

Forex Medium-Term Outlook

31 January 2020

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Derivatives & Forex Department

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Overview of Outlook

USD/JPY continued to lack movement in the first month of 2020. The currency pair did not break out of its range despite an abundance of major headlines – the military confrontation between the U.S. and Iran, the Phase 1 trade agreement between the U.S. and China, the emergence of a new strain of pneumonia (Novel Coronavirus; hereafter “coronavirus”) from China, and the completion of Brexit, as the UK finally left the EU. However, the potential economic or financial impact of the coronavirus is still largely uncertain, so at the present time, all one can do is wait and watch. One possible scenario going forward is very similar to what happened in 2019 – if the Chinese economy slows down and drags the European economy down with it, the U.S. may have to further cut interest rates out of consideration. If that happens, last year’s so-called “preventative” rate cuts will turn out to have been the start of a longer phase of rate cuts. This scenario cannot be ruled out. In fact, according to the IMF’s World Economic Outlook, the U.S. economy peaked in 2018 and is set to slow down over the next three years. In a monetary policy strategy aligned with such an outlook, the next move would have to be a rate cut, and it would also be reasonable for USD/JPY to move in a direction aligned with such developments. Although I do not predict a phase of extreme JPY strength similar to the one a few years ago, the global state of affairs is too unfavorable to predict a mutually-stimulated strengthening of U.S. interest rates and USD.

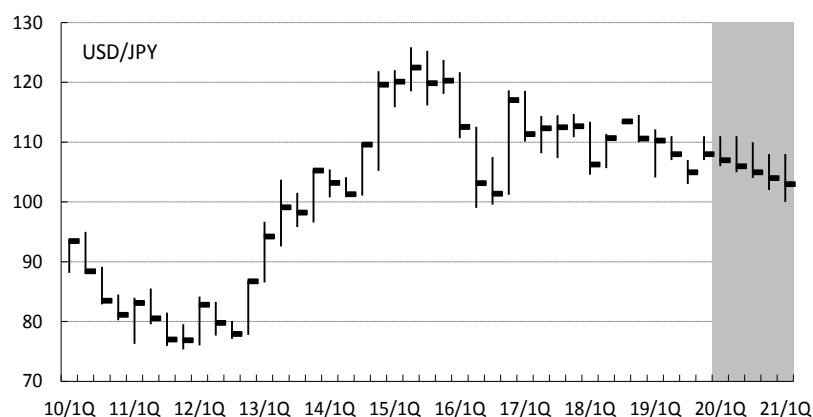
EUR has also been unable to break out of its range. As reflected by the region’s manufacturing PMI, there are now signs of improvement in euro area business confidence, which had until recently been at rock-bottom even by global standards. Given this region’s excessively poor economic performance in the recent past, its growth rate seems likely to have the strongest chance of an upward revision this year. However, the ECB, which launched a review of its monetary policy strategy in January, plans to indicate a strong inclination in the revised policy strategy toward continuing with monetary accommodation until inflation rates are well over 2%. On top of this, there are growing concerns that the coronavirus could slow down the Chinese economy, which in turn could weigh down the economy of the euro area. Given this, the “next move” of the ECB seems likely to be a rate cut if anything. I do not think it prudent to base my risk scenario on the potential risks associated with the coronavirus, but one must keep in mind that China and Europe (mainly Germany) are in the same boat because of their strong trade relations. As the correction of USD strength is the main pillar of my forecast scenario in this report, I do not predict a major EUR crash, but given the region’s negative interest rate of -0.50%, the currency may not have much of an opportunity to appreciate either.

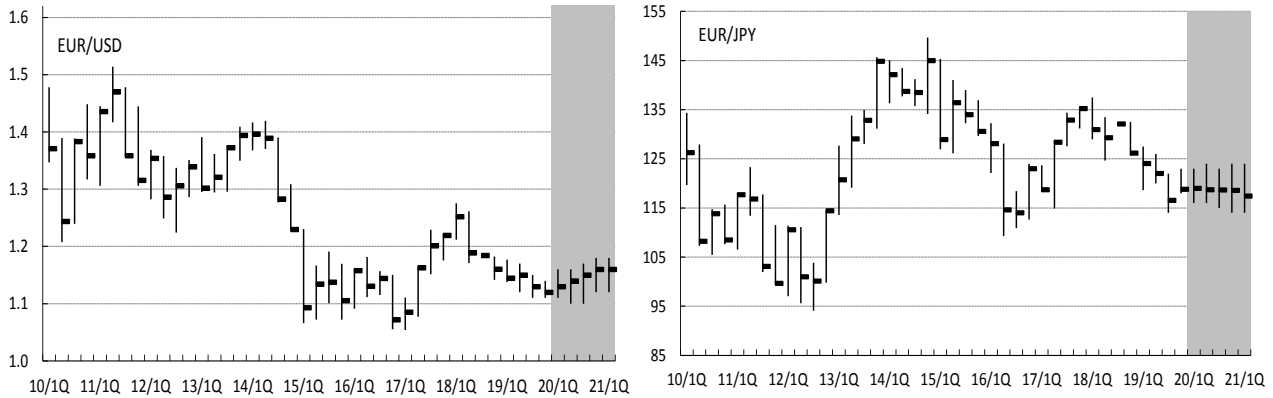
Summary Table of Forecasts

	2020					2021
	Jan (actual)	Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
USD/JPY	107.65 ~ 110.30 (109.07)	106 ~ 111 (107)	105 ~ 111 (106)	104 ~ 110 (105)	102 ~ 108 (104)	100 ~ 108 (103)
EUR/USD	1.0992 ~ 1.1224 (1.1032)	1.09 ~ 1.14 (1.11)	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	119.82 ~ 122.88 (120.32)	116 ~ 123 (119)	116 ~ 124 (119)	115 ~ 123 (119)	114 ~ 124 (119)	114 ~ 124 (117)

(Notes) 1. Actual results released around 10am TKY time on 31 JAN 2020. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts



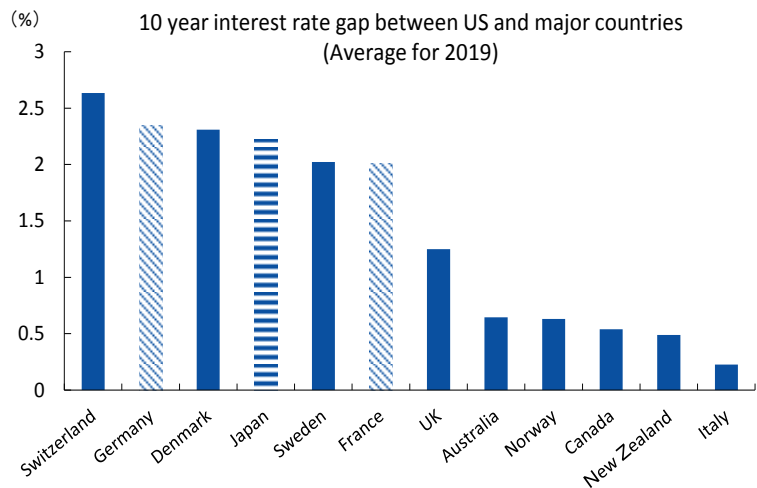


USD/JPY Outlook – “Preventative Rate Cuts” Fail to Lead to a Resumption of Rate Hikes

Outlook for 2020 – Three Points Worth Noting

No Rate Hikes in the U.S., Japan, or Europe over the Next Few Years

The forex markets opened relatively placidly in 2020 in contrast to last year, when they were beset by flash crashes. A risk-off mood strengthened in the markets following U.S. killing of an Iranian Revolutionary Guard Corps commander on January 2, and USD/JPY temporarily fell to the 107 level, its lowest since October 2019. However, military confrontation between the two nations was averted after a brief tit-for-tat, and the resultant sense of relief drove the resurgence of a risk-on mood, the momentum of which continued through the rest of the month. Despite subsequently being weighed down by concerns related to the coronavirus, USD/JPY continues strong.



(Source) Bloomberg

Looking back at last year, market turmoil early in the year translated directly to the Fed reversing its policy stance, which invited a dramatic decline in U.S. interest rates. However, forex rate movements consistent with this development (i.e., USD depreciation) did not take place, and the forex markets remained extremely stable throughout the year – so much so that USD/JPY posted its smallest annual rate range for the second year in a row. I have explained the background to this quietness in the markets several times before, so will refrain from doing so again, but in short, the fact that U.S. interest rates remained relatively high despite their decline is likely to have shaped forex market trends in 2019 (see figure). As this fact still holds mostly true, there is no sense of a major impending change in the forex markets. In the dot plot, FOMC members projected no change in the federal funds (FF) rate for this year, and only two rate hikes by the end of 2022. U.S. inflation also shows no sign of strengthening, so it seems reasonable to assume that rate hikes will be a rare event over the next few years in all three major economies – the U.S., Japan, and the euro area.

Three Key Points for 2020 – (1) Likelihood of Another Rate Cut Aimed at “Preventing Stock Price Crashes”

Within the bigger assumption that USD/JPY will essentially be range-bound, there are three points worth thinking about in 2020 – (1) whether the U.S. will implement another rate cut, (2) whether the European economy will recover, and (3) whether the Chinese economy will recover. Of course, (1) is the most fundamentally important of the three. As I mentioned at the beginning of this report, the biggest reason why the excessive strength of USD, which began its appreciation in June 2014, remains uncorrected to date is that U.S. interest rates remain relatively high. The FF rate is currently 1.75%, which is head and shoulders above interest rates anywhere else in the developed world apart from Canada. However, if the U.S. implements three more rate cuts (same as last year), the FF rate would fall to 1.00%, where it would be at par with interest rate in New Zealand, and barely above Australian and British interest rates (both at 0.75%). If that happens, USD interest rates will no longer be higher than most other currencies. The

reason for USD/JPY remaining range-bound in 2019 may well have been because of an advantageous investment climate adding to the historically unprecedented situation of USD interest rates being at just under 2% while interest rates in Japan and Europe were both negative. However, there is also the opinion among some analysts that the interest rate gap between USD and other currencies is narrowing, making it difficult to predict forex rates based on it. This is also a reasonable view, if somewhat premature. I think it would be better to wait until the Fed implements another round of rate cuts before making the above judgment.

Of course, as of the current time, market participants who think the Fed will cut rates three times this year are in the minority. But then, market participants who had expected the Fed to implement three rate cuts last year were in the minority a year ago. At the very least, it is worth considering the assumption that the U.S. will implement three rate cuts this year if only because a larger number of market participants seem to be fearing this scenario. As I have discussed in previous issues of this report, the reason key stock indices keep posting all-time highs despite the deterioration in corporate performance could partially be because the policy interest rate is being maintained (and/or is expected to continue being maintained) at a lower level than warranted by real economic performance. Consequently, my understanding is that corrections may already have been factored into the current persistently high stock prices. If stock prices do undergo a correction going forward, market expectations of a response from the Fed will definitely strengthen, as they did last year. Ultimately, therefore, one can say that the “preventative” rate cuts were for “preventing stock prices from falling,” and it is quite likely that the Fed will implement another round of rate cuts if stock prices begin to tumble, even if the employment and wage situations show no signs of major deterioration. More than a few market participants see the continued increase in U.S. stock prices since the October-December period last year as excessive, and one must prepare for the possibility that a decline in U.S. interest rates as a result of a stock price correction could determine forex market trends (i.e., lead to USD depreciation) going forward.

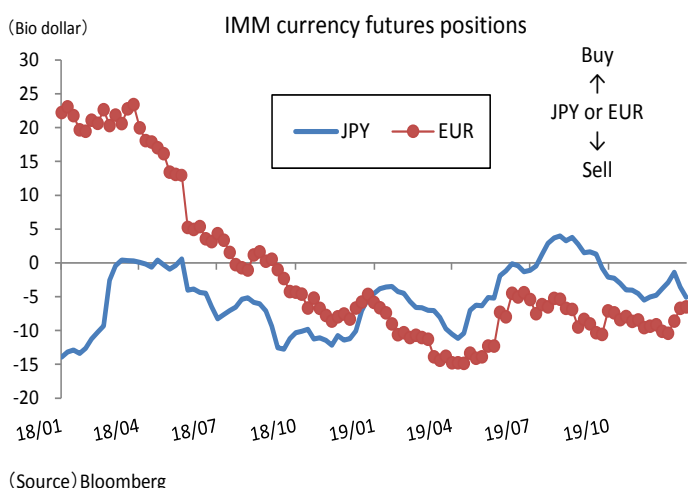
Possibility of Rollback in EUR as Funding Currency

Moving on to point (2) mentioned above, it would be natural to assume that the global economic slowdown in 2019 was led by Europe and China. If the European economy begins to recover sometime this year and the ECB (following in the footsteps of Sweden) feels compelled to take the policy normalization opportunity to raise its rates at least once, the resultant EUR buying could lead to a significant USD selling. In the case of EUR, a speculative short position has become normalized. I emphasized in last year's issues of this report that, in considering why JPY is no longer bought as a safe-haven currency or during risk-off phases in the markets, one must take note of the important fact that a large part of the JPY that is sold is no longer being bought back thanks to the robust rise in foreign direct investments in the medium/long term.

This is a fact that will continue to affect the JPY market trend going forward.

However, there are some who point out that JPY's waning as a safe-haven currency is because the vigorous rollback in JPY carry trade, which was once the main source of short-term JPY buying during risk-off phases, is no longer taking place. In other words, the theory is that JPY has been replaced by EUR as the preferred low-interest-rate funding currency in the two-step process involved in carry trade, namely (A) procuring a low-interest-rate currency → (B) investing in a high-interest-rate currency. The validity of this theory cannot be denied. There are two conditions for a currency to be chosen as the funding currency in carry trade. The first condition is that a low interest rate should be expected for that currency over the medium term. The other condition is that the currency should have low volatility. JPY meets both those conditions, but so does EUR, and given a choice between one or the other, most market participants would choose EUR, because it has much greater liquidity than JPY. On top of that, if you look at the nominal effective exchange rates (NEER) of JPY and EUR, the former had increased by +1.4% yoy as of December 2019 whereas the latter had fallen by -3.1% yoy, making it much more desirable as a funding currency (any appreciation in the funding currency eats away at the returns from carry trade). In fact, if we look at the IMM currency futures transactions over the past almost two years, the EUR speculative short position has been held for a long time now, while there was a switch to long position in the case of JPY recently (see figure). These types of transactions are thought to be easily influenced by words and actions of the central bank, specifically by any change in policy interest rates, so if the ECB were to implement a rate hike (for the putative reason of preventing side effects), a significant rollback could well take place

However, the possibility of such a thing actually happening is not that high. As I pointed out in this report last year, the slump in the auto industry was behind the cooling of the euro area economy, and thereby also the global economy. What led to the auto industry slump is thought to have been the reaction to the end of car tax rebates in



China at the end of 2017, and the enforcement of stronger exhaust emission standards in Europe. Europe has begun its shift to the Worldwide Harmonized Light Vehicles Test Procedure (WLTP). Starting September 2017, new models were required to conform to WLTP exhaust emission standards, and starting September 2018, newly registered vehicles in older models were required to do the same. It is pointed out that the reasons for the auto industry slump in recent years, and for the economic slump in individual European countries (notably Germany) as a result, are the inevitable delays in production resulting from having to conform to stricter standards and production cutbacks in response to the associated higher sales costs. The regulations were tightened even further starting January 2020.



Under such circumstances, it seems questionable whether the euro area economy and thereby EUR will begin to recover from this slump triggered by conditions in the auto industry in 2020. It is a relief to see a clear improvement in the leading indicators of the ZEW Indicator of Economic Sentiment in Germany, but the fact is that ZEW previously bottomed out in August 2018 and continued to recover for around eight months following that (see figure). However, after the real economy began to deteriorate with the tightening of exhaust emission standards in September 2018, the ZEW's recovery trend was abruptly reversed and it began to deteriorate sharply starting May 2019. One must pay close attention to see whether history will repeat itself again as geopolitical risks combine with the newly strengthened exhaust emissions standards in January. If we also take into account the inevitable slowing of the Chinese economy as a result of the coronavirus, the future of the German economy seems even grimmer.

Taking such recent circumstances into account, even if the ECB were to raise interest rates going forward, it would not be in response to an overheating of the economy, but rather in the context of suppressing the side effects from the negative interest rate, which amounts to a reversal rate at the level of -0.50%. A rate hike by the ECB in order to mitigate the side effects is not impossible as, in addition to peer pressure resulting from Sweden's abolition of negative interest rates, the ECB also faces complaints from its own member states regarding its negative interest rate.

CNY Rates Seen in the Context of the U.S.-China Trade War

Moving on to point (3), the Chinese economy has so far been at the mercy of developments related to the U.S.-China trade war, so the Phase 1 Agreement reached earlier this month was hailed as a smooth start to the new year (although one cannot take for granted that this agreement will hold firm). However, even as the risks associated with the U.S.-China trade war appear to fade, new risks associated with the coronavirus have emerged, and some are beginning to predict a first quarter growth rate of under 5% for the Chinese economy. Of course, it is not clear how long the coronavirus situation will continue, but there is a likelihood that it has already affected consumption and investment appetites significantly, and it has to be said that the prospects of a yoy improvement in China's demand are clearly declining.

Further, as the U.S. presidential election approaches, the forex rate problem is very likely to draw closer attention. Given that China is no longer a major current account surplus nation, it would not be surprising for CNY to be on the decline in the natural course of things, but there is no guarantee that the Trump administration will see things in this rational light. In fact, though China is no longer seen as a "currency manipulator" by the U.S. as of January, the grounds for declaring it a currency manipulator in the first place were weak, and there is no telling when the moniker might be applied to it again. As I will explain later, U.S. currency policy clearly takes a negative view of the current level of USD strength if the January Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States is any indication.

Under such circumstances, it is clear that any scenario that assumes a Chinese economic recovery may be at risk. If so, the flight of capital from China during the current forecasting period is likely to invite a major CNY crash, irking the Trump administration and possibly causing USD/CNY to surpass the 7-yuan threshold as it did last August. If that happens, the deterioration in market sentiment could result in a stock-price crash and damage business confidence worldwide, and the Fed will have to take action in response to this situation. In other words, a repeat of what happened in 2019. The sudden rise in risks related to the coronavirus in late January may have further heightened these insecurities. Points (1) to (3) above could demolish my main forecast scenario that USD/JPY will remain range-bound again this year, and I will pay close attention to them in formulating my outlook going forward.

U.S. Monetary Policy Now and Going Forward – Will 2020 be Similar to 1999?

A Summary of the Preventative Rate Cuts – Comparison with 1998-99

In January, the forex markets were affected by several factors that did not directly have to do with the economic or financial situation, such as the U.S.-Iran military confrontation and the rise of the coronavirus. One gets the impression that the most important point, which has to do with the Fed's policy operations, has disappeared in this midst, but in formulating this year's forex outlook, it is very important to find out whether the three "preventative rate cuts" implemented last year were successful. What I mean is that, if the "preventative" aspect of the rate cuts were successful, the situation is likely to improve to the extent of enabling a resumption of rate hikes by the end of this year. The preventative rate cuts of 2019 are often compared to those implemented in 1998 in the wake of the Asian financial crisis (1997) and the LTCM crisis (1998). At that time, the Fed, under former Fed Chair Alan Greenspan, implemented three 25-bps rate cuts (amounting to a total of 75 bps) within the space of three months between September and November 1998, but rate hikes were resumed in June the following year (1999). This phase of rate cuts, while successfully preventing an economic recession, is widely known to have later led to the formation and collapse of the IT bubble in 2000-01.

To be more specific, the FF rate was lowered from 5.50% to 4.75% between September and November 1998, but rate hikes were resumed in June 1999 and continued until January 2001, with the FF rate reaching 6.50% by that the end of that time. It was in this process that the IT bubble collapsed. If we take stock of the pros and cons of preventative rate cuts based on this experience from 1998-99, the pro was that it successfully prevented an economic recession, while the con was that it caused asset prices to soar (i.e., a bubble to form). Consequently, if the lessons learned from the 1998-99 experience are applied to the current phase of the Fed's policy operation, one of the questions that can be asked is – will the Fed resume rate hikes despite concern of the formation of a bubble similar to 1999? The success or otherwise of last year's preventative rate cuts will depend on how skillfully the Fed can control asset price adjustments without it causing a shock to the markets.

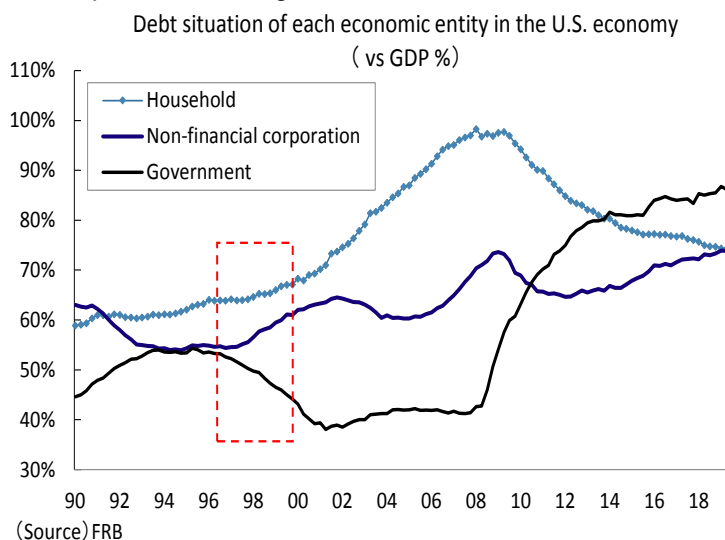
Incidentally, in March last year, Federal Reserve Bank of Chicago President Charles Evans praised the Fed's 1998-99 policy operation and pointed out that the current situation resembles it closely (Mr. Evans participated in FOMC meetings as a Chicago Fed staff member at that time). Fed Vice Chair Richard Clarida is also known to have expressed similar views. Given that the major stock indices have all been soaring since last year's preventative rate cuts, the possibility of a resumption of rate hikes is not nil.

Will 1999-Style Rate Hikes follow the 1998-Style Rate Cuts?

From the perspective of forex outlook, it will be important to see whether the Fed resumes rate hikes despite concerns over the soaring of asset prices, thereby expanding the interest rate gap between USD and other currencies. In other words, will the 1998-style rate cuts implemented in 2019 be followed by 1999-style rate hikes in 2020? As many market participants predict, this may be difficult for several reasons, the most important being that there are no major imbalances in the U.S. economy. This is an important point to consider when predicting the possibility of rate hikes not just for this year but for next year too.

When a central bank is concerned about a stock price or other asset bubble, the first thing to do is to find out what is fueling the bubble. In other words, it is necessary to find out which economic entity (households, corporations, or the government) is responsible for increasing the imbalances (i.e., taking loans) and creating unhealthy market conditions. When the imbalances can no longer be sustained and the bubble collapses, and the economic entity that was providing fuel for the bubble sustains severe damage, the process of recovery (i.e., balance sheet adjustments) triggers an economic recession. In the case of the Japanese bubble, it was the corporate sector that was responsible for its collapse, while the household sector (housing loans) was responsible for the collapse of the housing bubble in the U.S.

As the figure shows, the U.S. household sector's debt levels were expanding exponentially until 2007, and the past 10 years are proof that normalization following the collapse of the bubble is an extremely painful and time-consuming process. The portion within the red dotted square in the figure pertains to 1998-99, when preventative rate cuts were followed by a phase of rate hikes, and it is clear that both the household and corporate sectors were in the process of expanding their debt levels at that time. However, right now, corporate debt is already at peak levels while the household debt is still in the process of adjusting its balance sheet following the subprime mortgage crisis. The debt levels of the corporate sector are concerning, but given that personal consumption comprises 60% of the U.S. economy, the big question is whether rate hikes can be implemented while the household sector is still in

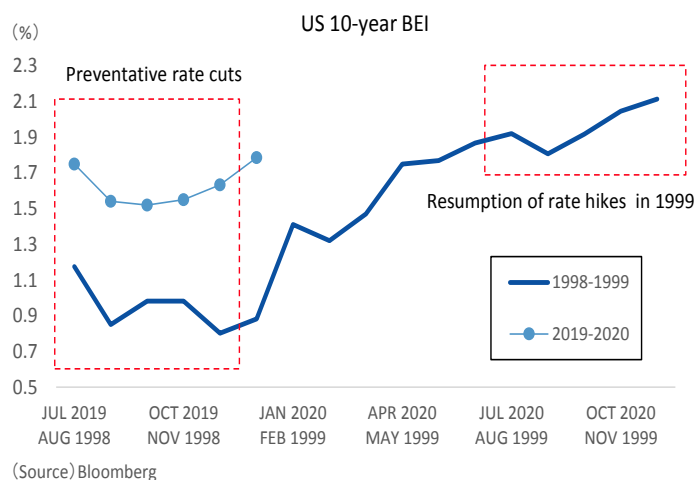


the process of balance sheet adjustment. Even though the current phase of U.S. economic expansion enters its 128th month in February, given that there are no signs of an increase in either wages nor inflation, it seems unlikely that 1999-style rate hikes will be resumed within the year. Rather, considering the various geopolitical (and pandemic) risks combined with the fact that the U.S. economy seems to have exhausted its scope for further growth, it seems likely that additional rate cuts may have to be implemented, making last year's rate cuts the start of a longer phase of rate cuts, rather than "preventative" rate cuts similar to those in 1998.

Taking all this into account, it seems very unlikely that the Fed will resume rate hikes this year. Of course, the possibility cannot be completely ruled out, given the persistently high stock prices and the corporate sector's accumulated debts, which may be seen as an asset bubble. However, considering the trenchant attitude of President Trump regarding rate hikes even under normal circumstances, it does not seem a good idea for the Fed to turn hawkish in the run up to the presidential election, at which Mr. Trump hopes to be reelected. Going by the Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States, the U.S. Department of the Treasury (and the Trump administration) seem to have very strong concerns regarding USD's strength. While it is true that the Fed ought not to decide policies based on political will, objectively speaking, I do not believe that the current circumstances justify implementing rate hikes at the cost of political support.

Other Differences Compared with 1998-99

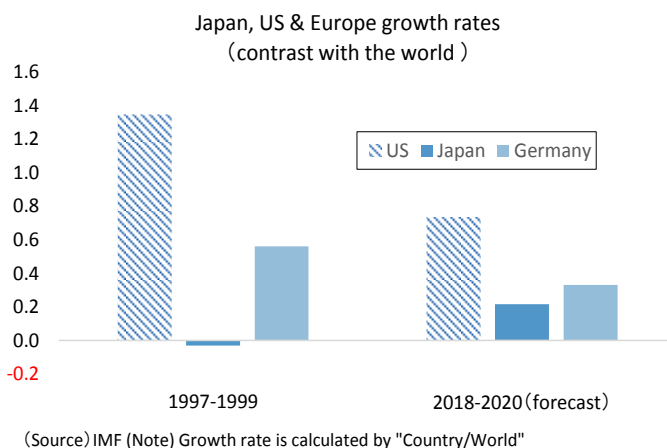
There are other reasons why a rate hike resumption seems difficult. For instance, some of the differences between 1998-99 and the present relate to (1) inflation expectations and (2) the U.S. economic growth rate. Regarding (1), let us take a look at the personal consumption expenditure (PCE) deflator, which is an indicator the Fed pays close attention to. In 1999, when rate hikes were resumed, the core PCE deflator was growing by only around +1.4% yoy on average, which is lower than its current growth rate (around 1.7% yoy on an average over the past year). Some may not consider this to be a good enough reason not to follow the 1998-99 pattern and resume rate hikes, but inflation expectations are also very different compared with those days. As the figure shows, market-based inflation expectations (the 10-



year BEI) began to rise steeply following the preventative rate cuts in 1998. Specifically, the 10-year BEI rose from below 1.0% to over 2.0% in less than a year. If we remember that there was also an increase in stock prices that eventually came to be known as the "IT bubble," the resumption of rate hikes could be justified from the perspective of forward-looking policy operation. Coming back to the present time, the 10-year BEI has not shown any signs of an increase despite nine rate hikes implemented since December 2015 (which is what invited ridicule that the Fed was raising rates simply as a way to create policy space). Will inflation expectations gain momentum in 2020 following three rate cuts by the Fed? Is it really likely for there to be a dramatic change in the inflation expectations trend, which has remained sluggish since the financial crisis? It seems rather unlikely that current inflation expectations levels could bolster an argument in favor of resuming rate hikes.

U.S. Economy Not as Strong as It Used to be

Another big difference between 1998-99 and the present is the position of the U.S. economy. As is obvious from interest rate levels, the U.S. economy has a relatively high rate of economic growth compared with other developed economies, and it would not be an exaggeration to say that it is one of the engines of the global economy. However, the strength of the U.S. economy within the global economy was much more prominent in 1998-99. For instance, the U.S. economy's average yearly growth rate in the two years before and after the preventative rate cuts, i.e., from 1997-99, was +4.6%. This is in contrast to Japan's economic growth rate during that same period of -0.1% (of course, Japan was reeling from its 1997 financial crisis), but even the German economic growth rate was less than half that of the U.S. at +1.9%. Incidentally, the global economic growth rate at that time was +3.4%, so even when compared with the world economy, which included emerging economies, the U.S. economy had an outstanding rate of growth.



(Source) IMF (Note) Growth rate is calculated by "Country/World"

Comparing the above figures with the state of affairs in 2018-20 (IMF forecasts used for 2020), the U.S. economic growth rate is +2.5%, Japan's is +0.7%, and Germany's is +1.1%, while the global economic growth rate is +3.4%. The global economic growth rate is the same as it was in 1998-99, but the U.S. economy's position within this has waned, and it is no longer in an outstandingly strong position (see figure). Considering that, in 1998-99, the U.S. economy was the only one that seemed to be overheating, with soaring inflation expectations, it is not difficult to see why the Fed would resume rate hikes. However, at the current time, the U.S. economy, though doing well on a global level, is not quite as outstanding a presence, and it would be hard to argue that it is overheating or that a bubble is forming. It would, therefore, not be out of place to say that the U.S. economy today is not in a position of unique strength sufficient to warrant resumption of rate hikes (from the perspective of economic cycles, the current phase of economic expansion is probably nearing its end).

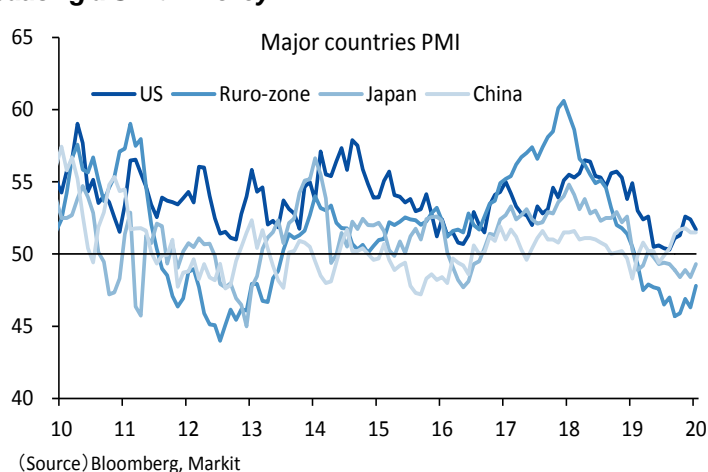
Prudent to Bet on USD Depreciation Against JPY Despite Phases of Waiting

It seems highly unlikely that the Fed will resume rate hikes this year. In fact, there is a higher chance of additional rate cuts. Of course, considering all the rumors of the marked deterioration in business sentiment across the corporate sector, especially in the manufacturing industry, a rebound may naturally occur. Forex rates in January reflected exactly this. The Fed could turn more hawkish in its policy stance in response to the receding of political (and geopolitical) risks that have been weighing down the economy, such as those related to the U.S.-China trade war, Brexit, and the Middle East. However, the coronavirus scare poses a risk to that scenario, and leave alone implement rate hikes, the Fed may find it difficult even to issue a hawkish-toned message.

However, the Fed not implementing rate hikes may not translate to USD depreciation/JPY appreciation right away. As mentioned above, some are of the view that the U.S.-Japan interest rate gap margin's scope for change is decreasing, thereby limiting USD/JPY movement in response to such a change. The possibility of this cannot be ruled out. Having said that, U.S. economic growth and inflation are not expected to strengthen. Consequently, the Fed is not expected to raise interest rates. My basic understanding, therefore, is that the risk to U.S. interest rates and USD/JPY will expand on the lower side. Even historically speaking, it has been difficult for a weak JPY trend to take hold in the absence of a U.S.-Japan interest rate gap expansion.

Likelihood of Risks Associated with coronavirus Causing a Shift in Policy

At the January 28-29 FOMC meeting, the FF rates were kept unchanged as per market forecasts. The FOMC statement was also more or less unchanged from the previous meeting, inviting no more than a mild reaction from the financial markets. Though the Fed increased the interest on the excess reserves, it emphasized that this was merely a technical adjustment and did not imply any intent with regard to monetary policy, and the markets shows no reaction either. Fed Chair Jerome Powell touched upon the waning of downside risks in his press conference, stating that "some of the uncertainties around trade have diminished recently, and there are some signs that global growth may be stabilizing after declining since mid-2018," giving the sense that the preventative rate cuts implemented

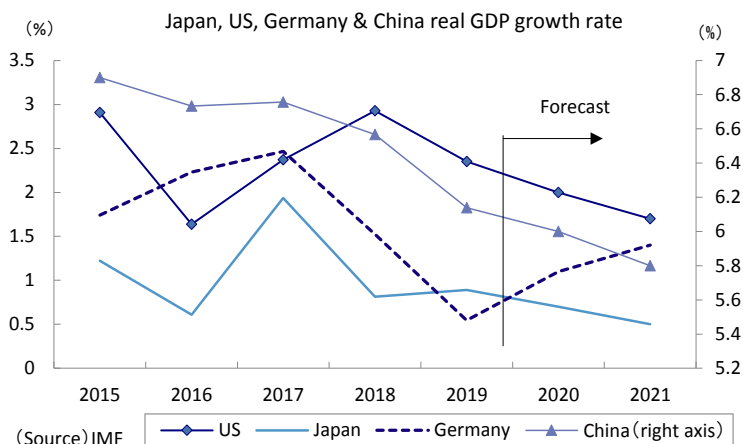


last year have been successful and that the need for additional rate cuts has declined. In fact, manufacturing PMIs around the world have been on the mend (see figure), so going just by this, it would not be surprising to see some members call for a resumption of rate hikes because of the success of last year's preventative rate cuts.

However, Mr. Powell also mentioned the emergence of new risks: "Nonetheless, uncertainties about the outlook remain, including those posed by the new coronavirus." In fact, it was a matter of some interest to see the level of caution regarding the coronavirus that would be indicated by the FOMC statement and Mr. Powell's press conference this time. Already economic activity has been thrown into turmoil in China, with travel and other restrictions being imposed, and Mr. Powell did mention the possibility of a spillover to other economies. Some analysts predict that China's GDP could fall below 5% for the first quarter of the year, so global economic slowdown is seen as an inevitable consequence even if only a temporary one. Of course, there is no way of telling at this time what the ultimate impact will amount to, but the SARS epidemic in 2003 continued for four months, and if we take into account that the coronavirus is spreading faster than SARS did, it could significantly impact the direction of next time's dot plot (which will be published in March). The coronavirus risk emerged just as geopolitical risks including those related to the U.S.-China trade war and Brexit receded, so the balance of risks will have to be either kept unchanged or downwardly revised.

U.S. Economic Slowdown

As I have already argued, it would be possible for the Fed to resume rate hikes this year if last year's three rate cuts were indeed "preventative." However, it seems quite likely that last year's rate cuts were not preventative but simply the start of a new phase of rate cuts. As indicated in the figure to the right, the U.S. economy is forecast to slow down going forward rather than accelerate. From 2015 through 2018, during which the Fed implemented nine rate hikes, U.S. economic growth had really been accelerating. However, having peaked in 2018, it is clearly poised to go into a decline over the next three years. Under these circumstances, it would seem that the Fed's next move ought to be a rate cut. The figure shows the latest numbers published by the IMF in January, but as of their publication, the risks associated with the coronavirus had not



been factored into them. As I mentioned above, it is not clear the extent to which this risk will drag on or spread, but it may be reasonable to assume that the growth rates of all the countries and regions include the risk of downward revision.

In the midst of the chaos resulting from the coronavirus, the most important thing to take into account is that the European economy, led by the German economy, which alone had been forecast to improve, may lose its opportunity for recovery. As I have mentioned several times previously, the Chinese and European economies slowed down in 2019, dragging the global economy down with them. This is the reason the Fed had to respond by implementing "preventative" rate cuts despite the U.S. economy itself being quite strong. The longer the coronavirus pandemic continues this year, the more likely it is that the scenario will be repeated all over again, and the recently revived fears of another inversion of the yield curve (3-month – 10-year bonds) raises the possibility of this happening. From the perspective of formulating my forex outlook, it may become difficult to retain my main scenario of a decline in U.S. interest rates and USD.

U.S. Currency Policies Now and Going Forward – Promoting USD Selling Intervention?

Exculpation from Currency Manipulation Accusation as a "Reward"

The most noteworthy element of the latest edition of the U.S. Treasury Department's semiannual Report on Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States (released on January 14) is that China was removed from the list of "currency manipulator" countries, to which it had been added last August. While the report is supposed to be produced based on objective criteria, one gets a strong impression that it was tweaked to facilitate the Phase I U.S.-China trade agreement's signing, which took place on January 15, the day after the release of the latest report. The Phase I U.S.-China trade agreement includes provisions to increase the transparency of China's currency policies, and it appears that China's removal from the list of the list of "currency manipulation" countries was a kind of "reward" for the acceptance of those provisions. Despite its removal from the list of "currency manipulator" countries, however, China was kept on the "monitoring list", which currently includes 10 countries – China, Japan, Korea, Germany, Italy, Ireland, Singapore, Malaysia, Vietnam, and Switzerland. (Switzerland had been temporarily removed from the list, but was re-included this time.)

When the Obama administration introduced the "Monitoring List" in April 2016, only five countries (China, Japan, Korea, Taiwan, and Germany) were included. The doubling of the number of countries on the list during a period of less than four years reflects growth in the number of countries that have trade surpluses with the United States. A significant bilateral trade surplus with the United States (annual levels of USD20 billion or more) is one of three criteria for inclusion in the "currency manipulation" country list. Only seven countries (China, Germany, Japan, Mexico, Korea, Italy, and India) exceeded that trade surplus level as of April 2016, but the number of such countries has now increased to 12 (see the chart below). The U.S. Treasury's assertion that sustained USD appreciation is promoting this trend is quite convincing. It is surprising that many people think the monitoring list approach was introduced by the Trump administration, although it was actually launched during the previous Obama administration. That factoid should serve as a reminder that U.S. concerns about sustained USD appreciation and other countries' excessive trade surpluses with the United States predate the Trump administration.

Promoting USD Selling Intervention?

The fact that China's removal from the list of "currency manipulator" countries was a kind of "reward" was clearly explained in the report's Executive Summary section:

- "Intensive trade and currency negotiations between the United States and China over the last few months resulted in a Phase One agreement that requires structural reforms and other changes to China's economic and trade regime in several key areas, including currency and foreign exchange issues. In this agreement, China has made enforceable commitments to refrain from competitive devaluation and not target its exchange rate for competitive purposes. China has also agreed to publish relevant information related to exchange rates and external balances. Meanwhile, after depreciating as far as 7.18 RMB per U.S. dollar in early September, the RMB subsequently appreciated in October and is currently trading at about 6.93 RMB per dollar.
- In this context, Treasury has determined that China should no longer be designated as a currency manipulator at this time."

In short, the Chinese side vowed during the trade negotiations that it will not intentionally promote RMB depreciation and, in return, it was removed from the list of "currency manipulator" countries. The report's "Treasury Conclusions Related to China" section gives a more-detailed explanation of the situation, saying – "China needs to take the necessary steps to avoid a persistently weak currency." For example, the United States is pressuring China to publish foreign exchange intervention data. (The Phase One agreement is likely to require the publication of such data.) Regarding RMB selling and buying interventions, the report states that – "The PBOC appears to have largely refrained from intervening in foreign exchange markets in 2019, but financial entities beyond the PBOC (notably state banks) purchased foreign exchange on net over the first six months of 2019." The report notes that, because China does not publish foreign exchange intervention data, U.S. Treasury staff must estimate the scale of China's direct and indirect intervention by means of the PBOC and state-owned banks. It seems clear that the question of whether China would make honest efforts to augment its intervention-related transparency was a key issue in Phase One agreement negotiations, and that the United States was strongly emphasizing this issue. The Phase One agreement does include sections designed to upgrade the transparency of exchange rate-related policies, but it is not clear what concrete actions China will take in this regard.

The report also notes that China's system of establishing a RMB/USD reference rate (the "central parity rate" or "daily fix") and keeping RMB within a forex trading band centered on that rate is playing an "increasingly important role in the authorities' management of the RMB", and it appears that the U.S. Treasury Department may consider the reform of this system an top objective on a par with the augmentation of China's foreign exchange intervention data transparency. Nevertheless, China's current account surplus has declined considerably owing to growth in China's services balance deficit that has accompanied an increase in the number of Chinese traveling overseas. This current account surplus decline can be cited to support arguments that RMB appreciation is not necessarily justified. In light of a series of statement by Trump administration figures, however, it does not seem that the Trump administration is inclined to accept such a "theoretically correct" forex trend, so disputes about USD/RMB levels are likely to persist going forward.

Other Report Sections Seeming to Promote USD Selling Intervention

Aside from China-related issues, the Trump administration's keen aversion to USD appreciation in general seems apparent from the very beginning of the report. Immediately after the above-cited portion regarding China, the Executive Summary discusses how G-20 and G-7 agreements prohibit member countries from undertaking exchange rate manipulation. Even more striking is the ironic tone of the first sentence of the following paragraph, which reads – "While there has been a decline in the scale and persistence of foreign exchange intervention among most major U.S. trading partners in recent years, this has come during a period in which the dollar has generally been strong relative to historical averages and there have been less persistent appreciation pressures across other currencies." The gist of this (and probably the U.S. Treasury Department's actual view) appears to be that USD appreciation has enabled trading partners to do without foreign exchange intervention and that the decline in such intervention is not actually attributable to trading partners' active efforts to reduce such intervention. Following the ironic sentence just cited, the report hints at dissatisfaction with this situation, stating – "In this context, Treasury will continue to monitor closely the extent to which intervention by our trading partners is symmetrical, and whether economies that choose to smooth exchange rate movements resist depreciation pressure [≈ USD appreciation pressure] in the same manner as appreciation pressure [≈ USD depreciation pressure]."

The overall significance of these statements appears to be to justify and promote USD selling intervention measures during USD appreciation scenarios. Given that the question of whether the United States has been undertaking USD selling intervention through the Treasury Department's Exchange Stability Fund has become a hot topic since last summer, the statements are cause for concern, since they hint that such intervention may have already been begun. At the end of last August, U.S. Treasury Secretary Steven Mnuchin stated in a press interview that the Treasury Department has – "no intention of intervention at this time." But he immediately qualified that statement, saying – "Situations could change in the future but right now we are not contemplating an intervention."

The report's explicit promotion of symmetrical intervention (concurrent own-currency selling and own-currency buying operations) logically suggests that, while the U.S. Treasury may not be intervening, it should be intervening if it is facing problematic USD appreciation. This is a kind of logic characteristic of the Trump administration.

One also finds hints of this perspective in sections of the report other than the Executive Summary. For example, the Foreign Exchange Reserves section includes the statement – “The economies covered in this Report continue to maintain ample — or more than ample — foreign currency reserves compared to standard adequacy benchmarks. [...] Excessive reserve accumulation imposes costs both on the local economy (in terms of sterilization costs and foregone domestic investment) and the world.” This is suggesting the restraint of foreign currency reserve accumulation resulting from countries' own-currency-selling and USD-buying intervention operations. The statement just cited was included in the report's previous edition (released last May) and retained in the latest edition.

Evaluation Based on a Political Standard?

Regarding the turmoil last August related to RMB depreciation and China's “currency manipulator” designation (see the August 6, 2019, issue of Mizuho Market Topic, “Finally Breaking through the ‘USD1 = RMB7.0’ Level – RMB Depreciation as a Countermeasure” for detailed information), the removal of the “currency manipulator” designation after only five months appears to be evidence indicating that the designation itself was a guileless political measure. The U.S. Treasury Department mainly employs objective criteria (related to a given country's (1) bilateral trade surplus with the United States, (2) current account surplus level, and (3) persistent and one-sided forex intervention) for determining which countries are placed on the “monitoring list” and which are designated as a “currency manipulator”. The system generally calls for a country meeting two of the criteria to be placed on the “monitoring list” (a step away from becoming a “currency manipulator”) and a country meeting all three criteria to be designated a “currency manipulator”. China only meets one of the criteria ((1) bilateral trade surplus with the United States), so it would be expected to be merely a candidate for being placed on the “monitoring list”, but the U.S. Treasury Department explained that it had placed China on the list because it “constitutes a disproportionate share of the overall U.S. trade deficit”. In light of this, it is thought that the RMB's depreciation past the “USD1 = RMB7.0” level last August was the decisive factor leading to China's designation as a “currency manipulator”, but it is not actually so surprising that RMB depreciated given the current account situation described above. The U.S. Treasury Department report indicates that China is being evaluated based on another standard (≈ a political one), and it appears that the use of the additional standard will become the norm going forward.

Resurgence of Speculation about USD Selling Intervention?

It is also significant that the timing of the Treasury Department's semiannual reports has completely deviated from the original (April and October) schedule and that the timing of China's “currency manipulator” designation last year was completely unrelated to the reports' timing (as there was no new report issued last August). These developments appear to be undeniable indications that the Trump administration is “weaponizing” the report. Previously, forex market participants became accustomed to scrutinizing the reports and taking into account their implications based on the assumptions that the reports would be issued every six months (in April and October) and that countries would be placed on the monitoring list if they met two of the following three criteria – (1) a significant bilateral trade surplus with the United States (at least USD20 billion over a 12-month period), (2) a material current account surplus (2% or more of GDP over a 12-month period), and (3) engaged in persistent one-sided forex market intervention (net foreign currency purchases amounting to 2% or more of GDP over a 12-month period). Now that the timing of the report is unclear and the content appears to be managed at the U.S. President's discretion, there is a perception that it has become more-difficult for market observers to take the report into account. As mentioned above, it now seems that the only thing that can be assumed with confidence is that the Trump administration has become and will continue becoming more sensitive in its reactions to USD appreciation trends as the U.S. presidential elections approach. Above all, I am worried about statements that appear to be promoting the undertaking of USD selling forex intervention operations. Concerns about the possibility of USD selling intervention began attracting growing attention last summer, and there is a possibility that additional hints about such a possibility – whether they originate from the U.S. Treasury Department or from other countries' financial authorities – will again become a hot topic of discussion.

Monitoring list 3 conditions (Highlighted countries are on the monitoring list as of JAN 2020)

	Trade surplus vis-à-vis the U.S. (Bil dollar)	Current balance			Buying USD & selling own ccy intervention
		vs GDP (%)	Change in last 3 yrs (% pts)	Amount (Bil dollar)	vs GDP
China	401	1.2%	-1.2%	166	-0.3%
Mexico	93	-1.0%	1.7%	-13	0.0%
Japan	69	3.4%	-0.2%	168	0.0%
Germany	67	7.3%	-1.5%	283	-
Ireland	50	-0.8%	0.4%	-3	-
Vietnam	47	1.7%	1.2%	4	0.8%
Italy	33	2.8%	0.7%	56	-
Malaysia	26	3.0%	0.9%	11	-0.3%
Switzerland	22	10.7%	0.9%	74	0.5%
Canada	21	-2.2%	1.3%	-37	0.0%
India	21	-2.0%	-1.3%	-56	-0.6%
S.Korea	20	4.0%	-3.5%	67	-0.5%
Thailand	19	5.3%	-4.4%	27	1.5%
France	19	-0.7%	-0.2%	-18	-
Taiwan	18	11.0%	-2.8%	66	0.1%
UK	-4	-5.0%	0.4%	-141	0.0%
Singapore	-4	17.9%	0.3%	65	9.0%
Brazil	-9	-2.4%	-0.8%	-44	-0.5%
Belgium	-14	-1.3%	-2.2%	-7	-
Netherland	-24	10.3%	2.2%	93	-
Euro-zone	156	2.7%	-0.4%	362	0.0%

(Notes) Trade surplus vis-à-vis the U.S., current balance & intervention amount cover for 1 year until June 2019 (4 Quarter)

Risks to My Main Scenario – U.S. Presidential Election and Novel Coronavirus

JPY Appreciation Risks Associated with the U.S. Presidential Election and the Novel Coronavirus

As I do each month, I will at this point review the risk factors related to my main forecast scenario. The six risk factors I am most concerned about are listed in the chart. As discussed in this article last month, the most prominent risk factors for 2020 are associated with the U.S. presidential election.

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	Others	Disease risk/Middle East geopolitical risk/ Hong Kong military intervention risk	Strong JPY	low

(Source) by Karakama, Mizuho Bank

Many people are wary of the potential effects of the presidential election, 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. The results of a monthly survey of forex market participants jointly conducted by the financial market information vendor QUICK Corp. and the Nikkei Veritas financial weekly in January are helpful indicators of the perception of such risks. Asked about their expectations if one of two strongly leftist candidates – senators Elizabeth Warren and Bernie Sanders – were to win, 40% of respondents anticipated “a 5-10% USD depreciation/JPY appreciation trend” and 17% of respondents anticipated “a 10%-or-greater USD depreciation/JPY appreciation trend”. A large share of

respondents are concerned about the possibility of progressive JPY appreciation. The survey also asked respondents to predict who will become the Democratic party candidate, finding that 12% of respondents expect Sanders will be the candidate and 8% expect Warren to be the candidate. There appears to be a perception that there is a rather low likelihood that an extreme leftist candidate will be nominated and defeat President Trump, and the possibility of such events leading to JPY appreciation can be considered to fall into the category of a tail risk. On the other hand, 65% of respondents expect relatively moderate Joe Biden to become the Democratic candidate, and that scenario can be considered the main scenario from market participants' perspective. In the case of a Biden win over Trump in the actual election, the largest share (38%) of respondents said they expect roughly zero impact on USD/JPY to ensue. It seems reasonable to conclude that market participants do not generally expect a Trump reelection or emergent Biden presidency to have a particularly significant effect on forex markets.

In addition, it has become impossible to ignore the potential impact of the spread of a new strain of the coronavirus from China, which has become a matter of serious concern around the world and is listed in the chart as one of the elements of risk factor ⑥. Not being personally qualified to evaluate the likelihood that the coronavirus will greatly spread, I can only include it among the risk scenarios, but if it were to greatly spread, it seems reasonable to expect the nature of the impact to be similar to that of the "China slowdown → European slowdown → Fed preventive mitigation" risk scenario from 2019. If U.S. interest rate cuts were to be implemented at the same pace as seen last year (three times), it is likely that JPY would appreciate more than this article's main scenario anticipates.

Continued "No Deal" Brexit Concerns

It is also worth considering other JPY appreciation-related risks, particularly the "No Deal" Brexit risk of risk factor ④, which now appears quite plausible. While the U.K. finally left the EU at the end of January, that is only the starting point of the Brexit process. 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. On January 27, the EU's chief Brexit negotiator, Michel Barnier, presented a speech in which he hinted that U.K. may need more than eleven months to strike a future trade deal with the European Union.

Of course, if both the UK and EU decide by the end of this June 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. 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.

General Shift toward 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.

At the press conference following the January 23 ECB Governing Council (GC) meeting, ECB President Christine Lagarde rejected the possibility that the ECB might follow the lead of Riksbank and said that comparisons of the euro area to Sweden were "odious". 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 and regions with negative interest rates. Given that the strategy review the ECB launched in January relates to enabling the continuation of monetary easing even when inflation rates surpass the 2% level, it appears that any change to ECB policies is more likely to involve interest rate cuts than interest rate increases. However, Riksbank's decision to raise interest rates was clearly not in response to strong conditions in Sweden's economy, and it appears the basis for the decision related primarily to the side effects rather than the intended effects of the negative interest rate policy.

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 current dot plot), 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.

Other JPY appreciation risk factors include those mentioned in the description of risk factor ⑥ in the chart. At the time this article was written, these risks relate to such diverse situations as trends regarding the coronavirus, which merit close monitoring, along with the possibility of US-Iran military clashes and the possibility of Chinese military intervention to counter demonstrations in Hong Kong. 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.

Continued Need to Monitor U.S. Fiscal Stimulus-Related JPY Depreciation Risk Factors

The number of JPY depreciation risk factors is smaller than that of JPY appreciation risk factors. However, as I have been arguing each month, given that the US economy has already realized an exceptionally lengthy expansion period, there is a basis for concern that the Trump administration will undertake fiscal stimulus programs to prolong and accelerate that expansion. This is risk factor ① in the chart. As 2020 is a US presidential election year, the possibility that this risk will eventuate this year cannot be disregarded. In January, the U.S. Treasury Department announced a plan to start issuing 20-year government bonds in the first half of 2020, and this may reflect plans to stimulate the U.S. economy ahead of the presidential election, a worrisome risk factor with respect to this article's JPY appreciation main scenario. Another risk factor related to the Trump administration that one should be closely monitoring is the JPY depreciation risk associated with risk factor ②. The U.S.-China Phase One trade agreement was reached against the backdrop of USD/JPY levels that have reached new highs since the start of the year. Of course, in light of the upcoming presidential election, it is unlikely that President Trump will want to completely stop playing the role of "the president who confronted China on behalf of fair trade", so it currently remains difficult to anticipate additional good news related to U.S.-China trade negotiations that might promote additional JPY depreciation. If such expectations were to be confounded by a scenario involving something akin to a complete elimination of punitive tariffs, it could conceivably have a very large upside impact on USD/JPY. At this point immediately after the signing of the Phase One trade agreement, however, there is a general perception that the likelihood of such a scenario has considerably decreased.

EUR Outlook – A Glimpse of EUR’s Funding-Currency Capability

Euro Area Monetary Policies Now and Going Forward – ECB President Lagarde in Danger of Getting ahead of Herself

ECB President Lagarde Getting ahead of Herself?

At the January ECB Governing Council (GC) 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. President Lagarde’s second GC meeting (the ECB’s 500th such meeting) was an extremely moderate one. As the U.S.-China Phase One trade agreement was acknowledged to have lowered the level of uncertainty and downside risks somewhat, the meeting basically retained the status quo and offered very little that was new information. The meeting’s main highlight (although it was also a confirmation of the status quo) was the official announcement of the start of the first monetary policy strategy review the ECB has conducted since 2003. The strategy review does definitely represent a historic milestone from the perspective of ECB watchers, although it may not directly relate to their analysis aimed at discerning the ECB’s “next move” in the shorter term future. This time, the standard GC meeting statement was supplemented by a concurrently released news release entitled “ECB launches review of its monetary policy strategy”.

As the significance of the strategy review is not generally understood, a reporter at the post-GC-meeting press conference posed the straightforward question – “Now, most citizens, whether they are savers or borrowers, they have just one thing in mind; when will the ECB raise the rates? [...] Could you maybe explain right now in simple words to these people; why is it so important to review a strategy, because maybe it’s not very evident for them to understand this long-distance exercise?” The press release appears to have been designed to respond to such questions about the need for a strategy review.

As expected, the press conference featured a number of questions related to the strategy review, with a particular focus on such timely themes as environmental protection and climate change. Reflecting that, the phrase “climate change” was spoken 19 times at the press conference alone, while the phrase “interest rate(s)” was spoken only seven times. While not everyone agrees that it is proper for monetary policy managers to address climate change issues, it does appear that the monetary policy management community is now generally coming to the conclusion that it must take some sort of action in response to the potential risks posed by climate change in line with the views of society at large, and the questions at the press conference reflected this trend. It is noteworthy, however, that such phrases such as “climate change” and “environment (in the sense of ‘environmental protection’)” do not appear at all in the GC statement – a summary of issues on which there is something akin to unanimous agreement within the GC. This may be a surprisingly important point. One intuitively gets the impression that President Lagarde is getting a bit ahead of herself in expressing her passion for addressing climate change.

Four Key Points Regarding the Strategy Review

The following four points summarize the key points of the press release announcing the start of the strategy review:

- (1) The review will encompass quantitative formulation of price stability, monetary policy toolkit, economic and monetary analyses (“two pillar approach”), and communication practices.
- (2) Other considerations, such as financial stability, employment and environmental sustainability, will also be part of the review. In addition, the stability of the financial system, employment and the stability of the environment must be within the scope of the review.
- (3) The review is expected to be concluded by end of 2020.
- (4) The review will be based on thorough analysis and open minds, engaging with all stakeholders.

In short, the press release is saying the strategy review will be comprehensive. On the positive side, it is comprehensive, and viewed pessimistically, one might say it is not very focused, but it is not yet possible to make any firm conclusions about how it should ideally be viewed. At the press conference, President Lagarde said – “we will not leave any stone unturned” – and this can be seen as reconfirming the emphasis on comprehensiveness. From the perspective of financial market participants, however, the “quantitative formulation of price stability” mentioned in point (1) is particularly important. It is expected that the current “below, but close to, 2% over the medium term” definition, which suggests that monetary policies may be tightened when the inflation rate approaches 2%, will be eliminated and replaced by a definition that justifies a more-permissive response to the surpassing of the 2% level. In this regard, a reporter at the press conference posed the question – “[...] there is a big gap between how people think inflation is actually developing and how inflation is measured in terms of, people feel that inflation is a lot higher. Would you also include real estate price development in a new inflation measurement, perhaps?” In response, President Lagarde said – “how we measure inflation is clearly something that we need to look at” – but went on to say she would not suggest that the measurement issue is something the ECB can resolve in a year. She noted the difficulty of apprehending and calculating the difference in perception between people in large

urban centers and in rural areas, for example, and said that if such differences are significant, then Eurostat should be given the task of devising more-sophisticated measurement methods.

Climate Change Risk and the ECB – President Lagarde not Necessarily Insistent on Consensus

In addition to the price stability definition, another key element of the strategy review is the addressing of risks associated with environmental sustainability, or climate change. Several reporters at the press conference asked about what specific steps the ECB might take in this regard. In her lengthy responses, President Lagarde said the ECB had decided to increase the share of green investment held in the ECB's own funds portfolio and would consider a similar increase the share of green investment by means of the Corporate Sector Purchase Programme (CSPP). While the CSPP focused mainly on corporate bond purchases, it is a significant entity that has come to account for a gradually increasing share of the current Expanded Asset Purchase Program (APP), but it still cannot be denied that it is still relatively small in scale. In light of that current situation, President Lagarde said – “the strategy is going to have to review what it can – what the Bank can do, should do, how much it collides with the mandate.” She went on to make a less-than-completely-clear suggestion that the ECB would be considering the application of environmental standards to the collateral it accepts (perhaps regarding the calculation of loan-to-value ratios). While there have been rumors about the consideration of such measures for some time, the measures are likely to become a hot topic of discussion when the ECB pursues additional easing in the future, even if the strategy review has not been completed at that time, and that discussion will inevitably continue in 2021 and subsequently.

Another frank question posed by a reporter at the press conference was – “you have raised quite high expectations on the future role of the ECB on the fight against climate change. Do you not fear that it will be difficult to deliver on that?” In her response, President Lagarde acknowledged the validity of concerns about “mandate creep” and distractions from core central banking tasks as well as about the appropriateness of central banks undertaking tasks that are ordinarily the responsibility of other government entities, but then said – “I'm aware of all that, but I'm also aware of the danger of doing nothing and I think that failing to try is already failing.” She thereby clearly articulated her view that the ECB should consider addressing climate change. She then further expanded the potential scope of the ECB's operations, saying – “We should at least try to explore every area where we can actually participate in a determination” – and explained that she wanted the ECB to become engaged with the decision-making processes of the European Commission and euro area leaders as well as the private sector.

As previously mentioned, there is a tension between President Lagarde's omnidirectionally positive attitude and the relatively dry tone of the GC meeting's statement. In fact, President Lagarde is probably keenly aware of that, and it can be surmised that that is the reason she noted after the above-cited quotes that – “That's my personal take on that[.]” President Lagarde also expressed support for a Bank for International Settlements (BIS) report finding that climate change is a threat to financial stability and said she would welcome the involvement of accounting firms in the setting of international accounting standards that take that finding into account. I think it would be very premature, however, to conclude that the enthusiasm for proactively addressing climate change that President Lagarde demonstrated at the press conference reflects the overall view of the ECB.

Change to the Consensus System?

The press conference also included a question about the ECB's decision-making process. The ECB's policy decisions are theoretically consensus-based, as the ECB's standard practice is to present Governing Council decisions as representing a consensus of council members' views. This is different from the approaches of the BOJ and the Fed, which straightforwardly use a transparent voting system, and there is general interest in whether the ECB's strategy review will encompass consideration of whether the consensus system should be retained. A reporter at the press conference noted that the consensus system has advantages but might also have some disadvantages and then asked – “How important is it for you to reach unanimity or broad consensus in important monetary policy decisions?” President Lagarde responded that – “I draw a line between consensus building and repressing alternative views, and I can assure you that we are not short of alternative views, right? There are multiple views around the table on multiple aspects of monetary policies. I am not a despotic President of the Governing Council; all views are welcome. All governors have their space and time in order to share their perspective and submit their views. At the end of the day, and at the end of the process, we still have to complete the introductory statement and release the monetary policy decision if and when it is expected and required. I don't think it is repressing views.” This response makes it clear that she does not consider the current consensus method to be problematic, and it is therefore probably reasonable to assume that the ECB's decision-making process may not be an important focus of the strategy review. There have been reports, however, that there are increasing calls for the introduction of a voting system in the wake of a major crack in the Governing Council's unanimity last September. This seems to indicate that there are some Governing Council members (probably those from Germany) who do not wholeheartedly support President Lagarde's views on this issue.

Relationship Between Strategy Review and Interest Rate Outlook

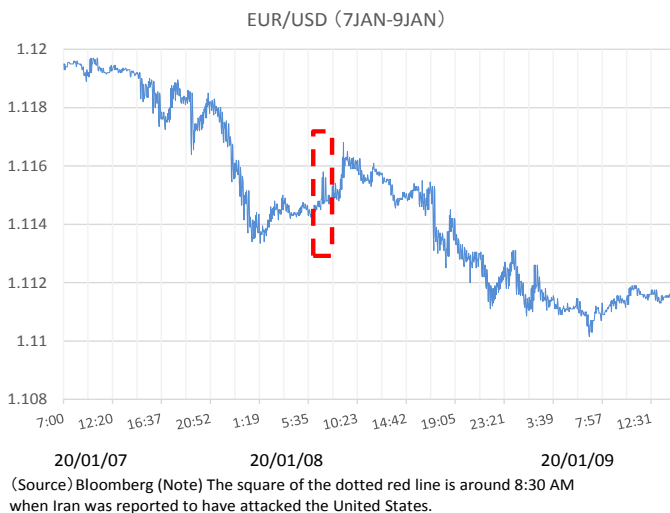
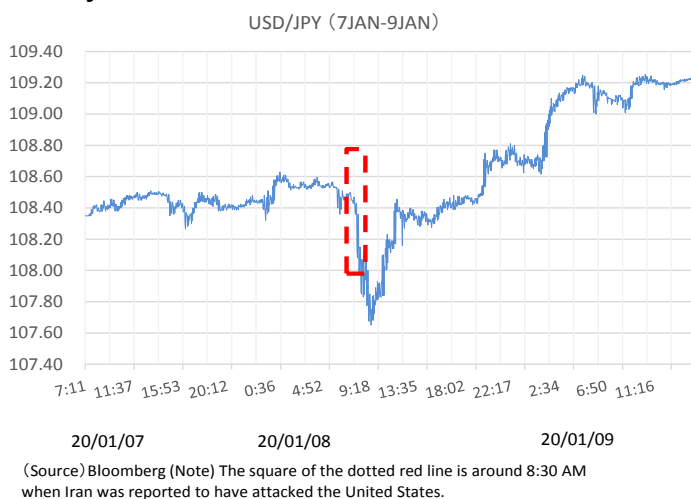
Many market participants probably consider the question of how the strategy review might affect the nature of the “next move” to be of paramount importance. In this regard, a reporter posed the question – “is the view that the ECB can't or won't raise or cut interest rates as long as the review is being discussed, justified?” In short, there is fear that the ECB's policy responses may be more-difficult to anticipate during the strategic review process, decreasing transparency and causing greater uncertainty. This is an issue I personally am concerned about. In her response, President Lagarde said – “we will have a new strategy when we have concluded the exercise.” – and suggested that decisions prior to the strategic review's completion will be based on the current strategy. As mentioned above, however, it is generally believed that the ECB's inflation target going forward will be significantly higher than previously (tolerating inflation rates above the 2% level), and it can be anticipated that this belief will promote market expectations of greater easing even prior to the strategic review's completion. Some of President Lagarde's language is cause for additional concern, such as the statement – “Our expectation at this point is that it will take a year.” – and – “When I say it will be over when it is over, what it means is that [...]” – followed by a long explanation of how strategic review discussions will progress in parallel with the ECB's ordinary monitoring, analysis, and conclusion-drawing work regarding economic and financial conditions but separate from and independent of that work. These statements seem to hint at a possibility that the strategic review might not be completed this year. Whether or not the hints prove true, they are an additional noise factor likely to diminish the clarity of the ECB's policy stance. In any case, the slight difference in tone between the GC meeting statement and the post-meeting press conference is encouraging speculation about whether the tone difference might reflect some internal frictions or discord associated with the strategic review, and one can only hope that the strategic review process will be successfully completed without conjuring up fractious divisions within the Governing Council.

EUR now and going forward – Verifying that EUR Dominates JPY as a Funding Currency

Does EUR Really Dominate JPY as a Funding Currency?

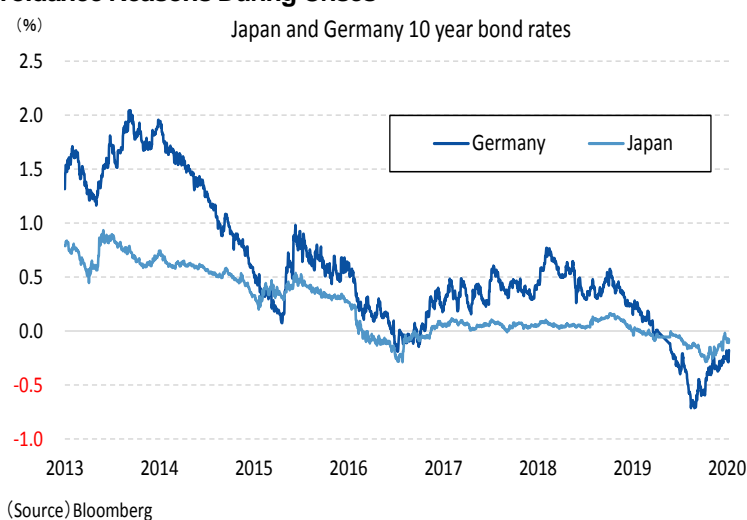
The appreciation of JPY in response to rising tensions Middle East from early this year quickly became a hot topic of discussion. In this regard, it is worth reexamining the – “EUR has become preferred to JPY as a funding currency for carry trading, so risk avoidance moods will lead to greater EUR buying than JPY buying (therefore decreasing the ease of JPY appreciation).” – theory. This theory has been receiving a certain amount of attention since last year as an explanation for the relative stability of JPY forex rates during crisis periods. The period of market volatility associated with the perceived rise in Middle East-related risks seems to have been a good opportunity to test this theory. The rise in Middle East-related risks did in fact spur some EUR appreciation against USD. However, one gets the impression that the EUR appreciation was not as great as the JPY appreciation at that time.

Iran's attack on the United States was reported around 8:25 AM on January 8, Japan time. For example, Reuters reported the hearing of blasts in Iraq at 8:25am. Subsequently, as the details gradually became more clear, there was a risk aversion mood that continued for about an hour. Looking at the movements of JPY and EUR during that time, one finds that EUR appreciated against USD by a maximum of about 0.2% during the hour following the report. (EUR/USD moved roughly from about 1.115 to 1.117.) At the same time, JPY appreciated against USD by a maximum of approximately 0.7%. (USD/JPY moved roughly from 108.50 to 107.70.) If EUR is more dominant than JPY as a funding currency, a growing risk-off mood would be expected to cause roughly comparable levels of EUR appreciation and JPY appreciation, but in the January case, the JPY appreciation was greater.



EUR Clearly a Currency Purchased for Risk-Avoidance Reasons During Crises

However, it was also interesting to see that EUR was in fact a currency bought during a crisis. Given Europe's increasingly limited leeway for the use of monetary policies and its huge current account surpluses, it is believed that the ECB and the euro area are gradually becoming BOJ-ized and Japanized, respectively. While EUR is also in the process of becoming JPY-ized, however, it is questionable whether the process should be considered to be gradually progressing. Although the period of heightened perception of Middle East risk was transient, it offered a good opportunity to observe the change in the nature of EUR. About five and a half years has past since the publication of my book, "Ready for the Japanization of Eurozone, Euro and ECB" (Toyo Keizai Shinposha, July 2014). In



2014, the German 10-year interest rate was around 2%, but now German interest rates have fallen below zero, just as in Japan, and the German rates are now at levels that are consistently below the Japanese rates. This is just one of the results of the ECB's BOJ-ization, but one must also note the prior loss of attractive investment opportunities in the euro area along with a decrease in the euro area's interest rate (the natural interest rate) that matches savings with investment. In other words, these changes are consequences of a drop in the euro area's potential growth rate. The prospective euro area scenario described in "Ready for the Japanization of Eurozone, Euro and ECB" is slowly but surely being realized. In particular, the reactions to the rise of Middle East-related risks appear to be additional evidence of EUR's JPY-ization.

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