

Forex Medium-Term Outlook

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Derivatives & Forex Department

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Overview of Outlook

USD/JPY lacked volatility during November. It is frustrating to see the markets at the mercy of U.S.-China trade war headlines, but given that this is part of the bigger story of a power struggle, it seems likely that the Trump administration will retain its stance of “neither letting live nor letting die” in 2020 also. Amid the softening of political tensions, rate cut expectations, which had been weighing on the Fed, have also receded, and there have been a series of communications from senior Fed officials hinting at the suspension of rate cuts. It seems likely that the bottoming out of the PMI and ISM indices will also help prop up U.S. interest rates and USD/JPY. However, it must be noted that the suspension of rate cuts is not the same as the start of rate hikes. Given political pressures, the challenges of dealing with a dollarized world, and the stubborn lack of inflation in the U.S., it seems that the Fed may maintain the *status quo*, at best, if not have to implement additional easing in 2020. As a result, it is possible that U.S. interest rates will also be less volatile than they have been this year. Incidentally, it is not that JPY did not strengthen in 2019 or that the currency is no longer being bought. JPY has clearly strengthened in real effective terms. It is just that, because of both JPY and USD being bought, the exchange rate of the currency pair (USD/JPY) did not have a chance to decrease significantly. Based on the very natural assumption that one cannot expect USD/JPY to rise if U.S. interest rates are unable to rise, this report continues to forecast a bigger downside risk for USD/JPY.

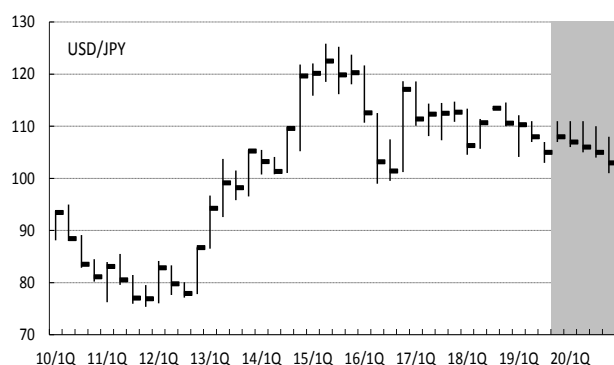
EUR also remains range-bound despite the ECB's large negative interest rate (-0.50%). Perhaps this reflects the euro area's fundamentals, namely ownership of the world's largest current account surplus. The disputes within the Governing Council over EUR and the new ECB President Christine Lagarde's efforts to ease tensions have been in the headlines often. In fact, the split that resulted from the Bank's announcement of its comprehensive monetary easing policy package in September is not minor and will have to be repaired before the new administration can move forward. Even after it is repaired, it may not be easy to conduct dynamic policy operation based on majority votes as in the case of the previous administration under Mario Draghi. There is concern that such a situation is bound to delay the ECB's initial crisis response ability and result in EUR sell-offs. Meanwhile, the regional economy underwent significant corrections during 2018-19, so it seems natural to assume that it will start recovering as part of the cyclical process rather than continuing to deteriorate. Therefore, though forecasting the bottoming out of the regional economy and the exhaustion of the ECB's monetary easing options, I also think EUR could have a chance to climb higher if USD, which has remained persistently strong, weakens.

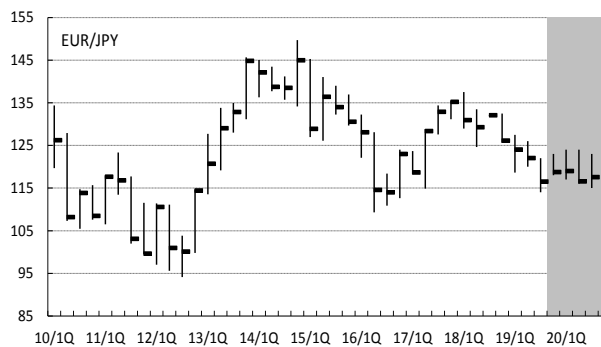
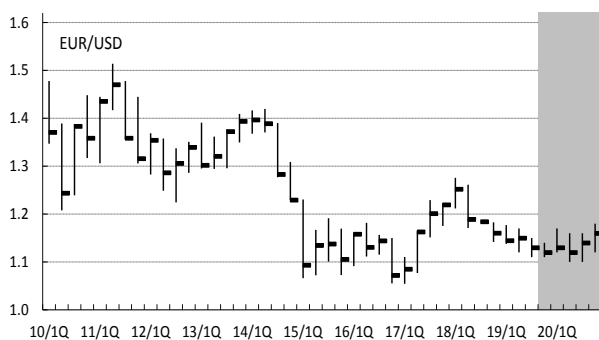
Summary Table of Forecasts

	2019		2020			
	Jan -Nov (actual)	Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	104.10 ~ 112.40 (109.51)	107 ~ 111 (108)	106 ~ 111 (107)	105 ~ 111 (106)	104 ~ 110 (105)	101 ~ 108 (103)
EUR/USD	1.0879 ~ 1.1570 (1.1010)	1.09 ~ 1.12 (1.10)	1.10 ~ 1.15 (1.11)	1.08 ~ 1.14 (1.10)	1.08 ~ 1.14 (1.12)	1.10 ~ 1.16 (1.14)
EUR/JPY	115.87 ~ 127.50 (120.59)	118 ~ 123 (119)	117 ~ 124 (119)	116 ~ 124 (117)	115 ~ 123 (118)	114 ~ 124 (117)

(Notes) 1. Actual results released around 10 am TKY time on 30 November 2019. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





USD/JPY Outlook – Miscalculation in Predicting JPY Strength

Basic Understanding of USD/JPY – Miscalculation in Predicting JPY Strength and the Challenges of a Dollarized World

Clear Decline in Popularity of JPY and Tokyo Market

With just another month to go before this year also ends, USD/JPY still retains its narrow year-to-date range (8.30 yen) and seems increasingly likely to post an all-time narrow rate range for the second year in a row. Some say that this lack of volatility is because JPY buying and selling are neck and neck, while others say that the increase in AI-driven high-frequency trading (HFT) is behind the narrow rate range. It is hard to understand which of these theories is true. However, yet another theory is that this may be because JPY is not popular to begin with, which seems plausible going by the September 2019 issue of the “Triennial Central Bank Survey - Foreign Exchange Turnover” by the Bank for International Settlements (BIS). A look at the results of this survey clearly reveal the fall of JPY.

If we take a look at the currency-wise trading turnover, JPY’s share (8.4%) is the lowest it has been in the past five surveys (15 years). Incidentally, the shares of the top four currencies except for USD have all fallen when compared with 15 years ago (the 2004 survey), but JPY is the only one that has fallen compared with the previous (2016) survey (see figure). Even in term of currency pairs, the share of the top pair (EUR/USD) rose from 23.1% to 24.0% as compared to the share of the second-ranking USD/JPY, which fell significantly from 17.8% to 13.2%. The third-ranking USD/GBP increased its share from 9.3% to 9.6%, followed by USD/AUD, USD/CAD, and USD/CNY, which also increased their shares from 5.2% to 5.4%, 4.3% to 4.4%, and 3.8% to 4.1%, respectively. In seventh place, USD/CHF decreased its share from 3.6% to 3.5%, but the extent of decline is nothing compared with that of USD/JPY. It does seem, therefore, that there is a trend of moving away from JPY. One also cannot overlook the fact that the Tokyo forex market’s rank has fallen. Some say this is because of hard-to-solve problems such as the language barrier and the time difference in trading hours, but as I will discuss later, the fact that nothing interesting is going on with JPY may also be a factor. The Tokyo market, which ranked third in the world with a share of 8.0% in 2004 has sunk to fifth place (below Singapore and Hong Kong) with a share of 4.5% as of 2019 (see figure).

Of course, there is no telling whether this trend will continue next time and the time after that, but it seems ominous that, despite trading in the forex markets overall increasing by approximately 30% from USD 5.10 trillion to USD 6.59 trillion between 2016 and 2019, the weights of JPY and the Tokyo market have fallen. One imagines that USD/JPY is being seen as a rather uninteresting currency pair.

Volume of major currencies handled (Trends over the past 15 years)

	Year 2004	Year 2016	Year 2019	Changes over 15 years (%pts)	Changes over 3 years (%pts)
USD	44.0	43.8	44.2	0.1	0.4
EUR	18.7	15.7	16.2	-2.6	0.4
JPY	10.4	10.8	8.4	-2.0	-2.4
GBP	8.3	6.4	6.4	-1.9	0.0
AUD	3.0	3.5	3.4	0.4	-0.1
CAD	2.1	2.6	2.5	0.4	-0.0
CHF	3.0	2.4	2.5	-0.5	0.1
CNY	0.1	2.0	2.2	2.1	0.2
HKD	0.9	0.9	1.8	0.9	0.9
NZD	0.6	1.1	1.1	0.5	0.0

(Source) BIS (Note) Survey of average daily transaction volume in April

Volume of FX transactions (Share by region)

	Year 2004	Year 2016	Year 2019	Ranking Year 2004	Ranking Year 2019
UK	32.0	36.9	43.1	No.1	No.1
US	19.1	19.5	16.5	No.2	No.2
Singapore	5.1	7.9	7.6	No.4	No.3
HK	4.1	6.7	7.6	No.5	No.4
Japan	8.0	6.1	4.5	No.3	No.5
Switzerland	3.3	2.4	3.3	No.6	No.6

(Source) BIS (Note) Survey of average daily transaction volume in April each year

The Vicious Cycle of “No Movement → No Profits → No Trading → No Movement”

According to the aforementioned BIS survey, “The fall in JPY turnover was mostly due to a contraction in the important JPY/USD cross amid low volatility.” Indeed, it is true that trading in JPY crosses with other key currencies such as EUR and AUD have increased in the past three years, so it seems that the unpopularity of USD/JPY may have to do with the unpopularity of JPY overall. Further, though the overall trading turnover for JPY is small, trading against high-yielding currencies such as TRY, ZAR, and BRL by retail margin traders is growing faster than the global average, and the BIS survey mentions that “the combined average daily turnover in JPY/TRY, JPY/ZAR, and JPY/BRL close to doubled, from \$7 billion in 2016 to \$12 billion in 2019.” Perhaps such a development is inevitable given that retail traders can now choose from a wide variety of trading currencies. Their motivation being to make quick profits, there is no reason for such traders to deliberately choose a non-moving pair such as USD/JPY when other options are available. Going by the BIS survey results, therefore, it seems that USD/JPY remaining range-bound in recent years could simply be a reflection of traders’ preference for more volatile currency pairs that enable market manipulation, whereas USD/JPY has become uninteresting due to lack of movement.

I think it is important to be aware that the currency pair has become trapped in a vicious cycle of “no movement → no gains → no trading → no movement,” and it may not be easy for it to break out of this cycle unless something earthshaking happens specifically to set USD/JPY in motion. Of course, the fundamental cause behind this lack of movement of USD/JPY merits uncovering. It could be because (1) there is nothing of interest going on with regard to JPY (i.e., the Japanese economy, i.e., Abenomics), (2) JPY buying and selling are neck and neck, making it difficult for the JPY supply and demand balance to tilt to any one side clearly, or (3) investors see no reason to touch a currency with decreasing yields. However, it is difficult to say for sure one way or the other. Whatever the case, there seems quite a high likelihood of the aforementioned vicious cycle being at play. The BIS survey’s target month was April 2019, when volatility was especially low, but as I mentioned at the start, nothing has happened since then to break USD/JPY out of its narrowest range ever, so the results may not have been much different had the survey been conducted in any other month. Again, having analyzed the reason for the lack of volatility, the fact remains that the fate of the U.S. economy and U.S. interest rates hold the key to future developments in this regard. JPY’s lack of popularity in the forex markets is becoming difficult to cover up, but it seems foolhardy to deliberately zoom in on the upside risks of JPY given its marked failure to strengthen against USD so far. It is worth keeping in mind that central banks around the world are finding it difficult to contemplate rate hikes as economies around the world suffer from a lack of inflation.

Miscalculation in Predicting JPY Appreciation

With U.S. stocks successively renewing all-time highs and U.S. interest rates also on the rise, analysts forecasting USD appreciation as the main scenario are bound to increase. In fact, given that the ISM indices are showing signs of bottoming out, such scenarios are worth considering. What is more, looking at global manufacturing PMIs, those of the U.S. and China are obviously on the mend. Despite the severe deterioration in business sentiment in the manufacturing sector since last year and U.S. interest rates declining by more than 50% over the past year (from 3.2% in October 2018 to 1.4% in September 2019), USD/JPY did not fall below 104. This report’s main scenario correctly predicted that the global economy would slow down, that the Fed’s policy stance would turn dovish in response, and that U.S. interest rates would fall as a result. However, in the face of the abnormal resilience of USD/JPY, I have no choice but to admit that I made a miscalculation in predicting JPY appreciation against USD. The reasons for my miscalculations are not entirely clear (see chart on previous page), but the change in the structure of Japan’s net external assets (the relative decline in foreign securities investment and increase in foreign direct investment) is almost sure to have something to do with it, as I have discussed before. Another factor that seems very likely to be propping up USD/(JPY) is the fact that U.S. interest rates remain high even as interest rates in other developed economies sink below zero. Another reason USD has not been sold off could be because the global economic slowdown since last year has been led by China and the euro area, while the damage to the U.S. economy was superficial to begin with.

At any rate, it is not insignificant that USD/JPY did not fall as much as warranted by the considerable decline in corporate confidence and the associated sharp fall in U.S. interest rates. Given that business confidence is already showing signs of bottoming out, it seems that the risks for USD/JPY in 2020 are on the higher side.

The reason why the appreciation of the yen stopped

Changes in the structure of Japan's external net assets

- From securities investment to direct investment. The repatriation of direct investment is small.

U.S. interest rates are relatively high

- Interest rates in Europe and Japan are submerged

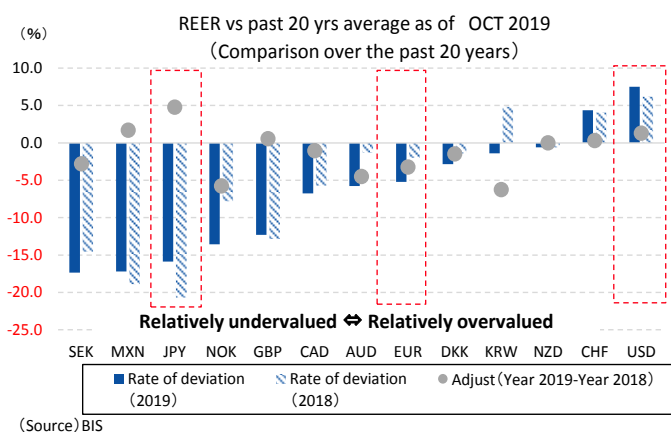
The epicenter was not the United States

- The slowdown from the end of 2018 is due to China and Europe.

(Source) Created by Karakama

Not that “JPY Failed to Strengthen” but that “USD Failed to Weaken”

Despite acknowledging the presence of upside risks, I cannot help feeling that this year’s year-to-date high (112.40 yen) may be the most that USD/JPY can rise next year as well. To be precise, it was not that JPY did not strengthen, but rather than USD did not weaken in 2019. Looking at the real effective exchange rate (REER), JPY has strengthened quite a bit, by +1.3% year-to-date, and +3.8% yoy, so there is no doubt that this has been a year of JPY strengthening. However, USD’s REER has also increased by +2.1% year-to-date and +1.3% yoy. So, it is not that JPY is no longer being bought, but simply that JPY has not been able to appreciate significantly against USD in this scenario of both JPY and USD being bought.



As the graph shows, among the major currencies, JPY and USD are the only two that have seen a clear increase in REER over the past year, so, to some extent, the USD/JPY deadlock is the result of both currencies’ appreciations cancelling each other out. However, as mentioned above, there is also the fact that investors have been losing interest in JPY and in the Japanese economy, and one must take note of the alarming fact that the JPY trading turnover itself is dwindling. Meanwhile, EUR’s REER fell by -0.8% year-to-date and -3.6% yoy, clearly revealing that of the three key regions (the U.S., Japan, and Europe), Europe has the weakest fundamentals.

Still, the World Remains Dollarized

The question now is, is it possible for the U.S. economy to enter a new phase of economic expansion as is, and for USD/JPY to continue rising alongside U.S. interest rates? This is a rather unlikely scenario (see chart on the next page). As many people have pointed out, the U.S.-China trade war (which is the biggest risk for financial markets) has gone beyond being a simple matter of trade negotiations and acquired the characteristics of a power struggle, and seems unlikely to be resolved anytime soon. The merest word or gesture from U.S. President Donald Trump is even now sufficient to change the market’s mood from positive to negative or vice versa, so that the most one can say is that things are looking positive at the moment. As already reported, President Trump has continued to make unpredictable remarks regarding trade negotiations with China, so one must be prepared for the situation to turn negative at any moment. Also, though the October FOMC meeting hinted at the suspension of rate cuts, this does not warrant predicting the resumption of rate hikes. It is also unthinkable that the ECB or the BOJ will set their sights on policy normalization. Under such circumstances, my basic understanding is that currency rates must be forecast on the basis of the rise in each country’s interest rates.

The reason why it is hard to think of a weak yen

Problem of "dollarized world"

- The world (≠ Emerging countries) cannot stand the rise in U.S. interest rates.

Trade war between the United States and China is a semi-permanent problem

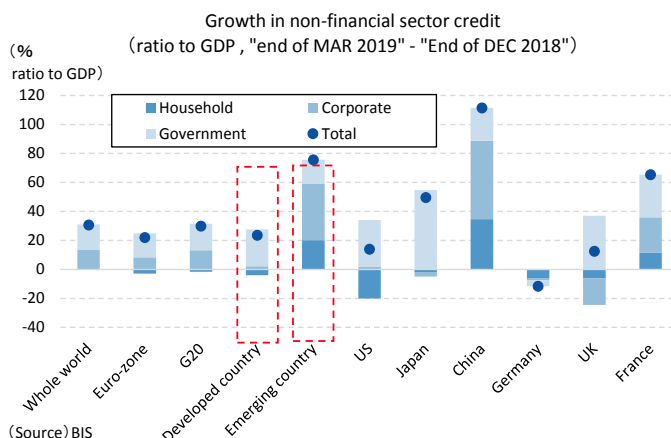
- Repeating the partial agreement will not end the struggle for hegemony.

The problem is that prices have stopped rising

- Even in the United States, it is difficult to reach 2%.

(Source) Created by Karakama

In connection with the assumption that U.S. interest rates will increase, one must recall the argument related to an increasingly dollarized world. As we saw in 2017-2018, any increase in U.S. interest rates triggers a flight of capital from emerging economies (EMEs), leaving the international financial markets shaken. In 2018, U.S. stock markets were the first to be hit by any rise in U.S. interest rates. The tipping point seemed to be around 3.0% for 10-year U.S. bonds. The biggest concern at that time was that falling stock prices would dampen U.S. consumption and investment appetites through a reverse wealth effect (in the end, such a scenario was avoided by the Fed making a sudden switch to a dovish policy stance, thereby helping stock prices recover).



The important thing to note here is that this kind of impact from the rise in U.S. interest rates is not limited to the U.S. economy but extends also to other economies around the world. Simply speaking, whenever U.S. interest rates rise, EMEs are forced to raise their own interest

rates in a defensive move aimed at preventing a flight of capital, a move that is feared to eventually dampen consumption and investment in those economies. This was one of the causes of the global economic slowdown during the second half of 2018. As the figure shows, EMEs have accumulated a great deal of debt, especially in their corporate sectors, in the years since the collapse of Lehman Brothers. When U.S. interest rates rise or USD appreciates, the debt burdens of these countries, which have borrowed heavily in USD, naturally increase. If U.S. interest rates rise again going forward, similar problems are likely to resurface.

In other words, the U.S. federal funds (FF) rate is now the world's "cost of capital," and in forecasting the outlook for U.S. interest rates or the global economy, one must do so based on the understanding that the Fed is the central bank of the world economy, and regardless of how strong the U.S. economy is, I think that the current position of the global economy is such that U.S. interest rates can only increase at a gradual pace.

USD/JPY to Sadly Remain Range-Bound in 2020?

Of course, there is also the political challenge of resuming rate hikes while disregarding the impending presidential elections. President Trump, who would like to be reelected, is bound to counter with harsh words, and we may hear talk of "firing" (Fed Chair Jerome Powell) yet again. So, if we take such domestic political circumstances into account in addition to the domestic and global economic/financial circumstances, it seems likely that one of the Fed's goals in 2020 will be to maintain the *status quo*. Sadly for market participants (although extremely fortunate for the actual economy), it seems increasingly likely that USD/JPY will remain range-bound again in 2020 as U.S. interest rates remain rudderless.

However, the current situation of maintaining stock-price levels by keeping interest rates stably low cannot continue forever. In phases of economic slowdown over the past year, the Fed used up 75 bps worth of policy space (in what it called "mid-cycle adjustments"), but if such adjustments are repeated and the FF rate begins to approach zero, it will become difficult to maintain current stock-price levels. It is conceivable that stock and other asset prices could crash when the markets become aware of this. Such a scenario seems unlikely to unfold during an election year, but it still merits caution.

U.S. Monetary Policies Now and Going Forward – The Fed's Subordination to Stock Prices and Its Preventative Easing

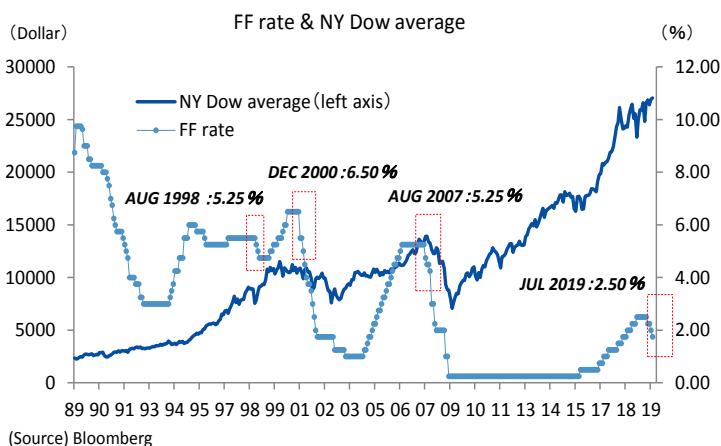
Was the Fed's Preventative Easing Successful?

In November, the three main U.S. stock market indices repeatedly renewed all-time highs. This is being explained entirely as the result of optimism related to trade agreements between the U.S. and China. Even assuming that partial agreements are reached, I am skeptical about the wisdom of allowing such an increase in risk tolerance, but if things continue this way, it seems likely that the Fed's "preventative easing" will have to be labeled a success.

However, things are not really that simple. At the very least, it must be noted that the FF rate was 525 bps in August 2007, just before the previous phase of rate cuts began. In December 2000, right before the rate cut phase prior to that began

(in the wake of the IT bubble collapsing), the FF rate was 650 bps. This time (July 2019), the FF rate was a mere 250 bps when rate cuts began, and it has been brought down to 175 bps following three rate cuts (based on target-range peaks; see graph). Given that almost no one is predicting a resumption of rate hikes as the next move, and that market expectations appear to be strongly tilted toward somehow avoiding additional rate cuts, could it be that the next phase of rate cuts will begin at 175 bps? It is worth noting that, though possessing the most policy space among developed economies, the Fed is also slowly but surely dissipating it. It is easy to be distracted by the recent stock-price highs and lose sight of an important fact like this.

In 2018-19, the Fed implemented four rate hikes and three rate cuts. At the very least, the justification for the policy normalization process, which had been in full swing around this time a year ago, has now become questionable. The financial markets tend to be dominated by current factors (especially closing stock prices), so based on the fact that stock prices have recently renewed the all-time high multiple times, many are bound to believe that the Fed's preventative easing was a success. The Fed is also, naturally, bound to be carried away by this idea. In the case of the U.S., the wealth effect resulting from an increase in stock prices can, in fact, improve consumption and



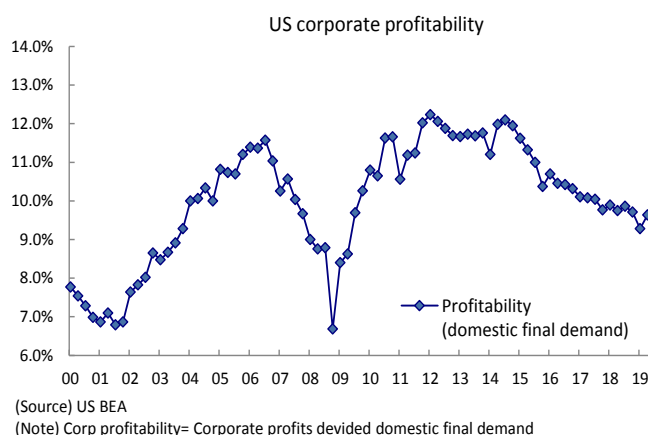
investment, because over 30% of U.S. households' financial assets is in the form of equity. Unlike in the case of Japan, high stock prices in the U.S. can certainly be a causal factor for the recovery of the real economy. The virtuous cycle of "monetary easing → low interest rates → high share prices → increased spending and investment → economic recovery" is one of the strengths of the U.S. economy. However, on the flip side, a decline in stock prices is a definite cause for concern in terms of the ripple effect it could have on the real economy, and is a grave risk that the Fed has to deal with during rate hike phases.

Subordinate to the Stock Markets

The fact that the decline in stock prices was the reason behind the Fed's sudden policy switch, implementing three rate cuts right after four rate hikes, is still fresh in the memory. Concerns about the Fed's austerity overkill with so many rate hikes began to surface after U.S. 10-year interest rates shot past 3.0% in February 2018 and then hit 3.2% in October the same year. Both those times, the Dow underwent several significant corrections. However, there was no notable deterioration in retail sales, industrial production, employment- or wage-related indicators in the backdrop of these corrections. Even as it is indisputable that stock and other asset prices affect the behavior of the household sector, it is also a fact that the validity of the policy normalization process was reassessed in the wake of stock price turbulence. Over the past year, it has become clear that, even if the real economy remains robust, the Fed cannot afford turn a blind eye to tumbling stock prices and continue with monetary tightening, and will relax monetary policy in the name of "preventative easing." It appears, therefore, that U.S. monetary policies are subordinate to the stock markets.

At Some Point, a Distortion will Become Apparent

In short, the cause of the recent rate cuts was not economic deterioration but rather a decline in stock prices. As anyone who regularly reads market analysis reports will know, the recent strength of the stock markets is based on the assumption that there will be no rate hikes in the near future. The morning edition of the November 18 *Nihon Keizai Shimbun* ran an article about corporate sector weakness titled "World's Listed Companies Continue to Lose Profits; Manufacturing Performance Weak for July-September," so it is not as though the current share prices are sustained by strong corporate performance. My tentative calculations based on SNA statistics reveal a decline in profitability (corporate profits ÷ domestic final demand) in the U.S. corporate sector (see figure).



The fact that stock prices continue to post all-time highs despite this is partly due to the assurance of accommodative monetary conditions by the Fed, which has become subordinated to the stock market. However, if the Fed bases its monetary policy operations on stock price movements, it will naturally use up its policy space (rate cut options) more quickly given that stock price declines are usually more rapid and more dramatic than the process of economic deterioration. If forced to repeatedly conduct preventative easing, the Fed will, at some point, find itself in a distorted situation where the FF rate is extremely low despite the economy not being weak. It is natural to assume that, at that point, equity and other risk assets would be overvalued. Of course, so long as U.S. interest rates remain low, the corporate sector of EMEs will continue to accumulate USD-denominated debt as they have done over the past 10 years. Both share prices and USD-denominated debt will continue to expand beyond desirable levels. Such a distorted state of affairs is definitely not sustainable, but provided the Fed still has the policy space to cut rates, it will probably bring the situation under control through preventative rate cuts in the event that a correction seems inevitable. However, once the Fed exhausts its rate cut options, the markets will have no choice but to undergo a correction. Now that the European and Chinese economies are on the mend, there may be no need to anticipate such a situation in 2020, but it is good to keep in mind that this is something that could happen further down the road. My outlook for the forex markets in 2020 is optimistic, but my basic understanding is that there is no guarantee of things continuing well beyond that.

Monetary Policies Have Become Increasingly Uniform in a Dollarized World

Incidentally, since the beginning of November, it has seemed as though the monetary policies of the U.S., Europe and Japan will remain unchanged for some time to come, but there have been signs of considerable change in the monetary policies of EMEs. For instance, in November, the Bank of Mexico made the headlines when it boldly implemented its third consecutive rate cut in November (following from August and September). As the chart shows, most EME central banks have implemented rate cuts this year, with several of them cutting rates in excess of the rate hikes they implemented the year before that. Needless to say, they are following the Fed's policy path of "four rate hikes followed by three rate cuts." In other words, monetary policies around the world are increasingly becoming uniform in a dollarized world. The central banks of countries that have enormous USD-

Policy interest rate of the world

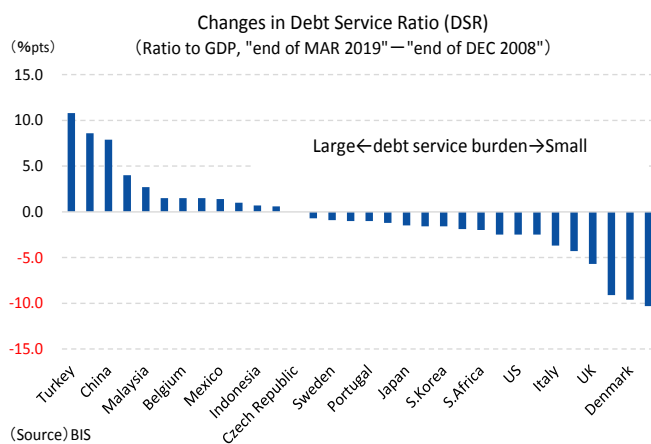
		urrent (%)	Latest policy trends		2019 Cumulative change width	2018 Cumulative change width
			Date	Decision		
Emerging Asia						
China	Deposit reserve ratio	13.00	2019/9/6	Rate cut	▲150bp	▲250bp
India	Overnight repo rate	5.15	2019/10/4	Rate cut	▲135bp	+50bp
Indonesia	7day reverse repo rate	5.00	2019/10/24	Rate cut	▲100bp	+175bp
S.Korea	7day repo rate	1.25	2019/10/16	Rate cut	▲50bp	+25bp
Malaysia	Overnight policy rate	3.00	2019/11/5	Unchange	▲25bp	+25bp
Philippines	Overnight reverse repurct	4.00	2019/11/14	Unchange	▲75bp	+175bp
Thailand	1 day official rate	1.25	2019/11/6	Rate cut	▲50bp	+25bp
Vietnam	Refinance rate	6.00	2019/9/16	Rate cut	▲25bp	0bp
Oceania						
Australia	Overnight policy rate	0.75	2019/11/5	Unchange	▲75bp	0bp
New Zealand	Overnight policy rate	1.00	2019/11/13	Unchange	▲75bp	0bp
Central and Eastern Europe and Africa						
Russia	1week repo rate	6.50	2019/10/25	Rate cut	▲125bp	+50bp
S.Africa	Repo rate	6.50	2019/9/19	Unchange	▲25bp	0bp
Turkey	1 week repo	14.00	2019/10/24	Rate cut	▲1000bp	+1600bp
Latin America						
Brazil	Selic target rate	5.00	2019/10/30	Rate cut	▲150bp	▲50bp
Mexico	Official overnight rate	7.50	2019/11/15	Rate cut	▲75bp	+100bp

(Note) Bank Indonesia changed policy interest rate's BI rate to a 7-day reverse repo rate on August 19 2016

(Source) Bloomberg & Mizuho Bank

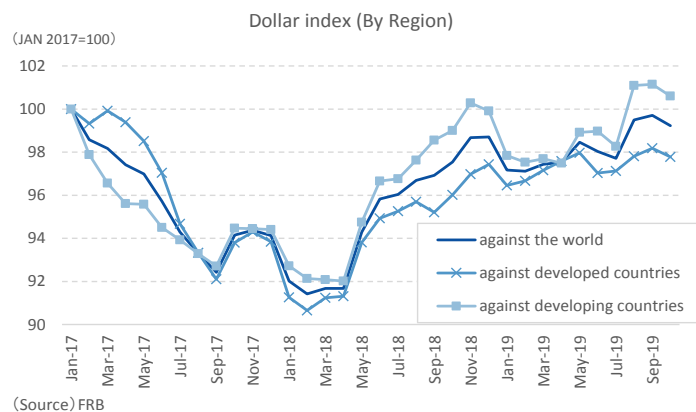
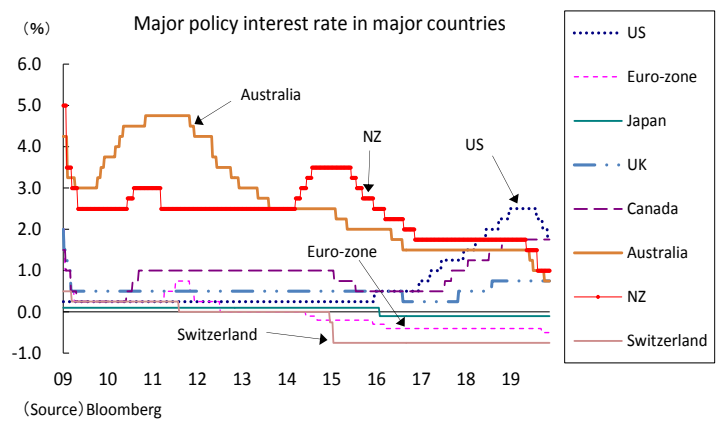
denominated debt burdens are forced to keep in step with the Fed in order to avoid financial turmoil through the forex markets. In fact, during the Fed's rate-hike phase last year, some EMEs experienced a flight of capital, followed by the devaluation of their domestic currencies, and a rise in inflation fears. It was precisely in order to avoid this that many EMEs ended up implementing successive rate hikes even though their economies were not overheating. This came at the cost of their economic growth and is thought to be one of the factors behind the global economic slowdown since 2H of last year.

Any rise in U.S. interest rates or USD naturally increases the repayment burden for EMEs, which have accumulated a lot of USD-denominated debt in the years since the financial crisis. Unless these countries' monetary policies closely reflect those of the Fed, they could face domestic macroeconomic crises through the devaluation of their domestic currencies against their will. In this way, they end up in a situation where they cannot cut rates unless the Fed cuts rates, resulting in the policy operation patterns seen over the past two years. The graph shows the extent of change in different countries' debt service ratios (DSRs), which is their debt repayment burden (principal + interest) as a ratio of GDP, since the start of the financial crisis. It is obvious at a glance that the debt repayment burden is quite large for countries like Turkey and China, which have faced currency devaluation problems over the past two years.



USD as a High-Yielding Currency

One of the characteristics of this year's forex markets is that USD did not depreciate despite rate cuts by the Fed. However, if the majority of the currencies in the forex markets cannot undergo interest rate cuts except when the Fed is cutting rates, this makes it difficult for USD interest rates to decline in comparison to that of other currencies. As the chart to the right (top) shows, the official interest rates of countries including South Korea, Thailand, Australia, and New Zealand are already lower than the FF rate. If this is the state of currencies like AUD and NZD, which had the highest interest rates among developed economies three or four years ago, it is easy to accept the logic that USD did not depreciate despite rate cuts by the Fed because the absolute value of USD interest rates is high, i.e., USD is a high-yielding currency. Looking at the region-wise USD index published by the Fed (see figure, bottom), it is clear that USD has appreciated in particular against EME currencies since mid-year 2018. It is easy to see that, against the background of high U.S. interest rates in absolute terms, USD remained strong against EME currencies not just when the Fed was raising rates, but even when it was cutting them. Against such forex market circumstances, it seems that the Fed would have to continue cutting rates and lower the FF rate to below 1% before we begin to see an across-the-board weakening of USD. Though not something that is expected to happen in the near future, the fact is that the Fed could use up its policy space in the blink of an eye if it continues with its "preventative easing" in response to stock price movements. When preparing forex rate outlooks, therefore, it is important to think about the timing of USD's fall from its position as a high-yielding currency.



Risks to My Main Scenario – Intimidating Bill for Corporate Sentiment Deterioration Coming in 2020

Continued Possibility of a Comprehensive Agreement on U.S.-China Trade Issues

As I do each month, I will at this point review the risk factors related to my main forecast scenario. This article's main scenario anticipates a correction of the USD appreciation that has continued since June 2014, and it is somewhat disturbing that this correction has yet to come. I have frequently discussed the fact that 2019 has been a year in which the Fed shifted to interest rate cuts and U.S. interest rates have declined, but the height of the absolute level of U.S. interest rates and other factors has prevented significant progress of USD depreciation in general. Focusing on USD/JPY, however, there has undeniably been a progressive depreciation of USD against JPY, albeit restrained, and I believe there is a high likelihood that this trend will continue during 2020.

On the other hand, it is also true that economic conditions appear to be close to bottoming out, as already reflected in the PMI and ISM economic indices. For example, the ISM Manufacturing Index and the PMI Manufacturing Index both deteriorated rapidly and sharply this year, and U.S. interest rates fell accordingly, but those trends were insufficient to depress the level of USD/JPY. Even in the absence of special factors during 2020, it is likely that U.S. interest rates will rise as the indices improve, and that appears liable to promote an increase in USD/JPY. Since forex movements in response to asset price trends are not always symmetrical, there is an undeniable possibility that, even though USD/JPY did not drop in response to the deterioration of the indices, it may rise in response to improvement in the indices.

Regarding situations that might further intensify such a prospective trend, the table on the right summarizes future risk factors. I find it impossible not to be concerned about risk factors ① and ②. With respect to risk factor ①, a key point is whether the U.S. Congress will approve legislation calling for additional fiscal spending,

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, tax reduction	medium/high
②	Discontinuation of the Trump administration's protectionist policies	Complete resolution of US-China trade war (Complete elimination of additional tariffs)	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	low/medium

(Source) create by Karakama, Mizuho Bank

and it should probably be kept in mind that the Democratic Party, despite its opposition to President Trump, may not want to be viewed as being responsible for an economic slowdown as the upcoming presidential election approaches. Consequently, there does still remain a possibility that expansionary fiscal policies will be implemented. This may be considered a headwind factor for forecasts of U.S. interest rate declines and USD depreciation. In addition, it is conceivable that the supplementary tariffs recently imposed based on presidential authority may be progressively removed. In the case that existing tariffs were eliminated or lowered, the financial markets (particularly forex markets) are quite likely to perceive that as a tax cut and respond positively. Although President Trump might be justifiably criticized for stirring up trouble to get credit for the solution, such an approach is very likely to be a successful means of boosting financial market sentiment. There is due cause for keeping in mind the possibility that Trump administration measures may become an exogenous factor boosting the U.S. economy.

While not much more needs to be said regarding risk factor ②, it is noteworthy that USD/JPY has been boosted since the start of November merely by expectations that U.S.-China trade negotiations may lead to a partial agreement. Given that, it is clear that there is a basis for concern about the potential forex ramifications of an unexpected upside scenario involving complete resolution of U.S.-China trade issues and the complete elimination of punitive tariffs. Seeming to have little interest in such China-related issues such as those associated with national territory and human rights, President Trump is not a typical hard-line anti-China politician, and he may well endeavor to make a pragmatic deal with China and emphasize the positive results of that deal. In light of that, the possibility of a sharp adjustment to trade negotiation positions enabling a comprehensive agreement with China on trade issues cannot be completely discounted. Such a potential situation represents a major JPY depreciation risk factor.

German Manufacturers Calling for Greater Fiscal Spending

During 2019, economic deceleration in China and Europe (particularly Germany) had an adverse effect on the global economy and also influenced the Fed's policies, and risk factor ⑤ is a JPY depreciation risk related to the possibility of a reversal of that economic deceleration trend. In other words, it is the risk that the Fed will be reassured when it perceives a trend of economic bottoming out in China and Europe and therefore choose to take the opportunity to re-begin normalizing its policies. The likelihood that the Fed might shift to interest rate hikes during 2020 does not seem high in light of the political pressures on it (principally from President Trump) and the U.S. presidential election, but given that expectations of an interest rate cut suspension are already firmly embedded in financial markets, it is impossible to deny the possibility that improvement in the Chinese and European economies might embolden the Fed.

In Germany, for example, there are continued reports that the government is prepared to undertake large-scale fiscal spending measures and, in November, the Federation of German Industries (BDI) and the German Trade Union Confederation (DGB) issued an unusual joint statement supporting a reexamination of budget priorities and asking the government to significantly augment public investment. It is likely that economic bottoming-out trends in China and the euro zone would significantly brighten global economic sentiment. Of course, there are still insufficient indications of such trends to incorporate them into the main forecast scenario, but it does seem likely that when China's economy resurges, the benefits to Germany exports may well promote a general recovery in the euro area economy. Sustained signs of recovery in both China and Europe could sharply change the mood of international financial markets. This is the JPY depreciation risk associated with risk factor ⑤.

BOJ-Related Risks of JPY Appreciation Greater than those of JPY Depreciation

At the time this article was written, there was not much new to write about the Brexit-related risk factor ③. A U.K. general election will be held on December 12, and public opinion surveys currently indicate that, while the opposition Labour Party supported the idea of holding the election, it does not have much of a chance of winning it (although it may be questionable whether much credence should be attached to public opinion surveys nowadays). If the Labour Party were to confound expectations and win the election, it might be expected to cause considerable JPY depreciation, but there does not currently seem to be a realistic likelihood of that.

Regarding risk factor ④ concerning the BOJ's monetary policies, there is similarly not much to write. Looking about for some kind of new development related to the BOJ, one might consider the potential impact of the fact that the Swedish central bank (Riksbank) has begun considering discontinuing its employment of negative interest rates. It may be worth monitoring that situation to see if there is a possibility that the inclination to discontinue negative interest rates might spread throughout Europe, including the ECB. Riksbank seems to be concerned about two issues – asset bubble generation and financial system strains – that are faced by all countries utilizing negative interest rates. It will be interesting to see if such moves toward monetary policy normalization could spread beyond Europe to affect the BOJ, but such a situation would have the potential to increase JPY interest rates and thereby promote JPY appreciation, so it is not a JPY depreciation risk factor. If one were determined to identify possible JPY depreciation risk factors, one might consider the possibility that the BOJ might further increase the magnitude of its negative interest rates, but the behavior of Riksbank seems to indicate that such a BOJ move would be swimming against the general current of the present era. It is hard to imagine the BOJ considering measures to further depress negative interest rates unless USD/JPY descends below JPY100 and the BOJ becomes desperate to halt that descent.

Intimidating Bill for Corporate Sentiment Deterioration Coming in 2020

The above sections are an overview of the JPY depreciation risks to this article's main forecast scenario. As previously mentioned, while the sharp deterioration of corporate sentiment has not been able to push USD/JPY downward so far, there is a high likelihood that the bill for that corporate sentiment deterioration will finally arrive sometime around 2020, and this is cause for concern. I do not believe the current environment will support a sharp improvement in corporate sentiment. However, taking the ISM Manufacturing Index for example, it has fallen almost ten points in the past year, the data do not suggest that it might deteriorate by a similar margin going forward, and, moreover, it seems clear that we are gradually entering a phase in which an autonomous reversal of the corporate sentiment deterioration trend can be expected. Even with a temporary improvement in U.S. business sentiment, the fact that the U.S. labor market has almost achieved full employment makes it appear that the leeway for further improvement is limited. Given the Fed's strong fundamental inclination to resume monetary policy normalization, however, there does exist a risk that it might move to hike interest rates during a temporary period of improvement in the economic and financial environment. The likelihood of that is not high, but it does represent a JPY depreciation risk factor for this article's main forecast scenario.

As the United States continues to extend its record-long period of economic expansion and its unemployment rate descends to levels not seen for half a century, it seems most reasonable to conclude that there is a high likelihood that the country's economic fundamentals will gradually become more shaky going forward. In light of current and prospective political and economic situations, most people would probably continue to be disinclined to disagree with the view that the eventuation of JPY appreciation risk factors is more likely than that of JPY depreciation risk factors. Given that the U.S. economy has already grown for so long and has limited leeway for additional growth, it is natural to assume that there are greater prospective downside than upside risks regarding both U.S. interest rates and USD. Japan's sensitivity to trends promoting JPY appreciation has diminished owing to such factors as changes in the country's external net asset structure, and it is still debatable whether it will be possible for USD/JPY to move down to a level close to descending below USD1/JPY100 during the forecast period, but I believe there is no need to adjust the directionality of this article's main forecast scenario, which anticipates JPY appreciation. While it is true that the margin of JPY appreciation has been less than anticipated so far during 2019, I think it worth noting that the directionality of the trend of JPY appreciation is in line with my forecast.

EUR Outlook – Origin of European Economy’s “Weakness”?

Euro Area Monetary Policies Now and Going Forward – ECB President Lagarde’s First Mission Orchestrating “Unity”

Strong Calls for Unity

Although there was no ECB Governing Council meeting in November, the Account of the October 23-24 Governing Council meeting was released on November 21. It is generally understood that the October Governing Council meeting was the first meeting following the September 12 meeting, at which there was an unprecedented degree of internal divisiveness, and the October meeting was also the last meeting presided over by former ECB President Draghi. As discussed in last month’s edition of this article, the press conference after the October meeting was dominated by a retrospective atmosphere, as participants looked back at President Draghi’s eight years in office, but the Account of that meeting reflected a strong determination to overcome divisiveness and show unity. As the post-meeting press conference, President Draghi noted regarding his opponents at the September Governing Council meeting that – “one of the dissenters called for unity and the full implementation of the policy package. Another dissenter said, “Bygones are bygones.”” The Account’s “Monetary policy stance and policy considerations” section, which often provides hints about ECB’s monetary policies’ “next move”, includes the sentences – “Looking ahead, a strong call was made for unity of the Governing Council. While it was underlined that open and frank discussions in the Governing Council were absolutely necessary and legitimate, it was regarded as important to form a consensus and to unite behind the Governing Council’s commitment to pursuing its inflation aim.” It seems that the inclusion of these sentences indicates that the ECB indeed felt a strong sense of crisis following the September Governing Council meeting.

Emphasizing the Need for Fiscal Policy Initiatives

Fundamentally, however, the underlying meaning of the appeals for unity may be interpreted as meaning that continued monetary easing is the default route and that the portion of Governing Council members opposed to the default route should unite in supporting that route. This is reflected in a portion of the Account that reads – “Accordingly, it was vital for the Governing Council to remain prepared to act by using its full set of instruments if the inflation outlook so required.” That statement was somewhat moderated in the next sentences – “It was, however, cautioned that due account also had to be taken of the assessment of the possible side effects of monetary policy measures. At the same time, a plea was made for patience to allow the measures taken in September to work through the economy, supporting a “wait and see” posture at the current juncture.” – but it is hard not to get the impression that these sentences were no more than a footnote to the main point made in the previous sentence.

However, the Governing Council is not presenting a posture of being prepared to overcome current challenges by means of monetary policies alone. The final paragraph of the Account’s “Monetary policy stance and policy considerations” section states – “the call on other policymakers was reiterated, emphasizing that they needed to contribute more decisively to supporting the euro area economy.” That is basically an appeal for greater use of fiscal stimulus measures. It is fairly well known that the ECB repeatedly made strong appeals for greater use of fiscal stimulus measures during the last few years of President Draghi’s term. For example, at the October 28 farewell event in his honor, former-President Draghi emphasized the need for and importance of fiscal policies throughout his Farewell Remarks speech. Early in the Farewell Remarks, he said – “I see today more as an occasion to reflect than to celebrate.” – and later on, he hinted at what the topic of reflection should be, saying – “Monetary policy can still achieve its objective, but it can do so faster and with fewer side effects if fiscal policies are aligned with it.” In a particularly striking portion of his remarks, he became quite specific in noting that – “the US has had both a capital markets union and a counter-cyclical fiscal policy. The euro area had no capital markets union and a pro-cyclical fiscal policy.” In short, compared to the United States, the euro area is handicapped by its lack of a capital markets union and a counter-cyclical fiscal policy, and that is the reason the ECB was forced to become so proactive. It goes without saying that, rather than merely seeking to promote the formation of banking and fiscal alliances, former-President Draghi’s comments were also designed to highlight the fact that Germany has continued to accumulate fiscal surpluses by restraining the level of its fiscal expenditures even within its own boundaries.

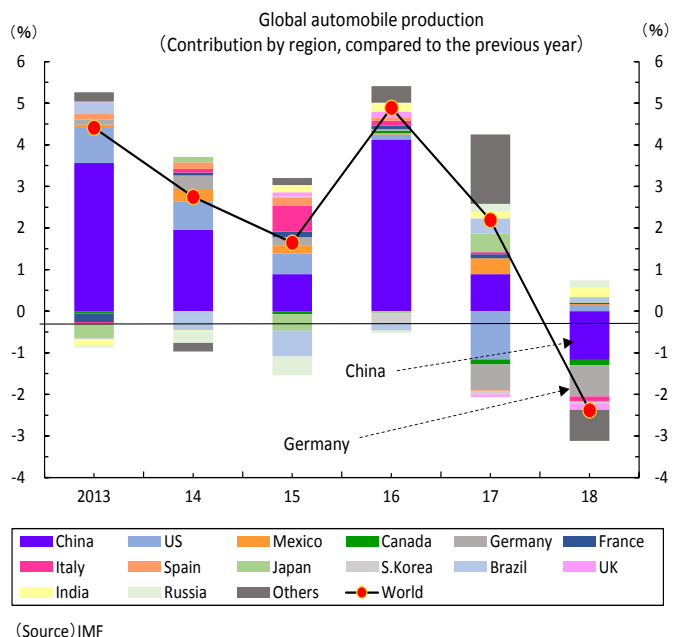
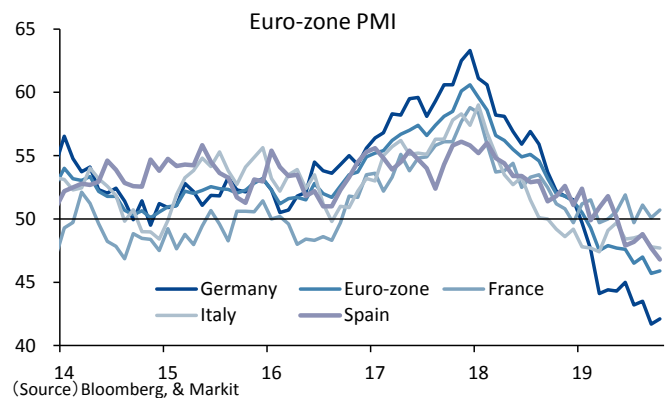
Expectations Regarding the Lagarde-Led ECB

There is no doubt that the latest Account's key theme is "unity". This reflects both impatience with the Governing Council's contemporaneously occurring problems as well as expectations regarding the prospective characteristics of the Governing Council under the leadership of President designate Lagarde (who attended the October meeting). According to some news media reports¹, President Lagarde has quickly taken the initiative in seeking to alleviate divisions within the Governing Council. An ECB spokesman said – "Members of the Governing Council met at the invitation of President Lagarde for an off-site retreat to discuss in an open and informal setting the running of the Governing Council going forward." Under President Lagarde's leadership, the ECB is basically expected to continue emphasizing the appropriateness of the easing package approved under President Draghi's guidance in September while also maintaining a proactive "remain prepared to act by using its full set of instruments" posture. To successfully respond to market expectations, it is thought likely that President Lagarde will position the task of considering and implementing revisions to the ECB's definition of price stability – a fundamental element of the ECB's policy target-setting system – as a key task to be completed during her first year in office.

Euro Area Inflation Situation Now and Going Forward – Has Germany's Economy Bottomed Out?

Auto Manufacturing Slump – Chief Source of Euro Area Economy Weakness

While expectations of a global economic bottoming out can be seen here and there throughout most of the world, the situation in the euro area economy continues to be unclear. As the graph shows, trends in euro area countries' PMI manufacturing indices have been quite negative, particularly regarding Germany's index, and only France is remaining (barely) above the 50 level. What are the principal sources of economic weakness in major euro area countries? The largest factor contributing to the weakness seems to be the area's structural dependence on external demand, especially with respect to automobiles (a top export item), as automobile sales have recently been stagnant worldwide. In 2018, for example, more than a quarter of global car exports came from Germany, France, Italy, and Spain, so ups and downs in automobile sales will inevitably have a strong impact on the euro area economy. The IMF World Economic Outlook released in October allocated quite a few pages to discussing the sluggishness of the global automobile industry, pointing out the problematic fact that 2018 was the first year since the financial crisis in which global automobile manufacturing volume decreased. There are two well-known issues that have been making major contributions to the manufacturing volume slump – the abolition of reduced tax rates on small cars in China and the introduction of strict emission standards in Europe. Chinese reduced tax rates on small cars were introduced in October 2015 and originally scheduled to end in 2016. They were extended through 2017 although the tax reduction margin was decreased for that additional year. The end of the tax reductions is said to have made the Chinese automobile market sluggish in 2018. Of course, it should be understood that temporary tax reductions (≈ price reductions) naturally cause accelerated demand followed by demand slumps. The impact of China's termination of reduced tax rates on small cars may have a strong effect throughout the 2018-2019 period.

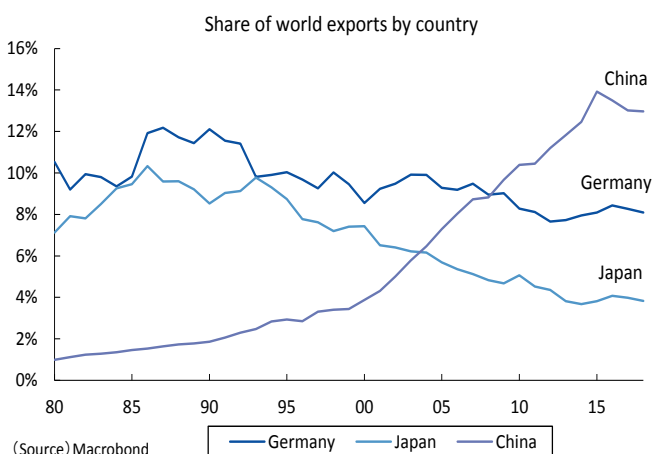


¹ Please see the November 14, 2019 Reuters article entitled "UPDATE 1-Lagarde takes ECB governors on retreat to iron out differences - sources".

Regarding the introduction of strict emission standards in Europe, it appears that automobile manufacturing and sales have been restrained by such factors as delayed inaugurations of manufacturing operations of models in compliance with the new standards as well as by manufacturing cost increases associated with regulatory compliance measures. While it is anticipated that the impact of China's reduced tax rate termination will dissipate in the short term, many observers expect the demand drop accompanying European emission standards compliance measures to persist over the medium term. The automobile industry accounts for just under 6% of the world's industrial production, and the contribution of that industry's weakness to global economic deceleration cannot be ignored. The graph clearly shows that it is principally China and Germany that have been depressing global automobile manufacturing and, given the well-known strength of political and economic ties between those countries, it is reasonable to conclude that the trends in the two countries are inter-related.

Factors Underlying Export-Base Power

Besides its strong ties with China, Germany has additional structural problems associated with its continued power as an export base. Germany's export dependence ratio (exports ÷ real GDP) is slightly below 40% – considerably higher than Japan's ratio of slightly less than 20%. The graph on the right shows that, while Japan's share of global automobile export volume has been shrinking as China's share has increased, Germany has firmly maintained its strong share of global exports. Many observers have noted that this situation reflects such positive factors as labor regulation reforms (the Hartz reforms) instituted by the government of Prime Minister Gerhard Schröder in the first half of the 2000s, which have been generally

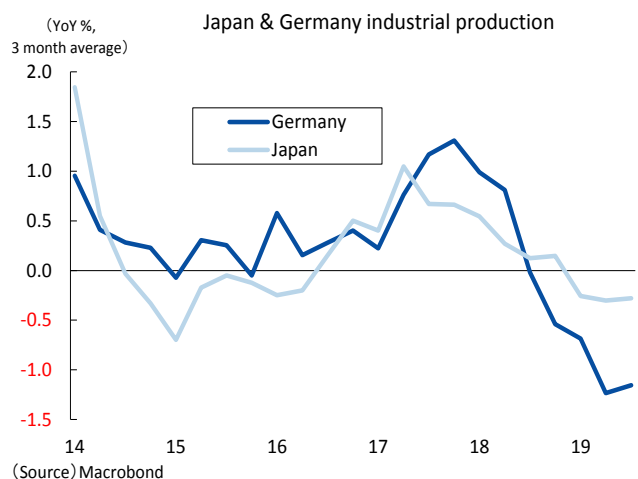


reducing Germany's domestic manufacturing costs, and the relaxation of restrictions imposed by individual Germany states, which have been facilitating highly-competitive operations on the parts of small and medium-sized (Mittelstand) companies. However, it is not difficult to come up with other kinds of reasons for retaining domestic manufacturing bases, such as the perennially undervalued currency Germany utilizes as a euro area member and the availability of inexpensive workers from Eastern Europe, and it may be that these factors are more powerful than the previously mentioned ones.

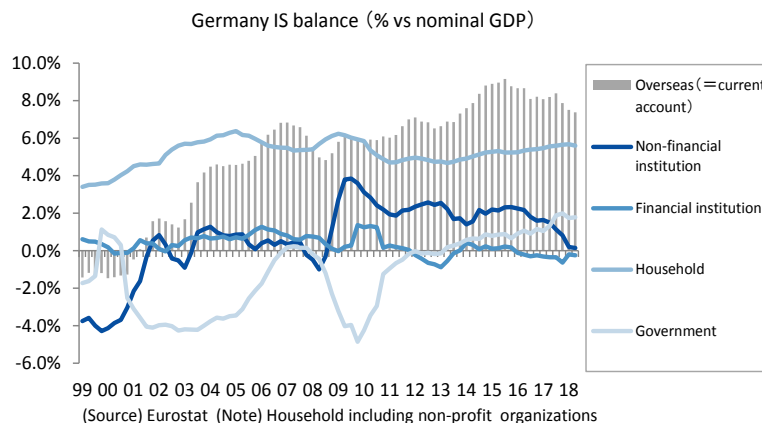
Germany's ability to retain its power as a production/export base has facilitated its ability to create domestic jobs, so when things are going well, this retained power is considered to be a strength. However, having an economy driven by strong exports means that changes to overseas economic/financial environments can quickly transform the strengths into weaknesses that depress the domestic economy. During the 2005-2006 JPY depreciation bubble era, Japanese manufacturers generated considerable profits through the production of flat-screen televisions, but the 2007-2008 financial crisis promoted JPY appreciation and a shrinkage of overseas demand, and Japanese manufacturers' sales of those products plunged. Although not as powerful as the 2007-2008 financial crisis (Lehman shock), the global economic slowdown since last year has had an impact on Germany that is somewhat similar to the Lehman shock's impact on Japan.

Difference between Japan and Germany

The reason why Japan has not slumped as much Germany recently probably stems from lessons Japan learned in the course of repeated bouts of JPY appreciation along with the 2011 Great East Japan Earthquake, which promoted the dispersion of production bases in Japan along with the shifting of production bases to overseas locations. In the absence of domestic production bases for exports, external demand declines' impact on the real domestic economy will be diminished. (On the other hand, the absence of domestic production bases for exports also makes it unlikely that JPY depreciation will promote Japanese export volume growth.) Comparing recent trends in the two countries' industrial production, it is clear that the magnitude Germany's drop is considerably larger than that of Japan (see graph). In any case, for Germany to overcome its current difficult situation, it will have to expand government sector spending to alleviate the impact of the



external demand decline, although there are no clear signs the country is preparing to implement bold initiatives in this regard. In a November 8 news media interview, Germany's finance minister, Olaf Scholz made such comments as – “We have a very expansionary financial policy and an all-time high of public investment.” – and these remarks appear to indicate that, although it had seemed that Germany was open to the idea of fiscal stimulus measures at one point, it is no longer inclined to go that route. Looking at Germany's savings and investment (IS) balance (see graph, middle right), however, one finds that the government sector has a savings surplus (or fiscal surplus) of almost 2%. It seems that the disinclination to adjust this resource allocation structure even when on the brink of recession may reflect a triumph of national character over objectively rational decision making. As explained below, Germany's July-September GDP figures indicate the country just barely avoided a recession, but they should not be considered a basis for justifying continued fiscal austerity. In view of Germany's powerful sway on the euro area economy, it can be anticipated that “Germany”, “automobiles”, and “public spending” will be key factors to consider when seeking to anticipate future ECB monetary policy decisions.

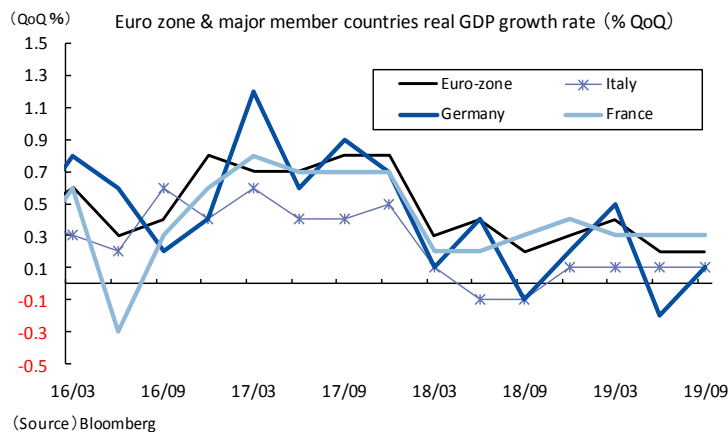


(Source) Eurostat (Note) Household including non-profit organizations

It seems that the disinclination to adjust this resource allocation structure even when on the brink of recession may reflect a triumph of national character over objectively rational decision making. As explained below, Germany's July-September GDP figures indicate the country just barely avoided a recession, but they should not be considered a basis for justifying continued fiscal austerity. In view of Germany's powerful sway on the euro area economy, it can be anticipated that “Germany”, “automobiles”, and “public spending” will be key factors to consider when seeking to anticipate future ECB monetary policy decisions.

Germany Just Barely Avoided a Recession

The euro area July-September real GDP growth rate statistics (second provisional figures) were released on November 14, clarifying trends by individual country. The euro area's overall growth was +0.2% qoq, unchanged from the first provisional figures and in line with market expectations. Looking at individual countries, however, one finds that Germany boosted its GDP growth rate from -0.2% qoq in the April-June quarter to +0.1% qoq in the July-September quarter, thereby scraping over the hurdles to defy widespread expectations that it might technically fall into a recession (defined as two consecutive quarters of negative growth; see graph).



(Source) Bloomberg

This can be said to be the most newsworthy element of the newly released figures. Germany's April-June quarter figure has been revised downward from -0.1% to -0.2%, however, and the latest figure should be carefully evaluated given that its launch pad has been lowered. Another complicating factor regarding the evaluation of April-June quarter figures is the fact that Brexit-related expectations caused an acceleration of economic activities centered on consumption and investment, temporarily promoting a GDP uptick in the January-March quarter. In light of these complications, one should currently avoid attributing excessive significance to the nominally measured levels of GDP growth. At this point, it is probably advisable to focus on the generally dismal state of affairs – a further continuation of close-to-zero GDP growth. Euro area figures for the contribution to GDP by individual demand segments have not yet been released, although a press release from Germany's Federal Statistical Office indicated that German household final consumption expenditure and government final consumption expenditure had increased qoq and that, while imports were roughly unchanged, exports grew, so that net exports also contributed to qoq German GDP growth. On the other hand, the news release also noted that fixed capital formation in machinery and equipment (capital investment) was down qoq, and this appears to indicate that the sluggishness of production activities centered on those of manufacturing industries is holding the Germany economy back. This can be considered an illustration of the argument made above, that Germany is suffering from a side-effect of its domestic retention of export-oriented manufacturing bases. Overlooking the qoq GDP growth rates of other major euro area countries, one finds that the rate was +0.3% for France, +0.4% for Spain, +0.1% for Italy, and +0.4% for the Netherlands, and all these rates were flat from the previous quarter. These rates may all seem discouragingly low but, given the generally dismal image of the euro zone economy recently, they might also be considered to be positive indications that a significant level of positive growth is being sustained.

Sharp Improvement in Soft Data but...

As mentioned above, there are technical aspects of GDP statistics that make it difficult to determine whether the German economy has actually bottomed out or not. In such cases, it may be helpful to refer to relatively timely soft data statistics. For example, the November ZEW Indicator of Economic Sentiment for Germany (measuring financial experts' expectations about economic conditions six months in the future), released on November 12, stands at -2.1 points, a significant improvement of 20.7 points from the previous month's level (-22.8 points). Personally, I am still in doubt about whether to consider this sufficient evidence to judge that the German economy is bottoming out. Taking into account various factors – such as the fact that the ZEW survey period of November 4-11 corresponded to a period of rising expectations that US-China trade talks might reach a partial agreement and the fact that risk capital prices centered on stock prices were amid an accelerating rise during that period – I feel there is a need to give sufficient attention to the possibility that the soft data are showing an excessive upswing. Moreover, the November ZEW survey's assessment of Germany's current economic situation remained at -24.7, a very weak level. It is impossible to be sure about whether the expectations are excessively positive or not.

Given the fact Germany's production activities are sluggish, it seems rational to be prepared for the possibility that that situation will exert an impact on the employment and wage markets going forward. Germany's unemployment rate has fallen to a level that seems to correspond to the natural unemployment rate, and there are currently signs that it will start to rise (see graph). It is probably impossible to say that there is no longer any risk that an intensification of such trends will cause Germany to fall into a recession. It was the general perception that Germany was at a critical point on the brink of a recession that generated widespread expectations that the government sector would undertake fiscal stimulus measures, but it now seems that Germany's policy stance is to keep government expenditures to a necessary minimum level while continuing to seek to dispel the anxiety with optimistic talk. Going forward, there certainly is a possibility that trends of recovery in China and other emerging economies will enable Germany to get back on track for export-led economic recovery. I am still uneasy about making a related assumption into a basis for the main forecast scenario, however, and intend to mainly focus on objectively analyzing the current situation. My view is that one should avoid excessive optimism regarding the question of whether Germany has already successfully escaped from the risk of a negative growth trend.



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