Forex Medium-Term Outlook

September 30, 2020

MIZUHO

Overview of Outlook

In September, there were signs of a reversal in the USD depreciation trend, but the currency saw some phases of significant depreciation against JPY. In Japan, the new Yoshihide Suga administration is expected as a matter of course to continue with the policies of the previous, long-running Shinzo Abe administration. As a result, the recent regime change has not affected the markets. Nor have there been any new developments in U.S. monetary policy, which tends to be a driver of forex market trends. The new “average inflation target” framework suggests close to zero percent interest rates at least through 2023, but this merely reinforces the current trend in a world without interest rate differentials rather than indicating a new trend. Meanwhile, the sharp rise in money supply in the industrialized world has been in the news lately, but this is not a cause for inflationary concerns. The rise in money supply in this case merely indicates increased saving by anxious people uncertain of what the future will bring. It is not a forward-looking development. In the financial markets (as well as in political, diplomatic, and other circles), the main focus is on the forecast for the coming winter – whether we can safely get through winter without another wave of COVID-19 infections. As of the current time, the downside risks (additional measures being taken in the U.S. following a new wave of infections and USD weakening at a renewed pace due to a pervasive sense of its overvaluation) are bigger than upside risks that depend on a vaccine for the virus being developed. Note that positioning the January-March 2021 quarter as the nadir of the current forecasting period (wishfully) assumes the shift to a post-COVID phase starting the April-June 2021 quarter.

Meanwhile, there has been a break in the EUR appreciation trend. It is rather a healthy development for the currency to undergo a considerable correction after having been purchased to the extent of posting its highest ever nominal effective exchange rate. The recent depreciation is based on concerns of a second wave of COVID infections in Europe, and there is a possibility of similar concerns causing relevant currencies being sold off in Japan too. Depending on the conditions, EUR could be on the list of purchased currencies then. The ECB’s attempt to deter EUR appreciation also drew attention in September, but if we look at the EUR rate trend for the whole of September, it seems clear that the correction was not a result of the ECB’s deterrent words and actions but due to COVID-related fears. The disinflationary trend in the euro area and the fact that it has the world’s largest current account surplus (including a trade surplus, which promotes EUR buying) are textbook reasons for buying EUR – reasons that are perhaps even more respected in a world without interest rate differentials. My view is that EUR buying could strengthen during phases of overall USD depreciation in forex markets going forward, irrespective of what the ECB wants. The situation is extremely reminiscent of what the BOJ faced at one time in the recent past.

Summary Table of Forecasts

	2020 Jan -Sep (actual)	Oct-Dec	2021 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	101.18 ～ 112.23 (105.65)	101 ～ 107 (103)	98 ～ 105 (100)	98 ～ 105 (101)	99 ～ 107 (102)	100 ～ 108 (104)
EUR/USD	1.0636 ～ 1.2014 (1.1741)	1.15 ～ 1.20 (1.18)	1.17 ～ 1.21 (1.19)	1.15 ～ 1.20 (1.17)	1.14 ～ 1.19 (1.17)	1.14 ～ 1.19 (1.16)
EUR/JPY	114.43 ～ 127.06 (124.04)	120 ～ 126 (122)	117 ～ 125 (119)	117 ～ 126 (118)	118 ～ 127 (119)	118 ～ 128 (121)

(Notes) 1. Actual results released around 10 am TKY time on 30 September 2020. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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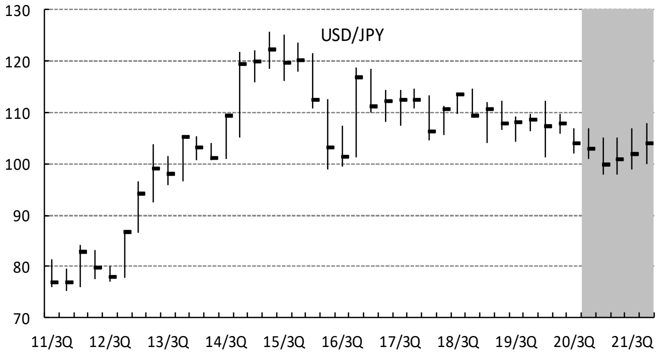
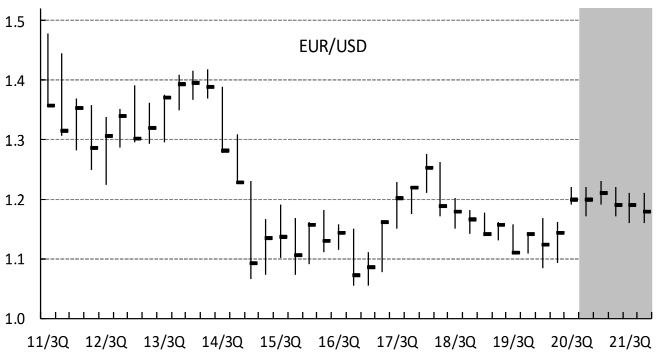
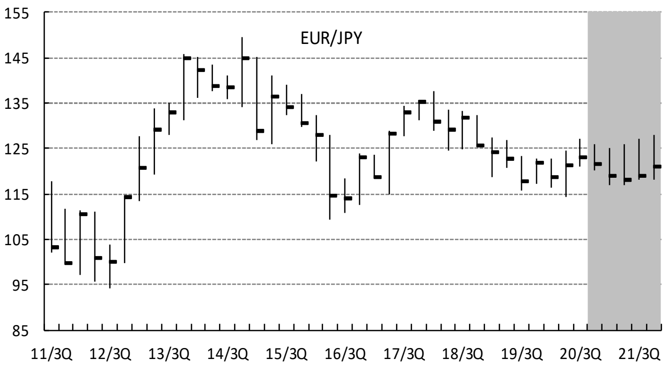
Exchange Rate Trends & Forecasts







USD/JPY Outlook – Financial Markets Brace for Winter Risk

A Recap of Abenomics and Prospects for Suganomics – From Monetary Policy to Structural Reforms

Markets Not Seeing it as a Regime Change
The ruling Liberal Democratic Party elected Yoshihide Suga as its 26th president at the party presidential election held on September 14. Following this, Mr. Suga was elected the 99th prime minister of Japan at the extraordinary Diet session held on September 16. Prime Minister Suga's office term will be one year, through September 2021, which was the remaining office term of Prime Minister Shinzo Abe. For the moment, the main focus is on the cabinet reshuffle, but going forward, the dissolution of the House of Representatives at the end of its term in October 2021, the snap general election following this, and the LDP presidential election in September 2021 will become more important political topics. Rumors have it that the general election may take place in the near future – that the Lower House could be dissolved in October this year, once the approval rating for the Suga administration stabilizes and before the opposition has had the time to gather its forces. At the press conference following his election, Prime Minister Suga stated that he intended to carry out thorough regulatory reforms and expressed the will to take measures against the COVID-19 pandemic, including the reduction of mobile phone charges, reorganization of SMEs and regional banks, and the digitalization of government processes. However, most people interpreted his message as a confirmation that the new administration will carry on in the footsteps of the previous one, and the reaction to the LDP presidential election results in the financial markets was limited. The view in the financial markets also seems to be that Mr. Suga has inherited the Abe administration as a going concern and that it will be difficult see much "regime change" trade.

Scars of the Abe Administration – Reflected in Consciousness of Link Between Politics and Monetary Policy
One of the most common inquiries I have received ever since it became clear that Mr. Suga would run for LDP president is regarding the future of monetary policy operation under the Suga administration and its impact on the markets. This is understandable when one recalls the market boom that took place with the transfer of power from the Democratic Party of Japan (DPJ) to the LDP seven years and eight months ago. However, it is inappropriate to assume that a change in government implies a big change in monetary policies too. The very act of focusing on the monetary policy intent of the government/ruling party and forecasting monetary policy operations and asset price trends based on this intent contributes to conscious or unconscious dismissal of the fact that the central bank is supposed to be autonomous. Of course, given the recent situation of a marked lack of inflation around the world, it is always possible to fundamentally question the need for central bank autonomy. However, this is a big theme of its own, one that I will refrain from discussing in this month's report. At any rate, the fact that many people reflexively thought about monetary policy operation in response to the recent sudden change in administration reveals the deep scars left behind by the Abe administration's approach to politics and monetary policy.

Meanwhile, the financial markets are well aware that the BOJ, for better or for worse, has used up all its options. Of the three key central banks – the Fed, the ECB, and the BOJ – the BOJ is faced with the fewest number of issues as of the current time. The Bank succeeded in removing itself from the limelight with the introduction of its yield curve control (YCC) policy, and has not been plagued by idle market expectations since that time. I see this as a triumph of self-effacement achieved by the BOJ under the leadership of Governor Haruhiko Kuroda. The BOJ's presence appears to have disappeared not just from the consciousness of the financial markets but even from that of the Japanese government, and despite market attention, the BOJ did not come up very much in discussions following the recent election of Mr. Suga as LDP president. It will probably not be before the replacement of Policy Board Member Makoto Sakurai in March 2021 that the BOJ has occasion to interact with the political establishment.

Expectations of a highly flexible monetary policy will remain as long as the COVID pandemic lasts, but taking global trends into account, it seems likely that fiscal policy, i.e., the government, will be the focus of attention when it comes to policy response expectations.

From Macro-Abenomics to Micro-Suganomics?

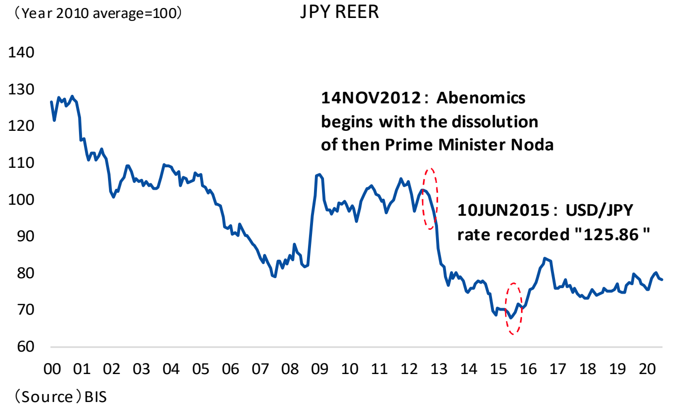
Let us take a look at Mr. Suga's true feelings regarding the role of the government. In the public debate leading up to the LDP presidential election, Mr. Suga said regarding economic policies in view of the spread of COVID that he would consider additional measures if present measures were not sufficient to keep the impact of the pandemic in check, thereby not ruling out the possibility of further fiscal mobilization. However, going by media reports before the debate, Mr. Suga appears to feel that efficiency gains achieved through structural reforms would be more effective than boosting the economy through fiscal measures. Measures including the lowering of mobile phone rates, the reorganization of the Ministry of Health, Labour and Welfare as well as regional banks and SMEs, and the setting up of a Digital Agency to integrate the policies of various government ministries all indicate plans to improve the Japanese economy's potential growth rate through structural reforms rather than short-term economic stimulation. In particular, utilizing knowledge and experience acquired during his time as Senior Vice-Minister (2005) and then Minister (2006) for Public Management, Home Affairs, Posts and Telecommunications, Mr. Suga appears determined to thoroughly tackle inefficiencies in the telecommunications sector, and "Suga vs. the Telecom Giants" is already being treated a banner for the Suga administration. Although lowering communication charges seems inconsistent with reflationary policies, it is bound to have public support, and debates regarding this topic are likely to become increasingly strident as the election approaches.

During his time as Minister for Public Management, Home Affairs, Posts and Telecommunications, Mr. Suga was also involved in decentralization reform as Minister of State for Special Missions. The extent to which he can take on this issue may be the true test of his skills in the current scenario, amid dwindling inbound demand (the pillar of regional economic development). However, he may not have the leisure to get round to it amid real economic contraction. If we set aside COVID measures, the main difference between Abenomics and Suganomics would be that the former's principle objective was macroeconomic policy operation centering on monetary policy, while the later seems likely to focus more on microeconomic industrial policies centering on structural reforms. This impression was underscored by Mr. Suga's statement soon after being elected LDP president, in which he said, "We will tear down the vertical divisions between government offices, eradicate vested interests and bad precedents, and proceed with regulatory reform." Having said all that, Mr. Suga cannot afford to focus on the things he would like to do unless we get through this year's fall and winter seasons without a serious new wave of COVID infections. The country is still fundamentally in crisis mode as it battles the pandemic, which is likely to impose severe restrictions on policy options available.

Moreover, the financial markets are unlikely to take much heed of long-term policies such as structural reform. What the financial markets are interested in is whether Mr. Suga can get through his first six months in office with a steady approval rate and without any major failures in terms of handling the pandemic. From this point of view, Mr. Suga's best bet may be to hold a snap general election, win the support of the people, and focus on steering the country safely through the coming winter months first.

Bar Set High for Suga Administration, Downside Risks Greater

When considered from the perspective of the financial markets, one feels a slight sense of anxiety regarding new administration. Historically, the advent of a strong-JPY phase has tended to spell misfortune for the Japanese economy, but thanks to the vanishing of the U.S.-Japan interest rate differential and the change in the structure of Japan's trade balance, the Abe administration managed to evade a strong-JPY phase even in spite of the COVID crisis. It seems likely that the Suga administration will also avoid the powerlessness of being at the mercy of a strong-JPY trend as experienced by the DPJ administration.



（Source）BIS

However, in contrast to the second Abe administration, which began from what can only be described as “rock bottom” given the level of JPY strength and share price weakness at that time, the Suga administration has begun from a place of relative strength from the perspective of the financial markets. Consequently, it seems reasonable to say that Mr. Suga has inherited an administration that faces greater downside risks than upside risks in terms of JPY rate levels. When the second Abe administration began in November 2012, the real effective JPY rate was 20% stronger than it currently is (see figure on previous page).

However, the spread of COVID infections has recently been expanding and contracting by turns, and one of the positive trends being pointed out globally is that, though the number of cases may be on the rise again, the number of deaths has not been rising. I am not in a position to go into the details regarding the science behind this, but some are beginning to say that the virus is weakening. If a snap general election is held in October, as rumors suggest, and if the ruling party wins the election, the Suga administration will have the support of the people both in name and reality. Assuming all this comes true and Mr. Suga takes the reigns in earnest starting November and manages to get the country safely through the winter, he will have laid the foundations for a long stint in office as a prime minister who took charge during an extremely tough period and managed to overcome the crisis.

As I will explain later, getting through winter safely is the biggest element of uncertainty during the current forecasting period. U.S. interest rates as well as USD/JPY are highly likely to rebound once we put this period of uncertainty behind us. If that happens, Nikkei stock prices are also likely to stabilize and strengthen, and a weak JPY and strong share prices are bound to help the administration maintain a strong approval rate. The best one can hope for at this point, therefore, is that the true value of the Suga administration – centering on structural reforms – can be put to the test starting next Spring.

U.S. Monetary Policy Now and Going Forward – Fed Increasingly Similar to BOJ in Communication Style

Zero Interest Rates Likely for Three Years Going Forward

Monetary policy was kept unchanged following the FOMC meeting held on September 16. The Committee decided to keep the target range for the federal funds (FF) rate at 0-0.25% and continue purchasing U.S. Treasury securities at the rate of USD 80 billion a month, and mortgage-backed securities (MBSs) at the rate of USD 40 billion a month. Even as the concrete details of the policy remain unchanged, the interest rate projections of FOMC members (the dot plot, see figure to right) almost unanimously indicate interest rates close to zero for the next three years, through 2023, reaffirming the feeling that FF rates will not be a major topic of discussion in the financial markets for some time to come. The dot plot projections along with the newly added forward guidance in the September FOMC statement, which read “The Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent,” amount to a monetary policy commitment for the coming months, <u>so one will have to consider things in light of the fact that the FF rate, which is the global cost of capital, is going to be zero for the next three years</u>.

Policy interest rate outlook as of each year end (median estimate)

FOMC Date	2021	2022	2023	Longer run
Mar-18	n.a.	n.a.	n.a.	2.875%
Jun-18	n.a.	n.a.	n.a.	2.875%
Sep-18	3.375%	n.a.	n.a.	3.000%
Dec-18	3.125%	n.a.	n.a.	2.750%
Mar-19	2.625%	n.a.	n.a.	2.750%
Jun-19	2.375%	n.a.	n.a.	2.500%
Sep-19	2.125%	2.375%	n.a.	2.500%
Dec-19	1.875%	2.125%	n.a.	2.500%
Jun-20	0.125%	0.125%	n.a.	2.500%
Sep-20	0.125%	0.125%	0.125%	2.500%

(Source) FRB

However, this protraction of a world without interest rate differentials is not a new trend that has just come to light, but simply a reconfirmation of an already existing situation. In fact, though USD was sold off in the forex markets immediately after the meeting, the trend did not last long. I continue to foresee a gentle JPY appreciation against USD, but I see the stabilization of U.S. interest rates at a low level merely as a given underlying condition. The main driver of USD weakness is likely to be the scale of the U.S. fiscal deficit for the current accounting year (i.e., the sense of USD overvaluation). In that sense, the development I would like to focus on as a new factor that could influence the markets is the fourth stimulus package, which is still under discussion in the U.S. Congress as of the writing of this report. At any rate, <u>the argument that USD is not worth buying at this moment is quite convincing</u>, and this report continues to forecast the likelihood of USD/JPY falling below 100 within the year.

Fed’s Dot Plot and SEP Could Go the Way of the BOJ’s “Desired Outcome Report”

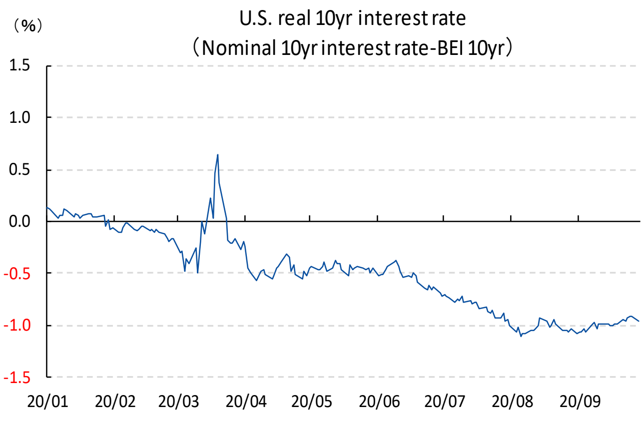
There is very little disparity between the interest rate projections of FOMC members in the dot plot. All 17 members predict a close to zero% interest rate (0.125% at end of year) for both 2020 and 2021, while 16 members predict the same for the end of 2022, and 13 members predict it for the end of 2023. Only four members see any possibility of a rate hike over the next three years. At this rate, the dot plot itself seems to be functioning as a strong forward guidance. Again, according to the Fed’s Summary of Economic Projections (SEP), the 2020-2023 PCE deflator (aggregate) is predicted to increase from 1.2% → 1.7% → 1.8% → 2.0%, indicating a +0.4pp increase for the 2020 projection compared with the previous SEP. However, the figures for 2021 and 2022 have only been raised by

+0.1pp each (the figure for 2023 was included for the first time). The SEP projections seem to imply that rate hikes will be impossible right through 2023 if the "average inflation target" of 2% is to be met for a given duration under the new framework, and the recent dot plot seems to be consistent with the SEP.

However, taking into account the above dot plot and inflation projections, it would be natural to assume that further monetary accommodation may be warranted given the low inflation projections and the resignation to the prospect of inflation over 2%. In fact, one of the reporters at the recent press conference did ask about this, but Fed Chair Jerome Powell did not have a convincing answer. He merely stressed the effectiveness of the average inflation target in response. The inability to provide a clear answer was not a big problem this time, as the recent dot plot and SEP were the first ones to be released since the introduction of the average inflation target, but if things continue this way, they could very well damage the Fed's credibility as the central bank. The situation is reminiscent of the BOJ under Governor Kuroda bringing up its 2% price stability target at every opportunity, to the point that the Outlook Report began to be ridiculed as the "Desired Outcome Report." One hopes the Fed's communications going forward do not become as hollow as the BOJ's.

Forward Guidance Could be Dismissed at Any Time

The financial markets appear to be buying the Fed's new forward guidance based on the average inflation target as of the present time. However, this type of forward guidance is easily dismissed as soon as there is a change in the situation. This time is no exception. For instance, nobody knows what "moderately" means in the phrase "moderately above 2 percent." What is an acceptable level of divergence above 2%? Is it 0.1-0.2 pp, or is it more like 0.5 pp? The difference between the two is certainly not insignificant from the perspective of inflation indicators released monthly. Again, leaving aside the question of the divergence, there is no information on the duration for which the "average" inflation target applies. Mr. Powel has been asked about these important factors that constitute the average inflation target at his press conferences, but he has managed to evade the questions each time and appears to be doing his best to keep the markets guessing. Further, the recent FOMC statement stated, "The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run," emphasizing the intent to aim for maximum employment in addition to achieving the average inflation target. When asked about this, Mr. Powell was evasive again, saying "(…) that would certainly mean low unemployment. It would mean high labor force participation. It would mean wages. It would be a whole range of things."



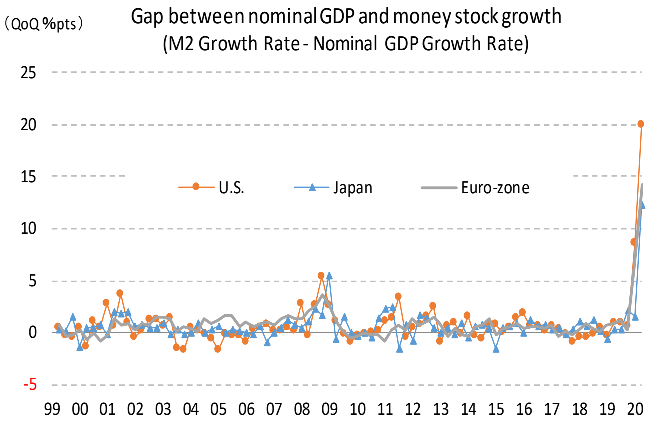
(Source) Bloomberg

In other words, while making both inflation and employment the core of its forward guidance, the Fed has retained for itself a great deal of wiggle room for judging the overall situation going forward. As the central bank, the Fed has the prerogative to choose this style of policy operation, but the greater the scope for flexibility in reading a forward guidance, the less effective it is as a forward guidance. Note, however, that though USD/JPY clearly declined in the immediate wake of the meeting, the break-even inflation rate (BEI) and U.S. 10-year interest rates showed no conspicuous movement, and the real interest rate, which is derived from the two, remained level (see figure). The new forward guidance does not appear to have achieved much market penetration.

Note also that the recent FOMC monetary action was not passed unanimously. Two members voted against the action. One was Dallas Fed President Robert Kaplan, who called for "greater policy rate flexibility," i.e., even greater scope for discretion than at present in reading the forward guidance. This position could suddenly gain in popularity once the spread of COVID infections slows down. When that happens, the "average inflation target" could take on an entirely different meaning than what the market currently understands it to be (i.e., a stable phase of monetary accommodation). For instance, there is no sense of discrepancy at the present time because the median of FOMC member forecasts in the dot plot is almost unanimously near zero, while the policy framework aims to achieve an average inflation target of 2% by allowing an inflation of over 2% going forward. However, what if the dot chart becomes more hawkish (projects rate hikes)? If that were to happen, the Fed would no longer be able to evade questions about what level of divergence above 2% inflation would be acceptable and what duration the average inflation target will be calculated over. One cannot help thinking that the average target, which was introduced with fanfare, conceals a great deal of vulnerability that may surface in the coming months and years.

Money Supply Trends in Major Economies – Should Rise in Money be Seen as Sign of Future Inflation?

Understanding the Steep Rise in Money Supply



(Source) macrobond

Six months have gone by since the depths of despair in the markets resulting from the pandemic in March this year, and a number of arguments have been put forward regarding the economic and financial situations since then. With employment trends more volatile than ever seen before (job loss and recovery taking place at an unprecedented pace), the U.S. employment situation is, naturally, a subject that comes up in any discussion on the real economy (please see the next section titled "U.S. Economic Conditions Now and Going Forward – Unprecedented Number of Job Losses" for details). In the sense that employment has already begun to recover, if only by a small margin each month, there is something positive to be said about this phase compared with past phases of employment decline. However, complacence is not warranted given the scale of jobs lost. Hard data including jobs, wages, and production tend to be the focus when it comes to the real economy, <u>but recently, the sharp rise in money supply (called money stock in Japan) in the industrialized world has been in the news a lot</u>. For instance, the September 13 Nikkei Shimbun online edition (Japanese) discussed this issue in an article titled "Corporate and Household Sector Cash and Deposits Rise Sharply – COVID Subsidies in the U.S., Japan, and Europe." As money supply trends have the potential to affect inflation and forex rates going forward, I would also like to discuss the matter here.

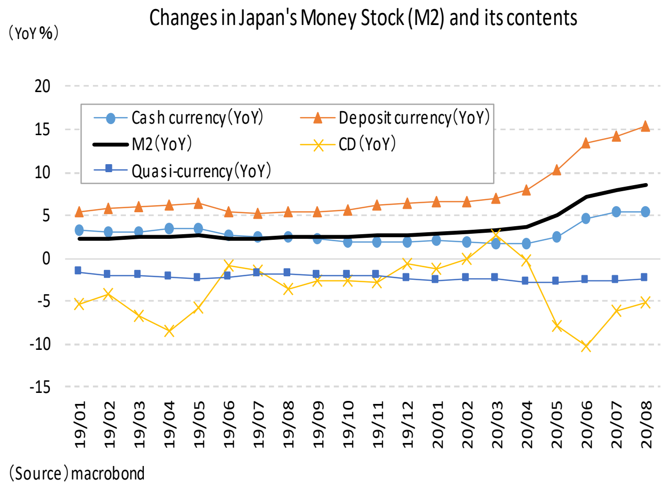
To begin with, it may be appropriate to define some of the money supply indicators. Money supply is a measure of the total amount of money supplied to the economy by the financial sector (please see the BOJ website for detailed explanations; same below). The idea is that base money, which is the amount of money supplied to the financial sector by the central bank, goes on to affect money supply (and boost inflation), but the sharp rise in base money under Governor Kuroda did not result in a commensurate increase in money supply. This, however, is a separate issue and one I will refrain from discussing here. General corporations, individuals, local governments and others – simply speaking, entities other than financial institutions and the central government – are the targets of money supply (simply "money" from here on). Different countries may define "money" differently, but of the various measures of money supply – M1, M2, M3, and broad liquidity, which include an increasingly broader range of accounts – M2 is commonly used in discussions. The BOJ's Outlook Report also uses M2 to assess money supply trends. Since economic growth leads to an increase in demand for funds, a stable correlation between money and GDP is naturally assumed. To begin with, GDP functions as the "cause" while money is the "effect." However, it is also possible for money to be the cause, and economic growth to be the effect, because an increase in money can trigger changes (increases) in a variety of asset prices, including share, forex, bond, and real-estate prices, thereby impacting economic growth. At any rate, taking into account this mutual correlation, <u>it is difficult to imagine a big gap between the growth rate of money and that of the GDP</u>.

However, that is exactly what is happening now. The figure to the right shows the difference between the qoq growth rates of M2 and nominal GDP (M2-Nominal GDP). Given that the U.S., Japan, and Europe have all posted all-time record low GDP growth rates for the April-June quarter, it is quite obvious that the recently seen M2 growth rates are not the result of economic growth. In theory (specifically, according to Keynesian economic theory), there can be three motives for holding cash – (1) a transactions motive, (2) a precautionary motive, or (3) a speculative motive. As obvious, Motive (1) involves holding cash for use in economic transactions, Motive (2) involves holding cash in preparation for an uncertain future (i.e., savings), and Motive (3) involves holding cash for investment gains.

The assumption that money (and the demand for cash) increases with an increase in GDP growth is predicated on Motive (1). However, against the backdrop of the pandemic, one can imagine that Motive (2) could be playing a big role in the recent increase in demand for cash. Of course, with interest rate differentials gone, Motive (3) cannot be ruled out either, based on the theory that the lower the interest rates, the greater the preference of investors for more liquid assets (cash), but intuitively, one feels that Motive (2) may be most powerfully at work at the present time.

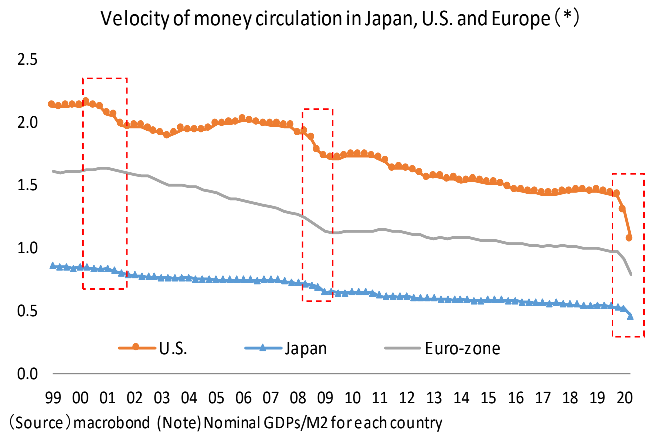
Driven by Growth in Deposit Currency

The recent growth in M2 is seen as a trend that reflects fiscal policy measures. When loans increase, the deposits of borrowers will increase, resulting in a rise in deposit currency. It is not rare to see an increase in bank loans and some resultant rise in deposit currency during periods of crisis. This time, however, the extraordinary fiscal policy measures taken in response to the crisis are likely to have had a considerable impact. For instance, in the case of Japan, one can assume that the Special Supplementary Income Benefit (JPY 100,000 per person) and the Subsidy Program for Sustaining Businesses have increased the amount of deposit currency. In the U.S., the extra jobless benefits, cash handouts, and other support programs from the government to households can be seen as a special factor. In the euro area too, despite national differences in the subsidy amounts and targets, policies similar to fixed-amount subsidies have been implemented. Clearly, in addition to bank loans in response to the demand for funds, these special fiscal measures are directly contributing to a rise in M2.



Let us take a look at the components of M2. The figure to the right plots the movement of M2 and its components in Japan. It is not difficult to see that the recent sharp rise in M2 is being driven by the increase in deposit currency (current, ordinary deposit, savings, demand deposit, and special deposit accounts) due to an increase in loans and subsidy payments. The second big factor is likely to be an increase in cash holdings (cash stashes). Households and corporations saving the subsidies they have received based on Motive (2) seems likely to be the main reason behind the sharp rise in M2.

Is the Sharp Rise in Money a Sign of Future Inflation?



In forecasting economic and financial trends, not limited to forex market trends, it will be important to think about the potential impact of the recent sharp rise in money. The impact is likely to be diverse, but looking at it from the point of view of the quantity theory of money, which states that price fluctuations are a factor of the amount of money in circulation, leads one to fear that this rise in money supply is bound to result in rapid inflation at some point. According to the quantity theory of money, the relationship between the real economy and money can be given as "Nominal GDP = Volume of money (money stock, M) x Velocity of circulation (V). The velocity of circulation is understood as the frequency, pace, and rate of rotation of money in the real economy. Taking the example of 2019, when Japan's nominal GDP was around JPY 554 trillion, and money stock (M2) was around JPY 1040 trillion, the velocity of circulation could be calculated as JPY 554 trillion ÷ JPY 1040 trillion, which gives 0.5 rotations. Most discussions assume that V is constant over the short term. Further, as nominal GDP can be expressed in terms of real GDP and prices as "Nominal GDP = Prices (P) x Volume (real GDP: Y), we can assume that the relation MV=PY holds true as per the quantity theory of money. In the world of the quantity theory of money, money is no more than an instrument of exchange for making economic transactions more efficient. In such a world, money is neutral and so it is assumed that Y remains unchanged even if M increases. In other words, Y is also taken to be a constant in addition to V. That being the case, we can cancel out Y and V in the equation MV=PY to get M=P, which means that a sharp rise in money (M) will inevitably result in a sharp rise in prices (P). This is what leads some to warn that the sharp rise in money is a sign of inflation to come.

Since threshing out this point requires a detailed exposition, I will refrain from it here, but let me simply say that there is no need to worry about the rise in money supply being a sign of future inflation as of the current time. Certainly, it would be wise to worry about soaring asset prices in the post-COVID world, given the unprecedented scale of discretionary macroeconomic policies adopted recently. However, it is a leap of faith to use the increase in money supply to predict the soaring of prices, which are impossible to control. For instance, would it be right to take V as a constant under current conditions, with the economy reeling from an extraordinary blow. As mentioned above, the recent sharp increase in money is the result of people holding on to cash out of a precautionary motive. In such a scenario, the velocity of circulation (V) can be expected to inevitably fall, and this can actually be confirmed as shown in the figure on the previous page. History shows that V has declined during phases of major crisis, including the collapse of the IT bubble, the September 11 attacks on the World Trade Center, the collapse of Lehman Brothers, and so on. What is more, the economy has never been struck by steep inflation in the wake of these crises. Going back to the equation MV=PY discussed earlier, even if M rises steeply, if this coincides with a sharp fall in V, there is no need for P to rise. In other words, there is no need to worry about inflation. Precisely because this is a crisis, the simple relationship between money and prices assumed by the quantity theory of money does not work.

Further, even if V is a constant, if we imagine a world where an increase in M can raise Y, i.e., a world where money is not neutral, there is once again no need for P to rise. However, I will not go into the details of such an argument, because it begins to resemble a theological discussion. At any rate, one must exercise caution when it comes to believing that the recent rise in money holds promise of future inflation.

Stored Money Could be Released into the Economy All at Once

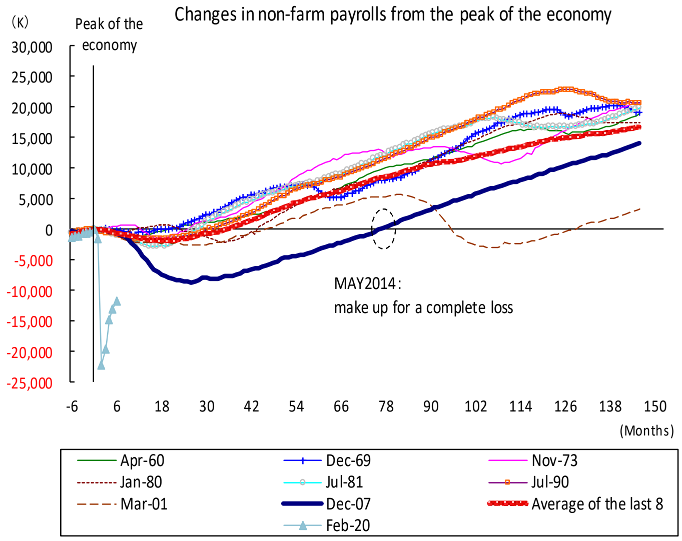
Of course, there is concern that the current that the current phase of economic decline holds the possibility of dramatic change simply based on people's state of mind regarding the pandemic. For instance, if there is news of the development of a vaccine or research results showing that the virus has weakened, money that had been stored as a precaution could be released into the real economy all at once. However, <u>at the current stage, it seems prudent to gain a theoretical understanding of why the money supply has increased and attempt to rationally seek out potential future developments based on this</u>. The idea of inflation soaring as a result of an increase in money supply may seem plausible, but it is not based on a deep understanding of the facts.

Personally, though concerned about the soaring of asset prices, I do not think it necessary to worry about a steep rise in general prices in the actual economy. In the first place, it is hardly practical to expect, simply based on aforementioned fears, that current macroeconomic policies can be revised before the end of the pandemic is in sight, and I do not see the point in worrying about something that cannot be addressed through policies.

U.S. Economic Conditions Now and Going Forward – Unprecedented Number of Job Losses

Aftermath of Six-Months of Pandemic – Overview of U.S. Job Market Damage

Six months have passed since March, when the COVID-19 pandemic emerged and cast a dark veil of pessimism over the financial markets. Although the financial markets have regained their composure, the real economy remains severely damaged. It is particularly important to monitor the dire situation of the U.S. job market. The longest period of economic expansion in U.S. history began in June 2009 and peaked out in February 2020. It lasted 128 months, exceeding the previous record long expansion (120 months) by 8 months. U.S. employment statistics are available for months through August, so there are exactly a half year of statistics since the current recession period began. The graph shows the progress of changes in nonfarm payrolls (NFP) during past recessions beginning from their peak levels at the end of the previous expansion. One can see at a glance that the post-Lehman shock recession (starting after a peaking out in December 2007) caused a greater number of job losses than any other post-war recession at that time. However, those job losses are far exceeded by those during the COVID-19 pandemic shock (starting after a peaking out in February 2020), which can be considered a true shock of unprecedented magnitude. The numbers are quite astounding. Following the economic peaking out in December 2007, the greatest number of job losses during the post-Lehman-shock recession was recorded in February 2010, 27 months after the recession's start, at which point total employment had been reduced by 8,694,000 jobs. Even that was a job-loss shock on a scale rarely seen in history.



(Source) Datastream

This time, the numbers are incomparable. This time, the economic peaking out was in February 2020, and just two months later, in April, the number of job losses was 22,160,000. <u>Both the magnitude of job losses and the speed at which they occurred are extraordinary. Throughout human history, it seems that only wars have been able to cause such a dramatic trend discontinuity</u>. In just one month (February → March), the U.S. unemployment rate skyrocketed from "the lowest level in half a century" to "the highest level in history" (see graph). <u>It can be surmised that the dramatic turnabout deeply traumatized the household sector, which explains why consumer sentiment is not recovering despite the recovery of stock prices.</u>

(Source) Datastream

Existence of Causes for Optimism

Job losses following the Lehman shock (peaking at 8,694,000) were completely restored in May 2014 – the 78th month following the economy's previous peak. If one calculates from the economic peaking out in February 2020, 78 months later corresponds to July 2026. It is worth noting that, following the Lehman shock, the Fed was able to implement an interest rate hike in December 2015, a year and a half after the previous peak number of jobs had been restored. If this timing were to be replicated this time, the interest rate hike would be in January 2028.

U.S. employment statistics for the past 6 months

	Recovery rate	Job loss（k）
Total（NFP）	***47.9%***	-11,549
Goods sector	***50.5%***	-1,242
Automobiles and auto parts	*73.9%*	-94
Service sector	***49.3%***	-9,476
Transportation and warehousing	*33.2%*	-381
Retail	*72.5%*	-655
Temporary staffing service	*47.1%*	-472
Accommodation and restaurant	*53.2%*	-3,269

(Source) macrobond

The more one compares past recessions to the current scenario in this way, the more desperate the situation may seem, but one can also find causes for optimism. After all, the post-Lehman shock recession was literally the bursting of a debt bubble, particularly regarding the excessive debt held in the U.S. household sector, and that situation required a prolonged process of adjustments during which economic growth rates were retarded. The current pandemic shock recession is not associated with a bubble bursting, and the U.S. economy is not facing problems stemming from accumulated imbalances. Consequently, there is need to worry about a balance sheet adjustment process during which households and companies emphasize expeditious debt repayments and thereby cause consumption and investment to become listless. Of course, there do exist problematic imbalances with respect to high-yield bonds and leveraged loans, but their scale is not comparable to that of U.S. household mortgages. The current scenario is one of a pandemic that has required measures to compel the temporary suspension of economic activities, and in that sense it is an "intentionally induced recession." It can therefore be anticipated that, when pandemic countermeasures are discontinued, the ensuing economic recovery should be smoother and quicker than recoveries following bubble bursts. Governmental bodies' continued impositions of restrictions and warnings about the challenges likely to be faced during the autumn and winter are making it difficult for consumption and investment proclivities to increase, thereby creating conditions promoting a tendency toward excessive saving, and it is not yet clear what factor can be expected to spur a trend of increase in consumption and investment proclivities. For example, the mere announcement of an optimistic timeline for the development and utilization of an effective and safe vaccine might change things considerably. While some people have likened the current scenario to a wartime situation, it should be remembered that wars tend to destroy societal infrastructure and such infrastructure destruction is not taking place at this time. To a great extent, the speed of the upcoming recovery will depend on the philosophical attitude society adopts with regard to threats from COVID-19 as well as other ever-present infectious diseases, as an extremely conservative attitude will tend to impede the normalization process, and yet the nature and pace of the upcoming economic recovery will inevitably be different from those associated with recoveries following bubble bursts. NFP initially dropped by more than 20 million, but half of the drop had been recovered as of August. While the situation is still dire in that more than 10 million jobs have been lost, it should be noted that the jobs recovery has been extremely rapid. During the post-Lehman shock recession, almost two years passed after the previous peak before a mom increase in NFP was recorded, and it was not until about November 2010 (roughly three years after the previous peak) that a sustained rise in NFP began. So the post-Lehman shock recession was essentially different from the current recession, in which the jobs recovery began quite quickly.

Despite that, it is probably still too soon to become optimistic and start worrying about the upside risk that the current recession might end unexpectedly early. It bears repeating that more than 10 million jobs have been lost, and it is worth noting that the recent increase in employment mostly just reflects relaxation of lockdown measures. But rather than focusing exclusively on the damage suffered by the real economy, it is important to compare the current situation to previous recessions and identify points of similarity and difference. In analyzing and forecasting market movements, it is always important to avoid being overly affected by pessimistic emotions so that one can maintain an objective perspective. At this point, however, it is still difficult for me begin discussing potential upside risks, even merely as unlikely risk scenarios.

Risks to my main scenario – Rehearsal for Facing Wintertime Risks

Market Participants Focusing on Expression of "Concern"

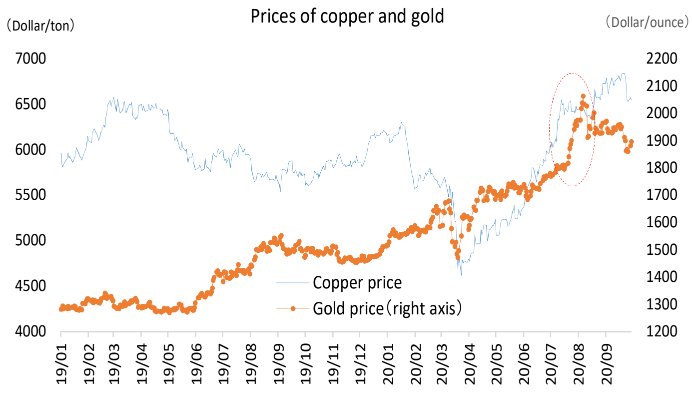
In late September, financial markets' consciousness of numerous uncertain factors caused the general risk-off mood to temporarily strengthen. Pessimism was promoted by concerns about the possibility of a second wave of pandemic spread in Europe and the announcement of a renewed lockdown in the United Kingdom. UK Prime Minister Boris Johnson announced restrictions less strict than those of the March UK lockdown and emphasized that most economic activities will continue, but it seems likely that many market participants focused on his mention that he was 'concerned' about potential growth in the number of infections before winter. Regarding continental Europe, there are rumors about the possibility of renewed lockdowns in France and Spain. If this situation persists, it might possibly affect the United Kingdom's Brexit negotiation schedule. In fact, the current situation should be considered quite different from that seen in the spring in that the number of deaths has hardly increased despite the growing number of newly detected infections, but current trends are exacerbating long-existing concerns about a potential sharp rise in infections during the winter, and it is thought that some people are preparing for the kind of turbulent market conditions seen in March.

Besides pandemic-related concerns, it seems possible that market sentiment is being restrained by worries about the fate of a fourth U.S. economic stimulus package, which is continuing to be discussed and negotiated in the U.S. Congress. The political mood was already strained owing to the approach of the presidential election, causing the outlook for agreement on additional economic measures to remain unclear, and the death of U.S. Supreme Court Justice Ruth Ginsburg has further decreased the likelihood that the discussions will be fruitful. On September 26, President Trump announced his nomination of a conservative federal appellate judge – Amy Coney Barrett – to replace Justice Ginsburg, but the Democratic Party is fiercely resisting the idea of an incumbent president nominating a candidate for a lifelong Supreme Court position just before the presidential election. The Senate has the power to approve Supreme Court Justice nominees, and the Senate's Republican Leader – Mitch McConnell – is intent on approving as many conservative judges as possible (to the great displeasure of the Democrats). The Republican and Democratic sides were already finding it difficult to compromise on the scale of additional economic stimulus measures, and the prospect for their agreement has been further diminished by the vehement political strife associated with the Supreme Court Justice nomination. Moreover, the U.S.-China conflict has intensified with respect to IT-related companies' regulation, and there have emerged allegations that several global banks have engaged in large-scale money laundering activities. It can be said that a heightened risk-off mood is an inevitable consequence of the sudden appearance of numerous and diverse anxiety-inducing factors.

The anxiety-inducing factors that market players have become strongly conscious of since early September seem likely to continue existing in October and subsequently. As explained below, all these factors represent downside risks that can be considered JPY appreciation risk factors.

Traditional Patterns Intact

The general pattern of financial market trends under these circumstances included trends of appreciation in USD and U.S. Treasuries and depreciation in such risk assets as stocks, and it is noteworthy that gold also depreciated, despite being widely considered a relatively peaceful haven for anxious investors in turbulent times. The cashing out selling in response to or anticipation of stock price declines is often characterized as a move to realize latent gains, but it is worth noting that the assets cashed out of when conditions are perceived as truly perilous are those relatively low on an asset-safety-appraisal scale.



(Source) macrobond

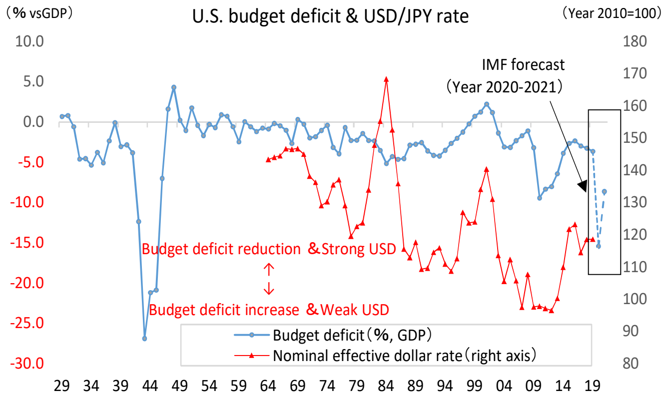
On the other hand, both USD and JPY strengthened. This appears to demonstrate that, in the most serious risk-off periods, expectations of the traditional pattern of "emergency situation USD buying" and "(world's largest creditor currency) JPY buying" remain valid. One might also expect a surge of EUR buying in this situation, given that the euro area includes Germany (boasting the world's largest current account surplus (trade surplus)). Given that the risk-off mood is centered on "concerns about a second pandemic wave in Europe" and that there has been a robust EUR buying trend over the past three months, however, it seems unavoidable that there would be a certain amount of EUR selling. Looking at EUR/USD, for example, one finds that it peaked in early September at about 13% above the March year-to-date nadir and, at the time this article was written, the margin of increase from the nadir had shrunk by somewhat less than three percentage points.

It is worth taking another look at gold price trends. As I have repeatedly argued in Mizuho Market Topic articles and externally published articles, trends of increase in gold prices emerge as a by-product of financial markets' excess liquidity and are liable to be discontinued when the markets are confronted with serious anxiety-inducing factors. Looking at developments since the start of September, for example, one finds that gold prices have stalled while copper prices have continued to surge (see graph). Looking at developments from a longer perspective – over the past six months – one finds that gold prices certainly had strong upward momentum, but their momentum exceeded that of copper prices only during an approximately one-month period from mid-July (see portion of graph within red dotted circle). Gold prices were outpaced by copper prices during the rest of the six-month period.

While observers have speculated that pandemic-related anxiety was propelling growth in gold buying, there were also increases in the buying of copper (a leading indicator of global economic conditions) as well as of stocks. Moreover, there was also increased bond buying – there was an indiscriminate rise in the buying of both risk assets and safe assets. While not going so far as to say that pandemic-related concerns did not play a role in pushing gold prices to their peak level, I would argue that – fundamentally – it is more appropriate to consider the rise in gold prices in the context of the overall behavior of financial markets anticipating the impact of major monetary policy and fiscal stimulus measures. In particular, in the absence of supplementary U.S. fiscal stimulus measures, corporate profitability would be in a dire state even worse than following the Lehman shock, and downward stock price adjustments would be an inevitable consequence. In this regard, the continued inter-party stalemate in the U.S. Congress should probably be considered to be exerting a large downward pressure on stock prices in the United States as well as globally.

Intimidating Wintertime Risks, but "USD Excessive Supply" Perception Key Issue

During this year, this article continues to anticipate that USD/JPY will fluctuate within a range with a bottom limit of JPY100. While the eventual scale of the United States' supplementary economic stimulus measures remains uncertain, it is clear that the U.S. government's budget deficit for this fiscal year will increase to at least 15% of the country's nominal GDP. As can be seen from the graph, this will be largest single-year deficit excepting the world war years, and it is a sufficient basis for expectations of USD depreciation. Given that the main scenario medium-term forecast already anticipates USD depreciation, however, my basic understanding is that it is not yet necessary to significantly revise the forecast to take into account the increased size of fiscal deficit and the "USD excessive supply" perception issue.



（Source）macrobond, IMF & White House

There remains a question of whether it is necessary to consider adjusting the main scenario's potential downside range, but the late September emergence of a risk-off mood stemming from Europe suggests that financial market movements' directionality may change dramatically depending on pandemic-related trends. Accordingly, it should be recognized that considering downside risks is "always necessary". Previous issues of this article argued that the trend of growth in EUR buying in recent months has been largely based on the economic fundamentals in that the euro area was expected to realize a higher economic growth rate than the United States in 2021. However, expectations of faster euro area growth have dissipated in light of the pandemic's spread in Europe. Ultimately, whatever forecast scenario one might make at this time, it will always be necessary append a proviso that "everything is subject to change in the case of new pandemic trends".

September as a Rehearsal for Coping with Wintertime Risks

When forecasts are subject to major impact from difficult-to-predict pandemic trends, the only way economists can present their forecasts is in the form of multiple scenarios, such as the "two equally probable scenarios" of the OECD's latest economic outlook. If one assumes that the United States will reintroduce lock downs as winter approaches (if wintertime risks were to become the focus of concern), then one will anticipate that the scale of economic stimulus measures will further expand and the "USD excessive supply" perception theme will gain additional momentum. On the other hand, if one assumes a high likelihood of rapid vaccine development and distribution, one may anticipate a post-pandemic rise in U.S. interest rates and a reversal of USD forex rate trends. Not many market players are preparing for upside risks based on expectations of rapid vaccine development and distribution, however, as there is a dearth of evidence justifying such expectations.

The risk-off market mood seen in September seems to indicate that market players have a keen sense that people in political, economic, diplomatic and other spheres are all preparing plans for dealing with the (potentially) serious wintertime risks they are anticipating, and it seems likely that that a market theme based on that perception will persist throughout the current October-December quarter as well as the upcoming January-March quarter. I think what we have seen in September may be akin to a rehearsal for what will be happening during the winter months.

EUR Outlook – ECB Increasingly Impatient Regarding EUR appreciation

EUR Area Monetary Policies Now and Going Forward – Progress of the ECB's "BOJ-izaton" and EUR's "JPY-ization"

Statement Expresses Concern about EUR Appreciation

As the financial markets expected, the September 10 ECB Governing Council meeting maintained the status quo. This reflects the fact that the staff forecast announced on that day was roughly the same as the staff forecast released in June (see chart). In line with previous media reports, however, the meeting did feature a significant amount of statements indicating opposition to EUR appreciation. In addition to answers to questions at the press conference, discussed below, the meeting's statement also expressed concern that – "in the near-term price pressures will remain subdued owing to weak demand, lower wage pressures and the appreciation of the euro exchange rate". The statement also noted that the Governing Council is beginning to consider EUR appreciation a risk factor with respect to the economic and inflation situations, saying – "in the current environment of elevated uncertainty, the Governing Council will carefully assess incoming information, including developments in the exchange rate, with regard to its implications for the medium-term inflation outlook." Since the statement must be approved by all Governing Council members, the fact that the statement clearly expressed concern about EUR appreciation indicates that the Governing Council considers EUR appreciation to be an important problem.

ECB staff outlook（SEP 2020）

(%)

	2019	2020	2021	2022
HICP	**1.2**	**0.3**	**1.0**	**1.3**
(Previous : JUN 2020)	1.2	0.3	0.8	1.3
Real GDP	1.3	-8.0	5.0	3.2
(Previous : JUN 2020)	1.2	-8.7	5.2	3.3

(Source)ECB (Note) EURUSD rate is assumed to be 1.14 year 2019-2021

Price Declines Mainly due to EUR Appreciation?

It is natural that press conference was also largely focused on the EUR appreciation issue. The first reporter directly posed the key questions, saying – "your words indicate to me that the exchange rate was a topic of discussion in the Governing Council today, so could you give me a bit of detail about that discussion? How concerned are you about the current level of the euro? Do you think this strength is justified and how much does this affect the policy?" In response, ECB President Lagarde admitted that – "Yes, indeed the Governing Council discussed the appreciation of the euro" – and then presented the standard position – "but as you know, we do not target the exchange rate." – before stating that – "Our mandate is price stability and clearly to the extent that the appreciation of the euro exercises a negative pressure on prices, we have to monitor carefully such a matter. This was indeed extensively discussed during our Governing Council." In fact, this is probably the only kind of answer that a central bank governor is generally allowed to give.

However, that first question was not the only question posed about the EUR appreciation issue. In light of the above-cited answer, another reporter posed the question – "I have a question about your comments on the strength of the euro. You were saying that you have discussed it extensively but at the same time, you and the ECB don't seem to be overly concerned about the strength of the euro. Was that view shared by all policy makers?" It can be presumed that the question was a politely roundabout way of asking something along the lines of "Don't you care about France and Italy?" In response, President Lagarde first quoted the key portion of the statement – "in the current environment of elevated uncertainty, the Governing Council will carefully assess incoming information, including developments in the exchange rate, with regard to its implications for the medium-term inflation outlook." – and then said – "As a good observer of our introductory statements, exchange rate and the appreciation of our currency was not mentioned in previous documents." Essentially, she was saying that the ECB was indeed giving additional attention to EUR appreciation, but only insofar as it presents a risk of impeding the ECB's attainment of its inflation target.

But the very next reporter maintained the focus on this issue, asking – "I guess I had a follow up on the exchange rate question. You were quite clear that the ECB is looking at it closely, but I wondered if you could say anything about whether the development so far has been basically benign or if it's something that is worrying most members." President Lagarde responded by first reiterating that the ECB does not target exchange rates but has a mandate to achieve price stability, after which she said – "we are observing negative pressure on the price level. That is partly attributable – largely attributable actually – to the appreciation of the euro." As the ECB and other major central banks are not permitted to promote the depreciation of their currencies except under the guise of promoting higher inflation rates, this is probably the most explicit statement that President Lagarde could allow herself to make about the problematic nature of EUR appreciation. As explained below, however, I believe the ECB's assessment that downward pressure on the inflation rate is "largely attributable" to EUR appreciation is somewhat exaggerated.

Relationship between Fiscal Policy and Monetary Policy

In addition to the query about EUR appreciation, the first reporter asked – "about whether you discussed any change to any of your policies, whether it's the PEPP or APP, TLTRO, tiering, was there any change being discussed today?" In her response, President Lagarde restricted herself to emphasizing previous policy decisions, saying – "we as always look at how effective and efficient our policies are and our purchase programmes have been. [...] and certainly under current circumstances it is very likely that the full envelope of PEPP will be used [...]." However, another reporter posed a highly interesting question, saying – "what you called the ambitious fiscal measures in response to coronavirus pandemic by the euro area member states will result this year and next year in a massive increase in debt-to-GDP levels, adding pressure on debt sustainability in some countries. Are you and the Governing Council worried that public debt increases might jeopardise financial stability and provoke unwanted tightening, higher yields and spreads? So in that sense, the market suspects the PEPP to be increased and what do you think about market expectations on that front?" President Lagarde responded by clearly praising the increased fiscal spending, saying – "[We] acknowledge and celebrate the fiscal measures that were taken. We had repeatedly over the course of time asked for fiscal measures to be taken, and for fiscal policies to work hand in hand with monetary policy."

This stance regarding fiscal spending can be considered to have become the international standard for central banks. Because the EU's Stability and Growth Pact (SGP) restricts the freedom of euro area countries to flexibly augment their fiscal spending (and deficits), the pressure to respond to economic problems has tended to be shifted to the ECB, and this situation was clearly regarded as problematic by the Draghi-led ECB. (Former ECB President Draghi called for the expansion of euro area fiscal spending in his farewell speech just before retiring.) In her response to the last-cited question, Lagarde said that the flexibility property of the Pandemic Emergency Purchasing Program (PEPP) has become less prominent, and that – "The role of the PEPP in easing our monetary policy stance has taken a central stage instead." Of course, admitting an intention to expand the PEPP in line with the expansion of fiscal spending would be liable to provoke accusations of debt monetization, so it is natural that she would avoid excessive frankness in this regard. However, <u>her use of the phrase "for fiscal policies to work hand in hand with monetary policy" seems to indicate that she wants to diplomatically hint at her intentions</u>. In the past, making this kind of hint may well have been considered very controversial.

It is worth noting that the PEPP was initially launched as an emergency policy designed to (1) overcome pandemic-related risks that might impair the smooth transmission of monetary policy. As the situation has settled down, however, it was progressively given the objective of (2) promoting greater inflation by augmenting monetary easing. As a result, the ECB has recently begun arguing that "target (1) was successfully attained, but target (2) requires continued implementation". Understanding the goals would help understand what the PEPP exit strategy might be, so some reporters have been posing related questions, but I do not think it worth going into greater depth about what I anticipate in the near future will no longer be high-profile issue.

Gradual Resumption of Strategic Review

Currently, the Fed's strategic review (and associated introduction of average inflation targeting) is a hot topic among central bank watchers, while the ECB's strategic review remains stalled due to pandemic-related disruption. Asked about the ECB's strategic review, President Lagarde said – "We are now resuming our strategy review with the appropriate sequence of seminars" – gave the example of a September 23 seminar focused on inflation measurements, and added that the ECB's price stability objective would be a key focus of the review. It has long been anticipated that the strategic review will reflect President Lagarde's personal emphasis on such subjects as a EUR digital currency and climate change, and President Lagarde noted that the review will also address such subjects as macroprudential policies and the interaction between monetary policies and fiscal policies.

President Lagarde said that the ECB's strategic review has a wider scope than that of the Fed and will therefore take more time and that it is too early to say much about the results. It had been clear from the start that the review process was designed to involve dialog with as many civil and governmental stakeholders as possible, and President Lagarde specified that the plans call for constant dialog with the European Parliament. It should be noted, however, that the ECB's strategic review is somewhat distanced from its immediate policy management tasks. While there has recently been public discussion of whether the ECB's strategic review might lead to some kind of measures in response to the Fed's shift to the targeting of average inflation levels, it seems likely that such discussion may be based on a misunderstanding of what the ECB's strategic review actually entails.

EUR Now and Going Forward – EUR Appreciation Promoting the ECB's BOJ-ization

Questionable Legitimacy of ECB Efforts to Restrain EUR Appreciation

Despite the ECB's various expressions of a desire to restrain EUR's strength, EUR did not weaken. In her remarks at the September 13 meeting of the Council of Governors of the Arab Central Banks and Monetary Authorities, ECB President Lagarde stated that EUR appreciation has partly offset the positive impact that the ECB's stimulus had in boosting inflation (Bloomberg, September 13), but EUR still remained robust. EUR did finally start weakening in the last third of September after news about a potential second pandemic wave in Europe began to be considered a market-moving theme. Looking at EUR/USD, however, one finds that it peaked in early September at about 13% above the March year-to-date nadir and, at the time this article was written, the margin of increase from the nadir had shrunk by somewhat less than three percentage points. Concerns about a "hard Brexit" have also risen sharply, and the adjustment of speculative EUR-buying positions that have accumulated for some time seems inevitable, but there is a need to recognize the fact that EUR/USD has remained quite firm despite proactive efforts made to lower it since the beginning of September and to keep that fact in mind going forward.

While it can be argued that the manner in which exchange rate fluctuations affect import goods' prices and thereby impact domestic price levels is due cause for concern on the part of central banks, the conventional taboo on central bank efforts to influence exchange rates makes the degree to which it is justified for central banks to outspokenly editorialize about exchange rates debatable. Germany's central bank (Bundesbank) released several reports on September 21 that argue that, while the ECB has no intention of moving EUR, its policy management has greatly affected EUR, and one of the reports stated that – "This suggests that potential effects on the exchange rate should be taken into account when communicating monetary policy." This can probably be seen as tantamount to a Bundesbank admonishment of the ECB. The fact that such admonishment is stemming from within the euro area offers additional support for the conjecture that the ECB's policy management may be focused more on exchange rates than price levels.

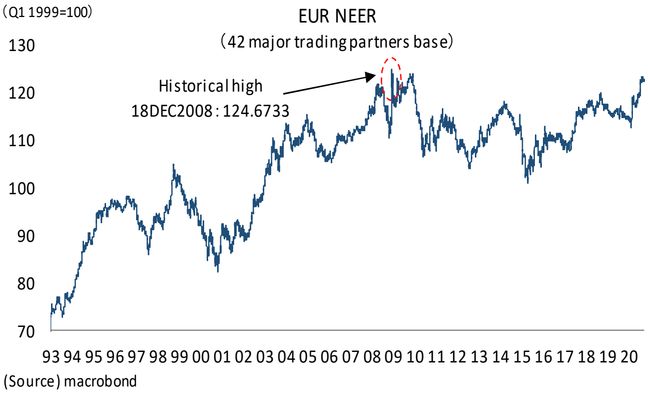
ECB Concern about EUR Appreciation Justified?

EUR has strengthened in earnest for about three months, since June, and about six months have passed since EUR reached its year-to-date low in March. It seems unreasonable to argue that exchange rate movements over a period of merely three or six months have impacted prices to a degree that dictates monetary policy adjustments. A working paper[1] published quite some time ago by the ECB offers some insight regarding this situation. According to that working paper, a 1% appreciation of EUR will one year later (four quarters later) push down the euro area Consumer Price Index (HICP) by 0.07 percentage point. In addition, at the press conference following the March 6, 2014 Governing Council meeting, former ECB President Draghi said that – "as a rule of thumb, each 10% permanent effective exchange rate appreciation lowers inflation by around 40 to 50 basis points." Using the working paper's formula, one can roughly calculate that, for a three month period, "1% EUR appreciation causes an 0.0175 percentage point HICP reduction", and for a six month period, "1% EUR appreciation causes an 0.035 percentage point HICP reduction".

Of course, the working paper does not stipulate that the impact in each quarter of the period in question will be equal, but it seems reasonable to use this equal-quarterly-impact method for the sake of simplicity. HICP figures are available for the period through August, at which time comprehensive basis HICP growth was -0.2% yoy (the first time in four years that negative growth had been recorded), and core basis HICP growth (excluding food, alcoholic beverages and tobacco) was +0.4% yoy (the lowest level ever recorded). Many people are conjecturing that these disastrous results have inspired the ECB with a sense of crisis, and it can be presumed the results were given considerable discussion at the September Governing Council meeting. According to President Lagarde, they are "partly attributable – largely attributable actually – to the appreciation of the euro."

Unreasonable to Attribute Price Slump to EUR Appreciation

Let us assume that EUR appreciation through July affected HICP through August. The ECB's daily announced nominal effective exchange rate for EUR (based on 42 major trading partners) rose about 6.8% in the six months from the start of February through the end of July (see graph). Inserting this roughly 6.8% appreciation into the above-mentioned "1% EUR appreciation causes an 0.035 percentage point HICP reduction" formula, one finds that HICP will be depressed by somewhat more than 0.2 percentage point. As of this past February, however, HICP growth on both comprehensive and core bases was +1.2% yoy. As August, it was -0.2% on a comprehensive basis and +0.4% on a core basis.



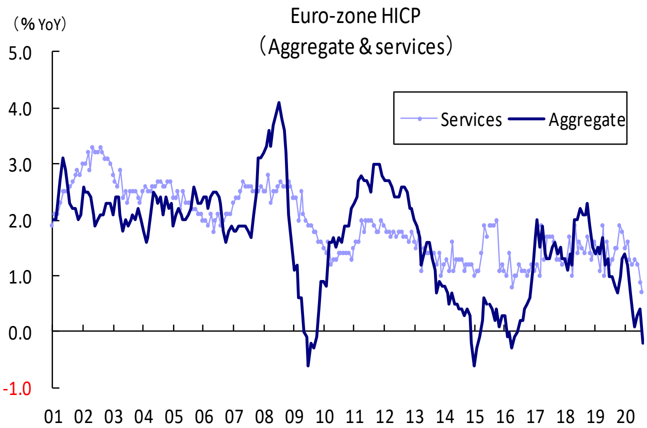
(Source) macrobond
(Notes) EU 19 countries vs 42 major trading partners base

1 ECB『The impact of exchange rate shocks on sectoral activity and prices in the Euro area』Aug.2007
ECB, "The impact of exchange rate shocks on sectoral activity and prices in the Euro area", August 2007.

It is somewhat unreasonable to try to attribute the more-than-one-percentage-point drop during the last 6 months to EUR appreciation. (That drop is dramatically larger than the somewhat-more-than-0.2-percentage-point depressive effect just roughly calculated.) It seems that President Lagarde's statement that the drop was – "partly attributable – largely attributable actually – to the appreciation of the euro." – may essentially be based on no more than a vague perception that the dramatic weakening of HICP must somehow be stemming from EUR appreciation.

Justified Concern about Services Prices Slump

Of course, EUR appreciation will certainly have the effect of restraining HICP growth in coming months. However, (as shown in the graph above,) it seems reasonable to assume that most of the price slump at this point mainly reflects changes in energy prices. Essentially, rather than EUR appreciation, it was the yoy fall in crude oil prices that began from early this past spring that depressed HICP. On the other hand, given the noteworthy deceleration of services prices (which are believed to be closely correlated with trends in wages), it is apparent that there is a severely problematic trend that cannot be attributed to the impact of energy prices alone. In August, service prices grew 0.7% yoy, the lowest rate of growth recorded since calculation of the services prices statistic commenced. Fluctuations in services prices tend to be smaller than those in the overall HICP level, but a trend of sharp deceleration in services prices has clearly begun (see graph). If this trend reflects the effect of decreases in wages, which ordinarily show considerable downward rigidity, then it would seem more reasonable for the ECB to focus its concern on this situation rather than on the exchange rate situation.

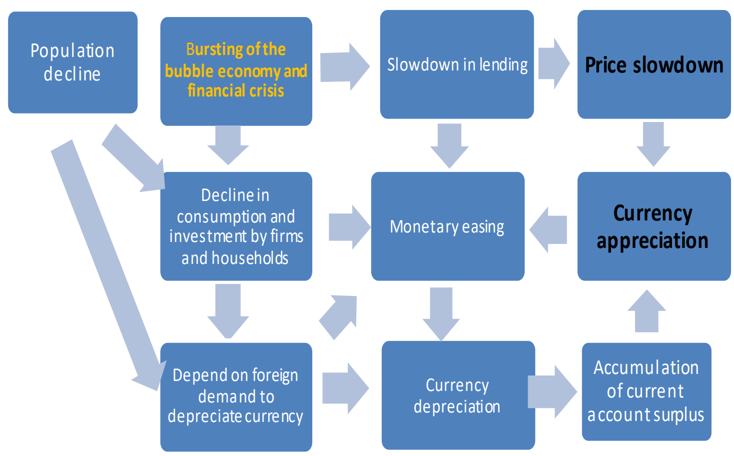


(Source) Datastream

Japan's Experience Suggests Futility of Resisting EUR Appreciation

As this article has repeatedly argued, in a world forecast to be without interest rate differentials over the long term, it is becoming increasingly easy to explain forex market trends based on simple supply-demand factors. As the euro area has the world's largest current account surplus (primarily reflecting its trade surplus), it is not surprising that EUR would strengthen not only against USD but also on an effective basis. As reviewed above, the ECB Governing Council released a consensually approved statement expressing concern about EUR appreciation and about the current and prospective weakness of HICP growth. Given that, and despite the statement of ECB President Lagarde that – "we do not target the exchange rate" – there seems to be a high likelihood that the ECB will take some kind of measure to address the EUR appreciation situation during October. Perhaps the easiest measure for the ECB to implement would be to further expand the EUR120 billion temporary envelope of the asset purchase programme (APP) that was created in March. The ECB would be very pleased if such a measure were to reverse the trend of EUR appreciation. Based on Japan's experience, however, I think it will be very difficult to use monetary easing measures to countervail currency appreciation when the Fed has clearly indicated its intent to move toward monetary easing and when the currency in question is that of an area with a huge current account (trade) surplus and a disinflationary trend – factors that theoretically justify the appreciation of that currency. As is well known, the "history of USD/JPY" has largely been a "history of JPY appreciation", and the "history of JPY appreciation" has reflected Japan's "history of trade surpluses" and "history of a deflationary trend". The loss of "risk-off-mood JPY buying" power since December 2012 coincided with the second Abe administration's inauguration, but it has not happened owing to Abenomics, and it bears emphasizing that it has not happened owing to the Kuroda-led BOJ's monetary easing of a "different dimension". The two main factors responsible include, first, the Fed's increased momentum toward policy normalization and, second, the fact that Japan began recording trade deficits. In light of this history, it can be surmised that the ECB will not find it easy to restrain the EUR appreciation trend based on its own efforts.

Process of Japanization



(Source) by Karakama, Mizuho Bank

The ECB is likely to continue doing its utmost to restrain EUR appreciation. Regardless of how effective its efforts turn out to be, it will be treading the same "transformation of monetary policies into currency policies" path that the BOJ has already trodden. Even if it doggedly implements repeated measures to countervail a USD depreciation trend, it is highly likely that ECB will merely be exhausting its monetary policy cards in vain. It would be difficult for the ECB Governing Council to passively observe the EUR appreciation trend while ignoring the increasingly strident protests of the euro area countries that are particularly vulnerable to the impact of EUR appreciation. Going forward, it seems most likely that the ECB will continue playing its monetary policy cards even when it knows that it cannot expect those cards to be effective. This (see chart) is a flow chart illustrating the Japanification process that was included in my book – "Ready for the Japanization of Eurozone, Euro and ECB" (Toyo Keizai Shinposha, July 2014) – published six years ago. To a large extent, if not completely, it seems to be in line with recent economic and financial developments in the euro area. I think forex market forecasting is best undertaken based on an understanding of Japan's experience, as is explained in my book.

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