear with regard to the present fuss, that many are critical of the EC and seek more flexibility in the interpretation of fiscal rules.

### The Probability of Discontinuing Reinvestments

There was considerable interest regarding whether or not reinvestment policies would be discussed at the October meeting. Mr. Draghi had mentioned following the September meeting that the issue would be discussed at one of the two remaining meetings of the year (October or December). In this regard, he said this time, “We didn’t discuss anything in this meeting so we’re going to discuss in the next meeting, where we’ll also have the projections, which will also cast some more light on what’s going to happen next.” This has inevitably raised the level of interest in the next meeting. Some reports state that internal discussions within the ECB have already begun, but no information has been made public as of the moment. Also, the once-in-five-years revision of the capital key will take place next year (in 2019), and it is expected that

Germany’s contribution will be increased while Italy’s contribution is lowered. One of the reporters asked, “What consequences does it have for the reinvestment programme next year?” Of course, Mr. Draghi’s response was that the matter had not yet been discussed at all, but it will be interesting to see how complicated matters, such as the effect of changes in the capital key at the time of purchase and at the time of repayment and the handling of government bonds that were not purchased in alignment with the capital key to begin with, are sorted out.

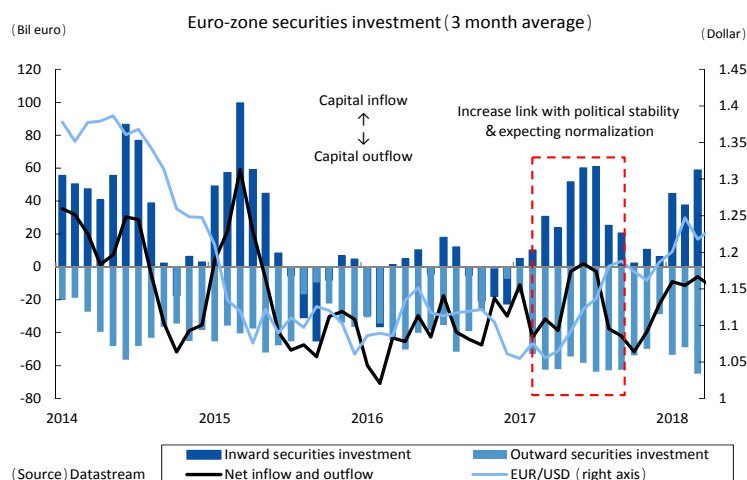
Having said that, the political situation in Italy may be a transient phenomenon that is soon resolved, but given that the regional economy is beginning to show signs of slowing down, pursuing discontinuation of reinvestments (exit from quantitative easing) in addition to interest rate hikes seems somewhat hasty. Except for the purpose of creating policy space for future requirements, there is no real need for it at the moment. Looking at the euro area Harmonized Index of Consumer Prices (HICP), for instance, while energy prices have been boosting the aggregate HICP, almost no acceleration is apparent in the core HICP (see graph to the right, top). Rather, the 5-year/5-year swap rate (breakeven inflation, BEI), which is an inflation expectation indicator traditionally monitored by the ECB, is showing strong signs of peaking out (see graph to the right, bottom). Judging by the fundamental economic and inflation climate, the situation certainly does not indicate a high probability of discontinuing reinvestments. Of course, the introductory statement mentions that reinvestments will be conducted “for as long as necessary,” so it seems unlikely that they will be discontinued without warning. As I explained in yesterday’s issue of this report, given the complex composition of its assets, the ECB is likely to first consider the methodology of discontinuing reinvestments, go on to think about the conditions for beginning the process, establish the pace at which it should proceed, and only then consider what would be an appropriate time to decide on discontinuing reinvestments. This may take at least until 2020 to implement, as the major task of starting rate hikes awaits the ECB next year.



## EUR Exchange Rate and Capital Flow Situation – Importance of Capital Flows as an Indicator

### Relationship between EUR Exchange Rates and Capital Flows

While such political factors as those associated with Italy, Brexit, and Germany are conspicuous EUR exchange rate drivers, in some respects, actual forex trends are obediently responding to trends in capital flows. The graph on the right shows trends in the euro area’s inward and outward securities investment from balance of payments statistics along with trends in EUR/USD. The year 2017 may be generally remembered as a period when EUR rapidly appreciated following ECB President Draghi’s Sintra speech (in June that year), but the direction of trends actually changed at the time of French Emmanuel Macron’s victory in the France’s presidential election in March. After having been very low from 2015 to 2016, inward securities investment has been recovering since

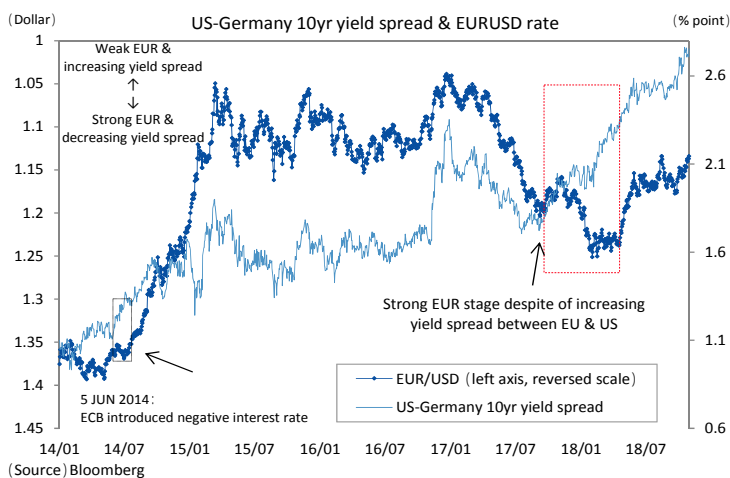


the start of 2017, and the chain of principal factors promoting this recovery can be roughly sketched as – “EU political stability & Sintra lecture → Increase in expectations of ECB normalization → expansion of inward securities investment from outside the region → EUR appreciation”. As the graph shows, during the first half of 2017, inward securities investment was clearly surging, and EUR was being buoyed up by that trend. The slackening of inward securities investment in the latter half of 2017 reflected the ECB’s statements (in response to EUR appreciation) suggesting that it

was not in a hurry to normalize its policies. The renewed rise of inward securities investment this year is attributed to the ECB's deletion of the easing bias in its forward guidance along with expectations that quantitative easing (QE) would be terminated during the year and expectations of an interest rate rise preceding that termination.

### EUR and Europe-U.S. Interest Rate Gap Shrinkage

However, the above graph also shows another noteworthy trend. Outward portfolio investment to outside the region has been consistently high, this was particularly true as EUR strengthened throughout 2017. Consequently, looking at net capital flows, one notes that there has not been a shift to a net inflow into the region – at most, there have been periods of supply-demand changes in which net flows became “almost neutral”. Ultimately, this reflects the facts that, while the ECB is not expected to commence its interest rate hikes until sometime in 2019 or later, because the Fed has continued dispassionately implementing rate hikes, it appears that shrinkage of the Europe-U.S. interest rate gap (represented by the U.S. rate less the German rate) reached a limit, and the ability of EUR/USD to rise was also limited (see graph).

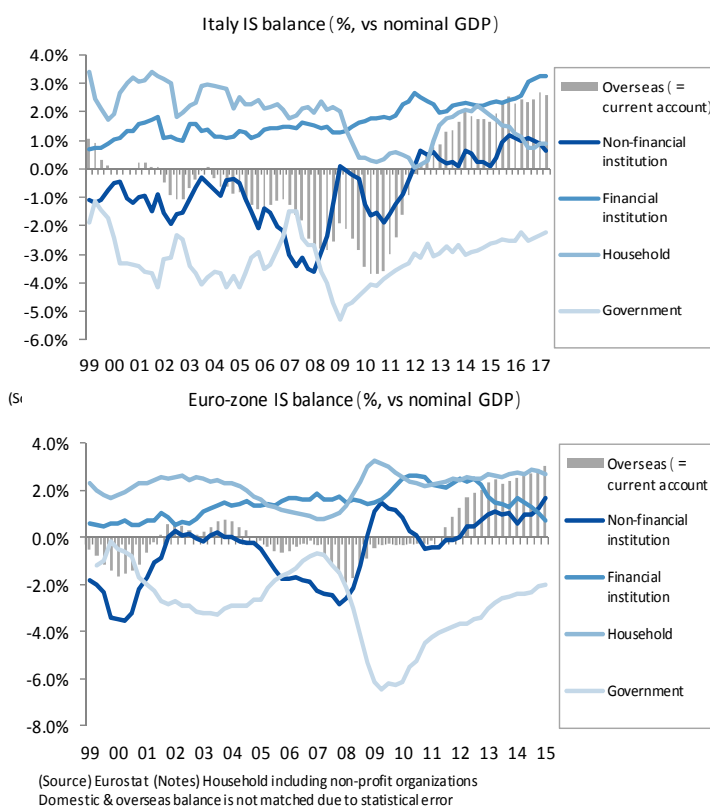


Looking at last year, the rise in EUR from the beginning of the year to the middle of the year was a trend that was consistent with the Europe-U.S. interest rate gap shrinkage trend, but the trend of EUR appreciation from the middle of the year to the beginning of 2018 against the backdrop of expansion of interest rate gap expansion trend was a kind of inconsistency or ‘disparity’ of trends. The trend of decrease in EUR/USD since the start of this year may be considered to be a correction of that ‘disparity.’ At the time this article was written, euro area international balance of payments statistics were available only for the period through July, but it seems likely that the euro area’s net capital outflow increased during August and September amid increasingly strong expectations regarding the Fed’s normalization process. So long as the euro area’s negative interest rate policy is not fundamentally eliminated, it appears that it will be difficult for EUR/USD to become stable at levels above USD1.20. While EUR forex rates are considered to be greatly affected by politics-related noise factors, EUR forex rates actually move in accordance with trends in such very fundamental factors as interest rates and as capital flows in line with interest rates, and this is an important point to keep in mind when creating forex forecasts.

## The Euro Area Economy Now and Going Forward – Euro Area’s Germanization

### IS Balance’s Germanization Effect

As expected, a dispute broke out between Italy and the European Commission in October regarding Italy’s budget for the upcoming fiscal year, causing a surge in Italian government bond yields and putting downward pressure on EUR. The Italian government is displaying a problematically defiant attitude about the flouting of its previously made commitments, but the European Commission’s sticking about rule enforcement is also somewhat problematic. The budget proposal drafted by Italy’s current populist government calls for a fiscal deficit that is not particularly extravagant, and it is not impossible to understand why Italy might consider it reasonable. Depending on one’s perspective, one might rationally question whether it is absolutely necessary to enforce strict fiscal budget deficit limits at a time when the ECB’s monetary policies are slated to be tightened. Moreover, Italy’s investment and savings (IS) balance situation can be considered to offer additional support for that kind of perspective. The graph shows trends in the principal components of the Italian economy’s IS balance. In the private sector, both the corporate and household sectors have had savings surpluses since 2013, and government sector’s



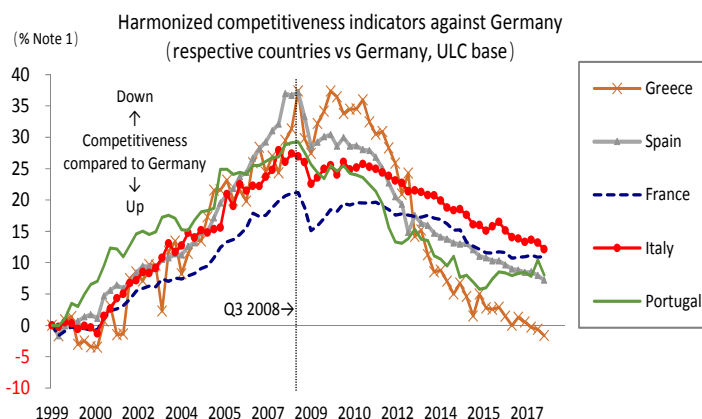


savings deficit has also been shrinking at a fairly rapid pace since 2013. In short, this IS balance suggests that the Italian economy's domestic demand is being impacted by the increasingly tight restraint of consumption and investment activities. As a result, Italian economy has become increasingly dependent on foreign sector demand, causing Italy to accumulate current account surpluses. In fact, similar scenarios have also taken shape in Spain and Portugal, which are similarly recording current account surpluses.

This article has repeatedly noted that Germany takes this type of lopsided IS balance yet a step further, to an extreme form in which all domestic sectors including the government sector record savings surpluses. As a result, the IS balance of the euro area as a whole also has the characteristics of growing private-sector savings surpluses, shrinking government sector savings deficits, and growing current account surpluses (see graph). In this sense, it can be said that the euro area economy has been undergoing progressive Germanization since the European debt crisis. In light of this, one is naturally inclined to ask the question – “Is this the trend that the European Commission is seeking to promote going forward?” One would not normally expect the desired result of intra-regional integration to be increased dependence on external demand.

### **Gradually Closing Competitiveness Gap with Germany**

It is also noteworthy that, just before the European debt crisis, there was a divergence between the real effective exchange rate (REER) of Germany and those of other euro area countries – this reflected an intraregional imbalance stemming from Germany's large current account surpluses and the chronic current account deficits of southern European countries. The ECB releases REER figures quarterly in the form of Harmonized Competitiveness Index (HCI) figures and, as the graph shows, the competitiveness gaps of individual euro area countries compared to Germany have tended to shrink since the Lehman shock. Since HCI is measured in terms of unit labor cost (ULC), the figures can be interpreted as suggesting that labor costs as a component of Germany's added value calculation equation have been increasing, and other euro area countries have begun taking advantage of the opportunity to narrow their competitiveness gaps.



(Source) ECB

(Note 1) (each country /Germany) x 100-100

(Note 2) Unit labor cost (ULC) = Nominal employees compensation / real GDP

Italy is no exception to this trend – as of March 31, 2018, its HCI had dropped approximately 20% from its level on September 30, 2008. During the same interval, Germany's HCI fell by about 10%, so the Italy-Germany competitiveness gap shrank by roughly 10%. France's HCI drop was approximately 17%, so the France-Germany competitiveness gap has not shrunk as much as the Italy-Germany competitiveness gap has. This is probably not unrelated to the fact that, of the four Southern European countries (PIGS), Germany, and France, France is the only country recording current account deficits.

### **Recognizing Germany's Advantageous Positioning within the Euro Area**

Of course, each country's progress in shrinking its competitiveness gap with Germany has entailed painful macroeconomic adjustments, including measures to reduce prices and wages. While it might be considered optimal to supplement each country's self-help efforts through a regional fiscal funding transfer system, such a system has not yet been realized in the euro area. As mentioned above, the actual situation is that euro area countries were forced by EU rules to maintain fiscal austerity following the debt crisis. That they did not suffer hard landings is probably attributable to the fact that the ECB was supporting them by means of its negative interest rate policy and previously taboo quantitative easing policy (QE). As discussed in yesterday's edition of Mizuho Market Topic, however, plans now call for shrinking QE from this month, ending QE two months later, and considering the possibility of interest rate hikes starting a year from now. Some observers have even begun saying that, in response to the uptrend in the euro area Harmonized Index of Consumer Prices (HICP), it may be possible for the ECB to modify its forward guidance and begin hiking interest rates from a somewhat earlier date. A policy mix that includes a tightening of both fiscal policies and monetary policies is suitable for preventing economic overheating, but it is probably obvious that neither Italy nor France is seeking such a policy mix. Frankly speaking, the only euro area country seeking such a policy mix is Germany, which is beginning to be concerned about the possibility of a bubble within its domestic economy.

I have already pointed out many times that one of the fundamental factors driving the German economy is EUR's characteristic of being a perennially undervalued currency, but it is still worth pointing this out once more. The EU is increasingly inclined to promote dogmatically concerted macroeconomic policies throughout the euro area, but there is a tension between two key euro area precepts – “Euro area members will use a common currency,” and “Euro area members do not intend to make fiscal funding transfers to other euro area members.” Although it is dominated by Germans and members who share the German way of thinking, the European Commission should acknowledge that, given that Germany is positioned quite advantageously within the euro area, it should at least consider the possibility of assisting less-advantageously-positioned euro area members. On October 1, European Commission President Jean-Claude Juncker said – “... we have to prevent Italy from being able to get a special treatment here that, if everybody were to get it, would mean the end of the euro.” It should be kept in mind, however, that Germany has been getting a kind of beneficial special

treatment owing to its use of a perennially undervalued currency, and one of the key lessons that can be learned from the European debt crisis is that the gap between Germany and other euro area countries centered on southern European countries is likely to only grow larger unless those countries are also given some type of special treatment.

Returning to the Italian situation, although the current government's populist label has elicited concerns from the start, given that that government has come up with a budget proposal that calls for a budget deficit corresponding to less than 3% of Italy's GDP, it does not seem to be an issue worth fighting about so divisively that it causes turmoil in the financial markets. So long as the euro area's fiscal consolidation is not undertaken, it would seem necessary to allow for some regulatory leeway and adjustments (such as adjustments of the extent to which Stability and Growth Pact (SGP) standards are rigorously enforced) in light of special situations. In particular, the EU should avoid actions likely to cause an upsurge in support for populist parties in each member country, and I hope to see the European Commission demonstrate a correct spirit of leadership in this regard.

Daisuke Karakama  
Chief Market Economist  
Forex Department  
Mizuho Bank, Ltd.  
Tel: +81-3-3242-7065  
[daisuke.karakama@mizuho-bk.co.jp](mailto:daisuke.karakama@mizuho-bk.co.jp)

These materials and the content of any related presentation are confidential and proprietary and may not be passed on to any third party and are provided for informational purposes only. Assumptions have been made in the preparation of these materials and any such presentation and Mizuho Bank, Ltd. ("Mizuho") does not guarantee completeness or accuracy of, and no reliance should be placed on, the contents of these materials or such presentation. Nothing in these materials or any related presentation constitutes an offer to buy or sell or trade and the terms of any transaction which may be finally agreed will be contained in the legal documentation for any such transaction, with such transaction being priced at market rates at the relevant time (the rates herein or in any related presentation being purely illustrative). (As a general rule you will not have a right to terminate early any transaction entered into – if you wish to do so, losses may be incurred by you.) These materials and any related presentation should not be considered an assertion by Mizuho of suitability for you of any transaction, scheme or product herein or therein. Mizuho has no duty to advise you on such suitability, nor to update these materials or contents of any related presentation. You must determine in your own judgment the potential risks involved in the transactions outlined herein or in any related presentation (taking professional financial, legal and tax and other advice) and whether or not you will enter into any transaction that may arise from these materials or related presentation. Nothing herein or in any related presentation should be construed as providing any projection, prediction or guarantee of performance or any financial, legal, tax, accounting or other advice. Mizuho shall have no liability for any losses you may incur as a result of relying on the information herein or in any related presentation. "MHBK provides this information for free. Please request for cancellation of subscription if you do not want to receive free-of-charge information from MHBK."