Mizuho Bank

One MIZUHO

Forex Medium-Term Outlook

1 August 2019

Mizuho Bank, Ltd.
Derivatives &Forex Department

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Overview of Outlook

USD/JPY was unable to find a clear sense of direction in July either. Despite the Fed cutting rates for the first time in 10 years, USD actually recovered after Fed Chair Jerome Powell expressed skepticism regarding the continuation of rate cuts. Many, especially in the bond markets, still predict additional rate cuts, but with no clear consensus regarding the federal funds (FF) rate path, USD/JPY also continues directionless. To get right to the point, I believe that this report's main scenario of "a correction of the past five years of USD appreciation" is slowly but steadily coming true alongside the Fed's path-change. The Fed, which began rate cuts following a tumble in share prices, is likely to be forced to continue with them in an effort to continue placating the share markets (and U.S. President Donald Trump). Also, with the U.S. labor market having reached a state of full employment, the U.S. economy can essentially only go down from here, so I believe that rate cuts will be the appropriate action even in the natural course of things. However, in the run up to the November 2020 U.S. presidential elections, it is difficult to imagine that President Trump will remain idle as the economy slows down. Against this backdrop, over the upcoming one-year period, a "short and shallow interest rate reduction phase" associated with a soft patch is closer to my main scenario compared with a "long and deep interest rate reduction phase" associated with a recession. I predict a gentle decline in U.S. interest rates accompanying a U.S. economic slowdown and a gradual drop in the lower bound of USD/JPY as USD weakens.

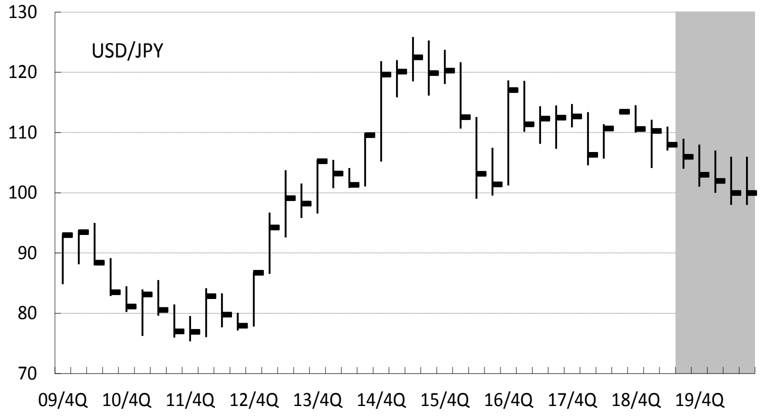
EUR weakened slightly in July but not enough to break its range of the past three months. Following the July ECB Governing Council meeting, it has become clear that the ECB's next move will be a rate cut, and predictions of that taking place at the upcoming meeting in September are strengthening. The region's manufacturing sector, led by the German manufacturing sector, is deteriorating painfully, and there seems no hope of the ECB returning to its policy normalization process during the current forecasting period. Politically, the inauguration of the new government in the UK has been in the news, and there is no change in the difficult situation surrounding Brexit negotiations. In other words, the region's economic, financial, and political situations have all deteriorated, and it remains difficult to intuitively buy EUR. However, as in the case of the BOJ and JPY, regardless of how fragile the situation surrounding the ECB or EUR, the trend of "USD depreciation and U.S. interest rate decline" accompanying Fed rate cuts is unlikely to change, so EUR is unlikely to crash. The ECB seems set to struggle under the regime of its new president Christine Lagarde. During the current forecasting period, I predict that EUR will, in fact, appreciate as USD weakens, in spite of the ECB's more dovish stance.

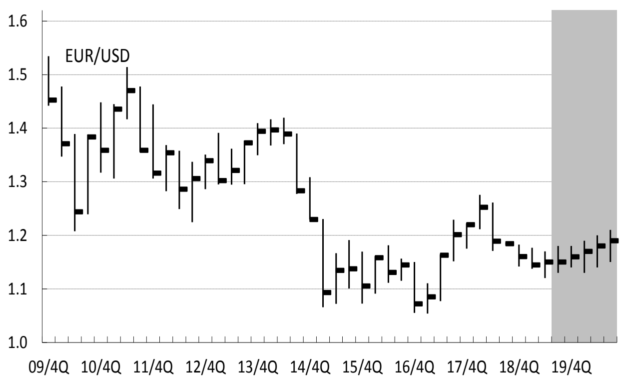
Summary Table of Forecasts

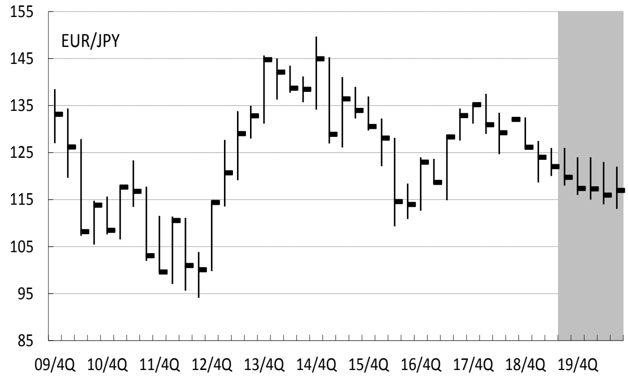
	2019 Jan -Jul (actual)	Aug-Sep	Oct-Dec	2020 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	104.10 ～ 112.40 (109.28)	105 ～ 110 (107)	102 ～ 108 (104)	100 ～ 107 (102)	98 ～ 106 (100)	98 ～ 106 (100)
EUR/USD	1.1034 ～ 1.1570 (1.1040)	1.09 ～ 1.14 (1.12)	1.11 ～ 1.15 (1.13)	1.10 ～ 1.16 (1.14)	1.11 ～ 1.17 (1.15)	1.12 ～ 1.18 (1.16)
EUR/JPY	117.85 ～ 127.50 (120.65)	117 ～ 125 (120)	116 ～ 124 (118)	115 ～ 124 (116)	114 ～ 123 (115)	113 ～ 122 (116)

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



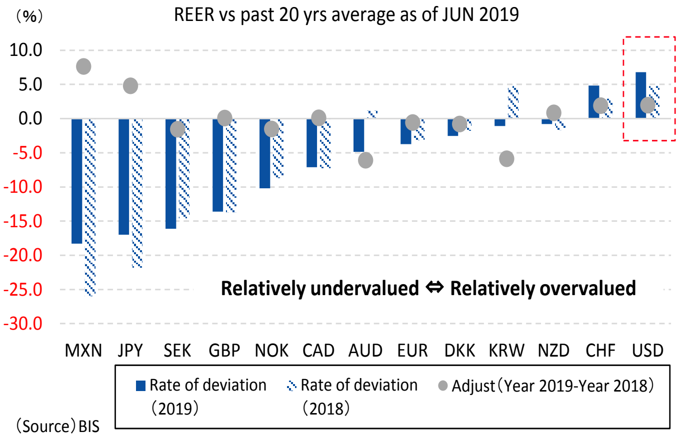




USD/JPY Outlook – An Overvalued USD and a BOJ Surrounded by Rate Cuts

Current State and Future Prospects for Real Effective Exchange Rate (REER) – IMF Says USD is Overvalued

USD Overvalued by 6-12%



(Source) BIS

In the 2019 External Sector Report (ESR), which was published in July, the IMF pointed out something interesting. In this annual report, the IMF publishes the results of its quantitative assessment of imbalances in the external sector including balance of payments and accompanying forex market imbalances. Through the ESR report, the IMF's aim is to point out the presence of imbalances in the external sector, identify the risks at an early stage, and use this information to provide advice on policy measures that can be taken. Currencies are assessed using a variety of approaches, to see whether they are overvalued or undervalued. <u>With regard to USD, the report considers "the 2018 average REER to be somewhat overvalued, in the 6 to 12 percent range." So, taking the median of that range, one could say USD is thought to be overvalued by around 9%</u>. Incidentally, this overvaluation assessment is based on multiple models, with each model's assessment being slightly different. For instance, USD is thought to be overvalued by around 8% as per the EBA REER index model, 11.9% as per the EBA REER level model, 10.3% as per the External Sustainability approach and so on. What is more, USD's REER is overvalued by around 7% (as of June this year) even based simply on the 20-year average (see figure). At any rate, all approaches share the view that USD has been over-bought.

So, JPY and EUR are Valued Appropriately?

Meanwhile, the 2018 average REER of JPY is considered to be undervalued by around -1.5% and that of EUR by around -3%. As per the ESR's quantitative assessment, a REER gap within ±5% interval is described as broadly in line with fundamentals, so the interpretation with regard to JPY and EUR seems to be that they are not imbalanced.
However, it is not quite as simple as that. With regard to JPY, the report explains that "The EBA REER Index and Level models estimate the 2018 average REER to be 17 to 22 percent lower than the level consistent with fundamentals and desirable policies. However, the EBA REER gaps are unexplained by the models, partly because the REER models do not include Japan-specific factors that affect the REER, including the Japanese government bond–US Treasury spread, portfolio rebalancing, and temporary speculative positions vis-à-vis JPY." It would be prudent to remember that JPY is thought to be undervalued based on the IMF's standard model. Incidentally, based simply on the 20-year average, JPY is undervalued by around -17% as of June this year (see figure on previous page), making it the second-most undervalued currency among key currencies, after MXN.

The situation is complex when it comes to EUR too. The REER for the euro area is merely the average for the entire region, and the report clearly points out that "the aggregate masks a large degree of heterogeneity in REER gaps across euro area member states, ranging from an undervaluation of 8 to 18 percent in Germany to overvaluations of 0 to 10 percent in several small to mid-sized euro area member states." In this context, the report suggests that there is a need for the region's net external debtor countries (typified by the southern European nations) to improve their external competitiveness and for net external creditor countries (typified by Germany) to boost domestic demand, and that a nonpartisan assessment of EUR itself does not indicate a lack of problems when it comes to the region's economy. In this context, one cannot help thinking about the smoldering trade friction between the U.S. and Europe, which I will discuss in detail later.

USD-Selling Currency Intervention by the U.S. Would be Impractical

Reports and news media in July pointed out the possibility of a USD-selling currency intervention by the U.S. and were widely discussed. The recent IMF report's assessment of USD as overvalued is bound to further encourage such speculation. However, such a move would be impractical for the U.S. at least in terms of (1) causing it to lose any justification for criticizing the countries on the Monitoring List of its Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States, and (2) inviting retaliatory interventions by the ECB and other central banks.

Of the two, the former is more important. As you know, one of the criteria for placing a country on the Monitoring List managed by the U.S. Department of the Treasury is "persistent, one-sided intervention in terms of net purchases of foreign currency conducted repeatedly, in at least 6 out of 12 months, with these net purchases totaling at least 2 percent of an economy's GDP over a 12-month period." The period mentioned was shortened from 8 months to 6 months (the condition was made more stringent) only recently, in the latest report published in May this year. Of course, one cannot totally rule out the possibility of Washington intervening, maybe just once as a warning short rather than persistently and one-sidedly, but would the U.S. really set off a currency intervention war, given that this is the biggest unfair practice it has been reproving other countries for? If the U.S. were to embark on such a course, it would weaken its position in trade negotiations with China as well. Incidentally, the Exchange Stabilization Fund (ESF), managed by the Treasury Department, is thought likely to be used if the U.S. were to intervene in the forex market, but U.S. Treasury Secretary Steven Mnuchin made a point of mentioning on July 18 that there had been no changes to the policies on the ESF (that the fund would be used to help minimize market fluctuations rather than to help weaken USD).

Reason (2) does not need much explanation. EUR is currently overvalued for most member states excluding Germany. If the U.S. intervenes in the forex market, one can already imagine that pressure the ECB would face from the EU summit and the Eurogroup to implement similar policy measures. Even though USD is thought to be overvalued, one should assume that it will be corrected in a more appropriate manner through monetary accommodation rather than through forex interventions.

BOJ's Position in the World – Surrounded by Rate Cuts

BOJ Surrounded by Rate Cuts

Many times in July, the BOJ seemed to be sandwiched between the increasingly dovish Fed and ECB. However, taking a look at the rest of the world, dovish trends are spreading to include the central banks of emerging countries, in sharp contrast with last year, when all the banks were raising their interest rates. As the chart on the next page shows, many emerging market central banks have embarked on rate cuts all at once this year. Most of these had implemented significant rate hikes last year. One could see this as a direct reflection of the situation in the U.S., where the Fed, which dared implement four rate hikes last year, is now expected to make a sharp policy turn and implement two rate cuts this year. As I have discussed in the past in this report, emerging markets have accumulated USD-denominated debts in the post-financial-crisis word, and this has resulted in a highly "dollarized" world. As a result of this situation, these countries' central banks are compelled to match the direction of their monetary policies with those of the U.S. Of course, emerging countries could cut rates while the U.S. is raising them, but their currencies would be very likely to depreciate in such a scenario, so, in an attempt to prevent inflation, they end up raising interest rates despite this not being good for their economies.

Though not an emerging economy, the chance of a rate cut seems quite good also in the UK, where the inauguration of Boris Johnson as the new prime minister has been in the news. On July 12, Bank of England Monetary Policy Committee member Gertjan Vlieghe hinted that the need for the BOE to cut rates had increased in light of the global economic slowdown and a no-deal Brexit. He predicted that, especially in the case of the latter coming true, the policy interest rate would be lowered from the present 0.75% to 0.25%. With Mr. Johnson as the new prime minister, that scenario is not all that unrealistic. Since 2017, the BOE has implemented two rate hikes to get to the current level of 0.75%, and any rate cut it implements going forward will be the first since August 2016. In this way, rate cuts are becoming the standard monetary policy action around the world. Many are saying that the BOJ is sandwiched between the ECB and the Fed, but if you take into account the rest of the world as well, it may be more accurate to say that the BOJ is surrounded on all sides by rate cuts.

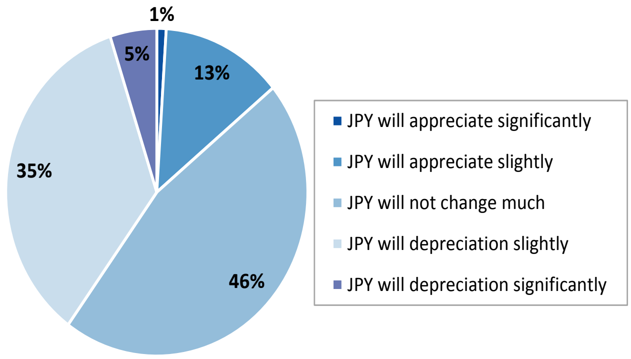
		Current(%)	Latest policy trends		2019 Cumulative change width	2018 Cumulative change width
			Date	Decision		
Asia Emerging						
China	1-year benchmark lending rates	4.35	2019/1/4	Unchange	0bp	0bp
India	Repurchase rate	5.75	2019/6/6	Rate cut	▲75bp	+50bp
Indonesia	7day reverse repo rate	5.75	2019/7/18	Rate cut	▲25bp	+175bp
S.Korea	7day repo rate	1.50	2019/7/18	Rate cut	▲25bp	+25bp
Malaysia	Overnight policy rate	3.00	2019/7/9	Unchange	▲25bp	+25bp
Philippines	Overnight reverse repurchase agreement RRR rate	4.50	2019/6/20	Unchange	▲25bp	+175bp
Thailand	1 day official rates	1.75	2019/6/26	Unchange	0bp	+25bp
Vietnam	Refinance rate	6.25	2018/9/30	Unchange	0bp	0bp
Oceania						
Australia	Overnight policy rate	1.00	2019/7/2	Rate cut	▲50bp	0bp
New Zealand	Overnight policy rate	1.50	2019/6/26	Unchange	▲25bp	0bp
Central and Eastern Europe and Africa						
Russia	1week repo rate	7.25	2019/7/26	Rate cut	▲50bp	+50bp
S.Africa	Repo rate	6.75	2019/7/18	Rate cut	▲25bp	0bp
Turkey	1 week repo	19.75	2019/7/25	Rate cut	▲425bp	+1600bp
Latin America						
Brazil	Selic target rate	6.50	2019/6/19	Unchange	0bp	▲50bp
Mexico	Official overnight rate	8.25	2019/6/27	Unchange	0bp	+100bp

(Note) Indonesia has changed policy rate 7 day reverse repo rate instead of BI rate on 19AUG2016
(Source) Bloomberg & Mizuho Bank

Which Country will Take Up the Baton of Currency Strength?

Monetary policy is originally supposed to be conducted based on each country's domestic economic situation, so countries shouldn't logically be able to influence or even be conscious of each other's monetary policies. However, forex rates, which are greatly affected by monetary policy, do not work in isolation. If central banks around the world begin cutting rates in concert, that would exert downward pressure on their respective currencies. On the flip side of this, some currency would have to bear the burden of currency strength as it is impossible for all the currencies to move in the same direction.

"What do you predict will happen to USD/JPY in the short term the event that BOJ implements additional monetary easing?"



(Source) QUICK monthly survey (FX)

So, the question arises – which country seems most likely to pick up the baton of currency strength this time round? First, it would have to be a currency with sufficient liquidity (a currency that can accept investments channeled out of other currencies), i.e., a key currency. Additionally, it would have to be a currency with very little scope for further monetary easing (further decline in interest rates), and a currency with no external sector weakness (i.e., with a current account surplus). These are some important criteria. Political stability is also desirable. Practically speaking, few currencies other than JPY and EUR meet these conditions. This is the reason I have been predicting that both these currencies will remain strong against USD, but of the two, EUR loses significantly to JPY if we focus on political stability. Therefore, my basic understanding is that JPY is in the best position to pick up the baton of currency strength from USD at this time. Of course, policy interest rates are not the only factor that affect changes in forex rates. However, most market participants seem to have given up hope when it comes to the extent to which BOJ can single-handedly push back against the downward pressure on currencies around the world (i.e., the upward pressure on JPY). The monthly survey (survey period July 8-10) of forex market participants jointly conducted by QUICK Corp. and Nikkei Veritas clearly reflected this fact. According to the survey results, in response to the question "What do you predict will happen to USD/JPY in the short term the event that the BOJ implements additional monetary easing," 46% of respondents said "The rate will not change much" while 14% said "JPY will appreciate (either significantly or slightly)." In other words, 60% of respondents (a majority) considered that an additional monetary easing by the BOJ would either have no effect or result rather in JPY strengthening. Not to mention that JPY is the most undervalued among the currencies of advanced economies in terms of REER, so there exists a strong latent upward pressure on it.

Monetary Policies Around the World Becoming More Like Currency Policy

The arguments presented above are an implicit acknowledgement that monetary policy is subordinated not to prices but to forex rates. As I mentioned before, given that monetary policy operation is based on the domestic (or regional) economy and inflation, there should be no need for the markets to focus on policy meetings in terms of the dates compared with some other country's policy meetings. The reason policy meetings end up attracting so much attention is because any fluctuation in U.S. interest rates (the cost of capital for the world) directly results in fluctuations in other currencies, and this is feared to impact the real economy in terms of external demand (i.e., export trends). Such concerns are often seen during phases of global economic slowdown such as the present, when domestic demand becomes uncertain. The trend of beggar-thy-neighbor policies aimed at propping up the domestic economy, which are often seen during times of recession, has not begun yet, but the ECB has recently begun to be quite blatant regarding its intention to avoid a strengthening of its domestic currency (the BOJ has been doing this for years). In the U.S. too, with President Trump cherishing the support of labor unions, especially in the manufacturing sector, the administrative stance is biased in favor of USD weakness (whether or not this is good for the U.S. economy is a different question). The same seems likely to be true of the UK as well, not to say anything of emerging economies. Around the world, monetary policy is slowly but steadily acquiring the characteristics of currency policy; in other words, one could say central banks around the world are becoming more like the BOJ. And the BOJ, the originator of this trend, is finding itself in an increasingly tight corner as it is faces a marked lack of options.

U.S. and Japanese Monetary Policies Now and Going Forward – Fed Defiant in the Face of Political Pressure

BOJ Willing to Implement Preventative Easing

As expected by most, the monetary policy was kept unchanged at the July 29-30 BOJ Monetary Policy Meeting. The forward guidance regarding interest rates, which some had expected to be revised, was also kept unchanged at "for an extended period of time, at least through around spring 2020." Naturally, the BOJ does not want to use up its precious remaining options while forex rates, its most important monetary policy reaction function, remain stable. Meanwhile, the sentence "in a situation where downside risks to economic activity and prices, mainly regarding developments in overseas economies, are significant, the Bank will not hesitate to take additional easing measures if there is a greater possibility that the momentum toward achieving the price stability target will be lost" was added to both its monetary policy statement and its Outlook Report. The BOJ (Governor Haruhiko Kuroda) explained that the addition of this sentence has made the BOJ's monetary easing more proactive. Mr. Kuroda's press conferences originally included the language "the Bank will not hesitate to consider additional easing measures if the momentum toward achieving the price stability target is lost." The modification of that to "if there is a greater possibility that the momentum toward achieving the price stability target will be lost" appears to indicate that the criteria for implementing additional monetary easing has been relaxed. The interpretation is that the Bank would be willing to implement "preventative" monetary easing as soon as it perceives the possibility of the momentum being lost, even before the actual event.

Major outlook by BOJ policy board members （YoY %）

	Real GDP	Core CPI (ex fresh food)	Ex consumption tax impact
FY 2019	+0.6～+0.9 <+0.7>	+0.8～+1.1 <+1.0>	+0.6～+0.9 <+0.8>
Outlook as of Apr	+0.7～+0.9 <+0.8>	+0.9～+1.2 <+1.1>	+0.7～+1.0 <+0.9>
FY 2020	+0.8～+1.0 <+0.9>	+1.1～+1.4 <+1.3>	+1.0～+1.3 <+1.2>
Outlook as of Apr	+0.8～+1.1 <+0.9>	+1.2～+1.5 <+1.4>	+1.1～+1.4 <+1.3>
FY 2021	+0.9～+1.2 <+1.1>	+1.3～+1.7 <+1.6>	
Outlook as of Apr	+0.9～+1.2 <+1.2>	+1.4～+1.7 <+1.6>	

（Source）Bank of Japan
（Note）＜＞ indicate the median estimate by policy board members

Mr. Kuroda himself acknowledged during his press conference that it could be called "preventative." As usual, it is important to know how momentum is defined and measured, and Mr. Kuroda said in his press conference that some ways of measuring it would be based on the GDP gap and inflation expectations. Of course, he has merely mentioned two of the variables used to plot the Phillips curve, but given that the estimation of the GDP gap is not easy to begin with, there is a lot of uncertainty regarding whether a shrinking GDP gap (even when the gap itself is positive) should be perceived as a loss of momentum or not. Ultimately, therefore, the thinking seems to be that an arbitrary decision would do just fine. In the Outlook Report, the (median, see chart) of forecasts for the Real GDP growth rate for FY 2019 was +0.7% yoy, while that of forecasts for the Core CPI (excluding fresh foods) growth rate was +1.0% yoy, both down -0.1 pp compared with the previous (April) time. As for FY 2020, the GDP growth rate figure was level while that for Core CPI was down by -0.1 pp. Overall, there was no improvement compared with the previous time, but the Core CPI forecast remains optimistic with an implicit sense of downward revision.

Low Impact as No Hesitation Observed So Far Either

With the Fed attempting to embark on its first rate cut in ten and a half years for a similar reason, "preventative easing" is quickly becoming a watchword for those following central bank operations. Having said that, such a declaration is unconvincing coming from the BOJ, which never attempted to change its accommodative posture even when the economic and financial situations were strong in 2017-18. The reason the Fed and the ECB attracted attention when they switched to monetary easing was because both had been attempting to normalize their policies during 207-18. In the case of the BOJ, most market participants did not see any hesitation in its accommodative policy stance before, so they remain unaffected by its recent vow to "not hesitate to take additional easing measures."

As the odds of monetary easing increase around the world, not just in Europe and the U.S., the BOJ would like to avoid coming across as passively letting JPY appreciate, so perhaps the recent effort is mainly an attempt to communicate to the markets that it is doing something. However, in the event that the Fed and the ECB both cut rates in September, the BOJ will not be able to get away simply issuing verbal messages. As per the schedules, the BOJ will be the last of the three banks to hold a policy meeting in September and, if there are upward pressures on JPY at that time, will be forced to take the long-awaited countermeasures.

In such a situation, what is the one option remaining to the BOJ? In his press conference, Mr. Kuroda mentioned several potential options for the BOJ's next move, including an expansion of the negative interest rate margin, a reduction of the long-term interest rate operation target, expansion of asset purchases, acceleration of the pace at which the monetary base is expanded, and so on, indicating that there were several potential additional measures that could be taken. The list of examples he cited, however, did not include other potential options such as a strengthening of the forward guidance or the possibility of linking the forward guidance to the price stability target (for instance 2%) rather than to a calendar date, as suggested by Policy Board Member Yutaka Harada this time. Having said all that, regardless of what the BOJ's next move is, this report's basic understanding remains that it would be difficult to push back against the upward pressure on JPY resulting from the downward pressure on USD due to U.S. policy measures.

As Feared, Powell Misspeaks

Meanwhile, the Fed decided to lower the target range for the FF rate from 2.25-2.50% to 2.00-2.25% at the closely watched FOMC meeting, which came right after the BOJ's Monetary Policy Meeting. This was the first rate cut by the Fed in ten years and a half. The Fed also ended the reduction of its asset portfolio (its "quantitative tightening") on August 1, two months earlier than originally planned, at the end of September. Given the current economic and financial situations in the U.S., the recent move by the Fed was probably a major effort (as per the real sentiments of Fed Chair Jerome Powell). In his press conference, Mr. Powell explained that "it is intended to insure against downside risks from weak global growth and trade policy uncertainty," emphasizing that the move was not in response to current conditions but a measure against future economic slowdown. Of course, not all FOMC members agree with this logic, as indicated by the negative votes from Kansas City Fed President Esther George and Boston Fed President Eric Rosengren.

The rate cut was as expected, but in his press conference, Mr. Powel said that a rate cut does not necessarily imply the start of a cycle of monetary easing, describing it as being "essentially in the nature of a midcycle adjustment to policy" and expressing doubt regarding its continuity. The idea seems to be that the rate cut is essentially a device for prolonging the economic expansion, but such logic leads one to think that rate hikes will be resumed at some point. Possibly this message was partly in defiance at the political pressure, but the share markets responded sharply and the NY Dow Jones Industrial Average fell sharply by -USD 333.75. In his press conference, Mr. Powell made some statements that appeared to hint at a continuation of rate hikes ("I didn't say it was just one," "(rate cuts) have supported the economy"), but the damage from his statement that the recent rate cut was "not the beginning of a long series of rate cuts" seems to have been significant.

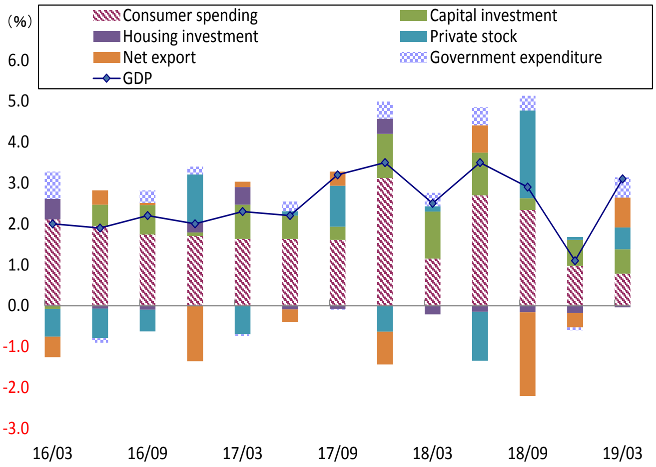
The financial market response to the press conference included a plunge in stock prices and USD appreciation. In the bond markets, U.S. 10-year interest rates remained level and 2-year interest rates, despite fluctuating between 1.80 and 1.96%, settled eventually at a level not far from before the FOMC meeting (1.87% or so). The bond markets appear to have taken things calmly, perhaps assuming that the rate cuts will continue, and I am inclined to think the same – that rate cuts cannot but continue. All in all, following the recent FOMC meeting, it became clear that Mr. Powell does, indeed, have a communication problem with the markets, as is often pointed out. In addition to the rate cut itself, which was only by 25 bps, his message to the markets that this was a "hawkish rate cut" has created a situation conducive to further verbal interventions from President Trump rather than silencing them. Following the Fed's decision to cut rates, Mr. Trump complained as usual, saying, "Powell let us down." The financial markets need to keep in mind the possibility that such tensions could result in concrete action in the form of a reshuffle.

Give Them an Inch and They'll Take a Mile

Before the FOMC meeting, a Bloomberg headline (July 30, 2019) read, "If Powell Gives an Inch, Bond Traders May Ask Fed for a Mile." I fully agree with that sentiment. The recent rate cut decision was spurred by the sudden fall in share prices, which began gradually last year, rather than by a deterioration in fundamental economic indicators. The most important indicator, the unemployment rate, remains below 4%, and there has been no major fall in nonfarm payrolls. Real GDP growth, too, though slower than in 2018, when the expansionary fiscal policies boosted growth, is not so slow as to derail monetary policy (see figure). There has been no marked decline in price-related indicators such as the CPI and Personal Consumption Deflator (PCE) either (in fact, these indicators are stronger now than they were in 2015, when rate hikes began). Even so, forecasts regarding the target range for the FF rate have deteriorated from "four rate hikes a year" in 2018 to "three rate cuts a year" for 2019. There has hardly been enough of a deterioration in fundamental economic indicators to justify such a sharp change in the path of policy interest rates.

Of course, that is the reason why the rate cut was described as an “insurance” against future developments and could be described as a proactive response. However, one cannot help thinking that the trigger was the fall in share prices. The Dow fell by up to -20% or so from its peak levels between October and December last year, and as this was happening President Trump began to take every opportunity to complain about the Fed’s monetary policy operations. Ultimately, therefore, share market trends have played a big role in bringing about the recent rate cuts, and one could safely say that the decision may have been affected to some extent also by political noise. Though the Dow fell sharply following the FOMC meeting, share prices (represented by the Dow) do happen to be at a historically high level. It cannot be denied that this has played a part in keeping USD from crashing. However, share price and USD strength are only possible because they are supported by the decline in U.S. interest rates.

U.S. real GDP(QTD, %)



（Source）U.S. BEA

Taking into account the background so far, it seems prudent to assume that the markets will call for rate cuts again whenever share prices fall. Some aspects of this can be glimpsed from the market reaction following the recent meeting. Having given into the market’s whims once, the Fed may be called upon to play more of its cards, potentially leading to a resumption of quantitative easing (in fact, it did move up the end of its quantitative tightening). For this not to happen, U.S. consumption and investment appetites would have to be boosted by the high share prices, but my worry is that, before that can happen, the U.S. labor market, which is in a state of full employment, will begin to deteriorate. At the very least, it may be too optimistic to assume that the current phase of rate hikes will end after just one or two rate hikes. This report’s main forecast scenario is that it will continue at least for the next year. Under such circumstances, it seems rather difficult to expect an upside risk for USD/JPY.

Risks to My Main Scenario – Risks Related to Second Brexit Referendum Activities Etc.

Will U.S. Economic Strength Continue?

At this point, I would like to review the risk factors related to my main forecast scenario. As has been discussed numerous times, this article’s main scenario anticipates “a correction of the USD appreciation that has occurred over past five years” and this correction is expected to cause appreciation of JPY and EUR.

Since the most important risk scenaros are those related to JPY depreciation, I think it important to focus here mainly on JPY depreciation risks. The main risk factors are listed in the table, and these have not greatly changed since last month. The most important of the risk factors is risk factor ①, which appears to continue to be both the most important risk factor as well as the risk factor most likely to eventuate. Looking at one aspect of the situation – the U.S. unemployment rate – one finds that the argument is beginning to be made that the current unemployment rate (the lowest level in 49 years) is not excessively low and can be further lowered by restricting the influx of immigrants, although a further lowering of the rate may well increase the upward pressure on wages going forward. I traveled to New York in July and was able to get a better grasp of the situation there through meetings with representatives of various local companies, a large share of whom pointed out that the real economy was performing robustly amid the full employment situation. (I was struck by the number of people who noted how difficult it was to hire additional employees.) Nobody, including the Fed, is anticipating a lengthy continuation of the current labor market expansion, and it appears highly unlikely that employment will further strengthen for very much longer.

JPY depreciation risk factors

	Risk	Detail	Possibility
①	U.S. economy is surprisingly robust	Economic policy by the Trump administration such as elimination of tariffs	medium /high
②	Discontinuation of the Trump administration’s protectionist policies	Complete resolution of US-China trade war	low
③	BREXIT related	General election and 2nd referendum	low /medium
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

Furthermore, since June, the Fed’s increasing dovishness has been intensifying the upsurge in stock prices. Such asset price growth may well have the effect of breathing new life into the U.S. household sector, which is easily influenced by asset or wealth effects. I have been assuming that the U.S. labor market trends were peaking out, and my main forecast scenario is based on the assumption that the increasingly apparent decline in employment would impede the rise of stock prices, but it is possible that a revival of strong consumption activities may take place prior to such a stock price weakening. Another factor in this is the upcoming U.S. presidential election in November 2020. Is it realistic to expect President Trump to take no action to counter economic deceleration as the election approaches? While the hurdles on the path toward implementing expansionary fiscal policies seem quite high in light of the recent behavior of the U.S. Congress, there is a possibility that the various supplementary tariffs that have already been imposed might be successively eliminated or lowered. This suggests the possibility of a simultaneous eventuation of risk factors ① and ②. In the case that existing tariffs were eliminated or lowered, the U.S. economy may perceive that as a tax cut and respond accordingly. There is certainly a possibility that financial markets (particularly forex markets), which are inclined to straightforwardly respond to such measures, will show a positive response to such tariff cuts, although President Trump might be justifiably criticized for stirring up trouble to get credit for the solution.

In any case, financial markets are ineluctably influenced by the ups and downs of the U.S. economy, and forex market trends are likely to take shape in response to positive and negative U.S. economic trends. Naturally, if the U.S. economy shows more resilience than expected, there is a possibility that any moves by the Fed to cut interest rates might end up being short-lived. At that time, U.S. interest rates are likely to rise, and USD/JPY should move in accordance. I consider this JPY depreciation risk to be the most realistic as well as the largest risk factor.

Concerns about Clear-Cut Recovery Trends in China and Europe

Risk factor ⑤ is also attracting considerable attention owing to the significant effect it may have on the Fed's policies. As the economic deceleration trend in China and Europe seems to be showing signs of bottoming out, the risk is essentially that the Fed will be so reassured by those signs that it will renew its policy normalization efforts. Fundamentally, the Fed's widely anticipated July rate cut is seen as a precautionary measure, and many observers expect it to be similar to the temporary rate cut of 1998. Such a theory would be even more convincing if a trend of recovery in China and Europe were to become more clear-cut.

As I argued last month, I currently believe that the upcoming period may be a "short and shallow interest rate reduction phase" associated with a soft patch rather than a "long and deep interest rate reduction phase" associated with a recession but, even so, I anticipate that rate cuts may well continue throughout the forecast period (roughly one year). If the economic recovery trends in China and Europe become more clear-cut than expected, however, the interest rate reduction phase may end by the end of the year after only one or two rate cuts and be followed by renewed interest rate hikes in 2020. For the JPY appreciation scenario, this possibility is a big risk factor. Especially regarding Europe, economic trends during the past year have been so bad that many people are anticipating a trend of improvement going forward. At the time this article was written, expectations were increasing that the ECB may move to cut interest rates rate more quickly owing to the delayed recovery of German manufacturing industries, so rather than unexpected economic recovery in Europe, it seems more realistic to be concerned about unexpected economic deceleration there. Regarding China, also, signs of a decrease in U.S.-China trade frictions appear to have completely disappeared at this point, which makes it difficult to anticipate a strong increase in consumption and investment activities in China.

On the other hand, price formation in financial markets is currently proceeding based on the premise that economic conditions in China and Europe will continue to deteriorate. There are probably grounds for concern that trends that might undermine this premise could change the overall mood (leading to a rise in U.S. interest rates and USD appreciation).

U.K. General Elections to Revive Possibility of a Second Brexit Vote?

Previously, this article has noted such worrisome political JPY depreciation risk factors as the potential for "a discontinuance of the Trump administration's protectionist politics" (≒"a complete resolution of the U.S.-China trade war") and the possibility that "the Brexit initiative might be withdrawn following a second referendum". Since strong-Brexit-supporter Boris Johnson became U.K. prime minister in July, it now appears that the likelihood of the latter risk has become quite low. Prime Minister Johnson is clearly opposed to a second referendum, but the Brexit negotiation outlook will be essentially the same as previously despite the new prime minister and cabinet so long as there is no change in the positions of the current members of Parliament.

When Parliament reconvenes in September, <u>if a no confidence vote designed to prevent Prime Minister Johnson from undertaking a "no deal" Brexit were to be held and passed, it would call for the dissolution of Parliament and holding of general elections as early as this autumn. In the case that the pro-second-referendum Labour Party were to attain a majority in Parliament, it would immediately revive the "second referendum → JPY depreciation" scenario.</u> Based on public opinion polls, it currently appears that neither the Conservative Party nor the Labour Party would be likely to realize a Parliamentary majority on their own, but it is generally believed that the Conservative Party will be weakened by losing voters to the Brexit Party and that the Labor Party may benefit from that situation. In the case of new elections, it seems likely that JPY will weaken as the financial markets take into account various post-election possibilities, such as a discontinuation of the Brexit policy or a clear transition to a soft Brexit policy. (However, such possibilities are premised on the assumption that the European Commission's new executives will allow negotiations to proceed beyond October 31.)

What about the potential for "a discontinuance of the Trump administration's protectionist politics" (≈ "a complete resolution of the U.S.-China trade war")? The parties in the U.S.-China trade negotiations remain far from reaching an agreement, and there are no apparent indications that such an agreement will eventually be reached. In fact, some observers in the United States believe that the anti-Trump Democratic Party along with pro-Trump labor unions are promoting anti-China sentiment to a degree even greater than that desired by President Trump. In light of such circumstances, there is a possibility that it will prove impossible to reap the potential benefits of mutual compromises during the negotiations and that the tragedy of stubborn U.S.-China confrontation will continue. Of course, 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 he intends to sustain his basic strategy aimed at keeping relations with China moderately strained while avoiding sharp trends of deterioration or improvement. However, if it turns out that the president cannot single-handedly terminate the US-China trade war, there are grounds for concern about the risk that the situation will escalate to a level that cannot be controlled.

As mentioned above, in view of signs of increasing sluggishness in the domestic and foreign economic situations, it seems reasonable to assume that President Trump would like to undertake as many discretionary measures as possible that might have a positive effect on the United States' real economy. If he were to progressively eliminate the various tariff sanctions recently imposed on China, it can be expected that it might unfetter the world's leading economy, leading to appreciation of USD and an uptrend in U.S. interest rates.

Japan-Origin JPY Depreciation Risks Still Sparse

Are there JPY depreciation risks originating in Japan worth being concerned about? In light of how dovish the Fed has already become, it seems inevitable that expectations that the BOJ will launch some sort of policy initiative will increase going forward, although it continues to be thought that such initiatives are fundamentally not likely to exert powerful effects. The BOJ will probably be taking measures in line with those of the Fed and the ECB and, regarding the possibility of a major BOJ initiative capable of reversing the strong USD appreciation trend seen over the past five years, there is almost no rational basis for even placing that possibility in the risk scenario category. However, some believe that it is precisely because many market players believe in this possibility that an unexpected and brilliant BOJ policy initiative would have the potential to bring about major market fluctuations. It is thought that such measures as those to further depress negative interest rates and introduce a negative lending rate will only be considered if USD/JPY descends below JPY100, but if the BOJ were to take initiatives in advance of expectations, it would might help elevate USD/JPY. Basically, however, it seems most appropriate to categorize this possibility as a risk scenario that is considerably less likely to eventuate than other risk scenarios, because the BOJ simply is not believed to have sufficient power to reverse the USD appreciation trend.

"JPY Appreciation Risk Factors > JPY Depreciation Risk Factors" Situation Unchanged

While this article has focused primarily on worrisome JPY depreciation risk factors, the risk factor range naturally encompasses JPY appreciation risk factors also. In fact, this article will continue to argue that the number of JPY appreciation risk factors seems relatively large. For example, there has been a perceived risk of war between the United States and Iran evident since June, and an actual war at some future time would tend to promote USD depreciation in connection with the United States' "twin deficits". This makes such war-related risks a JPY appreciation risk factor. In addition, as described above, under Prime Minister Johnson, a "no-deal" Brexit is progressively becoming the default route. This is another situation likely to elicit JPY appreciation.

Furthermore, if the U.S.-China trade talks go awry again, one can expect increased attention will be given to the frictions associated with the pegging of RMB at roughly USD1=RMB7.00. If the United States continues expanding the scope of its supplemental tariffs on Chinese goods, it will not be surprising to see the Chinese authorities consider the option of promoting RMB depreciation as a means of offsetting the effects of the tariffs. As discussed in detail in a previous edition of Mizuho Market Topic , however, China is already incapable of maintaining its previous levels of current account surpluses, and a trend of RMB depreciation, while heartily welcomed by China, could easily spur a unwelcome replay of the China Shock situation that occurred on August 11, 2015, when China adjusted its USD/RMB pegging system and promoted sharp RMB depreciation along with a plunge in Chinese stock prices. In the case that China were to fail to successfully sustain the subtle adjustments entailed by its 'optimized RMB depreciation guidance' program and thereby become unable to sustain the roughly USD1=RMB7.00 level, the situation might have the potential to stir up considerable market turbulence. Many observers consider it prudent to keep in mind the lessons of the China Shock, and this could also become a factor promoting the acceleration of risk-off mood JPY buying. Another risk factor is associated with the question of whether the euro area – confronted with German economic deceleration precisely at a time when had begun to see signs of a general trend of economic acceleration – can avoid recession? In any case, the ECB has become anxious about that, and having strengthening its easing stance, it has to deal with market expectations of a September interest rate cut. If there is serious talk of a German recession, it may become impossible to ignore the JPY appreciation pressures stemming from Europe.

In addition, the markets often tend to view a wide range of "negative" situations as being factors that promote JPY appreciation, but it would not be worthwhile to examine each such potential situation individually. During the forecasting period, there is a possibility that "distortions"' stemming from the record-long period of economic expansion could manifest themselves in innumerable problematic forms and locations. In light of current and prospective political and economic situations, most people would probably not be inclined to disagree with the view that the eventuation of JPY appreciation risk factors is more likely than that of JPY depreciation risk factors. As mentioned above, if the Fed's current round of "precautionary interest rate reductions" ends up limited about two to three reductions, as in 1998, it does not seem likely to promote a JPY appreciation trend over several years. However, I continue to believe there is no need to adjust this article's main forecast scenario anticipating a decrease in U.S. interest rates along with across-the-board USD depreciation during the next 12 months.

EUR Outlook – Accelerated Easing and Europe-U.S. Trade Frictions

Euro Area Monetary Policies Now and Going Forward – Sharp Rise in Expectations of a September Interest Rate Cut

Staff Forecasts to be Big Events Going Forward

At the July 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. Strictly speaking, however, the meeting did not merely maintain the status quo, as the forward guidance text was slightly modified. As described below, this was the third time during the last four meetings that the forward guidance has been revised, and it is somewhat unusual see such a flurry of revisions. Although EUR weakened after the release of the post-meeting statement, EUR rebounded after it emerged during the subsequent press conference that no additional easing measures were considered at the meeting. ECB President Mario Draghi summarized the main lines of the meeting as being (1) an assessment of the economic growth and inflation outlooks (particularly the historically low level of inflation expectations) and (2) how to prepare to respond to those outlooks. However, he emphasized that concrete measures were not discussed ("We didn't discuss them at all, really."), and this appears to have promoted EUR buying. The most noteworthy portion of the meeting was the addition to the statement of the following text:

> "In this context, we have tasked the relevant Eurosystem Committees with examining options, including ways to reinforce our forward guidance on policy rates, mitigating measures, such as the design of a tiered system for reserve remuneration, and options for the size and composition of potential new net asset purchases."

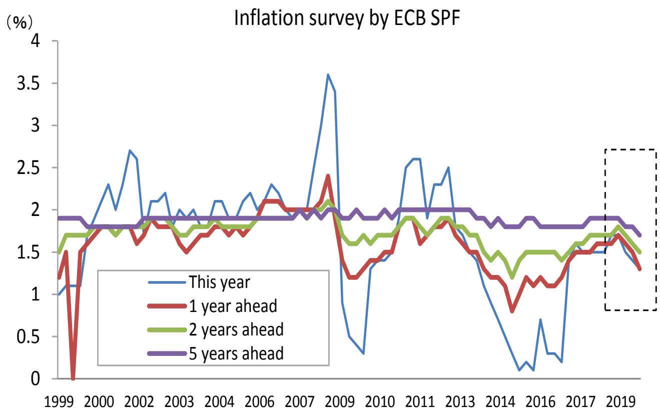
Regarding future actions, President Draghi employed his customary signaling language, saying – "we have tasked the relevant Eurosystem Committees with examining options." He has often used such language at the last meetings prior to those meetings that are accompanied by staff forecast revisions (those in March, June, September, and December). It would probably be good to supplement that language with such a phrase as "based on the nature of progress observed in the economic and financial situations." During the press conference this time, as at previous press conferences, President Draghi did also say that – "we decided that we want to see the next projections before taking action." Another noteworthy aspect of the statement was its mention of a tiered system for reserve remuneration. So far as I remember, <u>although tiered systems have long been discussed among market participants, the ECB previously had recognized the possibility of such a system only at press conferences</u>. The specific mention of a tiered system in the statement is believed to reflect progress in the examination of negative interest rate deepening methods that might be the ECB's "next move".

Although President Draghi said that none of the listed easing measure options has been prioritized, market players are assuming that negative interest rate deepening methods associated with a tiered system and the resumption of asset purchasing are candidates to become the ECB's "next move", and <u>it is believed that the ECB's options are progressively being narrowed down to an implementable package of "forward guidance strengthening + negative interest rate deepening + tiering system introduction".</u> Of course, it is possible that the ECB may decide to introduce an 'all out' package that includes quantitative easing resumption. Historically, the Draghi ECB has often mentioned numerous measure options at one time and subsequently sought to narrow them down[1]. Given that it will coincide with the last staff projection revision during President Draghi's term, there is a possibility that the September Governing Council meeting may be a major event. The press conference featured remarks about the desire to give the specialized committees sufficient time to analyze the current situation and make preparations, and there is a high likelihood that this reflects the challenges associated in particular with the introduction of a tiering system that requires complicated systemic adjustments and also with the need to prepare for adjusting the capital key, the 33% rule, and other previous expanded asset purchase programme (APP) parameters.

It is understood that the mention of their consideration of the package of measures in the statement means that there was unanimous support for the consideration, but President Draghi hinted at the existence of Governing Council members with nuanced differences in their support for individual items in the package. It is not clear which option might be a focus of disagreement, but Deutsche Bundesbank President Jens Weidmann is known to have a negative opinion about the use of a tiered system for current deposit accounts, for example. He recently said that – "The potential relief through interest-rate tiering, as it's currently being discussed, would certainly be felt, but ultimately be negligible."

[1] For example, the June 5, 2014 GC meeting responded to growing anticipation of additional easing with five measures – (1) the surprise initial introduction of a negative interest rate along with the announcement of (2) the start of targeted longer-term refinancing operations (TLTRO), (3) preparations for outright purchases in the asset-backed securities (ABS) market, (4) the continuation of main refinancing operations (MROs) as fixed rate tender procedures with full allotment, and (5) the transition to non-sterilization of bond purchases under the Securities Market Program (SMP).

Changing ECB Mission Statement: Inflation Targets with Emphasis on Symmetry



(Source) ECB "Survey of professional forecasters" (Note Looking ahead 5 years, Q2 – Q4 1999 is horizontal in Q1 1999, and Q2 – Q4 2000 is horizontal in Q1 2000.

And there was one other big change in the statement, the addition of the sentence – "[...] if the medium-term inflation outlook continues to fall short of our aim, the Governing Council is determined to act, in line with its commitment to symmetry in the inflation aim." In his answer to the first question at the press conference, President Draghi emphasized that this expression is – "new to our language". Traditionally, the ECB has described its medium-term price target as "below, but close to, 2% over the medium term", but this description has been conducive to a market expectation that the ECB will not tolerate inflation above 2% (the 2% figure being interpreted as being a cap). This is a relic of an era when inflation was of greater concern than deflation, and can be considered inappropriate for the current situation, in which there is mainly concern about the lack of inflation promoting effects and the semi-permanent depression of both inflation rate expectations and actual inflation rates. Of course, many questions have been raised about whether the ECB has actually discontinued the traditional wording of its medium-term inflation goal definition, but President Draghi has yet gone so far as to admit that discontinuation. Although he did acknowledge that there was discussion within the Governing Council about "should we go to another different objective?", he also explained that some Governing Council members suggested such a shift would be an important change and it would therefore be prudent to "carry out a reflection on this". <u>The gist of 'symmetry' probably means "a short-term policy stance that accepts an overshooting of the 2% inflation target" along with "efforts to sustain an inflation rate of less than 2% over the medium term". If the current situation continues for a long time, however, there is a possibility that the Lagarde-led ECB may undertake a formal review of the ECB's mission statement</u>.

Recently, high-level ECB officials have frequently disseminated information suggesting that the usefulness of emphasizing five-year in five years inflation swap break-even inflation (5-year, 5-year forward BEI) movements is decreasing for technical reasons. However, President Draghi noted during the press conference that the inflation levels suggested by the ECB's quarterly Survey of Professional Forecasters (SPF) have been "sturdy" for a long time but are now also beginning to decline, so despite maintaining the view that the usefulness of 5-year, 5-year forward BEI is decreasing, he emphasized that it would be imprudent to have excessive confidence in that view. <u>In fact, the SPF inflation expectation levels for all time periods are starting to deviate downwards (see graph on previous page).</u>

Forward Guidance Adjustments: Strictly Speaking, Additional Mitigation This Time Too

The latest Governing Council meeting may appear to have simply maintained the status quo, but in light of the revision of the forward guidance and the mention of the option of additional easing, it should be recognized that the meeting has elements that can not be considered status quo maintenance in a strict sense of the phrase. In view of the repeated incidence of forward guidance revisions, it also bears saying that the ECB has also had difficulty clearly communicating about its policy management this year, although its shortcomings in this respect are not quite as glaring as those of the Fed. Regarding the period of maintaining key ECB interest rates unchanged, the forward guidance was changed this March from "at least through the summer of 2019" to "at least through the end of 2019", thereby delaying the potential interest rate hike timing from September to December. The June Governing Council meeting changed this phrase to "at least through the first half of 2020", ruling out a hike during the first half of 2020. In this manner, the ECB has delayed a potential hike timing by another year. While the July Governing Council meeting maintained the previous time period, it changed the phrase "We now expect them to remain at their present levels at least through the first half of 2020" to read "We expect them to remain at their present or lower levels at least through the first half of 2020". In other words, <u>if there is to be a change in a policy interest rate level, the ECB has made a commitment that the change would be an "interest rate reduction", and this can be considered tantamount to an official announcement of the termination of the ECB normalization process that had advanced to the termination of the expanded asset purchase programme (APP) at the end of 2018</u>.

It is worth recalling that the first question posed at the June press conference was rather brusque – "You said that interest rates will remain at their current levels through the first half of next year, but the market is actually pricing for the next interest rate move to be a cut." The decision to revise the forward guidance yet again in July may well be attributable to the appositeness of that question.

How Does the ECB Evaluate the APP?

Personally, I would think that, rather than a deepening of negative interest rates accompanied by serious reversal rate-related concerns, it would be more rational to resume the APP, which was terminated at the end of last year. (It is noteworthy that President Draghi categorically stated at the latest press conference that "we see no sign of [reaching the reversal rate].") However, a reporter at the press conference asked a tough question about the APP – "If four years of QE and 2.6 trillion didn't do the trick and achieve the goal, how would more QE help and what would be different?" In his response, President Draghi boasted that the APP was effective in raising the inflation rate from 2014 and in creating 11 million jobs over the past five to six years, thereby enabling some euro area countries to attain a full employment condition.

(It is worth noting that each Governing Council meeting features members' discussions about the volume of jobs they are helping create.) As there were various risk factors faced during the period from 2014, leaving aside the question of whether those factors may have diminished monetary policy effects, President Draghi's view is that the APP was basically effective. He admits that euro area inflation has been sluggish but notes that that situation is not limited to the euro area, and for that reason he asserts that the effectiveness of the APP cannot be denied based on the sluggishness of inflation. Although he cannot state it out loud, President Draghi's real view may well be that there is little leeway remaining for effective monetary policy measures. In any case, it would seem somewhat unlikely that the ECB will re-launch the APP as its "next move" based on the argument that the APP can effectively boost inflation rates.

President Draghi Passes the Fiscal-Policy-Emphasis Baton to President Lagarde

As mentioned above, while he continued discussing the effectiveness of the APP and other monetary policies, President Draghi made a strong impression when he emphasized that what is really required is fiscal policy measures. When questioned by another reporter about the possibility of a recession in the region, President Draghi responded that fiscal policy is "really very important" for Germany and other member countries with large manufacturing sectors, and if there is a further deterioration in the regional economy, then monetary policies will continue to do "a lot", but he also emphasized that "fiscal policy will become of the essence". The March Governing Council meeting's statement also includes a sentence – "Regarding fiscal policies, the mildly expansionary euro area fiscal stance and the operation of automatic stabilisers are providing support to economic activity." – that reflects the ECB's stance shift toward greater emphasis on fiscal policies. At the latest press conference, President Draghi said – "I think fiscal policy was important, is important, will be even more important if the economic situation deteriorates everywhere." – and this statement probably reflects his consciousness that there remains only limited leeway for the use of monetary policies. A key point regarding the transition to a Christine Lagarde-led ECB will be the extent to which President-to-be Lagarde shares President Draghi's view that – "monetary policy has done a lot to support the euro area and continues, as you can see today, to do a lot but if we continue with this deteriorating outlook, fiscal policy will become of the essence."

IMF Decision-Making Processes Applicable to the ECB?

The latest Governing Council meeting was also the first Governing Council meeting to be held following the decision to appoint Christine Lagarde to be the ECB's new president. Conscious of President Draghi's impending retirement, a reporter at the press conference posed the question – "have you given a thought to what you will do at the end of your mandate?" President Draghi responded – "I haven't come to a determination of what I will be doing in the future. Let me say one thing about my successor." He then explained that Ms Lagarde's long experience as the IMF's managing director equips her to be an outstanding ECB president, saying – "if you think about the way decision-making has been actually done in the IMF, it's collegial; it uses the vast input of the staff, of economists. It involves discussions with colleagues, with the staff, with the various parts of the IMF. It isn't that different from what we do at the ECB."

It is certainly true that the ECB and IMF are both international organizations with multinational staffs and that their decision-making processes involves discussions with diverse colleagues and staff members[2]. To promote harmony among euro area countries, the ECB features a decision-making process that entails considerable interactions among colleagues and staff members of various nationalities even though such interactions may often reduce the speed of decision-making. There are probably very few potential successors to President Draghi who are as knowledgeable about and capable of effectively managing this kind of decision-making process as Ms Lagarde, who successfully steered the IMF through the European debt crisis. On the other hand, a reporter at the press conference posed President Draghi the question – "the French government is reportedly starting to lobby for you to become the next IMF President. Would you be willing to take that job?" – and President Draghi limited himself to a brief response – "Of course I am very honoured by that, but I am not available so it's not an issue." But for the same reasons that Ms. Lagarde is well positioned to deftly manage the ECB's decision-making processes, it should be apparent that President Draghi is equally well positioned to take over the helm of the IMF. Although it might seem a bit peculiar for the heads of the IMF and the ECB to swap their posts, there would be a logical rationale for such a swap.

Appendix: Interpreting the Appointment of ECB President Lagarde – Three Main Points

Overturning the "Standard Rumor" to Create the Lagarde-Led ECB

At an extraordinary European Summit meeting on July 2, the European Council nominated Christine Lagarde, from France, as candidate for the President of the ECB and proposed Ursula von der Leyen, Germany's defense minister, as candidate for the President of the European Commission. It is the first time that women have been selected for both posts (each will assume their new posts on October 31, 2019). Since 1999, it has not appeared likely that Germany and France would share the positions of the ECB president and European Commission president between themselves. The European Commission presidential nomination did not comply with the convention that the nominee should be proposed by the largest group in the European Parliament, however, and many people predicted that the European parliament would not confirm it. (Although Ursula von der Leyen's nomination was in fact narrowly confirmed.) In addition, Belgium's Prime Minister Charles Michel was elected to replace Donald Tusk as European Council President, and Spain's Foreign Minister

[2] For details, please refer to my book: *European Central Bank: From Organization, Strategy to Banking Supervision,* Toyo Keizai Inc., November 2017.

Josep Borrell Fontelles was nominated to be the EU's High Representative for Foreign Affairs (equivalent to the EU's foreign minister; each will assume their new posts on December 1, 2019). In sum, the EU's four top posts have been allocated to Germany, France, Spain, and Belgium.

The biggest surprise was the nomination of Ms Lagarde, who has for years been proposed as a candidate to fill almost every impending top post vacancy in Europe. In addition to the ECB presidency, she was said to be a candidate for the European Commission presidency, and she was also a candidate in the latest French presidential election. Ms Lagarde's prominence has engendered the "Lagarde theory" – a standard rumor about the potential for Ms Lagarde's nomination for major posts – and this theory reflects the general perception that the number of serious candidates for such posts is rather small. It may appear surprising that one of Europe's most famous female politicians (ranking alongside German Chancellor Angela Merkel) was selected to become the ECB's president. After analyzing the situation, however, it seems quite likely that the selection will cause problems in the future. The reasons for this are explained below.

Three interesting points – A Frenchwoman and the ECB

There are numerous interesting points regarding Ms Lagarde's accession to the ECB presidency, and this article will focus on three of them. The first point is that Ms Lagarde will be the ECB's first female president. This reflects a strong and deeply rooted trend of increase in the selection of women to fill top level positions in Europe as well as the rest of the world. The ECB currently has one woman in its six-member Executive Board – which consists of the president, the vice-president and four other members – and Ms Lagarde's accession to the ECB presidency means that two of six (33%) will be women. The woman currently on the board is Sabine Lautenschläger, from Germany, and this reflects the pattern of Germany and France dividing top posts between themselves. The European Parliament has previously expressed discontent with scarcity of women in the ECB's high-level posts[3], and it appears that female candidates are more likely than male candidates to be approved for such posts at this time. In addition to monetary policy, for example, the ECB's scope of authority encompasses banking supervision policy, and the top official in charge of banking supervision policy is the Chair of the Supervisory Board, also regarded as the President of the Single Supervisory Mechanism (SSM). It was a Frenchwoman, Danièle Nouy, who became the SSM's first president in November 2014 (replaced by an Italian, Mr. Andrea Enria, from January 1 this year). In other words, Ms Lagarde's accession to the ECB presidency means that Frenchwomen will have filled both of the ECB's two top posts – ECB president and SSM president.

Incidentally, there is an unwritten rule that no two members of the Executive Board can have the same nationality. Therefore, Ms Lagarde's accession to the ECB presidency would customarily require the mid-term resignation of her French compatriot Benoît Cœuré. However, they are fortunate in that Mr. Cœuré's term of office ends on December 31, 2019, as it would seem likely that the system would permit him to overlap Ms Lagarde's term for a mere two months. When President Draghi assumed his post in November 2011, it became necessary for his Italian compatriot Lorenzo Bini Smaghi to terminate his Executive Board membership midway through his term, and it happens to be Mr. Cœuré who replaced him. A review of these events illustrates how France effectively works to ensure its continuous representation in high-level ECB posts.

ECB board members（as of July 2019）

Position	Name	Country	Start date	End date
President	Draghi	Italy	11 NOV 2011	31 OCT 2019
Vice president	de Guindos	Spain	1JUN 2018	31 MAY 2026
Board member（Chief economist）	Lane	Ireland	1 JUN 2011	31 MAY 2027
Board member	Lautenschlager	Germany	27 JAN 2014	26 JAN 2022
Board member	Coeure	France	1 JAN 2012	31 DEC 2019
Board member	Mersch	Luxemberg	15 DEC 2012	14 DEC 2020

（Source）ECB　(Notes) Colored part means the term of office will come in 2019.

Issue of Having Former Politicians as the ECB's President and Vice-President

The second of the three interesting points is that there is concern about appointing a former politician to the ECB presidency. While not aired openly, there is usually some controversy about politicians assuming high posts within the ECB. In this regard, it is worth noting that ECB Vice-President Luis de Guindos, who assumed his current post on June 1, 2018, had previously served as Spain's minister of economy, industry and competitiveness, and there was some controversy about someone with his background as a politician becoming ECB vice-president. To many, one of the most striking aspects of the ECB's recent personnel matters is that the ECB will soon have former politicians serving as both president and vice-president. It has been reported that French President Macron exerted considerable influence on the process leading to Ms Lagarde's selection, and it goes without saying that France generally seeks to promote ECB policy management with a bias toward easing measures. There is already commentary suggesting that the French government's intention is that the Lagarde-led ECB should become more dovish and, regardless of whether it is true or not, this can be considered a highly regrettable situation. Although Ms Lagarde's name recognition, crisis response abilities, and

[3] In 2012, when the president of Luxembourg's central bank, Yves Mersch, was nominated to become an ECB Executive Board member, it was reported that the European Parliament was reluctant to confirm his nomination because all ECB Executive Board members at that time were men.

coordination abilities are undisputed, it is a fact that there are grounds for concern about her political background and the process that led to her selection. When he was in the United Kingdom this past April, ECB President Draghi criticized U.S. President Trump's political intervention into central banking matters, but it is likely that the ECB may have some sense of awkwardness in making such criticisms when it has former politicians serving as its president and vice-president. Such an issue did not arise in the past, because all the previous ECB presidents were formerly presidents of their respective countries' central banks. This seems likely to be considered one of the primary problematic aspects of the ECB's recent personnel matters.

Not a Monetary Policy Expert

The third of the three interesting points – while somewhat similar to the second point – is that Ms Lagarde is not a monetary policy expert. Originally a lawyer, Ms Lagarde later became a politician and served in such important posts as finance minister, but has no experience in central banking. She was serving as France's finance minister amid the European debt crisis until June 2011, when she was named Managing Director of the IMF, so she does have outstanding experience regarding emergency response situations, but it seems likely that she will require considerable support from colleagues and staff to handle the ordinary management of monetary policy during non-crisis periods. In this respect, the requisite support will be available from ECB Executive Board member and chief economist Philip Lane, who just joined the ECB in June, and it is somewhat reassuring to note that his involvement is likely to prevent the ECB from shifting to excessive dovishness.

However, Ms Lagarde is not necessarily expected to wield the kind of flamboyant communication skills that President Draghi has demonstrated since soon after taking his post to effectively manipulate market psychology. Fed Chair Jerome Powell is also a lawyer, while BOJ governor Haruhiko Kuroda studied law and has passed the bar examination. So with Ms Lagarde's accession to the ECB presidency, the central bank leaders of Japan, the United States, and Europe will all be legal specialists. It may well be that, rather than expertise in economics and finance, it is the ability to keep a distance from politics and coordination abilities that are becoming the most important requirements for effectively managing developed countries' central banks.

Lagarde's Likely Impact on Policy Management

The replacement of the ECB's president in itself cannot be expected to augment what the ECB is capable of accomplishing. Basically, the Lagarde-led ECB will have to struggle with the difficulty of determining its "next move" while burdened by a deposit facility interest rate of -0.40% and a balance sheet that has swelled to about EUR4.7 trillion. If the euro area strongly emphasizes an export-oriented style of economic growth promotion (in deference to the French government ≈ President Macron), its basic strategy will be to guide regional interest rates downward to promote EUR depreciation. That process will entail the resumption of quantitative easing and to deepening of negative interest rates. President Trump has recently blasted ECB President Draghi for speaking about such a policy, and it appears quite possible that Ms Lagarde will have the same experience when she grasps the ECB rudder. And the news that the United States will impose punitive tariffs on the EU owing to EU aircraft subsidies has been a major topic of discussion recently. Amid such political confrontations, issues related to the ECB's policy management and the euro area's common currency (both of which have greatly redounded to the benefit of Germany) can be expected to provoke US animosity. Many of President Trump's demands may be considered unreasonable, but it is indisputable that Germany is deriving unreasonable benefits from EUR weakness, and there is no simple way of resolving the inherent conflict between the two sides.

Going forward, it is highly likely that the Lagarde-led ECB will primarily be implementing measures in a steady and balanced way that contrasts sharply with President Draghi's flamboyant style, which was often referred to as 'Draghi magic'. Since his very first Governing Council meeting, President Draghi has used such measures as interest rate cuts and 36-month LTROs to effectively manipulate market expectations, but it would probably be difficult for Lagarde-led ECB to emulate that strategy. However, the outcome the euro area economy requires remains the same – falling interest rates and EUR weakness. On the other hand, if Ms Lagarde progressively leverages her renowned coordination abilities, it seems that it may be possible to accelerate ECB decision making processes (for example, by not so frequently declaring that "we have tasked the relevant committees with examining options") and thereby effect positive changes to the ECB's policy management.

U.S.-Europe Trade Frictions Now and Going Forward – U.S. Side Correct in Some Ways

Impact of More than 15 Years of U.S.-Europe Confrontations and Trade Frictions

On July 2, the U.S. Trade Representative (USTR) published a list of USD4 billion of EU goods that may become subject to punitive tariffs owing to a dispute regarding EU subsidies for aircraft manufacturing. The list includes such products as cherries, meats, cheeses, and olives, and the associated tariffs are positioned to supplement the tariffs against about USD21 billion of EU imports announced this past April 12. On May 28 last year, the World Trade Organization (WTO) ruled that the EU's provision of subsidies to Airbus is a violation of WTO obligations and that the U.S. was entitled to employ the WTO process for imposing retaliatory tariffs. The same day, however, the WTO also recognized EU claims that U.S. subsidies to Boeing violated WTO obligations. Accordingly, the EU has maintained that is has the right to impose retaliatory tariffs on U.S. products, making the situation quite complicated. The controversy about the EU's subsidization of plane makers has gone on for 15 years, since 2004, so the U.S. threats of punitive tariffs are not a fitful Trump administration measure, but it does appear that the Trump administration's strong protectionist tendency is making the controversy more liable to become exacerbated. As discussed below, U.S.-Europe trade frictions differ from U.S.-China and U.S.-Japan trade frictions in that the U.S. criticisms of Europe have a more-solid basis.

U.S.-Europe Trade Frictions Have a Valid Basis

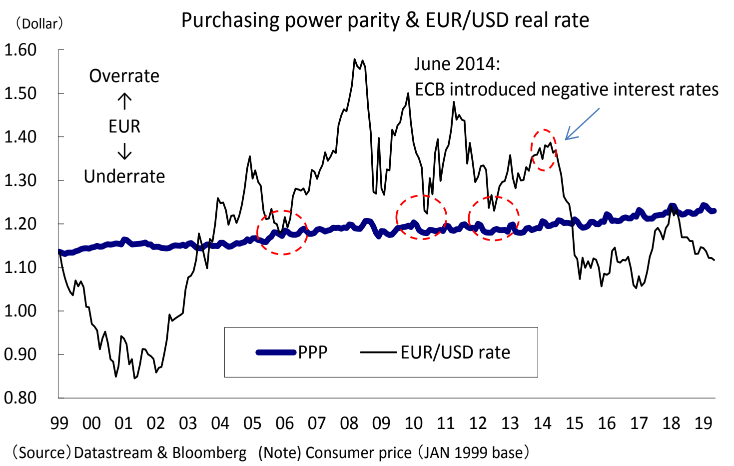
The intensification of the Trump administration's protectionism has impacted many counties throughout the world, and one gets the impression that a significant portion of it has consisted of picking quarrels based on false pretexts, yet the European side bears a large portion of the blame for U.S.-Europe trade frictions. The situation regarding the United States' trade frictions with China and Japan is quite different. In short, my basic recognition is that the United States has a legitimate basis for much of its trade frictions with Europe.

For example, the U.S.-China trade war is a complex and wide-ranging struggle with ramifications related to such issues as next-generation technology supremacy and future military supremacy. It overflows the boundaries of ordinary economic and financial conflicts focused on such issues as commerce, trade, and currency depreciation. It can be said that the U.S.-China trade war is worse and more worrisome than ordinary trade frictions, but most people will agree that it is too complex and wide-ranging to fall within the definition of 'trade friction'. Regarding the forex issue that the Trump administration mentions from time to time (downward guidance of RMB), it should be noted that China's current account surplus is already decreasing and that China has become quite concerned about the size of its foreign currency reserves since the August 2015 China shock situation (when China adjusted its USD/RMB pegging system and promoted sharp RMB depreciation along with a plunge in Chinese stock prices) and does not desire an excessively weak currency[4]. In this regard, China is quite different from Germany, which is free-riding on its perennially undervalued currency to continue recording huge current account surpluses.

In contrast, the key issue regarding U.S.-Japan trade frictions is that Japan no longer has a large trade surplus. Japan's current account surplus is almost equal to its primary income balance. In short, Japan is not earning surpluses from its current international trade transactions but from the profits generated by its previous investments, so the surpluses are basically unrelated to the trade frictions topic. This point was also recently confirmed in the Osaka G20 Summit declaration, and a post-conference Mizuho Market Topic article argued that the declaration probably reflected the arguments presented by Japan at the summit[5]. Of course, Japan does still have a large surplus in its trade with the United States, but it would be unreasonable to argue that an imbalance in trade between two countries indicates the illegitimacy of the systems and the economic policies of one of the countries.

Three Reasons for the U.S. to Criticize the EU

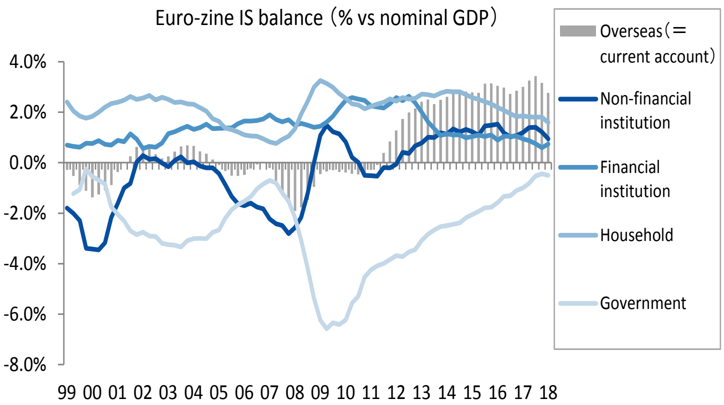
Unlike the international sectors of China and Japan, the EU's international sector currently has characteristics that are clearly cause for criticism. For example, (1) EUR's characteristic of being a perennially undervalued currency and Germany's characteristic of making the most of it, (2) the existence of an extremely low negative interest rate (-0.40%), and (3) the existence of EU fiscal rules that restrict fiscal spending in the euro area (the Stability and Growth Pact (SGP)). The United States is justified in criticizing the EU regarding these three points.



The point (1) above requires a lot of explanation. EUR is the common currency both in Greece and Germany, but if there is a fair value of EUR, it can be expected to be too high for Greece and too low for Germany. The EUR/USD purchasing power parity (PPP) exchange rate calculated based on the euro area Harmonized Index of Consumer Prices (HICP) is in the vicinity of EUR1/USD1.20, but EUR1/USD1.20 means that EUR is excessively weak to be appropriate for Germany[6]. Moreover, EUR/USD has continued to fall below even the EUR1/USD1.20 level for a protracted period of time, and it is undeniable that a foreign exchange environment that favors German exporters has become the norm (see graph). When these situations are considered along with the point (2) – the adoption of a very deeply negative interest rate of -0.40% – then German monetary and financial policies inevitably appear from the perspective of countries outside the euro area to be beggar-thy-neighbor policies. Looking at the graph, there appears to be a very strong basis for suspecting that EUR/USD's descent to levels chronically below the PPP level was triggered by the introduction of negative interest rates.

[4] Please see the April 18, 2019 edition of Mizuho Market Topic, entitled "China's Current Account Cannot Tolerate USD Appreciation".
[5] Please see the July 1, 2019 edition of Mizuho Market Topic, entitled "Osaka G20 – JPY Forex Rates Driven by Interest Rates Rather than Stock Prices".
[6] On the other hand, although it should be theoretically legitimate to argue that EUR depreciation is appropriate for southern European countries with a fundamental proclivity toward inflation, it is currently thought EUR1/USD1.20 is too high for those countries.

The point (3) is generally understood to be a fact. A country with a pattern of maintaining a government sector savings surplus (≒ fiscal surplus) while seeking to realize economic growth dependent on external demand will inevitably be criticized for having the capability to stimulate and rely more on domestic demand but purposely choosing not to utilize that capability. This point is also mentioned in the U.S. Treasury Department's Semiannual Report on International Economic and Exchange Rate Policies. So long as there is an SGP that requires fiscal deficits to be kept below 3% of GDP, economic stimulus measures based on proactive fiscal spending will be considered evil, regardless of the nature of a country's macroeconomic savings and investment (IS) balance. As the second graph shows, the household and corporate sectors are recording savings surpluses not only in Germany but in the entire euro area. Under such circumstances, it would be desirable to augment the government sector's consumption and investment activities, but the existence of the SGP has led to efforts to make up for government sector savings deficits created following the financial crisis, and those deficits are currently coming close to being offset. Consequently, the pattern of promoting support for the euro area economy from the overseas sector (relying on external demand) has become chronic and has led to the current situation.



(Source) Eurostat (Notes) Household including non -profit organizations
Domestic & overseas balance are not always matched due to statistical error

As just overviewed, the euro area been less than proactive in strengthening its competitiveness owing to its common currency, has been benefiting from the tailwind generated by its negative interest rate policy, and has maintained a negative attitude towards domestic demand stimulation. It is natural for countries outside the euro area to be dissatisfied with such a situation, and it is easy to imagine how the situation will encourage the protectionism-oriented Trump administration to intensify its confrontations. I hope that greater recognition will be given to the fact that U.S.-Europe trade frictions are being caused by factors other than the Trump administration picking quarrels based on false pretexts.

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