Mizuho Bank

One MIZUHO

# Forex Medium-Term Outlook

26 April 2019

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Forex Department

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## Overview of Outlook

The USD/JPY stalemate has become more pronounced. The U.S.-Japan interest rate gap has continued to narrow since last fall, but it was only until mid-January this year that USD/JPY declined in line with this narrowing. Since February, USD/JPY has rather begun to increase. In that sense, it could be said that the past three months have been characterized by “a weakening of JPY amid a narrowing of the U.S.-Japan interest rate gap.” Perhaps this is because many investors are finding USD-denominated assets attractive due to persistently high U.S. interest rates, even if the gap between the U.S. and Japanese interest rates is shrinking. As can be seen in IMM currency futures transactions, speculative JPY selling (i.e., USD buying) has, indeed, continued to build up against the considerable interest-rate gap. However, one must recognize the instability in this increase in speculative investments that bet on a strong USD even as the Fed becomes more dovish. Some senior Fed officials have already begun to hint at the possibility of rate cuts. I think it is rather unlikely for these rate cuts to materialize during the current forecasting period, but under current circumstances, one would be prudent to bet on rate cuts rather than on the resumption of rate hikes. Given that USD is being propped up by the speculative position bias despite the shrinking of the interest rate gap, the current strength of USD is practically on thin ice. If the European or Chinese economies were to recover their strength during the second half of the year and there is another spurt in U.S. inflation, there is the risk of another phase of JPY weakening, but that is a risk scenario rather than the main one.

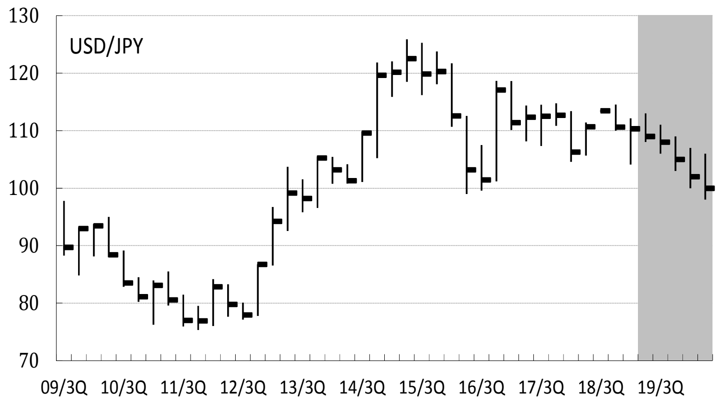
Meanwhile, EUR also remains level. The fate of Brexit negotiations remains uncertain and the region’s economic indicators continue to deteriorate, so the climate surrounding EUR is as bad as ever. With regard to the ECB, too, the rate hike forecasts that the markets are factoring in are getting pushed back further and further, so a revision of the forward guidance may soon become necessary. The EUR short position of speculators as seen in IMM currency futures transactions has built up to a level last seen 2 years and 4 months ago. On the other hand, one can point out that EUR has not weakened despite all these developments. Going forward, U.S. interest rates are more likely to fall than to rise. One must be warned of the potential for EUR appreciation to strengthen amid a rollback in the built-up speculative positions. Again, even as its economy stagnates, the euro area continues to strongly maintain its status as the holder of the world’s largest current account surplus, which could also be helping EUR remain strong vis-à-vis USD. At any rate, the current persistent strength of USD seems untenable amid the Fed’s increasingly dovish stance and the downward trend of U.S. interest rates, so I still predict a scenario of the relative strengthening of EUR as USD depreciation gathers momentum.

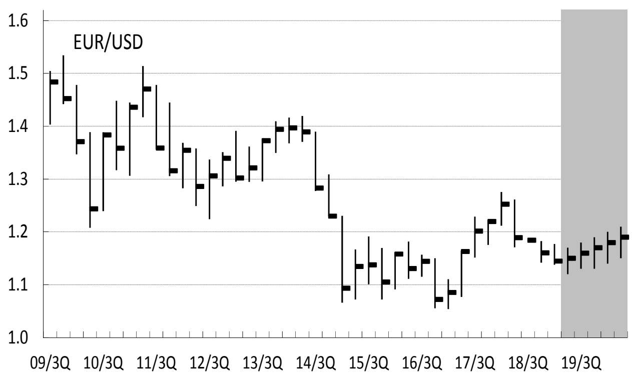
### Summary Table of Forecasts

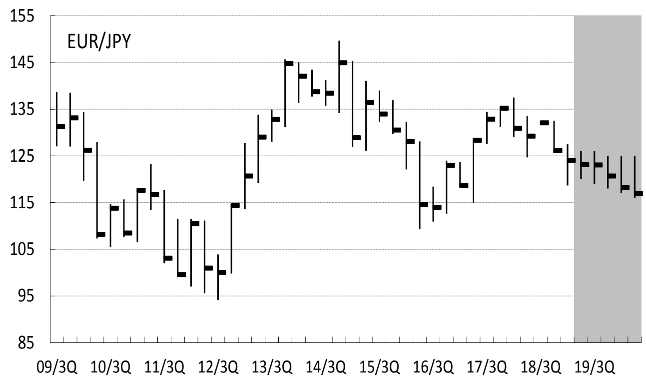
| | 2019<br>Jan -Apr (actual) | May-Jun | Jul-Sep | Oct-Dec | 2020<br>Jan-Mar | Apr-Jun |
|---|---|---|---|---|---|---|
| USD/JPY | 104.10 ～ 112.40<br>(111.64) | 108 ～ 113<br>(109) | 106 ～ 111<br>(108) | 103 ～ 109<br>(105) | 100 ～ 107<br>(102) | 98 ～ 106<br>(100) |
| EUR/USD | 1.1118 ～ 1.1570<br>(1.1130) | 1.10 ～ 1.15<br>(1.13) | 1.11 ～ 1.16<br>(1.14) | 1.11 ～ 1.17<br>(1.15) | 1.12 ～ 1.18<br>(1.16) | 1.13 ～ 1.19<br>(1.17) |
| EUR/JPY | 117.85 ～ 127.50<br>(124.25) | 120 ～ 126<br>(123) | 119 ～ 126<br>(123) | 118 ～ 125<br>(121) | 117 ～ 125<br>(118) | 116 ～ 125<br>(117) |

(Notes) 1. Actual results released around 10 am TKY time on 26 April 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



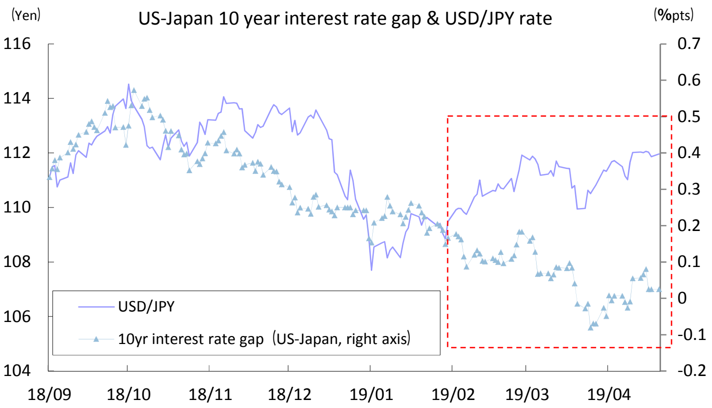


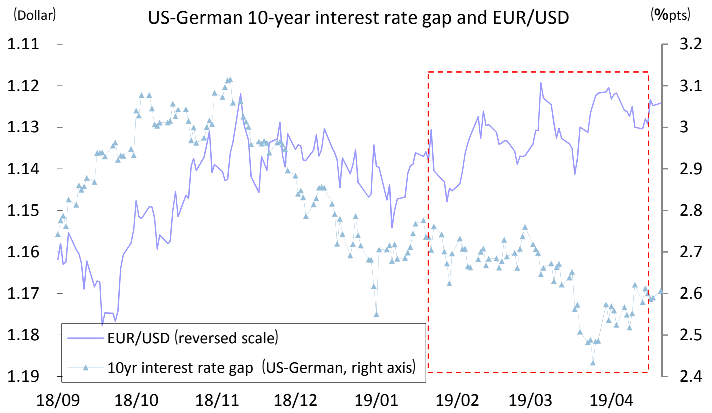

# USD/JPY Outlook – A “Surplus Devoid of JPY Buying” and Range-Bound Rates

## USD/JPY Now and Going Forward – USD Strength Remains “On Thin Ice”

### *USD Shows Resilience in the Face of Interest Rate Decline*




(Source) Bloomberg

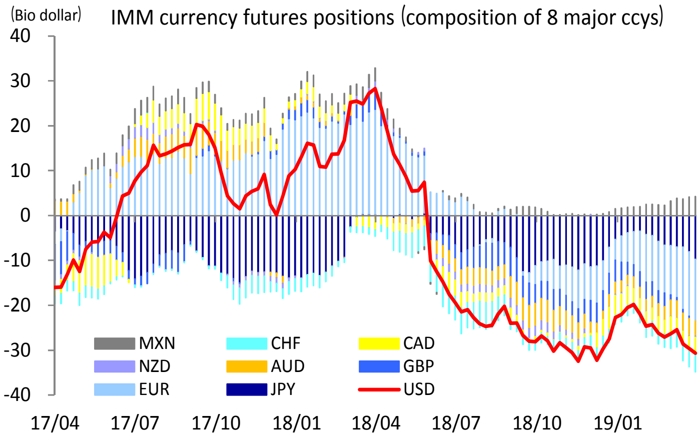



(Source) Bloomberg

USD/JPY remains deadlocked. The range over the past two months (March 1 to April 23) has been quite narrow, at 2.47 (109.70 to 112.17), and even narrower, at 1.36 (110.8 to 112.7) if only April (April 1 to April 23) is considered. During this time, the Fed has indicated a suspension of rate hikes for the rest of this year in its dot plot and also announced the suspension of its balance sheet normalization efforts. As I will discuss later, there are even hints, recently, of the possibility of rate cuts. Thanks in part to these various developments, U.S. 10-year interest rates have fallen as much as -40 bp since March, from 2.77% to 2.34%. Since its peak in October last year, the U.S.-Japan interest rate gap has clearly been contracting, but USD/JPY declined in tandem with the interest rate gap only until mid-January this year. Since February, it has rather been rising. As the figure shows, the past three months have been characterized by “a weakening of JPY amid a narrowing of the U.S.-Japan interest rate gap.” A similar structural relation can be seen between the U.S.-German 10-year interest rate gap and EUR/USD. There are many interpretations of this situation, but it seems reasonable to assume that the resilience of USD is supported by the fact that, given the negative interest rates of JPY and EUR, investors can still see a reason to invest in USD-denominated assets despite the slight decline in U.S. interest rates. Another possibility is that the rise in asset prices, as stock prices rise strongly on the back of the Fed turning dovish, is generating greater optimism over U.S. economic strength. However, given the already limited scope for further improvement in the labor market, the expectation that the real economy will expand eternally is no more than escapism.

### *Speculative USD Buying will Soon Become Excessive*

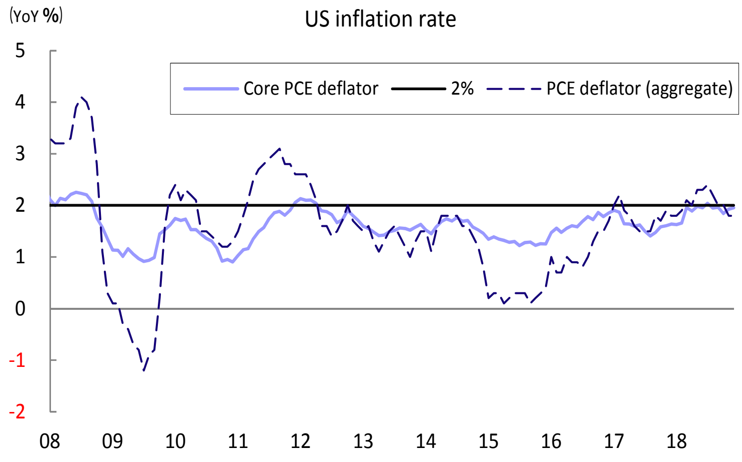
With a considerable interest-rate gap available, speculative JPY selling (i.e., USD buying) has been steadily building up. The JPY short position in IMM currency futures transactions as of April 16 is -USD 9.72 billion, the highest it has been since January 1, 2019 (see figure). However, talking of January, one recalls that, as investors covered their short position, JPY soared to hit the 104 level against USD. It is probably because of the existence of an absolute interest rate level that the JPY short position is being maintained without being covered, but as I have already mentioned, the interest rate gap is in the process of steadily narrowing, and there are no signs of it beginning to expand again. Incidentally, the EUR short position is even larger at -USD 13.82 billion, the largest in the 2 years and 4 months since December 2016. In looking at current forex rates, it would be wise to be at least aware of the fact that, despite this level of buildup in speculative USD buying, the currency has not appreciated that much. Even against the composite of eight major currencies, the USD long position is higher than it has ever been since December 25, 2018, and there is a sense that the position bias is excessive. I dare say one ought to feel concern at this intensifying trend of betting on USD strength despite the Fed's switch to a more dovish stance.



(Source) Bloomberg

### *Wiser to Bet on a Rate Cut*

If we assume that this absolute interest-rate level is propping up USD, the next fundamental question is – could U.S. interest rates fall further? In this connection, it must be noted that the Fed has offered clear hints of a downward trend in recent days. It has been reported (Wall Street Journal, Japan edition, April 22) that, taking into account the slump in core Personal Consumption Expenditure (PCE) deflator (excluding food and energy categories), Chicago Fed President Charles Evans said in a speech given on April 15 that the Fed would definitely consider the need for insurance against bad outcomes (by cutting rates) if the core PCE deflator remained in the vicinity of +1.5% yoy over a period of a few months. In his speech on the topic "Risk Management and the Credibility of Monetary Policy," Mr. Evans mentioned that adjustments to the policy path had been discussed "in about one-third of the 128 FOMC meetings between 1993 and 2008" "due to uncertainty over the outlook or as insurance against particular risks." In illustrating how this course of action has not been rare historically, it is possible that Mr. Evans intended to prepare the ground for rate cuts being considered, as "insurance," if inflation expectations begin to recede going forward.



(Source) Bloomberg

In the speech, Mr. Evans also touched upon the fact that the 2% target was no more than a "symmetric target," which is a point that has often been made recently when discussing the Fed's policies. One of the leaders of the dovish faction of the Fed, Minneapolis Fed President Neel Kashkari, has stressed this point for quite some time, and I have frequently expressed strong agreement in this report[1]. In his December 2017 essay, Mr. Kashkari stated, "even if (core inflation) met or exceeded our target, 2.6 percent should not be of any more concern than the current reading of 1.4 percent, because our target is symmetric" (the PCE deflator was near 1.4% at that time). In other words, in the sense that both 1.4% and 2.6% are at a distance of 0.6 pp from the 2% target, the risks are equal in both cases, and Mr. Kashkari's point is that the Fed should work essentially to narrow this 0.6 pp gap to the extent it can (i.e., to continue monetary accommodation). Again, given that the Fed has only a limited set of policy options available if the economy enters deflation going forward, Mr. Kashkari strongly advocated policy risk management by avoiding the possibility of unseating the inflation trend by raising rates "too soon" rather than "not soon enough." The Fed in those days, however, was not all that interested in either the symmetric nature of its target or in risk management.

However, going by the series of communications from senior Fed officials in recent days, it appears that Mr. Kashkari's ideas are beginning to gain currency – the Fed seems to be toying with the idea of policy risk management by cutting rates as "insurance," despite the risk of pushing inflation beyond 2%, based on the principle of a "symmetric target." Dallas Fed

[1] Please see the December 20, 2017 Market Topic titled "My Thoughts on Neel Kashkari's Third Essay."

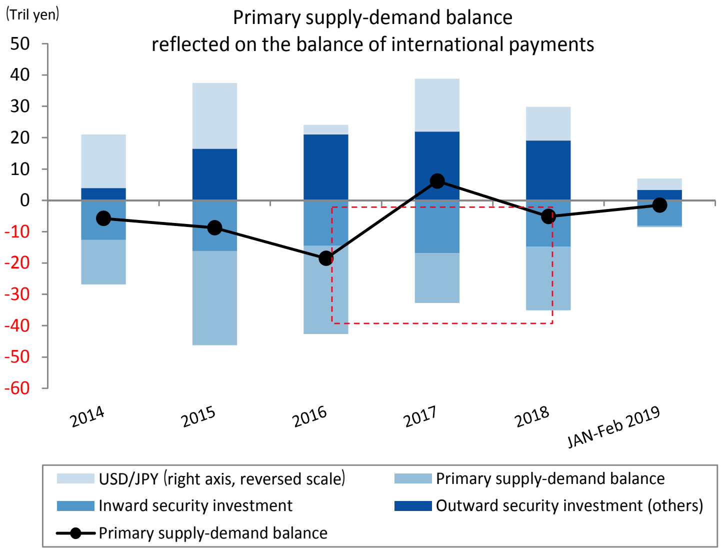
President Robert Kaplan is also reported (WSJ, Japan edition, April 22) to have said that the option of cutting rates would definitely be taken into consideration should such a situation (core PCE deflator remaining at or below +1.5%) arise. The Fed probably does not want to be seen has having buckled under political pressure, but one does sense some abruptness in this change in its position.

However, the core PCE deflator is currently at a level quite close to the target +2.0% (+1.8%), so the scenario envisaged above is not all that realistic (see figure). The U.S. government has announced an end to its current waivers on sanctions to eight countries/regions including Japan that import Iranian crude oil starting May (i.e., if said countries continue to import Iranian crude oil, they will face U.S. sanctions), and this is expected to cause crude oil prices to soar. Now, the core PCE deflator, though excluding energy prices, is not completely unaffected by energy prices, so it would be hard to imagine it going into a one-sided decline in the coming months. Having said that, given the recent series of hints at future rate cuts from senior Fed officials, one would do better to bet on rate cuts as the next move rather than on a resumption of rate hikes. Considering that the hurdles against rate cuts appear to have been lowered on the pretext of "insurance," the current strength of USD, which is being propped up by the speculative position bias, is practically on thin ice.

## JPY Supply-Demand Balance – The Reality of a Surplus Devoid of JPY Buying

### *JPY Supply-Demand Neutral on Average over Past Two Years*

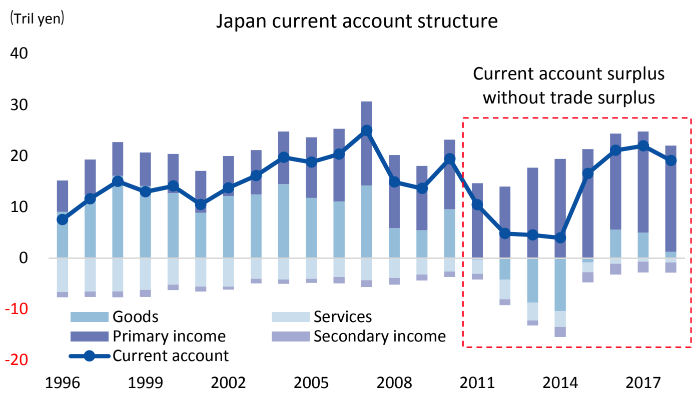
USD/JPY continues to lack a clear sense of direction. There are many explanations for why this may be so, but perhaps the straight answer is also possible – that this is because of a state of equilibrium in supply and demand. In this report, I use the international Balance of Payments to monitor the JPY supply-demand balance at definite points during the year, and I have observed that JPY demand been inclined neither toward JPY buying nor selling since 2017 as of February 2019 (see portion within dotted square in figure). If we aggregate the numbers for the period from 2017 to February 2019, there is a small net selling of JPY amounting to -JPY 630 billion, but this no more than within the margin of error judging the supply-demand balance considering the enormous sums of money traded in the forex markets, where just spot transactions amount to around USD 2 trillion (JPY 220 trillion) per day. It seems implausible that there is no connection between the neutral JPY supply-demand balance and the fact that USD/JPY posted its narrowest and third narrowest annual ranges ever in 2018 and 2017, respectively. The idea that this "balanced" supply-demand climate may be causing USD/JPY to be range-bound is quite valid.




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

### *JPY – Once Sold, Gone for Good*

The change in the JPY supply-demand structure can also not be overlooked. Given that USD/JPY has failed to fall despite the markets factoring in a decline in U.S. bond interest rates and the sharp fall in stock prices, one must be prepared for the possibility of a major, unprecedented change. As I have discussed in detail in past issues of this report, there is a significant possibility that foreign direct investment trends over the past almost 10 years could be having an impact. Japan has had the world's largest net external assets for 27 years in a row (through 2017), but if we look at the composition of these external assets, 44.5% are in the form of outstanding foreign direct investment. Meanwhile, the outstanding securities investment amounted to 26.1%. This is a dramatic flip in the composition considering that, in 2000, the two components had amounted, respectively, to 19.7% and 36.5%. During risk-off phases, investors can repatriate (returned to the country of origin) any funds that are invested in marketable securities, but it is not so easy to let go of an acquired foreign company just because of a rise in a risk-off mood. In other words, as a result of this increase in Japanese foreign direct investment, a situation has become established where JPY once sold, is gone for good.



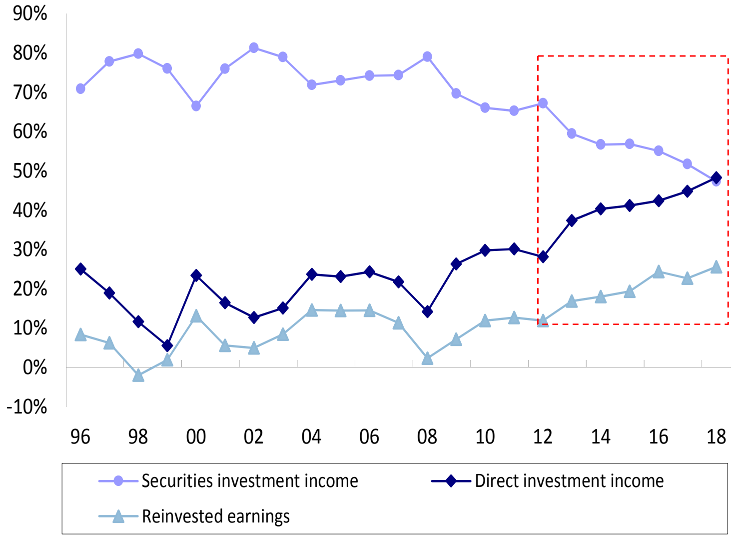

(Source) Macrobond

The above are stock-related points, but of course, similar implications can be derived from flow-related arguments. It was around 2011 that foreign direct investment really took off, and from around the same time onward, Japan's current account surplus began to be led by the primary income surplus rather than the trade surplus, which took a backseat (see figure). Based on Geoffrey Crowther's theory of the six phases of evolution of a country's balance of payments, it can be said that Japan began to transition in earnest from a "young creditor nation" to a "mature creditor nation" at around this time (although it is not yet a fully mature creditor nation as it still intermittently posts goods and services surpluses). The level of Japan's current account surplus has not changed that much between the ten years before the financial crisis (1999-2008) and the ten years since (2009-2018). Specifically, if we compare 10-year averages, the average before the crisis was around +JPY 16.7 trillion while the average following the crisis was around +JPY 13.5 trillion. The goods and trade surplus has declined drastically from around +JPY 10.9 trillion to around +JPY 184 billion. Meanwhile, the primary income surplus has clearly gone up from around +JPY 11.2 trillion to around +JPY 17.3 trillion. At the same time, the halving of the service account deficit from around -JPY 4.4 trillion to -JPY 2.4 trillion or so is also conspicuous, but the main reason why Japan's current account surplus level has not changed much compared with the former ten-year period despite its inability to post trade surpluses is because its primary income surplus has increased in the form of the "yield" from past investments. From the perspective of forecasting trends in the forex market, it must be pointed out that there has been a structural change in that trade surpluses, which lead to outright buying of JPY, have decreased, and primary income surpluses, which do not necessarily result in outright JPY buying, have increased.

***Foreign Direct Investment Now Leads Even in Terms of Flow***

I would like to explain what I actually mean by "primary income surpluses, which do not necessarily result in outright JPY buying." The components of primary income are investment income, employee compensation, and other primary income, but mainly investment income. Investment income is further divided into securities investment income and direct investment income. The graph to the right traces the composition ratio of the two over the years. As one can see, the composition ratio was 66.5% for securities investment income and 23.3% for direct investment income in 2000, but had become more or less equal, at 47.3% and 48.2%, respectively, by 2018 (for the first time in 2018, the relative sizes of the two flipped). As I discussed in detail in a past issue of this report[2], there seems no logical reason for Japan's foreign direct investment growth to slow down in the near future when you consider the various factors that affect Japanese companies at home, including Japan's population dynamics, state of corporate profits, corporate tax rates, electricity prices and other costs, rigid employment regulations, and so on. It seems very likely, therefore, that foreign direct investment growth will continue to outpace that of securities investment in the upcoming phase. Summarizing the points made so far, Japan's current account surplus is shifting from a focus on trade surplus to that on primary income surplus, and within this, from securities investment income to direct investment income.

Share ratio of direct investment income & securities investment in primary income surpluses (net base)



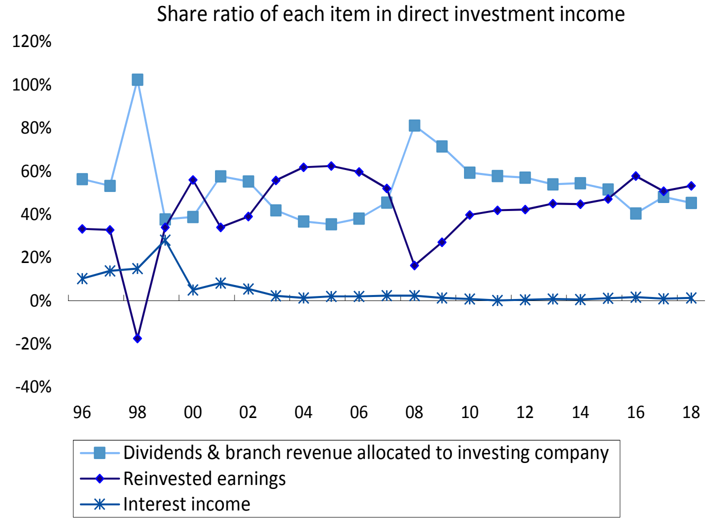

(Source) Bank of Japan

***Impact on JPY***

What impact is this structural change in the current account surplus having on JPY? As I mentioned earlier, in the case of a trade surplus, export companies have to convert the foreign exchange they earn from their exports into JPY, so this directly exerts a JPY buying/foreign currency selling pressure. This type of "outright" forex transaction (outright buying/selling of a currency) is voluminous on its own, but also influences investors and speculators, who follow the trend. It thereby sets the direction of the trend. When trade surplus comprised the large part of current account surplus, there was a good reason to link the current account surplus figure with JPY buying.

[2] Please see the February 12, 2019 Market Topic titled "Trend of Foreign Direct Investment Seems Unlikely to Change."

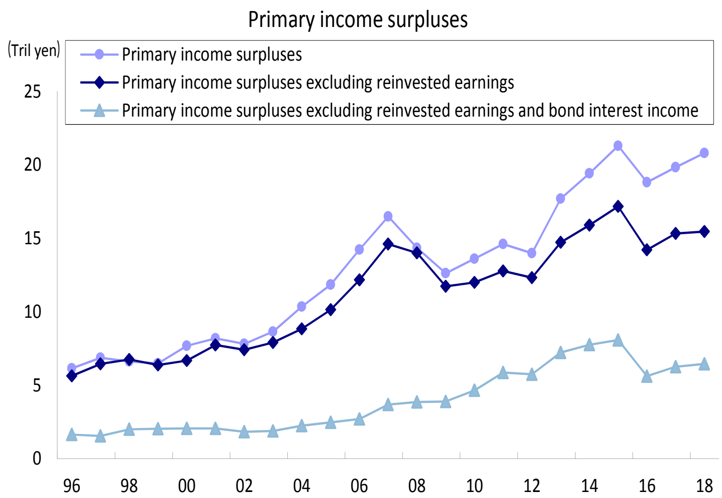
However, now that the primary income surplus has become the component that determines the current account surplus trend, the path by which it impacts the forex markets has become less simple. For instance, securities investment income can be divided into dividend income and bond interest income, but in reality, 80-90% of it is interest income. It is important to note that in the case of such flow variables, they are still in foreign currency at the point when the surplus is registered. For instance, in the case of a Japanese investor A who receives interest income from U.S. Treasury bonds he owns, a primary income "surplus" will be registered as soon as this interest income is transferred to his account abroad. If we assume that the interest received is automatically reinvested (this is thought to be often the case), then very little JPY conversion flow can be expected from securities investment income. Meanwhile, direct investment income is made up of dividends & branch revenue allocated to investing company, reinvested earnings, and interest income, and for 2018, dividends & branch revenue allocated to investing company comprised 45.4%, while reinvested earnings comprised 53.2%. The relative weights of these two components have not changed much over the years, but it must be pointed out that while dividends & branch revenue allocated to investing company are actually transferred back to the direct investor (or parent company), reinvested earnings are that part of the investee company's operating profits that are not allocated to the investor, but rather set aside as internal reserves. In other words, it is clear that even in the case of direct investment, very little JPY conversion flow can be expected from around half of the resultant income.



(Source) Bank of Japan

***The Reality of a Surplus Devoid of JPY Buying***

Compiling the points mentioned above, it is clear that, within the primary income surplus, about 80% of securities investment income (pertaining to bond interest income) and about 50% of direct investment income (pertaining to reinvested earnings) are not forecast to generate a JPY buying/foreign currency selling flow. However, what if we use absolute numbers rather than percentages? The primary income balance for 2018 was about +JPY 20.8 trillion, but excluding reinvested earnings, it was about +JPY 15.5 trillion, and excluding both reinvested earnings and bond interest income, it fell to about +JPY 6.5 trillion (see figure). Of course, not all the bond interest income is reinvested, so the actual surplus value is likely to be somewhat higher. Meanwhile, the largest ever current account surplus was posted in 2007, at around +JPY 24.9 trillion, and within this, the trade surplus was as much as +JPY 14.2 trillion. Even if we assume that about one-third of that year's primary income surplus (approx. +JPY 16.5 trillion) did not generate a JPY conversion flow, there was still the remaining +JPY 20 trillion or so of the current account surplus that possibly did translate into a JPY buying/foreign currency selling flow. However, trade surpluses have almost disappeared now, so that the current account surplus has become almost synonymous with the primary income surplus. In that scenario, there is a strong suspicion that the surplus is devoid of JPY buying.



(Source) Bank of Japan

Even in the past, JPY movements were often described as being "weak due to speculative trade, strong in terms of real demand[3]." It was thought that weak-JPY trends only became established during phases of U.S.-Japan interest rate gap expansion, when Japanese investors (institutional investors) sold JPY and carry trade by foreign speculators accelerated. It was also pointed out that, when the economy began to decline, the risk appetites of both institutional investors and foreign speculators suffered, and a rollback of their positions resulted in JPY strength. However, if we assume that structural changes have made it difficult for a strong-JPY trend to take hold even in real demand terms, then it may be time to gradually revise our understanding of what causes weak or strong JPY trends. It is in this context that we have recently been hearing new theories like, "JPY no longer strengthens during risk-off phases" or "buying JPY as a safe-haven currency is a thing of the past."

[3] Please see 1996 book titled "JPY – Weak Due to Speculative Trade, Strong in Terms of Real Demand" (Toyo Keizai Inc.) by Richard C. Koo.

***Not Yet a Phase of Despair Strong Enough to Reject Existing Theory***

Having said that, I think it is still too early to promote these new theories at the present stage, given that the U.S. economy has not yet really entered a downturn, and the Fed has not entered a phase of accommodative monetary policy. If the Fed begins cutting rates, there could be a significant rollback of the JPY selling/USD buying of Japanese institutional investors betting on an expansion of the U.S.-Japan interest rate gap. The same would be true of foreign speculators. For instance, since 2013, when the Fed embarked on a policy normalization process, the JPY position of speculators as seen in IMM currency futures transactions has essentially been a short position (net selling). However, many investors closed their short positions during 1H of 2016, resulting in a JPY long position (net buying) when the global economy began to slowdown, led by emerging economies, and Britain decided to leave the EU, among other developments. During this time, USD/JPY crashed from 120 to 99, offering a brief glimpse of the nature of forex markets, in which JPY strengthened robustly during periods dominated by pessimism. Again, <u>though earning its current account surplus in a different manner now, Japan's status as the world's largest net external creditor has not changed, and this fact by itself is likely to guarantee demand for JPY as a safe haven currency to a significant extent</u>. It is important to note that there have been structural changes that make it difficult to drum up as much real demand for JPY as there had been in the past. However, though this might be a "reason that makes it difficult for a strong-JPY trend to be established," it is not a "reason that helps usher in a weak-JPY trend." In forecasting the near-term trend, one must remember that we have not yet entered a phase of despair strong enough to trigger a strong-JPY phase, and so it may be too early to reject the existing theory.

## The Japanese Corporate Sector's Understanding of Forex Rates – Cabinet Office's Survey Confirms Favorable Exchange Rate Climate

***Another Small Range (JPY10.45) for FY 2018***

As I have been saying repeatedly, USD/JPY has remained steady since the start of the new fiscal year. Thanks to the "flash crash" early into 2019, the USD/JPY range for FY 2018 expanded to 10.45 (114.55 – 104.10) compared with the 9.99 range for the calendar year 2018. Even so, it did not end up that different from the 10.17 range for FY2017, the smallest in the last 10 years. In recent years, USD and JPY have tended to move in the same direction depending on the market mood – JPY selling and USD selling during risk-on phases and JPY buying and USD buying during risk-off phases. This has led to a clear loss of a sense of direction for USD/JPY. Of the five smallest USD/JPY annual ranges posted since switching to the floating exchange rate system, four have been recorded since 2010 (the exception was 2006). Perhaps small ranges have become the new normal?

There are certainly those who make such exaggerated claims. However, I think it is still too early to make such bold assertions. <u>The stability of USD/JPY in recent years is largely due to the Fed's policy normalization efforts</u>. Of course, there are also structural changes in the market, but my basic understanding is that it would be unwise to expect markets to behave in the same way as they have over the past six years when the Fed has only recently announced an end to its policy normalization process (the suspension of interest rate normalization was announced in January and that of quantitative normalization was announced in March).

***Resilience to Forex Rates Different Depending on Company Size***

With the emergence of exaggerated claims about small ranges being the new normal, there are bound to be those in the corporate sector who are also taking exchange rate stability to be the new norm. The "FY2018 Annual Survey of Corporate Behavior," which was released by the Cabinet Office on March 29, reflects this tendency. The Annual Survey of Corporate Behavior is conducted once a year in the period leading up to the end of the fiscal year, and 69.3% percent of listed companies responded that they expected an increase in employees over the next three years (average for fiscal years 2017 through 2019). For the same period, 68.8% of companies responded that they expected an increase in regular employees. Both figures were the highest ever posted, as has been widely reported in the media. It is not surprising to see so much attention focused on this subject given that a shortage of hands is the largest and most pressing issue facing Japanese companies. Meanwhile, in this report, I like to check the forecast USD/JPY exchange rate as shown by this survey every year, and would like to take a look at it again this year.

First, Listed Companies (companies listed in the first and second sections of both the Tokyo and Nagoya stock exchanges) reported a break-even USD/JPY rate of 99.8 (all companies, average of actual reported numbers, same below), which is a slight shift in the direction of JPY strength compared with the previous fiscal year's JPY100.6. This is the first time in four years, since 2014, that the break-even rate has fallen below 100 (see table on next page). Meanwhile, Medium-Sized Companies and SMEs (companies with a capital of JPY 0.1 billion to JPY 1 billion, excluding those covered in Listed Companies) reported a break-even USD/JPY rate of 107.0, which was a slight shift in the direction of JPY weakness compared with the previous fiscal year's JPY106.4. <u>The fact that the exchange-rate resilience of listed versus non-listed companies has moved in opposite directions is conspicuous. Perhaps medium-sized companies and SMEs, which are thought to be more sensitive to the state of the economy, are beginning to feel the pinch from the worsening business climate</u>? Incidentally, looking at the response rate, in the case of the former (Listed Companies), 1106 out of 2669 (41.4%) responded, while in the case of the latter (Medium-Sized Companies and SMEs), 2975 out of 7675 (38.8%) responded. Although a well-known fact, I would still like to point out that medium-sized companies and SMEs are overwhelmingly greater in number. At any rate, it is important to realize that while Listed Companies have a buffer of more than JPY10 compared with the current USD/JPY rate, Medium-Sized Companies and SMEs do not have that much protection. The strong-JPY rate early this year (104.10) was already significantly below the break-even rate for Medium-Sized Companies and SMEs.

Further, looking at Listed Companies by industry sector, it is conspicuous that companies in the Transportation Equipment sector (which tends to draw a lot of attention), report a break-even rate of JPY100.00, which is a higher rate than the average for all Listed Companies. The fact that the average break-even rate for all industry sectors has shifted in the direction of JPY strength certainly makes it seem as though the resilience of the Japanese economy to a strong JPY has increased, but it is important also to look individually at industry sectors that have broader perspectives, such as the transportation equipment sector (in fact, the forecast exchange rate of major Japanese car companies has always been a point of discussion).

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

| Survey year | Forecast USDJPY rate after 1 year ① | Break-even USDJPY rate ② | USDJPY rate 1 month before survey (③) | ①-② | ③-② | ③-1 year before ① (Deviation of the forecast) |
|---|---|---|---|---|---|---|
| **12 (2000)** | **114.2** | **107.0** | **112.2** | **7.2** | **5.2** | **4.6** |
| **13 (2001)** | **132.8** | **115.3** | **127.4** | **17.5** | **12.1** | **13.2** |
| 2002 | 124.5 | 114.9 | 122.3 | 9.6 | 7.4 | -10.5 |
| 2003 | 109.3 | 105.9 | 107.9 | 3.4 | 2.0 | -16.6 |
| 2004 | 106.4 | 102.6 | 103.8 | 3.8 | 1.2 | -5.5 |
| 2005 | 113.2 | 104.5 | 118.6 | 8.7 | 14.1 | 12.2 |
| 2006 | 115.5 | 106.6 | 117.3 | 8.9 | 10.7 | 4.1 |
| 2007 | 111.0 | 104.7 | 112.3 | 6.3 | 7.6 | -3.2 |
| 2008 | 97.0 | 97.3 | 90.4 | -0.3 | -6.9 | -20.6 |
| 2009 | 95.9 | 92.9 | 89.6 | 3.0 | -3.3 | -7.4 |
| 2010 | 88.4 | 86.3 | 83.4 | 2.1 | -2.9 | -12.5 |
| 2011 | 80.3 | 82.0 | 77.9 | -1.7 | -4.1 | -10.5 |
| 2012 | 88.4 | 83.9 | 83.6 | 4.5 | -0.3 | 3.3 |
| 2013 | 105.7 | 92.2 | 103.5 | **13.5** | **11.3** | 15.1 |
| 2014 | 119.5 | 99.0 | 119.4 | **20.5** | **20.4** | 13.7 |
| 2015 | 120.9 | 103.2 | 121.8 | **17.7** | **18.6** | 2.3 |
| 2016 | 113.1 | 100.5 | 116.0 | **12.6** | **15.5** | -4.9 |
| 2017 | 114.3 | 100.6 | 113.0 | **13.7** | **12.4** | -0.1 |
| 2018 | 111.2 | 99.8 | 112.5 | **11.4** | **12.7** | -1.8 |

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

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

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

### *Increasing Recognition of the "Favorable Forex Environment"*

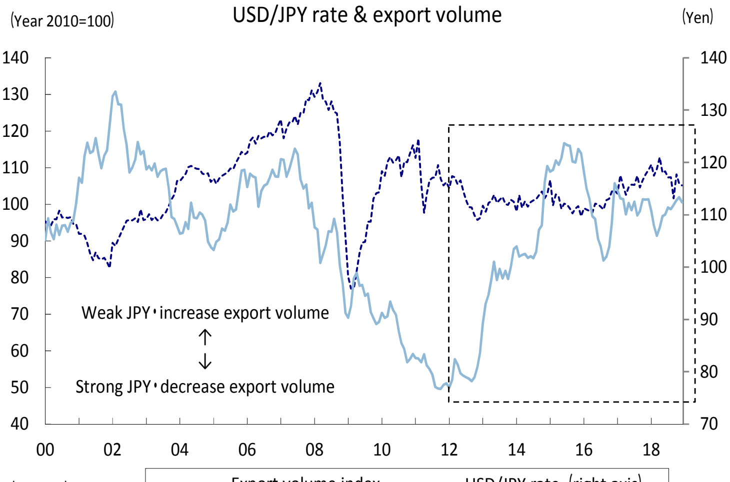
The survey also asks respondents for their forecast of the USD/JPY level a year later. Listed companies' forecast was USD/JPY111.2, up JPY3.1 from the level of their forecast in the previous year's survey (JPY114.3). The actual level just before the survey (December 2018) was USD/JPY112.5, so the listed companies are anticipating JPY1.3 of additional JPY appreciation against USD. Small and medium-sized enterprises' forecast was USD/JPY111.7, up JPY2.1 from their forecast in the previous year's survey (USD/JPY113.9) and JPY0.7 higher than the actual level during the month prior to the survey. As the directionality of the survey's corporate forex rate forecasts is not very clear-cut, the significance of the forecasts is not so great in most years. (During the past three years, actual USD/JPY levels have shown greater JPY appreciation than the year-ahead USD/JPY forecasts, but the margin of deviation has not been significant enough to merit much attention.) Looking at the figures in the table, when one compares the "profitability rate" to the "previous-month rate" or compares the "profitability rate" to the "year-ahead rate", one finds that there has been a buffer margin of more than JPY10 (allowing for JPY10 of JPY appreciation without impairing profitability) for six consecutive years, including 2018 (yellow-shaded figures). This pattern of sustained buffer margins had never been seen before since the survey's commencement, and it can be said that the extremely favorable nature of the forex environment with respect to exporters is now gaining increasing recognition. Strictly speaking, of course, since the profitability rate and the predicted rate are different, it is possible for JPY to be both weaker than the profitability rate and stronger than the predicted rate. However, the predicted rate shown from the BOJ Tankan (March survey) is USD/JPY108.87, so there remains considerable leeway regarding both the profitability and predicted rates.

### *Wasting Policy Cards by Stickling about USD/JPY100*

Given that the profitability rate is roughly USD/JPY100, it can be expected that a descent of USD/JPY to below 100 will elicit considerable debate about how serious that situation should be considered both economically and politically. Many market participants consider USD/JPY100 to be a nice round milestone level (regarding their forecasts, orders, etc.), so if JPY appreciation touches that level it is not likely to stop there. In fact, expectations regarding BOJ responses will probably increase at such a time. Although one gets the impression that the BOJ's straightforward and simple inclination to undertake monetary easing aimed at promoting JPY depreciation and inflation has diminished somewhat compared to six years ago, there are still many who believe the BOJ to be omnipotent with respect to forex rates (as well as inflation). (To a certain extent, this may well relate to the success of a "moving misunderstandings" concept rather than the success of the "moving expectations" concept.) When USD/JPY approaches JPY100, the BOJ can probably be expected to be inclined to undertake additional relaxation based on a simple spinal reflex reaction.

However, it will be difficult not only for the BOJ but also for the ECB and the Bank of England to countervail exchange rate trends promoted by the Fed. If the BOJ reflexively implements discretionary macroeconomic policies simply because of USD/JPY's relationship to the "year-ahead forecast rate" or the "profitability rate", it may end up wasting limited array of monetary policy cards to little benefit. Weak JPY periods often correspond to periods of strong conditions in the U.S. economy as well as the world economy, and they also tend to be periods characterized by high levels of stock prices. Given that, even if the BOJ were to restrain its easing measures during such a period and allow a moderate amount of JPY appreciation, it can probably be expected that a certain amount of export volume growth will be possible against the backdrop of the positive overseas economic conditions. Moreover, the positive trends in the overseas economic environment should prevent a collapse of multinational companies' earnings and stock prices should remain robust. First of all, U.S. interest rate hikes were implemented continuously from 2013 through 2018, so it is unclear whether JPY has appreciated. If the BOJ wants to pursue policy normalization, this period presented an opportunity for that, but there is a strong basis for suspecting that the opportunity has already been missed.

### *Using Weak-JPY Periods to Accumulate Strength in Preparation for Strong-JPY Periods*



(Source) INDB

In the past, the leaders of Japan's major automobile manufacturers have explicitly noted that their high levels of profitability during periods of JPY weakness were largely attributable to "strong tailwinds". While exchange rates have been extraordinarily stable during recent years, because the nature of the floating exchange rate system often allows for considerable forex rate fluctuations, it might be considered optimal for Japanese exporters to maintain a stance of using the tailwinds of weak-JPY periods to accumulate strength in preparation for facing the headwinds of strong-JPY periods. In fact, it does appear that Japanese companies have upgraded their capabilities for facing the headwinds of JPY appreciation in recent years. It is already evident, for example, that the export volume-boosting effect of JPY depreciation has become relatively limited (see graph). This is often attributed to the efforts of exporters to progressively shift production operations overseas and set selling prices in local currencies in response to the extraordinarily sharp JPY appreciation trend that followed the global financial crisis and the Great East Japan Earthquake of 2011. In short, Japanese companies have been able to leverage the lessons learned during their difficult experience to enhance their resilience and resistance to the impact of JPY appreciation. In retrospect, when the JPY depreciation/USD appreciation trend was at a peak in 2014-15 period, the Japanese business community began voicing the argument that excessive JPY depreciation could be at a cost. For example, at a New Year's party co-sponsored by Japan's three leading business associations on January 6, 2015, Japan Business Federation (Keidanren) Chairman Kasahara Keidanren said – "The impact of the progress of rapid JPY depreciation is becoming apparent, particularly on regional economies and small and medium enterprises." Historically speaking, incidences of Keidanren chairs expressing concern about the weakness of JPY are somewhat rare.

It should be cause for concern that the FRB's normalization process and the BOJ's concurrent implementation of unprecedented levels of monetary easing in recent years appear to have fostered an odd sense of security – a general belief that "there will not be (the BOJ will not allow) a major JPY appreciation trend". The survey indicates there has been a buffer margin of more than JPY10 (allowing for JPY10 of JPY appreciation without impairing profitability) for six consecutive years, and the way that this situation affects fiscal and monetary policy management going forward is likely to be important. The continuation of easing policies has fostered a relaxed mood, but there is a need for measures to prevent this from leading to the preservation of macroeconomic inefficiencies. Given how long such a situation of stability and tail winds has continued under the floating exchange rate system, I am quite concerned about what will happen when the reaction to the situation comes.

## Risks to My Main Scenario – Recoveries in China and Europe are the Key Point

### *Recoveries in China and Europe are the Key Point*

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. In short, I think there has been no significant change in the nature of risk factors since the beginning of the year and that the key issue is whether the expected economic recoveries in China and Europe during the latter half of the year will be sufficient to offset a U.S. economic slowdown during that period.

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 | Funds supply with negative interest rates | low |
| ⑤ | Reacceleration in China & Europe | GDP acceleration | medium |

(Source) Daisuke Karakama by Mizuho Bank

As previously explained, 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." Looking back at monetary policy history, one finds that it is quite rare that a decision to halt interest rate hikes has been immediately followed by a decision to resume interest rate hikes. Given that the U.S. economic expansion has already been sustained for a record-long period of 10 years, I think it would be dangerous to create a forecast scenario based on expectations of a further rise in U.S. interest rates. The baseline Fed policy outlook scenario appears to be "status quo at best and possibility of additional easing depending on the circumstances". Under such circumstances, it has become difficult to forecast a JPY depreciation scenario based on expectations of an increase in U.S. interest rates and, for the time being, I think it safe to assume that the end of the Fed's normalization process will cause a U.S. interest rate decline and across-the-board USD depreciation, resulting in the progressive appreciation of JPY and EUR.

### *Preparing for Clear-Cut Slowdown in the U.S. Economy*

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 about which this article had been particularly concerned is – "a situation in which the U.S. economy is surprisingly robust and the Fed therefore finds itself positioned to continue its normalization process". Another aspect of this is the risk that, amid signs of a bottoming out of economic conditions in China and Europe, the Fed might feel reassured enough to resume its normalization. In this sense, risk factors ① and ⑤ should be considered as a set. In any case, there is worldwide concern that the Fed might become eager to resume its normalization process in response to an improvement in market psychology, regardless of the reason for that improvement. In fact, the U.S. stock market has been robust since early this year against the backdrop of the Fed's increasing dovishness, and it is possible that the wealth effect's growing influence on the household sector may support positive U.S. economic trends going forward. Once the global economic recovery cycle has been interrupted, it would seem difficult for the U.S. economy to regain its momentum independently; yet the U.S. economy has continued to demonstrate unexpected strength regarding consumption and employment, and this is disturbing situation for those anticipating U.S. interest rate cuts along with USD depreciation.

Looking at events in the past, it would not be surprising to see a lag of about one to two years following the U.S. yield curve inversion before the stock market undergoes a major adjustment. This may be considered a kind of bonus period stemming from the Fed's shift from tightening to easing in response to the economic sluggishness. (Note that the 10-year and 3-month interest rate inversion occurred in late March.) Although the potential lag period of one to two years is a fairly lengthy one, if investors are fairly confident that a major stock market adjustment is inevitable in the near future, one wonders how motivated they will be to buy stocks going forward. Moreover, given that the U.S. economy has been expanding for an extraordinarily long period of time, it appears unquestionable that the remaining margin for improvement is small. Frankly speaking, I believe the likelihood of progressive JPY depreciation is not high, but given that a JPY appreciation scenario cannot be realized in the absence of a clear-cut slowdown in the U.S. economy, the "unexpected U.S. economic robustness" risk is still the top JPY depreciation risk factor.

### *Continued Political Risk Factor of a Potential Brexit Referendum Rerun*

While "unexpected U.S. economic robustness" is an economics-related JPY depreciation risk, there are also political JPY depreciation risk factors. This article has previously noted the need to monitor the potential for "a discontinuance of the Trump administration's protectionist politics" and considered the ramifications of a complete resolution of the U.S.-China trade war, which would be a potent symbol of trade war threat elimination. 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. Media reports seem to indicate that there is hope for the complete resolution of US-China trade issues. Even agreement is reached regarding the reforms that the United States is demanding from China – such as intellectual property rights protection and the ending of forcible technology transfers – it is said that there is still a large gap between the two sides' positions regarding the reform verification method. It will not be possible for China to accept a verification method that could be regarded as interference in its domestic affairs. 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 that his basic strategy is to keep relations with China moderately strained while avoiding sharp trends of deterioration or improvement. It is clear that the provocative nature of President Trump's communications and actions related to trade wars and other situations are background factors promoting the deterioration of business sentiment, but if the situation were to deteriorate to an extreme degree, there is a greater-than-zero possibility that the president might take bold measures to realize reconciliation deals. In such a case, it seems likely that JPY will become more susceptible to weakening in the forex market.

I think another political JPY depreciation risk factor that potentially requires the most vigilant monitoring relates to the possibility that the Brexit initiative might be withdrawn following a second referendum. It turned out that the U.K. and EU could not reach an agreement by April 12 deadline, so they agreed to an extension of about six months, until this coming October 31. (In the case that the U.K. cannot participate in the May 23 European Parliament elections, the deadline is to be advanced to May 31.) However it is questionable how issues that have already been under discussion for almost three years can be settled in six months. Various things might happen by the October 31 deadline – such as the approval of the current withdrawal agreement proposal, the drafting of a new withdrawal agreement proposal, and a decision to move ahead with a no-deal withdrawal – and one also wonders about whether it is possible that the withdrawal initiative might be discontinued. When this article was written, reports had begun emerging that U.K. Prime Minister May might be forced to resign by the end of June, and in that case, there will be concern about the potential for sudden movement toward scenarios that had previously been considered quite unlikely. Among those scenarios, a Brexit referendum rerun would be the most earth-shaking. Given the momentous nature of national referendums and the respect accorded to them, it seems that the only legitimate way to reverse a referendum would be through another referendum. Given that noteworthy U.K. public opinion surveys have indicated that "remain" supporters are in the majority, it is worth keeping in mind the possibility of a "second referendum → risk-on mood generated → JPY depreciation" sequence. If a second referendum were to be held, the magnitude of the ensuing earthquake would probably be similar to that caused by the first referendum.

***JPY Depreciation Risks Originating in Japan – Headline Impact of Negative Lending Rate Proposal***

It is basically much less likely that Japanese factors will strongly affect USD/JPY trends, but it is still worth paying close attention to the BOJ's actions. The March BOJ Monetary Policy Meeting expanded its general appraisal of current conditions with downward adjustments to its assessments of export and production operations, and this has attracted attention as an early sign suggesting that the BOJ is having difficulty in maintaining the status quo. While the possibility that the BOJ will decide to adjust its policies soon is currently low, it seems quite likely that the "next move" during the forecasting period will be in the direction of easing rather than tightening. Given 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 is not at all surprising, one must keep in mind the possibility that the BOJ may suddenly announce an easing initiative. It is needless to say that the BOJ does not have many policy cards left to play. Within the current framework, a further lowering of the level of negative interest rates must be accompanied by a downward adjustment to the long-term interest rate target, but amid increasing domestic and overseas concern regarding financial institutions' management, that is no longer a viable option. In addition, 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. Although it is not considered a viable option at this time, in the case of considerable JPY appreciation, it cannot be said with certainty that such a measure will not be taken. 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 cannot be said that such a measure would be unprecedented.

***Stickling about JPY Depreciation Risk Factors***

While this article has focused primarily on JPY depreciation risk factors worthy of being concerned about, the risk factor range naturally encompasses JPY appreciation risk factors also. 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. However, the 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 situation individually. As this article has each month pointed out, the easiest 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 or the Chinese and/or European economies 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. Does it not seem that the eventuation of these JPY appreciation risk factors is more likely than that of the previously discussed JPY depreciation risk factors? As one can see from overviewing the forecasts made by various institutions, regardless of whether the institutions are bullish or bearish about the global economy in 2019, they agree on the point that "deceleration is inevitable". 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. Intuitively, I am expecting that numerous factors capable of promoting sharp JPY appreciation will present themselves. In these circumstances, it may seem that only sticklers for comprehensive perspectives will feel a need to give much attention to the JPY depreciation risk factors.

Looking at the world economy in the latter half of 2019, U.S. economic deceleration is expected to result from the progressive dissipation of the supportive effects of the Trump tax reductions, but observers have been pointing out increasingly clear-cut indications of improvement in the economies of China and Europe, which had been showing increasingly strong signs of deceleration last year. The key to the question of whether economic turmoil can be avoided during 2019 lies in the question of whether a general "U.S. weakness vs. Chinese/European recovery" scenario will eventuate or not. I do recognize that the trend toward recovery in China and Europe is quite important. However, I believe the main tidal trend will stem from the US, which has considerable leeway for rolling back its monetary policies, and that trends in other countries/regions will prove unable to completely offset the U.S.-determined trend. Amid these conditions, my basic understanding is that it is unreasonable to expect the current situation to be conducive to a renewed rise in U.S. interest rates and USD accompanied by JPY depreciation.

# EUR Outlook – Economic Deceleration Promoted by Germany

## The Euro Area Monetary Policy Now and Going Forward – Tiering and TLTRO3 Details

***Financial Intermediation Channel Spotlighted at ECB Governing Council Meeting***

At the April 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. Based on prior reports and such materials as speeches by ECB President Draghi (ECB and Its Watchers Conference on March 27), it had been expected that the meeting would address such issues as (1) the tiering of banks' excess reserves balances subject to negative interest rates, (2) the precise terms of the new series of targeted longer-term refinancing operations (TLTRO3) and (3) the need for forward guidance adjustments. In short, although the meeting made no concrete decisions or commitments regarding these, reporters posed several questions related to issues (1) and (2) at the press conference, reflecting a rise in concerns about how best to show consideration for the financial intermediation channel going forward.

Regarding issue (3), President Draghi stated in a speech on March 27 that – "Our current reaction function is well designed to respond [...] just as we did at our March meeting, we would ensure that monetary policy continues to accompany the economy by adjusting our rate forward guidance to reflect the new inflation outlook." – and this promoted some speculation that the ECB may soon use the current fragility of the EU economy to justify modifying the ECB's forward guidance. As expected, however, the recently revised forward guidance has been retained, and the ECB has not disseminated information suggesting it will be modified in the near future.

This was the last monetary policy meeting attended by the ECB's chief economist Peter Praet. At the end of the press conference, President Draghi acknowledged Praet's contributions, saying – "Much of what I say in the press conferences and what I read in the introductory statement has been based on his work, on work that he and his staff and the team and the rest of the ECB does with him." As discussed below, a reporter asked during the press conference if the ECB intended to complete most of the preparatory work for TLTRO 3 while Chief Economist Peter Praet remained in office, so it was a meeting that emphasized Praet's important presence in several ways. It is interesting to note that Praet said at the recent spring meeting of the International Monetary Fund (IMF) and World Bank that it is not unreasonable to reconsider measures to mitigate possible side effects of negative interest rates on bank intermediation and, given that he plays a leading role in the Governing Council's discussions, I think it quite likely some such measures will be considered in the near future. Following Praet's retirement, Central Bank of Ireland Governor, Philip Lane, will take his place beginning from the next meeting. Governor Lane has an impressive reputation as a scholar, and there are few objections to his appointment as ECB chief economist.

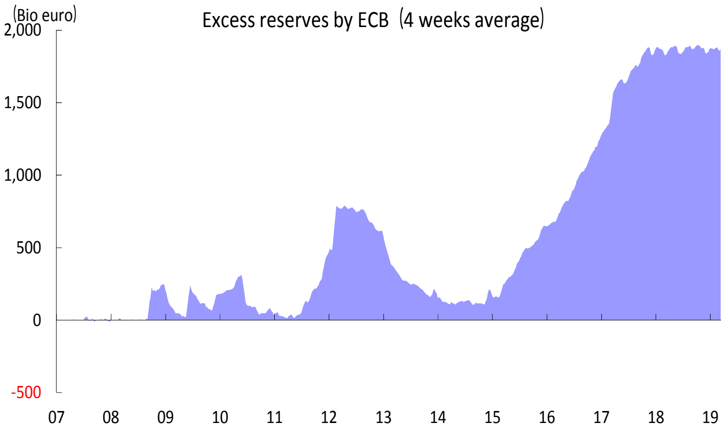
***Tiering of Negative Interest Rates on Excess Reserve Deposits***

Among the individual issues addressed, reporters show a high level of interest in the tiering of negative interest rates on the ECB's excess reserve deposits, and related questions were posed one after another. The introductory statement included a single sentence in this regard – "In the context of our regular assessment, we will also consider whether the preservation of the favourable implications of negative interest rates for the economy requires the mitigation of their possible side effects, if any, on bank intermediation." – but the significance of this sentence was impossible to miss. In short, if the ECB finds that there is a side effect affecting the financial intermediation function, it will consider measures designed to ease that side effect. Given that the statement was approved unanimously by all the Governing Council members, there is no doubt that the council is concerned about the side effects of negative interest rates and is considering measures to mitigate those side effects.

The first reporter to pose a question at the press conference noted the mention of mitigation in the statement along with the similar gist of comments previously voiced by President Draghi, then asked whether the ECB was "on the cusp of introducing a tiering system". President Draghi responded noncommittally, saying – "[W]e have to see how the economic outlook will turn out between now and the next monetary policy meeting. Where, by the way, we also will be having the new projections." A second reporter posed the somewhat aggressive question – "A second question is on the tiered deposit rate issue. Did you discuss the merits of this at today's meeting, and might we see this on the agenda of the Governing Council during your tenure?" – and President Draghi responded that – "we haven't discussed the merits or the cons of mitigation measures either. I don't want to identify that with a specific word, and I never did." (It is believed that he is referring to the word "tiering".) There is a strong general tendency to consider tiering systems as the principle example of potential measures to mitigate the side effects of negative interest rates, but it seems that the ECB wants to emphasize that tiering systems are not necessarily what they are considering. If is worth noting that there were rumors that the ECB was considering the introduction of a tiering system three years ago but ultimately abandoned that initiative because its implementation in the single currency region would entail administrative difficulties. Such technical barriers may still remain, and it is reasonable to speculate that the ECB faces a sensitive internal situation that makes it impossible to assume that its "next move" will involve a tiering system.

***Consideration of Banks' Profitability***

The debate about tiering stems from concerns about financial institutions' earnings. In early April, the president of the Association of German Banks made the statement – "If the ECB is unable to end the era of negative interest rates this year, then it should at least take the central banks in Switzerland and Japan as a model" (April 8, Reuters), and this public criticism of the negative interest rate policy attracted considerable attention. A reporter at the press conference asked President Draghi's opinion about such criticism, and he responded, saying – "the way this negative deposit rate affects different banking institutions is very different, banks' business models are profoundly different. But in the aggregate we see that profitability of euro zone banks is by and large like the ones in Japan, higher than in the UK, where there is no negative rate, and of course, lower than in the United States." In response to a question posed by another reporter, President Draghi emphatically said – "What is pretty clear, however, is that the banking system in Europe is overcrowded. The need for consolidation is very, very significant." He then noted that Europe's banking system is characterized by an "overcapacity in terms of number of people, number of branches, costs," and argued that banks should address their overcapacity-related profitability problems rather than complaining about profitability problems stemming from negative interest rates.




(Source) Bloomberg
(Note) It was calculated as Excess reserve = Deposit facility + current accounts- legal reserve

While President Draghi's counterargument has a factual basis, it is somewhat difficult to understand in that it is not consistent with President Draghi's previously expressed concerns about the side effects of negative interest rates. It may be that there is a slight disharmony between President Draghi's personal view and that of the Governing Council regarding the side effects of negative interest rates. President Draghi may also be seeking to obscure the problem that banks' earnings are being unfairly pressured by the fact that about EUR2 trillion of excess reserves (the broadly defined balance for both the deposit facility and current accounts) is being subjected to a -0.40% interest rate penalty.

***TLTRO3 Details Announcement in June***

Another high-profile issue at the meeting relates to TLTRO3. The first reporter to ask about a tiering system also posed a question about the pricing of TLTRO3. In response, President Draghi said – "We'll take into account a thorough assessment of the bank-based transmission channel for our monetary policy, as well as further developments in the economic outlook." – indicating that pricing decisions would be based on the revised economic outlook available by the upcoming meeting in June. As it was said at the March meeting that TLTRO3 would be launched in September, the details of TLTRO3 will have to be announced in June or perhaps July, and it is generally believed that there is a higher likelihood of a June announcement along with the release of the revised outlook. Another reporter referred to the retirement of Chief Economist Praet at the end of May and a perception that there may be a desire to complete preparations for TILTRO3 before that time, asking – "So am I correct to assume and understand that you did discuss the precise terms of the TLTROs at today's meeting?" President Draghi rejected this speculation, saying – "it's not that we actually put our decision making in our calendar depending on who's going to be on board or not. So let me just separate the two things. You asked me whether we discussed the TLTRO deal [...] we haven't discussed that today."

***Four More Meetings – Draghi Regime Begins and Ends with LTROs***

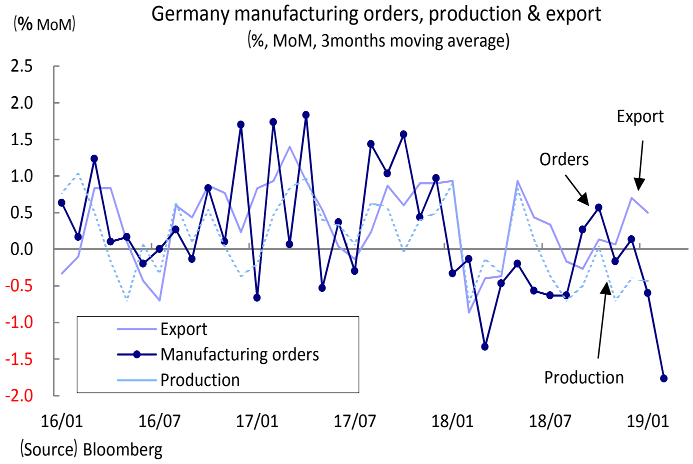
As previously mentioned, President Draghi expressed his appreciation of the soon-to-retire Chief Economist Praet at the end of the press conference. However, President Draghi himself will only be attending four more Governing Council meetings (including two more economic outlook revisions) before his own retirement. President Draghi assumed his post in November 2011, during the worst phase of the European debt crisis, and began slowly taking moves toward a normalization process from 2017. Owing to the deterioration of economic conditions during the past year, however, it is likely that he will retire without ever raising interest rates. In fact, it seems likely that, rather than raising interest rates, he will be obliged to undertake still more easing measures as he approaches the end of his term (the end of October).

It is worth noting that the prototype of the TLTRO3 program now attracting attention as the ECB's "next move" is the 36-month LTRO, which was abruptly launched at President Draghi's first Governing Council meeting in November 2011. It was a striking debut performance, which some even believe was the key factor preventing a general financial collapse of the euro area. The provision of long-term liquidity was undertaken because of concerns about the area's financial system. In this regard, it may be that President Draghi will be remarkable as being an ECB president who addressed concerns about the area's financial system at both the start and end of his term in office. In any case – together with Angela Merkel, who is scheduled to retire in 2021 – President Draghi will probably go down in history largely as a leading figure who survived the European debt crisis. Attention will be focused on the kind of a curtain call he might make.

## Euro Area Economy Now and Going Forward – Euro Area Slowdown Led by Germany

### *German Economy May Take a While to Recover*

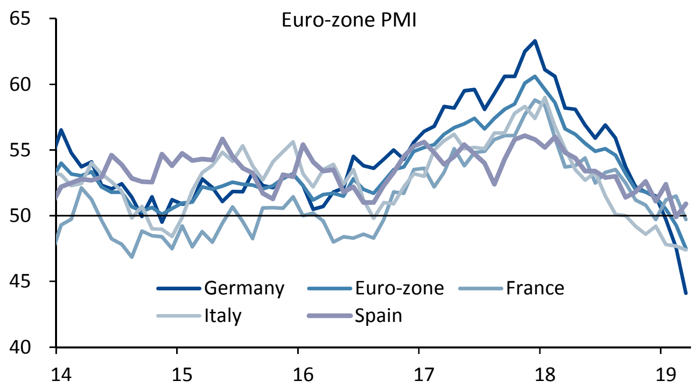
Incidentally, there are concerns that the global economy from 2019 through 2020 will be weighed down by the weakness of not just the Chinese economy but also the European economy, especially that of the euro area led by Germany. Germany's February Manufacturing Orders, which were released in April, served to intensify these concerns. The results (-4.2% mom) were significantly weaker than the median of market forecasts, which predicted a slight increase (+0.3% mom). Yoy growth was even worse at -8.4%, indicating that the decline in manufacturing orders has gathered pace both in mom and yoy terms. Looking at domestic versus external orders, new overseas orders fell by a whopping -6.0% mom compared with new domestic orders, which fell by -1.6% mom, indicating a significant decline in external demand. Incidentally, within external demand, new orders from other euro member states fell by -2.9% mom while those from countries outside the region fell by -7.9% mom. It would appear that the statistic has been greatly affected by the decline in demand from outside the euro region (probably largely from China). Going by prior context (see figure on previous page), it seems likely that this slump in external demand (i.e., exports) will keep growth in orders and production stagnant for some time to come. Given that net exports have been the demand category determining the direction of economic growth in the euro area over the past two years (see figure to the right, bottom), the future as seen through the lens of the recent German manufacturing orders does not seem bright. An economic slowdown for the foreseeable future must be accepted as given.



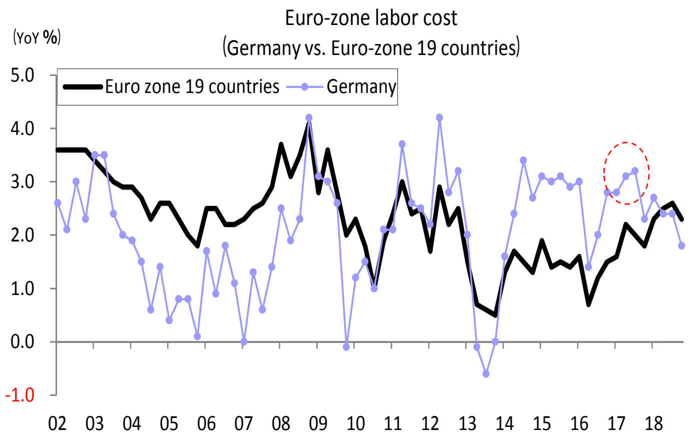
(Source) Bloomberg

### *Germany Leads Dampening of Confidence*

Looking back, phases of real euro area economic recovery causing the ECB to become more hawkish and resulting in EUR buying have been during times when the strength of the German economy has made up for the weakness of other euro member states and driven improvement in regional economic indicators (typically the euro area GDP). However, as seen above, it seems unlikely that the German economy will recover in any clear way in the foreseeable future. Loosely speaking, the path to real economic deterioration (and not just in the case of Germany) involves an economic shock → decline in personal spending and fixed investment due to deterioration in corporate and household confidence → ripple effect on employment and wages. In this context, one cannot overlook the fact that over the past one year, the decline in confidence regarding the German manufacturing sector has weighed down the regional economy overall, resulting in the deterioration of not just the German but also other member states' economies (see figure). It is hard to imagine that such a steep decline will kept up for the rest of the year, but it is quite possible that the regional economy will remain weak after it has bottomed out. Despite having just revised the forward guidance in the direction of greater monetary accommodation at the ECB Governing Council meeting held on March 7, ECB President Mario Draghi hinted at a further revision in a lecture barely three weeks later. Perhaps he anticipates sluggishness of the regional economy, led by Germany, and realizes that the deterioration may be protracted (thereby postponing any rate hikes).



(Source) Bloomberg, Markit



(Source) ECB "Business Economy" base, seasonally adjusted

Meanwhile, on the same day that Germany's Manufacturing Orders were released, German Federal Minister for Economic Affairs and Energy Peter Altmaier expressed the view that the German economic slowdown, which has been continuing since last year, will be overcome in stages starting this year. He cited higher wages and other encouraging developments in the labor market as his reasons. To be sure, the euro area and German labor cost[4] has remained strong compared with the previous year, but it is also a fact that labor cost growth began to slow down in Germany in 2H of 2017 (see figure). If we consider that employment and wages are backward-looking indicators based on the status of the real economy, it seems rather dangerous to conjure up optimism over the future based on a current wage increase.

***New President will have to be Patient for a Year***

Incidentally, the first rate hike by the ECB as factored in by the financial markets based on communications from the ECB since the beginning of the year has been pushed back to as far as January-March 2021, i.e., two years from now (see chart). The ECB is likely to have to revise its policy operations significantly to match the reality of market expectations of "no rate hikes not just in 2019 but also in 2020." It seems likely that the new ECB President, expected to take office in November this year, will also have to patiently put off policy normalization for at least a year after taking office. The present forward guidance rules out a rate hike within the year. One reason for this may have been to avoid tying the hands of the new president early on in his regime. As for the true feelings of Governing Council members, one conjectures that members who have confidence in a recovery within the year are not in the majority. In fact, the Account of the March monetary policy meeting, which was released yesterday, revealed that "A number of members voiced an initial preference for extending the forward guidance through the end of the first quarter of 2020" but that they eventually backed down so as to "join a consensus forming on (Chief Economist Peter) Praet's proposal." In a previous issue of this report, published soon after the March Governing Council meeting, I pointed out that extending the forward guidance by a mere three months was inconsistent with how the financial markets had factored in rate hikes as well as with the significant downward revision of staff projections. It must be noted that the Account of the meeting points out something to the same effect. Under such circumstances, and depending on the economic and financial situation, it seems likely that the forward guidance for rate hikes will be pushed back to around mid-2020 at the October 24 meeting (the last meeting under President Draghi) at the earliest, or at the December 5 meeting (the first meeting under the new president) at the latest. When that happens, market participants may respond by keeping their distance from EUR. However, the basic understanding of this report is that EUR/USD will not crash, thanks to a clear economic slowdown in the U.S. starting the second half of this year, and the resultant decline in U.S. interest rates and USD.

EONIA & deposit facility rateas of 24 APR

| | EONIA | Assumed deposit facility rate | Timing |
|---|---|---|---|
| Current | -0.37 | -0.40 | |
| 6month forward 6months | -0.37 | -0.40 | APR 2020 |
| 12month forward 3months | -0.35 | -0.38 | JUL 2020 |
| 15month forward 3months | -0.34 | -0.37 | OCT 2020 |
| 18month forward 3months | -0.30 | -0.33 | JAN 2021 |
| 21month forward 3months | -0.28 | -0.31 | APR 2021 |
| 24month forward 3months | -0.22 | -0.25 | JUL 2021 |
| 24month forward 6months | -0.21 | -0.24 | OCT 2021 |

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

## The Future of Brexit Negotiations – The Emergency EU Summit's Outcome Was "Typical of the EU"

***An Outcome Typical of the EU***

At the emergency EU summit convened on April 10, EU leaders agreed following an eight-hour long discussion to re-extend the deadline for Brexit (Britain's withdrawal from the EU) until October 31. As we know from reports prior to the summit, the EU had favored a 12-month delay while British Prime Minister Theresa May had insisted on a three-month delay (up to the end of June), but the final result was a six-month extension starting now. It is an outcome quite typical of the EU, which tends to resolve every problem by throwing time at it. The common interpretation of the October 31 timing is that it coincides with the reshuffling of European Commission Commissioners. To be sure, this may have been one of the intents. However, to some extent the choice of October 31 may also have been arbitrary, a date chosen in an effort to reconcile the various interests at the meeting. Going by the aforementioned logic, July 1 could have been an equally good date, given that the European Parliament is due to be reshuffled on July 2. However, July 2 was probably not a date everyone could agree upon.

My guess is that a six-month duration was the best compromise that could be found between the short extension favored by the UK and some EU member states (France), and the long extension favored by the majority of EU member states. The deadline following the said six-month extension (October 31) just happened to coincide with the significant event of a reshuffling of the EC commissioners. French President Emmanuel Macron said, "It's true that the majority was more in favour of a very long extension. But it was not logical in my view, and above all, it was neither good for us, nor for

[4] Companies' payroll cost per hour. It takes into account the gross income of all employees as well as indirect costs. Gross income includes remunerations, special bonuses, income tax, and social insurance premiums. Indirect costs include social security expenditure toward employee welfare and employment tax.

the UK." Had it not been for France's opposition, a longer extension to the withdrawal process is likely to have been the outcome. Mr. Macron stressed that the longer the extension, the greater the obstacles to progress on EU reforms, including the formulation of a common budget. That is certainly true. As for why the majority of EU member states favored a long extension, it is said that this was due to their calculation that the longer the extension, the stronger the British electorate's expectation that Britain would remain with the EU, which would force the hardline Brexiters to support the Withdrawal Agreement. Such calculations may also have a point, but in reality, it seems likely that hardliners who are bound to get upset at a longer extension, considering it to be a ploy to keep Britain in the EU, are in the majority.

***Ms. May's Wishes Could Still Come True, but…***

Strictly speaking, the latest extension comes with the option that the withdrawal can be brought forward if the Withdrawal Agreement manages to be ratified by the British Parliament, so a more accurate description would be that Brexit could take place at any time on or before October 31. Prime Minister May also said something similar (details later), but essentially, Brexit could take place by the end of June as originally desired if the Withdrawal Agreement is ratified sometime in early May. However, practically speaking, it is not an early resolution to the problem that is of concern, but rather the possibility of another extension. It is hard to imagine that a Withdrawal Agreement will be ratified by Parliament in less than a month – one cannot help thinking that the UK will end up taking every last day of the extension received, and the real question is, will there be a clear resolution by the end of that? After the EU summit, Dutch Prime Minister Mark Rutte remarked that there was very little chance of a further extension after the October 31 deadline, but one has to remember that similar remarks had previously been made about the March 29 deadline. Market participants would be prudent not to take such remarks at face value.

***An Important Date that cannot be Trusted***

Even if only as a postscript, it has to be said that October 31 is an "important date." Naturally, the situation could be handled in a much smoother manner by the current team of Commissioners, who have been negotiating with the UK over the past almost three years. However, going by past history, there is no guarantee that the UK will respect a date just because it is "important." To begin with, the original deadline for Brexit negotiations, taking into account time to deliberate on, approve, and enforce measures related to the withdrawal, was said to be autumn 2018. The idea was that all the agreements must be reached by then if the withdrawal from the EU was to take place on March 29, 2019, as intended. In the event, however, negotiations continued until a week before March 29. Had the agreement been reached at the EU summit meeting immediately before the deadline (on March 21), would Brexit have taken place as per the original schedule? It was thought that a minimum of 6 months' preparation time was necessary following an agreement between the UK and the EU before the withdrawal could actually take place. Given that, it seems likely that the UK would have remained an EU member state until September even if the Withdrawal Agreement had been ratified by the British Parliament in March. And if so, the UK would have had to participate in the European Parliament elections to begin with. Further, April 12, a deadline that had been established even before the recent extraordinary summit, also had a great significance. If the UK was to participate in the European Parliament elections, it had to notify its policies clearly six weeks before the election date, which falls on April 12. However, going by the recent agreement, there are no signs of the April 12 date having been given any significance. The EC decision taken in agreement with the UK stated that "If the United Kingdom is still a Member State on 23-26 May 2019, and if it has not ratified the Withdrawal Agreement by 22 May 2019, it will be under an obligation to hold the elections to the European Parliament in accordance with Union law. In the event that those elections do not take place in the United Kingdom, the extension should cease on 31 May 2019." Does this mean that the UK does not need to notify its policies by April 12? In her press conference following the summit, Prime Minister May said, "We need to leave the EU (…) as soon as possible. (…) If we're able to pass the Deal in the first two weeks of May, we will not have to take part in European elections." Going by this, it seems Britain has been allowed to decide whether or not to participate in the elections by May 22. Ultimately, then, the relationship between April 12 and the European Parliament elections is rather vague.

***Could it be that the EU Really Want the UK to Leave before May 31?***

Going by developments thus far, it is hard to understand how seriously to take "important dates" going forward, but if I still had to pick some, they would be May 22, May 31, and October 31. It is quite possible that these dates will also be relegated to the waste heap as though nothing had happened, but the dates are still bound to draw the attention of market participants. Further, there are reports suggesting that the EU summit meeting to be held on June 20-21 will verify the British Parliament's progress on ratifying the Withdrawal Agreement and what actions the EU is to take. It is difficult to even guess what will be verified and how, but these dates may also be important to keep in mind.

Frankly, it is hard to imagine that a Withdrawal Agreement that has been rejected three times will soon be ratified, so the important dates may be May 22, when the UK decides to participate in the European elections, or May 31. However, in that case, there will be the problem of how to deal with the number of seats in the European Parliament, which were decided to be revised in February 2018. It has already been decided that the removal of the UK's 73 seats will bring the total number of seats down to 705; meanwhile, of the UK's 73 seats, 27 would be redistributed among other member states to correct the proportional representation in terms of population, while the remaining 46 seats are held in reserve for in case of a future expansion. If the UK decides to participate in the election after all, will that earlier decision have to be reversed? Or will a new proposal be considered? At any rate, holding elections to choose legislators who will ultimately leave is the height of wasteful expenditure, and this is perhaps felt most keenly by the EU itself. Thinking about it that way, perhaps the true intent behind the recent EU agreement is not to extend the deadline up to October 31, but rather to get the UK to leave by May 31, without participating in the election.

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