

March 31, 2020

## Overview of Outlook

USD/JPY was very volatile in March. Having first plunged to a year-to-date low, it rose steeply, almost hitting the year-to-date high. With the spread in coronavirus infections, the Fed has embarked on monetary accommodation on an unprecedented scale. Calling three emergency meetings in one month, cutting the federal funds (FF) rate by 150 bps, and pledging to resume unlimited quantitative easing (QE), the Fed adopted a never-before-seen short-term stance. Unfortunately, this only helped exacerbate market jitters, and USD/JPY crashed amid an intensifying risk-off mood. Subsequently, the currency pair recovered strongly as people rushed to buy USD as a safe-haven currency, and the abnormal trend did not continue long. The important thing to note is that USD/JPY rates have now entered a new world of no interest rates, where one has to figure out the signposts all over again.

How must we view USD/JPY in the Reiwa era? My position is that Japan's status as the world's largest external creditor is going to play a key role. This factor cannot be overlooked, given that exchange rates are ultimately determined by supply and demand. Another factor that cannot be disregarded is JPY's status as the currency of a deflationary economy. The fact that Japan has a relatively low inflation rate compared with other advanced economies will continue to provide a theoretical basis for JPY appreciation. Predicting forex rates is difficult even under normal circumstances, and the current crisis has led us into an unfamiliar world. At such times, one has to go back to the textbook basics in formulating a forex outlook.

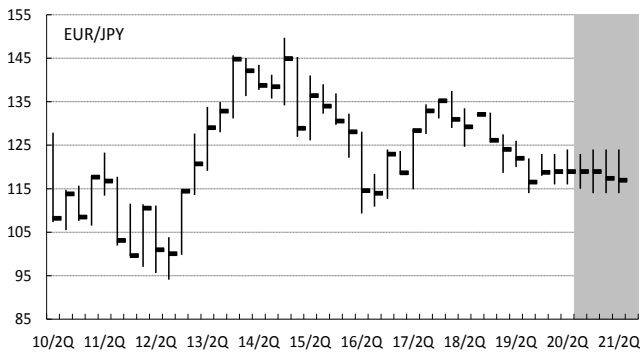
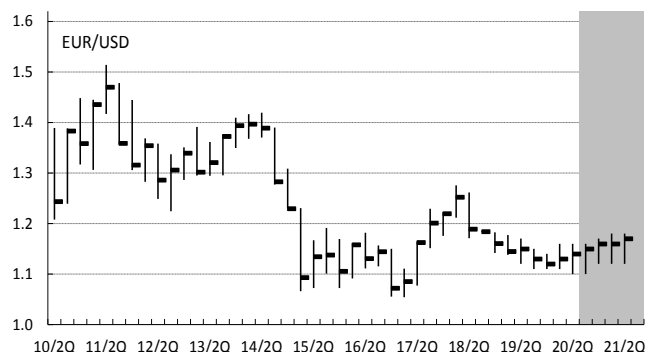
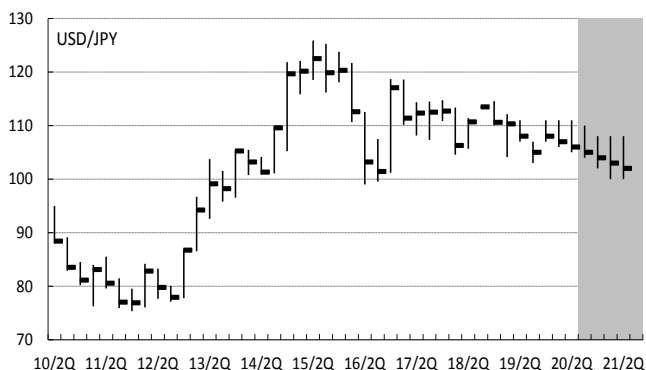
EUR has also been fluctuating considerably. Though it remains difficult to buy EUR because of its -0.50% negative interest rate margin, there is also the impression that the currency has been avoiding a crash thanks to the EU having the world's largest current account surplus. The euro area itself still has some response options, including the European Stability Mechanism (ESM) and the ECB's outright monetary transactions (OMTs). In particular, EU politicians' responses in connection with the ESM will draw attention in the coming days and months, as EUR's fate hangs on how united these politicians are in implementing speedy and precise measures to preserve the integrity of the EU. The delicacy of the situation is strongly reminiscent of the European sovereign debt crisis. As with USD/JPY, EUR/USD has also entered a world of no interest rates. Given that EUR's negative interest rate margin is larger than that of JPY, investors are not likely to rush to buy back EUR in exchange for USD, but at the same time, one cannot afford to underestimate the demand for EUR, which is backed by the region's enormous current account surplus. As before, taking into consideration the risk of USD remaining persistently strong (the paucity of USD rate corrections), I believe EUR is more likely to remain strong against USD.

Summary Table of Forecasts

|         | 2020                        |                       |                       |                       | 2021                  |                       |
|---------|-----------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|         | Jan-Mar (actual)            | Apr-Jun               | Jul-Sep               | Oct-Dec               | Jan-Mar               | Apr-Jun               |
| USD/JPY | 101.18 ~ 112.23<br>(108.53) | 105 ~ 111<br>(106)    | 104 ~ 110<br>(105)    | 102 ~ 108<br>(104)    | 100 ~ 108<br>(103)    | 100 ~ 108<br>(102)    |
| EUR/USD | 1.0636 ~ 1.1495<br>(1.1013) | 1.08 ~ 1.14<br>(1.12) | 1.08 ~ 1.14<br>(1.13) | 1.10 ~ 1.15<br>(1.14) | 1.10 ~ 1.16<br>(1.14) | 1.10 ~ 1.16<br>(1.15) |
| EUR/JPY | 116.18 ~ 122.88<br>(119.57) | 116 ~ 124<br>(119)    | 115 ~ 123<br>(119)    | 114 ~ 124<br>(119)    | 114 ~ 124<br>(117)    | 114 ~ 124<br>(117)    |

(Notes) 1. Actual results released around 10 am TKY time on 31 March 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**

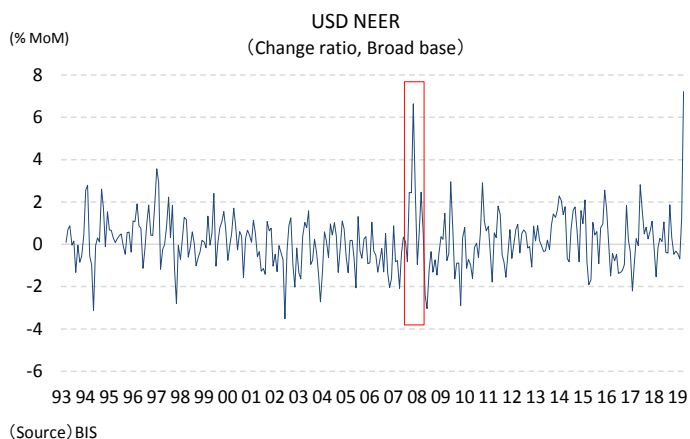


## USD/JPY Outlook – Signposts in a World of No Interest Rates

### Basic Understanding of USD’s Steep Appreciation – Fate of 2008-Style USD Appreciation

#### 2008-Style USD Appreciation

USD appreciated strongly in the forex markets in the last ten days of March. Although the rate stabilized toward the end of the month, the dramatic nature of the appreciation while it lasted evidenced the power of USD buying during a crisis. As the crisis mood intensified, the markets saw a drying up of liquidity (or, rather, concerns of it), resulting in a dominant trend of “buy USD for the present.” What began as a coordinated action to enhance the provision of USD liquidity by six key central banks, including the BOJ, expanded to also include the central banks of Australia, South Korea, and Brazil on March 19, resulting in a conspicuous expansion of each currency’s

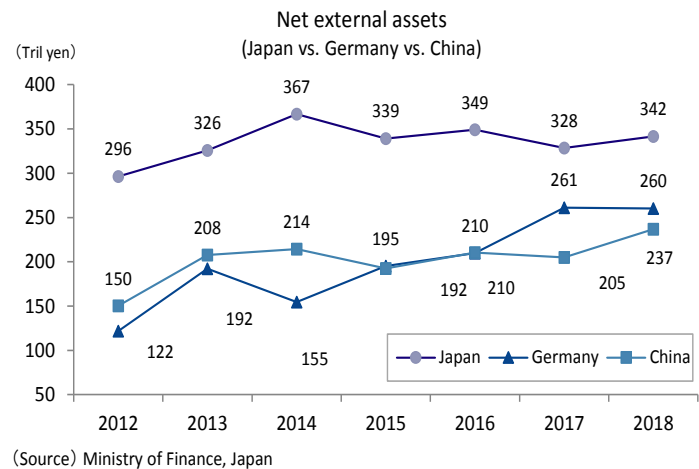


cross-currency basis against USD, even though the trend has begun to reverse as of the writing of this report. The Bank for International Settlements (BIS) has been publishing the nominal effective exchange rates (NEER) of different currencies against a broad basket of 60 currencies since January 1994, and USD’s broad-based NEER posted its highest ever, at 132.56, on March 23. Incidentally, this is not the first instance of USD appreciating in this manner. A similar phenomenon was observed for a year starting April 2008 through March 2009, around the time of the global financial crisis. USD’s NEER in October 2008 rose by +6.6% mom, its largest ever mom increase at the time. This time, the record has been renewed with a +7.2% mom increase (as of March 23, compared with the end of February). It would not be an exaggeration to say that the recent magnitude of USD appreciation is in a similar class as that seen during the global financial crisis. Incidentally, USD/JPY rose from 95 to 110 in the five months between March and August 2008. Some analysts appear to think the recent JPY weakening against USD is unprecedented,

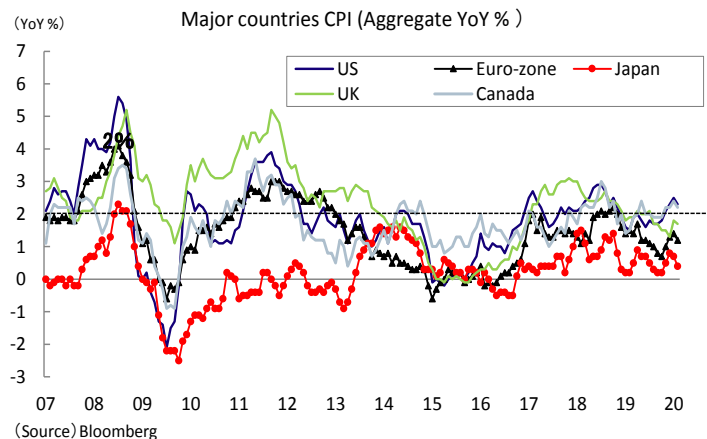
but one must remember that it is merely the flip side of the 2008-style USD appreciation. Looking back at that time, one remembers the furious pace at which the Fed implemented monetary accommodation starting Spring 2009, which resulted in a significant depreciation of USD. So long as there is a possibility of the Fed introducing negative interest rates (details later), one must watch out for a likely reversal of the USD appreciation trend. In fact, as of the writing of this report, this trend has lost some steam even as the cross-currency basis begins to stabilize.

### JPY's Status as Currency of (1) World's Largest External Creditor and (2) a Deflationary Economy

The USD appreciation trend may have lost some steam but, of course, it is still doubtful whether this will lead to a USD depreciation trend. One decisive difference between 2008 and the present is that the Fed has no scope for further monetary accommodation this time. In the foreseeable future, there is no scope of the Fed's policy response turning hawkish. At best, the current policy will continue unchanged, but additional monetary easing could be implemented depending on the circumstances. However, even assuming that the Fed adopts negative interest rates, the narrowing of the interest rate gap as a result will be limited, and its impact on forex markets may not be very large. The U.S.-Japan interest rate gap has been one of the most influential and obvious predictors of forex trends, and no longer being able to bank on it will make forex predictions much more difficult. Under these new circumstances in a world without interest rates, new variables that could have an impact on the forex outlook will have to be found. The question of the hour is, how will Japan view USD/JPY in the Reiwa era? My position is that Japan's status as the world's largest external creditor is going to play a key role (see figure above). The underlying strength of JPY seems the only way to explain the enormous gap between Japan's net external credit and debt. Given that exchange rates are ultimately determined by supply and demand, Japan's status as the world's largest external creditor cannot be overlooked.

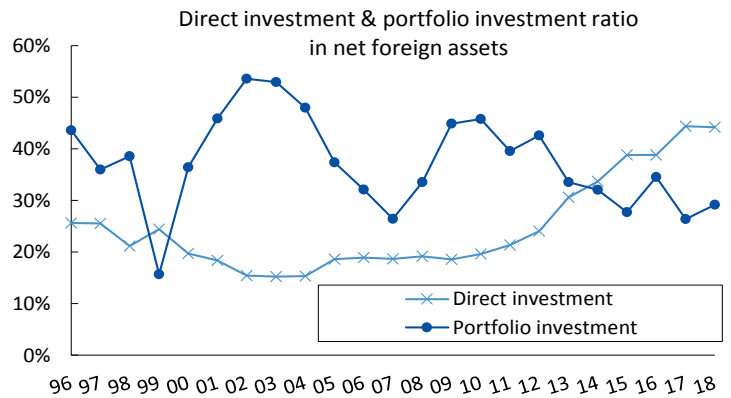


Another factor that cannot be disregarded is JPY's status as the currency of a deflationary economy. There may be no deflation at the present time, given that the consumer price index (CPI) is not chronically negative, but as forex rates inevitably involve two currencies, the position of each currency relative to the other becomes paramount. There is a clear trend toward an elimination of the gap between various countries not just in terms of interest rates but also in terms of inflation (see figure below), but Japan has a relatively low inflation rate even compared with other advanced economies. This provides a theoretical basis for JPY appreciation. Historically, at least going back to the beginning of the Heisei era, the history of USD/JPY has been characterized by both JPY appreciation and economic deflation. Theoretically speaking, deflation is the cause of currency appreciation (JPY, in this case), not its effect, and it would not be unconventional to state that this will remain the case even in the Reiwa era. Of course, one must keep in mind that economic deflation and the enormous demand for JPY in the form of net external credit are variables that regulate long-term trends. They are not suitable for explaining short-term forex trends.



However, as the world remains in crisis mode, there seems very little reason to believe that JPY, the currency of a deflationary economy and the world's largest net external creditor, will continue to be sold off. I can see how some people may find it hard to understand how JPY can remain strong despite the many problems besetting the Japanese economy, but my basic understanding is that there are many other currencies that investors would do well to sell off before selling JPY. Foreign exchange transactions always involve two currencies, after all.

**100-110 Range Awaits a World of No Interest Rates**  
It is worth finding out why JPY appreciation is not as severe as it used to be. As already mentioned, the near disappearance of both interest rate and inflation gaps means the loss of two variables that can theoretically explain forex rate fluctuations, and this is also the reason for the absence of strong JPY appreciation. There is also a demand-side reason that must be acknowledged – the change in the net external credit structure of the world’s largest net external creditor, which I have discussed quite often in this report. Around the decade of 2000, over half of Japan’s net external credit was made up of marketable securities (securities investment). This has now been replaced by direct investment (see figure) as a result of robust M&A activity by Japanese companies, which have been acquiring foreign companies at a voracious pace over the past ten years.



(Source) Ministry of Finance, Japan

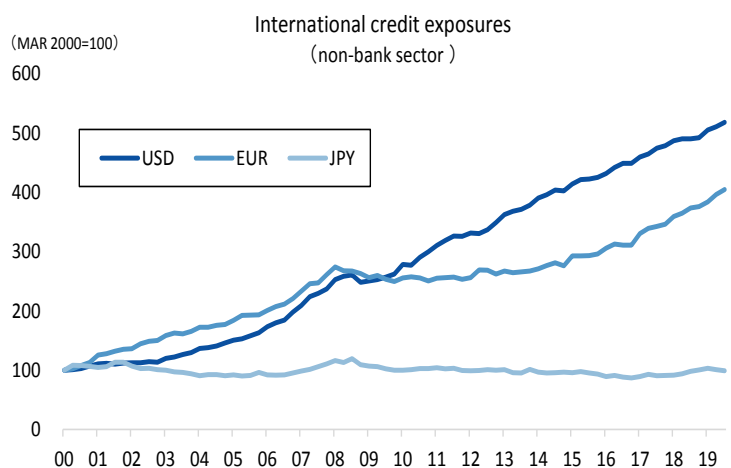
Even if some investors sell their foreign-currency securities in exchange for JPY amid the intensifying crisis mood, not many companies are likely to sell off the foreign companies they have acquired. In this sense, the Japanese economy’s enormous foreign investment may affirm JPY strength, but one must recognize that a significant portion of this foreign investment is of the kind that cannot be returned to JPY and will remain in foreign currency. The reason USD/JPY has not even approached the JPY100 milestone in the ongoing crisis is because of (1) very little scope for a further decrease in U.S. interest rates, which are already at their lower limit, and (2) the change in Japan’s foreign assets structure. Neither (1) nor (2) are likely to change easily. Although the USD appreciation this time around is likely to be more persistent than in 2008, it may still be difficult to justify a scenario of protracted and unilateral USD appreciation.

Despite the considerable fluctuation in currency rates, USD/JPY has remained within the larger 100-110 range in the current turmoil. There is no sense of a strong trend similar to the one in which the currency pair soared to 125.86 soon after Abenomics was introduced, or the one in which it plunged to 75.25 in the wake of the global financial crisis. I foresee USD/JPY remaining in the range of 100-110 for some time to come, falling to 100-105 during times of intensifying crisis and rising to 105-110 during times of optimism. Given that this range also overlaps with JPY’s purchasing power parity (PPP), the continuation of this range in a world of no interest rates may be a natural outcome.

**A Dollarizing World and Concerns Regarding Emerging Currencies – How to Categorize Currencies?**

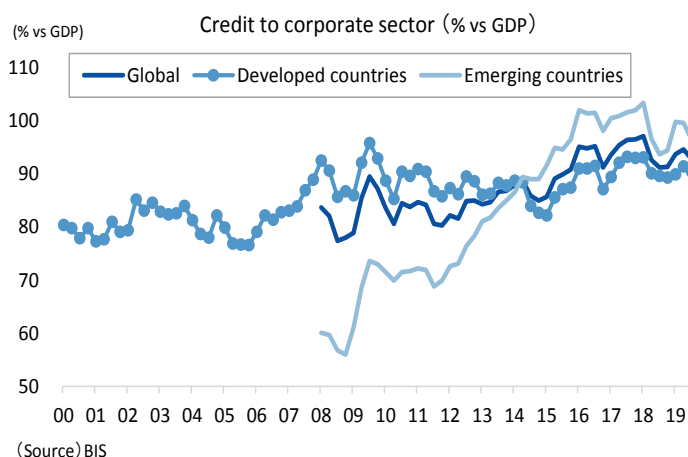
*Alarm Bells Regarding a Dollarizing World*

Although the steep appreciation of USD has slowed down somewhat, USD remains persistently strong. As already reported, such phases raise concerns of capital outflow from emerging countries. In March, the Institute of International Finance (IIF) pointed out in a report that capital outflows from emerging market economies (EMEs) have already reached twice the level seen during the global financial crisis in 2008. In the wake of the global financial crisis, USD-denominated debt expanded around the world. This was because it had become easier to procure USD for a lower cost during the phase of unprecedented monetary easing by the Fed. In the Forex Medium-Term Outlook Report, I have referred to this phenomenon in terms of a “dollarizing world.” In the wake of the crisis, USD-denominated debt rose much faster than EUR- or JPY-denominated debt (see figure). With regard to USD-denominated debt, in particular, BIS data has shown how EMEs have procured USD by issuing bonds over the past three years. Again, as the figure on the next page shows, these securities have been accumulated primarily by non-bank private sector corporations (i.e., non-financial entities or NFEs), and the ratio of debt to GDP has also been clearly increasing.



(Source) BIS (Note) Total of bank loans & debt securities

This situation has consistently been the focus of attention as something that could trigger the next financial crisis. During the previous two years, the Fed dramatically changed policy track, raising rates four times in 2018 and then cutting them three times the very next year, and EME central bank policy operation followed suit at each turn. This was no coincidence. Given that these economies have enormous USD-denominated debts relative to the scale of their economies, they had to mimic FF rate cuts as well as rate hikes, the former to prevent their own currencies depreciating as a result of USD depreciation, and the latter to prevent undesirable inflation as a result of domestic currency depreciation against USD. It seemed very much as though the Fed was the whole world's central bank. When USD appreciates in a dollarized world, it raises concerns of an increase in the debt burden of EMEs via depreciation of their domestic currencies against USD appreciation.

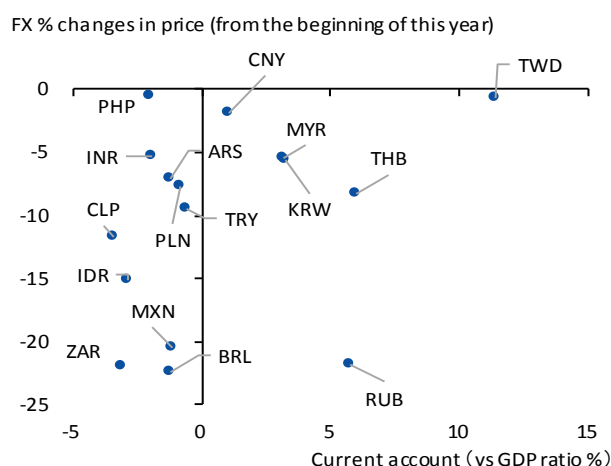


#### *Non-Oil-Producing Current Account Surplus Currencies Relatively Better Off*

Under current trying circumstances, how should one categorize EME currencies? In a dollarized world, currencies of countries with greater amounts of debt, i.e., countries that have current account deficits, are likely to be sold off more easily. During USD appreciation phases in 2017-18, countries like Argentina and Turkey were the cause of turmoil, and these countries did, in fact, have large current account deficits. Conversely, then, countries with robust external economic sectors, i.e., current account surpluses, should be in a better position. However, with oil prices also crashing, it is difficult to assess the robustness of a currency simply based on its current account balance.

Plotting the current account surplus against the percentage change in the relevant currency shows why this is so. Ordinarily, the larger the current account deficit (as a percentage of GDP), the larger the rate of decline in a currency's value, but this has not necessarily been true in the ongoing crisis. For instance, Russia has a relatively large current account surplus among EMEs (5.7% for 2019 as per the IMF's forecast), but RUB has lost more than 20% of its value, symbolizing the hardships of oil producing countries at the current time. There are other similar currencies, where the strength of the country's current account balance is not reflected in its currency's strength because the country produces oil. MXN and BRL are examples of currencies that have both crashed by 20% or so despite having only a modest current account deficit of 1.0% to 1.2% of GDP. Incidentally, in addition to being oil producers, Mexico and Brazil have high official discount rates, so the relatively large scope for monetary easing by lowering interest rates may be compounding the problem in their cases. The high interest rates of these currencies made them quite desirable in the current world of no interest rates, and they had been seeing a commensurate level of capital inflow.

#### Current account balance of emerging countries & FX market



(Source) IMF, Bloomberg

(Notes) Current account balance:2019

FX: from the beginning of this year to 30 MAR 2020

Meanwhile, ZAR, a non-oil-producing currency has also fallen by more than 20%, indicating that current account balance health is an important factor after all. South Africa has relatively large current account deficit of over 3% of GDP. By contrast, TWD has fallen by only around 0.6%, probably thanks to Taiwan's large current account surplus of over 11% of GDP. Having said that, the currencies of several current account surplus countries in East and South East Asia (THB, KRW, MYR) have also fallen anywhere from 5% to 10%, which would be considered significant during normal times. Ultimately, the harshness of the present situation means that large current account surpluses do not protect currencies caught up in the storm of emergency USD buying. Having said that, the currencies of current account surplus countries that are also non-oil-producing countries are doing relatively well compared with the others, especially if the country also has a relatively strong foreign currency reserve, and in this sense, perhaps SE Asian currencies will emerge the winners among EMEs.

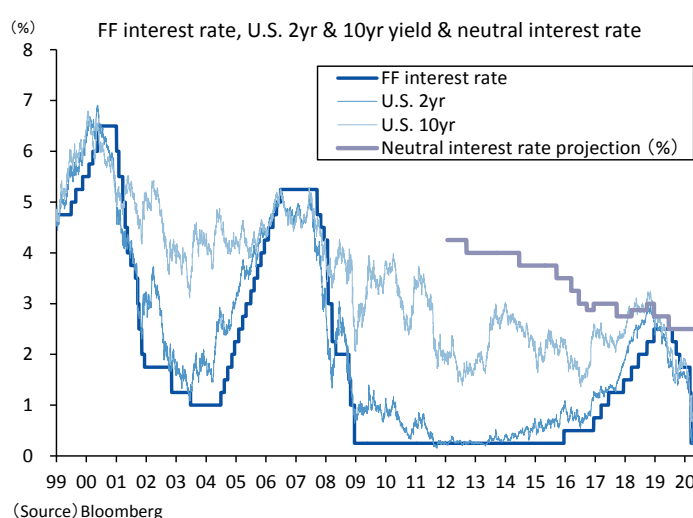


## U.S. Monetary Policies Now and Going Forward – The Danger of Following Williams' Strategy

### *Painstakingly Earned Policy Space Wasted in an Instant*

The Fed's actions in March were anything but ordinary. Two emergency meetings were called in quick succession (March 3 and 15), and the FF rate was cut by a total of 150 bps. The first cut was by 50 bps, followed by another one of 100 bps. The second emergency meeting was called a mere three days before a regular one was scheduled. This was not all. At the second meeting, in addition to the rate cut, the forward guidance was strengthened, the purchase of Treasury securities and mortgage-backed securities (QE) was resumed, and a comprehensive monetary accommodation package including USD liquidity swap line arrangements with six key central banks was announced. With regard to QE, the statement said that "over coming months the Committee will increase its holdings of Treasury securities by at least \$500 billion and its holdings of agency mortgage-backed securities by at least \$200 billion." This was later changed to a more open-ended "The Committee directs the Desk to increase the System Open Market Account holdings of Treasury securities and agency mortgage-backed securities (MBS) *in the amounts needed to support* the smooth functioning of markets for Treasury securities and agency MBS" (emphasis mine) following the third emergency FOMC meeting of March, which was held on March 23. Needless to say, this was an all-out policy effort on the Fed's part, but it had nearly no impact on the markets except to create further confusion. The markets had not been expecting or hoping for that extent of monetary expansion, and the effect appears to have been merely to fan insecurities.

A rate cut is not going to eliminate the coronavirus. The most that any central bank can do in this situation is to buy some time. This can be achieved by doling out rate cuts and other expansionary monetary measures in small installments, and most central banks around the world probably dread the arrival of another regular meeting. Meanwhile, the Fed went all out to deliberately call emergency meetings and implement massive rate cuts. There seems no way to interpret this except as a major failure. At the beginning of March, the target range for the FF rate was 1.50-1.75%. This meant that the Fed could afford to make six rate cuts before it reached the lower limit of 0.00-0.25%. Given that regular FOMC meetings were scheduled for March, April, June, July, September, November, and December, the Fed had enough policy space to buy time at least until the end of the year even if it implemented a 25-bp rate cut at every regular meeting.



This policy space had been accumulated painstakingly under three separate Fed chairs. It began with Ben Bernanke hinting at the possibility of QE tapering in his May 2013 Congressional testimony, continued under Janet Yellen (in office from February 3, 2014 to February 3, 2018), under whom tapering was completed and rate hikes were begun, and was taken further by current Fed Chair Jerome Powell (February 4, 2018~), who carried on with the rate hike path inherited from Ms. Yellen. A total of nine rate hikes were implemented between December 2015 and December 2018 (see figure). Many were skeptical about the rate hikes, especially from 2018 onward, but the argument that the Fed needed policy space for a contingency was not without reason. Mr. Powell, especially, appeared to see the justification for creating sufficient policy space. And yet, the Fed wasted all its painstakingly created policy space within the matter of an instant, and that too without achieving the impact it had hoped. Astonishment is the only reaction that seems possible in this situation.

### *Act Quickly When at ZLB?*

So far, the Fed has rejected the possibility of adopting negative interest rates on the grounds that it would have serious negative consequences for market functioning and financial stability. If so, it would appear that it has already reached the end of the road, having decided to lower the FF rate effectively to zero and also resumed QE. The confusion in the market was also the result of pessimism resulting from the Fed, which controls the world's key currency, having spent all its policy space. The only thing that can fully restore market optimism in this situation may be news about the development of a wonder drug to cure the coronavirus (or a peaking out of the infection rate). It is ironic to think that it was in an attempt to avoid precisely this kind of cul-de-sac that the Fed had worked to create precious policy space for all those many years.

The Fed's recent actions have drawn a great deal of attention in the sense that they are considered a failure by nearly all market participants. However, some say that the Fed took these actions not in panic, but deliberately, based on strategic thinking. A speech titled "Living Life Near the ZLB" given by New York Federal Reserve Bank President John C. Williams last July comes to mind.<sup>1</sup> In the speech, Mr. Williams stressed that "When you only have so much stimulus at your disposal, it pays to act quickly to lower rates at the first sign of economic distress." The gist of the speech was, "When the ZLB is nowhere in view, one can afford to move slowly and take a "wait and see" approach to gain additional clarity about potentially adverse economic developments," but when that is not the case, one must act resolutely to eliminate risk. This speech gave rise to speculations of a 50-bp rate cut for a time, but the markets calmed down following a statement put out by the NY Fed to the effect that Mr. Williams had merely presented an academic viewpoint in his speech, and that the speech did not signify any intent with regard to policy operation. However, it would not be all that surprising for the FOMC to put the NY Fed President's wisdom to practice, and there seems a good chance that this was what happened with regard to its recent decisions (of course, there is also the possibility that the Fed buckled under political pressure).

However, the Fed is not alone in having lost its policy space. Many central banks around the world lost their policy space following the global financial crisis. Precisely because of this, the Fed ought to have waited for a better time – if markets were slow to turn around even after signs of a peak-out in infection rates in the U.S. and Europe, that would have been an effective time for resolute action. Taking action at the present time, with every day bringing more dejecting news regarding coronavirus infections, is a complete waste of effort, like sprinkling water on parched soil or pouring water through a sieve.

### Sinful Outcome of Enforced Rate Cuts

There is also a risk that this will not be an isolated phenomenon concerning the Fed. The FF rate functions as the world's cost of capital, and the Fed lowering the FF rate forces many other central banks to lower their own policy rates. In phases of financial market confusion, if the Fed cuts FF rates, any response less than that of the Fed from the other central banks invites disappointment in their respective markets. Now that the Fed has spearheaded not one but two shocking FF rate cuts in the space of two weeks, the central banks of other key and emerging economies will inevitably have to move in a similar direction. In fact, several central banks have already been compelled to cut rates following in the footsteps of the Fed. There is something sinful about this outcome of the Fed's recent actions based on armchair logic. Barely three months into the new year, most EME central banks have been forced to cut rates (see chart below).

Incidentally, the ECB and BOJ managed to maintain the *status quo* despite the pressure. The ECB's postponement of rate cuts was met with disappointment immediately after the announcement, but it was a wise decision considering that systemic risks are heightened in an abnormal situation like the current one. In that sense, perhaps the BOJ should be grateful to the ECB. Had the ECB gone ahead with a rate cut, it seems quite likely that expectations of the same from the BOJ would have strengthened. In both Japan and Europe, negative interest rates have dramatically worsened the business environment for financial institutions, and it is often argued that the current policy interest rates may be at reversal rate levels. The credit climate is expected to further deteriorate going forward, and a negative interest rate policy further cuts into the revenues of financial institutions. In the current phase, more than ever, we need financial intermediary functions to be healthy, and further deepening the negative interest rate cannot be justified. Moreover, the ECB has introduced liquidity provision measures amply incorporating interest rate reduction and exemption (details later), which are thought to have an impact close to rate cuts, without actually cutting rates and further deepening the negative interest rate margin.

|  |                         | Current (%) | Latest policy trends |          | 2020                    | 2019                    | 2018                    |
|--|-------------------------|-------------|----------------------|----------|-------------------------|-------------------------|-------------------------|
|  |                         |             | Date                 | Decision | Cumulative change width | Cumulative change width | Cumulative change width |
| <b>Asia Emerging</b>                         |                         |             |                      |          |                         |                         |                         |
| China  | 1-year benchmark lendi  | 12.50       | 2020/1/6             | Rate cut | ▲50bp                   | ▲150bp                  | ▲250bp                  |
| India  | Repurchase rate         | 4.40        | 2020/3/27            | Rate cut | ▲75bp                   | ▲135bp                  | +50bp                   |
| Indonesia                                    | 7day reverse repo rate  | 4.50        | 2020/3/19            | Rate cut | ▲50bp                   | ▲100bp                  | +175bp                  |
| S.Korea                                      | 7day repo rate          | 0.75        | 2020/3/16            | Rate cut | ▲50bp                   | ▲50bp                   | +25bp                   |
| Malaysia                                     | Overnight policy rate   | 2.50        | 2020/3/3             | Rate cut | ▲50bp                   | ▲25bp                   | +25bp                   |
| Philippines                                  | Overnight reverse repur | 3.25        | 2020/3/19            | Rate cut | ▲75bp                   | ▲75bp                   | +175bp                  |
| Thailand                                     | 1 day official rates    | 0.75        | 2020/3/20            | Rate cut | ▲50bp                   | ▲50bp                   | +25bp                   |
| Vietnam                                      | Refinance rate          | 6.00        | 2019/9/16            | Rate cut | 0bp                     | ▲25bp                   | 0bp                     |
| <b>Oceania</b>                               |                         |             |                      |          |                         |                         |                         |
| Australia                                    | Overnight policy rate   | 0.25        | 2020/3/19            | Rate cut | ▲50bp                   | ▲75bp                   | 0bp                     |
| New Zealand                                  | Overnight policy rate   | 0.25        | 2020/3/16            | Rate cut | ▲75bp                   | ▲75bp                   | 0bp                     |
| <b>Central and Eastern Europe and Africa</b> |                         |             |                      |          |                         |                         |                         |
| Russia                                       | 1week repo rate         | 6.00        | 2020/2/7             | Rate cut | ▲25bp                   | ▲150bp                  | +50bp                   |
| S.Africa                                     | Repo rate               | 5.25        | 2020/3/19            | Rate cut | ▲125bp                  | ▲25bp                   | 0bp                     |
| Turkey                                       | 1 week repo             | 9.75        | 2020/3/17            | Rate cut | ▲225bp                  | ▲1200bp                 | +1600bp                 |
| <b>Latin America</b>                         |                         |             |                      |          |                         |                         |                         |
| Brazil                                       | Selic target rate       | 3.75        | 2020/3/18            | Rate cut | ▲75bp                   | ▲200bp                  | ▲50bp                   |
| Mexico                                       | Official overnight rate | 6.50        | 2020/3/20            | Rate cut | ▲75bp                   | ▲100bp                  | +100bp                  |

(Note) Indonesia has changed policy rate 7 day reverse repo rate instead of BI rate on 19AUG2016

(Source) Bloomberg & Mizuho Bank

<sup>1</sup> John C. Williams, "Living Life Near the ZLB", July 18, 2019, Federal Reserve Bank of New York

*The Risk of FF Rate Descending Below Zero*

Predicting asset price trends at the moment is next to impossible. The trend will naturally change depending on when coronavirus infections begin to taper off. While some say that the development of a vaccine will restore asset prices in a shot, it seems risky to make any conjectures regarding timing at this point in the discussion of trends. One must, however, take into consideration the risk of the Fed introducing negative interest rates, even though this seems very unlikely going by the information available at present. In his speech, in addition to acting quickly to lowering the interest rates, Mr. Williams recommended maintaining them at that level over the longer duration. If Mr. Powell continues to act in accordance with Mr. Williams' strategy going forward, FF rates may not be raised for a while even after the coronavirus crisis subsides. This much seems certain.

However, can we be absolutely sure that the Fed, in sticking to Mr. Williams' strategy, will not consider any next moves? Leaving aside the possibility or outcome of the Fed considering further moves, it has to be said that the markets could well bring this topic up again if current levels of confusion continue. The introduction of negative interest rates is worth some consideration as a risk scenario, given the Fed's stance in exhausting all its options at once and taking most market participants by surprise. Of course, Mr. Powell and other fed officials have consistently taken a stand against negative interest rates, including right after the recent emergency rate cuts. But the fact is that the ECB and the BOJ also kept rejecting the idea until suddenly implementing it one day. In fact, given that the recent all-out efforts did not fundamentally alter the mood in the markets, it would be natural for the Fed to think about its next move. I personally believe that this is not the time for central banks to act ineptly, but going by the Fed's actions in March, I am beginning to think that the possibility of U.S. interest rates turning negative cannot be ruled out altogether.

**Risks to My Main Scenario – Risk of FF Rate Descending Below Zero***No-Longer-Important Risk Scenarios*

As I do each month, I will at this point review the risk factors related to my main forecast scenario, but this time it must first be acknowledged that the global spread of the new coronavirus (COVID-19) has dramatically changed our overall perspective on the significance of various potential risks. At this point, market participants are less interested in a tightly-focused discussion of JPY-related risk scenarios than they are in a broader-ranging discussion of how the spread of COVID-19 may cause major changes throughout the world. In light of that, it does not seem wise to focus on the relatively minor issues ordinarily analyzed in this portion of the report.

For example, the United Kingdom and the EU need to decide by the end of this June whether to extend the Brexit transition period. Previous editions of this report have discussed the worrisome possibility that the transition period may not be extended and it may not be possible to conclude UK-EU trade negotiations before this December 31, causing a “no deal” Brexit. Given the current situation, however, it appears likely that there will be very little opposition to extending the transition period, as the level of economic and societal turmoil is already too high to consider adding yet another element of uncertainty. In light of the fact that even the Olympic games have been postponed, it seems unlikely that the transition period – which was designed to be extendable – would not be extended. As even such high profile UK personages as Prince Charles and Prime Minister Boris Johnson have been infected with COVID-19, it appears inevitable that ambitious goals regarding the speed of Brexit negotiations will be overshadowed by public health goals, and negotiations will be placed on the back burner. I therefore anticipate that the transition period will be extended into 2021.

This report has also discussed concerns about the possibility that the Trump administration might undertake large-scale fiscal stimulus programs. However, the US has already passed a USD2 trillion stimulus bill in response to the COVID-19 situation. If the perception of a crisis situation is protracted, there seems to be a possibility that the Trump administration will scale down its emphasis on protectionist policies and perhaps even consider reducing tariffs levied on imports from China. Thus, the policy response has already led to the eventuation of a situation previously considered an upside risk factor (although it is not likely to be sufficient to actually improve economic conditions).

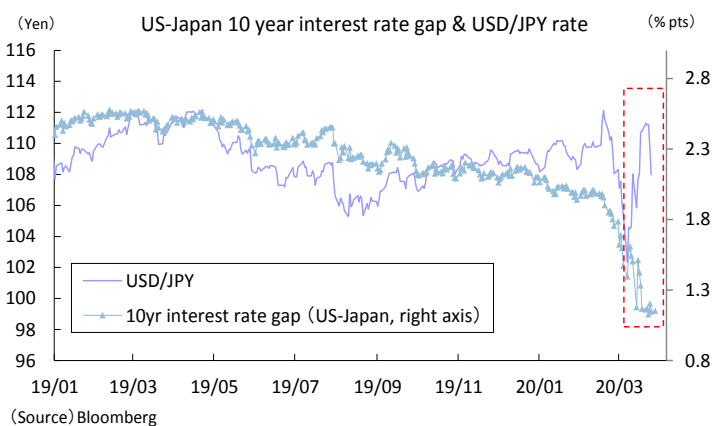
*Realistic Possibility of FF Rate Descending Below Zero*

Since the spread of COVID-19 has already led to the realization of a series of situations previously considered impossible, it is not easy to make assumptions about the impossibility of numerous other situations. The worst-case risk scenario would be that fear of COVID-19 causes sustained shrinkage of economic activity over a period of years. The best-case risk scenario would be that the virus's spread is quickly contained, and the subsequent release of pent-up propensities to consume and invest effectively boost the real economy. In the worst-case risk scenario, there will be a general and protracted flight from stocks and other risk assets. In the best-case risk scenario, a trend of increase in risk tolerance may support the re-attainment of stock price levels seen in early February. If the information coming from Chinese authorities is true, the epidemic's spread in its epicenter (Wuhan) has been contained, and we have grounds for hoping that conditions in the rest of the world – including Europe and the United States – may become fairly normal by the summer. Risk scenarios regarding this situation differ primarily insofar as they anticipate the passage of longer or shorter periods of time prior to the normalization.



It is currently difficult to make rational arguments about which of these two types of risk scenarios is more likely, but one immediate risk factor that market participants should be concerned about is the Fed's prospective posture. Having already decreased the FF rate by 150 bps and approved unlimited quantitative expansion (QE) in March, the only policy card remaining in the Fed's hand is negative interest rates. Of course, both before and after the emergency FF rate cut decisions in March, Fed Chairman Jerome Powell and other Fed officials have been consistently expressing their opposition to negative interest rate policies. However, given that the ECB and the BOJ denied their intention to introduce negative interest rate policies and then suddenly launched such policies, it is hard to make a rational prediction about what the Fed might do in this regard. As discussed in previous editions of this article, the Fed's recent series of strong policy response measures is generally thought to reflect the ideas of New York Fed President John C. Williams. If the Fed continues to act based on a "when the leeway for additional policy moves is small, it is best to dramatically augment easing measures at a single stroke" philosophy, it is impossible to rule out the possibility that a negative interest rate policy might be suddenly introduced.

If the Fed had already adopted a negative interest rate policy, it would now be focused on the question of how great its leeway is for depressing interest rates to still-deeper negative levels. Not only regarding USD/JPY but in general, now, the forex market is progressively losing its fundamental guidelines amid a "world without interest rate differentials". Given that JPY interest rates are pegged to roughly zero by the yield curve control system, if the Fed were to begin assessing its leeway for depressing interest rates to negative levels, we might conceivably see the advent of an unprecedented situation in which the US-Japan interest rate differential structure is inverted. While such a prospect, of course, remains quite unlikely, it is necessary at this point to keep in mind that the seemingly impossible may actually be possible nowadays, so this situation is worth keeping in mind as a risk scenario. It is impossible to deny the possibility of a world in which the Fed, the ECB, and the Bank of England (BOE) are all engaged in the management of their respective yield curve control systems, and it is important to note that the advent of such a situation should be considered a JPY appreciation risk factor.



## EUR Outlook – The Whatever-It-Takes Scenario Version 2.0

### The Euro Area Economy Now and Going Forward – ECB President Lagarde’s Crisis Response Debut Performance

#### *Showing Backbone in Not Catering to Market Expectations*

The March 12 ECB Governing Council (GC) meeting approved steps to augment liquidity provision measures and asset purchases but seems to have put the possibility of further deepening the level of negative interest rates on the back burner. Although the shelving of moves to further deepen the negative level of interest rates caused some disappointment immediately after the meeting, it appears that the Lagarde-led GC’s early demonstration of a posture of not attempting to satisfy unreasonable market expectations has earned general appreciation. This was the third GC meeting led by ECB President Christine Lagarde, but it was her debut performance in a crisis response situation. While ECB President Lagarde was able to calmly discuss such grand ambitions as climate change countermeasures and the digital euro at her first two GC meetings, she appeared to have been somewhat disconcerted by the sudden onset of a major crisis (which may have led to her slip of the tongue discussed below). It is worth reiterating that many people were disappointed by the lack of moves to further deepen the negative level of interest rates. Prior to the meeting, I had anticipated (1) a deepening of negative interest rates, (2) a relaxation of restrictions regarding third-phase long-term liquidity supply (TLTRO3) operations, and (3) an expansion of the asset purchase programme (APP).

Although I expected the ECB to further lower interest rates, however, I don’t think that it should have. My basic understanding about the pursuit of ever-lower negative interest rates is that it is an “all pain, no gain” endeavor. As the Fed, Bank of Canada, and BOE have all been cutting their interest rates (the related decisions of the Fed and BOE were made at extraordinary meetings), it was expected that the ECB would not be able to resist the temptation to swim along with the current. In fact, I believe Governor Lagarde and the rest of the GC merit praise for their decision to reject unnecessary and non-urgent interest rate cuts despite coming under heavy pressure. Measures to respond to market expectations do not necessarily correspond to optimal policy management measures. Even if interest rates had been cut, the selling of stocks, particularly financial company stocks, would probably have progressed regardless of the cut. Former President Draghi would almost certainly have responded with an “all out” array of measures including an interest rate cut, but President Lagarde did not bend to the pressures. My guess is that she has just demonstrated the strength of the backbone she developed while working as IMF Managing Director and as a lawyer. The view that there are benefits to meeting market expectations during emergency situations is valid to a certain extent but, given that further deepening the depth of negative interest rates is a recipe for undermining the entire financial system’s soundness, deepening measures should not be recklessly undertaken during a crisis situation such as the current one.

While one reporter at the post-GC press conference posed questions about the financial markets’ negative reaction, President Lagarde responded by noting that – “it takes a little bit of time, generally, for decisions to be analysed, digested and appreciated [by the markets]” – and she showed confidence when she went on to say – “we’re talking about an entry rate of -25 basis points, and we’re talking about an ultimate interest rate based on the track record of the lending institution of -75 basis points. I’m not sure that you can actually so much rival with that at the moment[.]” Regardless of how one examines the situation, it seems clear that supplying liquidity with a reduced interest rate is likely to be a more effective means of improving financial institutions’ risk tolerance than a 10 bps interest rate cut.

#### *Emphasizing More-Favorable Terms for TLTRO3*

Policies approved at the GC meeting include (1) immediate liquidity support (additional longer-term refinancing operations (LTROs)), (2) the application of more favorable terms (lower interest rates) to all outstanding TLTRO3 operations during a one-year period, and (3) the expansion of the asset purchase programme (APP) through a temporary EUR120 billion envelope of additional net asset purchases during 2020.

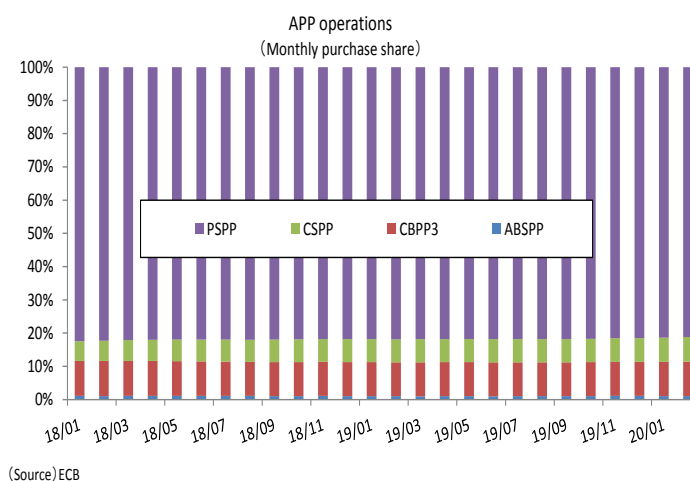
Designed to provide liquidity at favorable terms to bridge the period until the next TLTRO3 bidding process on June 24, the asset purchasing operations of policy (1) have been implemented weekly since March 18 (with the maturity date of June 24 for all purchases regardless of their timing). The applicable interest rate is the main refinancing operation (MRO) interest rate, which is currently 0%. This policy (1) is positioned as temporary “bridge” financing, while policy (2) is the main operation for supplying additional liquidity. In light of somewhat weak usage of the current TLTRO framework, much is being made of the introduction of more favorable terms. Previously equivalent to the MRO interest rate, the applicable interest rate but will now be 25 basis points below the MRO interest rate, and the 25 bps reduction will be applied to all TLTRO III operations outstanding during the one-year period. In addition, the maximum preferential treatment (reward) obtained by counterparties maintaining or increasing their outstanding loan balances was the previously the maximum deposit facility interest rate (-0.50%), but will now temporarily equal the deposit

facility interest rate minus 25bps, so maximum preferential treatment will be -0.75%. In short, these measures can be considered tantamount to an interest rate reduction implemented in a somewhat complex manner. Emphasis has tended to be placed on the magnitude of interest rate reductions, but it is also noteworthy that the maximum amount of assets that individual institutions can supply to TLTRO operations has always previously been limited to 30% of the total balance of that institution's outstanding loans to companies and households (excluding mortgages), but this ratio limit has been increased to 50%. These measures appear to reflect the ECB's strong desire to provide liquidity.

#### Temporary Expansion of APP

Of the three measures, the expansion of the APP through measure (3) is expected to have the most significant economic stimulus effect. The EUR120 billion envelope of additional net asset purchases is not surprisingly large, and – for the nine-month period from April through December – could be considered to amount to EUR13.3 billion per month. Since the envelope is not allocated in monthly installments, however, it is possible that the front-loading of those purchases may cause it to have a very powerful effect in the short term. In extreme cases, it is possible that the entire EUR120 billion envelope might be used during the first month or two after the current point of perceived crisis. Exhausting the envelope in two months could mean EUR60 billion of additional purchases in each of those months, which would quadruple the monthly level of APP purchases – from EUR20 billion to EUR80 billion. Since there is no way to predict when the threat of COVID-19 will dissipate or how long EU members will be fighting the direct and indirect impact of the virus, this might be considered a highly flexible program that could be strongly front-loaded but might possibly not be needed in its entirety. Moreover, as explained below, there is also a newly created Pandemic Emergency Purchase Programme (PEPP), which has an additional temporary envelope of EUR75 billion of additional asset purchases for 2020. Together, asset purchases under the temporarily expanded APP and the PEPP could amount to the very large figure of EUR195 billion.

The prospective composition of assets purchased in connection with the EUR120 billion envelope of additional net asset purchases is not known. What is currently known is that the purchasing will be focused on private sector assets (corporate bonds, covered bonds, and asset-backed securities). The APP encompasses several sub-programs focused on private-sector assets, including the corporate sector purchase programme (CSPP, for the purchase of corporate bonds), the third covered bond purchase programme (CBPP3), and the asset-backed securities purchasing program (ABSPP). The CSPP, for example, currently accounts for around 7% of APP assets. Although this share is incomparably smaller than the share of government bonds within APP assets, it still positions the ECB as a quasi-leader in terms of its share of the corporate bond market and it is possible that current policies will lead to an increase in that share.



By the way, given that President Lagarde had consistently emphasized her intention to address climate change issues before her inauguration, it is thought that she may at some point add her own personal touch to ECB programs by instituting asset purchase targets for "green bonds". However, that is likely to be among one of the issues discussed during the strategic review, and I think there will be considerable opposition to giving special treatment to green bonds within ECB policy management at this point from Germany as well as other countries. Of course, there is also a widespread feeling that the strategy review itself may be shelved, although there remains a possibility that special green bond treatment provisions may still somehow be incorporated within individual new policies. As acknowledged during the press conference, the strategy review will be put on hold for the time being, and the associated public hearing originally scheduled for April 1 will be delayed by about six weeks. It seems likely that the public hearing delay will cause a similar delay in the overall schedule for the strategy review.

### *Various Restrictions on Asset Purchases*

As mentioned, the temporary expansion of the APP should be evaluated together with the Pandemic Emergency Purchase Programme (PEPP), which was approved a week after the regular GC meeting on March 12. ECB asset purchases are ordinarily constrained by the capital key, “issue limits”, and “issuer limits”<sup>2</sup>. The possibility such constraints could impede the emergency response operations attracted considerable attention, and several questions were posed about those constraints at the post-regular-GC meeting press conference. In this regard, on March 24, the EU issued a legal document stating that the constraints “should not apply to PEPP holdings”<sup>3</sup>. Issue and issuer limits were originally intended to eliminate the risk that the ECB would obtain a blocking minority in the event of a debt restructuring and thereby hinder the issuer’s reorganization and rehabilitation efforts. Since the issuers currently likely to be affected by this situation are located in such financially healthy countries as Germany, however, there is realistically speaking no actual need for such a risk prevention constraint. It is noteworthy that the PEPP’s legal finalization statement includes the text – “[...] the Governing Council also decided that to the extent some self-imposed limits might hamper action that the Eurosystem is required to take in order to fulfil its mandate, the Governing Council will consider revising them to the extent necessary to make its action proportionate to the risks faced.” This appears to indicate that the ECB was considering ways of avoiding being constrained by issue and issuer limits when it decided to create the PEPP on March 19.

In any case, the ECB is now positioned to quickly accumulate a huge amount of assets. At the post-GC-meeting press conference, President Lagarde also pointed out that some countries are likely to be increasing their issuance of bonds going forward, and that may make it easier to purchase such bonds while avoiding conflict with issuer limits, since the larger amount of outstanding bonds will increase the denominator used to calculate the issuer limit ratio. In brief, she was saying that countries’ augmentation of their fiscal stimulus spending will enable the ECB to buy greater amounts of those countries’ bonds. Regarding the capital key constraint, President Lagarde indicated that the ECB would for the time being not necessarily be strictly complying with the constraints but – “at the end of the asset purchase programme we will converge towards the capital keys” – and this can be interpreted to mean that the constraint will be loosened in the short term but eventually restored. Overall, the ECB has clearly communicated the idea that it will not allow self-imposed constraints to become obstacles to its efforts to respond effectively to the COVID-19 crisis.

### *Counteracting the Effects of a Verbal Blunder*

In general, I felt that the ECB was able to create a comprehensive package that reflected President Lagarde’s productive efforts, and I would give her a passing score on her overall performance at the post-meeting press conference, but there was also an unfortunate portion of the press conference. That portion relates to her verbal slip in the following question-answer portion of the conference.

- Reporter: At the moment [the government bonds of] certain countries are hit especially hard, like Italy. What can the ECB do if the spread for government bonds increase? Would it be an option to activate, for example, the OMT programme [Outright Monetary Transactions (OMT) programme, through which the ECB positions itself to purchase an unlimited number of government bonds], or could there be other possibilities to help certain countries?
- President Lagarde: Well, we will be there, as I said earlier on, using full flexibility, but we are not here to close spreads. This is not the function or the mission of the ECB. There are other tools for that, and there are other actors to actually deal with those issues.

Former ECB President Draghi made several memorable remarks during his tenure that are still widely remembered with admiration, but unfortunately this remark is the first of President Lagarde’s remarks that is likely to stick in people’s memories. President Lagarde had good intentions in making that remark, and what she said is actually correct. From the perspective of mass psychology, however, there are things that are generally considered “good to say” and “bad to say” in such a situation as she found herself in. The way this works can be seen in the behavior of the BOJ when it was led by Governor Masaaki Shirakawa, whose efforts to emphasize realities and logical imperatives (rather than cheerleading) earned him responses of pessimism, disappointment, and sometimes resentment. Not surprisingly, Italian government bond yields soared after President Lagarde’s statement. Given the current state of Italy’s politics, economy and society, President Lagarde’s statement has to be considered a blunder. The transcript of the post-meeting press conference includes a footnote containing a “clarifying” statement President Lagarde made during a subsequent interview with CNBC. This clarification and the ECB’s message that it will be flexibly managing the public sector purchase programme (PSPP, for purchases of government bonds, public sector entity bonds, and agency and supranational bonds) appear to be efforts to throw cold water on the source of the turbulence. For reference, the abovementioned footnote is as follows.

<sup>2</sup> The “issue limit” restricts ECB purchases to 33% of a given bond issue while the “issuer limit” restricts ECB purchases to 33% of a given bond issuer’s outstanding bonds.

<sup>3</sup> DECISION (EU) 2020/440 OF THE EUROPEAN CENTRAL BANK of 24 March 2020 on a temporary pandemic emergency purchase programme (ECB/2020/17)



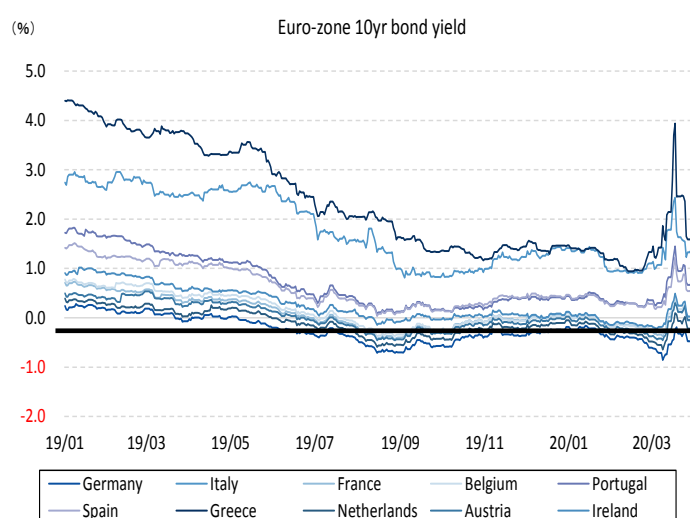
- I am fully committed to avoid any fragmentation in a difficult moment for the euro area. High spreads due to the coronavirus impair the transmission of monetary policy. We will use the flexibility embedded in the asset purchase programme, including within the public sector purchase programme. The package approved today can be used flexibly to avoid dislocations in bond markets, and we are ready to use the necessary determination and strength.

#### *President Lagarde's "Do-Whatever-It-Takes" Moment?*

The portion of the post-meeting press conference that left the strongest impression on me was a question posed by a reporter – “is this your do-whatever-it-takes moment, and did you expect to have one so quickly?” – and President Lagarde’s response to that. Needless to say, the question was referring the most-famous statement of former ECB President Draghi – “The ECB is ready to do whatever it takes to preserve the euro.” In response, President Lagarde recalls saying on the occasion of President Draghi’s retirement that – “I would hope that I would never have to do whatever it takes.” She then said – “I don’t have a claim to history for being whatever-it-takes number two.” – and emphasized the importance of cooperation among parties including the financial authorities of individual EU countries. This seems to imply a complaint that those countries did not undertake sufficiently proactive expansionary fiscal spending policies during President Draghi’s term, thereby shifting the responsibility for crisis countermeasures to the ECB. This might be considered a kind of indirect communication from former President Draghi about the lessons he learned while leading the ECB.

#### *The Pandemic Emergency Purchase Programme*

About a week after the regular GC meeting on March 12 (early in the morning of March 19, Japan time), the GC decided to hold an emergency conference call, during which it approved the creation of the Pandemic Emergency Purchase Programme (PEPP), which is authorized to purchase up to EUR750 billion of assets. The PEPP appears to be designed to counter a widespread trend of increase in intra-regional interest rates following the regular meeting that was initially centered on Italy but showed signs of spreading to France and Spain. Interest rates were rising by significant margins not only in Italy – reflecting its various financial problems – but also in other EU countries, including even Germany. Since the PEPP announcement, however, the trend has clearly reversed, and interest rates have sharply declined (see graph on previous page). People were initially anticipating that the pandemic would cause increases in the government sector’s financial burden along with interest rate levels, but that panic-driven trend has dissipated in light of the PEPP and the Fed’s unrestricted QE. As noted above, the EUR120 billion boost to ECB asset purchases approved at the regular ECB GC is primarily designed to ensure “a strong contribution from the private sector purchase programmes”, and it appears that the ECB decided that addressing the government bond yields situation requires a separate program. On the other hand, interest rates were still fairly stable at the time Governor Lagarde made her abovementioned slip of the tongue following the regular GC meeting, so it could be argued that there should have been enough leeway for her to speak as she did.



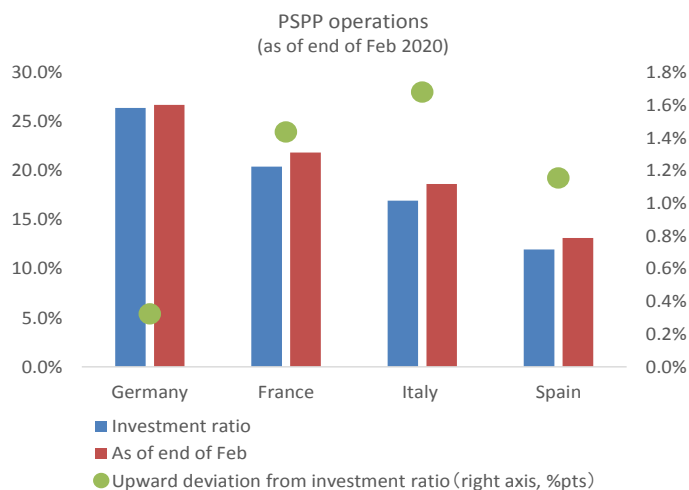
(Source) Bloomberg

#### *Time Period and Targeted Assets*

The implementation of PEPP is scheduled to end at the end of 2020. Officially, the time period is described as – “The Governing Council will terminate PEPP net asset purchases once it considers that the COVID-19 crisis phase is over, but in any event not before the end of 2020.” This suggests that the program could be continued for as long as the COVID-19 crisis is considered to be persisting. The PEPP is authorized to purchase assets in “all the asset categories eligible under the APP”, meaning it can purchase a wide range of securities, including government bonds, corporate bonds, regional or local government bonds, and asset-backed securities. Since the additional EUR120 billion APP envelope is intended to focus primarily on private sector assets, however, it seems reasonable to conclude that the PEPP’s EUR750 billion will principally be invested in government bonds. This is a very large sum, and if it had been announced immediately after the regular GC meeting, the evaluation of President Lagarde’s statements at the press conference would have been quite different.

It is obvious that investing such a huge amount of money in the government bond market would be liable to make it difficult to maintain strict conformance with issue limits, issuer limits, and capital key but, as mentioned above, the EU announced on March 24 that the issue limits and issuer limits will not be applied to the PEPP. In addition, although there will be efforts to conform to the capital key, PEPP is to be – “conducted in a flexible manner allowing for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions.”

For example, the ECB’s Italian government bond holdings are already 1.7 percentage points above the capital key ratio (see graph), but it appears that the widening of such divergences will be temporarily accepted. In addition to all the asset categories eligible under the APP, the PEPP is allowed to purchase Greek Government bonds not in compliance with previous eligibility requirements. Non-financial commercial papers are now eligible for purchases both under the PEPP and the corporate sector purchase programme (CSPP) within the APP.



## The EU Faces Its Third Major Crisis – Remembering the Goal of Peaceful Cooperation

### *ESM Akin to an “Ace Up the Sleeve”*

The ECB’s total balance sheet at the time this article was written was about EUR4.7 trillion, so it should be understood that the EUR750 billion value of the PEPP is a huge sum corresponding to 16% of the balance sheet figure. Given the lack of provisions to allocate the EUR750 billion on a monthly basis, PEPP can be expected to enable a very-large-scale ECB market intervention in the near future. The press release announcing the PEPP’s creation states – “The Governing Council is fully prepared to increase the size of its asset purchase programmes and adjust their composition, by as much as necessary and for as long as needed.” Considering the PEPP together with the additional APP envelope focused primarily on private sector assets, it appears that the ECB has now pulled out all the stops and played all its policy cards.

The next problem likely to come to the fore is political strife. In particular, attention will be focused on how freely the European Commission and the European Summit meeting can utilize the European Stability Mechanism (ESM) and other financial support instruments. Set up as a permanent rescue fund during the debt crisis, the ESM originally had EUR500 billion of lending capacity, although that capacity is currently only EUR 410 billion). The ESM is positioned to provide assistance to euro area countries based on the principle of “conditionality” – the countries are required to implement such policy measures as those to increase their fiscal soundness and make structural reforms. In other words, the financial management of a country seeking aid will become subject to EU supervision. As conditionality makes it more difficult for a country to obtain assistance, Italy and some other countries are seeking to receive ESM aid without conditionality, but no agreement had been reached on this at the time of writing this article, after the EU Summit.

A “child of the European debt crisis,” the ESM is firmly based on the idea that countries receiving assistance require financial education and guidance. Given that the emergency conditions are encouraging even Germany to allow for more flexible fiscal management policies, the European Commission has indicated that it will shift to a policy of allowing for exceptional fiscal management policies. Such circumstances do not seem harmonious with the application of such ESM fiscal guidance policies as those requiring fiscal austerity on the parts of aid recipients, but the stance of such fiscally healthy countries as Germany, the Netherlands, and Austria appears to be that it is a different story when it comes to receiving assistance from the ESM. This is precisely the scenario that – in light of certain developments during the 2009-2013 period – I have been expecting to inevitably arise. It seems likely that the European Commission will eventually shift to a more-flexible stance and adopt a more-liberal interpretation of assistance-related rules, but the current delay prior to that shift is quite reminiscent of the early days of the European debt crisis.

### *Fiscally Healthy Countries Have a Point – Replacing OMT with PEPP*

However, the fiscally healthy countries are making a valid point, as the ECB has already relaxed the 33% rule in connection with the EUR750 billion PEPP. As already mentioned, the PEPP is essentially an unrestricted asset purchase program scheduled to continue operating until the end of the COVID-19 crisis, and regional interest rates have clearly trending downward in response to the launch of the PEPP. The economic effect of the PEPP is almost the same as that of the ECB's Outright Monetary Transactions (OMT) program. OMT has been considered a kind of "trump card" or an "ace up the sleeve", as it positions the ECB to purchase an unlimited number of short and medium-term government bonds.

It is presumed that the reason for establishing the PEPP separate from the powerful "ace up the sleeve" OMT program is because the need for countries to apply for assistance from the ESM and submit to fiscal supervision was considered an obstacle. Largely because of the benefits of the PEPP, the financial markets do not currently expect there will be a need to use the ESM and OMT, and neither does the European Commission feel it necessary to relax the related conditions. Given that we are facing an unprecedented crisis and do not really know what is going to happen, it is probably a good idea to keep the "ace up the sleeve" OMT program where it is and not play the last trump card. That is probably what the fiscally healthy countries are thinking – that after launching the PEPP it would be excessive to also make use of the ESM and OMT.

### *Consideration of "Corona Bonds" and other Joint-Debt Euro bonds*

There have been some news reports about the unfamiliar concept of "corona bonds". It seems that, at a meeting of the Eurozone Finance Ministers on March 24, ECB Governor Lagarde promoted the idea of issuing "corona bonds" – a one-off issue of joint-debt "euro bonds" to combat the impact of COVID-19. Since this is a story from a March 25 Bloomberg report about the statements of two anonymous officials, it is not possible to be completely certain about the facts, but on the March 26, the next day, the heads of nine countries including Italy and France did in fact call for a euro bond issue to fund coronavirus countermeasures. This seems to corroborate the report that President Lagarde had been promoting the euro bond concept. As one might expect, the nine countries in question are mainly southern countries known for their liberal fiscal policies – Italy, France, Spain, Portugal, Ireland, Belgium, Luxembourg, Slovenia, and Greece – and the absence among them of such fiscally conservative countries as Germany and the Netherlands is noteworthy. As of March 27, there had been additional follow-up media reports about the possibility that the ESM might issue temporary bonds under such names as "social stability bonds" or "corona bonds", but as of the time this article was written it was not clear whether a related proposal would be made or what the exact nature of such a proposal might be.

As noted above, there seems to be no need to make use of the ESM and OMT at this time. However, the issuance of joint-debt euro bonds is one of the major progressive reforms that the EU has been considering for some time, and the EU is currently facing unprecedented challenges in its efforts to unite as a community. Rather than viewing the current situation as an aberrant one-off situation, it probably is wiser to consider the possibility that the crisis may be used as an opportunity to take steps toward what some parties envision for the future of the EU. It seems possible that President Lagarde may have said that the ECB had already done its utmost and called for more-proactive cooperation on the parts of EU countries' governments, but it is unlikely that her request met with positive resonations in all the EU member states.

### *Potential Degree of ESM Usage Condition Relaxation*

On the political side, there is no new consensus regarding the more-liberal use of the ESM. A March 24 Eurogroup statement said that there was widespread support for the use of ESM as a precautionary measure but that the ESM was strictly for the use of countries desiring to apply for its use. But there are no countries desiring to apply for its use under the current conditions, in which conditionality is mandatory. Aside from the issue of what name to give euro bonds issued by the ESM (corona bonds?), going forward, it will be interesting to see how much the EU will be willing to modify the design of the systems it has created to ameliorate debt crises, particularly the degree to which EU will be willing to liberalize the conditionality terms for countries receiving emergency assistance. Of course, excessively liberal terms will blur the distinction between a country's receipt of emergency assistance and that country's issuance of government bonds, so it is desirable that any euro bonds to be issued should have relatively short-term maturities. It will be worth monitoring future reports about this issue to learn more about what kinds of specific euro bond characteristics are being proposed.

*Remembering the Goal of Peaceful Cooperation as the EU Faces Its Third Major Crisis*

The EU has already faced many large challenges, and the current COVID-19 crisis could be called the EU's third major crisis, following the debt crisis and the refugee crisis. But there has never yet been an EU crisis in which the value of EU integration has been as critical a factor in the lives of many ordinary EU citizens as it is currently. The EU was created with the goals of promoting peaceful cooperation and preventing wars. The EU was beset by internal disputes about the proactive use of fiscal stimulus policies during the debt crisis, and there were also serious disagreements among EU countries about the influx of immigrants and refugees during the refugee crisis. The pandemic crisis has led to disputes among EU countries about restrictions on the movement of medical supplies, and some observers believe that this situation is being exploited by China. As described above, the EU continues to suffer from its perennial dispute about how liberally to provide support to financially distressed member states. It is worth considering whether current events are likely to give additional momentum to anti-EU sentiment in the post-COVID-19 era. To prevent the possibility that some member states might decide to emulate the UK's Brexit initiative, it is becoming increasingly important for the EU to devise ways to harmoniously develop crisis-response policies.

Daisuke Karakama  
Chief Market Economist  
Derivatives & Forex Department  
Mizuho Bank, Ltd.  
Tel: +81-3-3242-7065  
daisuke.karakama@mizuho-bk.co.jp

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