

# Forex Medium-Term Outlook

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Derivatives & Forex Department

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## Overview of Outlook

For the second year in a row in 2019, USD/JPY posted the narrowest annual exchange rate range of all time (8.30 yen). Regarding this lack of volatility, four main factors have been pointed out, namely (1) a decline in investor interest in JPY or in the Tokyo market, (2) a decline in the amount of foreign currency earnings being repatriated to Japan as a result of structural changes, (3) no decline in the relative attractiveness of U.S. interest rates, and (4) the increasing popularity of AI-based trading. Of the above, I discussed the first three factors time and again in various issues of this report in 2019. In preparing our outlook for 2020, it will be important to think about how the above points could change. To cut to the chase, none of the factors above except (3) are likely to change easily, given that they are structural issues. Factor (3) also seems unlikely to change in the near future, which means that USD/JPY may remain range-bound again in 2020. However, one of the unnerving things about the stock market in 2019 was that the major stock indices continued to renew all-time record highs despite a spate of deteriorating profits for companies. There is a significant possibility, therefore, that there will be a backwash at some point, forcing the Fed to implement another rate cut in response. Given that the possibility of a rate cut in either Japan or Europe is quite low, their interest rate gaps with the U.S. could shrink in 2020. It is quite basic to predict the direction of forex rate movements based on interest rate gap movements, and this basic perspective could come into fresh focus in 2020. While it seems unlikely that JPY will appreciate to the extent expected at one time, I do think it likely that the direction of currency movement will be toward a stronger JPY in 2020 also.

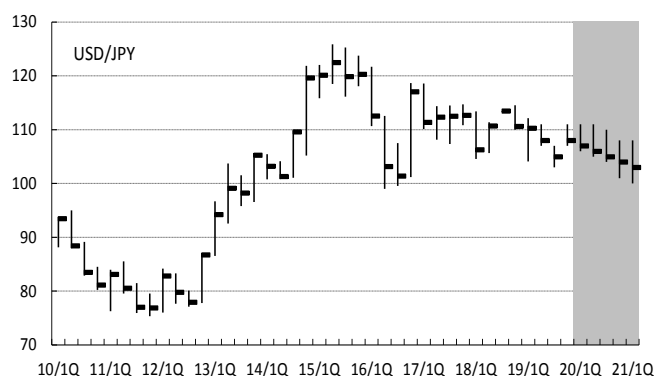
EUR rates also lacked direction in 2019. Having said that, EUR has remained strong given the circumstances, namely that Europe has the worst fundamentals of the three key regions (U.S., Japan, and Europe), the ECB's negative interest rates are a whopping -0.50%, and there has been a great deal of political turmoil surrounding Brexit. A number of major issues seem likely to receive attention under the regime of new ECB President Christine Lagarde, including a reexamination of the ECB's policy strategies and exploring the possibility of a digital euro. If we were to focus on monetary policy developments, the impact of the abolition of negative interest rates by Sweden's central bank (Sveriges Riksbank) in December is of concern. The Riksbank raised interest rates out of concern regarding the side effects of a negative interest rate policy, and though this concern does not apply directly to the ECB, some in the euro area are beginning to point out the damage resulting from negative interest rates. Political and economic conditions permitting, the possibility of the ECB implementing a rate hike cannot be ruled out. This would narrow the interest rate gap between the ECB and the Fed and be seen as a symbolic event, which is likely to spur on EUR buying. It seems rather unlikely that a greater deterioration of the real economy compared with 2019 awaits the euro area in 2020, so I think it possible that EUR could recover its value.

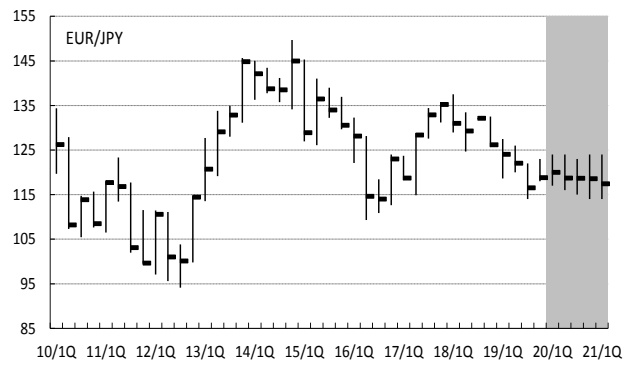
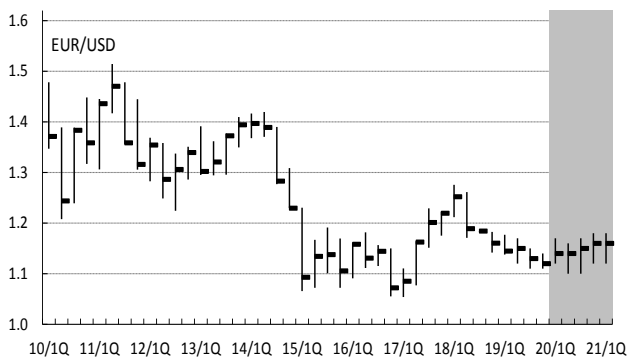
### Summary Table of Forecasts

	2019	2020			2021	
	Jan-Dec (actual)	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
USD/JPY	104.10 ~ 112.40 (109.48)	106 ~ 111 (107)	105 ~ 111 (106)	104 ~ 110 (105)	101 ~ 108 (104)	100 ~ 108 (103)
EUR/USD	1.0879 ~ 1.1570 (1.1101)	1.10 ~ 1.15 (1.12)	1.08 ~ 1.14 (1.12)	1.08 ~ 1.15 (1.13)	1.10 ~ 1.16 (1.14)	1.10 ~ 1.16 (1.14)
EUR/JPY	115.87 ~ 127.50 (121.65)	117 ~ 124 (120)	116 ~ 124 (119)	115 ~ 123 (119)	114 ~ 124 (119)	114 ~ 124 (117)

(Notes) 1. Actual results released around 10am TKY time on 27 DEC 2019. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

### Exchange Rate Trends & Forecasts





## USD/JPY Outlook – What is Needed for Breaking USD/JPY Out of its Range in 2020?

### Overview of the Forex Markets in 2020 – What is Needed for Breaking USD/JPY Out of its Range in 2020?

#### Background to the Deadlocked Rates in 2019

As of the writing of this report, USD/JPY's annual exchange rate range (the highest rate minus the lowest rate) this year is the narrowest it has ever been, at 8.30 (the highest being 112.40, and the lowest being 104.10). Given that last year's 9.99 yen is the narrowest annual range posted so far, USD/JPY will renew the all-time historical low range for the second year in a row this year unless it exceeds its highest rate or falls below its lowest rate so far by 1.69, hitting either 114.90 or 102.41. However, the forex markets overall (not just USD/JPY) seem to be losing dynamism, and one feels that there will be fewer big booms or busts going forward. Over the past year, many theories have been put forward for the why the markets remain unmoved. It is rather sad that many media and analyst reports seem to be focused on the question of why the markets

are not moving. For instance, the December 25, 2019 morning edition of the *Nikkei* ran an article titled "A Lukewarm Economy, Unmoving Forex Rates, Lowest Ever USD/JPY Annual Range," to which I also contributed through comments and exhibits used in the article, but to be honest, it is difficult to pinpoint exactly why the markets remain unmoving. However, the various reasons pointed out by market participants and analysts can be summarized in the form of four factors as shown in the chart. Of the four, I discussed the first three factors time and again in various issues of this report in 2019. My knowledge regarding factor ④ is not very deep, but to give you an idea of what happens, while trading based on market movements monitored by the human eye tend to go no further than the second decimal point, AI-based high-frequency trading (HFT) works by accumulating a large number of very small profits based on smaller rate movements, so even movements at the level of the fourth decimal point can be significant. Consequently, it is only from a human point of view, for traders who are immersed in conventional trading practices, that the markets are not moving. This may not necessarily be the case for traders who predominantly engage in HFT. This is also something that is frequently pointed out.

#### The background of the range market

##### ① JPY and Tokyo market are not popular in the first place

- According to the BIS survey, it is clearly subsiding

##### ② The amount of foreign currency returning to Japan is decreasing

- The decline in U.S. interest rates has also reduced the amount of foreign currencies returning to Japan

##### ③ U.S. interest rates remain higher than others

- U.S. interest rates fell but there's no reason to buy a currency with negative interest rates.

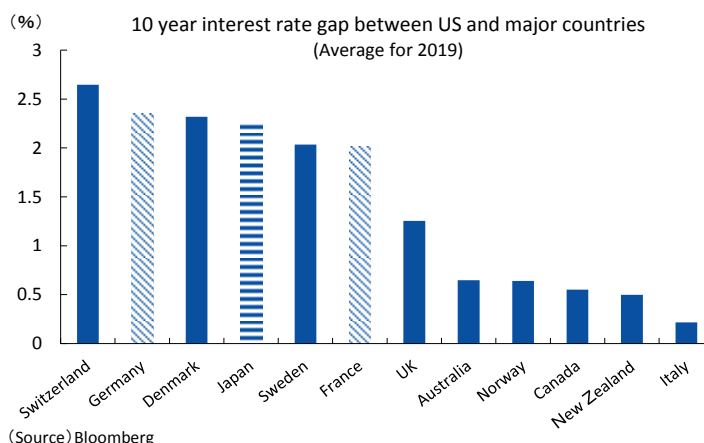
##### ④ The rise of AI trading?

- The second decimal point is range but the fourth decimal point can be significant

(Source.) by Karakama, Mizuho Bank

## USD Maintained Position as a High-Yielding Currency

Of course, there are bound to be reasons other than the four pointed out above for the lack of movement in the markets (for instance, because of the state of equilibrium in the market in terms of supply and demand). However, if we assume that the four factors mentioned are the major reasons for lack of market movement, it would be meaningful to think about what kind of changes there could be in each of those factors during 2020. To cut to the chase, none of the factors except ③ are likely to change easily, given that they are structural. With regard to factor ②, in particular, Japan's net asset structure is undergoing a clear change as a consequence



of vigorous cross-border M&A activity in the Japanese corporate sector, and it can be statistically confirmed that funds that leave Japan in the form of foreign currency increasingly fail to be repatriated back to Japan in the form of JPY. I feel that one of the reasons for the weakening of the trend of buying JPY as a safe-haven currency, which was overwhelmingly strong in the immediate wake of the financial crisis, is the fundamental problem that JPY is no longer that much of a safe-haven currency. Perhaps this is because of the relative decline in net external assets that can be flexibly converted to JPY. Given that there are fewer domestic opportunities for investment, it seems unlikely that this change in the structure of the external economic sector will be reversed in 2020 or thereafter. Rather, the trend is likely to gather steam. Apart from this, ① the unpopularity of JPY and the Tokyo market and ④ the flourishing of HFT are also factors that are unlikely to change in the next year or two.

That being the case, it seems reasonable to assume that factor ③ is the only one that has any possibility of changing in a way that could break USD/JPY out of its narrow range in 2020. Between 2018 and 2019, U.S. 10-year interest rates fell dramatically from 3.2% (in October 2018) to 1.4% (in September 2019). This ought to have resulted in a significant appreciation of JPY against USD as per the assumptions of this report. However, USD/JPY never fell below the 104 level during that phase, nor did EUR/USD rise above 1.15 dollar. This was solely because, despite the dramatic decline in its interest rates, USD was still a high-yielding currency for the forex markets. For instance, if we compare the 10-year interest rate gap between the U.S. and other major economies for the period from the beginning of 2019 to the present (average values), there was an over 2.0 pp gap with Germany and France in the euro area. This was true of Japan too. Ultimately, therefore, even though it is true that the sharp fall in U.S. interest rates was cause for selling USD, the fact was that, having sold USD, investors would have nowhere else to go. To a large extent, I believe it was this wretched investment climate that propped USD up (when 10-year U.S. interest rates sank to 1.4%, German 10-year interest rates were -0.7%, while Japanese 10-year interest rates were -0.3%). Note further that the currencies that had an average 10-year interest rate gap of 2.0 pp compared with USD in the chart are all currencies that have negative interest rates, although this is not surprising. It could be said, therefore, that the forex markets in 2019 were characterized by investors being unwilling to buy currencies with negative interest rates. This is why the impact of Sweden's abolition of its negative interest rates in December 2019, in preparation for the new year, is of interest.

## Returning to the Basics, i.e., the Interest Rate Gap Against USD

At the present time, the dot plot projections suggest no movement in the federal funds (FF) rate over the next three years (see chart). If we further assume that neither Europe nor Japan are likely to embark on successive rate hikes, it seems likely that USD will, by and large, remain a high-yielding currency in 2020 also, making it likely that forex rates will remain range-bound yet again in 2020. To be very honest, that likelihood seems quite high. However, as I will explain in more detail from page 9 onward, when thinking about the direction in which the risk is expanding, it will be very important to monitor how the

Policy interest rate outlook as of each year end (median estimate)

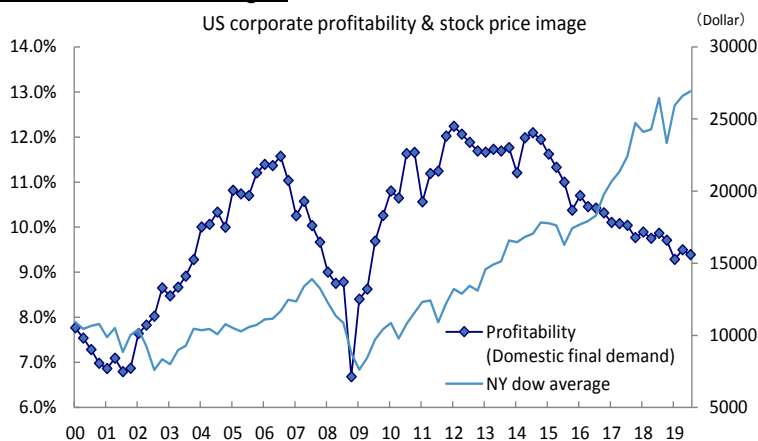
FOMC Date	2019	2020	2021	2022	Longer run
Sep-17	2.688%	2.875%	n.a.	n.a.	2.750%
Dec-17	2.688%	3.063%	n.a.	n.a.	2.750%
Mar-18	2.875%	3.375%	n.a.	n.a.	2.875%
Jun-18	3.125%	3.375%	n.a.	n.a.	2.875%
Sep-18	3.125%	3.375%	3.375%	n.a.	3.000%
Dec-18	2.875%	3.125%	3.125%	n.a.	2.750%
Mar-19	2.375%	2.625%	2.625%	n.a.	2.750%
Jun-19	2.375%	2.125%	2.375%	n.a.	2.500%
Sep-19	1.875%	1.875%	2.125%	2.375%	2.500%
Dec-19	1.625%	1.625%	1.875%	2.125%	2.500%

(Source) FRB

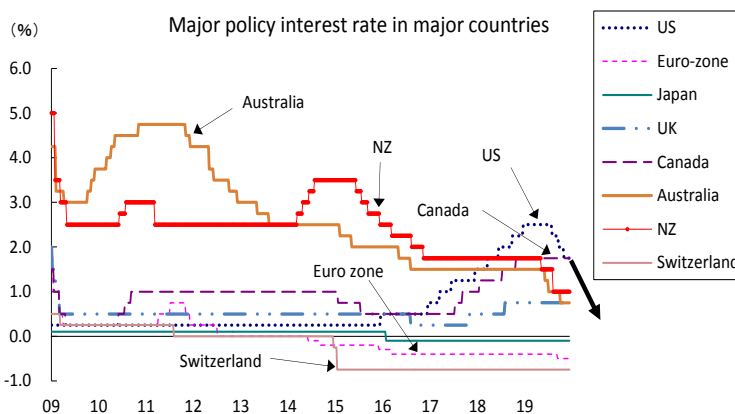
Riksbank's decision to abolish negative interest rates out of concern for side effects impacts monetary policy discussions in 2020. At the very least, almost no one is predicting a further deepening of negative interest rates in the euro area or in Japan at this point. Should an interest rate adjustment feature in the next move of either the ECB or

the BOJ, it is more likely to be a rate hike than a rate cut, and if that happens, the interest rate gap between the euro area/Japan and the U.S. will shrink even if the FF rate remains unchanged.

What is more, the probability of the FF rates remaining level, as suggested by the dot plot, is not all that high. Many market participants seem to be of the opinion that the FF rate will remain level at best, but could be lowered depending on the circumstances. Especially considering that 2020 is the year of the presidential election, the policy climate is such that there could be talk of another “preventative easing” whenever the stock market tumbles. For the Fed, which managed to change track so sharply as to implement three rate cuts the very next year after it had implemented four rate hikes, it would hardly be difficult to extend its “preventative easing” argument to implement additional rate cuts. In 2019, major stock indices continued to renew all-time record highs despite a spate of deteriorating profits for companies. This tendency has, in fact, been quite marked over the past three years, and it would not be surprising to see a backwash at some point. When that happens, there is definitely a possibility of the Fed being forced to lower its rates again, which would also result in a shrinking of the interest rate gap between the U.S. and the other major economies.



(Source) US BEA  
 (Notes) Corp profitability= Corporate profits divided domestic final demand  
 Domestic final demand is nominal GDP minus net exports and inventory investment



(Source) Bloomberg

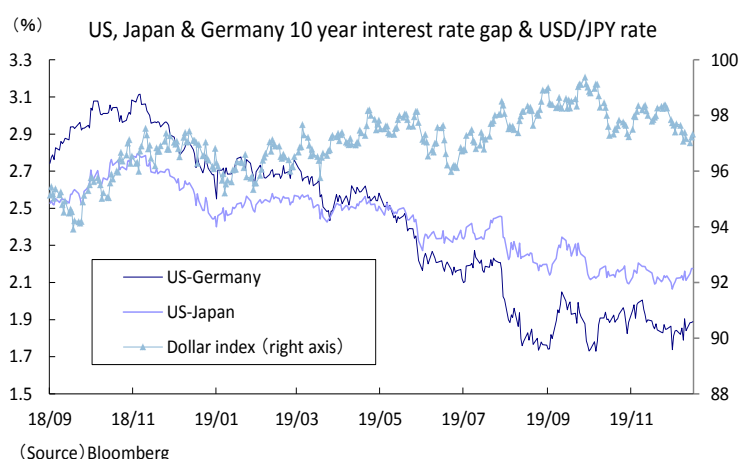
Looking at it this way, it seems that apart from some explosive political situation that could jolt the rates out of their immobility, it may be necessary to consider the possibility of the interest rate gap between the U.S. and other key economies shrinking as a result of the Fed revising its policy path. My basic understanding is that the likelihood of this, while not very high, is not too low either. Given that current stock price levels are based on the assumption of continued accommodative policy conditions, it seems easy to see that the FF rates, and U.S. bond interest rates alongside them, could slide downward as the Fed gives in to market demands during phases of stock-price correction. In 2019, USD underwent almost no correction despite the shrinking gap between the interest rates of the U.S. and other economies. However, if U.S. interest rates continue to decline in 2020 as they did in 2019, there will be a marked shrinking of the interest rate gap between USD and EUR or JPY, which have very little scope for further decline. It may become difficult to get a 10-year interest rate gap of even 2.0%. For instance, if the Fed were to implement three rate cuts in 2020 as it did in 2019, the FF rate would drop to 1.0%. At 1.0%, the rate becomes comparable to that of other key currencies such as NZD (1.0%), AUD (0.75%) and GBP (0.75%). In such a scenario, USD may no longer be seen as a high-yielding currency, and there may emerge signs of change in the current deadlocked forex rate situation based on USD strength. It is one of the most basic economic strategies to predict the direction of forex rate movements based on interest rate gap movements, and the importance of this basic strategy could come into fresh focus in 2020.



## The Complication of the Relationship Between Forex Rates and Interest Rate Gap – Abolition of Negative Rates Could Act as a Trigger

### Lost Forex Market Signposts

Looking back at the interest rate gap and forex rate trends in 2019 (see chart to the right), it is clear that USD remained stably strong throughout the year despite the gap between the U.S. interest rates vs. European (German) and Japanese interest rates shrinking markedly. There could be several interpretations of this situation in which interest rate trends no longer function as signposts in the forex market, but it is probably just that forex market participants really have no incentive to invest in negative-interest-rate currencies. As mentioned earlier, the fact that U.S. interest rates remain high relative to other economies despite several rate cuts seems to have created this perplexing situation.

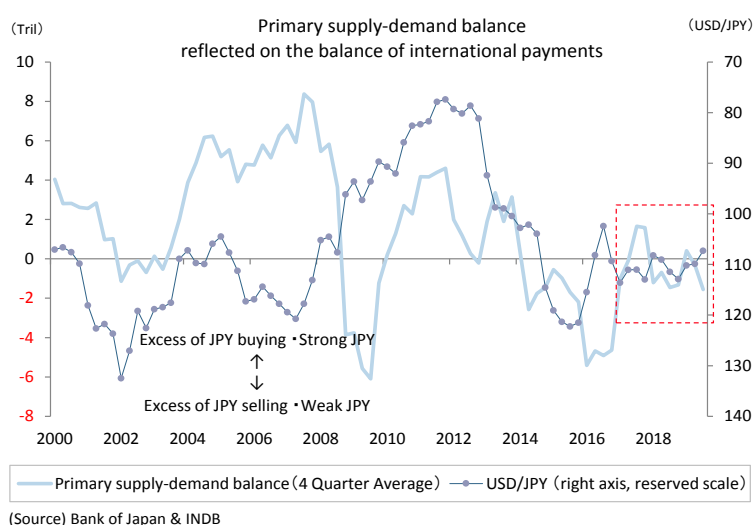


Japanese 10-year interest rates settled at a rate that was barely above zero in December 2019, but the German 10-year interest rates are still deep in negative territory, at the -0.20% level. Amid a consistent 2.0 pp or so gap between U.S. versus both Japanese and European 10-year interest rates, and historically low levels of volatility in the forex markets, investors have essentially no reason to let go of their USD holdings. As mentioned above, if we compare the year-to-date 10-year interest rate gap (average) between the U.S. and other major countries for 2019, Germany and France in the euro area consistently maintained a 2.0 pp or higher gap, and so did Japan (see chart on the previous page). Therefore, even though it is true that the sharp fall in U.S. interest rates was incentive for selling USD, the fact was that, having sold USD, investors would have nowhere else to go. It is likely that USD strength was supported by this miserable investment climate (when U.S. 10-year interest rates fell to 1.4%, German 10-year interest rates were -0.7%, while Japanese 10-year interest rates were -0.3%). Note further that the currencies in the chart that had an average 10-year interest rate gap of 2.0 pp compared with USD are all currencies with negative interest rates, although this is not surprising. My conjecture is that the flow of capital from both major and emerging currencies converged on the high-yielding USD. In other words, forex market investors in 2019 found the climate uncondusive to buying the negative-interest-rate currencies. Taking this into consideration, it seems likely that the abolition of negative interest rates could be the event that acts as the trigger for a return of capital to Europe and Japan. It is for this reason that the impact of Sweden's abolition of negative interest rates in December 2019, in the run up to the start of 2020, is of interest. I will discuss this in greater detail from page 17 onward.

## JPY Supply and Demand Now and Going Forward – Changes Reflected in the Basic Balance

### State of Equilibrium Continues

In December, Japan's October balance of payments were published. The JPY supply-demand balance for the January-October period was around -JPY 7.4 trillion, amounting to a small net supply of JPY, but when seen alongside the -JPY 10.3 trillion net supply for the same period of the previous year (January-October 2018), things seem to be moving in the direction of equilibrium. As I have said in past issues of this report, it is getting more difficult to predict the direction of USD/JPY based on JPY supply and demand. My hypothesis is that USD/JPY is at the mercy of qualitative headlines, such as those related to the U.S.-China trade war, mainly because it can no longer depend for direction on a clear trend of net JPY supply or demand amid this state of market equilibrium. As I have been arguing for some time now, the supply and demand trend depends on

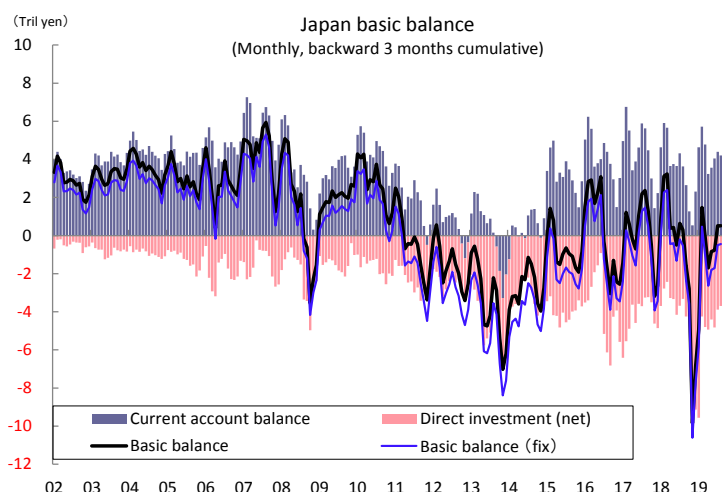


the current account balance and foreign securities investment trends. In recent years, the amount of direct investment has been large, but direct investment results in a stable JPY sale and does not fluctuate. As the chart shows, the fluctuations in JPY supply and balance have clearly been growing smaller and some think that this may be one of the reasons behind the limited movement of USD/JPY. Moreover, as I mentioned in last month's issue of this report, the Bank for International Settlements (BIS) survey results show that the popularity of JPY and the volume of transactions handled in the Tokyo foreign exchange market are on the wane. Given the decline in transaction volumes and the supply-demand equilibrium, it is only natural that USD/JPY would lose most of its movement. Further, if we also take into account the increasing weight of outstanding foreign direct investments (which do not result in a repatriation of JPY) in the outstanding net external assets, the lack of reasons to trade in JPY given its negative interest rates, and the dearth of interesting developments in Japanese monetary policy, the narrow rate range begins to seem quite understandable.

### **Structural Changes Obvious from Basic Balance**

The "basic balance," which is the sum of the current account balance and the long-term balance of the capital account, has long been viewed as a representative indicator of JPY supply and demand as gauged from the balance of payments. The balance of payments is made up of the current account balance and the capital account balance, of which the latter tends to be at the mercy of large, short-term fluctuations in forex and interest rates. Because of this, it is excluded to arrive at the long-term balance of the capital account, which is a measure used for understanding the balance of payment trend. The more stable the basic balance, the more the level of confidence in that currency. However, in the present age of large-scale and rapid international migration of capital, the fact is that the level of expectations in the financial market have a much bigger impact than the solvency of a country as indicated by its balance of payments. For this reason, it seems rather outdated in some ways to discuss the level of confidence in a currency based on its basic balance. Having said that, I am sometimes asked by my clients how long it will be before market confidence in JPY collapses, and in formulating my response, I find that the "strength" of Japan's external economic sector, as reflected by the basic balance, is still useful as a reference.

As the chart shows, one gets the impression that the structure of Japan's basic balance has been undergoing a change post the financial crisis. Although the country's current account surplus, which is based mainly (almost entirely) on the primary income balance, is still enormous, the fact is that the basic balance is increasingly being dragged in the direction of a deficit amid vigorous direct investment activity by Japanese companies. However, although the amount posted as primary income surplus is quite large, the percentage of this that is repatriated to Japan through JPY buying is quite low compared with the trade balance. Just subtracting reinvested earnings, which are certain not to be repatriated to Japan, the primary income surplus shrinks by JPY 5 trillion. The "basic balance" shown in the chart takes this into account. However, there are also categories other than reinvested earnings that are not repatriated to Japan. For instance, a large part of the interest earned on foreign bonds are also likely to be reinvested. Subtracting all of this, the primary income surplus of around JPY 20 trillion a year shrinks by over JPY 6 trillion. Of course, not all of the interest earned on bonds is reinvested (i.e., not repatriated to Japan), so the "basic balance (revised)" shown in the chart is based on the assumption that half of this amount is not repatriated. In the most-recent data point, "basic balance" is in the black while "basic balance (revised)" is in the red. Of course, there is no need to be too particular about the difference in sign here as the figures are hypothetical. However, the key point to remember is that the basic balance, which was consistently in surplus before the financial crisis, appears to have shifted to a by-and-large neutral level as a result of the sharp rise in foreign direct investments. It is unlikely that confidence in JPY, the currency of the world's largest creditor country, will collapse anytime soon, but there is a slow but sure structural change taking place, and this could be the reason why, in recent years, JPY no longer appreciate much even in times of crisis.



(Source) Ministry of Finance  
 (Notes) Basic balance=current account balance excl reinvestment income + direct investment (net)  
 Basic balance (fix)=current account balance excl reinvestment income & half of the bond interest + direct investment (net)



## **U.S. Monetary Policies Now and Going Forward – From “Hawkish Cuts” to “Dovish Stay”**

### ***The Outcome of Preventative Rate Cuts***

At the December 10-11, 2019 FOMC meeting, no rate cut was implemented for the first time in four meetings, keeping the target range for the FF rate unchanged at 1.50-1.75%, as per market forecasts. Going by the vote count, the decision was a unanimous one. Committee members appear to have been of one mind for the first time in a long while. The Summary of Economic Projections (SEP) for the growth rate, the unemployment rate and the PCE deflator was also by and large the same as last time (September), and the policy stance inevitably remains unchanged. To put a different spin on this, perhaps we could say that the preventative action taken in September was successful in preventing a further deterioration of the situation, resulting in the economic and price outlook remaining unchanged. As I argued in a previous issue of this report, given that stock prices play a large role in regulating the moods of the market, one could positively evaluate the recent set of three preventative rate cuts as having been successful in the short term. However, the Fed will use up its limited response options very quickly if it repeatedly changes its policy based on share prices and other market conditions rather than on hard data related to the real economy (production, inflation, employment, and so on). My guess is that FOMC members, while heaving a sigh of relief at having brought the situation under control through preventative rate cuts, are discussing their next move carefully based on the knowledge that they only have 175 bps of policy space left.

### ***Split Projections***

The only point of interest in the recent FOMC meeting, which was expected to be eventless, was the dot plot (see chart on page 4), and this too had no surprises, with projections for 2020 remaining unchanged as expected. Looking at the breakdown, while 4 members expected a rate hike, 13 members made no changes to their projections, leaving the median value naturally unchanged. If one has to find something of note, then perhaps it is the fact that the median value for 2021 is also 1.875%, indicating a very slow pace of rate hikes going forward. The decline in U.S. interest rates following the meeting may indicate that market participants who had expected that level of delay in returning to the rate hike path were in the minority. Looking at the dot plot this time, only three of the 17 FOMC members seem to be of the view that the policy space lost over the recent spate of preventative rate cuts can be recovered through a series of three rate cuts over the next two years (2020 and 2021). As for the projections for the end of 2021, there seems absolutely no consensus, with 5 members predicting no change (1.625%), 4 members predicting one rate hike (1.875%), 5 members predicting two rate hikes (2.125%), and 3 members predicting three rate hikes (2.375%).

Going by this split result, it seems the next move could be a rate hike but it is hard to tell for sure. This ambiguity also seems quite consistent with the median of market forecasts, but there are likely to be many market participants (including myself) who, bracing themselves for the maturing of the current phase of U.S. economic expansion, think that the next move by the Fed need not necessarily be a rate hike; that it could even be a rate cut. Naturally, if we assume that the dot plot helps shape market predictions, the markets could experience a shock when that prediction (of a rate hike as the next move) has to be significantly revised as the result of some crisis such as another rise in tensions over the U.S.-China trade war. In my view, the possibility of such a thing happening is certainly not small.

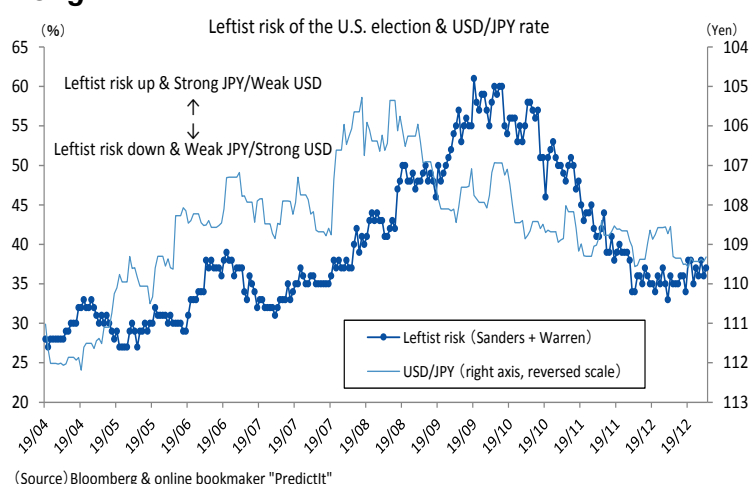
### ***Implications for the Forex Outlook***

When predicting forex market trends, especially USD/JPY, a good starting point is to assume that USD/JPY will not move unless the FF rates move. However, as I argued above, there is no guarantee that the FF rate will remain unchanged. My basic understanding is that the odds are stacked in favor of a rate cut as the next move. The FOMC's feeling that “the next move could be a rate hike, although there is no way to be sure” seems to suggest a shift from its recent “hawkish cuts” (disguised as “preventative”) to a “dovish stay.” The Fed's current stance in favor of a rate hike as the next move is simply a message aimed at preserving its dignity as a central bank. Meanwhile, it is quite uncertain whether such a forecast is appropriate in the face of the current super-long phase of economic growth, which is already in its 127th month. At any rate, so long as the Fed continues its “dovish stay,” there is no way for U.S. interest rates to rise, and it is natural to assume that USD/JPY will be weighed down by this.

## Risks to My Main Scenario – Where Might Unexpected Factors Lie? Six Issues.

### JPY Depreciation Risks Few But Likelihoods Rising

As we enter the new year, I have been receiving many inquiries about what kinds of highly unlikely risk factors – or “black swan” events – we should be keeping in mind during 2020. One of the situations that seems most liable to create a kind of black swan event is the upcoming US presidential election (risk factor ③ in the chart below). Many people are wary of the potential effects of US presidential elections, especially the risk of JPY appreciation and USD depreciation trends that could stem from the policies being proposed by Democratic party candidates during their competitive campaigns. In particular, there is a considerable concern that if the strongly leftist



positions of senators Elizabeth Warren and Bernie Sanders were to become dominant, it could cause stock market turmoil that could lead to a drop in US interest rates, thereby promoting JPY appreciation and USD depreciation trends. Looking back on 2019, while one does not really get the impression that forex rates have actually moved owing to a consciousness of such left-wing policy risks emerging during in the US presidential election campaign, there is a reasonable basis for suspecting that a rise in the level of left-wing policy risks (the combined level of support for senators Warren and Sanders) may have helped promote a decrease in USD/JPY (see chart). If a relatively moderate candidate such as Mr. Joe Biden were to be nominated, the ‘incumbent victory or moderate policy changes’ scenario would continue to be the baseline forecast scenario, but if a candidate with relatively extreme policy proposals such as Senator Warren were to be nominated, many people expect the results will become difficult to forecast. Since Senator Warren’s approval rating has considerably decreased at this point, it can be said that the possibility of “JPY appreciation due to leftist policy risk” is declining, but this is an issue that should be kept in mind, as there is still considerable time before the Democratic Party’s candidate is selected.

JPY depreciation risk factors

	Risk	Detail	Weak JPY/Strong JPY	Possibility
①	U.S. economy is surprisingly robust	Trump administration's expansionary fiscal policy	Weak JPY	medium/high
②	Discontinuation of the Trump administration's protectionist policies	Complete resolution of US-China trade war (Complete elimination of additional tariffs)	Weak JPY	low/medium
③	Trump's defeat in U.S. presidential election	Warren/Sanders' triumph of leftist forces	Strong JPY	low
④	“No Deal” Brexit concerns	No deal to delay transition	Strong JPY	low/medium
⑤	Boom in cancellation of negative interest rates	Europe led by the ECB & BOJ	Strong JPY	low
⑥	Geopolitical risk	Military intervention in demonstrations in HK/ U.S.-Iran military clash	Strong JPY	low

(Source) by Karakama, Mizuho Bank

In fact, this US election situation is probably the largest potential risk factor during the coming year, but there are other significant risk factors. The six main risk factors that I am concerned about are listed in the table on the next page. First, as I have been arguing each month, given that the US economy has already realized an exceptionally lengthy expansion period, it appears that only an exogenous shock from the Trump administration (fiscal stimulus programs) could prolong and accelerate that expansion. This is risk factor ① in the chart. As 2020 is a US presidential election year, it seems that this risk has a fairly large chance of eventuating this year. With respect to this article's JPY appreciation scenario, this is the most worrisome risk factor. Another risk factor related to the Trump administration that one should be closely monitoring is the JPY depreciation risk associated with risk factor ②. Just as in 2019, it is likely this year that, when there are signs of progress in resolving the US-China trade war, market sentiment will become more optimistic, thereby promoting trends of stock price increases and JPY depreciation. It seems that the sharp upturns in US interest rates and stock prices seen during the October-December quarter of 2019 clearly reflected growing expectations that US-China trade negotiations would be successful, and this kind of

reaction to trade negotiation progress is probably likely to happen in 2020 also. If a scenario involving something akin to a complete elimination of punitive tariffs were to occur, it could have a very large upside impact on USD/JPY. As explained below, when considering unexpected risks in 2020, one gets the impression that the “number” of JPY appreciation risk factors is greater than the “number” of JPY depreciation risk factors. Regarding the “likelihood” of risk factors eventuating, however, risk factors ① and ② are cause for concern despite constituting only two risk factors, since they have a quite high likelihood of eventuating.

### ***Continued “No Deal” Brexit Concerns***

The remaining risk factors – ④, ⑤, and ⑥ – are JPY appreciation risk factors. In particular, there is cause for concern about the possibility of a no-deal Brexit, or risk factor ④. The Conservative Party’s overwhelming victory in the December 12 UK general election has boosted optimism about the Brexit process, but that process is actually still on the starting line. Although the current UK-EU economic relationship can be sustained during the transition period through the end of 2020, it seems extremely difficult for the UK and the EU to successfully negotiate and ratify a new trade relationship framework during that transition period, so that the framework can take effect from the start of 2021. A failure to conclude a free trade agreement by the end of 2020 will result in the imposition of tariffs and/or non-tariff barriers at the end of the transition period (from 2021), which is what is referred to as a no-deal Brexit. Since most of the trade agreements the EU has signed so far have required several years from the start of negotiations to ratification, it seems somewhat unrealistic to anticipate that negotiations can be successfully completed during a period of only 11 months. Consequently, there remains due cause for concerns about the possibility of a no-deal Brexit.

Of course, if both the UK and EU decide by the end of June 2020 that they would like to extend the transition period, they have the option of extending the transition period by up to two years, at the discretion of the UK/EU Joint Committee. However, UK Prime Minister Boris Johnson vehemently denied any possibility of such an extension prior to the general election, so he appears to have cut off any avenue for retreat on this issue. On the other hand, so long as his Conservative Party holds a majority of Parliament seats, it is possible for Prime Minister Johnson to withdraw his previous vow and resort to an extension. Given that the Brexit issue is a high profile issue on which Prime Minister Johnson has personally made the decision and bears personal responsibility for that decision, however, it will be impossible for him to make the opposition parties share responsibility for any Brexit-related problems, and such problems could sharply reduce his support among voters. It seems likely that Prime Minister Johnson will contrive some sort of an excuse to maintain face for both sides by requesting a postponement, but given his political savvy, he is likely to delay such a request until the last minute. It seems unlikely that misunderstandings between the EU and the UK will lead to a no-deal Brexit, but the possibility of that cannot be completely discounted.

### ***Possibility of Negative Interest Rate Discontinuation***

In addition, risk factor ⑤ relates to the possibility that other central banks may emulate the Swedish central bank’s (Riksbank’s) December 19 move to discontinue its use of negative interest rates. Of course, Riksbank’s move is in response to the problem of rising housing prices and associated growth of household debt in Sweden, which is not exactly the situation in other countries with negative interest rates. However, the fact that interest rates have been raised despite non-rock-solid economic and financial situations was confirmed in Riksbank’s report, which noted that – “the Swedish economy is going from a stronger-than-normal cycle to a more normal situation” – and this seems to indicate that the focus was on the side effects of the negative interest rate policy rather than the policy’s intended effects.

In both Europe and Japan, growing numbers of observers are noting that negative interest rate policies’ side effects may be more powerful than their intended effects, but Sweden is the first case in which this view actually led to a policy change. If continued improvement is seen in the global political, economic and financial situation, it would not be surprising to see interest rate hikes by other central banks employing negative interest rates. (At the time this article was written, these included the central banks of the Eurozone, Denmark, Switzerland, Hungary, and Japan.) If those interest rate hikes are implemented while the FF rate stays flat (as suggested by the dot plot described above), the US-Japan and US-EU interest rate gaps will shrink, promoting USD depreciation, JPY appreciation, and EUR appreciation. Of course, since both the ECB and the BOJ are greatly concerned about the sluggishness of inflation rates in their bailiwicks, there will be high hurdles on the paths to their raising of interest rates regardless of strong arguments that negative interest rates have reached reversal rate levels. In the central bank watcher world, which is dealing with a diminishing number of major themes, however, the issue of whether negative interest rates can be discontinued or not will be a key focus of attention along with digital central bank digital currencies (CBDCs) and environmental protection measures. Other JPY appreciation risk factors include geopolitical risks that cannot be ignored. Specifically, these risks relate to such situations as the possibility of Chinese military intervention to counter demonstrations in Hong Kong and the possibility of US-Iran military clashes. While these situations are not likely enough to be incorporated within the main scenario, the risks they could present are worth keeping in mind during the coming year.

## EUR Outlook – Interpreting ECB President Lagarde’s Debut Performance

### Euro Area Monetary Policies Now and Going Forward – Aiming to Be an Owlishly Wise ECB President

#### ***ECB President Lagarde’s Debut Press Conference – Insight into “the Kind of Person” She Aspires to Be***

At the December 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 -0.50%, respectively, thereby also maintaining the interest rate corridor (the difference between the ceiling and the floor) unchanged at 0.75pp. ECB President Lagarde’s first GC meeting had a moderate tone throughout, in sharp contrast to the first Governing Council meeting of former President Draghi, who was forced to present a comprehensive easing package immediately after his inauguration. At the latest Governing Council meeting, monetary policies were less of a focus than President Lagarde herself. The meeting can be said to have been a highly noteworthy opportunity to gain an understanding of her policy stance and communication skills as well as “the kind of person” she aspires to be. As it was her first Governing Council meeting, President Lagarde began the press conference by saying – “Before the questions I’m going to take just a couple of minutes of your time to tell you a few things.” – and then took considerable time to explain the nature of her personal style as well as the ECB’s strategic review. Both her style and the strategic review are quite interesting subjects that I think worth discussing separately in the following sections of this article.

#### ***“I’m going to be myself”***

Regarding communication styles, President Lagarde said – “each and every President has his or her own style of communicating. I know some of you are keen to compare and rate or rank. I will have my own style. As I’ve said before, don’t over-interpret, don’t second-guess, don’t cross-reference. I’m going to be myself and therefore probably different.” Indeed, it was noticeable throughout the press conference that – unlike former President Draghi, who responded to awkward questions with confusing smokescreens (that was his personal technique) – President Lagarde spoke in an easily understandable manner that enabled listeners to clearly grasp individual arguments and the reasoning underlying them. Some people may be inclined to discount the significance of her calm and easy-to-understand style, as it was President Lagarde’s first press conference and the press conference was held at time when there was no urgent need for an monetary policy response measure. However, given President Lagarde’s experience leading the IMF when the European debt crisis was generating intense pressures, it does in fact seem quite likely that she will be able to sustain a calm demeanor and continue “being herself” going forward. Just before beginning to take questions, President Lagarde mildly admonished the reporters, saying – “You are a main audience for the central bank. But you are not the only audience, and I would also encourage you not to try to draw too many conclusions or decisive findings from communication that I would address to a different audience with a slightly different language in order to be maybe better understood by those who do not have your level of skills and in-depth knowledge of the matters that we deal with.” Broadly interpreted, these simple remarks appear to be acknowledging that the ECB president’s words have a formidable market-moving power and it is dangerous to over-interpret them. This appears to indicate that President Lagarde will be making painstaking efforts to maintain a clear-cut communication style.

#### ***Strategic Review – To Be Completed before the End of 2020***

The second subject of President Lagarde’s introductory remarks at the press conference is the ECB’s strategic review, which is attracting a great amount of attention. Currently, rather than focusing on the ECB’s next policy move, ECB watchers are more keenly interested in the kinds of issues and arguments that will be incorporated into the ECB’s strategic review process. However, the most recent Governing Council meeting’s introductory statement did not say anything about the strategic review. Preempting related questions, President Lagarde said – “some of you will be disappointed that it does not include anything having to do with the strategic review. It is intended to be that way, so the introductory statement does not include, does not refer and should not be associated with the strategic review that we are considering.” So it appears that the ECB now has a policy that the Governing Council meeting statements should not discuss the strategic review, and this policy may be considered a reasonable one. If the goals of the “current policy strategy” and the “new policy strategy” are different, then mixing the disparate goals together in Governing Council meeting statements will undoubtedly make the logic of decision making difficult to understand. In responses to a related question from a reporter, President Lagarde seems to hint that the Governing Council meeting statements cannot discuss the strategic review because the strategic review framework – “has not yet been completely agreed and discussed with members of the Governing Council.” President Lagarde said she intends to proceed with the strategic review while consulting with members of the European Parliament, academic societies,

and the general public, and she also said that she has no pre-determined conclusions. Moreover, she said the strategic review – “will also address the major changes that have taken place over the course of the last 16 years” – including climate change, technological progress, and widening economic disparities. Considering such a wide range of issues does appear to be a new kind of approach for the ECB.

Before beginning to take questions, President Lagarde preempted inevitable questions about the key issue of the strategic review process’s time schedule, saying – “that strategic review needs to be comprehensive, needs to look at all and every issue, will turn each and every stone and will take its time but will not take too much time. By that I mean my plan is to actually get the review started in the course of January. Don’t ask me which week or which day or which second, but it will be in the course of January. Our goal is to complete it before the end of 2020.” So the review process is expected to require all of 2020 to complete, and this is in line with the assumptions previously expressed in this article.

### ***Neither Dove nor Hawk but Owl***

In response to a question about her policy stance within the Governing Council, President Lagarde answered – “once and for all, I’m neither dove nor hawk and my ambition is to be this owl that is often associated with a little bit of wisdom.” – and this statement made headlines. President Lagarde then added that she would like to elicit wisdom from all Governing Council members and make monetary policy decisions that are as consensual as possible. That was a characteristic remark for President Lagarde, who has a reputation for excellent coordination capabilities, and it appears that she is already taking potential internal rift lines into account. But she qualified her position, saying – “I am not suggesting that we will arrive at complete agreement on everything” – and this appears to suggest that Governing Council decisions will sometimes be made on the basis of majority votes, as unanimity among the Governing Council’s more than 20 voting members is difficult to achieve.

### ***Regarding Negative Interest Rates***

Regarding specific monetary policies, many observers have raised questions about the side effects of negative interest rates. The increased focus on the problematic side effects of negative interest rates has already become widespread at such venues as euro area finance minister meetings (Eurogroup meetings), and President Lagarde was asked at the press conference about her opinion regarding the widely reported view of a Governing Council member, Bank of Italy Governor Ignazio Visco, who recently said in an interview with the German newspaper Handelsblatt that negative interest rates were almost useless and quantitative easing (QE) was more effective. President Lagarde acknowledged that negative interest rates have side effects, but she did not comment on whether reversal rate effects might outweigh negative interest rates’ positive effect nor on whether negative interest rates were superior or inferior to such other policies as QE. Asked about whether the reversal rate was exerting an effect in the current interest rate environment, President Lagarde said – “my understanding of the reversal rate is that you are facing a reversal rate when credit begins contracting. That’s how in economic theory the reversal rate is defined.” – and she went on to note that the euro area’s current credit expansion (growth in new lending) indicates that the reversal rate has not yet been reached. It will be interesting to see if her view changes in 2020 and subsequently following such developments as Sweden’s decision (on December 19, soon after the December 12 Governing Council meeting) to discontinue the use of negative interest rates.

Asked to compare the effectiveness of negative interest rates and QE asset purchases, President Lagarde said that the ECB’s monetary policies form a package of policies with complementary effects, stating – “The two-tier [negative interest rate] system is also part and parcel of the package. I wouldn’t take a view on one element or the other.” More specifically, regarding the yield curve, she said the (negative) policy interest rate impacts the short-term portion, forward guidance impacts the medium-term portion, and the asset purchase program is intended to impact the long-term portion, so it would not be useful to try to compare the effect of individual elements of the policy package in isolation from each other. This is a classic answer in line with the kind of answers the ECB has given in the past, and it reflects the same logic underlying many statements by former President Draghi. The gist of that statement, however, is that assessing the benefits and demerits of negative interest rates cannot be done simply on the basis of whether credit is contracting or expanding – the issue of whether negative interest rates should be discontinued must be considered in the context of the role of negative interest rates in conjunction with other monetary policies.

### ***Outlook for a Digital Euro***

Aside from monetary policy management issues, a question was posed about the digital euro and central bank digital currencies. After the EU Economic and Financial Affairs Council (ECOFIN) made a statement urging the ECB to prepare for digital currencies, the ECB is in the position of having to muster some sort of response. Asked about this, President Lagarde said the ECB has already set up a task force and intends to accelerate work by cooperating with national central banks in the euro system that have already started experiments and pilot projects, aiming to identify what the ECB is aiming for in this regard by mid-2020. It goes without saying that ECB’s review of its monetary policy strategies is of utmost importance, but deciding how to deal with the digital euro is also expected to be a significant new task for the Lagarde-led ECB. It can be surmised that President Lagarde is pleased to be able to have the leeway to deal with such big issues given that there is currently no urgent need to consider the next move

regarding monetary policy. As ECB watchers encounter this kind of situation only once every few decades, I will be very attentively observing related developments.

## **Should Monetary Policy Incorporate Environmental Protection Measures? – Better to Focus on Controlling Inflation Rather than the Environment**

### ***Need to Revise the ECB's Definition of "Price Stability"***

As mentioned above, having assumed her new position in November, ECB President Lagarde's first major mission will be to radically revise the ECB's definition of "price stability" (currently, "below, but close to, 2% over the medium term") and reconsider the ideal nature of the ECB's monetary policy strategies. Since the previous strategic review was done in 2003, the current review is the ECB's first fundamental review of its monetary policy strategy in 17 years, so it can be considered a major project. A straightforward consideration of the price stability definition can easily lead to the misinterpretation that the ECB will tighten its monetary policies if the inflation rate reaches 2%, so the ECB has been seeking to clarify that the 2% level is a "symmetric" target – in other words, overshooting the target is just as acceptable as undershooting in the short term. It appears that the ECB's goal in making the target "symmetric" is to emphasize that it does not see a need to immediately launch countermeasures when the inflation rate exceeds the target rather than undershoots it. For example, since inflation rates of 1.5% and 2.5% have the same margin of deviation (0.5% percentage point) from the 2.0% target, they can be considered to be comparable and calling for similar responses. The importance of this process of "clarifying the symmetry of our aim" was clearly emphasized by former President Draghi at the ECB's annual meeting in last June, and now the project will be taken over by President Lagarde.

### ***EU Now Very Serious about Environmental Issues***

Such a revision of the price stability definition is a necessary measure in line with the times. At this point, however, we are seeing intermittent reports about other ECB initiatives that are cause for concern. ECB President Lagarde has expressed her interest in having the bank's strategic review address the climate change issue and stated that she intends to make environmental issues a key factor to be considered in monetary policy management. European Commission President Ursula von der Leyen, who assumed her post at the same time as ECB President Lagarde, emphasized in a speech at the European Parliament that a European Green Deal program was essential and that there is an urgent need to establish new environmental protection systems. The fact that the two new top-level EU leaders have so strongly emphasized environmental issues suggests that the level of concern about such issues is stronger in Europe than in other countries and regions.

### ***Are Central Banks Positioned to Do Something about Environmental Issues?***

Regardless about how important environmental issues may be, however, the question of whether a central bank should be addressing such issues is a completely separate matter. Frankly speaking, it does not seem unreasonable to manage monetary policies in a manner that takes environmental issues into account. In this article, I would like to consider two related points – (1) the difficulty of imagining the policy transmission routes for the ECB to address environmental issues and (2) the confusion about the scope of the ECB's institutional role. Again, the key question focused on here is not whether climate change is an important issue or not, it is whether it is reasonable for a central bank to become active in addressing climate change and other environmental issues.

First, regarding point (1), it seems likely that most market participants simply cannot imagine the prospective policy transmission route(s). It is difficult enough for a central bank to handle its original responsibilities for controlling prices and wages and moderating fluctuations in economic conditions, so how could a central bank make a meaningful contribution to controlling climate fluctuations? What kind of measures and transmission routes could a central bank utilize in order to be confident of exerting a significant impact on climate change? And how would one verify the efficacy of the bank's efforts? Some people believe that climate change is a phenomenon that should be considered in 10,000-year time units, that it is a long-term phenomenon in which several generations of people replace each other by the time economic agents clearly realize the changes triggered long ago. How can one design optimal monetary policy countermeasures when it is difficult to determine when current climate changes may have been (or might not have been) triggered by some kind of past economic activity? It seems somewhat arrogant that a central bank ordinarily focused on monthly fluctuations in stock prices and forex rates would take it upon itself to address environmental variables that change over eons of time. Another issue is that, if global warming really has a causal relationship with the intensification of human economic activities, then it may be considered optimal to counter global warming by tightening monetary policies in order to diminish human economic activities. This seems to be the simplest and most easily understandable route for using monetary policies to affect climate change, but it seems unlikely that a central bank would openly choose such a route.

The UK-based Financial Times recently reported that Bank of France Governor François Villeroy de Galhau told it that by increasing energy prices and lowering economic growth, global warming could cause a stagflationary shock,



which meant it was already part of the ECB's price stability mandate. The logic of that statement is not unreasonable. However, I am not alone in raising the fundamental question of whether monetary policy can be an effective means of controlling climate change. Governor Villeroy de Galhau also says that climate change should be included in the ECB's economic forecasts and models. Such forecasts and models are revised on a quarterly basis, however, and it is not uncommon to see ECB staff projections with a directionality quite different from the same projections made a year previously, so it is questionable whether the ECB's next policy move will be affected if environmental issues are incorporated in the bank's forecasts and models. Moreover, many people would agree that if the ECB cannot effectively address its avowed fundamental and immediate objective of boosting the inflation rate to 2% and stabilizing it at that level, then there is little likelihood that it will be more effective at addressing additional, more ambitious tasks. It is worth noting that Governor Villeroy de Galhau is a founding member of the Network for Greening the Financial System (NGFS), which presented a report to the BOJ at the end of November, and he is likely to continue making statements about expanding central banks' environmental protection roles going forward.

### ***What Can Central Banks Actually Do?***

Last November 28, ECB Executive Board member Benoit Cœuré said – “Central banks cannot be at the forefront in fighting climate change. This is and should remain a political task. But they can help within their mandates.” I basically agree with the first sentence of that statement, but even if one were to agree with the last sentence of the statement, one has to give some consideration to the actual extent to which central banks could conceivably “help within their mandates.”

In this regard, the concept of a “Green QE” program designed to promote the acquisition of a greater number of “green bonds”<sup>1</sup> (bonds issued by environment-friendly enterprises) within the framework of QE programs is being bandied about among ECB officials. Even Governor Villeroy de Galhau, who has expressed support for giving greater consideration to environmental issues, has voiced qualms about the Green QE, saying – “Massive purchases on a relatively shallow pool of green bonds could seriously distort the market.” But the real issue is not related to how large or small the green bond market may be. Last October, Deutsche Bundesbank President Jens Weidmann criticized the Green QE concept, saying – “it is not immediately apparent why efforts to combat climate change should only be made when price pressures are weak.” – and I concur with his view. Even if environmental measures are acknowledged to be urgently important, implementing them in the form of QE purchases implies that the measures should be discontinued when economic conditions make monetary easing (≈ QE) unnecessary. It should be remembered that provisions to ensure central banks can operate independently from politics have been made precisely so that central banks would never be forced to make such unnecessary political judgements. In addition, there is a possibility that other schemes for promoting green bonds may be devised, such as a scheme in which a central bank's permanent liquidity supply system would give preferential treatment to green bonds received from private-sector banks as collateral. It is true that this might be considered a sustainable measure through which central banks could “help within their mandates.” However, such an approach would probably be difficult to implement in the absence of a quantitative measure of how environment friendly (or unfriendly) the relevant assets are.

### ***Should Central Banks Be Doing It in the First Place?***

Even if environmental issues are very important and there are ways that central bank can effectively address the issues, there remains the fundamental question, “should central banks be addressing environment issues in the first place?” This relates to the abovementioned point (2) “confusion about the scope of the ECB's institutional role.” As noted by ECB Executive Board member Cœuré above, basically, addressing environmental issues is “a political task”, not the responsibility of a central bank that must maintain its political neutrality. In his speech last October, Deutsche Bundesbank President Weidmann said – “How hard should government, business and society push back against climate change? These are political questions for elected governments and parliaments to answer. They are decisions which are not for central banks to take, because they lack the requisite democratic legitimacy.” In the case of the above-described approach of handling collateral in different ways based on environmental standards, it is questionable whether it is appropriate for a central bank to go so far as to become directly involved in the financing of private companies, regardless of whether the companies are evaluated as environment friendly or unfriendly. One might not mind that so much if the assessment method is simple and completely indisputable, but even then there are likely to be subtle cases in which the bank's judgement is called into question. For example, what happens if Company A is given preferential treatment over Company B owing to the companies' respective environmental impact levels, and then Company B files a complaint?\_ Since the central bank is not an institution with expertise related to environmental issues, it will have to consult third party experts. Such consultations may also be controversial, leading to disputes about such issues as whether the third party consultant was appropriate. Fundamentally, it is unsound to have monetary policy management specialists who should be focusing on price

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<sup>1</sup> Bonds issued to fund a limited range of enterprises that contribute to environmental improvements, such as solar and wind power generation projects and other renewable energy enterprises.

stability extend their activities into areas outside their core competence. Central banks' original mission is to pursue price stability from a neutral standpoint, and it is undeniable that branching out toward new policy objectives will diminish the clarity of policies associated with the original mission.

### ***Internal Rifts to Be Repaired or Expand?***

Besides the ECB, there are other central banks that appear to have an interest in addressing the climate change issue, but movements in that direction are currently at a standstill. Last July, Fed Chairman Jerome Powell told the US Congress that – “I see climate change as a longer-run issue. I don't know that integrating it into the day-to-day financial supervision of financial institutions would add much value.” – but he declined to explicitly acknowledge the potential impact addressing the climate change issue might exert on the Fed's core central banking responsibilities. A key problem is that the time frames of environmental issues and central banking activities are completely different. Under Governor Mark Carney's leadership, the Bank of England (BOE) recently announced that its “stress tests” will seek to assess domestic banks' exposure to climate-change-related risks, but the BOE is apparently not yet eager to dedicate a portion of its own monetary policies to combatting climate change. The Bank of France has also indicated its intention to subject domestic banks and insurance companies to climate change stress tests this year. It is likely that many central banks' may undertake climate change stress tests as an initial step toward directly addressing the climate change issue, but it remains questionable whether the banks will subsequently move to further escalate their climate change-related measures.

Globally, although climate change is acknowledged to be an important issue, the mainstream view is that it is not an issue that central banks should be addressing through monetary policies. If ECB President Lagarde follows through with her tentative indications that she may incorporate environmental issue-related factors within the ECB's new monetary policy strategy, then she will probably be considered a leader in this respect (regardless of whether such an initiative is appropriate or not). If she were to insist on becoming a leader in this way despite opposition from what can be assumed to be a considerable number of officials who may disagree with the initiative in whole or in part, however, she would probably run the risk of further widening existing rifts among Governing Council members. Debates about long-term strategies that cannot be easily modified once decided are bound to require considerably more time and effort than deliberations about short-term monetary policy management decisions, and it does not appear that the time is yet ripe for incorporating environmental issue-related factors within the ECB's new monetary policy strategy.

It is generally understood that President Lagarde is optimistic that her renowned coordination capabilities will enable her to repair the cracks of dissension that arose within the Governing Council during President Draghi's tenure. Nevertheless, there is some cause for concern that her bringing a new contentious issue to the table immediately after taking office may complicate the task. Germany has already clearly articulated its opposition to having the ECB directly engaged in fighting climate change. One can only hope and pray that the Governing Council's cracks of internal dissension will somehow be repaired rather than grow wider. This situation, along with the central bank digital currency issue, is likely to be a major financial theme worth closely monitoring during 2020.

## **Appendix 1: How to Interpret Sweden's Abolition of Negative Interest Rates – Hints for 2020**

### ***Interest Rate Not Negative for First Time in Five Years***

On December 19, Sweden's central bank (Sveriges Riksbank) decided to raise its policy interest rate, the repo rate, by 25 bps, bringing the rate up to zero. With this, Sweden ended its negative interest rate policy of around five years, since February 2015. The official statement emphasized that the December rate hike was not the start of a series of rate hikes, stating that the “forecast for the repo rate is unchanged, and the repo rate is expected to remain at zero per cent in the coming years,” but it is quite significant that this decision to exit the negative interest rate policy out of concern for its side effects was made at a time when the economic and inflationary conditions were less than remarkable. To what extent will this move by the Riksbank affect (or fail to affect) Europe, the pioneer of negative interest rates? This will be a key point to take into account when considering the monetary policies of other central banks (especially the ECB and the BOJ) in 2020. Of course, one should make simplistic comparisons cautiously given that every central bank's situation is different, but the fact is that this kind of discussion has started taking place in Europe. If the ECB begins to discuss this issue seriously, it is very likely that the BOJ, which tends to be easily swayed by external influences, will be affected.

### ***The Point is that the Move is in Response to Adverse Effects***

The important thing about the recent rate hike is that it was not implemented in response to the economy overheating, but rather as a countermeasure against the side effects of negative interest rates. Though it was not explicitly stated that the move was in response to adverse effects, it is certain that it was made taking side effects into account. Riksbank Governor Stefan Ingves, while acknowledging that the negative interest rate policy helped boost economic activity, told reporters, “It is a completely different question what would happen in an economy if you had

negative rates for a very long period.” The recent move, then, was due to “fear” over what might happen if negative interest rates were continued. In both Europe and Japan, concerns that the adverse effects of negative interest rates could be greater than its benefits have been gradually strengthening, but there have been no instances of actual changes in policy based on these concerns. The recently released Monetary Policy Report (hereafter: Report) noted: “That the repo rate is being raised from the very lowest levels when the economy is weakening from a strong level does not mean that the inflation target is in jeopardy. An interest rate of zero per cent, in combination with large holdings of government bonds, means that monetary policy will remain expansionary and thereby create the conditions for inflation to remain close to the target. The real repo rate is expected to remain negative over the entire forecast period.” The noteworthy point in the above is not “the real (emphasis mine) repo rate,” but the Riksbank’s acknowledgement that “the repo rate is being raised from the very lowest levels when the economy is weakening from a strong level.” According to the economic and inflation forecasts released at the same time, Sweden’s real GDP for 2019 and 2020 is forecast to be +1.1% and +1.2%, respectively, and another indicator the Riksbank pays close attention to when making policy decisions, the Consumer Price Index with a Fixed Interest Rate (CPIF; CPI excluding the impact of housing loans), is also expected to be somewhat sluggish, at +1.7% and +1.7%, respectively, for the two years.

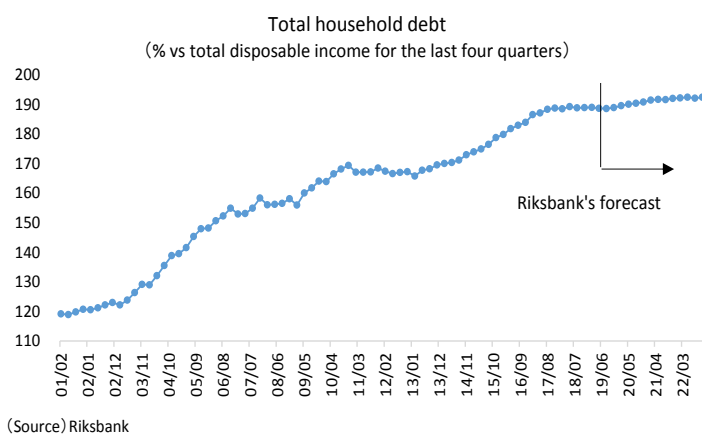
The Report explains the background to implementing rate hikes despite this condition of the economy as: “if negative nominal interest rates are perceived as a more permanent state, the behaviour of economic agents may change and negative effects may arise.” (This is similar to the remark by Mr. Ingves.) The Report includes a textbox titled “Side-effects of monetary policy,” which explains that, if things continue the way they are, negative interest rates could be applied to personal deposits (something that has already happened in Germany and Denmark). As per the Riksbank’s analysis, the reason for “banks not having introduced negative deposit rates for households (could be) due to banks having perceived the negative policy rate as temporary. If the period of negative policy rates is expected to be more permanent, the introduction of negative deposit rates for households cannot be ruled out.”

Apart from this, the Report points out, for instance, that asset prices, especially housing prices, have been increasingly stronger as an inevitable result of negative interest rates, and that as a result of this, household debt in relation to household income has been on the rise. This is the main concern for the Riksbank at the moment. The Report expresses concern that

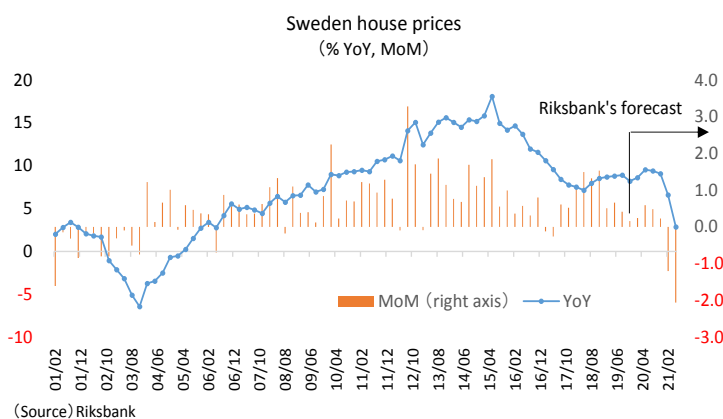
“low interest rates can create incentives for excessive risk-taking,” and that, if asset prices continued their sharp rise, “the indebtedness of various agents (including households) may increase in an unsustainable manner.” In this connection, it must be noted that the ratio of household debt to disposable income is increasing in Sweden and this deterioration is expected to continue during the current forecasting period (see chart to the right, top). If housing prices were to start falling, the resulting correction in household balance sheets could push the country’s real economy into a long-term stagnation, which is certainly not a minor concern. We already know based on the experience of the U.S. following the subprime mortgage crisis that, if something like the above were to happen, it would take quite a long time for the economy to get back on track again. The Riksbank seems to assume that housing price trends will change once negative interest rates are removed. However, it remains to be seen whether or not that will happen (see chart on previous page, bottom).

### Considerable Thoughtfulness Comes Through

The Report shows that a great deal of effort was put into ensuring that the recent rate hike would not be perceived as the start of a phase of monetary tightening. For instance, the concluding line in the Report summary states that “the repo rate is expected to remain at zero per cent in the coming years,” expressing the Bank’s desire to soften what may be seen as an austerity bias. The Report predicts that the repo rate will be maintained at 0% until the end of 2021 and be raised to +0.1% by the end of 2022. In other words, the main forecast scenario as of the present time



(Source) Riksbank



(Source) Riksbank

is that the repo rate will remain unchanged for the next two years. The Report is also structured in such a way that a paragraph titled “Repo rate raised to zero per cent” is followed immediately by another one titled “A repo rate of zero per cent provides continued support,” indicating that no efforts were spared to emphasize that a 0% repo rate is an accommodative measure that will continue to provide support.

Further, while noting that “In the longer term, it is reasonable to expect the repo rate to be higher than zero per cent,” the Report goes on to explain that “lower rates and uncertainty about economic and inflation development abroad and in Sweden make it difficult to say at present when it will be appropriate to raise the rate next time. The forecast indicates that the repo rate will be unchanged during almost the entire forecast period.” It, however goes on to say that “The forecast assumes that uncertainty will gradually decrease in the period ahead and that the economic outlook will stabilise.” The Report also hints that it is possible to go back to negative interest rates at short notice, should there be signs of instability, saying, “if the economy were to develop more weakly than what is consistent with the forecasts, the Executive Board could both cut the repo rate and take other measures to make monetary policy more expansionary.” The presentation slides that were used at the press conference even contained the phrase, “In a world with low interest rates, the repo rate may periodically need to be negative.” Overall, one got the impression that the Executive board was working to present both sides of the argument (justifying both rate hikes and rate cuts) while also laying emphasis on the message that “we can return to negative interest rates any time.”

### ***The Significance of Having Avoided a Currency Appreciation***

The most typical example of how negative interest rates help boost the real economy is the increase in exports accompanying the devaluation of the currency. To look at this another way, when deciding to end negative interest rates, the biggest obstacle for a country is the likelihood of a drop in exports as the currency gains value. In the first place, the reason for Sweden, Switzerland, and other non-euro European countries adopting low interest rate policies was to address the fact that their domestic currencies ended up appreciating steeply in response to the extreme weakening of euro in the wake of the sovereign debt crisis. Now, however, the euro area is no longer in a crisis, though its economy is slowing. There is no longer a wide enough disparity between Sweden and the euro area to cause forex market imbalances. It seems likely that the Riksbank saw this as a good time to exit negative interest rates without triggering a dramatic currency appreciation. In fact, though the Swedish krona (SEK) appreciated against EUR briefly right after the recent decision, it fell back right away and has since remained more or less level. Of course, the response of the forex market depends on various conditions, so the recent experience cannot be applied as is to all scenarios. However, it is probably a relief for the ECB and the BOJ to see that SEK did not appreciate that much despite the termination of negative interest rates.

### ***Levied Taxes Will be Passed On***

Regardless of its currency appreciating or not appreciating, there were some important lessons from the Riksbank’s recent decision. No matter how one presents it, a negative interest rate is a tax on the financial sector. The amount of taxes levied will be transferred to customers in the form of service prices at some point down the lane. So long as financial institutions are for-profit organizations, there is no reason to assume otherwise. In fact, in Europe, which is the pioneer of negative interest rates, a negative interest rate is already being applied to private deposits. Though slightly lagging behind Europe, a similar trend has already begun in Japan, in the form of various fees and commissions. Going by the Riksbank’s monetary policy statement and report, a desire to deal with this situation before such trends spread seems to be the clear motivation behind its recent decision.

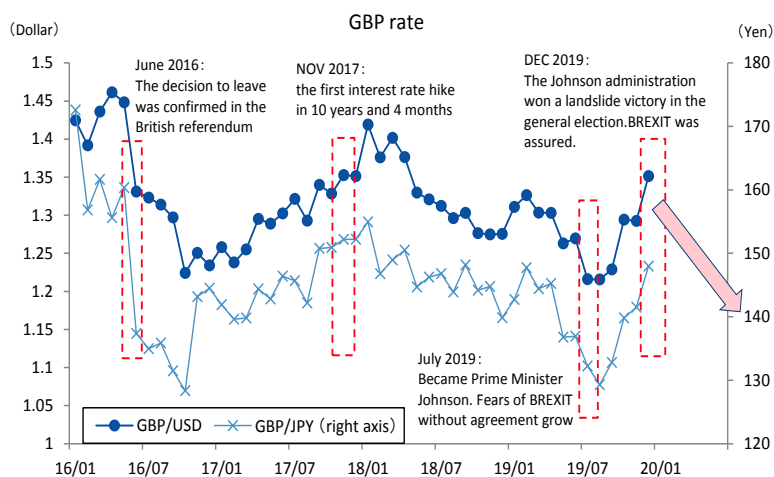
In sum, so long as negative interest rates continue, the banking sector has only two options, (1) to transfer the costs by spreading them wide and thin, or (2) to bear the cost burden and decline. If both (1) and (2) are to be avoided, the central banks will have to take drastic measures similar to the Riksbank. Only countries that show a strong correlation between “negative interest rates and weak domestic currency” and “weak domestic currency and strong exports” as well as having economic structures that require strong exports to survive may be justified in continuing with negative interest rates. Barring that, we are definitely entering a phase where the point of continuing with negative interest rates is beginning to be questioned. The Southern European countries, led by Italy, are always quick to blame currency appreciation for all their problems, but Governor of the Bank of Italy Ignazio Visco went so far as to declare that negative interest rates were mostly useless and could have harmful side-effects on the financial system. This is proof that people are beginning to experience for themselves that the demerits of negative interest rates outweigh their merits.

How much support can the idea that ending negative interest rates is not an end to monetary easing, but rather a means to increase the effectiveness of monetary easing in the long term gain in Europe, the birthplace of negative interest rates? In other words, how much support can the argument that current interest rates are equivalent to the “reversal rate” gain? It will be very interesting to see what the implications of the Riksbank’s recent decision are for monetary policy operations in 2020.

## Appendix 2: Future GBP Trends – How Will GBP Move When Brexit Actually Takes Place?

### **Dissipation of the Post-Election GBP Surge**

The United Kingdom's Conservative Party led by Prime Minister Johnson won a historic landslide victory in the British House of Commons general election on December 12, so the United Kingdom is in a position to implement Brexit some time up to the current deadline of the end of January 2020. However, it seems unlikely that the UK and EU will be able to agree on and implement a new trade relationship during the current transitional period, which is scheduled to end on December 31, 2020. While GBP soared immediately after the general election, it appears that the current trend of GBP depreciation reflects market participants' belief that the same kind of forex trends



(Source) Bloomberg (Note) December 2019 was the highest since the general election

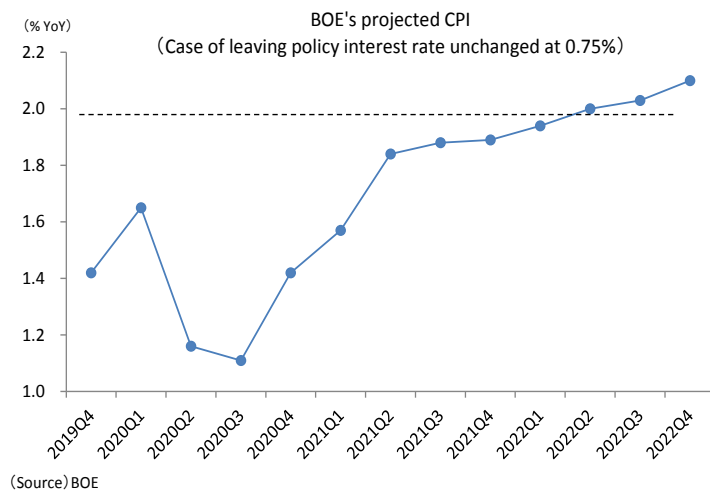
are likely to recur some time before June 30, 2020, the deadline for further postponing the end of the transition period. The Conservative Party's acquisition of a large-margin majority in the House of Commons has resolved the "indecisive parliament" problem, and Prime Minister Johnson's government has pledged to refuse to extend the transition period, which is currently scheduled to end on December 31, 2020. Of course, there will be no problem if the UK-EU trade negotiations have been concluded by that time, but considering the complex ties between the interests of the UK and the 27 other European Union countries involved in Brexit negotiations, it seems somewhat unrealistic to expect that a consensus agreement can be easily reached in just 11 months. As mentioned, the deadline for extending the transition period is June 30, 2020, but in light of the history of Brexit related developments to date, it appears highly likely that difficult negotiations will proceed until just before that deadline. Given that, it might seem that the most reasonable risk management move would be to proceed with trade negotiations while immediately beginning the concurrent negotiation of a transition period extension; however, a series of statements and actions by Prime Minister Johnson gives one the impression that it may be unrealistic to expect him to make related concessions.

The European Commission has already begun to express its concern about this situation. The director-general of the EU's trade department, Sabine Weyand, is reported to have said on December 17 that – "Given all the signals... we are well advised to take seriously that the UK does not intend to go for an extension of the transition and we need to be prepared for that. That means in the negotiations we have to look at those issues where failing to reach an agreement by 2020 would lead to another cliff-edge situation." GBP depreciated sharply in response to this statement.

### **Political Risk Factors along with the Risk of an Interest Rate Reduction**

Although political instability factors have long been exerting downward pressure on GBP, it is important to note that economic and financial factors are presenting what appears to be a rather large downside risk for GBP. On November 7, the BOE's Monetary Policy Committee (MPC) decided to keep the policy rate unchanged at 0.75%, but it was considered surprising that two out of the nine MPC members (Michael Saunders and Jonathan Haskel) voted for a rate cut at that time. A portion of the meeting's Summary and Minutes – "If global growth fails to stabilise or if Brexit uncertainties remain entrenched, monetary policy may need to reinforce the expected recovery in UK GDP growth and inflation." – suggests a conditional possibility of monetary easing measures (an interest rate cut). On the other hand, the Summary and Minutes goes on to state that – "provided these risks do not materialise and the economy recovers broadly in line with the MPC's latest projections, some modest tightening of policy, at a gradual pace and to a limited extent, may be needed to maintain inflation sustainably at the target." – and the "MPC's latest projections" are of key importance in interpreting that statement. The Summary and Minutes clearly states that the projections – "are now based on the assumption of an orderly transition to a deep free trade agreement between the United Kingdom and the European Union." In other words, the MPC is assuming that UK-EU FTA negotiations will proceed smoothly during the transition period, and consensus building will be completed before the transition period ends in 2021 or subsequently. It seems likely that the two dissident MPC members are proposing a rate cut because of their concerns that things might not go as expected.

Furthermore, according to the latest edition of the BOE's Monetary Policy Report (previously called "Inflation Reports"), if the policy interest rate is kept at the current level (0.75%), the rate of inflation is projected to remain below 2% until the second quarter of 2022 (see chart). The report states that – "If the economy develops as we expect, then upward pressure on prices should build gradually over the next few years. In that case, we think a modest increase in interest rates is likely to be needed to keep inflation at our 2% target." Although the BOE currently considers this to be the baseline scenario, it seems that, if only that kind of slow and weak rise in inflation is anticipated when the policy rate is maintained at its current level, the hurdles on the path to a rate increase must be quite high. While it is not easy to forecast a rate cut given that seven of the nine MPC members currently disapprove of such a cut, rate cuts appear more probable than rate increases in light of the prime minister's temperament and the prospective political situations that seem likely based on that temperament. One intuitively gets the impression that the level of GBP's downside risks is quite high. BOE Governor Carney will retire at the end of January 2020. It seems that half of Governor Carney's term leading the BOE has dominated by Brexit-related developments, and he is likely to continue beset by Brexit-related developments right up until his retirement.



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