

May 1, 2020

Overview of Outlook

In April, there was an improvement from the previous month's extreme risk-off mood to an ordinary risk-off mood, which resulted in a cooling of the USD buying trend and caused JPY to strengthen. Here on, I will endeavor to base my forecasts mainly on the fundamentals. The forex markets are increasingly reflecting the realities of a world without interest rate gaps, so it is becoming relatively more important to turn one's attention to such fundamental factors as supply & demand and inflation trends. No matter which criterion one goes by, theoretically, the time seems ripe for JPY to strengthen against USD. Apart from this, one must keep in mind the possibility of "confidence in USD" becoming a topic for consideration against the backdrop of the recent large-scale fiscal expansion. There is a certain stable correlation between USD rates and U.S. debt or fiscal balance. It would not be surprising if USD were to weaken in the coming months as a result of the quadrupling of the U.S. fiscal deficit from -3.6% of GDP in 2019 to -15.4% of GDP in 2020. In the same context, the dramatic increase in "world dollar" could also become a factor that promotes USD selling. The current circumstances, which are difficult to analyze even for the International Monetary Fund (IMF), make it extremely difficult to forecast risk scenarios, which will change depending on when one expects COVID 19 (coronavirus) infections to end. No matter which of the three risk scenarios presented by the IMF one goes by, there is the prospect of USD/JPY falling below 100.

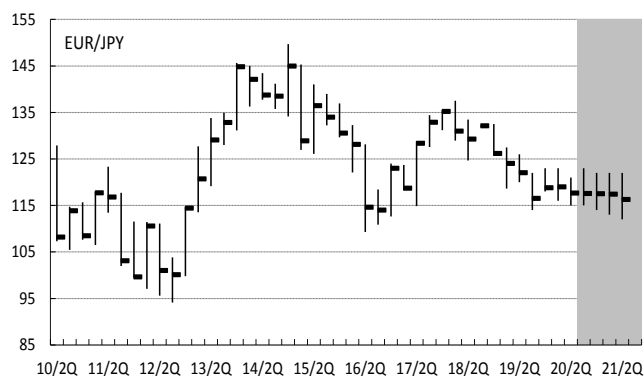
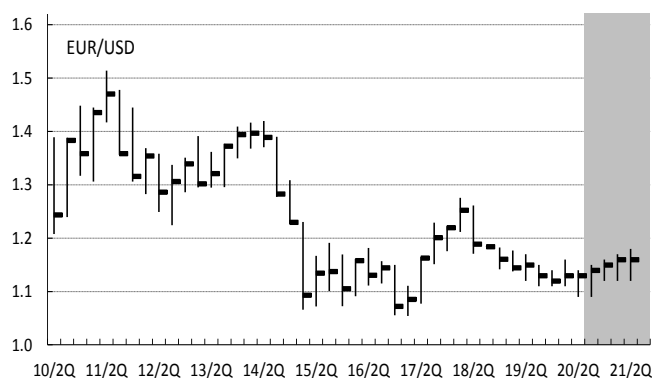
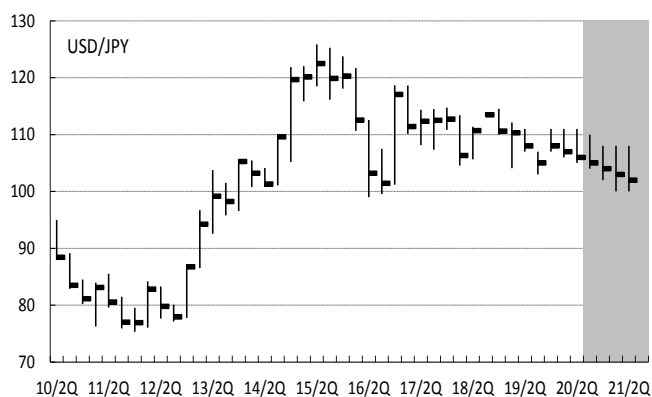
Meanwhile, EUR lacks movement despite showing signs of weakness. Unprecedented levels of asset purchases have been made to prevent yields in the region from rising and keep panic at bay, but unsurprisingly, the climate is still not conducive for investors to proactively choose to buy EUR, given the currency's deep negative interest rate level of -0.50%. Going by IMF forecasts also, Europe may suffer the deepest scars from the ongoing coronavirus crisis. Being the currency of the world's largest current account surplus country (region), EUR may not crash, but it does remain beset by too many problems. In particular, the EU's special circumstance of being unable to make political decisions regarding fiscal support is once again in the news, and is also the reason fiscal measures are quite lacking in Europe compared with the U.S. and Japan. The reason euro area yields have failed to decrease sufficiently could be because of the negative perception of such uncertainties surrounding political decisions in the region. It is quite regrettable, given that the ECB has been doing everything it can within the scope of its own responsibilities. Having said all that, I think the most likely scenario in the forex markets is a relative strengthening of EUR as USD loses its position as a high-yielding currency.

Summary Table of Forecasts

	2020				2021	
	Jan-Apr (actual)	May-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	101.18 ~ 112.23 (107.20)	105 ~ 111 (106)	104 ~ 110 (105)	102 ~ 108 (104)	100 ~ 108 (103)	100 ~ 108 (102)
EUR/USD	1.0636 ~ 1.1495 (1.0944)	1.07 ~ 1.12 (1.11)	1.07 ~ 1.13 (1.12)	1.10 ~ 1.14 (1.13)	1.10 ~ 1.15 (1.14)	1.10 ~ 1.16 (1.14)
EUR/JPY	115.45 ~ 122.88 (117.32)	115 ~ 121 (118)	115 ~ 123 (118)	114 ~ 122 (118)	113 ~ 122 (117)	112 ~ 122 (116)

(Notes) 1. Actual results released around 10 am TKY time on 1MAY2020. 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 – Will “Confidence in USD” Emerge as a Topic?

Signposts in a World without Interest Rate Gaps – Important to See the Big Picture in Current Phase

Signposts in a World without Interest Rate Gaps

In April, again, the financial markets remained at the mercy of the ongoing coronavirus crisis. Toward the end of the month, in particular, there was a long spell during which the markets were jolted by crude oil price trends. This made share prices somewhat volatile, but the forex markets stayed very quiet. The financial markets have been through a roller coaster over the past nearly three months, but USD/JPY has remained by and large within its 100- to 110-range of recent years, and the same can be said of EUR/USD. Perhaps, in a world where there are no longer any significant policy interest-rate gaps between countries, the loss of forex market volatility is only natural. Of course, interest rates are not the sole factor causing forex rate movements. Such factors as supply & demand, inflation, and current affairs also have considerable impact.

Also, taking into account the possibility of the U.S. adopting negative federal funds (FF) rates, perhaps interest rates have not lost their relevance fully. In a world without interest rate gaps, it will become relatively more important to look at factors other than interest rates, but should the Fed introduce negative FF rates and proceed to deepen them, things could reach a tipping point where USD begins to be sold off. In that sense, interest rates are still quite important.

Fundamental fluctuation factors in the foreign exchange market

① Interest rate [Short-term]

- Interest rates in policy interest rate and government bond

② Supply and demand [Short to medium]

- Trade and current account balance, external claims and liabilities

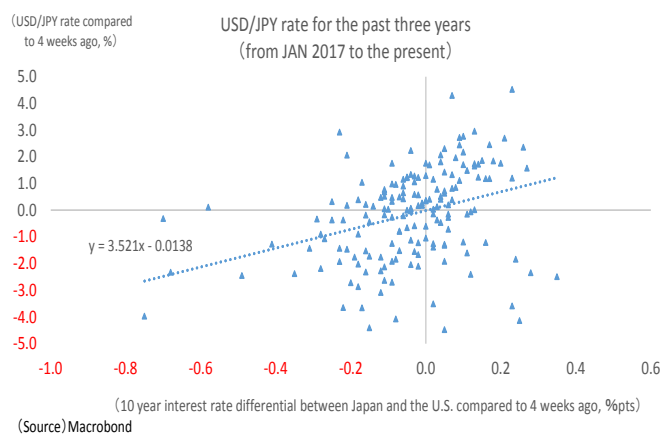
③ Prices [Long-term to very long-term]

- CPI, PPI & etc

④ Others [Short-term]

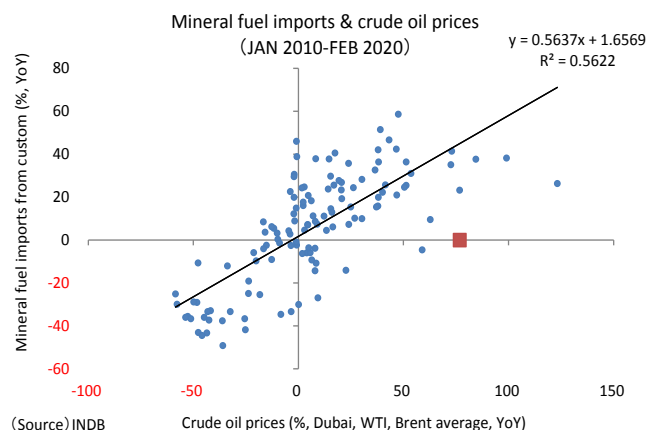
- Various Newsflows (Include geopolitical risks)

Having said that, there is no stable correlation between the U.S.-Japan interest rate gap and USD/JPY as of the moment (see figure). There is no linear relationship that can be used to predict how much USD/JPY will fall as a result of a 1-bps FF rate cut, so the focus will be on whether the introduction of a negative FF rate as an event will trigger a landslide selling of USD. The situation is not conducive to estimating forex rate levels based on interest rate gaps, and it seems inevitable that the interest rate gap will become increasingly irrelevant to price formation in the forex markets as the interest rate change margins become smaller and smaller. Meanwhile, another question emerges – will reserve players (entities that invest in foreign reserves) continue to hold USD as before even if the currency's interest rate turns negative? Some say that the ECB's introduction of negative policy interest rates in June 2014 was one of the triggers for the marked decline in the EUR ratio of global foreign reserves, although, of course, concerns of the common currency zone's disintegration following the European sovereign debt crisis also contributed. Going by the "Euro area investment fund statistics" published by the ECB once every quarter, it was around June 2014 that the domestic vs. external asset holdings ratio in euro area investment funds (outstanding domestic assets ÷ outstanding external assets) began to decline dramatically. Of course, there is also the view that not many investors would be willing to let go to their USD holdings in this time of emergency, but it still behooves one to be aware of the possibility of a USD selloff triggered by negative FF rate introduction when attempting to predict forex market trends based on interest rates. Additionally, one must also realize that it may be difficult to explain forex rates through the simple and easy-to-understand logic of the interest rate gap for some time to come.



Demand Suggests JPY Appreciation; Plummeting Crude Oil Prices Could Also Have an Impact

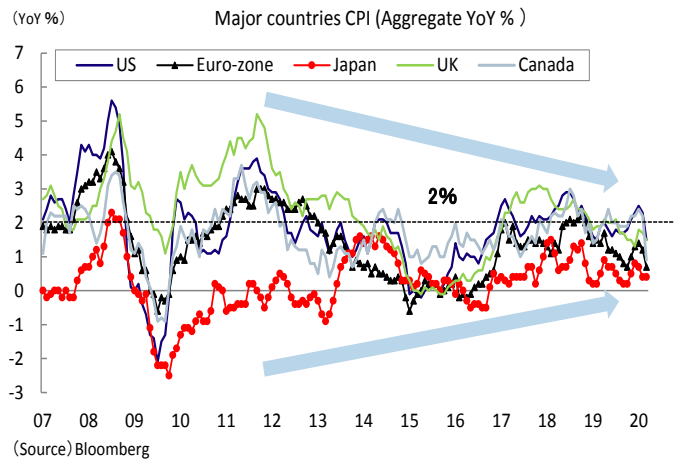
Apart from interest rates, other key factors influencing forex movements include supply & demand and inflation rates, as I have said time and again in this report. Current supply & demand conditions indicate a strengthening of JPY against USD. In terms of stock and flow, JPY remains the currency of the world's largest net external creditor (stock), the result of its strong current account surplus (flow) led by primary income balance. I will refrain from going into the details of these as I have already discussed them several times. The important point is to note that JPY's underlying strength is the only way to explain the gap between Japan's external credit vs. debt, which is the world's largest. This fact is unlikely to change over the next few years.



Further, an important new perspective has recently emerged in the form of the impact of crude oil prices, which have been plummeting. As mineral fuels account for a quarter of all of Japanese imports, the price of crude oil naturally plays a big role in determining the value of Japan's mineral fuel imports. A rough calculation shows that a 1% change in crude oil prices causes Japan's mineral fuel import value to change by 0.5% (see figure). The 70% year-to-date decline in crude oil prices from USD 60/barrel at the beginning of the year to USD 19/barrel at the time of writing this report, therefore, means that Japan's mineral fuel import value has fallen by 35%. This, in turn, means an 8.8% decline in Japan's overall import value, given that mineral fuels account for 25% of all Japanese imports. Of course, thanks to the current suspension of international trade, the import of other goods has also declined, leading to predictions of an even greater decline in overall import value. On the other hand, exports have also fallen for the same reason, so the impact on the trade balance overall is extremely difficult to predict. The difference between the import/export values of other products versus crude oil, however, is that the latter is impacted both by import volume and prices, while the former are only impacted in terms of volume. One must keep in mind, therefore, that the trade balance for some time to come could be skewed in the direction of a trade surplus thanks to the sharp decline in imports.

Inflation Also Suggests JPY Appreciation

The last factor, inflation, also suggests JPY appreciation pressures. Since the 2008 global financial crisis, international inflation rate gaps have clearly narrowed (see figure on previous page). In this sense, it can be said that this is the age of shrinking differences not just in interest rates but also in inflation, resulting in the loss of yet another key factor that could help determine forex rate trends. Having said that, the Japanese economy remains somewhat inclined toward deflation, and since forex rates always involve two currencies, the currency with the lower rate of inflation is theoretically the more likely to see a future strengthening. Of course, purchasing power parity (PPP), which is derived on the basis of inflation gaps, is different for different kinds of prices – spot prices, for instance, are at PPP levels only briefly – so it would be inappropriate to rely entirely on PPP. However, even if PPP were to be calculated taking all types of prices into account, a rate of 110 or above for USD/JPY does not seem that likely. There still remains a strong impression that PPP as calculated by international organizations and think tanks and PPP as derived from common price indexes (consumer price index, producer price index, etc.) are below 110, and even below 105 most of the time (see figure). Of course, day to day forex transactions are not conducted in response to price measures, but it is important to note that over the past 30 years or more, the history of USD/JPY has primarily been a history of JPY appreciation, and a history of deflation in Japan. One cause for slight concern is the possibility that in the wake of the coronavirus crisis, globalization could suffer a setback and we could see a reversion to a world where the law of one price does not necessarily apply. This would prevent the process of focusing on PPP as an indicator of forex rates.



With the sudden emergence of a world without interest rate gaps coinciding with emergency USD buying, forex market trends have become extremely difficult to predict. Moreover, in spite of the emergency USD buying trend, and completely disregarding the only slight decrease in LIBOR rate within the U.S. itself, currencies such as JPY and EUR were being sold at premiums against USD (i.e., a USD surplus) outside the U.S. when viewed in terms of cross-currency basis, so one is required to take multiple perspectives into account to read the current situation accurately. Given such chaotic circumstances, I believe that one has to move back a step, take a look at the big picture, and then formulate a medium- to long-term forecast. By doing so, even if one's prediction does not come true, an accurate understanding of the current circumstances will prove very rewarding when looking back later and trying to understand why. The daily trend of infections and responses taken by the governments are extremely important and will inevitably influence prices, but having lost the clearest and most important indicator (interest rate gaps), it is important to make an effort not to miss the forest for the trees.

Reference points of USD/JPY rate

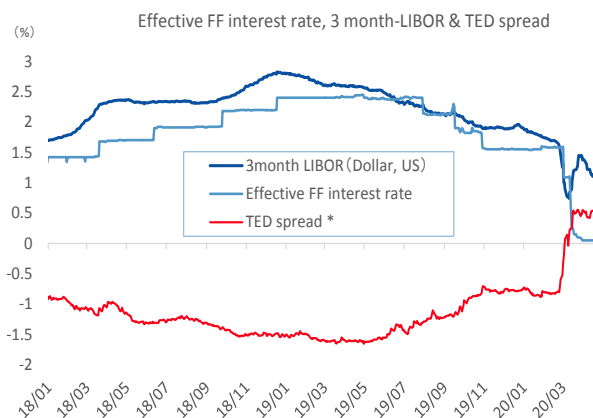
JPY rate	Evaluation Standard
55.1	Purchasing Power Parity (export prices, 1973 base, Mar 2020)
71.4	Big Mac Parity (Economist magazine, Mar 2020)
71.1	Purchasing Power Parity (export prices, 1980 base, Mar 2020)
75.5	Purchasing Power Parity (Mid point between export prices and corporate goods prices, 1973 base, Nov 2018) *Note 1
90.0	Purchasing Power Parity (corporate goods prices, 1980 base, Mar 2020)
95.9	Purchasing Power Parity (corporate goods prices, 1973 base, Mar 2020)
96.7	Purchasing Power Parity of materials within manufactured products, etc. (METI, FY2016 survey)
98.9	Purchasing Power Parity (consumer price, 1980 base, Mar 2020)
99.8	Break-even rate for exporters as of Mar 2019 (Cabinet survey, FY2018)
101.4	Purchasing Power Parity (World Bank, 2018)
103.0	Purchasing Power Parity (OECD, 2019, GDP base)
107.3	Rate as of 1 May 2020
108.0	Corporate planning rate (BOJ Tankan, Mar 2020 survey, fiscal year)
110.4	Equilibrium Exchange Rate by Japan Center for Economic Research (Oct -Dec 2019)
111.2	Next year ahead forecast rate as of Mar 2019 (Cabinet survey, FY2018)
121.2	Purchasing Power Parity (consumer price, 1973 base, Mar 2020)
132.7	Purchasing Power Parity of processing/assembly within manufactured products, etc. (METI, FY2016 survey)
159.0	Overall Purchasing Power Parity of manufactured products, etc. (METI, FY2016 survey)
260.9	Purchasing Power Parity of energy within manufactured products, etc. (METI, FY2016 survey)

(Source) Made by Daisuke Karakama, Mizuho Bank (Note 1) support level more than 10 years

The Change in Market Climate – From an Extreme to Ordinary Risk-Off Mood

From an Extreme to Ordinary Risk-Off Mood

The LIBOR, which was conspicuously high from mid through late March, eventually began to decline at the beginning of April. The extreme pessimism in the markets in March took place amid a sense of mutual distrust among financial institutions, reflected by the sharp increase in the LIBOR rate and the TED spread (3-month Eurodollar LIBOR rate – 3-month U.S. Treasury yield), which did not improve even after the FF rates were dramatically cut (see figure). This period was also marked by USD procurement difficulty, as seen from an increase in the cross-currency basis. Without the ability to procure USD, various types of settlements become impossible for financial institutions, and some transacting entities can be pushed to bankruptcy as a result. In the corporate sector, again, a shortage of foreign currency results in an inability to import things, which could bring trade and real economic activity to a standstill. One of the reasons behind the asset price crash and accompanying increase in mutual distrust in mid-March is thought to have been the trend of selling off assets on hand in exchange for USD. Some of the safest financial assets in the world including JPY and U.S., Japanese and German government bonds were sold off in exchange for USD, and this has to have played a role in causing the USD procurement difficulty (the argument that JPY is no longer considered a safe asset is an extremely trifling detail that fails to look at the bigger picture). Incidentally, rather than financial institutions actually suffering from a USD shortage, fears of a possible future shortage became a self-fulfilling prophecy and invited distrust among financial institutions. This scenario is very reminiscent of the stockpiling and subsequent shortages of medical supplies and food products.

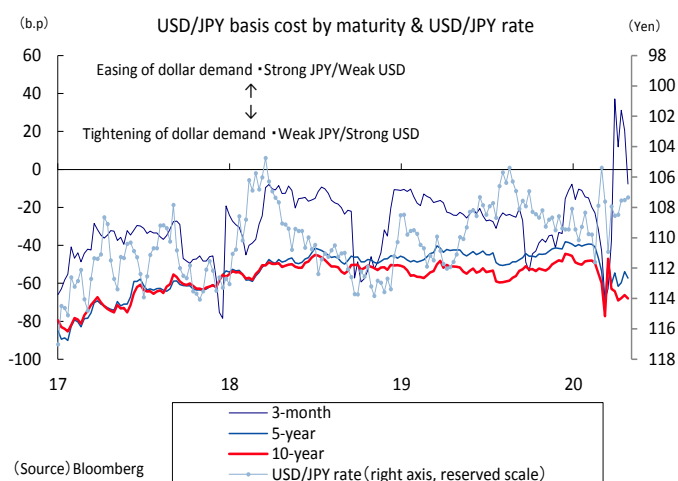


(Source) macrobond
(Note) TED spread: 3-month Eurodollar LIBOR rate – 3-month UST yield

It is widely known in the markets that one of the most sought-after central bank measures during an emergency is the provision of a speedy, large-scale, and convenient USD procurement scheme. The recent significant improvement in USD cross-currency basis (details later) as well as decrease in the LIBOR rate are worth taking note of as part of the process of the financial markets returning to an ordinary risk-off phase from the previous extreme risk-off phase rooted in USD procurement difficulties.

Desperate USD Provision

I would like to provide a brief recap of the Fed's speedy action in response to USD procurement difficulties. On March 3, the Fed called an emergency FOMC meeting and lowered the FF rate by 50 bps. On March 16, it called another emergency FOMC meeting and decided to return to a zero interest-rate policy and resume quantitative easing (QE, which was later made unlimited at a third emergency FOMC meeting called on March 23). The same day (March 16), it was decided that six key central banks around the world would expand their USD provisioning measures, which greatly relieved tensions in the market and was extremely well received. This decision resulted in a lowering of the interest rate on dollar swap arrangements from OIS + 0.50% to OIS + 0.25%, and a new 3-month (84-day) loan term was added to the existing 1-week term. Further, the frequency of liquidity provisioning operations for 1-week loans was increased from once a week to daily operations. On March 19, these measures were expanded to nine other central banks including those of Brazil, Denmark, Mexico, Norway, New Zealand, Singapore, and Sweden.

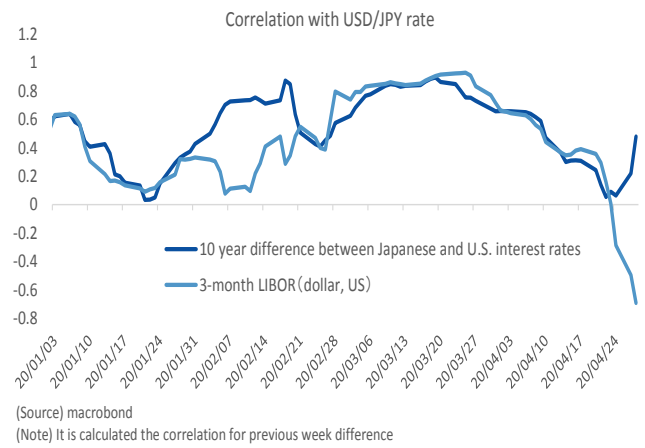


(Source) Bloomberg

This strengthening of dollar swap arrangements enabled central banks other than the Fed to procure USD at favorable conditions and supply it to the domestic banks under their jurisdiction. EUR and JPY also improved to stand at premiums against USD (i.e., USD was in surplus), even though they have since gone back to being traded at a discount against USD (see figure on previous page). In this sense, USD procurement difficulties have been eliminated outside the U.S. Reflecting this change in situation rather tardily, the LIBOR rate has only recently begun to decrease, finally reaching rates suitable for the current ordinary risk-off phase in the markets.

JPY Buying Dominates in Ordinary Risk-Off Phase

The resolution of USD procurement difficulties and mutual distrust among financial institutions is an important point to note when formulating an outlook for the forex markets. It is thought that forex market investors let go of their domestic currencies in exchange for USD in anticipation of USD procurement difficulties during the extreme risk-off phase. In fact, the values of safe currencies such as JPY and CHF fell during this time, with USD/JPY hitting 111.70 on March 24, for instance. This coincided with LIBOR rates strengthening (they were the strongest during the week of March 23, which included March 24). The figure shows the correlation between USD/JPY, the U.S.-Japan 10-year interest rate gap, and the 3-month LIBOR rate. In March, the correlation between USD/JPY and LIBOR rates strengthened. This is consistent with the phase during which mutual distrust increased in the short-term financial markets amid increasing difficulty in USD procurement and tight USD market conditions, which resulted in USD appreciating against JPY. There has been a significant positive correlation between USD/JPY and the U.S.-Japan 10-year interest rate gap since even before then, but the correlation between USD/JPY and the LIBOR rates was conspicuous in the sense that it strengthened starting the beginning of March. This correlation tends to strengthen also during phases of strong economic growth when the Fed is implementing regular rate hikes, but this time, it strengthened as a result of USD buying during extreme risk-off coinciding with stubbornly high LIBOR rates. When the LIBOR rates fell again at the start of April, the correlation also weakened significantly, but the positive correlation between USD/JPY and the U.S.-Japan 10-year interest rate gap is now strengthening again. This seems to indicate that USD/JPY is in the process of returning to its position during ordinary times. This is no more than a rough impression, but I present it here as a way to grasp the mood in the markets.



As mentioned above, USD procurement difficulties outside the U.S. have already been resolved, so the focus will now shift to the LIBOR rates – on whether their continued decline indicates a resolution of the mutual distrust among financial institutions. At this stage, the trend of USD buying amid extreme risk-off conditions having fully cooled down, the basic thinking is that USD/JPY will undergo correction in line with the decline in U.S. FF rates amid ordinary risk-off conditions (i.e., JPY will appreciate against USD).

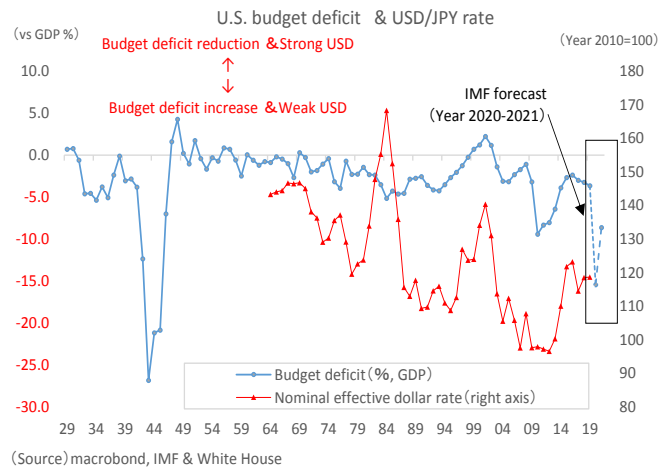
U.S. Fiscal and Monetary Policies Now and Going Forward – Fiscal Expansion and Confidence in USD

Fiscal Expansion and Confidence in USD

Countries around the world have been implementing unprecedented fiscal and monetary policies in an effort to cope with the coronavirus crisis. As IMF Chair and Managing director Kristalina Georgieva said at the G20 Finance Ministers and Central Bank Governors Meeting held in April, fiscal measures worth USD 8 trillion or so have been implemented globally. This is equivalent to 10% of the world's GDP (around USD 80 trillion), which is literally an unprecedented experience. Another noteworthy fact is that a quarter of that amount (over USD 2 trillion) is due to the economic policy measures implemented by the U.S. What impact will such measures have on asset prices going forward? Given that interest rate gaps have finally disappeared from the world, one can easily imagine that, once the crisis ends, funds will be channeled into risk assets led by equity. But how will USD's position in the forex markets change? This may be the time to consider a very important topic that draws attention periodically – the relationship between national debt and confidence in USD.



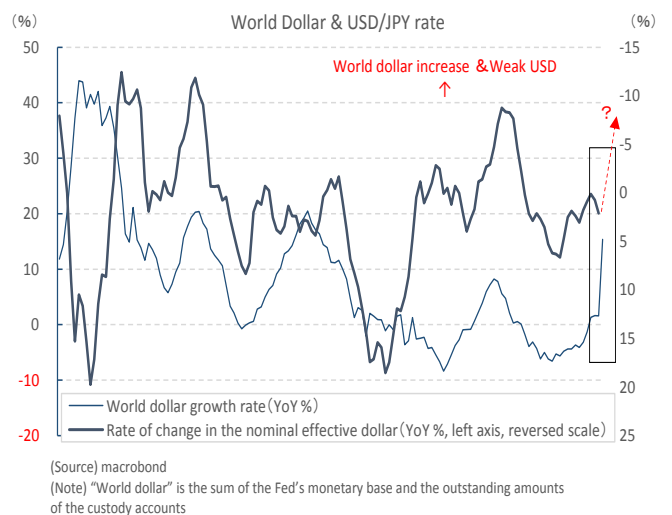
The reason USD has persistently retained its strength over the past six years is because, in a world where interest rates were disappearing, the U.S. alone was able to maintain a relatively high policy interest rate. However, that rate was eliminated in one fell swoop in rate cuts implemented in March. With the coronavirus crisis continuing to rage, there may continue to be a relatively strong demand for USD. However, once the crisis is over, the financial markets may begin to focus their attention on the greatly expanded U.S. national debt. It is not too early to consider this possibility, because the markets are liable to suddenly shift the focus of their attention. The series of USD fund provisioning operations in the forex swap markets have already been successful, and USD now stands at a premium against EUR and JPY (i.e., a USD surplus). Arguments based on correlating USD



procurement difficulties with USD appreciation are already in the past. Current estimates based on the scale of fiscal expansion in the U.S. and the IMF's World Economic Outlook are that the U.S. national debt is on track to reach 130% of nominal GDP for 2020-2021. This is a level even greater than the nearly 120% of GDP seen in the immediate wake of World War II in 1945 (see figure, top). There is a certain level of correlation between USD rates and U.S. national debt, but the correlation seems even stronger between USD rates and the fiscal balance, which is a flow concept. At the very least, it would not be surprising if USD were to weaken in the coming months as a result of the quadrupling of the U.S. fiscal deficit from -3.6% of GDP in 2019 to -15.4% of GDP in 2020 (see figure, bottom).

“World Dollar” Suggests USD Depreciation

In the context of confidence in USD in view of crisis-time fiscal and monetary policy responses, “world dollar” was an often heard concept in the immediate wake of the global financial crisis (following the collapse of Lehman Brothers). “World dollar” is the sum of the Fed’s monetary base and the outstanding amounts of the custody accounts (Custody Holdings, Securities in Custody for Foreign & International Accounts) held and managed by the Fed. Roughly speaking, world dollar is an indicator of the total volume of USD in circulation both within and outside the U.S. Intuitively, a negative correlation can be predicted between world dollar and USD rates, and this does seem to be the case in reality as well (see figure). World dollar has expanded dramatically along with the U.S. monetary base against the background of the Fed’s unlimited QE, and when this is seen in combination with U.S. fiscal deficit trends shown in the previous figure, the general impression is that USD could find it difficult to appreciate for some time to come except during times of emergency USD buying as seen in March.



Of course, in theory, it is not necessary for money stock to expand simply because the monetary base has expanded, so it would be inappropriate to forecast USD depreciation, but it is worth keeping the possibility in mind given the impulsive nature of the forex markets, where the very idea of something can sometimes affect trends.

Substantial USD Weakening Would be good for the Global Economy

One last thing I would like to clarify is that I do not believe it would be a bad thing if USD were to weaken as a result of loss of confidence due to U.S. fiscal expansion. The phrase “loss of confidence” might have a negative connotation, but the fact is that the situation is likely to have been even more critical had the U.S. government not acted as promptly and boldly as it did. In that case, confidence in the world economy may have been at risk earlier than confidence in USD. Again, given that excessive USD depreciation signifies an appreciation of non-USD currencies, it is unlikely that currency authorities around the world would let that level of USD depreciation go unchecked indefinitely. Different countries might take different measures, either in the form of currency intervention, monetary easing, or capital regulations, but they would very likely take some measure to counter the appreciation of their domestic currency against USD. It was, therefore, right that the U.S. government and the Fed should act even at the risk of loss of confidence in USD, and they did that. The Fed’s rapid pace of rate cuts was not appreciated by the markets, but the resolute move to supply USD funds has been highly appreciated. I believe there is a high likelihood of significant USD weakening as a result of the expansion of the total global supply of USD.

On the other hand, a USD crash, especially one that becomes a protracted problem, would be intolerable not just for U.S. authorities but even for other countries' currency authorities. All countries want to avoid excessive appreciation of their domestic currency. As I repeatedly say in this report, in a dollarized world where many countries have enormous amounts of USD-denominated debt, persistent strength of USD could cause the markets to become unstable due to concerns over debt repayment. Taking into account the future, when the world emerges from the current crisis, even a slight loss of confidence in USD as a result of bold measures taken by the U.S. government would be a good thing for the global economy.

Moving from Decision-Making to Implementation

Meanwhile, the monetary policy was kept unchanged at the April FOMC meeting. This was unsurprising, considering the three emergency meetings in March, where decisions were made to lower the FF rates by a total of 150 bps, unlimited asset purchases were initiated, including of corporate bonds and junk bonds. Going forward, the Fed is expected to move from a decision-making to implementation stage. This can be guessed from the change in language (the use of continuous tense) in the FOMC statement from "The Federal Reserve is committed to use its full range of tools to support the U.S. economy in this challenging time and thereby promote its maximum employment and price stability goals" in March to "The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals" in April. Perhaps it reflects the Fed's sense that the policy tools that had all along been available to it are now in the very process of being used.

As of the time of writing this report, there seems to be a soft light at the end of the tunnel of the coronavirus crisis even in the U.S., as people begin to gradually think of resuming economic activities. However, if we anticipate second or third waves of infections, it may be unwise to take further measures at this point. As discussed in detail later, if we take into account the worst-case scenario assumed by the IMF, the current situation may continue well into 2021. Should that happen, the Fed will have no choice (aside from strengthening forward guidance) but to purchase equity or introduce negative FF rates, subjects that have so far been considered taboo. At any rate, all these measures are factors that would prompt investors to let go of USD in the forex markets, so the longer the coronavirus crisis continues, the higher the risk of JPY appreciation. One may have to do with this somewhat incoherent understanding of the facts for now.

IMF's Fundamental Views on the Corona Shock: "World Economic Outlook" and "Global Financial Stability Report"

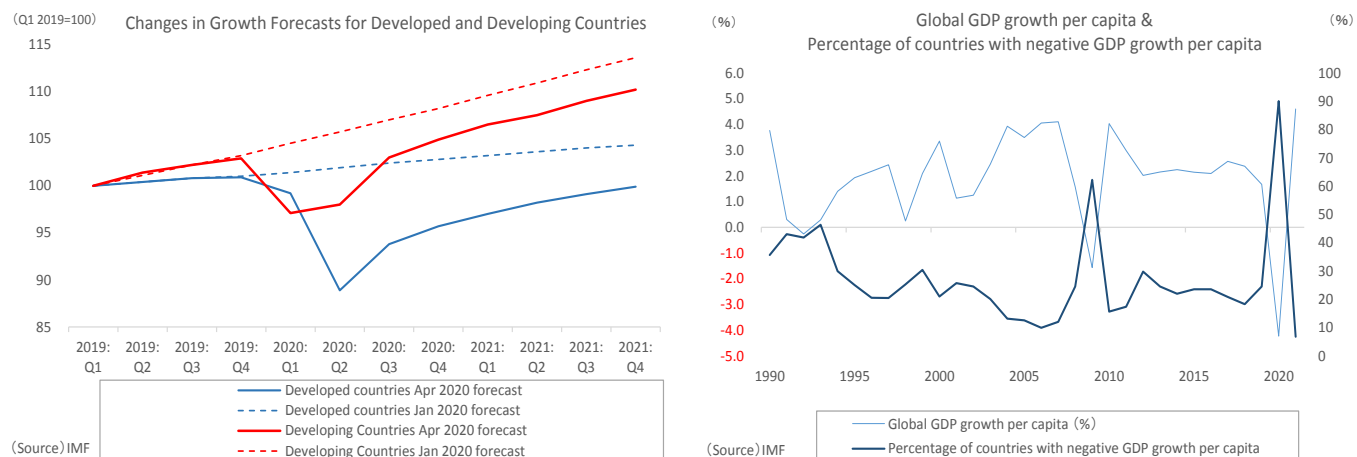
The Great Lockdown

The IMF regularly publishes its World Economic Outlook (WEO) and Global Financial Stability Report (GFSR) twice yearly, and the latest editions of these reports were released in April. This time, however, only "Chapter 1" of these reports were released in April, and the full versions will not appear until some time in May. As the contents of these reports are very interesting, I think it is worth overviewing them. I believe they contain information that is extremely important for forecasting market trends going forward.

Although the full WEO has not yet been released, the WEO Chapter 1 title – "The Great Lockdown" – suffices to give the gist of the story. Media headlines gave particular attention to the report's 2020 global GDP growth rate forecast, which was revised downward by 6.3 percentage points from the January forecast level, to -3.0%. IMF Managing Director Kristalina Georgieva emphasizes that the margin of drops in economic indicators will surpass the margin of drops during the Lehman shock and become the worst such drops seen since the Great Depression. Premised on the infection becoming contained within the year, the IMF forecast scenario anticipates a V-shaped recovery to +6% GDP growth in 2021. There are probably some people who consider this outlook – including the anticipated timing of the end of the pandemic – overly optimistic, but it is inevitable that certain tentative assumptions be made in order to prepare this kind of economic forecast.

Negative Growth Anticipated in 90% of the World's Countries

The graph (left) on the next page clearly shows how developed and developing countries' economic growth rates have plummeted since the initial corona shock, and it also shows how the growth forecasts for those two groups of countries have been revised downward from the January forecast levels. Downtrends in the business cycle do not ordinarily create GDP growth rate drops as sharp as those seen in the graph – such sharp drops are usually seen only in association with such situations as wars that depress the economy from both the supply and the demand sides. It has already become generally acknowledged that the corona shock will be a larger-scale crisis than the Lehman shock, and the difference between the two shocks is clearly reflected in the high proportion of countries that have now fallen into negative growth (see graph on right). Roughly 60% of the world's countries recorded negative growth during the Lehman shock, but about 90% of those countries will suffer from such negative growth this time. In other words, the economic contraction in 2020 will take place on a truly global level, and that is expected to make the corona shock particularly powerful.



Three Divergent Stress Scenarios after “-3% growth in 2020”

As previously mentioned, the main WEO forecast is based on the assumption that the pandemic will end in the latter half of 2020 and will be followed by a V-shaped recovery in 2021, but since the virus is still very imperfectly understood, the WEO presents multiple forecast scenarios. Many people consider the -3% growth forecast to be too optimistic. However, the WEO’s “Scenario Box. Alternative Evolutions in the Fight against COVID-19” section presents three alternative forecast scenarios. Scenario 1 assumes that measures to contain the spread of the virus in 2020 will last roughly 50% longer than assumed in the baseline. Scenario 2 assumes that there is a second outbreak of the virus in 2021 that is roughly two-thirds as severe as in the baseline. Scenario 3 assumes that it takes longer to contain the outbreak in 2020 and that there is a second outbreak in 2021. In each of these scenarios, it is assumed that the financial environment will become tighter due to rises in each country’s government bond yields and that monetary policy authorities will have to implement additional measures in response to that. The WEO’s analysis concludes that such situations will temporarily cause additional slowing in productivity growth and an additional increase in unemployment.

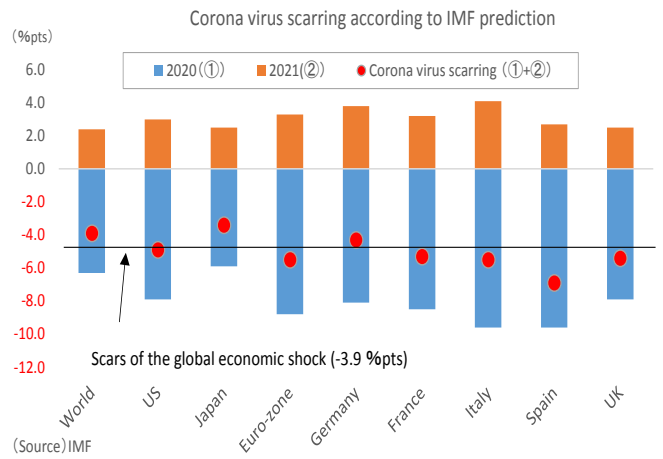
Compared to the baseline global output level, the scenario 1 level is -3% lower in 2020, the scenario 2 level is -5% lower in 2021, and the scenario 3 level is -8% lower in 2021. Presenting such multiple scenarios is reasonable given that the scenarios’ trend directions and value levels are determined by the timing of pandemic containment. The WEO also mentioned that in these alternative scenarios, emerging market economies more-limited fiscal capacity for maintaining incomes is assumed to result in greater economic scarring than in advanced economies. In the WEO’s main text (outside the Scenario Box section) it is noted that – “The pandemic could prove more persistent than assumed in the baseline. Moreover, the effects of the health crisis on economic activity and financial markets could turn out to be stronger and longer lasting, testing the limits of central banks to backstop the financial system and further raising the fiscal burden of the shock.” – and there is a subtle suggestion of particular concern regarding the ECB and Fed, which have played most of their policy cards at an early stage of the crisis.

The IMF’s is definitely not optimistic overall; while its baseline forecast describes the outlook based on the premise that pandemic’s spread will end during the second half of 2020, it is also considering different outlooks based on more pessimistic premises. If alternative scenario 3 were to be positioned as the baseline forecast, it would undoubtedly stimulate some intense discussions. Both scenario 2 and scenario 3 anticipate additional pandemic spread during 2021, and if either of those were to be positioned as the baseline forecast, it would be likely to affect the decision-making judgements of Tokyo Olympic Games stakeholders and many other businesses.

Particularly Serious Economic Scarring in Europe

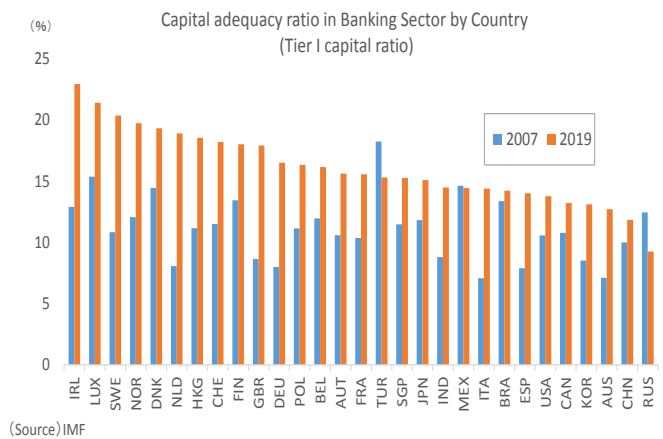
As the IMF’s global economic outlook – considered world’s benchmark forecast – projects economic growth rates based on the assumption that that the corona virus pandemic will end this year, market participants will have no choice but consider that scenario to be the main forecast scenario. Although that forecast scenario is quite pessimistic, there are considerable differences between the downtrends anticipated for individual countries and regions. Looking at the world’s three key economies of Japan, the US, and Europe, the magnitude of damage that Europe is likely to suffer is particularly large. Comparing the IMF’s January forecast of 2020/2021 growth rates to its revised forecast, one finds the percentage-point margin of revisions was -6.3/+2.4 for the world, -7.9/+3.0 for the United States, -5.9/+2.5 for Japan, -8.8/+3.3 for the Euro zone, and -7.9/+2.5 for the UK. The decline in Europe is relatively large. Looking at individual countries in the euro area, one finds the percentage-point margin of revisions was -8.1/+3.8 for Germany, -8.5/+3.2 for France, -9.6/+4.1 for Italy, and -9.6/+2.7 for Spain. All these declines are quite large. It should be noted that Japan experienced a large GDP drop in the fourth quarter of 2019 due to the consumption tax rate hike. Given that that drop and a subsequent counter-reaction to the drop will complicate comparisons between Japan and other economies, I think it better to leave such comparisons aside for the moment.

Since the increasing depths of 2020 GDP growth rate valleys is associated with the increasing heights of 2021 GDP growth rate mountains, it will be easier to understand the magnitude of “corona shock scarring” by comparing the magnitudes of valley-mountain sums. The graph on the right shows a comparison of such sums for major economies. The world economy’s scarring amounts to -3.9 percentage points, and the only major economy with less scarring than that is Japan, with -3.4 percentage-point scarring. It bears noting that there are strong grounds for suspecting that Japan’s scarring would be greater in the absence of a reaction to the above-mentioned consumption tax rate increase shock. On the other hand, the scarring in Europe is relatively deep, especially in the euro area. As one might imagine, the scarring is particularly deep in such countries as Italy and Spain, where the pandemic has been relatively serious and the government sector is likely to have insufficient financial resources to offset the pandemic’s impact. As a side effect of the unprecedented policy responses to the pandemic, I suspect that the post-corona world will suffer from bubble-like economic and financial situations. Under such circumstances, it is likely that each country will make efforts to decisively roll-back its pandemic response measures, but there is a high likelihood that Europe’s efforts in this regard will be weaker than such efforts elsewhere in the world. As I have repeatedly argued in this article, the ECB has compromised its principles by investing in the government bonds of specific countries, and it will presumably have to exercise considerable caution in rolling back those investments. I believe the euro area’s current situation and outlook may lead to a general trend away from EUR in the forex market, where there is always another currency to consider.



Comparison with the Lehman Shock – Positive and Negative Points

The GFSR focuses on trends in capital flows in financial markets and analyzes the expected impact of the Corona Shock on individual countries and regions and asset classes. I think it will be useful to overview the issues the GFSR mentions regarding the relatively positive and negative points that can be seen when comparing the current crisis to the time of the Lehman shock. Overall, the main positive point is the robustness of the financial system, and the main negative point is the speed of capital flight. First of all, the good news is that the IMF gives a positive assessment of the financial system’s robustness. While the corona shock has already caused serious economic and financial scarring, the good news is that the systemic risk associated with the failure of a major financial institution has been decreased. At the time of the



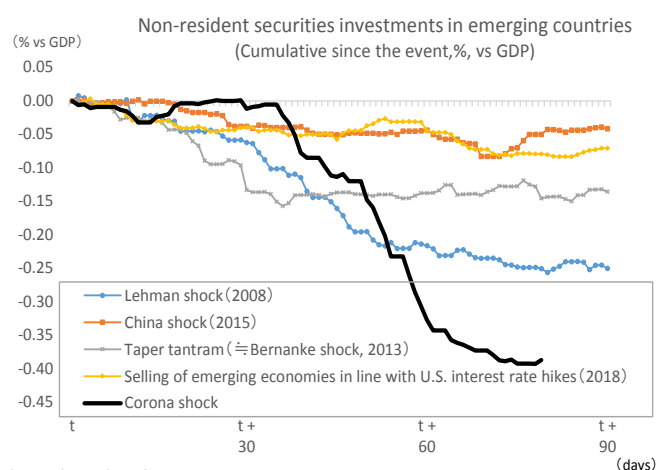
Lehman shock, liquidity constraints and growing losses on asset holdings led to the deterioration of financial institutions’ financial positions, which caused the overall situation to become even more serious. In this regard, a comparison of Tier 1 capital ratios at the end of 2007 and the end of 2019 shows that major financial institutions have generally been accumulating larger buffers against losses and strengthening their shock resistance. The GFSR points out that the average Tier 1 capital ratios have improved (increased) by more than 400 bps compared to the end of 2007 (see graph). It is well known that the Lehman shock (and its predecessor, the sub-prime shock), led to a significantly strengthening of banking supervision systems and the creation of diverse regulations. Over the past decade or so, financial institutions have gained greater robustness at the cost of decreased profitability, and the GFSR gives a positive assessment of the fact that the benefits of that robustness are now being enjoyed.

However, there is also a view that the corona shock-induced economic downturn and associated credit environment deterioration has yet to fully emerge and will be growing worse going forward. In this regard, the GFSR also expressed concern that – “The longer the sudden stop in economic activity continues, the more likely it is that banks will see credit losses on their lending to households and companies.” In particular, it pointed out that commercial banks account for a large share of loans for commercial real estate assets that are expected to significantly decrease in value in the future. Commercial banks’ share of commercial real estate debt is 53.9% in North America, 69.4% in Europe, and 70.1% in the Asia Pacific region. Banks have strengthened their equity from a stock perspective but, given that their profitability from a flow perspective is lower than previously, there is concern that their profits may prove insufficient to enable them to absorb upcoming losses.

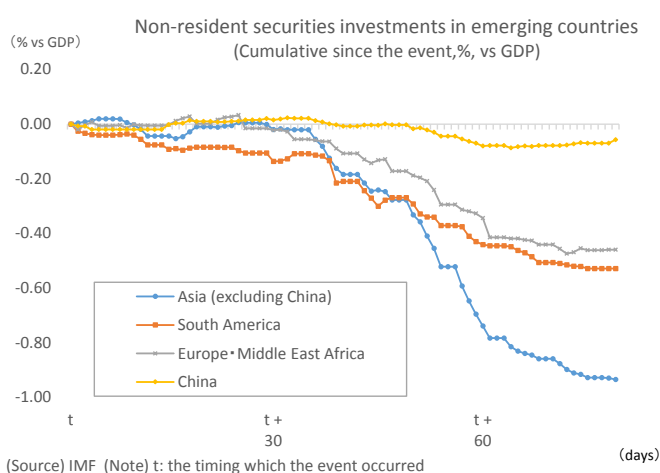
Systemic risk is the theme that the GFSR is most concerned about. Rather than being optimistic regarding systemic risk, the overall tone of the GFSR’s assessment is that the system is currently performing well but there is due cause for concern about how long it can continue to do that.

Negative Point – Capital Flight Proceeding 1.5 Times Faster than During the Lehman Shock

When comparing the current crisis to the time of the Lehman shock, the main negative point is the speed of capital flight. Capital flight from emerging countries is currently proceeding considerably faster than following the Lehman shock. The graph on the right shows changes in the cumulative scale of emerging economy securities investment (investment in stocks and bonds) as a percentage of GDP. It can be seen that the capital flight has been progressing about 1.5 times faster during corona shock period than following the Lehman shock. It is progressing about three times faster than during the 2013 taper tantrum (Bernanke shock) period, which caused considerable turmoil in emerging economies. So it is safe to say that the corona shock's impact on capital flight is of unprecedented magnitude.



Looking at capital flight by country and product, one can see particularly high levels of capital flight from the Asia region (excluding China; see graph) and from stocks, and the IMF attributes this to the undermining of high-economic-growth-rate expectations. The GFSR regularly monitors international financial system vulnerabilities by country and sector. At this point it is indicating that, compared to the Lehman shock period, the vulnerabilities of China and other emerging countries are particularly great, as are the vulnerabilities of the non-financial corporate sector and government sector. In particular, as noted below, given concerns about the “dollarized world” trend and emerging economies’ worrisome external debt situations, one of the points meriting greatest attention is the extent to which a severe capital flight situation will shake up relevant sectors of emerging economies and whether such turbulence will spread to impact the entirety of international financial markets. Conditions have not yet become chaotic, thanks largely to each country’s all-out mobilization of monetary and fiscal policies. However, just as regarding the potential impact of the corona shock-induced economic downturn and credit environment deterioration on the financial system mentioned above, the magnitude of the impact of capital flight will also depend on how long the period of restrained economic activity persists. Thus, the IMF can only say that the situation is currently still manageable, but it cannot confidently predict what will happen going forward. Considered from a pessimistic perspective, this could be interpreted to mean that the full ramifications of the corona shock are just beginning to emerge.



From the perspective of analysts, the WEO and GFSR are particularly interesting in that they provide quantitative data that is beginning to objectively support the previously vague perception that the corona virus shock will prove to be a more-severe crisis than the Lehman Shock was. As mentioned above, given that capital flight from emerging countries is proceeding on a larger-scale than during the Lehman shock, and given that international financial markets have been suffering from a pernicious “dollarized world” trend during the past 10 years, there appear to be grounds for considerable concern about the possibility that a debt crisis stemming from emerging countries may occur. At the moment, the IMF’s main message (although the full versions of its WEO and GFSR have not yet been released) is that the initial impact of the corona shock is greater than the initial impact of the Lehman shock. Beyond the headline data, however, the two reports also include diverse data relating to what kind of situations appear likely to occur depending on the degree of the pandemic’s persistence, so they are worth reading in their entirety.

Japanese Financial Policies Now and Going Forward – Presaging Future Policies

The BOJ Introduces the Word “Unlimited”

The April BOJ Monetary Policy Meeting (MPM) decided to strengthen its easing measures through measures centered on (1) an increase in the value of CP and corporate bond purchases, (2) the expansion of the Special Funds-Supplying Operations to Facilitate Corporate Financing regarding the Novel Coronavirus (COVID-19), and (3) more aggressive purchase of JGBs. This was in line with widespread expectations that the BOJ would step up its easing regarding both corporate finance and government bond purchases.

Media headlines gave particular attention to policy (3), which represents a shift away from the previous BOJ JGB purchasing target of “increase outstanding holdings at an annual pace of about JPY80 trillion” to an insistence that the BOJ is prepared to buy an unlimited amount of JGBs. This decision has two important implications – first, in presenting a BOJ stance that is not inferior to the “unlimited purchases” stance adopted by the Fed, and second, in laying the groundwork for a future exit strategy. Naturally, it is the second implication that is the key one. Through March this year, the BOJ had purchased roughly JPY10 trillion of JGBs, so the BOJ was free to quickly expand its JGB holdings by roughly an additional JPY70 trillion this year without modifying its previous target. This suggests that the removal of the JPY80 target level was designed to present an image of expanding easing measures in an abstract sense. As mentioned, this image is significant insofar as it presents the BOJ as being proactive on a level equal to that of the Fed. However, the true significance of the change lies in the fact that it enabled the BOJ to finally eliminate the JPY80 trillion target in a manner that is acceptable even to reflation-minded MPM members. Of course, if the existence of a numerical target is not currently problematic in a concrete sense, there is no need to take the trouble to change it amid crisis conditions, but if the specified target were to be increased by even one yen, it would naturally imply an obligation to prevent a subsequent year-on-year decrease in the monetary base balance.

But if one were also giving consideration to needs associated with a future exit strategy, then one would be aware of the need to eliminate the JPY80 trillion target at some point in time. Thus, the recent redefinition of the JGB purchasing target might be considered a cleverly disguised measure that took advantage of the pandemic crisis to lay the groundwork for a future exit strategy.

Concern about Keeping Monetary Policies Independent of Government Policies

Since the policy of expanding the amount of JGB purchases in line with the “Further ample supply of funds” objective was already confirmed at the extraordinary MPM meeting in March, it may be most appropriate to consider policy (3) to simply represent the implementation of the March decision rather than additional easing. At the post MPM meeting press conference on April 27, BOJ Governor Kuroda said that – “In light of the increase in government bond issuance due to the government’s emergency economic measures, the BOJ, with a view toward maintaining the bond market’s stability and stabilizing the overall yield curve at a low level, will for the time being be more-proactively undertaking purchases of both long-term and short-term government bonds.” – and this sentence makes it clear that the BOJ and Japanese government are working together to deal with the emergency situation. Such collaboration will inevitably be critically regarded by some as a step toward subordinating BOJ policies to the government’s requirements, but there is a strong general perception that this is not an important issue in context of dealing with the emergency situation. However, it should be kept in mind that there are in fact grounds for concern that Governor Kuroda’s statement may have crossed the line ordinarily expected to separate monetary policies from government policies.

Japanese TLTRO3

The corporate finance-related policies (1) and (2) are also important, but it should be noted that policy (1)’s strengthening of CP/corporate bond purchasing operations (prolonging the maximum remaining maturities of instruments purchased, expanding the purchase quota, and raising the BOJ holding ratio upper limit) is designed to meet the needs of large corporations, while there is a particularly urgent need to facilitate SME financing by expanding policy (2)’s Special Funds-Supplying Operations to Facilitate Corporate Financing regarding the Novel Coronavirus (COVID-19). Regarding policy (1), given that the credit spread is not so wide, there are grounds for questioning whether it is appropriate for the BOJ extend maximum remaining maturity periods to as long as 5 years to eliminate credit costs. On the other hand, as the special terms apply only until the end of this coming September, there is a general inclination to consider such measures acceptable in light of the emergency conditions. As expected, it can be said that the BOJ has no alternative but to seek to deal with the situation using temporary measures with time limits. There were three revisions with respect to Policy (2) – the determination that the target collateral will be private debt including not only conventional corporate sector debt but also household sector debt, the expansion of the eligible financial institution scope to include affiliated institutions, and the determination that a positive interest rate of 0.1 percent will be applied to the outstanding balances of current accounts held by financial institutions at the BOJ that correspond to the amounts outstanding of loans provided through this operation. This last revision corresponds to the conditions of the ECB’s third-phase long-term liquidity supply (TLTRO3) operations, which give financial institutions a “reward” in accordance with their loan extension performance. In this sense, it is the BOJ version of TLTRO3 and, amid a trend of the world’s central banks becoming BOJ-ized, it might be considered a rare case in which the BOJ has become ECB-ized to a certain extent. One might ideally like to alleviate financial intermediary function deterioration by raising the level of currently negative interest rates, but since this might cause market turbulence, it seems that the approach of tweaking the details of funding supply conditions has become the mainstream approach.

Perception of “Giving Up” on the 2% Inflation Target

The Kuroda-led BOJ’s outlook report has become widely considered a “aspiration report” because, despite various adverse conditions, it anticipates that annual growth in Japan’s consumer price index (CPI) will move toward the targeted +2% level at the end of the forecast period. However, the latest outlook report seems unable to sustain a convincing guise of aspiration. The BOJ Policy Board members’ forecast anticipates that the CPI growth rate will be -0.7% to -0.3% during fiscal 2020, 0.0% to 0.7% during fiscal 2021, and 0.4% to 1.0% during fiscal 2022. It expects the CPI growth rate to regain the 1.0% level after two years. As the forecast of real GDP growth rates anticipates a catastrophic performance of -5.0% to -3.0% in fiscal 2020, the Policy Board members had no choice but to create a

price outlook in line with that situation. In light of the timing of its release, it seems that this outlook report aims to take into account a prospective boost from the government's large-scale economic counter measures, but even so, the situation looks so dire that it is hard to characterize it as "aspirational". The unprecedented drop in crude oil prices makes the CPI growth rate outlook seem all the more unrealistic, and yet it might be hoped that it that could help adjust people's mind-sets in a way that facilitates the creation of a more-honest forecast. The above-mentioned elimination of the JPY80 trillion JGB purchasing target and other developments appear to be generating a mood in which the monetary policy rudder may be almost imperceptibly beginning to turn toward normalization.

The BOJ has adjusted its standard phraseology to reflect this changing perception of economic and inflation trends. Materials related to its policy countermeasures released by the BOJ since last year through March 16 of this year included the sentence – "As for the policy rates, the Bank expects short- and long-term to remain at their present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability target will be lost." In the BOJ's April 27 press release on "Enhancement of Monetary Easing," this sentence has been shortened to read – "[The Bank] expects short- and long-term policy interest rates to remain at their present or lower levels." As Governor Kuroda explained at the press conference, the momentum has already been impaired, and that might be considered to be a factor leading the BOJ to undertake additional easing.

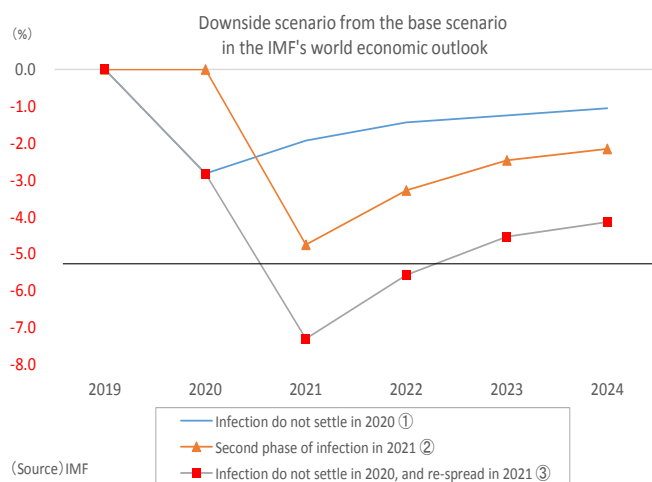
BOJ-Friendly Reiwa Era USD/JPY Trend

Except for policy (2) – the expansion of the Special Funds-Supplying Operations to Facilitate Corporate Financing regarding the Novel Coronavirus (COVID-19) – the BOJ's new package of policies appears to be akin to efforts to put the BOJ on a par with the Fed and ECB, and one gets the impression that their real significance is not so large. Past issues of this article have explained how the BOJ is the leader among central banks in terms of its proactive responses to problems, and this situation is obvious when one considers the scale of BOJ easing measures in comparison to the scale of the Japanese economy. But it still appears that the BOJ was feeling pressure to keep up with the kind of easing measures being implemented overseas and that that pressure was a factor in the BOJ's decision to augment its purchases of CP and corporate bonds (for which there was no great need) as well as to eliminate the JPY80 trillion JGB purchasing limit (which will facilitate its exit strategy). This seems to be a reasonable summary of the BOJ's most recent measures. When the JGB purchasing limit's elimination spurred flashy headlines along with a temporarily favorable response from financial markets, it seems likely that the BOJ was patting itself on the back for having had a highly successful MPM. Another reason why the BOJ need not trouble itself excessively about its policy countermeasures is the fact that the forex markets are not showing signs of a trend of excessive JPY appreciation. In this regard, it appears that the Reiwa Era USD/JPY trend is becoming more BOJ-friendly than the preceding Heisei Era trend.

Risks to My Main Scenario – Three Divergent Scenarios

Considering the IMF's Risk Scenarios

At this point, I would like to overview issues related to risk scenarios, but doing that is so difficult at this time that even the IMF is delaying the publication of the final versions of its regular reports (the WEO and GFSR). Frankly speaking, it is currently very difficult to comprehensively list the relevant risk factors and their likely impact on forex markets. In light of that, one reasonable approach is to borrow the WEO's use of multiple scenarios differentiated by differing pandemic period lengths and then analyze the economic downturn patterns in each scenario along with the forex outlooks associated with those patterns. As explained on page 11 of this article, the WEO presents three alternative forecast scenarios. Scenario 1 assumes that measures to contain the spread of the virus in 2020 will last roughly 50% longer than assumed in the baseline. Scenario 2 assumes that there is a second outbreak of the virus in 2021 that is roughly two-thirds as severe as in the baseline. Scenario 3 assumes that it takes longer to contain the outbreak in 2020 and that there is a second outbreak in 2021. In each of these scenarios, it is assumed that the financial environment will become tighter due to rises in each country's government bond yields and that monetary policy authorities will have to implement additional measures in response to that. Compared to the baseline global output level, the scenario 1 level is -3% lower in 2020, the scenario 2 level is -5% lower in 2021, and the scenario 3 level is -8% lower in 2021. These projections are shown graphically in the above graph.



With regard to USD/JPY, it appears that the likelihood of the Fed being forced to adopt negative interest rate policies increases in scenario 1 and becomes progressively higher in scenarios 2 and 3, and it can be understood that the risk of JPY appreciation will rise in step with that likelihood. It can also be anticipated that the prolonged suspension of economic activities will require stepped-up demand-stimulation measures, further magnifying the fiscal deficits of the United States, which has already recorded a budget deficit in most years since World War II. If so, there is a possibility that a “diminishing confidence in USD” theme will promote increased USD selling. In the WEO, the IMF worries that if the pandemic’s impact were greater and more persistent than assumed in the baseline, it could – “[test] the limits of central banks to backstop the financial system and further [raise] the fiscal burden of the shock.” – and this can be interpreted as implying a possibility of a USD depreciation trend based on the “diminishing confidence in USD” theme. While it is difficult to make specific forecasts for the three scenarios, it seems likely that in the case of scenario 1, USD/JPY will be less than 100 within this year, and in the case of scenario 2, USD/JPY will shift downward to the 95-100 range in 2021. In the worst case situation of scenario 3, one gets the impression that one should be expecting USD/JPY to descend below the 95 level.

EUR Outlook – EUR Likely to Continue to Mirror USD

Euro Area Monetary Policies Now and Going Forward – Policy Interest Rates Becoming a Facade

Policy Interest Rates Halfway to Becoming Dead Letters

The April 30 ECB Governing Council (GC) meeting decided to establish a new series of liquidity provision operations and reduce the interest rate on existing liquidity provision operations, but it disappointed expectations that it would expand the envelope of the pandemic emergency purchase programme (PEPP). The new liquidity provision operations – called pandemic emergency longer-term refinancing operations (PELTROs) – have an interest rate that is 25 basis points below the average rate on the main refinancing operations (currently 0%) prevailing over the life of each PELTRO. A total of seven PELTRO bidding rounds have been scheduled, and they are to take place in every month except July during the period from May through December. The operations provide funding with decreasing tenors, starting with a tenor of 16 months in the first operation and ending with a tenor of 8 months in the last operation. Regarding targeted longer-term refinancing operations (TLTRO3), the maximum profit exemption margin was relaxed from “deposit facility interest rate (-0.50%) + -25bps” to “deposit facility interest rate (-0.50%) + -50bps”. Thus, banks that reach the lending threshold are eligible to receive up to a maximum level of 100bps interest rate exemption. The enhancement of negative-interest-rate fund provision supply conditions appears to be causing the existing policy interest rate to progressively become something akin to a mere formality or facade. The policy rates are not purely a facade, since they are the standard for calculating the applicable rates of negative-interest-rate fund provision supply operations, but the way that the policy rates are utilized has become different from conventional usage method. In light of this, a reporter at the post-GC meeting press conference posed the question – “what was your rationale for not cutting interest rates today given that the rate on your new Pandemic Emergency Longer-Term Refinancing Operation seems to effectively act as a rate cut in the MRO rate by 25 basis points?” The ECB President Lagarde emphasized the enhanced effectiveness of the approach of flexibly structuring and combining different fund provision supply operations and easing associated collateral policies and would not go so far as to admit that those measures are tantamount to an interest rate cut, but it seems reasonable to speculate that she is concerned about the side effects of a further deepening of negative rates.

Strong Expectations for PEPP and OMT

Numerous media reports prior to the GC anticipated that the PEPP would be expanded. The post-meeting statement did not preclude that possibility, as it included the sentence – “We are, therefore, fully prepared to increase the size of the PEPP and adjust its composition, by as much as necessary and for as long as needed.” It has been pointed out that the PEPP expansion expectations may eventually be realized, as the envelopes of the asset purchase programme (APP) and PEPP will be exhausted before the end of 2020 if the rapid pace of purchases seen in March is sustained. However, it would be overly pessimistic at this point to assume that pace of purchases in March will be sustained, and it appears clear that PEPP expansion is not a policy card that would be appropriate to play at a time when lockdowns are being discontinued in some countries. A reporter repeated the frequently asked question of whether unlimited short- and medium-term bond purchases via the Outright Monetary Transactions (OMT) programme were possible, but President Lagarde responded that – “OMT was intended for particular country cases and particular circumstances where, because of fiscal policy or structural policy misguidance, there was a potential risk out there that the euro area be at risk and that it would be self-fulfilling.” – and she denied that there was currently such a situation. It is true that the current crisis is affecting all euro area countries – in fact, all the countries in the world – rather than just specific euro area countries, so it is not a situation for which OMT was designed to be used, but some market players have appeared disappointed that there has been no PEPP expansion nor hints that the OMT might be utilized. As President Lagarde clearly stated that – “The best tool that we have in our toolbox is indeed the Pandemic Emergency Purchase Programme, PEPP.” – it appears that, fundamentally, the only asset purchases-related policy card that people should be anticipating the ECB to play is that of PEPP expansion.

Strong Expectations for PEPP and OMT

One of the reporters posed a particularly interesting question, asking – “a lot of economists are saying the ECB should just adopt formal yield control policies. What do you think about that? Do you now believe that it is the ECB's role to control the spreads on government debt?” However, the main part of President Lagarde's response to that was merely that – “we are in a capacity to deal with the two key objectives that we have, which are; to make sure the monetary stance reaches its goal, and that monetary policy is properly transmitted.” – and it is perhaps natural that she did not directly answer the question. But she then went on to emphasize that the ECB – “will use any and all flexibility that we have in accordance with our mandate in order to make sure that our monetary policy is properly transmitted to all jurisdictions” – and that could be interpreted as not precluding the possibility of yield control policies at some point. As discussed in previous editions of this article,

I believe it would be feasible to establish a policy of limiting the yield fluctuation range of individual countries based on yield benchmark levels determined at pre-scheduled intervals, such as the first or last day of each month or the dates of GC meetings. The fact that a question about this has been posed at the post-GC press conference suggests that the possibility of an ECB version of the BOJ's yield curve control (YCC) framework could well become a factor considered in market forecasts in the near future. As mentioned above, anticipating such a possibility makes more sense when one considers the fact that the ECB is not positioned to implement additional interest rate decreases.

Treatment of Junk Bonds

Since the Fed's decision to purchase junk bonds, increasing attention has been focused on the question of whether the ECB might follow suit, so it is not surprising that two reporters at the press conference asked whether the ECB was considering such a move. At an extraordinary GC meeting on April 22, the ECB adopted a policy of accepting assets as collateral in fund provision operations that fall below current minimum credit quality requirements so long as the assets met the requirements as of April 7. This is designed to prevent panic in cases when the ratings of government bonds of certain worrisome countries such as Italy are downgraded. This can be considered a wise move as, on April 28, the UK branch of Fitch Ratings downgraded Italy's credit rating to BBB-, putting it on the brink of junk bond status.

However, one of the questions posed at the press conference specifically referred to the possibility of the ECB buying junk bonds rather than merely accepting them as collateral. President Lagarde responded that there had not been discussion of any change to the APP eligibility framework, but that a waiver of PEPP eligibility requirements had already been given for Greek government bonds. Although President Lagarde's answers do not actually indicate whether there is a possibility the ECB might purchase junk-rated private corporate bonds, her attitude of emphasizing flexibility hinted that while such purchases are not currently allowed, they might become allowable in the future. Since the PEPP is a limited-time-period program that only discloses aggregate value of asset purchases, it seems quite possible that there may be some purchases of unconventional assets. Another reporter posed the question – "there might be about three-quarters of a trillion of new government bond issuance in the eurozone. Is that the factor you're looking at closely when you think about whether to increase the scale of the PEPP?" In response, President Lagarde said that the PEPP is "one huge component of our purchase program capacity [...] we will use full flexibility to deploy this particular powder in the right direction where we feel that there is a risk of tightening and where we feel that we need to intervene to protect and preserve our monetary policy stance and our monetary policy transmission. As I said, flexibility means across classes of assets, across jurisdictions, across time." One gets a clear impression that, depending on how the situation develops, there is a possibility that corporate junk bond purchases might be undertaken. The negative depth of ECB policy interest rates and the inevitability that the ECB's "next move" will entail greater easing. However, those fundamental factors have not changed much since last year. Primarily, EUR trends simply reflect USD trends, and – even as USD's investment appeal diminishes in step with its transition away from being a high-interest currency – it seems most likely that USD will show a tendency to strengthen going forward in connection with the weaknesses that become evident regarding other major currencies.

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