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Forex Medium-Term Outlook

28 February 2019

Mizuho Bank, Ltd.
Forex Department

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Overview of Outlook

USD/JPY remains strong despite the Fed switching to a more dovish stance. The fact that U.S. economic indicators have not crashed, that some in the forex markets still expect the Fed to raise interest rates, and that there is an overall sense of pessimism regarding the political and economic conditions in the euro area – all these may be propping up USD. Above all, all we know about the Fed's policies as of now is that it has "suspended" its normalization process for the moment; there are no clear indications whether it has "ended" it for good, and we will not know for sure at least until it fully stops its balance sheet size reduction efforts. The first thing to do, therefore, is to wait for the last traces of the normalization process to disappear, and we can say for certain that the process has come to an end. Under such circumstances, I feel no real need to change this report's main forecast scenario that "with the end of the Fed's normalization process, U.S. interest rates and USD will weaken, inevitably causing JPY to strengthen." Going forward, if the outlook turns more pessimistic, the markets will begin to expect the Fed to use a different card. If that happens, a correction of the strong-USD trend seems unavoidable. The biggest risk to this report's assumptions is a repeat of what happened in 2018 – the U.S. economy remaining surprisingly strong, enabling the Fed to continue with its normalization process. However, even if the U.S. economy manages to maintain its current growth rate during the current forecasting period, it is very unlikely to accelerate. It will take considerable courage to forecast a scenario involving a further strengthening of U.S. interest rates and USD in the current climate.

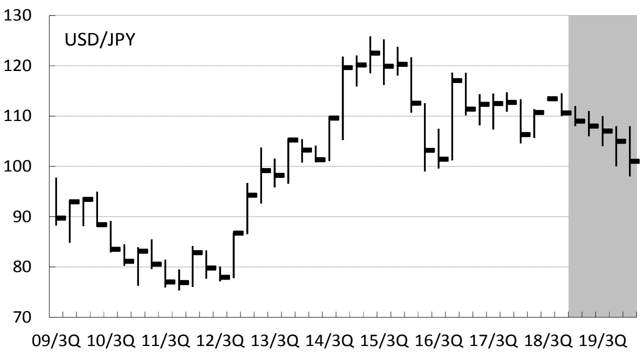
Meanwhile, despite the dire political and economic conditions in the euro area, EUR has been maintaining its underlying strength. Adding to continuing uncertainties over Brexit negotiations are frictions between EU member states (Germany and France), and the continuing deterioration of the region's fundamental economic indicators. To be honest, there is almost nothing positive to say about the climate currently surrounding EUR. Perhaps the reason EUR has not crashed despite this is because the ECB still wants to pursue policy normalization and there is a general sense that a no-deal Brexit can be avoided. With regard to Brexit, in particular, the date of Britain leaving the EU seems highly likely to be postponed from the original March 29, and the markets have been buying up EUR in order to dispel some of the uncertainty surrounding the immediate future. Whether this uneasy balance can be maintained will probably depend on the extent to which the regional economic indicators deteriorate. If the deterioration is worse or goes on for longer than anticipated, EUR could fall a notch as the ECB's policies swing toward monetary relaxation once again. However, this report predicts that EUR will maintain its strength against USD, given the significant impact of USD's inevitable depreciation from an even stronger place.

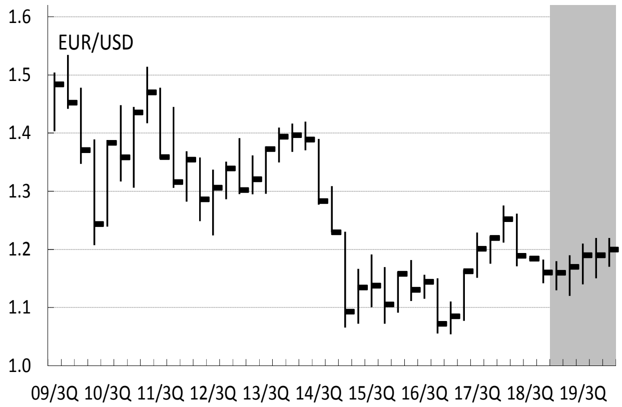
Summary Table of Forecasts

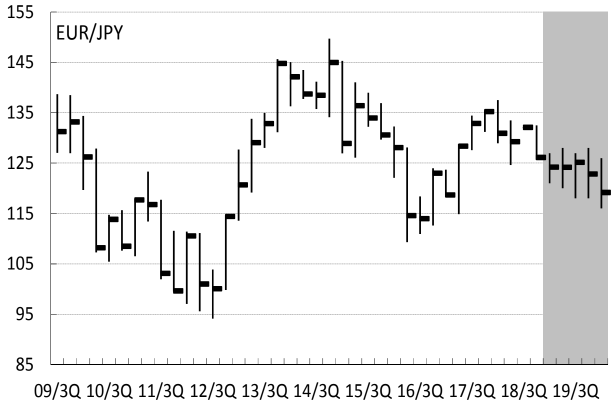
	2019 Jan -Feb (actual)	Mar	Apr-Jun	Jul-Sep	Oct-Dec	2020 Jan-Mar
USD/JPY	104.10 ～ 111.24 (110.81)	108 ～ 112 (109)	106 ～ 111 (108)	104 ～ 110 (107)	100 ～ 108 (105)	98 ～ 108 (101)
EUR/USD	1.1234 ～ 1.1570 (1.1374)	1.11 ～ 1.16 (1.14)	1.10 ～ 1.17 (1.15)	1.12 ～ 1.19 (1.17)	1.13 ～ 1.20 (1.17)	1.15 ～ 1.20 (1.18)
EUR/JPY	117.85 ～ 126.34 (126.05)	121 ～ 127 (124)	120 ～ 128 (124)	118 ～ 127 (125)	118 ～ 128 (123)	116 ～ 126 (119)

(Notes) 1. Actual results released around 10 am TKY time on 28 February 2019. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts



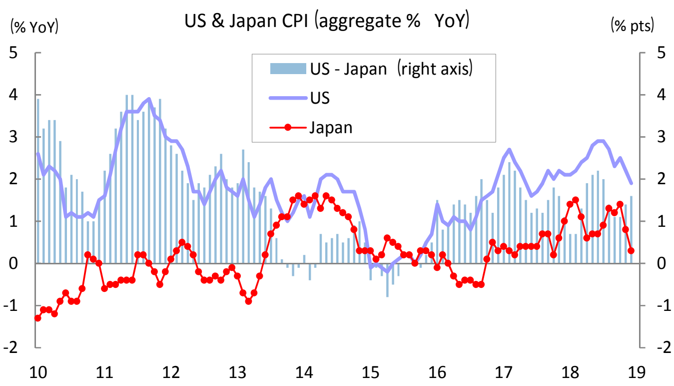




USD/JPY Outlook – The Background to Why JPY Appreciation does not Take Hold

USD/JPY Now and Going Forward – The Background to Why JPY Appreciation does not Take Hold

Moving Back a Step to Get a Better Perspective on the Rate Deadlock



(Source) Bloomberg

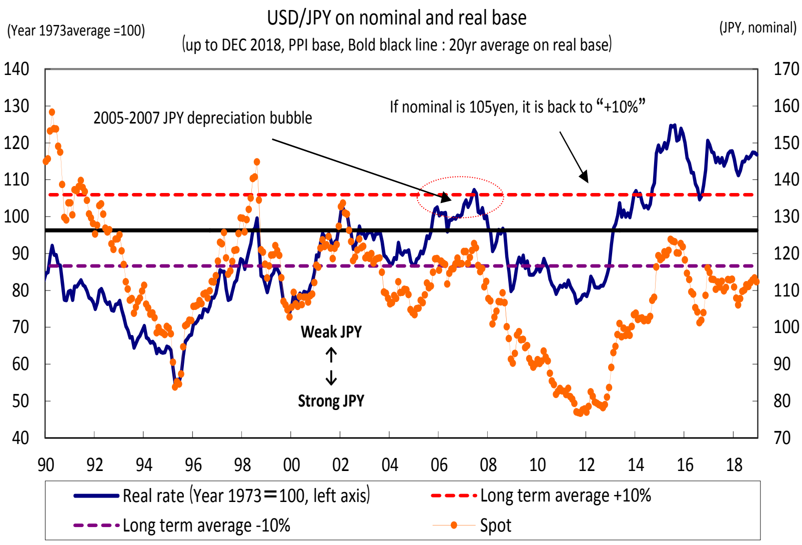
USD/JPY climbed back to the 110 level in February and has remained in a deadlock with no clear sense of direction since. There seems no dearth of factors arousing insecurity, including the fate of the China tariff hike deadline, turmoil in the U.S. Congress over border security proposals, and the confusion over Brexit (UK's withdrawal from the EU) negotiations, but none of these have been a determining factor for a pessimistic mood to set in. In such a situation, rather than chase after the latest developments as and when they happen, it may be wise to move back a step or two to get a better perspective on evaluating the situation. Under a floating exchange-rate system, exchange rates are supposed to move in such a way as to average out the difference in inflation levels between two countries. In this context, taking a look at the difference in inflation between the U.S. and Japan, U.S. inflation rates peaked out sometime in the middle of last year, but there still remains a clear gap between U.S. and Japanese inflation rates. In Japan, the unprecedented monetary easing appears to have had almost no impact in terms of boosting inflation, giving the sense of a stubbornly disinflationary situation. Specifically, comparing the rate of inflation of both countries since 2014, a 1.0 to 1.5 pp gap seems to have become normal (see figure).

In formulating a medium- to long-term forex outlook, how must we interpret the above fact? For instance, USD/JPY was trending at the level of 101-102 about five years ago, in February 2014. If exchange rates had moved toward balancing out differences in inflation rates (7.5 pp over the course of 5 years at the rate of 1.5 pp per year), it would not be surprising to see a USD/JPY rate of 95 or so. Of course, in the real world, forex market trends tend to be at odds with various factors, so a simple correlation as described above would be hard to come by. However, to be concerned that there is a steady buildup of JPY appreciation/USD depreciation pressures when seen from the perspective of inflation, is an extremely normal fundamental position to take.

Time for a Change in Concept?

Having said that, there are those who have accepted the present situation as the new normal. The figure to the right shows the real USD/JPY exchange rate based on the U.S.-Japan price (CPI) gap. As one can tell at a glance, the weakness of JPY against USD over the past five years seems quite extreme compared with the overall trend of the past almost 30 years. The chart only shows data from 1990 onward due to problems of scaling, but in fact, one has to go back to the first half of the 1980s, immediately before the signing of the Plaza Accord, to see a similar level of persistent upward divergence from the long-term average (20-year average) of real USD/JPY as there is now. Even during the "weak-JPY bubble" period in 2005-07, real USD/JPY rates were only +10% higher than the long-term average. Over the past five years, the rate of divergence has become normalized at +20% or so, a situation with no historic precedent.

Why is this happening? To begin with, the motivation for buying USD has undoubtedly become stronger over the decades. Some reasons pointed out for this are: the fact that, following the financial crisis, USD has emerged as the only currency for which rate hikes can be expected; the fact that demand for USD has increased amid the tightening of various regulations; and the fact that EUR, which should be a counterforce to USD, has completely failed to step into that position. However, the most commonly pointed out reason is the waning power of Japan as an export economy. This has partly to do with the simple fact that the export competitiveness of Japanese companies is declining, but it also has to do with the fact that many Japanese companies have made the strategic decision to shift their production bases overseas. The process of "weak JPY triggering a sharp increase in exports, leading to a rapid expansion of the trade surplus" is necessary for correcting the excessively weak JPY trend and turning it toward JPY strength, but as is widely known, such a trend can no longer be confirmed. One cannot afford to ignore the argument that price measures as regulators of the exchange rate only work when excessively weak JPY leads to an excessively large surplus.



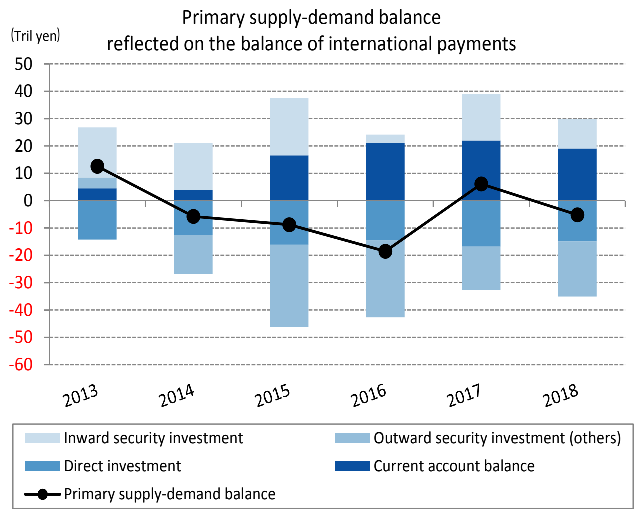
(Source) Datastream (Notes) Real= (nominal÷PPP) ×100 , base on Year 1973 average

That being the case, it may be time to accept the new concept that a +10% divergence of the real USD/JPY or a +20% divergence of the real effective USD/JPY from the long-term average is "normal." However, perhaps we could wait for a phase of decline in U.S. interest rates following the Fed's clear withdrawal from its balance sheet size reduction and other current policies, before deciding whether such a change in concept is really necessary. Even if it is unlikely that USD/JPY would fall to the 80-90 or 70-80 levels, which are benchmark levels for how strong JPY can get, my basic understanding is that the situation remains unconducive to forecasting a further weakening of JPY, direction wise.

JPY Supply and Demand Now and Going Forward – No Sign of a Waning in the Trend of Expanding Direct Investments

Over the Past Two Years, JPY Supply-Demand Balance Has been Neutral on Average

In February, the December 2018 Balance of Payments were released, making it possible to understand the JPY supply-demand balance for all of 2018 (see figure). I would, therefore, like to provide a brief summary of the situation here. The JPY supply-demand balance, which I use as a guide when formulating my JPY outlook for this report, posted a net JPY selling in 2018 for the first time in two years, at -JPY 5.2 trillion. Given the small net JPY buying (+JPY 6.1 trillion) posted in 2017, the figure for 2018 seems to have cancelled that out almost exactly. At any rate, neither of the figures indicate an excessive margin in one direction or other, so the most appropriate description of the trend over the past two years may be "a neutral level of demand for JPY on average." Come to think of it, USD/JPY's range of movement was the third smallest ever in 2017, and the smallest ever in 2018. Possibly one of the factors behind this was the lack of clear direction in terms of the JPY supply-demand balance in the Balance of Payments.



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

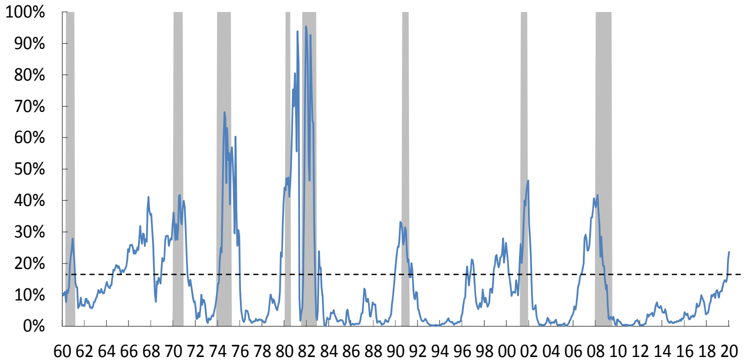
Will the Cross-Border M&A Trend Change?

Let us take a look at the JPY supply-demand balance for each category. The 2018 current account posted a surplus of approx. +JPY 19 trillion, the smallest surplus in three years, and the largest yoy decline in surplus in four years. One of the main reasons behind this was an increase in the import value due to a rise in crude oil prices, but going by the macroeconomic climate surrounding the global economy, which is expected to peak in 2019, the slowdown in exports is also likely to become a big factor going forward. When that happens, it will have an impact on the current account, but how much of an impact will depend on the offsetting impact from crude oil prices, which are thought to be peaking. However, if we assume no early resolution to the trade wars, Japanese exports, which are led by cars, are vulnerable to receiving a big blow, which could also dampen the current account surplus. Meanwhile, outward portfolio investment posted a net acquisition of approx. -JPY 20 trillion, accelerating slightly from the previous year's -JPY 16 trillion. Outward portfolio investment moves in tandem with the quarterly U.S. rate hikes, and as usual, it will be interesting to see how it changes this year (2019). Incidentally, inward portfolio investment has been posting a decline in net acquisitions due mainly to the selling of Japanese stocks, so taking inward and outward portfolio investment together, we get a net outflow of capital, or in other words, a net JPY selling pressure. Apart from that, foreign direct investment (FDI), which has been drawing attention as a stable motive for JPY selling in recent years, continues robust, posting a net acquisition of about -JPY 18 trillion, despite the slight decline from last year's -JPY 19 trillion or so. This is the first time since 2014 that we have seen a slowdown in FDI. Could the growing trend of major cross-border M&As be approaching a turning point? I foresee a continuation of the trend, but this is an issue that needs to be monitored closely, as I will explain in detail later.

Outward Portfolio Investment Expansion Should get Difficult Amid Increasing Probability of Recession

How will the JPY supply-demand balance climate change in 2019? As symbolized by the January FOMC statement, the Fed's next move is no longer likely to be a rate hike. That being the case, it is natural to assume that outward portfolio investment, which influences JPY's supply-demand balance, is unlikely to accelerate even if it does not decelerate. Looking at the January International Transactions in Securities (Weekly; based on reports from designated major investors), which was released at around the same time as the Balance of Payments, Portfolio Investment Assets, led by long-term debt securities, posted a net acquisition of -JPY 1.4 trillion, but Japanese institutional investors will inevitably feel the impact of the clear change in the Fed's monetary policy direction following the January FOMC meeting. Further, the recession probability as published by the Federal Reserve Bank of New York is currently at 24%, the highest level since 2008, and looking at the recession probability trend over time, it is only very rarely that recession has been avoided despite the probability being this high. Under such circumstances, it remains my basic understanding that it is quite unlikely that U.S. interest rates will continue to increase, causing the U.S.-Japan interest rate gap to expand, thereby driving a weak-JPY scenario. Going by past experience, it can be said that Japanese investors' risk aversion will tend to intensify coinciding with the ebbing of the U.S. economy, making it easy to see net dispositions in outward portfolio investment. As a result, it is difficult to predict developments that support JPY selling as far as the JPY supply-demand balance goes.

Recession probability estimated by FRB of NY

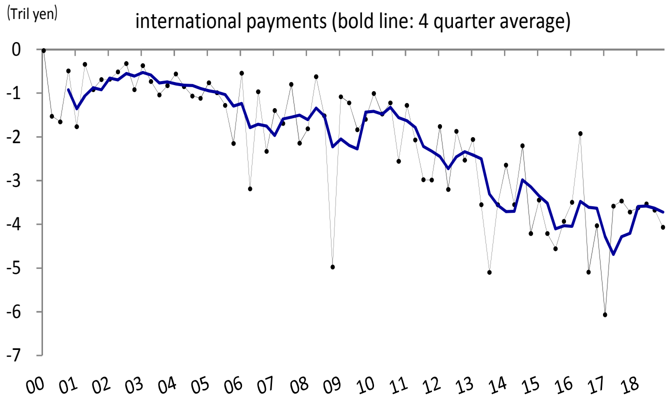


(Source) Bloomberg (Notes) Probability of recession by date on graph
This model uses the difference between 10-year and 3-month Treasury rates to estimate by FRB of NY on a montly basis.

FDI Increase Triggered by "Six-Fold Troubles"

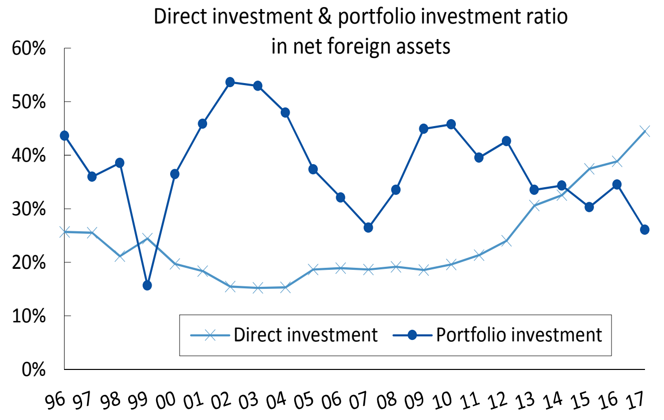
As mentioned above, FDI declined for the first time in four years (since 2014) in 2018. I would like to delve somewhat deeper into this point, as it has become a matter of significant interest in recent years. FDI trends, which have a significant weight in determining the JPY supply-demand balance, are important also when it comes to formulating forex outlooks. Over the past 20 years, Japanese outward FDI (hereafter: simply FDI) has consistently increased. The graph on the previous page shows the net FDI, including both inward and outward FDI, but even here, the trend is obvious (the growth in inward FDI is quite insignificant compared with that in outward FDI). Many are beginning to say that this increase in outright JPY selling could be the main reason JPY fails to appreciate significantly despite the heightening of risk-aversion moods in the market.

Direct investment reflected on the balance of international payments (bold line: 4 quarter average)



(Source) INDB

Ordinarily, FDI is divided into two main types: (1) a parent company building operations in a foreign country in the form of a sole corporation, a transferee company, or a subsidiary (commonly called green field investment), or (2) a parent company forming an alliance with a company in a foreign country through acquisition of the company or stock acquisition/swaps (M&A investment). As is widely known, it is the latter (cross-border M&A) that has been driving FDI growth over the past 20 years. In particular, from the Tohoku earthquake disaster in 2011 through 2012, it is said that Japanese companies were beset by "six-fold troubles," specifically an ultra-strong JPY, high effective tax rates, high electricity prices, stalled free trade agreements, ossified employment regulations, and strict environment-related regulations (CO_2 reduction targets). <u>With the business climate being so unfair for Japanese corporations, it is being said that they have no choice but to promote FDI. As a result, the outstanding FDI as of 2017 (approx. JPY 175 trillion) has ballooned to over five times the level at the end of 2000 (approx. JPY 32 trillion)</u>. Again, looking at the Survey on Overseas Business Activities published by the Ministry of Economy, Trade and Industry (METI), the overseas production ratio in the manufacturing industry has increased from 13.1% in 2000 to 23.8% in 2016, once again giving the impression that the times demand overseas rather than domestic production. Given that Japanese companies face as many as six constraints that companies in other countries do not face, it is natural for them to seek business opportunities abroad, but the momentum of such a trend is worth monitoring.



(Source) Ministry of Finance, Japan

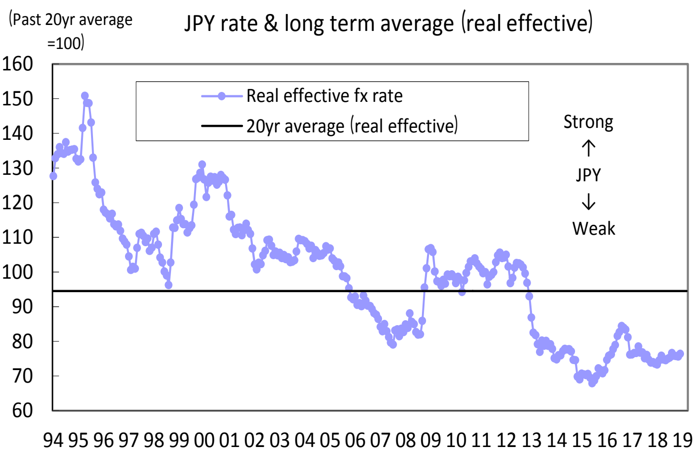
However, given that companies have limited surplus funds, an increase in investment abroad naturally implies a decline in investment within the country. In light of the argument that one of the causes of Japanese deflation is the lack of consumption/investment (including intent to raise wages) appetite among Japanese companies, rampant increase in FDI by Japanese companies is an ironic fact for the Japanese economy. <u>Japan posted the world's largest net external assets as of the end of 2017 for the 27th year in a row, and will probably do so again in 2018. However, that would be due to the presence of promising assets abroad rather than within the country, and is a rather sad fact for Japan</u>. What is more, the ratio of FDI within the balance of net external assets is rising by the year, as I argued in a past issue of my Market Topic[1] report (see figure).

Some of the Six Troubles Have Eased, but…

Some of the aforementioned six troubles, however, are no longer a problem, forex rates being the main one. JPY is far from being "ultra-strong." In fact, going by the purchasing power parity (PPP) and real effective exchange rate (REER), it has been on the weak side for the past six years (counting from April 2013, when Mr. Haruhiko Kuroda became the governor of the BOJ). In this context, Chairman of the Japan Association of Corporate Executives, Yoshimitsu Kobayashi, said at the first joint press conference of new year by the big three economic organizations of Japan held on January 7:

> Once there was talk of the "six-fold troubles," especially the high cost of energy, low employment mobility, and so on, but the main (problem) was that of forex rates. We simply cannot compete at the level of 80 (to the dollar). However, companies were liberated from their six-fold troubles, and it has now been six years.

The biggest reason why JPY hit clear rock bottom after 2013 was because the start of the Fed's normalization process coincided with the resolution of the European sovereign debt crisis. I believe the large-scale monetary easing conducted by the American and European authorities and their setting of a 2% inflation target is only one of the supplementary factors that raised the USD/JPY rate to over 100. However, <u>after 2013, we entered a phase that was clearly no longer a strong-JPY phase, releasing Japanese corporations from at least one of their many troubles. Precisely speaking, USD/JPY began to recover in November 2012, when former Prime Minister Yoshihiko Noda (of the Democratic Party of Japan; DPJ) dissolved the parliament, saying "Let's do it!" In two and a half</u>



(Source) BIS

[1] Please see the May 30, 2018 issue of Market Topic titled "Japan's external assets and liabilities as of the end of 2017 – The truth about JPY as a "safe haven" currency."

years following that, USD/JPY returned to the level of 125 (125.86 on June 10, 2015). During that time, JPY's REER fell by over -30% at one point (comparing the June 2015 level with the October 2011 level) (see figure). Even compared with the present, REER shows a decline of over -20%, and the possibility that the U.S. Department of the Treasury is not happy about this is reported now and again.

However, could the FDI trend (the overwhelmingly one-sided increase) change in the future simply based on this correction of the strong-JPY trend? I do not really think so. Some reasons for this being, (1) other "troubles" apart from forex rates remain problematic, (2) there is a global intensification in anti-liberal trends, (3) companies have an abundance of surplus funds, and (4) there is a "seventh trouble" in the form of Japan's graying society and increasingly low birth rates.

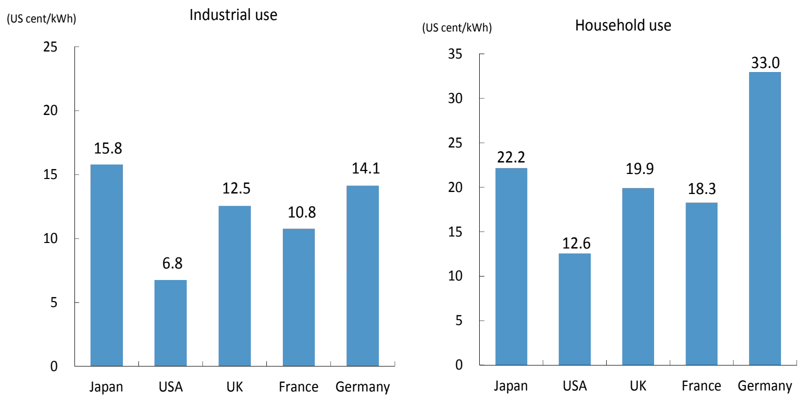
The Situation Regarding the Six-Fold Troubles has not Changed Much ((1) & (2))

Let us look at (1) first. Not all of the six troubles have improved as dramatically as forex rates. Although the administration of Prime Minister Shinzo Abe has successfully lowered the effective corporate tax rate, the essence of the problem is the relative corporate tax rates in Japan compared with those elsewhere. The graph on the previous page has been taken from the website of the Ministry of Finance. Following the lowering of Japan's effective corporate tax rate, it is no longer at an internationally high level, but it is not particularly low either. What about electricity rates? According to the FY2017 Annual Report on Energy (Energy White Paper 2018), "Japan's electricity rates, both for household and industrial use, remained at high levels, but thanks to forex rates as well as the increasing burden of taxes and policies promoting the introduction of renewable energy in other countries, the gap is shrinking." This statement has not changed in recent years. To put it more plainly, the fact is that although the gap between foreign and domestic electricity prices is in the process of narrowing, it still remains quite large. Going by the graph below, Japanese electricity prices (both for household and industrial use) remains on the high side among the world's major countries. The situation regarding corporate taxes and electricity prices, therefore, while not worse than it was five years ago, has not improved enough to put the brakes on FDI by Japanese companies as it gathers speed.

(Note) Tax rates are those (combining national and local taxes) imposed on corporate income. Local tax rates represent the standard rate for Japan,the Californian rate for the United States, the national average for Germany and the Ontario rate for Canada. If part of tax on corporate income is transferred to costs, rates after such adjustment are posted.
(Sources) OECD, relevant government documents

Meanwhile, while there has been significant progress in the situation related to free trade agreements, it would be fair to say that the trend of the times cannot be overlooked. If we go by the criteria of the signing or effectuation of agreements, things have progressed significantly between 2011 and 2019. First, the 11-member (including Japan) Comprehensive and Progressive Agreement for Trans-Pacific Partnership (TPP-11), an enormous free-trade zone in the Asia-Pacific region, came into force on December 30, 2018. The countries that are a part of TPP-11 together have about 13% of the world's GDP and a total population of over 500 million. This was followed by the effectuation of the Japan-EU Economic Partnership Agreement (EPA) on February 1, 2019. The Japan-EU EPA encompasses a third of the world's GDP and a total population of about 635 billion, making it one of the world's largest trade agreements. Thanks to the TPP-11 and the EPA, Japan is in a position to participate in a free trade market with a total population of approximately 1 billion (including its own), so going by the value system that existed in 2011, the lack of free-trade agreements should unquestionably no longer be a problem.

However, there has been a major change in value systems between 2011 and the present. This applies to (2), but also to (1). In today's world, the free trade faction is facing a crisis. As is widely known, the debate about whether "free trade is fair" has become more significant following two events in 2016 – Britain's decision to withdraw from the EU and the election of President Trump in the U.S. While not as significant as the above two developments, radical political forces from both the extreme left and right have been gaining the support of people around the world in an increasingly "populist" trend, making anti-global forces more influential. Five years ago, no one would have believed that the flag-bearer of free trade, the U.S., of all countries, would lead this movement. The free trade strategies promoted by Japan have been successful, but with the world's political and economic climate changing, it is possible that those strategies themselves are inappropriate.

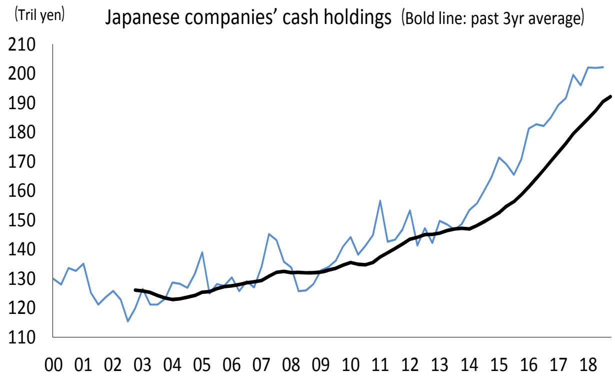


(Source) Agency for Natural Resources and Energy based on IEA "Energy Prices and Taxes 4th Quarter 2017"

Depending on the outcome of the U.S.-Japan trade negotiations, it would not be surprising to see Japanese companies become even more proactive toward FDI.
What about the remaining troubles? With regard to rigid employment laws, while widespread calls for a "workstyle reform" are robust, the root of the problem – relaxing rigid employment regulations, including financial compensation for dismissal – is not yet being addressed. As for environmental regulations, the level of oppression has decreased significantly from the "-25% compared with 1990 levels" target under the DPJ administration to "-3.8% compared with 2005 levels" under the current Liberal Democratic Party administration. As digging deeper into other ways in which the troubles have been ameliorated is beside the point of this report, I will stop here. To summarize, one can say that the situation has definitely improved over the past five years with regard to forex rates and environmental regulations, but I do not believe the overall situation has improved sufficiently to lure Japanese companies back to Japan.

Japanese Companies Continue to Have Abundant Surplus Funds ((3))

In order to promote cross-border M&A, you first need to have funds. In this context, Japanese companies' abundant surplus funds have been frequently pointed out, and these funds have further increased compared with five years ago. Their financial situation, therefore, does not impose a restriction on these companies' foreign investments. According to the Finance Ministry's Financial Statements Statistics of Corporations by Industry, Japanese companies' cash equivalents amount to JPY 202 trillion or so (as of the end of September 2018), when it hit the highest level ever (see figure). For a company that is quick to seize an opportunity, the financial situation seems conducive to corporate acquisitions.

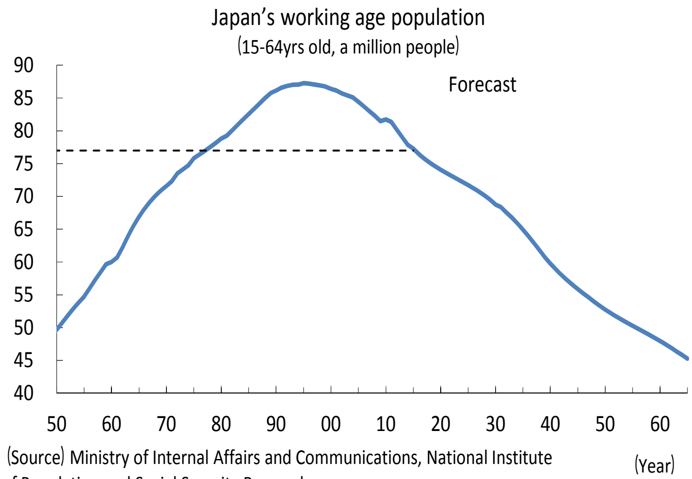


(Source) Ministry of Finance of Japan
(Note) All size & all industries excluding finance and insurance industry

However, as in the case of net external assets, the presence of such surplus funds can also be seen as the result (or evidence) of companies having suppressed consumption and investment (including wage raises) in Japan itself, so the presence of these funds is not exactly good news for the Japanese economy. One often hears the lament that wages are not rising despite companies posting their highest ever profits, but this is a reversal of cause and effect based on misunderstanding. It would be more accurate to say that it is because companies are suppressing domestic consumption and investment, including wage raises, that they are able to post their highest ever profits. As a reference, let us take a look at the trend of ordinary profits versus personnel expenses for Japanese companies (all sizes, all industries) in the Financial Statements Statistics of Corporations by Industry. If we take the 1980 level as 100, personnel expenses as of the end of 2017 have grown just under three-fold (288) while ordinary profits have grown over four-fold (452). The fact is that there is a big difference between the growth in profits and personnel expenses.

No Easy Solution to the Biggest Problem: Declining Birth Rates and the Ageing of Society ((4))

The six troubles are thought to have been a major factor that triggered the growth in FDI, but one cannot afford to forget an even more serious, seventh problem – perhaps the biggest problem. The demographic problem in the form of declining birth rates and the ageing of society, which is ongoing and intensifying. Given that the ultimate result of the declining of birth rates and the ageing of society is a decline in population, the market, which is where companies earn their revenues, itself shrinks. This is why companies have taken countermeasures in the form of "buying new markets" by investing in other countries, or "buying time" by acquiring foreign companies. This is the most essential and structurally important problem that must be addressed when discussing the increasing trend of FDI, and it is not a problem that can be solved easily. Looking at the current situation, the labor shortage has become so severe that the intake of foreign workers had to be decided as national policy. Given that Japan's working age population has clearly entered a phase of decline (see figure), securing high-quality Japanese workers will inevitably entail a considerable cost. From companies' point of view, this means a climate where it is more difficult than ever to do business. The question, then, is whether the domestic market is attractive enough for companies to want to remain while submitting to inevitable labor supply constraints. Unless we can find a straight answer to that question, it seems likely that Japanese companies' foreign investments will continue robust going forward.



(Source) Ministry of Internal Affairs and Communications, National Institute of Population and Social Security Research

In considering the future outlook for JPY rates, it will be important to focus on how “the buying of JPY during phases of risk aversion” or “the buying of JPY as a safe haven currency,” which have conventionally been taken for granted, will change going forward as a result of the change in Japan’s net external asset structure due to Japanese companies’ investment activities.

U.S. Fiscal Policies Now and Going Forward – Offstage Dynamics behind “Patient”

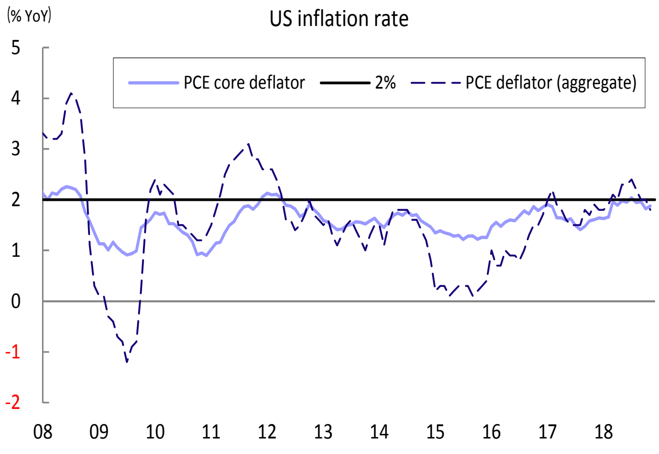
Background Factors Leading Up to “Patient”

Released on February 20, the FOMC Minutes for the January 29-30 meeting reported that – “Almost all participants thought that it would be desirable to announce before too long a plan to stop reducing the Federal Reserve’s asset holdings later this year.” – and this received a great amount of media coverage. One can apparently expect to see a plan for the balance sheet shrinkage suspension “before too long”. In light of various regulations and the current economic and financial situation, it has been pointed out since last year that the level of current deposits required by financial institutions may be higher than expected. There is now an FOMC consensus that the possibility is real, and it appears that this consensus will be reflected in policy decisions going forward.

Apart from the balance sheet shrinkage suspension, the FOMC’s frequent use of the word "patient" since January has been affecting market expectations, and considerable attention has been focused on understanding the FOMC’s internal discussions related to the word. The Minutes list several factors that supported a patient approach, including “various risks and uncertainties in the outlook”, “business and consumer sentiment”, the recent softness in core and total inflation and inflation compensation”, “the effect of the tightening of financial conditions on aggregate demand”, and “the effects of the recent partial federal government shutdown”. The Minutes also notes that patience will facilitate a clearer assessment of the international trade policy situation and the state of the global economy, particularly regarding the extent and persistence of the economic slowdown in Europe and China. The Minutes use such expressions as “particularly for Europe and China” several times, it can be assumed that the opacity of trends regarding Europe and China is a major cause of the FOMC’s uncertainty. Given the FOMC’s consciousness of so many unclear issues, it seems natural that it would judge that hiking interest rate hikes at this time is difficult. It is also worth noting that the Minutes includes the statement – “Many participants observed that if uncertainty abated, the Committee would need to reassess the characterization of monetary policy as "patient" and might then use different statement language.” However, it is quite unlikely that the currently great amount of uncertainty about numerous issues would be dispelled in one fell swoop. In the meantime it is reasonable to anticipate that the FOMC will continue to make frequent use of the word "patient" as it sustains its wait-and-see attitude.

Preconditions for Reassessing Interest Rate Hikes

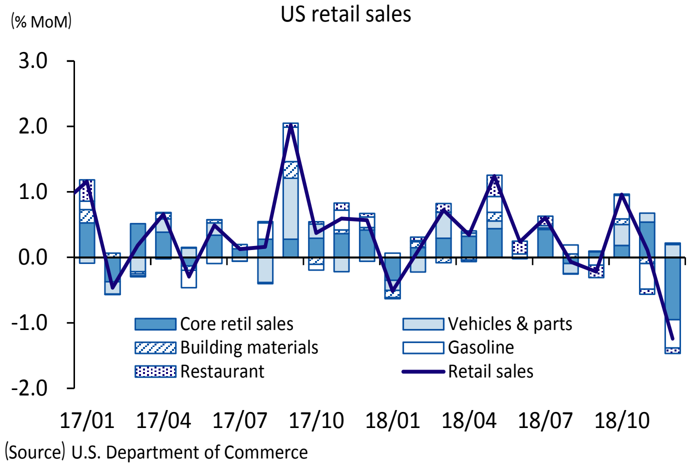
Although the factors described above offer interesting backstage information about the last FOMC meeting, the key issues for the financial markets going forward are "how to interpret the patient approach" and, ultimately, "the nature of preconditions for resuming interest rate hikes". In these regards, there appears to be some differences of opinion within the FOMC. Currently, the Minutes report that – “Many participants suggested that it was not yet clear what adjustments to the target range for the federal funds rate [≈ interest rate hike] may be appropriate later this year;” – but one wonders what kind of developments in what areas might be considered by the FOMC to be grounds for undertaking such adjustments. From a reading of the Minutes, the FOMC includes members with two different ways of thinking. Of the members supporting the ‘patient’ approach, several argued that a rate hike would be necessary – “only if inflation outcomes were higher than in their baseline outlook”. On the other hand, several other members indicated that they would consider such a hike appropriate – “if the economy evolved as they expected.”



(Source) Bloomberg

As the graph shows, the U.S. personal consumption expenditure (PCE) deflator has been in the vicinity of 2% on both comprehensive and core bases for the past year or so. Regarding the abovementioned two groups of FOMC members, in brief, it seems that the first group assumes that no rate hike is needed unless there is a sharp rise in the PCE while the second group assumes that rate hikes should be possible so long as there is no disruption and the PCE remains flat. Nonetheless, since even the latter group considers the appropriate timing of a potential hike to be during the latter half of the year, it can be assumed that there will be no rate hike in March and June. Given the PCE’s stability near 2% despite the sustained improvement in the labor market during the past two years, my basic understanding, intuitively, is that the Fed should be somewhat concerned about the weakness of inflationary pressures rather than a potential rise in the PCE. It would appear difficult to justify expectations of an increase in the hawkishness of U.S. monetary policy along with rises in U.S. interest rates and USD.

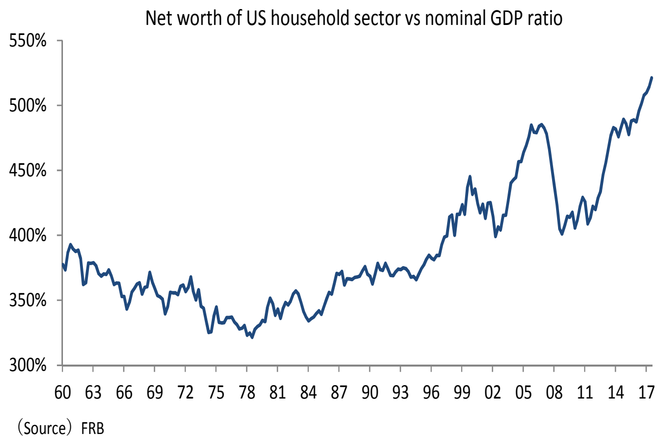
U.S. Retail Sales Post Largest Slump Since the "Depths of Despair"



Evaluations and forecasts of conditions in the U.S. real economy are particularly important bases for anticipating the Fed's "next move", and in this regard, the December retail sales statistics released in February are quite interesting. Overall, retail sales were down 1.2% mom – the largest such drop in about nine years, since September 2009 – while on a core basis (excluding restaurant, car dealer, construction material, and gasoline sales from the Aggregate) retail sales decreased 1.7% mom. These drops were a shock to the financial markets. In particular, an over 1% margin of decline in the Core figure was last been seen in March 2009 (-1.5%), during the depths of despair in the immediate wake of the collapse of Lehman Brothers. The gap between the results and market forecasts (of an increase) was so large that it caused a considerable decline in the U.S. 10-year interest rate. While optimism over the state of the U.S. and global economies had been recovering earlier this year, as of the end of February, the clear deterioration in hard data concerning the U.S. economy has dampened that optimism.

Fear of Reverse Wealth Effect Behind Sharp Deterioration in Sales

Taking into account that personal consumption accounts for 60% of the U.S. economy, how to interpret the recent large slump in Retail Sales will be an important topic related to the formulation of forecasts going forward. As already reported, there are several possible factors behind the deterioration: (1) the partial Federal government shutdown, (2) the sharp fall in share prices, (3) some of the year-end sales being brought forward to November. Of these, (3) is considered to be the main culprit, with analysts pointing out that a large volume of consumption, driven by online sales, was brought forward to November. December non-store Retail Sales (which includes online sales) posted significant deterioration at -3.9% mom, so there is extremely strong suspicion that factor (3) was what dragged down sales. Factor (1) is also bound to have had some impact, as government shutdowns do inevitably shrink economic activity. Going forward, (3) could be forgotten, but (1) will probably remain a factor.



However, it is factor (2) that is of concern to me. The stock markets have been unstable since November. The NY Dow Jones Industrial Average fell by approximately 10% in December alone and by -22% or so for the October-December quarter. The S&P 500 Index fell by 11% or so in December alone and -17% or so for the October-December quarter. As I have argued in past issues of this report, it is the wealth effect owing to strong share prices that has kept personal consumption in the U.S. strong in recent years despite sluggish wage growth. Given that stocks comprise at least 30% of the financial assets of U.S. households, strong stock prices have undeniably played a big role in whetting the consumption and investment appetites of Americans. As the graph shows, as of the end of September 2018, the net worth of the U.S. household sector was well over 500% of GDP, an all-time record high. Given that U.S. stocks began to fall starting October (and have tumbled especially since December), it would not be surprising if the effect of this were to manifest itself in sales. Going by the continued deterioration of consumer sentiment indices (leading indicators) in January, the January Retail Sales may not warrant optimism either.

Forecasts for the months ahead will change depending on whether one seeks the reason for the slump in the December Retail Sales in factors (1), (2) or (3) above, but if we assume that (2) is the most significant, the malady runs deep. To be sure, stock prices recovered in January, and both job and wage data for January were extremely strong, so the January Retail Sales may show a recovery. However, given that the Fed is seeking to pull back from a normalization process it has been pursuing for the past five years, it seems natural to assume that consumer sentiment will find it hard to remain buoyant (as I mentioned, consumer sentiment indices continued to deteriorate in January). Additionally, the government shutdown continued in January, and uncertainties related to the U.S.-China trade war continue to date. One must not, therefore, simplistically assume that sales are likely to have recovered in January simply because stock prices recovered. It would be wise to retain considerable caution in anticipating the next Retail Sales release (for January).

Risks to My Main Scenario – Nature of JPY Depreciation Risks

Turning Point Coming, but Adjustments Not Yet Needed

As I do each month, I would like to review the risk factors related to my main forecast scenario. As has been discussed numerous times, since this article's main scenario anticipates USD depreciation along with JPY appreciation stemming from the USD depreciation, the most important risk scenarios are those related to JPY depreciation. In view of this, I will focus here mainly on JPY depreciation risks.

Before examining the risks, I would like to quickly review this article's main forecast scenario. For more than a year, the basic story line of the scenario is – "The end of the Fed's normalization process is accompanied by U.S. interest rate decreases and USD depreciation, and that situation forces JPY to appreciate." Since the January FOMC statement is tantamount to a declaration of a halt to interest rate hikes, it seems safe to assume that the "turning point" long anticipated by this article has finally come, but the firmness of U.S. interest rates and USD has been maintained. Although prospective interest rate cuts have already been factored into FF interest rate futures market prices, there is still a feeling of surprise or miscalculation regarding the Fed's current degree of policy adjustment. It seems likely that this feeling is associated with the fact that political and economic situations in Europe are getting worse than I imagined, but the fact that the US economy has not collapsed is another reason. However, although the Fed has apparently "halted" its policy normalization process, it cannot really be said to have "ended" or "finished" the policy normalization process until the balance sheet reduction process is completed. The dot plot still indicates "two rate hikes in 2019", and the balance sheet is still being shrunk at the rate of USD50 billion per month. As discussed in a Mizuho Market Topic article[2] during February, a monthly survey of forex market participants jointly conducted by the financial market information vendor QUICK Corp. and the Nikkei Veritas financial weekly on February 12-13 found that more than 60% of respondents expect the Fed to hike interest rates "more than once" during 2019. Such expectations will not facilitate an upsurge in USD selling and JPY buying.

First of all, we should be waiting for a situation in which the "vestiges of the normalization process" no longer exist so that the process can truly be said to have "ended". Secondly, such adjustments as roll-backs or relaxations of the normalization process are likely to emerge after the "end". As mentioned above, the interest rate futures market has factored in such possibilities, but it does not seem that forex market participants have expectations of this type. In the future, when the forex market shifts toward pessimism, market forecasts are likely to take shape that anticipate the Fed playing different kinds of policy cards. While the current employment and wage situation obviates the need for such policy related judgements and decisions, the question remains regarding whether such developments as the sharp retail sales deterioration in December should be interpreted as signs of a real shift in fundamental economic trends. It appears that we will have to wait somewhat longer to see whether such judgements are called for.

"Unexpected U.S. economic robustness" Still the Most Important Risk Factor

There are several JPY depreciation risk factors that should be kept in mind with respect to the main forecast scenario (see chart). The biggest such risk factor is probably that of a situation in which the U.S. economy is surprisingly robust and the Fed therefore finds itself positioned to continue its normalization process. As I have repeatedly pointed out, then-FRB chairman Ben Bernanke began hinting about a tapering of quantitative easing in May 2013, when the U.S. long-term unemployment rate was 5.6% (according to the FRB staff projection released the following month). However, long-term unemployment rate decreased to 3.7% in November 2018, and currently (as of January 2019) still at the historically low level of 4%. It is probable that nobody, including the Fed, had been expecting the U.S. economic expansion to prove so long-winded. Minneapolis Federal Reserve Bank President Neel Kashkari, known as a leading dove within the FOMC, wrote in an essay (regarding the 2012 FOMC midpoint long-term unemployment rate estimate of 5.6%) that – "many more Americans wanted to work than we had expected" – and this reflects the fact that it is very difficult to accurately define a country's full-employment situation (or estimate a country's potential growth rate). Forex forecasters as well as economic and financial forecasters in general should humbly accept that they have not been quite up to the task of accurately assessing U.S. economic strength recently, and we should therefore keep in mind the risk that the U.S. economy will maintain robustness to an unexpected degree over the next year or so.

JPY depreciation risk factors

	Risk	Detail	Possibility
①	U.S. economy is surprisingly robust	Unemployment rate not rising, Recovering stock price and ISM index	medium /high
②	Discontinuation of the Trump administration's protectionist policies	Complete resolution of US-China trade war	low
③	BREXIT related	2nd referendum	medium /high
④	Additional monetary easing by BOJ	Further rate cut	low

(Source) Daisuke Karakama by Mizuho Bank

It was the strength of growth in non-agricultural employment that enabled the Fed to implement four interest hike rates in 2018, making it possible for the rise in U.S. interest rates and USD to continue until around autumn 2018. Although we are only two months into 2019, there is an atmosphere in which one cannot deny the possibility that similar signs of economic robustness may be sustained this year also. "Unexpected U.S. economic robustness" is the most important risk factor for this article's main scenario – so long as the unexpected robustness continues, the main scenario's forecast of JPY appreciation to roughly USD1 = JPY100 are not likely to be realized. Given that the latitude for further improvement in the U.S. economy is almost indisputably small, the possibility of movement toward JPY depreciation remains low, but it is

[2] Please see the February 18, 2019 edition of Mizuho Market Topic, entitled "Forex Markets and Lackluster Expectations Regarding the BOJ, FRB, and ECB."

unquestionable that movement toward JPY appreciation will be restrained. Barring a clear-cut and sharp deterioration of U.S. economic conditions, it is reasonable to anticipate that the forex market may continue to lack a clear sense of direction, just as during 2018.

Possibility of Brexit Referendum Rerun Greatest Political JPY Depreciation Risk Factor

While "unexpected U.S. economic robustness" is an economics-related JPY depreciation risk, there are also political JPY depreciation risk factors. Perhaps the biggest of such risk factors relates to the possibility of the discontinuation of the Trump administration's protectionist policies. Many forecasting institutions have suggested that the biggest issue of concern for the world economy at this time is the impossibility of predicting the future course of the Trump administration's trade war strategy. This is causing a trend of weakness in such soft data as purchasing managers' indexes, and it is also beginning to undermine the hard economic statistics of most countries. There are already some companies that are restraining their capital investment plans in light of uncertainties stemming from the Trump administration's trade policies. Rather than being a risk factor, the threat of trade war is gradually becoming a reality that can be said to be presenting the world economy with significant political obstacles. Thus, the elimination of the trade war threat could be expected to have a quite large psychological effect that would inevitably exert a positive effect on real economic indicators. A complete resolution of the U.S.-China trade war, for example, would be a potent symbol of trade war threat elimination, and it would be wise to be prepared for the potential ramifications of such an event. What I am referring to here is literally a complete ending of the U.S.-China trade war involving a complete discontinuation of the cycle of additional tariffs met with additional counter tariffs along with other initiatives symbolically conveying the message that the two parties were moving to normalize their relations, and I imagine that the markets would respond in a highly positive manner to such a scenario. However, the reforms the United States is demanding from China – such as intellectual property rights protection and the ending of forcible technology transfers – are not amenable to rapid resolutions, and I do not expect the related conflicts will be settled quickly. Moreover, with an eye to his reelection campaign, it appears that President Trump desires to continue playing the role of 'the president who confronted China on behalf of fair trade', and it seems most likely that he may seek to keep relations with China moderately strained while avoiding sharp trends of deterioration or improvement. While March 1 had previously been the deadline for raising tariff levels, the recent postponement of that deadline can be considered, in line with expectations, to reflect the United States' desire to maintain a certain level of harmony.

I also think it important to keep a close eye on the progress of Brexit negotiations and their potential to become another political JPY depreciation risk factor. Although predictions are difficult to make at the time this article was written, if speculation about the possible postponement of the March 29 deadline for reaching an agreement were to prove accurate, it can probably be expected that a general feeling of relief may promote JPY depreciation and USD appreciation. However, there is an even greater JPY depreciation risk associated with the potential for a decision to re-implement the Brexit referendum, which would revive expectations of an annulment of Brexit and promote a risk-off mood. Given that JPY depreciation is currently being promoted by mere rumors that the negotiation deadline might be postponed, it is reasonable to expect that the impact of a decision to re-implement the Brexit referendum might be as large as that stemming from the previous referendum's results. Regarding political risk factors, this seems to be the most fearsome JPY depreciation risk factor.

JPY Depreciation Risks Originating in Japan

Compared with overseas factors, it is basically much less likely that Japanese factors will strongly affect forex trends, but it is still worth paying close attention to the BOJ's actions. On February 19, BOJ Governor Kuroda responded to a question from the Diet's lower house financial affairs committee, saying – "If (sharp JPY appreciation) is having an impact on the economy and prices, and if we consider it necessary to achieve our price target, we'll consider easing policy." – promoting a bout of JPY depreciation and USD appreciation. Given that the statement itself has been repeatedly made in the past, that a downward revision of the risk balance assessment was clearly made in the BOJ "Outlook Report" released in January, and that the general situation is one in which consideration of additional relaxation as the BOJ's "next move" is not at all surprising, the market's response seems somewhat irrational. However, it remains true that the market has considerable expectations of the possibility of a "JPY appreciation → additional BOJ easing → JPY depreciation" scenario, and if such a scenario were to eventuate, it could potentially promote a large amount of JPY depreciation. The proposal of introducing a negative lending rate recently made by a former BOJ executive director has spurred media headlines that could potentially promote large forex rate movements. Given that such a measure could be considered a direct subsidy to financial institutions and that it almost surely would not augment lending volume, it is not considered a viable option at this time. In the case of considerable JPY appreciation, however, it may well be the BOJ's only available option. As a policy to supply negative-interest funds has already been implemented overseas in the form of the ECB's second round of targeted long-term refinancing operations (TLTRO2), it can be argued that the hurdles on the path to a Japanese negative lending rate policy are not as high as those faced at the time the BOJ introduced negative interest rates.

Innumerable JPY Appreciation Risk Factors

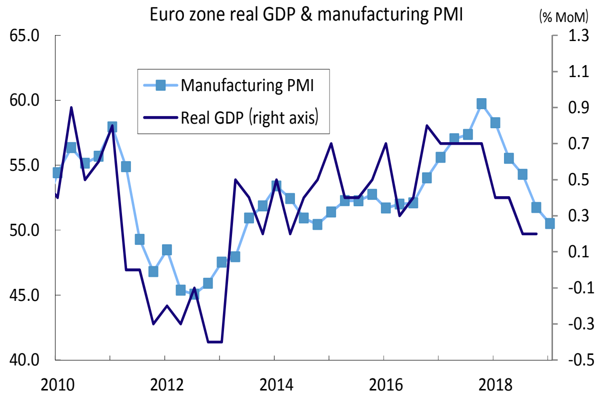
While this article has focused primarily on JPY depreciation risk factors, of course JPY appreciation risk factors also exist. Although a certain amount of JPY appreciation is consistent with the main forecast scenario, factors with the potential to promote considerably greater JPY appreciation than the main scenario anticipates are unquestionably risk factors. The financial markets often tend to view a wide range of 'negative' situations as being factors that promote JPY appreciation, and it would not be worthwhile to examine each such situation individually. One way to focus on relatively significant JPY appreciation risk factors is to take another look at the JPY depreciation risk factors just discussed and consider what would happen if the situation in question were to be exactly opposite to that associated with the JPY depreciation risk factor in question. For example, it is worth considering a case in which the U.S. economy unexpectedly stalls, pressuring the Fed into cutting interest rates and resuming quantitative easing measures, or a case in which the U.S.-China trade war suddenly intensifies. Other JPY appreciation risk scenarios worth thinking about include a case in which there is a complete breakdown of Brexit negotiations, making a "no-deal" Brexit inevitable, and a case in which the BOJ resolutely perseveres with its normalization process and boldly hikes interest rates. Looking at Europe, one can see a potential for a sharp rise of political instability in such core and semi-core countries as Germany, France, Italy, and such instability in each country could, depending on the situation, be considered to be JPY appreciation risk factors. The potential for a recurrence of the kind of turbulence related to fund flows involving emerging countries that caused financial markets to suffer several bouts of jitters last year is also worthy of being considered a JPY appreciation risk factor. Many observers are already whispering about the incipient peaking out of the global economy, and there is probably a high likelihood that numerous and diverse 'negative' situations will occur here and there in the world during the forecast period.

Given how far the U.S. unemployment rate has declined, as noted above, the U.S. economy may well maintain its current robustness going forward but seems extremely unlikely to accelerate from this point. In this situation, is it appropriate to anticipate a U.S. interest rate rise and USD appreciation accompanied by JPY depreciation? It seems more appropriate to assume that when the global and U.S. economies peak out, there will be a downward shift in U.S. interest rates and USD that will promote JPY strengthening. This is not to mean to suggest that USD/JPY would be likely to make a dramatic shift down into the JPY95-90 range. If one calmly considers the relative likelihood of upward and downward movements in USD/JPY, I think evaluating the current condition is not so difficult.

EUR Outlook – Difficult Outlook for an Interest Rate Hike

The Euro Area Economy Now and Going Forward – Market Abandoning Hope for Interest Rate Hike This Year

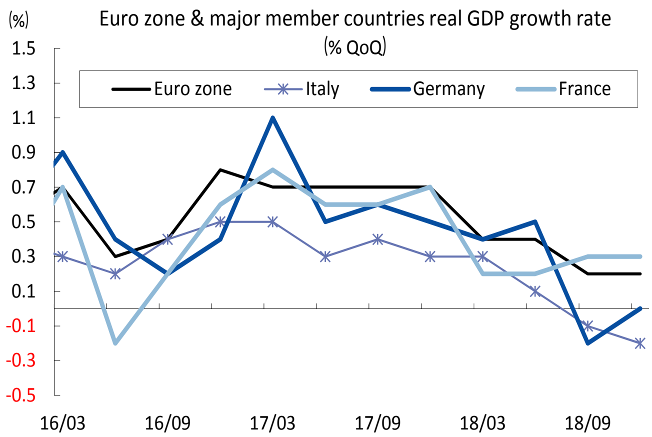
Euro Area Economy Showing no Sign of Bottoming Out



(Source) Bloomberg (Note) PMI: quarter average

While the EU's political situation is being muddied by the turbulence of Brexit negotiations, there are ominously dark clouds steadily approaching the EU's economic and financial situations. Announced on January 31, the euro area's fourth quarter real GDP growth rate was +0.2% qoq, roughly the same rate as achieved in the previous quarter. As the graph shows, however, the euro area economy has clearly decelerated during the past year, and its full-year growth rate declined from +2.4% in 2017 to +1.8% in 2018. This is the first time in four years that the euro area's full-year growth rate has fallen below the 2% level. It is possible to argue that this reflects an excessive growth rate in the 2016-2017 period, but it is a troubling situation given that the ECB is currently trying to promote a normalization process. Moreover, the euro area January manufacturing PMI announced on February 1 was 50.5 – a decline from 51.4 in the previous month and the lowest level since November 2014 – suggesting that, rather than recovering, a drop to below the 50% level is a realistic possibility. In light of the stable correlation between the manufacturing PMI and real GDP (see graph), it is hard to envision a clear-cut recovery of the euro area economy, at least with respect to the first quarter. This economic situation will naturally be taken into account in the March ECB staff forecast revision and can be expected to undermine bullishness in the ECB statement and ECB President Draghi's press conference for the March 7 Governing Council meeting.

Individual Countries' Growth Rates – Signs of Weakness in Germany



(Source) Bloomberg

Fourth quarter 2018 growth rates for individual countries are not available except for figures released ahead of time by the statistics bureaus of some member countries. (Figures for the contribution to GDP by individual demand segments will be announced on March 7.) As has already been widely reported, Italy expanded its negative qoq growth margin from -0.1% in the previous quarter to -0.2%, thereby, technically speaking, falling into a recession for the first time in about 6 years, since the first quarter of 2013. Despite concern about the impact of the yellow-vest demonstrations, France maintained a 0.3% qoq growth rate, and Spain accelerated to 0.7% qoq growth, from 0.6% in the previous quarter. While Germany had previously been a principal locomotive of the region's growth, it recorded only 0.0% qoq growth for the fourth quarter, up from the conspicuously weak rate of -0.2% in the previous quarter.

In a speech made on January 31 in the German city of Mannheim, Deutsche Bundesbank President Jens Weidmann, predicted that Germany's economic deceleration would continue during 2019, saying – "the German economy will probably grow at well below the potential rate of 1½% in 2019." The magnitude of the downward revision of the yoy German growth rate (to +1.3%) in the revised IMF World Economic Outlook released in January has attracted considerable attention. It appears inevitable that Germany's economic growth will be forced down to below the country's cruising speed during 2019, creating a time period of special challenges, and a major focus in this regard will be how the slackening of German growth will affect monetary policy management within the region (especially that of the ECB). Although President Weidmann went on to say – "Once the German economy has overcome the weak spell, it looks set to go back to growing at roughly the same pace as its capacity in 2020 and 2021." – it is quite significant that even he does not expect the German economy to strengthen much this year.

Impact on the Normalization Process

From the perspective of market participants, it is impossible to overlook the fact that economic deceleration is pervasively spreading within the euro area even as the ECB seeks to promote a monetary policy normalization process. At the very least, it can be assumed that interest rate hikes are unlikely to start until clear signs of a bottoming out emerge. First of all, people are hoping to see signs of recovery in such fast-paced soft data as the euro area manufacturing PMI and the EC business confidence index, but the inability to discern clear signs of a bottoming out in such data has created an atmosphere that seems to preclude monetary tightening. While acknowledging economic deceleration in the above-mentioned speech, President Weidmann also said – "the normalisation process will probably take a number of years, which is all the more reason not to squander any time." – thereby demonstrating his sustained support for moves toward policy tightening. <u>The content of the speech largely just reflected President Weidmann's fundamental monetary policy philosophy, however, and the financial markets are demonstrating that they are giving up on the possibility of an interest rate hike this year (see table)</u>. In the case that the rate hikes were to start in September 2019, which is the earliest possible timing in line with the ECB's forward guidance, there is concern that the gap between market assumptions and ECB moves may subject the financial product price formation process to a considerable shock (with such potential consequences as a sharp fall in interest rates and drops in stock prices and forex rates.) Media reports about the increasing likelihood that President Weidmann will become the next ECB president are beginning to become conspicuous in their number, but even if he does win that position, there will be a limit to the extent to which he will be positioned to promote policies that disregard the consequences of significant deviations from market expectations.

EONIA & deposit facility rate (as of 26 FEB 2019)

	EONIA	Assumed deposit facility rate	Timing
Current	-0.37	-0.40	
6month forward 6months	-0.33	-0.36	JAN 2020
12month forward 3months	-0.29	-0.32	APR 2020
15month forward 3months	-0.26	-0.29	JUL 2020
18month forward 3months	-0.22	-0.25	OCT 2020
21month forward 3months	-0.19	-0.22	JAN 2021
24month forward 3months	-0.13	-0.16	APR 2021
24month forward 6months	-0.11	-0.14	JUL 2021

(Source) Bloomberg
(Notes) Colored part is to expect the timing of 10bps rate hike
Assumptions associated with spread of deposit facility rate & EONIA is 3bps

Current State of EC Presidency Race – Germany's Turn?

New ECB Chief Economist

On March 30, Mário Centeno, president of the Eurogroup of euro area finance ministers, announced that Central Bank of Ireland Governor Philip Lane is the sole candidate nominated to replace ECB Executive Board member Peter Praet when Praet's term expires on May 31. Praet is serving as head of the ECB's economics department, making him the ECB's chief economist. The ECB Executive Board member serving as chief economist is responsible for summarizing economic forecasts prepared by the staff of the ECB's specialized committees. Materials regularly prepared for the Governing Council members' discussions of monetary policy are provided by ECB staff members to the ECB Executive Board member who is serving as chief economist and is in charge of the Directorate General Economics (DG-E), and the chief economist distributes them to the other Governing Council members. These materials serve as the basis of discussions at Executive Board meetings and are sent after approval through the secretariat to the other Governing Council members[3]. Because the chief economist plays this crucial role in the ECB's policy decision-making process, the chief economist post has a particularly high profile compared to other Executive Board posts. This nomination will have to be officially approved at the March 20-21 EU summit meeting, but the approval is considered almost a sure thing given Lane's celebrity as an economist, the fact that Ireland is an original euro area country that has never yet had one of its citizens appointed to the Executive Board, and the fact that there are no other candidates.

ECB board members (as of FEB 2019)

Position	name	Country	Start date	End date	Stance
President	Draghi	Italy	11 NOV 2011	31 OCT 2019	Dovish
Vice president	de Guindos	Spain	1JUN 2018	31 MAY 2026	Dovish
Board member (Note 1)	Praet	Belgium	1 JUN 2011	31 MAY 2019	Dovish
Board member	Lautenschlager	Germany	27 JAN 2014	26 JAN 2022	Hawkish
Board member	Coeure	France	1 JAN 2012	31 DEC 2019	Dovish
Board member	Mersch	Luxemberg	15 DEC 2012	14 DEC 2020	Hawkish

(Source) ECB (Notes) 1. Chief economist 2. Central Bank of Ireland Governor, Lane is expected to replace ECB Executive Board member, Praet. 3. Coloured part means the term of office will come in 2019.

[3] For details, please refer to my book : *European Central Bank- from Organization,Strategies to Banking Supervision* , Toyo Keizai Shinposha (November 2017)

Chancellor Merkel's shifting priorities

In addition to the outlook for Lane to become an Executive Board member, the news is associated with several other issues that are worth closely monitoring. One is the fact that Germany did not nominate Bundesbank President Jens Weidmann as a candidate to replace Chief Economist Praet. For some time, it was widely believed that Germany would nominate Weidmann for the chief economist post because it was thought Weidmann would not have sufficient support to become the ECB president. It is speculated that Germany's failure to win the Chief Economist post means that the country is aiming at nominating one of its citizens for one or both of the ECB presidency and the EC presidency positions. As previously noted in this article, on August 22, 2018, the German newspaper Handelsblatt reported the Chancellor Merkel has changed her priority ranking regarding the German nominees for top EU posts scheduled to be filled during 2019. According to the report, Chancellor Merkel has shifted her top priority from the ECB presidency to the European Commission (EC) presidency. The EC presidency is generally considered to be superior in status and power compared to the ECB presidency, so if Chancellor Merkel – renowned for her political perspicacity – believes she has a greater chance of succeeding in placing her candidate in the EC presidency position than in the ECB presidency position, it is not at all surprising that she would shift her emphasis to the ECB presidency. In fact, on November 8 last year, the European People's Party (EPP), a center-right group that is the faction with the greatest number of seats in the European Parliament, elected a German – EPP Chairman Manfred Weber – as its candidate for the EC presidency position.

However, it is anticipated that the EPP and other existing factions will face serious challenges in the May 23-26 European Parliament elections, so it is not clear whether the EC presidency position can be acquired in line with expectations. Chairman Manfred Weber is the chairman of the EPP, a pro-EU faction, and Chancellor Merkel has expressed her support for him, but the issue will be moot if the EPP cannot win the election. Article 17 of the Lisbon Treaty describes the process of selecting the EC President as follows – "Taking into account the elections to the European Parliament and after having held the appropriate consultations, the European Council, acting by a qualified majority, shall propose to the European Parliament a candidate for President of the Commission. This candidate shall be elected by the European Parliament by a majority of its component members." This system for selecting the EC President is modelled after the so-called parliamentary cabinet system, but there have constantly been arguments about how much weight to give to the results of the European Parliamentary elections – characterized by low rates of voter turnout – in the selection of the EC President, which is the EU's highest post. In this regard, French President Emmanuel Macron has argued that primary emphasis should be given to the discretion of the European Council and that the selection of the EC President is not necessarily bound by the results of the parliamentary elections.

There are also those questioning whether Mr. Weber is the most suitable candidate for the EC presidency. Although he was previously a member of the legislature of the German state of Bavaria, he has never served as a cabinet minister or in other high-level administrative posts, and it is hard for him to dispel the general impression that he is a relatively obscure and lightweight candidate. In comparison, four of the past five EC Presidents (including current EC President Jean-Claude Juncker) had been prime ministers of their countries, and the other had been the leader of the lower legislative body of his country. (One of them, the Spaniard Manuel Marín, served as interim president following the resignation of Jacques Santer, who previously was Luxembourg's prime minister.) It is self-evident that as the EU's highest post, the EC presidency must be filled by a personage with suitably eminent qualifications, and it is already being questioned whether Mr. Weber would be capable of effectively countering the centripetal forces the EU is currently facing. Given all this, it does not appear certain that Chancellor Merkel will be able to achieve the objective of capturing the EC presidency.

Moreover, rumors that Italy would support Deutsche Bundesbank President Weidmann's candidacy for the ECB presidency have been buttressed by comments recently made by Italy's Minister of Economy and Finance Giovanni Tria, and there are increasing signs that support for Mr. Weidmann's candidacy will grow sufficiently for him to win the requisite qualified majority vote (QMV)4. While it had previously been thought that Mr. Weidmann's candidacy for the ECB presidency had been squelched, his chances appear to be reviving. Owing to the unwritten law that no more than one person of a given nationality can serve on the ECB's Executive Board, if Mr. Weidmann were to become ECB president, Sabine Lautenschläger would theoretically have to retire from the board. Although this aspect of the ECB top-level personnel succession is difficult to address at present, there is a possibility that a perceived need to have at least one female member of the board might complicate that situation.

Finnish Obstacles to a Weidmann ECB Presidency

However, there are additional complicating factors. Many people are concerned about how concertedly the ECB Governing Council members could work together under a Weidmann ECB presidency, given that Mr. Weidmann has repeatedly spurred divisions within the Governing Council owing to his outspoken expression of hawkish views. It is not hard to imagine that there will be particularly strong resistance to Mr. Weidmann's views among southern European countries. But if not Weidmann, then who? One person currently enjoying a high level of support is Erkki Likkanen, who retired as governor of Finland's central bank last June and previously served as Finland's finance minister and ambassador to the EU in addition to serving in two European commissioner posts. It is generally believed that there is currently no ECB presidential candidate capable of competing with Mr. Likkanen in terms of connections and support within key EU entities in

[4] Qualified Majority Voting (QMV) is the voting procedure used by EU ministerial councils for making decisions on certain kinds of proposals. QMV decisions can be made based on a majority vote so long as two main conditions are satisfied: ① that 55% or more of the member countries are in favor (at least 15 countries) and ② that the population of the countries in favor accounts for at least 65% of the total EU population. Because QMV decisions are valid when these two conditions are satisfied, it is known as the 'double majority' system.

Brussels. Another Finnish candidate is Olli Rehn, who succeeded Mr. Likkanen last July as president of Finland's central bank and is thought to have performed well in helping deal with the financial crisis while serving as European commissioner for economic and monetary affairs and the euro. For Mr. Weidmann to become ECB president, he must gain greater support than these Finnish competitors.

While Germany is a leading EU country in many regards, it has never been able to place one of its citizens in the top posts of the European Commission or the ECB. The last German in a post comparable to that of the EC president was Walter Hallstein, who served as the president of the first commission of the European Economic Community (EEC) from January 1958 to June 1967, but there has never been a German EC president since the EU took its current form. It is possible that Germany will be able to win one of the two top posts in 2019? Or will they fail once again? The personnel transition of the top posts of the European Commission and ECB happens only once every five years. Because the nature of the transition will strongly influence the operations of the European Commission and ECB for years to come, it is an extremely important event for those seeking to anticipate Europe-related developments going forward.

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