

# Forex Medium-Term Outlook

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## Overview of Outlook

For the first time in many months, USD/JPY was highly volatile in February. At one point, some were mistakenly mocking this as a case of JPY selloff, but in the current risk-off mood associated with the coronavirus, the trend of buying JPY as a safe currency was more deeply persistent, and as of the writing of this report, JPY has blossomed into one of the strongest currencies of the year so far. However, my position is that this is no more than a development triggered by the pandemic. In the first place, the U.S. economic expansion and associated strength of USD have been going on far too long. However, U.S. interest rates, which act as guideposts for the forex markets, have declined significantly during this time. This distortion between USD rates and U.S. interest rates is most likely because interest rates associated with JPY and EUR, the main trading partner currencies for USD, have been negative, creating an investment climate in which USD was still the currency with relatively higher interest rates. The important point to note in the current phase of confusion, however, is that Japanese and European interest rates have not declined to the extent that U.S. interest rates have – Japanese and European authorities probably being conscious of having already hit the limit of negative interest rates. The decline in U.S. interest rates, therefore, has translated directly into a shrinking of the gap between U.S. versus European or Japanese interest rates, making USD-denominated assets that much less attractive as investment options. This report had predicted such a development, and the “corona shock” seems to have galvanized it. The current relationship between USD and U.S. interest rates is unhealthily distorted in any case, and my view is that 2020 will be the year that this distortion begins to be corrected. There seems no need to revise my outlook for USD/JPY from the previous month.

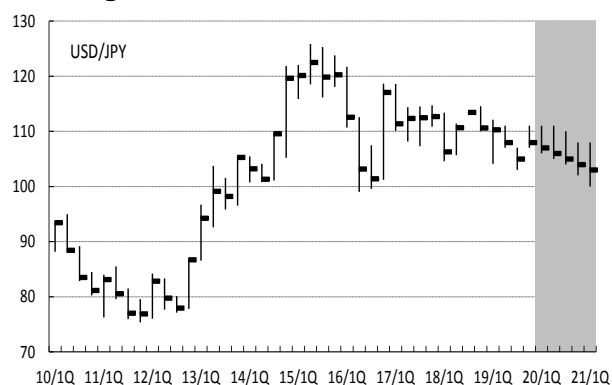
Meanwhile, EUR has also been facing significant volatility. Early in February, as the headlines focused on the area’s weak fundamentals and deep negative interest rates, political instability in Germany, an uncertain future for Brexit, and other negative news, EUR temporarily fell to an almost three-year low. However, toward the end of the month, EUR’s strength as a safe-haven currency led the currency to fully recover from its steep fall earlier in the month, resulting in quite a volatile month for EUR. However, the fate of the regional economy going forward is quite grim. The Chinese economy faces inevitable annihilation in the first quarter of this year, so the German economy is bound to continue battling severe shortage in external demand, given the extent to which it relies on the Chinese economy. Nor is it just about external demand. Coronavirus infections have been spreading rapidly within the region, centering on Italy. It is probably fundamental, then, to assume that the ECB’s policy operation will involve additional easing going forward. However, as we saw in February, monetary authorities in both Europe and Japan seem quite conscious that their negative interest rates have hit the limit. Assuming that the U.S.-Europe interest rate gap, a key driver for the forex markets, will shrink further, my prediction is that EUR could easily strengthen as a result of USD weakening.

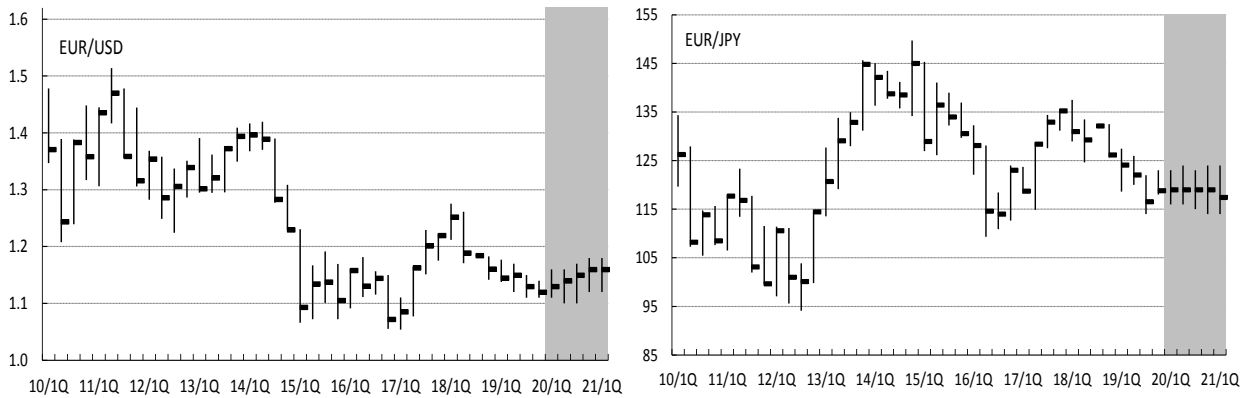
### Summary Table of Forecasts

	2020					2021
	Jan-Feb (actual)	Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
<b>USD/JPY</b>	107.51 ~ 112.23 (107.55)	106 ~ 111 (107)	105 ~ 111 (106)	104 ~ 110 (105)	102 ~ 108 (104)	100 ~ 108 (103)
<b>EUR/USD</b>	1.0778 ~ 1.1224 (1.1062)	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)
<b>EUR/JPY</b>	118.40 ~ 122.88 (119.00)	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 2 MAR 2020. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels  
3. Forecasts in parentheses are quarter-end levels

### Exchange Rate Trends & Forecasts





## USD/JPY Outlook – Pandemic Risk, U.S. Interest Rate Decline, “Dump Japan” Misinterpretation

### My Basic Understanding of the Coronavirus Shock – U.S. Interest Rates Especially Prone to Decline

#### ***Taking Stock of the Scars from the Coronavirus Shock***

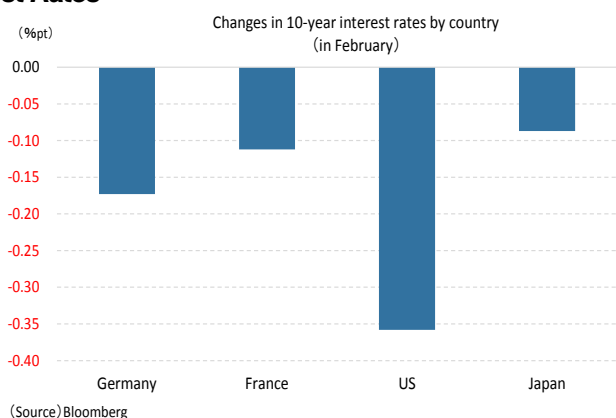
The spread of novel coronavirus (COVID-19) infections in February shook the global economy and financial markets. Frequently and in many circles, the “coronavirus shock” is mentioned as being similar in magnitude to the “Lehman shock” (economic impact of Lehman Brothers collapsing). It is true that the extent of price corrections of stocks and other assets is similar to that seen during the most critical period of the financial crisis following the collapse of Lehman Brothers in September 2008. However, despite the similarity in magnitude, the magnitude of the coronavirus shock is unlikely to surpass that of the Lehman shock. The most terrifying thing that happened in the financial markets following the collapse of Lehman Brothers was not the across-the-board asset-price crash. It was the liquidity crisis. Trading in the financial markets came to a standstill, creating a situation in which people were unable to sell the financial assets they owned, to know what their asset balance was, or even to gauge the extent of their losses. The current crisis has not created circumstances as dire and is, therefore, not quite as bad.

Having said that, “better than the Lehman Shock” is hardly a complimentary description of the current global economic and financial situation. Even if there is no liquidity crisis, the deterioration of asset prices, business confidence, and lagging indicators is quite severe. At 35.7, China’s February Manufacturing PMI, released on February 29, was conspicuously lower than its level following the Lehman Shock (38.8). What is worse, the Nonmanufacturing PMI, which analysts had been saying was relatively strong, plunge by a shocking 24.5 points mom to 29.6 (unsurprisingly, an all-time low), revealing the blow to domestic demand in China as a result of the forced suspension of economic activity. In March, a series of indicators reflecting the state of the economy in February will be released. The financial markets will then enter a phase of taking stock of the scars from the coronavirus shock.

#### ***Coronavirus Shock Highlights Steep Fall in U.S. Interest Rates***

I would like to defer to the experts when it comes to analyzing the threat from the coronavirus and when the outbreak is projected to end. However, one of the key points when it comes to financial market (especially interest-rate and forex market) trends accompanying the ongoing coronavirus crisis is that U.S. interest rates have fallen much more steeply than Japanese or European interest rates.

Let us review the changes in the 10-year interest rates of Japan, the U.S., Germany, and France during February. U.S. 10-year interest rates declined by about 0.35 pp, which is more than twice the decline in Japanese, German and French 10-year interest rates (see figure). In other words, the interest rate gap between the U.S. and the other countries shrank markedly. Of course, despite the shrinking gap, there is one absolute difference between U.S. and other interest rates – the fact



(Source) Bloomberg

that U.S. interest rates are positive while the other countries' interest rates are negative, which makes USD a more attractive investment option without a doubt. However, it is equally true that the aforementioned attractiveness is on the decline. In 2019, the federal funds (FF) rate was 1.75% after three rate cuts by the Fed (declining from 2.50% to 1.75%). Three more rate cuts in 2020, however, would bring the FF rate down to 1.00%, which could change the way market participants see USD. At 1.75% following the rate cuts, the FF rate was still head-and-shoulders above interest rates in most other developed nations (except Canada, which also has a 1.75% interest rate). However, at 1.00%, the FF rate will be at par with New Zealand's interest rate and barely above Australia's 0.75%. So far, the reason USD has remained unshakably strong no matter how hawkish the Fed's policy stance is because of USD's unchanging position as a high-yielding currency compared with JPY or EUR with their negative interest rates. However, if the Fed continues rate cuts going forward, USD's position could also begin to crumble.

Forex rates are said to follow a "random walk" pattern (i.e., they are impossible to forecast). However, the fact is that, until not very long ago, forex trend directions were influenced by the Fed's policy stance – so long as the Fed did not change its policy stance significantly, forex trends did not change direction. Yet, this tendency was not observed to be true in 2018-19. Even in cases where the Fed's policy stance has been a useful indicator of the U.S. economy and of the Fed's problem awareness, it has not proved a useful indicator of forex rates over the past two years. There may be several reasons for this, but the fact that USD's position as a high-yielding currency has not changed despite rate cuts is likely to be a significant one. However, can we say the same if the FF rate and U.S. 10-year interest rates fall below 1.00%? In the current climate, with Japanese and European authorities conscious of having reached the lower limit of negative interest rates, the U.S.-Japan and U.S.-Europe interest rate gaps can only shrink. My basic understanding, therefore, is that USD will remain level at best, but essentially weaken going forward.

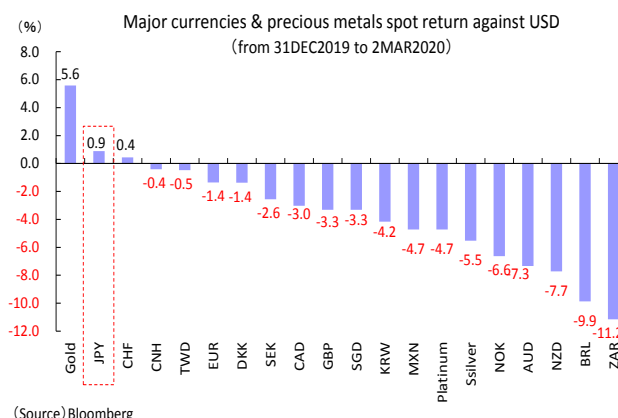
## JPY Now and Going Forward – “Dump Japan” Misinterpretation

### The “Dump Japan” Misinterpretation

The risk-off mood in February triggered a rare event in the forex markets, namely USD strengthening across the board even as JPY weakened sharply. This gave rise to sudden speculation in the financial markets that investors were “dumping Japan.” Factors such as the extremely large slump in Japan's October-December quarter GDP growth rate (annualized rate of -6.3% qoq) and the criticism levelled against the Japanese government over its coronavirus response gave credence to such an interpretation for a time. Market trends, however, soon returned to the established norm – stock prices in the U.S. and other parts of the world fell sharply, the U.S. 10-year interest rate declined steeply, and JPY strengthened rapidly. It seems safe to say, therefore, that the idea of “JPY as a safe-haven currency” is still alive and well. Given that there is no change in the basic or important facts surrounding JPY, it is wrong to incite the declaration of a change in the trend or supply-and-demand structure related to the currency. However, as of the writing of this report, coronavirus infections continue to spread, and the Japanese economy also seems likely to continue its poor performance, so we may see other instances going forward that are similarly interpreted. I would, therefore, like to take this opportunity to lay out the key points here in an effort to prevent confusion.

### No More than a Side Effect of USD Strength

The “dump Japan” trend speculation was no more than a misinterpretation by the markets. The depreciation of JPY we saw in February was no more than a side effect of USD strengthening. Even there, it was chance more than anything else. As of the writing of this report (March 2, 2020), JPY is one of the few currencies (along with CHF) that has strengthened against USD since the start of the year and blossomed into the strongest currency so far this year (see figure). However, even strong currencies such as JPY, CHF, and USD have not been as strong as precious metals, with gold prices, for instance, shooting up. The mood in the financial markets clearly reflects the critical situation. Precious metals, which had been climbing strongly since the beginning of the year, fell steeply at one point toward the end of February, but it is thought that this may have been due to the sale of precious metals for a profit to make up for the plunge in stock prices. This was the reversal of the voracious buying of precious metals until then. At any rate, there seems to be an ongoing shift in the flow of capital in the financial markets overall, from legal tender to a stateless currency (gold), while USD continues to be the single dominant currency when it comes to legal tender. USD/JPY could rise again going forward, but this should not be considered the result of any Japan-specific factor (such as a “dump Japan” trend).



### **Japan Remains World's Largest External Creditor**

It would be unnatural for the interest rates on Japanese government bonds (JGBs) to be stable had there been a “dump Japan” trend, because the level of confidence in JGBs reflects the state of the Japanese economy. However, the Nikkei Stock Price Average happily continued to ascend even after analysts had declared a “dump Japan” trend and JPY had depreciated against USD to the level of 112 yen to a dollar. JPY interest rates also remained stable at existent low levels. A real “dump Japan” trend is unlikely to selectively affect the forex markets while stocks and bonds remain unaffected. It seems unlikely, therefore, that the mood of giving up on JPY and the Japanese economy was all that intense.

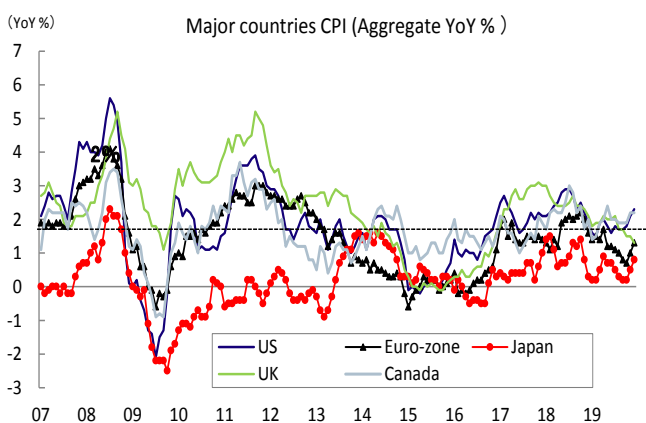
Moreover, one must not forget that Japan remains the world's largest external creditor. It is this that has upheld JPY's status as a safe-haven currency despite all of Japan's handicaps, including low economic growth rates, low inflation, enormous government debt, declining birth rates, and an aging society. As of the end of 2018, Japan was the world's largest external creditor for the 28<sup>th</sup> year in a row, and forecasts are that it probably retained that position at the end of 2019 (results to be announced at the end of May this year). To be sure, Japan has had stiff competition from Germany for that position in recent years, and it may at some point lose its status as the world's largest external creditor. However, that would still not change the fact of Japan being a major external creditor – a fact that underpins the confidence investors have in JPY. There may be other occasions going forward when market analysts declare a “dump Japan” trend if JPY happens to weaken in concert with poor government response to the coronavirus or a rapid decline in GDP. However, it is important to understand that they are simply trying to justify transient trading patterns.

### **Stateless Currencies Strengthen**

As mentioned above, precious metals have been appreciating more strongly than even JPY or USD, wielding their advantage as “stateless currencies.” As interest rates around the world dry up, the main disadvantage of gold, which is that it offers no carry (i.e., interest), is no longer such a big disadvantage. Meanwhile, crude oil prices have continued to weaken even though it is easy to assume that overall commodity prices may be in a similarly advantageous situation as stateless currencies such as precious metals compared with USD. Also, among precious metals, copper prices have been surprisingly weak, indicating the extent of the pessimism over the real economy in February. Having said all that, I have some concerns regarding the rise in gold prices, and will outline my basic understanding of the situation below.

### **Is It Right that Gold Prices Should Remain High?**

The “Keynesian beauty contest” principle is at work in financial markets, meaning that “any move considered right by the majority is right.” The consensus of market participants at this time seems to favor persistently high gold prices, and that is one of the appropriate approaches to price formation. However, the main reason for purchasing gold used to be to hedge against inflation – if we take inflation into account, the value of legal currencies will depreciate over time, a risk that can be avoided by investing in gold instead. This is the traditional rationale behind the demand for gold. However, as disinflationary trends become the norm around the world, there is no longer a great incentive to hedge against inflation. As of the moment, it seems unlikely that any developed nation would experience inflation consistently higher than 2% (see figure). Until not so long ago, people bought gold because they were concerned that protracted monetary accommodation would cause a non-linear rise in inflation, but it is no longer mainstream to bet on monetary policy having that kind of effect. Under such circumstances, some say that gold is being bought because of its scarcity.



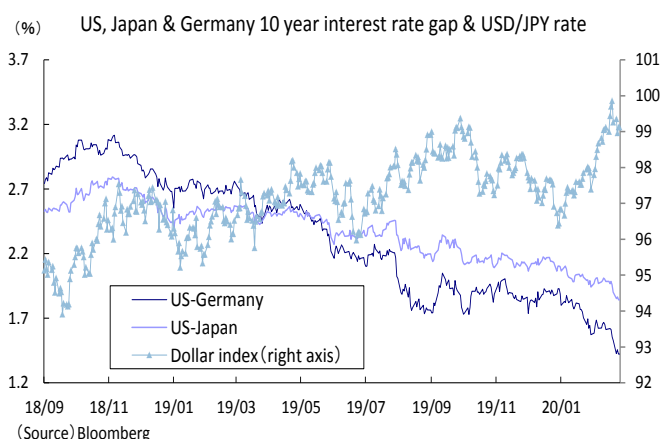
(Source) Bloomberg

The true test of the power of a scarce commodity lies in whether it can function as a means of exchange during times of crisis. In other words, should the need for it arise at some time going forward, will gold be accepted as payment in exchange for goods or services one may want to purchase? In this regard, it is clear that no asset has greater utility than USD. As a currency that has global circulation and is the most widely used as a unit for measuring value, USD is the asset that would be in the greatest demand when the going gets really tough. The fact that USD appreciated more than gold following the collapse of Lehman Brothers reflects the fact that, even if one had gold, one would be hard-put to find people who would accept it as payment in a crisis. The recent gold-buying trend reflects a popular investment strategy adopted against the backdrop of the coronavirus confusion, but I would like to make note of the fact that this strategy is not necessarily backed by solid reason.

## U.S. vs. Other Interest Rate Gaps Now and Going Forward – Gaps Begin to Shrink

### **Shrinking U.S. vs. Other Interest Rate Gaps**

As I mentioned at the start, U.S. bond market 10-year interest rates sank to an unprecedented low of 1.2% or so in February. Relative to this, German and Japanese interest rate declines were limited (see figure on previous page). However, looking back at September last year, when the mood in the markets was extremely pessimistic, U.S. 10-year interest rates fell to the level of 1.40% while German and Japanese 10-year interest rates fell to roughly -0.70% and -0.30%, respectively. Consequently, compared with September last year, the gap between the U.S. and German or Japanese interest rates has shrunk more markedly this time. Again, although U.S. interest rates have declined, there is no marked inversion of the 10-year yield curve.



The decline in interest rates for all maturities appears also to be reflected in the market's expectation of a rate cut from the Fed. Of course, one can see that there are expectations of further monetary accommodation from the Japanese and European authorities as well, but because there is also an awareness that any further deepening of the negative interest rate margin would be undesirable, there seems limited scope for rate cuts in Japan and Europe. As a result, the gaps between these countries' interest rates and those of the U.S. are narrowing and exerting pressure on USD to undergo a correction (see figure on previous page).

Many say that U.S. interest rates, stock prices, and USD began to decline following a warning from the Centers for Disease Control and Prevention (CDC) saying, "It's not so much a question of if (the pandemic) will happen anymore, but rather more a question of exactly when this will happen." That seems believable. If one can believe that a "dump Japan" trend was triggered by the sense that Japan was the country most affected by the coronavirus after China, it seems just as easy to believe that the CDC's warning would act as a trigger for letting go of USD. However, it seems to me that this turn of events in the market would have taken place even without the CDC's pessimistic outlook. Even assuming that the U.S. remains unaffected by the virus, the fact that other key economies including Japan, Europe, and China are struggling to deal with the pandemic would present a suitable excuse for the Fed to proclaim another round of "preventative" rate cuts. I know I repeat myself, but even after three rate cuts last year, USD remained a high-yielding currency, which gave it a relatively advantageous position as an investment option, but that may no longer be true if the Fed implements three more rate cuts from this point on. While admitting that these are extraordinary times, I still think that the discrepancy between USD rates and U.S. interest rates is too large.

### **As Pessimism Grows, Safe-Haven Currencies will be Put to the Test**

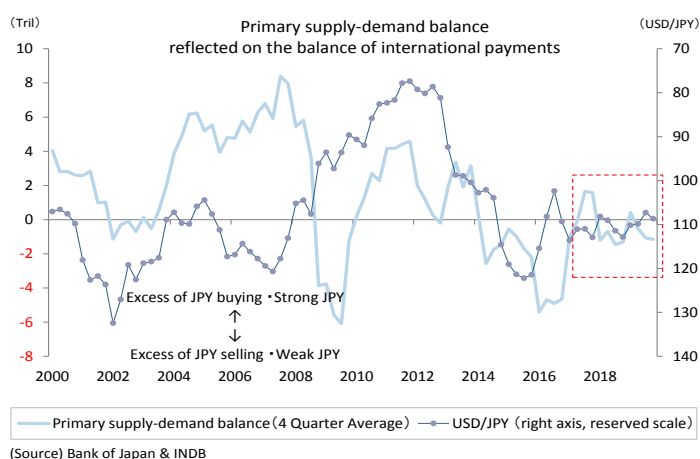
In the coming weeks, the U.S. ISM business indices and other countries' purchasing manager indices (PMI) for February will be released. January's figures were quite strong as they were released shortly before the coronavirus commotion took hold. For that reason, stock prices also increased. However, February's soft data will fully reflect the recent crisis. Although this is expected, there seems a strong likelihood that the financial markets will still receive a blow. In that sense, it may be too early to assume that the pessimism over the economic and financial situations (regardless of what the actual outcome is) has already peaked.

In the financial markets at present, U.S. interest rates are at all-time low levels even as USD is at a historically high level. This is a distortion made possible by the fact that U.S. interest rates are still relatively high (especially in comparison with the negative interest rates in Japan and Europe). However, as pessimism grows, U.S. 10-year interest rates have fallen to an all-time low level of 1.20%, and some predict an eventual fall to 1.00%. Meanwhile, it is difficult for Japanese and European interest rates to decline much further even at a time like this, because they have already reached their lower limits. If U.S. interest rates alone decline, causing the gap between U.S. and Japanese/European interest rates to narrow, USD-denominated assets will become less and less attractive. When such a situation arises, the true strength of old safe-haven currencies such as JPY and CHF will be put to the test.

## JPY Supply and Demand – March JPY Appreciation Theory Lacks Credibility

### JPY Supply-Balance Remains Neutral

In February, Japan's December Balance of Payments were released. With this, we have information regarding the JPY supply-demand balance<sup>1</sup> (an indicator this report focuses on as a guide for making forex forecasts) for all of 2019, so I would like to take stock of the situation in this section. The JPY supply-demand balance for 2019 amounted to a net JPY selling worth 4.6 trillion, which was almost unchanged from the net JPY selling worth 5.3 trillion in 2018. As I have argued time and again in this report, one possible reason for USD/JPY's lack of movement in recent years could be the loss of a clear trend in terms of a net supply or net demand for JPY. As shown in the image on the previous page (portion within the dotted square), the amplitude of the JPY supply-demand curve has become clearly smaller starting 2017, and one gets the impression that this may be contributing to the low volatility of USD/JPY. USD's annual movement range posted all-time record lows twice in a row in 2018 (9.99 yen) and 2019 (8.30 yen), and it is interesting to see that the USD supply-demand balance is more or less the same for these two years. Taking into account that the trade balance (which mainly comprises outright transactions) also posted only a modest deficit for both the years in question, at -JPY 1.2 trillion and -JPY 1.6 trillion, respectively, it is worth considering the possibility that USD/JPY remains range bound simply because there is no clear net supply or net demand trend for JPY. Incidentally, the 2017 trade balance was a surplus of +JPY 2.9 trillion, so the trade balance for all three years put together has been more or less neutral.



### No Grounds for Believing the March JPY Appreciation Theory

March is when the repatriation of dividends from Japanese companies draws attention. In particular, as a result of the recent surge in cross-border M&A activity, it is easy for market participants to speculate that the repatriation of funds from subsidiaries of Japanese companies abroad could exert an upward pressure on JPY, and I receive questions about this from my clients every year. As is generally known, Japan's current account surplus is now almost entirely due to its primary income balance, so this interest in dividends (or rather dividends & branch revenue allocated to investing company), which is one of the components of the primary income balance, is understandable. I must mention here that the Tokyo markets speculate about (i.e., expect) JPY appreciation toward the end of the fiscal year every year (not just recently), as though it were a seasonal poem. This is despite the fact that the theory does not have a good track record of proving true. Looking back at the past 20 years (from 2000 through 2019), we find 10 instances each of JPY strengthening and weakening, with there being no obvious bias toward strengthening (see chart). Even if we divide the past 20 years into two segments of 10 years each (2000 through 2009, and 2010 through 2019), there were four instances of weakening and six instances of strengthening in the former, and six instances of weakening versus four instances of strengthening in the latter, with no pronounced trends visible even here. The only thing that can be said in favor of this theory is that JPY has strengthened in March four times in a row from 2016 through 2019. This could be leading to the expectation that it might do so yet again this year, but the fact is that the appreciation has been extremely slight in all four years in question. This makes me think that the March JPY appreciation theory is not very credible.

March rates for each year

	Opening rate	Closing rate	JPY
2000	110.23	102.8	Strong
2001	117.35	126.22	Weak
2002	133.35	132.75	Strong
2003	118.21	118.04	Strong
2004	109.06	104.25	Strong
2005	104.62	107.15	Weak
2006	115.78	117.78	Weak
2007	118.55	117.82	Strong
2008	103.62	99.7	Strong
2009	97.85	98.98	Weak
2010	89.05	93.47	Weak
2011	81.78	83.13	Weak
2012	81.14	82.85	Weak
2013	92.6	94.25	Weak
2014	101.58	103.22	Weak
2015	119.595	120.145	Weak
2016	112.69	112.57	Strong
2017	112.75	111.4	Strong
2018	106.66	106.31	Strong
2019	111.4	110.82	Strong
		Strong JPY	10 times
		Weak JPY	10 times

(Source) Bloomberg

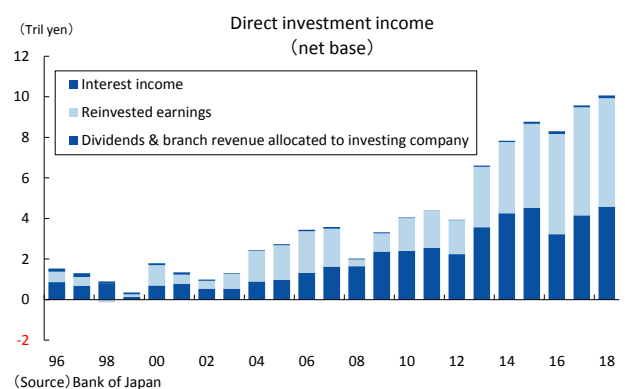
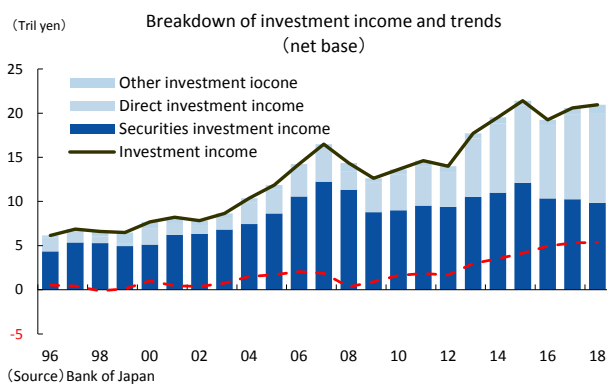
<sup>1</sup> An indicator calculated based on the Balance of Payments statistics, by adding the current account balance, the direct investment, outbound securities investment except that of the banking/government sectors, and inbound securities investment, and excluding reinvested earnings that remain in the form of foreign currency.



### Unrepatriated Reinvested Earnings on the Rise

As the figure to the left on the next page shows, half of Japan's investment income (i.e., primary balance surplus) over the past 10 years has been direct investment income. So, there is definitely an ongoing structural change, and many market participants expect a repatriation of funds from overseas corporations in the form of dividends. However, as the figure to the right on the next page shows, most of the increase in direct investment income over this period has been due to reinvested earnings. Of course, dividends have also increased so it is worth giving some thought to the theory of a repatriation of funds in March, but the key fact here is that most of the increase is in the form of foreign currency that is not repatriated but rather redirected into overseas investments as is. Taking the nature of this flow into consideration, the aforementioned theory, while worth considering, seems unlikely to have much of an impact. To repeat, the March JPY appreciation theory is not very convincing.

In conclusion, while Japan remains the world's largest external creditor, the fact is that JPY invested abroad is increasingly failing to be repatriated. This is a major structural change and a very important factor to take into consideration when formulating an outlook for JPY or the Japanese economy. In recent years, because of the weakening trend of buying JPY as a safe-haven currency, some analysts have been expressing pessimistic views in a very simplistic manner, suggesting that JPY is no longer a safe-haven currency and that Japan is on the decline. A more accurate reading of the situation would be that JPY is still a safe haven external currency, but it has become more difficult for a strong-JPY trend to take hold because of the change in Japan's external credit structure.



### Risks to My Main Scenario – COVID-19 as a JPY Appreciation Risk Factor

#### Potential for Prolonged Pandemic, Four Fed Rate Cuts, Revival of QE, etc.

As I do each month, I will at this point review the risk factors related to my main forecast scenario, but this time I will naturally have to give particular attention to the COVID-19-related situation. The six risk factors I am most concerned about are listed in the chart, and those are the same six factors listed in the chart last month. However, it has become important to note that the potential impact on the global economy from the spreading of COVID-19 has become quite significant. (For this reason, the likelihood of risk factor ⑥ has been upgraded from “low” to “medium”.) It is generally understood that the global economy, especially China, will inevitably suffer from a sharp fall in demand in the January through March quarter. As China has become a very important production center and market from the perspective of the global economy, the restriction of economic activities in China has impeded international flows of many goods and services and is expected to have a large impact on economies – such as those of Germany and the rest of the euro area – that are highly dependent on external demand.

From late last year through early this year, many observers' 2020 global economic forecast scenario anticipated that “the European economy will pass through a lingering period of sluggishness before getting back on track for recovery.” Some observers expected that China's economy would bottom out and begin accelerating again during 2020, accentuating the European economy's trend of strengthening. At this point, however, it is evident that the spreading of COVID-19 will keep Chinese domestic demand weak and thereby depress the exports of Germany and the rest of the euro area. In 2019, there was general belief that if Chinese and European economies catch a cold, the United States will need to defensively inoculate itself by means of interest rate cuts, and three interest rate cuts were in fact implemented. Already, U.S. stock prices have been adjusted significantly downward in light of COVID-19, and U.S. 10-year interest rates have fallen to record low levels. In this situation, it would not be surprising to see another one or two U.S. interest rate cuts, and more than a few market participants are anticipating such cuts.

However, we have no way of knowing how long the COVID-19 threat will persist during the forecast period. The spread of COVID-19 infections in the United States is rapidly proceeding, and if that trend continues, it is impossible to discount the possibility that the Fed may cut interest rates four times during the forecast period and eventually resume quantitative easing (QE). Many market participants seem to be assuming that the COVID-19 pandemic will

gradually fizzle out as summer approaches, but given that infections have continued even amid such a warm climate as that of Singapore, one cannot dismiss the possibility that the pandemic will continue to spread. If the spreading is protracted, one can expect that U.S. interest rates will fall further, causing a greater amount of USD depreciation, JPY appreciation, and EUR appreciation than this article's main scenario anticipates.

#### JPY depreciation risk factors

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

(Source) by Karakama, Mizuho Bank

#### ***Voter Appeal of Fiscal Stimulus Programs***

Looking at JPY depreciation risk factors, we must keep an eye on the possibility that the Trump administration will undertake fiscal stimulus programs, which corresponds to risk factor ① in the chart. On February 14, National Economic Council Director Lawrence Kudlow was reported to have said that the Trump administration hopes to launch an additional tax cut plan in September aimed at reducing middle class taxpayers' tax burden by an additional 10% and making current tax cuts from the Tax Cuts and Jobs Act of 2017 permanent. Other sources are reported to have indicated that the administration is considering tax reforms designed to encourage households to invest in stocks. There is no doubt that such moves are intended to appeal to voters prior to the November 3 presidential election. First of all, the Democrat-controlled House of Representatives is extremely unlikely to pass such proposals. Secondly, while middle-class tax cuts were instituted by the Tax Cuts and Jobs Act of 2017, passed prior to the 2018 midterm elections, there has been very little debate about those and similar tax cuts since then. The proposals are essentially a rhetorical strategy that leverages President Trump's position as the incumbent. Given the spread of COVID-19 infection and its potential for promoting a global economic slowdown, however, it is conceivable that some Democrat representatives might support such proposals to avoid being saddled with blame for an global economic slowdown, so there is a greater-than-zero possibility that Congress might approve fiscal stimulus programs. It is worth keeping this situation in mind as a JPY depreciation risk factor.

#### ***Continued Concerns about "No-Deal" Brexit Risks***

While the U.K. finally left the EU in January, it has only four months remaining before the deadline (June 30) for deciding whether to extend the Brexit transition period, which is currently scheduled to end at the end of 2020. As the U.K.'s Withdrawal Agreement Bill prohibits any transition period extension, the country must negotiate and approve a new agreement defining its future relationship with the EU by the end of this year. The negotiators will have to expeditiously determine all fundamental characteristics of the prospective UK-EU relationship, including those related to such issues as a Free Trade Agreement (FTA) and security systems.

As the negotiations are starting in March, there will be only 10 months – from the start of actual negotiations to the end of the transition period – in which the current economic relationship can continue. Given the time required for each side's ratification procedures, however, the negotiations cannot proceed right up to December 31. Assuming the ratification processes will take about a month, the parties have nine months (March through November) to discuss their future relationship. Since FTA negotiations usually require several years from the start of negotiations to ratification and implementation, the parties will have to work with extraordinary speed to negotiate the preconditions to a successful divorce in nine months. It is fully possible that such speedy success will not be achieved, causing a "no deal" Brexit.

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.” In short, the EU's basic perception is that negotiations must be undertaken based on due consideration of the potential problems associated with a “no deal” Brexit. Similar to the U.S.-China trade negotiations, which have been allowed to enter a lull period following the phase 1 agreement, the fundamental forecast scenario for the initial new UK-EU relationship agreement is that it will be a partial or less-than-comprehensive emergency agreement designed to mitigate Brexit-related economic damage by facilitating sustained trade relations. If there is a fairly tight focus on trade relations alone, it may be possible to reach an agreement by the end of the year.

However, reaching a “partial agreement” will not be easy. In negotiations leading up to the U.K.'s Withdrawal Agreement Bill, considerable time was spent discussing the Irish border issue. It is generally acknowledged that the Irish border issue is the biggest Brexit-associated challenge, and I agree with this view. However, there is another thorny issue that has not been in the spotlight prior to the start of actual negotiations regarding the trade-relations aspect of the future relationship. That is the issue of fishing rights, which some expect to be among the biggest challenges the negotiators will face. The February 3, 2020, of Mizuho Market Topic issue, entitled “Brexit Q&A: From Ireland Issues to Fishery Rights Issues”, offers a detailed discussion of this issue, but the core of the issue is whether EU fishermen will continue to have access to British territorial waters after Brexit. As this is of vital importance for such relatively vocal EU members as France, Spain and the Netherlands, it is likely to be an important issue in the negotiations. It now appears clear that the EU will not be able to finalize an FTA agreement that does not include sufficient resolution of the fishing rights issue.

The UK would prefer to exclude fishing rights issues from the FTA negotiations, but the EU does not appear to be willing to allow that. Without an post-Brexit FTA, the UK will lose free trade agreements with 27 countries, while the EU will lose only its free trade agreement with the UK. While this seems to be quite disadvantageous for the UK, it is important to note that EU member states do not always present a monolithically unified front in their negotiations. Some EU member states have a particularly strong interest in fishing rights, while other states are more focused on issues related to automobiles and agriculture, for example. One negotiating tactic the UK might employ is to strive to promote divisiveness among EU member states based on this diversity of interests. In any case, there is a high likelihood that the fishing rights issue will be comparable to the Irish border problem in its thorniness. And it is questionable whether this issue can be resolved within an extremely short nine-month time frame so that the transition period can end with a soft landing. The continued existence of the no-deal scenario should be kept in mind and, regarding the forex market, it should be remembered that such a scenario could be expected to increase the risk of JPY appreciation, EUR depreciation, and GBP depreciation trends.

### ***Overall Dominance of JPY Appreciation Risk Factors***

In addition to the risk factors reviewed above, there remain such risk factors as those associated with strongly leftist positions of certain U.S. presidential candidates and with a potential trend away from negative interest rates (both JPY appreciation risk factors), but those situations were discussed in last month's edition of this article and have not changed much since then. One continues to get the impression that the JPY depreciation risk factors are not very great in comparison to the JPY appreciation risk factors. While it is impossible to know how long it will be spreading, COVID-19 has clearly further shifted the balance of “unexpected exchange rate risk factors” in the direction of JPY appreciation. Conditions in the global economy have undoubtedly begun a trend of deterioration, at least regarding the January-March quarter, and the balance of USD/JPY-related risk factors is clearly on the downside. Of course, the pandemic is not likely to singlehandedly reverse the business cycle, and when the pandemic eventually ends, depressed demand factors can probably be expected to quickly retain their previous levels. Therefore, one should not be expecting COVID-19 to cause sharp movement in JPY forex rates.

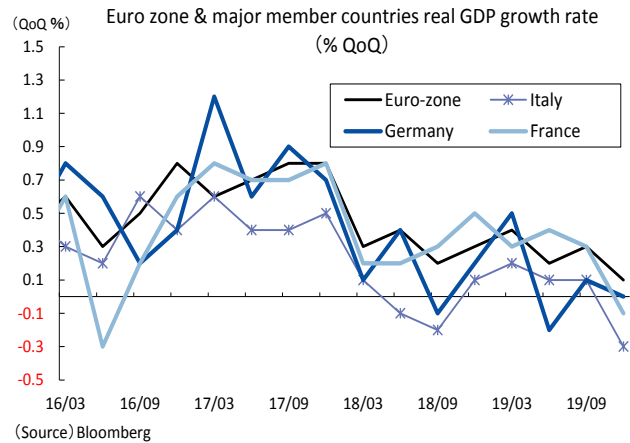
The situation is still quite complex. This article has repeatedly noted that the U.S. economy has already grown for so long – its current expansion period is about to enter its 11<sup>th</sup> year (132 consecutive months as of this June) – that it can be considered to have only limited leeway for additional growth. Given that situation, the U.S. economy's ability to resiliently absorb external shocks may be diminished, and it might be wise to consider the possibility that the global economy's current turbulence could well be the last straw for the current expansion period. Moreover, I think the most likely scenario going forward is that the Fed will continue lowering interest rates during 2020, thereby causing significant USD depreciation, and I think forex market players should be preparing themselves for this. In my view, the risk associated with this situation is mainly the risk of anticipating a particular level to which USD/JPY will descend – whether it will go to 105, 100, or lower. Should the FF rate be reduced at a rate of four times per year, it will soon reach 0.75%. Given that USD appreciation has been stemming from USD being a high-interest-rate currency, it would seem quite dangerous to assume that USD's strength will persist despite such an interest rate drop.

# EUR Outlook – Shakiness of the V-Shaped Recovery Scenario

## Euro Area Economy Now and Going Forward – A Few More Steps Down the Established Path in 2020?

### Clear Trend of Deceleration in Three Key Countries

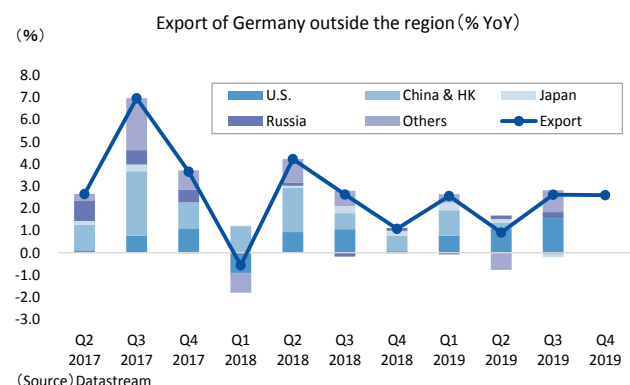
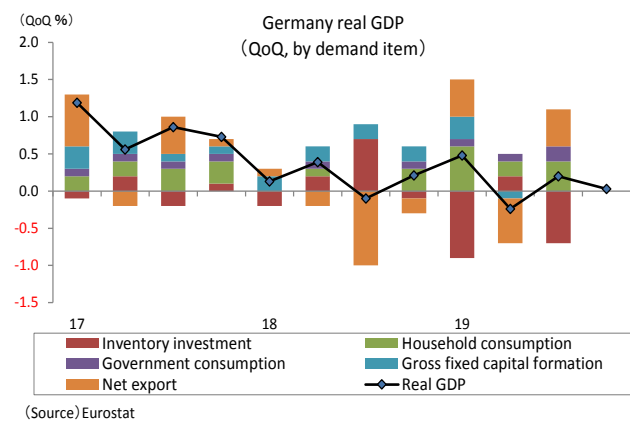
Significant euro area hard data deterioration proceeded during February, and the region's relationship with China – the epicenter of COVID-19 – complicates efforts to understand its short-term economic outlook. Released in February, euro area real GDP figures for the September-December period of last year (before the impact of COVID-19) are weak. The GDP growth rate for the euro area as a whole (second provisional figures) was +0.1% qoq, unchanged from the first provisional figures, while the annualized rate was revised down to +0.2%, from +0.4%. Euro area figures for the contribution to GDP by individual demand segments have not yet been released, but GDP figures for individual countries have been published (see graph),



showing that Germany continues to show a noteworthy downturn, while such core countries as France and Italy have fallen into negative growth. Given the deceleration trend that has been evident in Germany, France, and Italy during the past three years, it is very difficult to anticipate acceleration of the overall euro area economy. Global manufacturing sentiment bottomed out at the start of this year, exerting a positive effect on financial markets, and this situation was also seen in the euro area. Based on past experience, the bottoming out of manufacturing sentiment would suggest a prospective bottoming out in euro area GDP trends, but the January manufacturing sentiment figures (such as PMI figures for various countries and the ISM figure for the United States) were compiled prior to the full-scale recognition of the COVID-19 situation. In light of that, it is fully possible that the PMI will have to undergo a second bottoming out process during which euro area GDP figures can be expected to weaken.

### Germany's Shaky V-Shaped Recovery Scenario

There is particular cause for concern about Germany. The main scenario of the economic forecast released by Germany's central bank (the Bundesbank) last December envisioned a V-shaped recovery, with yoy GDP growth rates rising from a nadir of +0.5% in 2019 to +0.6% in 2020, +1.4% in 2021, and +1.4% in 2022. The most recent figures have revised Germany's 2019 GDP growth rate up to +0.6%, but that still represents as very sharp deceleration from the +1.5% rate recorded for 2018. In addition, the main forecast scenario does not anticipate that the rate of annual growth in Germany's CPI on a core basis, excluding food and energy, will reach +2% by 2022. Euro area figures for individual demand segments have not yet been disclosed, but a press release from Germany's Federal Statistical Office indicated that German household final consumption expenditure and government final consumption expenditure, which strengthened in the July-September quarter, slowed down markedly during the September-December quarter. Regarding fixed capital formation (capital investment) – a private-sector-demand pillar of a magnitude comparable to personal consumption – the press release indicated there was acceleration in construction-related and "other" investments but a marked slowdown in investment in machinery and equipment. As the graph on the previous page shows, in Germany considerably drew down its inventories during



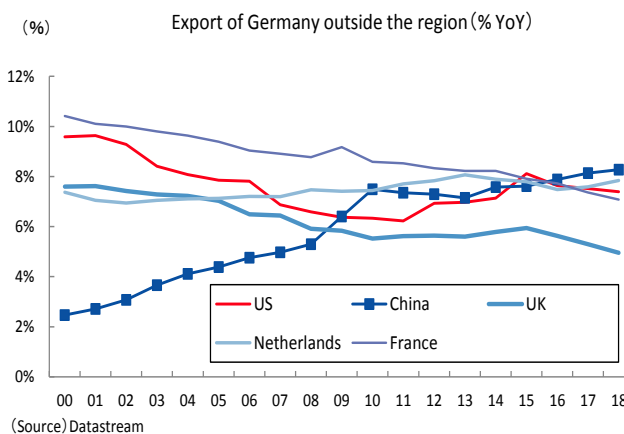
the first three quarters of 2019, although inventory investment did not seem to boost the GDP growth rate in the October-December period. There are thus reasons for doubting the feasibility of the Bundesbank's main forecast scenario of V-shaped recovery from a nadir in 2019.

Exports play a key role in propelling Germany's economic growth, but export growth also slowed during the final quarter of 2019. As shown in the graph on the right, Germany's exports to China decelerated in 2019, but that deceleration was offset by the strength of exports to the United States. That is why Germany's net exports made a positive contribution to GDP growth in the January-March and July-September quarters, thereby helping prevent a recession. As the deceleration of exports to China is likely to continue through the first quarter of 2020, the level of exports to the United States are likely to determine the overall trend in Germany's exports. It can be said that Germany's economy is based on external demand in a way similar to standing on dangerously thin-ice.

### US Needs a "Vaccination" to Protect Itself from China and Euro Area Deceleration

Among the global economy's four key regions – the United States, Europe, China, and Japan – Europe was the one that previously appeared most likely to realize an upward revision to its economic outlook during 2020. The basis for such an expectation was a simple but quite compelling theory that, after three years of steady deteriorating economic conditions, the time was becoming ripe for the euro area economy to rebound. In light of conditions in China's economy since the start of 2020 and the fact that German economic growth has previously been supported by Chinese demand, however, it now appears that Germany's economic recovery will inevitably be delayed and that that delay will have a considerable impact on the euro area's overall economic performance.

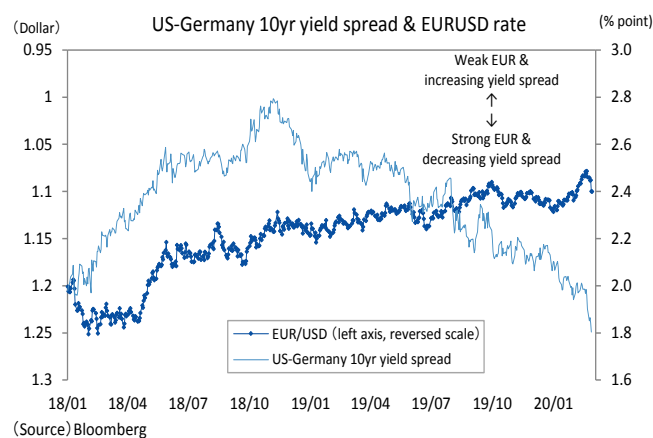
The share of Germany's international trade accounted for by China was only slightly more than 2% 20 years ago, in 2000, but it has subsequently risen to above 8% (see graph). The Germany-China honeymoon promoted by Chancellor Merkel has created a situation in which, when the Chinese economy catches a cold, that virus will be passed on to Germany and the rest of the euro area. In recent years, the overall global economic scenario has been strongly affected by the existence of that pattern of contagion along with U.S. efforts to protect itself by "inoculating" itself with interest rate reductions. That kind of analysis became increasingly convincing during 2019. Currently, it appears that 2020 may well be a year when the global economy take a few more steps down the road described by that analysis.



### EUR now and going forward – Strengthening the Negative Interest Rate Policy as a Currency Depreciation Policy

#### "Negative Interest Rate Depth" Promoting Aversion to EUR

In February forex markets, EUR at one point depreciated against other currencies to its lowest level in about three years. Reflecting the characteristic trait of being widely purchased during risk-off periods that it has demonstrated in recent years, EUR appreciated somewhat towards the end of the month, but it continues to have a heavy upside. It is highly likely that this heavy upside is a consequence of aversion to EUR's "negative interest rate depth", which expected to continue for the foreseeable future. As noted above, there are few positive aspects of the euro area's GDP growth and other basic economic indicators, and there is growing concern that the area's already-deep negative interest rates will be further deepened. Moreover, the growing fear that EUR interest rates will sink further into the negative range makes even such zero-interest assets as gold become evaluated as relatively-high-interest-rate (and rare) assets, and upward trends in the prices of such assets will further intensify this situation. (This may well be a reason for the general increase in central banks' gold purchases.) Looking at U.S.-euro area interest rate differentials, one finds that the margin of decrease in U.S. interest rates has exceeded that in euro area interest rates,



causing, for example, the U.S.-German 10-year interest rate differential to narrow sharply since the middle of last year (see graph). While EUR/USD would normally be expected to rise in this situation, it has contrarily trended downward. This may indicate that the depth of negative interest rates has not become a decisive factor in the eyes of prospective EUR buyers.

### Assets Flowing Outside Euro Area

The quarterly “Euro area investment fund statistics” released by the ECB on February 20 help clarify the situation. The rise in the balance of euro area investors’ extra-regional assets has consistently risen faster than the balance of their intra-regional assets since the financial crisis, and in recent years, the ratio of euro area investors’ intra-regional assets to their extra-regional assets (intra-regional assets ÷ extra-regional assets) has fallen below the 1.0 level. The ratio’s decline has been particularly noticeable since the start of 2019, most likely reflecting euro area investors’ growing aversion to EUR-denominated assets, the negative interest rates of which have deepened amid the global economy’s deceleration.

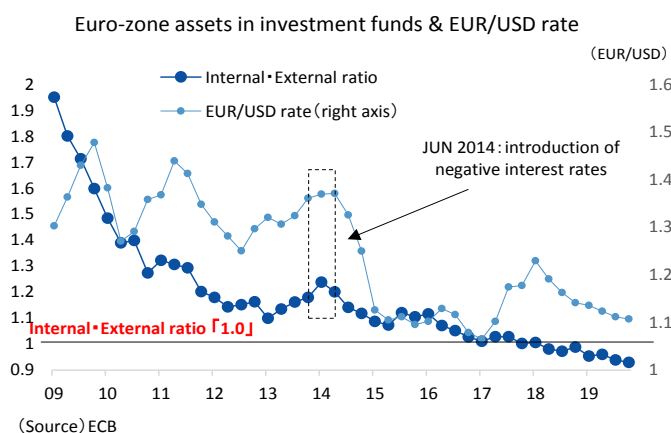
When the U.S. 10-year interest rate descended to 1.4% last September last year, the German 10-year interest rate dropped to -0.7% and the French 10-year interest rate fell to -0.4%. The market environment has kept U.S.-euro area interest rate differentials stable, and this stability is probably the reason USD appreciation has not been reversed despite U.S. interest rate cuts.

That said, things are changing. Following the COVID-19 Shock in February, the U.S. 10-year interest rate has fallen to record low levels in the 1.2-1.3% range, but the 10-year interest rates of Germany and France have been relatively stable at -0.5% and -0.3%, respectively. This may reflect market expectations that the ECB might already have reached the limit of its ability to further depress euro area interest rates. Since there has not been much change to the euro area interest rate submergence situation, it is still not expected that the direction of capital flows will shift from USD back to EUR. If the situation were to become extreme with, for example, the U.S. 10-year interest rate falling to around 1.0%, the principle of “buying USD because it is a high interest rate currency” may no longer hold, but this issue also relates to the difficult-to-answer question of how far below zero the interest rate levels of currencies with negative interest rates (EUR and JPY) can sink. Even in extreme cases such as a drop of the U.S. 10-year interest rate to 1.0%, USD may not collapse if the German 10-year interest rate falls below -1.0%.

### Strengthening the Negative Interest Rate Policy as a Currency Depreciation Policy

In light of all this, it seems reasonable to conclude that the strength of USD against EUR may continue so long as negative interest rates are not discontinued. USD has been appreciating against EUR for five and a half years, since June 2014, which happens to be the month when the ECB decided to introduce negative interest rates. This is probably not a mere coincidence. Ultimately, the apparent fact that USD will continue appreciating against EUR so long as negative interest rates are maintained means that the ECB’s negative interest rate policy is effectively functioning as a currency depreciation policy. If we can accept as a new kind of common sense that the ECB’s negative interest rate policy guarantees USD’s continued strength, then it will also simplify the process of forex rate forecasting – forecasters can feel free to just uniformly forecast USD strength against EUR without undertaking too many tiresome analyses. However, given the Trump administration’s record of actions so far, it seems quite unlikely that it will continue turning a blind eye to the issue of currency policies and the protracted trend of USD appreciation, which will soon enter its sixth year.

Regarding USD’s continued appreciation since the start of February, three situations – the expectation of political noise factors, the likelihood that the U.S. Dollar Index will exceed the milestone level of 100, and the fact that U.S. interest rates are falling sharply – make me increasingly convinced that the USD appreciation trend has finally progressed to a degree that can be generally acknowledged to be excessive.



## German Politics Now and Going Forward – Two Events in February

### *Two Events in German Politics*

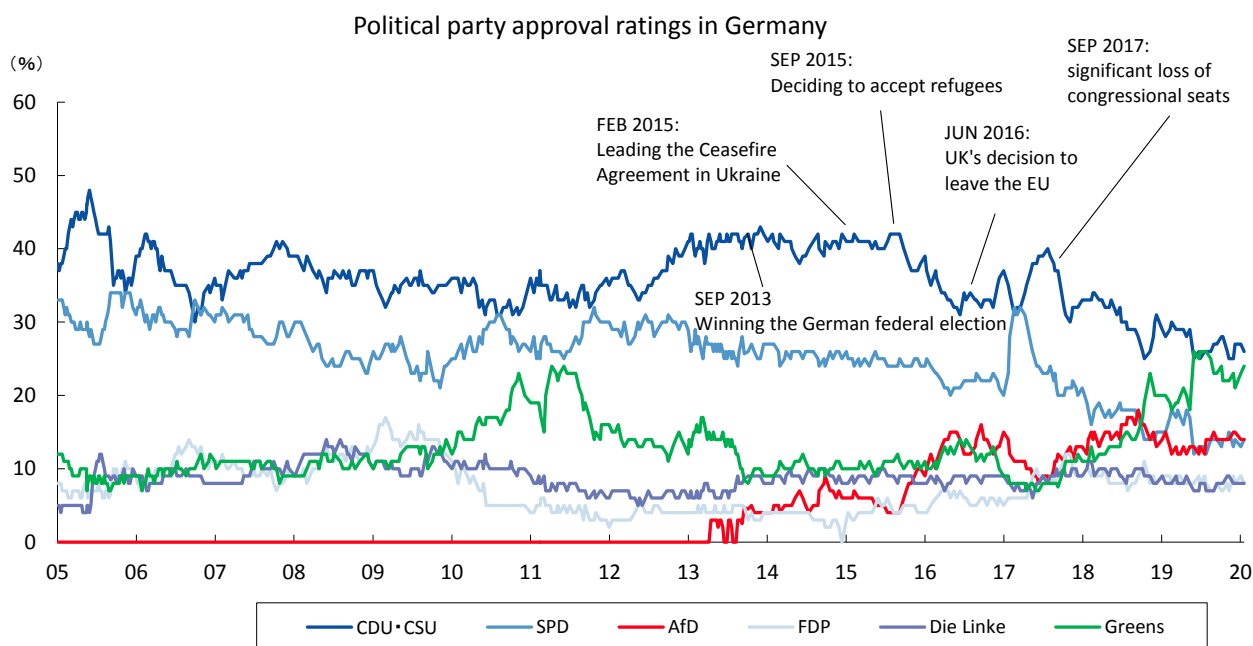
Although they have been overshadowed by the COVID-19 pandemic, two recent incidents in Germany are indicating that the state of political affairs in that country are now in flux. The first incident relates to turmoil surrounding the brief election of a new state premier in Thuringia (a part of Germany formerly within East Germany, or the German Democratic Republic), and the second incident relates to turmoil surrounding the choice of a successor to German Chancellor Angela Merkel. The former occurred on February 5-6 and the latter on February 10. Chancellor Merkel has the longest tenure among developed country leaders (since November 2005), and the fact that the aforementioned events are happening just somewhat more than a year before her scheduled retirement after the next German federal election (which must be held sometime in 2021) seems to suggest a likelihood of similar events going forward.

### *State Premiership Won with Help from the Far-Right*

Strictly speaking, it appears that the former event triggered the latter one. While the post-war German political world and German society at large has drawn a lesson from pre-war history in maintaining a convention of shunning far-right political parties, the election of Thuringia's state premier with support from the populist Alternative for Germany (AfD) party contravened that convention. As all other political parties have consistently avoided collaboration with the AfD, the news media characterized the election with great shock as a "taboo breaking". The Thuringia state legislative election last October resulted in a majority of legislative seats being held by a leftwing party (Die Linke) and the AfD, which seemed to be a dangerously unstable situation. Attention is now also being drawn to the fact that Thuringia is the first state in which the Nazi party joined a coalition government to win local power (in 1930) before going on to gain power nationally.

Understanding the election requires a bit of background information. The incumbent premier from Die Linke, Bodo Ramelow, sought to maintain his position based on a coalition with the Social Democratic Party (SPD) and the Green Party, but the coalition failed to win a majority. In the third round of voting for the state premiership, Thuringia state legislators from the pro-business Free Democrats (FDP), Chancellor Merkel's Christian Democratic Union (CDU), and the AfD combined to elect the FDP's candidate, Thomas Kemmerich. Looking at the various parties' shares of seats in the Thuringia state legislature, one finds Die Linke holds the top share, the AfD the second largest share, and the CDU the third largest share, while Kemmerich's FDP has the sixth largest share. After Ramelow's coalition lost the first two rounds of voting, the sixth largest party's candidate won the premiership with support from the second and third largest parties, spurring speculation about the extent to which the three parties had secretly collaborated in preparation for that vote. While Kemmerich naturally denied that there was a secret agreement with the AfD, suspicion about the possibility of such an agreement has remained strong. This is what happened on February 5, but State Premier Kemmerich was forced to announce his resignation the very next day, following severe criticism from German politicians as well as German society at large for having obtained his position with assistance from the far right. Kemmerich himself stated that he would not allow the AfD to participate in his administration and he denied participation the arrangement of a coalition with the AfD to support his candidacy. He was not able to shake off the label of being a "far-right-supported state premier", however, and given doubts about the sustainability of his government, his decision to resign appears wise.

The chain of events was reassuring in that it demonstrated that German society's self-cleansing power was sufficient to quickly force Kemmerich's resignation, but it was quite disturbing in that it demonstrated that the Germany's ruling CDU party may be beginning to show a newfound willingness to borrow strength from the far right. It also showed that the AfD is positioning itself to cast decisive votes in local elections and thereby exert a strong influence of Germany's national policies. Looking at trends in voter support for Germany's political parties, one finds that the ruling coalition of the CDU and SPD have support from about 40% of voters. The strongest opposition party, the Green Party, has 22% support, and the AfD is the second most popular opposition party, with 14% support (see graph). Given this division of voter support, it would not be so surprising to see events similar to the Thuringia election recur going forward.



### **Departure of “Mini Merkel”**

The regional political turmoil described above has also had an impact on Germany’s national politics. This is the second event. As mentioned, despite Kemmerich’s quick resignation, there remains a lingering perception that the Germany’s ruling CDU party may be beginning to show a newfound willingness to borrow strength from the far right. CDU Chairwoman Annegret Kramp-Karrenbauer declared that it was only a local Thuringian branch of the CDU that supported Kemmerich and that the CDU has no plans to collaborate with the AfD and Kemmerich’s FDP, but the CDU’s partner in the ruling coalition, the SPD, naturally criticized the CDU as being a party that broke a long-standing taboo. Some factions within the SPD had previously been promoting a shift back toward the party’s original left-wing identity, and the intraparty struggles about whether to maintain the coalition with a party (the CDU) suspected of collusion with the far right are now likely to become more intense.

Amid these turbulent events, CDU Chairwoman Kramp-Karrenbauer announced on February 10 that she had given up her aspiration to be the CDU’s next candidate for the chancellorship and would step down as CDU leader. Noting the growing divide between the left and right in Germany as well as divisiveness within the CDU, she said – “We currently feel strong centrifugal forces in our society and in our party.” While the CDU was originally a conservative (right-wing) party, it has progressively shifted toward the left in recent years owing to Chancellor Merkel’s flexible (some might even say opportunistic) style of policy management. That shift undermined support for the SPD, the CDU’s long-standing rival, but both parties have been weakened in recent years by a general shift of German voters away from centrism and toward relatively extreme parties on both the left and the right. From another perspective, it might be said that it was Chancellor Merkel’s somewhat opportunistic style of policy management itself that culminated in the CDU’s posture of supporting a candidate also supported by the far-right AfD party. This is not to suggest that Chancellor Merkel actually desired such a culmination. (She said the Thuringian election was “unforgivable” and a “bad day for democracy.”) To a certain extent, however, it was she herself who created the conditions inside and outside the CDU that led to the Thuringian election situation.

Ms. Kramp-Karrenbauer served as the CDU’s secretary general until December 2018, when she was elected to be the party’s chairwoman. In light of Chancellor Merkel’s similar “CDU secretary general → CDU chairwoman → chancellor” career path and the fact that she is a woman, Ms. Kramp-Karrenbauer has been considered to be a “mini Merkel” and the leading candidate to be Germany’s next chancellor. She was naturally expected to be the most conspicuous CDU participant in Germany’s 2021 federal elections, and she was also expected by many to smoothly take over Merkel’s role in light of her prospect of concurrently serving as CDU chairwomen and chancellor. This prospective course of events was stymied after a little more than one year. After personal setbacks regarding unpopular statements (proposing restricting the freedom of Internet speech in June 2019) and after consecutive CDU losses in regional elections promoted centrifugal forces that weakened the CDU, the Thuringian election incident was the coup de grâce. Although CDU Chairwoman Kramp-Karrenbauer opposed collaboration with the AfD, the fact that the CDU and the AfD voted to support the same candidate was construed as evidence of her weakening control of the party. (Despite Kemmerich’s resignation, the turbulence in Thuringia is continuing owing to the apparent impossibility of electing his replacement.)



### ***Next candidate to Break with Merkel?***

In any case, the process of selecting the CDU's next candidate for the chancellorship has had to be restarted. As the above graph of voter support trends shows, the share of voters supporting the CDU has been restrained to the 20%-30% range since Ms. Kramp-Karrenbauer became CDU chairwoman in December 2018, so it is possible that she would have had to relinquish the party chairpersonship sooner or later even if the Thuringia incident had not happened. The CDU's current leadership structure – Ms. Merkel as chancellor and Ms. Kramp-Karrenbauer as CDU chairwoman – will not change immediately but will be retained until the 2021 federal elections. Ms. Kramp-Karrenbauer is also expected to retain her position as defense minister, which she has held concurrently with her position as CDU chairwoman since July 2019.

Over the next year or so prior to the 2021 federal elections, the CDU will face the challenge of selecting a candidate to be its post-Merkel leader in those elections. The elections might possibly be held earlier if the SPD wanted to disband the ruling coalition at some point, but such an event is unlikely given that current conditions are not considered favorable for SPD electoral success. With most of the CDU's policy platform in place, Ms. Kramp-Karrenbauer is expected to step down from the party chairpersonship, and her most likely successor at this time appears to be Armin Laschet, who is one of the CDU's five deputy chairpeople and also serves as the premier of Germany's largest state, North Rhine-Westphalia. Mr. Laschet's positioning as a moderate centrist is expected to enable him to win considerable support, but he is also subject to criticism for personifying the kind of Merkel-led policies that have weakened the CDU. If the CDU decides to make a break from Merkelism, Friedrich Merz, a strongly conservative former Bundestag member, is considered the leading candidate.

### ***Problems Regarding the “Opportunism and Idealism” of the Merkel Administration***

Given the progressive weakening of support for the long-established mainstream parties (CDU/CSU and SPD), it is not inconceivable, depending on how coalitions are arranged, that Robert Habeck (co-leader of the Green Party, the largest opposition party) could become Germany's next chancellor. This seems particularly plausible in light of the contemporary momentum of extremist environmentalism in Europe. In Germany as well as elsewhere in Europe, the ascent of far-right and far-left parties (both of which could be characterized as “populist”) has undermined support for the long-established mainstream parties, increasing the complexity of coalition government organization. Far-right and far-left parties' growing power has sometimes positioned them to play decisive roles, increasing the likelihood of such situations as the recent Thuringia election going forward. The fact that support for far-right parties has grown to such a worrisome extent even in Germany, where the historical role of the Nazi Party continues to make cooperation with such parties a general taboo, is clear evidence that the European integration project will continue facing unprecedented challenges.

Before it addresses the overall European integration situation, however, Germany will have to deal with its own domestic political challenges. Much of these challenges appear to be attributable to Chancellor Merkel's September 2015 decision to adopt a policy of accepting an unlimited number of refugees. The repercussions of that decision led to a resurgence of passport controls in Europe along with a widening gap between the views of Western Europe (≈ Germany) and Eastern European countries, and those situations are considered to have been key factors behind Chancellor Merkel's decision to announce her prospective retirement despite the strength of economic conditions at the time. It is also worth noting that the time and efforts spent seeking to reach difficult-to-attain agreements regarding the allocation of refugees and immigrants within the EU have played a role in preventing the success of such EU reform proposals as those to issue euro area bonds and establish a euro area treasury department. The two above-reviewed incidents in the German political affairs spotlight the kinds of challenges EU countries will be facing going forward, but they also reflect problems stemming from the Merkel government's combination of idealism and opportunism.

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