Forex Medium-Term Outlook

July 31, 2020

MIZUHO

Overview of Outlook

USD/JPY dropped significantly in July, weighed down by across-the-board USD depreciation. In addition to EUR, which was bought up by market participants, JPY also bore some of the brunt of the USD sell-off. In terms of supply and demand, JPY's status as the currency of the world's largest net external creditor remains strong on the stock side, but flow-side variables such as the trade and current account balance indicate a net selling of JPY. There is a strong sense that past phases of dramatic JPY appreciation took place against the backdrop of trade surpluses driving significant USD sell-off, so it will be interesting to see how far the present phase of JPY appreciation progresses in the absence of a trade surplus. Given the state of USD supply and demand, there is a good chance of JPY appreciating further. The U.S. fiscal deficit could mount to 30% of GDP in the current accounting year, and USD is clearly overvalued by that measure. The relationship between the U.S. fiscal deficit and the nominal effective USD rate is more stable than it has been through most of history, so it seems natural to consider it unlikely for USD to appreciate further during the current forecasting period. In some ways, the appreciation of JPY against USD in July could also be reflecting the sudden rise in tensions between the U.S. and China. For instance, developments such as the collapse of the Hong Kong currency board could become a risk scenario triggering the fall of USD/JPY to below 100 in the financial markets.

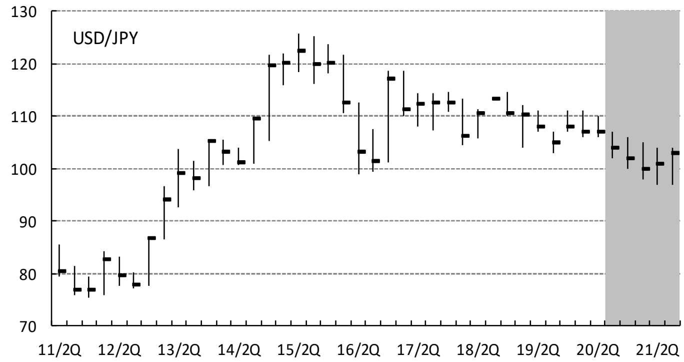
Meanwhile EUR also lacks movement. News reports regarding the proposed EU recovery fund are coming in at a dizzying pace, and the final decision on this subject is scheduled to be made at the EU summit meeting in June, so some fluctuation in EUR is expected as a byproduct. With regard to monetary policy, concerns may be raised at the sustainability of current government bond purchases, which are disproportionally weighted in favor of certain member states. The Pandemic Emergency Purchase Programme (PEPP) has been quite effective, but it also has major side effects. In May, the ECB published an article affirming the effectiveness of deepening negative interest rates, leading to speculation in some quarters that it may be paving the way for its next move. However, the ECB's policies have recently aimed to improve the risk tolerance of financial institutions by lowering the cost of fund procurement (to negative levels) in line with the policy interest rate level. It seems reasonable to assume, therefore, that it would not deliberately invite systemic instability by deepening negative interest rates. In the event that it does, EUR selling will gain momentum. My main forex-related prediction of this report continues to be USD depreciation, and the recent expansion in the U.S. fiscal deficit has only increased my conviction in this regard. As the opposite side of the coin, EUR could gain strength relative to USD.

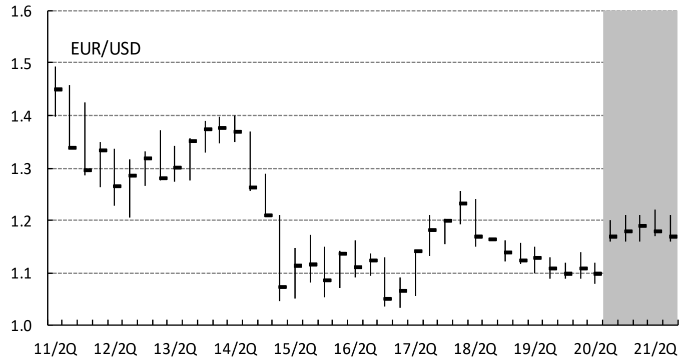
Summary Table of Forecasts

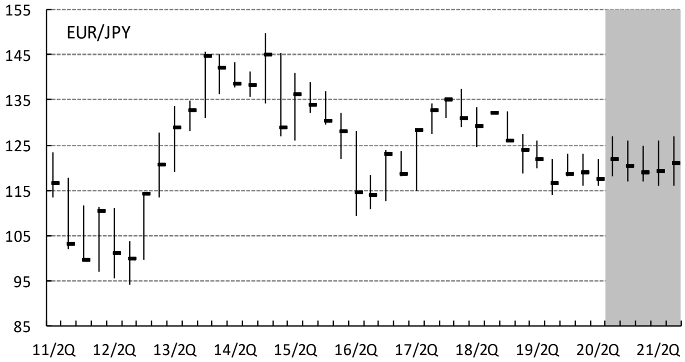
	2020 Jan -Jul (actual)	Aug-Sep	Oct-Dec	2021 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	101.18 ～ 112.23 (104.60)	102 ～ 107 (104)	100 ～ 106 (102)	98 ～ 105 (100)	97 ～ 104 (101)	97 ～ 104 (103)
EUR/USD	1.0636 ～ 1.1888 (1.1875)	1.16 ～ 1.20 (1.17)	1.16 ～ 1.21 (1.18)	1.16 ～ 1.21 (1.19)	1.17 ～ 1.22 (1.18)	1.16 ～ 1.21 (1.17)
EUR/JPY	114.43 ～ 124.43 (124.20)	118 ～ 127 (122)	117 ～ 126 (120)	117 ～ 125 (119)	116 ～ 126 (119)	116 ～ 127 (121)

(Notes) 1. Actual results released around 9 am TKY time on 31 July 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







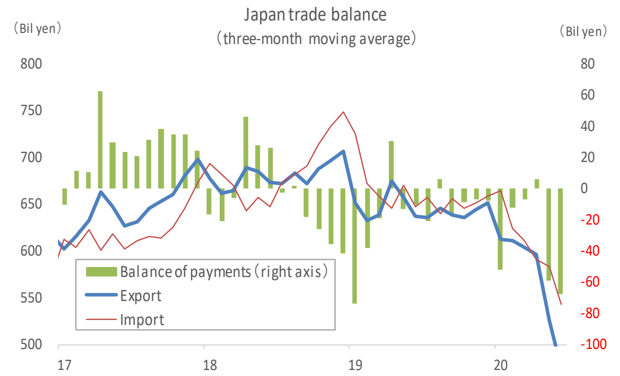
USD/JPY Outlook – The Encumbrance of an Overvalued USD

JPY Supply and Demand – Understanding Stock and Flow Variables; USD Overvaluation also a Key Point

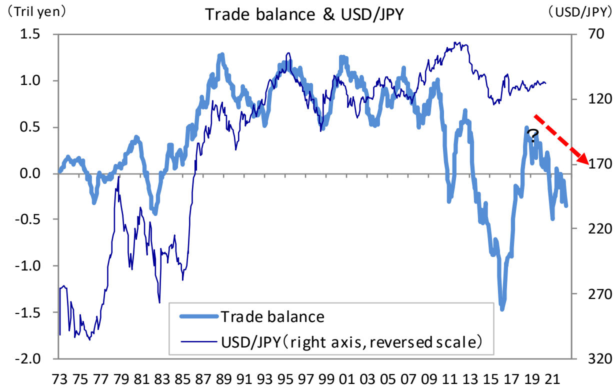
Demand Analysis: Which is More Important – Stock or Flow?
Since March, when the COVID-19 crisis started to become serious, this report has been maintaining that in a world without interest rate gaps, given that no inflation gaps are expected in the medium/long term either, demand analysis will take on relatively greater importance when it comes to forecasting forex rates. In this context, Japan's position as the world's largest net external creditor is one of the most important points when it comes to demand analysis, and my basic understanding is that JPY's ability to withstand crises remains solid. Note, however, that stock variables such as external assets or liabilities are no more than the accumulation of flow variables such as annual current account surpluses or deficits. Both stock and flow variables are important when contemplating the future prospects for a currency, but I believe that stock variables symbolize the state of a nation's external economy and are more important when it comes to gauging the endurance of its currency in times of crisis. The fact is that JPY, while not as powerful as it once was, is still a currency that is bought during times of crisis, which is in contrast to emerging currencies, which tend to crash in such times due to concerns of a capital drain.

Flow Variables Indicate JPY Selling, but…

Having said that, data related to external assets and liabilities (published only once a year around May) is not convenient for studying the forex market's current state or future outlook. On the other hand, flow variable movements offer substantial relevant information when discussing medium-term forex-market trends. The trade balance is probably one of the most representative flow-related statistics. Although trade values tend to be smaller in scale than capital transaction values in absolute terms, trade surpluses and deficits can easily affect the direction of forex movements because they involve outright buying or selling of a currency. In this context, it must be noted that Japan has posted a large trade deficit totaling more than -JPY 2 trillion over the past three months (April-June). This is contrary to expectations – against the sharp fall in crude oil prices, it was expected that the sharp decline in import value would result in a trade surplus, but in fact, export value declined even more than import value, resulting in a trade deficit (see figure to the right, top). However, there are signs of economic activity gradually resuming in countries around the world, with car sales in China, for instance, recovering to the extent of posting yoy increases since April. It would be wise, therefore, to reserve judgment on whether the recent deficit trend will go on to dictate the shape of the trade balance for the entire year.



(Source) Bloomberg

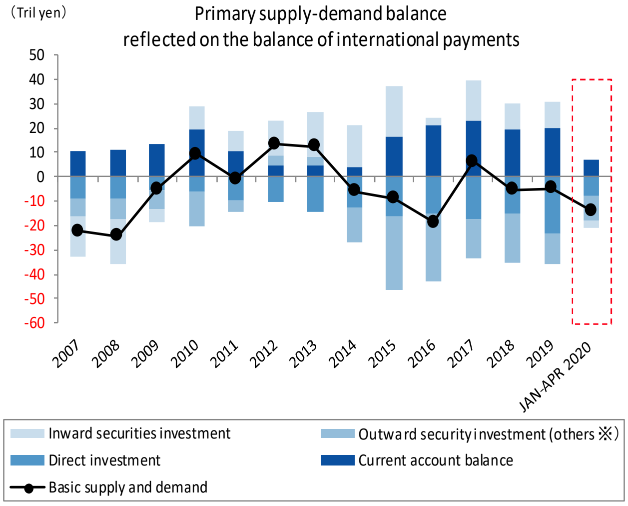


(Source) Bloomberg
(Note) Trade balance is presented two years ahead, using a six-month moving average

Note that it is in the past year or two that the deficit trend in Japan's trade balance has become conspicuous. If we assume that USD/JPY lags behind trade balance figures by around two years, it seems natural to assume that the supply and demand situation is unconducive to the establishment of a strong-JPY trend (see figure on previous page, bottom). However, given that the correlation between trade balance and USD/JPY has become more nebulous since the start of the crisis (see figure), one must exercise discretion when it comes to applying the trade balance (surplus or deficit) directly to forex rate forecasts.

JPY Supply and Demand

Again, trade balance is only one of the components of the international balance of payments. For a more comprehensive analysis of the forex market based on flow variables, one must look at the balance of payments in greater detail. In this context, this report has traditionally used an indicator called the "JPY supply-demand balance," arrived at by combining components of the balance of payments that are likely to have an impact on the forex markets, as a guide for formulating the forex outlook. The figure to the right shows the movement of the JPY supply-demand balance. Note that the supply-demand balance was almost neutral for the two years 2018 and 2019, both of which renewed the all-time narrow range for USD/JPY. As of the time of writing this report, Japan's balance of payments for the period through the end of May 2020 has become available, revealing a significant net selling of JPY to the tune of -JPY 14 trillion for the January-May period. Comparing this with the +JPY 2.2 trillion net buying and -JPY 10.1 trillion net selling of JPY for the same periods (January-May) in 2019 and 2018, respectively, a significant net JPY selling trend in recent years becomes clear. This trend is taking place against declining current account surpluses as well as a significant net selling in inbound securities investment in Japanese securities by foreign investors.



(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government

However, the first five months this year have been highly turbulent, including a phase of extreme pessimism in the markets resulting from the COVID-19 crisis, so one cannot fairly say that current movements are part of an established trend. Going by the recovery in asset prices since June, indicators released going forward could be completely different from the trend so far. Having said that, it must be admitted that a strong-JPY trend would be difficult to justify in light of the JPY supply-demand balance based not just on the aforementioned trade balance but also the international balance of payments as a whole.

The Risk of Direct Investment Assets Being Divested

As I have repeatedly said in this report, one of the factors responsible for a decline in “JPY buying during risk-off phases” in recent years is the robust foreign direct investment (i.e., cross-border M&A) activity in the Japanese corporate sector. Specifically, as the cross-border M&A trend becomes more strongly established, the share of direct investment in the net international investment position has increased, resulting in a decline in JPY buying during risk-off phases. As in the case of trade deficits, foreign direct investment contributes to an outright selling of JPY, which once implemented gets buried within the net international investment position. Consequently, it is difficult for companies that have acquired (made a direct investment in) foreign companies to divest their investment and buy back JPY when the market mood deteriorates, unlike in the case of foreign securities investment, where investors can dispose of their foreign securities to buy back JPY. My hypothesis, therefore, is that the larger the share of direct investment within the net international investment position, the more difficult for there to be a JPY buying trend during risk-off phases.

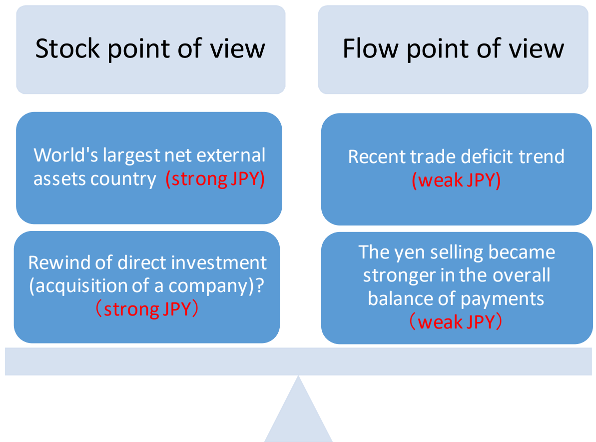
However, the COVID-19 crisis has come as a bigger shock to the corporate sector than even the 2008 global financial crisis did. As already reported, even among Japanese companies that have been proactively engaged in cross-border M&A, there are signs of a rollback in past direct investment for various reasons including the reconstruction of their financial bases. Public attention tends to be drawn to the widely reported cases relating to direct investment in major corporations by other major corporations, but it would not be surprising to learn that similar but smaller scale developments have been taking place (and will continue to do so) under the surface. If such developments accumulate over time, JPY buying will naturally receive a boost. Going forward, if there are phases of a sharp decline in asset prices with the advent of a second wave of infections, there may even be moves to divest direct investments accumulated over the past ten years. Japanese corporations were driven into foreign direct investment by a structural factor, namely the shrinking of the domestic market. In light of this, it seems unlikely that the trend of the past ten years will be reversed easily. Yet, the possibility does exist as a factor that could potentially drive JPY buying and can, therefore, not be overlooked.

Stock Variables Indicate JPY Strength and Flow Variables indicate JPY Weakness

Taking all the above into consideration, my view is that Japan’s status as a major external creditor remains quite solid, and so, from the stock point of view, JPY will remain a currency worth buying in the long term. There may also emerge another factor that promotes JPY buying – the direct investment by Japanese companies that has become embedded in Japan’s net international investment position over the past 10 years could be reversed to some extent in the wake of the COVID-19 crisis. It could be said, therefore, that there are some conspicuous stock-side factors favoring JPY strength.

Meanwhile, flow-side factors including both trade balance and the balance of payments overall are driving JPY selling, as already explained. As a result, unilateral JPY appreciation is difficult to anticipate. Going forward, the basic approach to forecasting JPY should be based on a broad understanding that stock variables indicate JPY strength and flow variables indicate JPY weakness while taking hints as to the direction of the rate movement from interest-rate trends.

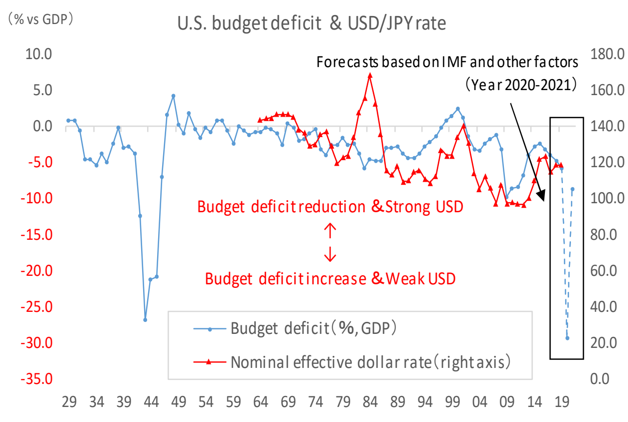
Supply-demand environment for JPY



(Source) Made by Karakama, Mizuho bank

My impression for the medium term is that USD/JPY rate levels will slowly fall amid intermittent share price crashes as the U.S.-Japan interest-rate gap becomes fixed (or narrows gently). Add to this the fact that the U.S. fiscal deficit (as percentage of GDP, figure on a later page) has ballooned to unprecedented levels, and this report’s long-time prediction of an all-round depreciation of USD seems poised to come true. Given the lack of volatility in the interest-rate gap and the major biases present in supply and demand (stock and flow variables), it is still most likely that USD/JPY will remain range-bound in the 100-110 range, but my basic understanding that the bias is on the side of JPY appreciation remains unchanged.

Understanding that USD is Overvalued



(Source) macrobond, IMF & White House
(Note) Assumed to be "$6 trillion budget deficit" in 2020

Of course, most of the discussion above has been about the JPY supply-demand situation, and one could certainly argue that the USD supply-demand situation is more important. In this context, one cannot overlook the increasing sense that USD is overvalued against the backdrop of the enormous U.S. fiscal deficit, which also lends weight to my theory that the odds favor JPY appreciation and USD depreciation. JPY, of course, strengthened in July, but EUR strengthened even more. In fact, EUR was the currency that played the lead role in the forex markets in July, and this month's issue of this report is, therefore, devoting more space to analyzing the recent EUR appreciation (P. 12 onward). However, EUR buying, which gained momentum in early July, appears to have hit a ceiling as we approach August. It would appear that the markets are beginning to look for other alternatives to USD apart from EUR. My view is that the drop in USD/JPY rates in the last week of July reflects a spillover of the effects of USD selling from the EUR market to the JPY market, JPY being a currency with similar attributes as EUR (sharp narrowing of interest-rate gap compared to USD, a disinflationary currency, a currency backed by an enormous current account surplus). The above situation is easy to understand when one plots USD rates against the U.S. fiscal deficit as a percentage of GDP (see figure on previous page).

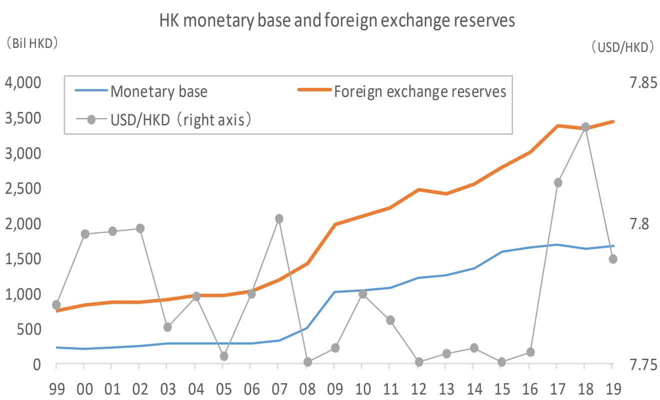
Risks to My Main Scenario – Collapse of Currency Board a Risk-Off Factor – A Double-Edged Sword for the U.S.

The Currency Board will Inevitably Become a Point of Dispute

Risks during the current forecasting period will depend on predictions regarding both the likelihood and severity of a potential second wave of COVID-19 infections. Unfortunately, I am not sufficiently knowledgeable about this issue and will, therefore, refrain from going in-depth into this topic. Having got that out of the way, the potential risk that worried me most of all in July was the turmoil surrounding the Hong Kong dollar (HKD). Specifically, I am concerned that the survival of Hong Kong's currency board may be at peril, and that this is not an issue that can be overlooked in any attempt to formulate an international financial market outlook.

On July 8, Bloomberg ran an article titled "Trump Aides Weigh Proposals to Undermine Hong Kong's Dollar Peg." According to the article, the Trump administration is considering a strike against the Hong Kong currency board, which is based on pegging HKD to USD, as part of a list of sanctions against China in response to its promulgation of the Hong Kong national security law. The article is merely based on reports by "people familiar with the matter" and is not fully credible as of the current time, but if true, the matter is bound to have serious implications for the international financial system going forward, so I would like to discuss it here. The morning edition of the July 2 *Nihon Keizai Shimbun* also ran an article by myself titled "Immobile HKD Poses Latent Risk to International Financial Stability," in which I noted that Hong Kong's currency system could become a flashpoint in the U.S.-China conflict going forward. The potential move by U.S. authorities to limit the ability of Hong Kong banks to buy USD is no more than speculation at the current time, but <u>given that the U.S.-China conflict has already spilled over to affect several areas, Hong Kong's currency system, which is closely linked with USD, may inevitably become a point of dispute</u>.

The U.S. is as much of a Threat as Mainland China

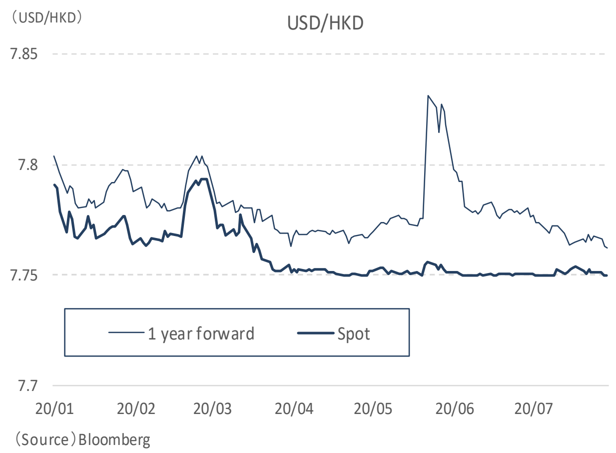


(Source) macrobond

To explain simply, a currency board is a system under which a monetary authority is instructed to back all units of domestic currency in circulation with the underlying foreign currency, thereby guaranteeing a fixed official exchange rate. In this context, Hong Kong currently possesses in excess of USD 440 billion, which is more than twice its monetary base, as its foreign currency reserve, with the Hong Kong Monetary Authority (HKMA) guaranteeing an official USD/HKD rate of 7.75-7.78. Even if speculators, anticipating turmoil, decided to hammer the HKD market, they would only succeed if they were able to absorb all the reserve USD sold by the HKMA as part of an HKD-buying intervention, and sell more HKD in excess of that. However, the process of procuring sufficient HKD (of which there is a limited supply) to pelt the markets with will result in a dramatic increase in HKD's short-term interest rate, thereby causing the speculators' scheme to ultimately fail (of course, the Hong Kong economy will suffer as a result of the sharp rise in short-term interest rates, but the official interest rate will be preserved). This is the mechanism that allowed the HKD to remain stable during the 1997 Asian financial crisis.

However, as is probably obvious by now, the main significance of a currency board lies in the foreign currency (USD) reserves it holds, so the system would immediately stop functioning as intended if the U.S. were to limit the amount of USD that could be procured or held by the currency board. The political intentions of mainland China are key to the continued existence of the currency board, but technically speaking, the intentions of the U.S. are also important. This is the reason why the contents of the recent Bloomberg article can be seen as threatening to HKD. If HKD rates become unstable, it will deal a severe blow not just to the currency but also to the economy of Hong Kong, which has thus far enjoyed the status of an international financial center, and therefore also to the Chinese government, which positions Hong Kong as a gateway linking foreign-owned companies to mainland China. Faced with the crisis of potentially losing its currency, Hong Kong's sentiments regarding mainland China are likely to sour even more. Dealing a blow to the Hong Kong currency board, therefore, has significance in the sense that it is likely to inflict pain on China both politically and economically.

The U.S. Would also Suffer Repercussions



This option, however, is a double-edged sword for the U.S. If the currency board were to collapse and HKD were no longer to be pegged to USD, Hong Kong may no longer need the large amount of U.S. Treasury securities it currently owns. This could affect U.S. interest rates significantly. In the event that Hong Kong is forbidden from conducting USD transactions as part of the U.S. government sanctions against China, the survival of the currency board system would become difficult from a technical point of view, forcing Hong Kong to find an alternative to the USD peg (be it a CNY peg or a basket peg – an issue I will not go into here). If that happens, a large portion of the current USD 440 billion owned by Hong Kong as its foreign currency reserve (ranked seventh in the world in terms of size as of 2019) will become unnecessary and, therefore, will likely be let go. This could have repercussions for the U.S. in the form of an unfavorable increase in interest rates, although things may turn out differently depending on the demand for USD at that point. An unintended rise in U.S. interest rates, which function as the cost of capital for the world at large, could throw not just the U.S. but also international financial markets into turmoil, and U.S. authorities need to take this into account when considering this option as a punitive measure against China.

In this context, the Bloomberg article notes that the aforementioned sources of the report also said that "the proposal faces strong opposition from others in the administration who worry such a move would only hurt Hong Kong banks and the U.S., not China." Although not specifically explained, it seems natural to assume that the concerns relate to the repercussions in terms of an increase in U.S. interest rates. The article goes on to say that "another person cautioned that the idea of attacking the dollar peg is lower on the list of possible options now under discussion," so this news may not be important enough at the current time for the forex markets to factor it in. In fact, this news did not affect the HKD/USD forward rate as much as the news of the Hong Kong national security law did toward the end of May (although a slight depreciation of HKD has been observed, see figure). The financial markets are taking the current state of affairs quite calmly. However, precisely because of this low level of awareness about it, the issue could become a surprisingly major risk going forward.

Trump Administration Capable of Supra-Rational move that could Push USD/JPY Below 100

Having said all that, the promulgation of the national security law has legalized not just the deletion of online comments by opponents, but the monitoring of communications, house searches without warrants, the confiscation of passports and so on. For the U.S. to stand by and let this happen would go against its honor, so the possibility of a rather harsh response cannot be ruled out. Given that the Trump administration has made many supra-rational moves without a thought for the repercussions, the risk of international financial markets being thrown into turmoil as a result of a U.S. attack on the Hong Kong currency board must be taken into account.

If that happens, the financial markets could let go of shares and other risk assets, and the forex markets could seek out non-USD safe-haven currencies such as JPY, EUR, or CHF. Tensions in the U.S.-China conflict rose in July, with both countries ordering the closure of each other’s consulates, which caused USD to weaken in the markets. The appreciation of EUR and JPY for the first time in a long while was probably also due to this political development. The collapse of the Hong Kong currency board would be a major event that could trigger not just political but also economic and financial instabilities. If it were to actually come about, the impact could cause USD/JPY to plummet to substantially below 100.

EUR Outlook – Exploring the Background of the EUR Surge

EUR Area Monetary Policies Now and Going Forward – Significant Elements of a Relatively Uneventful Meeting

Significant Elements of a Relatively Uneventful Meeting
As expected, the July 16 ECB Governing Council meeting maintained the status quo. In an interview with the UK-based Financial Times on July 8, prior to the Governing Council meeting, ECB President Lagarde was quoted as saying – “We have done so much that we have quite a bit of time to assess [the incoming economic data] carefully.” Given this statement, the Governing Council meeting’s status quo maintenance was generally anticipated. During that same interview, President Lagarde described the recovery fund proposal (which had not been approved prior to the Governing Council meeting) as – “the real game-changer element [...] in particular if a good chunk of it is in the form of grants rather than loans, because it will, in that case, establish a degree of unity and solidarity to benefit those that have suffered most.” – thereby emphasizing that political (fiscal spending) measures were of greater importance than central bank (monetary policy) measures. Throughout the interview as well as the post-Governing Council-meeting press conference, one got the impression that the “need time to evaluate the effect of existing policies” message was being emphasized. During the press conference, President Lagarde noted that – “our measures are providing critical support to growth and inflation [...] the measures that we have announced between March and June are estimated to add around 1.3 percentage points to euro area real GDP growth until the end of 2022 and 0.8 percentage points to annual inflation over the same period of time.” Although it may not possible to completely offset recent setbacks, the anticipated short term effects of recently launched policies are of an unprecedented magnitude. Given these expected results, it seems natural to maintain the policy status quo at this time. While the press conference was generally uneventful, attention was largely focused on two programs – the pandemic emergency purchase programme (PEPP) and the third series of targeted longer-term refinancing operations (TLTRO3) – that are providing an unprecedented level of liquidity.

“We Will Use the Entire PEPP Envelope”
This policy-related aspect of the latest Governing Council meeting that attracted the most attention was found in the answer to the first question posed at the press conference. The first reporter's question was – “what [is] your response [...] to those who are suggesting that the full envelope of the PEPP might actually not be needed and that you perhaps could spare some of the money[?]” In response, President Lagarde said, “the PEPP has a dual function [...] The first function is to address the risk of market fragmentation and impairment to monetary policy transmission. The second function is to ease the monetary policy stance in light of the contraction that resulted from COVID-19. In addition to the dual function, the PEPP is also marked by flexibility, which is one of its key elements, and we have made full use of it. We have frontloaded purchases.” Essentially, she was saying that the PEPP has the function of suppressing systemic risks along with the function of providing economic stimulus.

The PEPP is generally performing its systemic risks suppression function but, regarding the stimulus function, President Lagarde frankly stated that – “unless there were significant upside surprises, our baseline remains that we will use the entire envelope of the PEPP.” She then further emphasized that the ECB – “will continue to use the envelope of the PEPP and make sure that it helps us to get back to the trajectory of inflation pace pre-COVID-19.” Since the June Governing Council meeting, the ECB’s statements have increasingly emphasized the point that the PEPP is not exclusively designed to counter systemic risks but is also intended to have an economic stimulus effect (≈ boost the inflation rate), and it can be surmised that this approach reflects the ECB’s concern that, if the PEPP objective were limited to countering systemic risks, then there would be growing calls from the Netherlands and Germany to discontinue the PEPP in light of the already ameliorated systemic risk situation. Currently, it will be difficult for PEPP opponents to muster resistance so long as the PEPP’s second functional goal of boosting inflation is not attained.

There was also another interesting point made regarding the PEPP at the press conference. President Lagarde repeatedly emphasized the PEPP’s flexibility, praising – “It's flexibility across time: you can frontload, you can slow down, you can re-accelerate. It's flexibility across asset classes: as you know, we've extended the assets that we purchase.” She then went on to praise the PEPP’s flexibility across jurisdictions and made a noteworthy statement emphasizing that this flexibility enables deviations from the capital key. While it had previously been explained that some capital deviations would be permitted in connection with the PEPP, President Lagarde provided specific instances, saying – “Countries like Italy, Germany to a lesser extent, Portugal a little bit, are north of their capital keys. France is below, so deviation is part of the flexibility principle that we apply.” Previously, divergences from the capital key were akin to a “public secret” and were not proactively mentioned, and one gets the impression that this new approach to unabashedly recognizing such divergences may be a highly significant turning point. President Lagarde then further emphasized the new approach by saying – “We will never let capital key convergence that will take place at some stage impair the efficiency of the monetary policy that we have to deploy.” Since the ECB began government bond purchases as an easing measure in March 2015, it has always conscientiously kept those purchases in proportion to the capital key. Although the new approach of permitting deviations from the capital key may be justified on an emergency basis as being inevitable in connection with the pandemic crisis response measures, it will be worth paying close attention to the issue of whether rigorous capital key compliance will be reinstituted when the crisis period has passed.

Background of Unprecedentedly High TILTRO3 Take-Up Volume

During the interval between the June Governing Council meeting and July Governing Council meeting, the first round of post-interest-rate-relaxation TLTRO3 bidding was held. As discussed in a recent Mizuho Market Topic issue, the bids amounted to about EUR1.3 trillion euros (about EUR540 billion excluding refinancing-related bids), making that round the largest-scale liquidity provision bidding session ever. This scale naturally caused it to become a topic discussed at the press conference. President Lagarde described this result as a “great, great success” and went on to attribute the success to three factors, saying – “it has to do with the attractive terms under which TLTRO was offered. Second, it was also successful because there was clearly a demand [because of the pandemic crisis], and third, it was successful because there was no stigma associated with using the TLTRO [because many financial institutions used it].” TLTRO3 is expected to significantly expand the extension of credit to households and companies, and the determination of whether TLTRO3 users are awarded the maximum interest rate exemption provision of -1% (-0.50% deposit facility interest rate + -50bps) will depend on their lending performance as assessed in September (Even if a user’s lending performance is considered substandard, that user will still enjoy the -0.50% portion of the exemption rate.).

Although conditions in the euro area credit environment are currently considered to be favorable, a reporter posed the question – “banks see – as you mentioned – a net tightening coming up. What is the ECB prepared to do in order to prevent tightening?” This question reflected concern that the ECB’s Euro Area Bank Lending Survey (BLS) results released on July 14 (for the July-September, 2020 quarter) indicated signs that standards for lending to companies were becoming stricter. While the latest BLS is discussed in more detail below, it is worth noting that the perception that banks face severe outlooks reflect expectations that the governmental loan guarantee systems of principal euro area countries will expire going forward from the July-September period. Lagarde expressed her understanding that banks are concerned owing to “the fear of a cliff effect” associated with the expiration of loan guarantee systems, and she explained that the ECB would be encouraging fiscal authorities to implement policies in ways designed to avoid generating sharp tightening effects. It was apparent that her position is that the ECB is doing its utmost and the ECB can only hope that individual countries’ governments will also do their best.

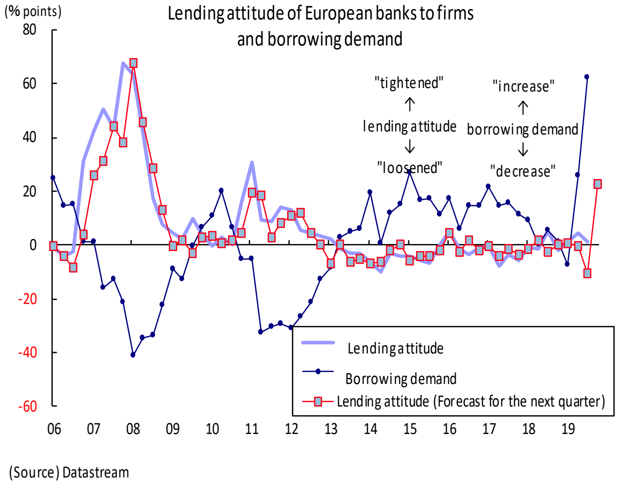
Another reporter asked the question – “Have you made a first assessment of the effectiveness of the measures [including TLTRO3] that you have taken since the beginning of the pandemic? Is there evidence that the liquidity you provide to euro area banks reaches its destination: businesses and households?” In her response, President Lagarde emphasized that bank lending to companies reached an unprecedentedly high level of EUR250 billion in the March-June period, and the yoy rate of growth in such lending rose to 7.3% in May. She explained that this reflected the benefits of ECB policies and of governments’ loan guarantee systems, and she concluded that such factors had so far prevented the kind of tightening seen during the 2008-2009 financial crisis period. Given this, when monitoring the euro area, it will probably be worth keeping a close eye on what measures will be taken to prevent a cliff effect associated with the expiry of loan guarantee systems.

Strategy Review Process Extended to Second Half of 2021

It should be noted that – perhaps reflecting the subsiding of pandemic-related turmoil – the latest press conference featured a resumption following a lengthy hiatus of comments with respect to the ECB’s monetary policy strategy review, which originally was expected to be the highest-profile ECB theme during 2020. A reporter posed the question – “Do you think that the results [of the strategy review] in the middle of next year are still feasible?” – and President Lagarde responded that – “it is clear that the strategy review has to resume shortly. It will be in September that we have our first meetings and review and discussions. Will we finish by mid-2021? I am not sure. I would probably say second half of 2021[.]” – suggesting that the completion of the review may be delayed by close to a year. Given that the pandemic has caused major changes in the economic and financial situation and that the ECB has recently launched an major unprecedented policy (PEPP), it can be surmised that there has been a large increase in the number of issues that require consideration during the review, so it is understandable that the review’s schedule would have to be delayed. It appears that the ECB is preparing to expand the scope of the review, as reflected in President Lagarde’s statement that the Governing Council has – “resolved [...] to take into account the learnings from the pandemic in our strategy review.” But President Lagarde also pointed out at the press conference that climate change will still be a major focus of the strategy review, and it appears that her determination to add her own personal “green” touch to ECB programs is unwavering despite the momentous changes wreaked by the pandemic since the strategy review was initially conceived.

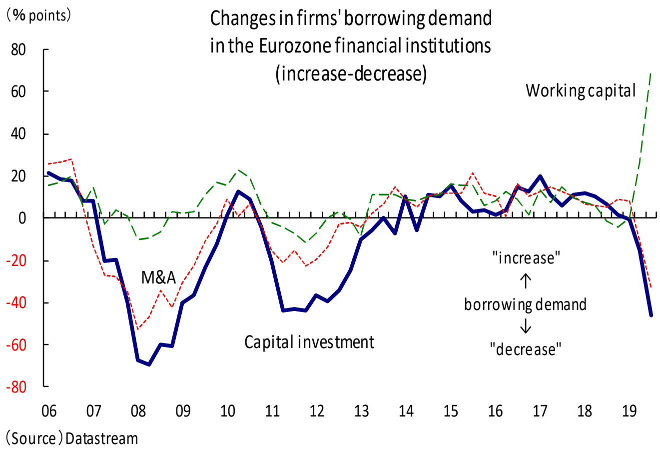
EUR Area Credit Environment Now and Going Forward – Europe Addresses Financing Concerns

Uncongenial Combination of "Increasing Lending Attitude Strictness" and "Rapid Rise in Demand for Funding"
As pointed out above, the phrase "the fear of a cliff effect" was mentioned during the press conference following the July Governing Council meeting. This phrase describes concerns that the lending attitudes of euro region banks will become stricter as major countries in the region discontinue their government loan guarantee systems during the period from July through September. While the Recovery and Resilience Facility (RRF) was Europe-related topic that attracted the most attention during July, the potential for a drastic deterioration in the euro area credit environment owing to political misjudgments by individual countries in the region should perhaps be attracting more attention at this time, as it represents a highly significant and realistic threat. The importance of this issue became apparent after the ECB's July 14 release of its Euro Area Bank Lending Survey (BLS) results for the 2020 July-September quarter.



Targeting a total of 144 banks, the survey was conducted in the June 5-23 period, an appropriate time to evaluate the state of the region's financial system after it was subjected to the various impacts of the pandemic (particularly the diminishment of economic activities). An especially noteworthy finding of the survey was that there are signs of an impending tightening of banks' standards for lending to companies. As the graph shows, European banks' posture regarding the extension of loans to companies had remained stable through this past June, but the survey results indicate that there will be a sharp increase in the strictness of that posture during the July-September period. Moreover, in a trend that is strikingly different from that seen immediately after the Lehman shock crisis began, corporate borrowing demand is rapidly upsurging. The BLS report attributes this upsurge to "strong emergency liquidity needs", "precautionary build-up of liquidity buffers", and the "drawing of previously and newly committed credit lines". Given the unprecedented magnitude of liquidity supply via TLTRO3 during the survey period (about EUR1.3 trillion), the situation may be less dire than suggested by the survey results, but a situation in which "increasing lending attitude strictness" coincides with "a rapid rise in demand for funding" is extremely dangerous.

Europe Faces Rising "Defensive" Funding Demand
As might be imagined, the "rapid rise in demand for funding" is by no means a positive trend. As the graph shows, the funding demand is not for such "offensive" purposes as capital investments or corporate acquisitions, but represents a growing need for "defensive" funding for operating funds or working capital – in short, companies are seeking emergency funding to enable them to survive the crisis period. Companies increased their borrowings to replenish working capital immediately after the Lehman shock and during the European debt crisis, but this time the scale of the increase is far larger than in those previous situations. The restriction of economic activities makes it difficult for many companies to prevent money leakage, so they need to quickly borrow funds from banks, but the continued restriction of economic activities makes the provision of additional funding akin to pumping water into a leaky bucket. It is probably fair to say that the survey results clearly illustrate the severity of the corporate (and household) environments created by lockdown policies.



Will there be second and third waves of the pandemic? I personally do not have a firm rational basis for making a forecast regarding that question, but I have noted that there are more than a few people arguing that lockdowns have not made major contributions to preventing the pandemic's spread. However, it is not enough to just conclude that lockdowns have not successfully contained the pandemic or made a sufficiently large contribution to attaining that goal. As noted, lockdown policies deprive companies of operating capital and place a heavy burden on the entire financial system. While the bulk of the pandemic's first wave may have passed at this point, it cannot be confidently asserted that the corporate sector can withstand second or third bouts of struggles with lockdown-related challenges. We should keep in mind the severity of the corporate credit environment overviewed above, and we should also not overlook such similarly worrisome trends as the increase in the strictness of lending policies with respect to households' applications for home mortgages. The importance of measures to prevent the spread of pandemic infections must be given due recognition. At the same time, however, we must give due recognition to the possibility that the financial instability or bankruptcies of major financial institutions could severely disrupt the entire financial system and cause major damage to the real economy, as seen following the Lehman shock. While pandemic control measures can be expected to save lives, it must be kept in mind that severe damage to the economy is liable to have terrible consequences that may be comparable or greater to the pandemic in terms of their persistently strong negative impact on countless peoples' lives. I fervently hope that the deliberation and implementation of lockdown policies and other quarantine measures will be based on a realistic understanding of the full spectrum of potential dangers along with efforts to optimally balance all the potential benefits and costs.

EUR Now and Going Forward – Why is EUR Surging?

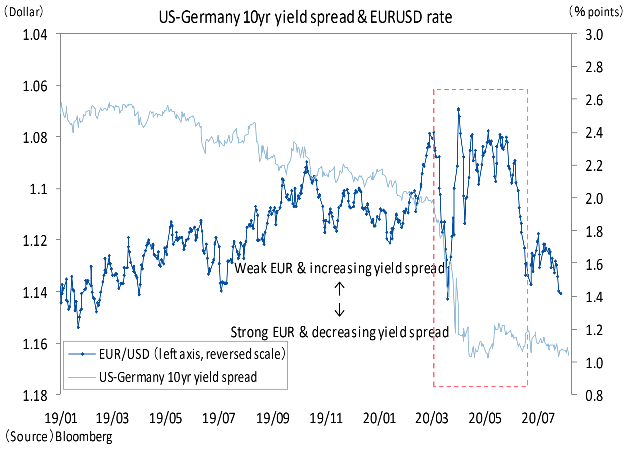
EUR's Continued Upsurge

EUR's upsurge was a top topic of discussion among forex market players during July. In the latter half of the month, EUR/USD ascended past the milestone 1.15 and 1.16 levels to reach the 1.18-1.19 range at the end of the month – the highest range seen in about 26 months. It appears that EUR's upward acceleration in late July reflected the July 21 agreement reached with respect to the Recovery and Resilience Facility (RRF), but it should also be noted that EUR's rise has been almost uninterrupted since late May. There are various plausible explanations for protracted rise, but my view is that, fundamentally, the trend most likely represents a delayed adjustment of forex rates in line with interest rate differentials.

This article has consistently argued that there is no possibility of a major EUR depreciation trend, and this argument is based on the fundamental factors that (1) the euro area has been recording the world's largest current account surpluses and (2) EUR is second most disinflationary currency after JPY. While the logic of this argument remains sound[1], I think that some EUR forex rate movements require some supplementary explanations. At this point I would again present the reasons for EUR's rise to date as well as my forecast of EUR forex rate movements going forward.

Starting Point – Narrowing of U.S.-Europe Interest Rate Gap

Although it cannot be asserted with absolute certainty, my view is that the starting point of the EUR appreciation trend is the narrowing of U.S.-Europe interest rate gap. As the graph shows, the U.S.-Germany 10-year interest rate began sharply shrinking from February and has remained in 100-110 bps range since April, roughly half the previous average level (see the portion of the graph within red dotted lines). However, the U.S.-Europe interest rate gap did not immediately cause EUR appreciation – EUR/USD temporarily fell to the 1.06-1.07 range, and remained weak in the 1.08-1.10 range during April through May. However, EUR/USD increased by 2% in the first two weeks of June and began occasionally attaining the 1.14-1.15 range. Despite some subsequent periods of weakening, EUR/USD generally moved upwards, and it had already clearly shifted to the 1.12-1.14 range around the end of May. In late July, the conclusion of the Recovery and Resilience Facility (RRF) agreement triggered a EUR/USD rise past the 1.15 level, after which it easily surmounted the 1.16 and 1.17 levels, and at the time this article was written it was advancing within the 1.18-1.19 range.



(Source) Bloomberg

With the benefit of hindsight, I think it is clear that that adjustments necessitated by the halving of the U.S.-Europe interest rate gap in April were later implemented after a time lag period. While the negative interest rate of -0.50% (the largest negative interest rate among developed countries) is a disadvantage of owning EUR, it is also probably undeniable that the marginal change in the U.S.-Europe interest rate gap, which became noteworthy from March, has promoted EUR buying. <u>This seems highly likely to be the starting point for the recent EUR appreciation trend</u>.

[1] For details, please see the book "Ready for the Japanization of Eurozone, Euro and ECB" (Toyo Keizai Shinposha, July 2014)

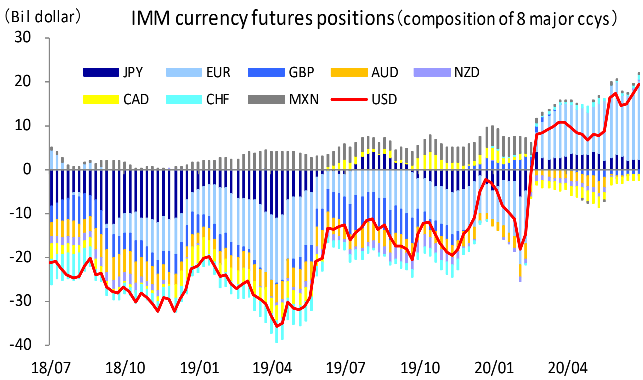
Acceleration of EUR Buying Affected by Perception of Excessive USD Strength

However, the narrowing of the U.S.-Europe interest rate gap is just the starting point – or the “trigger” – of the EUR appreciation trend. The perception of the “directionality” of the interest rate differential narrowing trend seems to have been a “trigger” for EUR buying; however, given the perception of the −0.50% “level” of the EUR policy interest rate, I do not think the interest rate differential narrowing trend is the main factor promoting the acceleration of EUR buying. My view is that the perception of USD's excessive strength may be the actual reason for the acceleration of EUR buying.

The expansion of fiscal spending in the United States is beginning to reach an unprecedented scale. Already, the Trump administration and the U.S. Congress have implemented fiscal spending measures since March with a value of about USD3 trillion, corresponding to more than 15% of the country’s annual GDP. During July, an additional (officially, the fourth) extraordinary spending bill calling for about USD1-2 trillion of spending was being discussed. Proposed adjustments to the bill are currently focused mainly on such issues as the extension of unemployment benefits and a payroll tax reduction (reinstatement bonus) measure and, if the additional plan calling for about USD2 trillion of spending is approved, the total scale of U.S. pandemic-related extraordinary fiscal spending will reach about USD5 trillion. This is well above the total level of fiscal spending in fiscal 2019 (about USD4.4 trillion). It is worth noting that, the fiscal 2019 deficit was projected to be USD0.9 trillion prior to the pandemic, so adding USD5 trillion would bring the total deficit to about USD6 trillion – about 30% of U.S. GDP. Over the past 50 years, the U.S. fiscal budget deficit averaged 3% of GDP, so the scale of this fiscal year's deficit can be understood to be “10 times greater than the average level during the last 50 years”. The fourth extraordinary spending bill currently under consideration is designed to prevent a so-called “cliff-edge effect” – downward pressure on the economy expected to result from the expiration of previous measures in July – and there may actually be a need for such a bill. Regardless of that, however, the scale of the proposed spending makes it not at all surprising that the forex market would be focused on the issue of the level of “confidence in USD”. The extraordinary scale of the U.S. fiscal deficit is quite clear when one takes a look at the graph on page 5 of this article.

Possibility of USD Depreciation against Currencies Other than EUR

Regarding the current state of the forex market, if we accept the premise that “a rise in U.S. budget deficits as a share of GDP will promote USD depreciation”, then, rather than discussing the question of whether USD is likely to strengthen or weaken, it makes more sense to consider the question of what currencies USD selling proceeds will be shifted to. As mentioned above, speculative positions reflected in IMM currency futures trading figures suggest that EUR buying has already reached its limit (see graph). It may seem a bit blunt to simply say that overbought currencies are likely to be sold, but given that EUR is one of the world's leading negative-interest-rate currencies, it would be wise to keep in mind the possibility that the EUR appreciation trend going forward from August may be suddenly interrupted by a sharp EUR depreciation trend.



(Source) Bloomberg

On the other hand, JPY long contract volume has been kept to a moderate level, and there is still a trend of net selling regarding some other major currencies, such as CND and the AUD. In light of that, it seems that funds from USD selling are likely to be shifted to currencies other than EUR, and it is noteworthy in this regard that JPY has rapidly strengthened since the last week of July. I do not think it would be so surprising to see EUR/USD rise to the 1.20 level during the July-September quarter, but given the EUR long contracts situation at the time this article was written, my basic understanding is that EUR/USD will not reach that level except after a fairly large adjustment. I think it most likely will be some time between October and December this year.

Euro Region GDP Growth Rate Expected to Exceed that of the U.S. by a Record-Level Margin in 2021

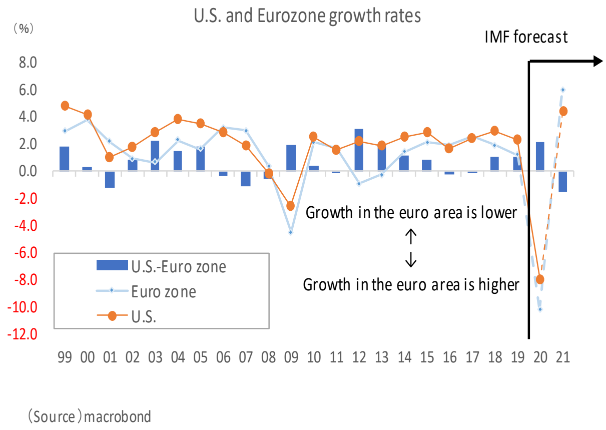
One of the simplest arguments for preferring EUR to USD is the view that “among the world’s major economies, that of Europe seems likely to show a relatively strong recovery.” Shown in the table on the right, the projected economic growth rates in the revised IMF World Economic Outlook released in June indicate the euro area is likely to have a worse drop in 2020 than Japan and the United States, but its recovery in 2021 is expected to be stronger than those of Japan and the United States. It is worth noting that, in the 21-year period from EUR’s creation in 1999 through 2019, the euro area’s economic growth rate exceeded that of the United

Growth trajectory of major economies through 2021

	Year 2020 (①)	Year 2021 (②)	Return (②-①)
U.S.	-8.0	4.5	**12.5**
Euro-zone	-10.2	6.0	**16.2**
Germany	-7.8	5.4	**13.2**
France	-12.5	7.3	**19.8**
Italy	-12.8	6.3	**19.1**
Spain	-12.8	6.3	**19.1**
Japan	-5.8	2.4	**8.2**

(Source) IMF、「World Economic Outlook」(Revised version in June 2020)

States in only 7 out of the 21 years (see graph on next page). During the 21 years, the best showing of the euro area compared to the United States was in 2001 when the United States suffered from terrorist attacks, and the euro area's GDP growth rate (2.2%) exceeded that of the United States (1.0%) by 1.2 percentage points. According to the latest IMF figures, however, the euro area's GDP growth rate (6.0%) will exceed that of the US (4.5%) by 1.5 percentage points in 2021, which seems likely to exceed the record-magnitude 2001 margin of the euro region's underdog victory in the GDP growth rate competition. Most reports have concluded that Europe has considerably outperformed the United States regarding pandemic containment measures, and this has probably encouraged the view that "EUR is safer than USD over the long term". Of course, as the IMF itself admits in its report's subtitle, "A Crisis Like No Other, An Uncertain Recovery," everyone is groping in the dark to find bases for their projections. For example, it would be hard to say with confidence whether the pandemic-related turmoil in Europe will have ended by this winter or not. At this point, however, it is clear that people are becoming increasingly confident that euro area economy will outperform the US economy in 2021, and it is quite possible that view is being reflected in the forex market performances of EUR and USD.



EU Recovery and Resilience Facility Agreement – Emergence of a "Third Crack"

A "Third Crack" Supplements the "North-South Conflict" and "East-West Conflict"

The recent high-profile extraordinary EU summit meeting was unable to reach agreement during the originally scheduled period of July 17-18, and the discussions dragged on for five days, until July 21. The main reason for the prolongation appears to be demands up to the bitter end by the "frugal four" (the Netherlands, Sweden, Denmark, and Austria) that the ratio of grants to loans be decreased, but it also appears that there were impediments regarding the treatment of Eastern European countries. In any case, it seems fairly clear that it was difficult to bridge the gap between the frugal four's desire to strictly manage the funding and the recipient countries (mainly in Southern Europe) desire to freely spend the money.

Such all-night conferences have become the norm in the EU when it comes to making important decisions, but the pattern of the region's divisive cracks seemed a bit different this time. Therefore, I would like to discuss the issues at stake this time with reference to the region's previously existing internal conflicts. As is well known, the EU is a project that aims bring the region's countries closer together by strengthening their sense of security through such Economic and Monetary Union (EMU) initiatives as common currency and common market policies that promote economic and financial alliances. This effort can be considered successful insofar as armed conflicts within the region have been avoided. Nonetheless, there have been significant divisive splits and political conflicts within the EU over the past decade, as economic disparities have caused a North-South pattern of conflict and immigration issues have caused an East-West pattern of conflict.

The North-South problem's structure is symbolized by the contrast between Germany and Greece. This pattern of conflict cannot be said to have completely disappeared, but the recent debate regarding the Recovery and Resilience Facility (RRF) showed how Germany has been transitioning into an intermediary role in which it cooperated with France to promote greater support for southern European countries particularly hard hit by the pandemic. Germany is also shifting away from its tradition of fiscal austerity (probably only temporarily) to adopt such liberal fiscal policies as those involving increased spending and consumption (value added) tax cuts. Currently, the EU's North-South conflict has become much more subdued than it was during the European debt crisis.

The EU's East-West conflict was most conspicuous after German Chancellor Merkel promoted the unrestricted acceptance of refugees in September 2015. While Germany was prepared to accept an unlimited number of refugees, the countries that the refugees would have to pass through on their way to Germany (Hungary, Poland, the Czech Republic, and Slovakia) were forced to process large numbers of refugees. (The Dublin Regulation originally made the first signatory country refugees entered responsible for related asylum claims, although the complexity of the regulation precludes discussing it here in depth.) In any case, the turmoil associated with dealing with incoming refugees led to an East-West confrontation generally considered to be one of Germany vs. Eastern Europe. The European Commission has also expressed concern that Central and Eastern European countries (especially Hungary under Prime Minister Viktor Orbán), have repeatedly revised their constitutions, increased their interventions in their judiciary systems, and have other "significant violations" of the EU's basic values, such as those related to the protection of human rights. Such concerns also frequently expressed with respect to Poland. In this sense, it is possible to argue that the East-West conflict is really one of the European Commission (Brussels) vs. Eastern Europe rather than one of Germany vs. Central and Eastern Europe. Although not yet mentioned, it is noteworthy that a provision of the RRF could block disbursements to countries that fail to uphold "the rule of law".

This provision could prevent countries with authoritarian governments, such as Hungary and Poland, from benefitting from the RRF. Although it has not figured prominently in media headlines, it seems that controversy regarding such conditionality provisions may have been a major factor prolonging the RRF negotiations. In that sense, the East-West confrontation can be considered to have played a role in the RRF negotiation protraction.

Personally, however, I think that the main divisions impeding the RRF negotiations were neither the North-South conflict nor the East-West conflict but an increasingly prominent new "third crack". The RRF-related strife may seem to be a case of North-South conflict, but the largest creditor country, Germany, has this time become a supporter of the southern countries' agenda. This may well the first time this has ever happened.

Is the "Third Crack" a "Large vs. Small Confrontation"?

What is happening now reflects a divisive crack within Europe that can be called a "Large vs. Small confrontation" (see chart). Of the four countries that have been isolated in their opposition to the RRF, three (the Netherlands, Sweden, and Denmark) are members of the New Hanseatic League, a group of eight relatively small countries in Northern Europe (Estonia, Finland, Ireland, Latvia, Lithuania, Netherlands, Sweden, and Denmark) established in 2018. Moreover, those three countries are the New Hanseatic League's top three members in terms of GDP. It is possible that their pride as New Hanseatic League core members is linked to their stubborn resistance. The New Hanseatic League is positioned to prevent the debate regarding EMU reforms from being completely dominated by large countries. Given that, it is natural that the league would like its views to be reflected in the RRF, a milestone in the long-standing European debate with respect to regional debt sharing.

Three confrontations in Europe

North-South confrontation (Germany vs. Southern Europe)
- The main cause is economic disparities.
- After October 2009, a conflict erupted over the alleged misrepresentation of financial statistics by Greece.

East-West confrontation (Germany vs. Eastern Europe)
- Conflict mainly caused by the acceptance of refugees.
- In September 15, confrontation erupted over Germany's policy of accepting unlimited refugees.

Conflict between large and small countries
- Conflict mainly due to debt sharing.
- From April to July in 2020, a disturbance broke out in the reconstruction fund due to the Corona shock.
- Small countries are the new HANSEA Union of 8 countries *

(Source) Made by Karakama, Mizuho Bank

(Note) Netherlands, Ireland, Northern Europe (Denmark, Finland and Sweden), Baltic countries (Estonia, Latvia and Lithuania) 8 countries

Looking back at the RRF negotiation process, it is noteworthy that European Commission's initial proposal (supported jointly by Germany and France) was for EUR500 billion of grants. Then the "frugal four" countries quickly denied they would support that joint proposal. It seems the "frugal four" felt strongly that it would be unsuitable to give the larger countries the power to dominate the RRF-related discussions. The Large vs. Small confrontation is taking shape between countries that have shared fundamental values and are also similar in that none are facing serious financial difficulties. It thus appears that the crack is taking shape in the core portion of the EU, which makes it seem serious in a different sense than the EU's previous internal divisions. It also seems to indicate an unpleasant "diversification of cracks" phenomenon is occurring, perhaps reflecting a general increase in the centrifugal forces promoting divisions within the EU. This time, the EU was in fact able to eventually reach agreement on the structure of the RRF, but it is said that there are high hurdles on the path toward actually making use of it. It is quite possible that, when Southern European countries begin seeking to utilize the RRF, the Large vs. Small confrontation will reemerge to complicate the situation.

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