

October 30, 2020

Overview of Outlook

USD/JPY continued weak in October. Looking back at the ten months since the beginning of the year, there have been very few phases during which USD has appreciated against JPY or CHF. It seems that JPY is, after all, a strong currency during a crisis. In general, currencies backed by current account surpluses seem to be preferred, and because of this, JPY is also likely to be cherished for the time being. The status of the COVID-19 pandemic will probably remain a relevant topic for the duration of the current forecasting period, but in the near term, developments related to the U.S. presidential election are bound to draw attention. Some are asserting “a win for the Democratic Party → fiscal expansion → stimulation of the U.S. economy → higher share prices and interest rates” on the pretext that Joe Biden is leading in the polls, but given Mr. Biden’s plans to increase taxes, the above logic does not seem fail-safe. A U.S. interest rate increase is unlikely to be sustainable, especially given the Fed’s great efforts to communicate that there will be no rate hikes until 2024. However, even assuming that U.S. interest rates increase in a sustained manner, it would be unreasonable to assume that USD weakness will continue to be tolerated. A negative correlation between U.S. interest rates and USD did emerge in October, but probably only because nobody believes U.S. interest rates will continue to rise. In this sense, the biggest risk to my forecast scenario during the current forecasting period is an early end to the COVID crisis. It is unfortunate that a bright future should be the biggest unexpected development at the current time, but there seems almost no hope among market participants that U.S. interest rates and USD will rise in tandem as a result of economic recovery. The coming phase seems to warrant monitoring upside risks more closely than downside risks.

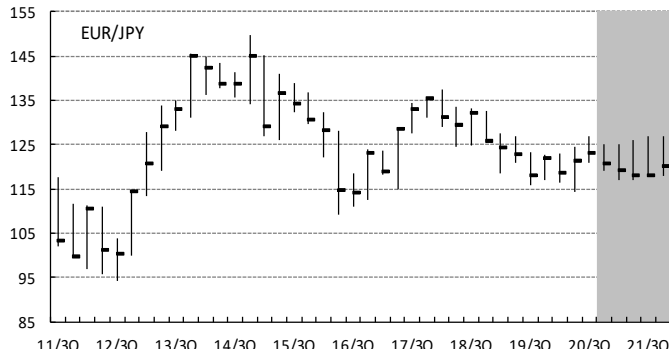
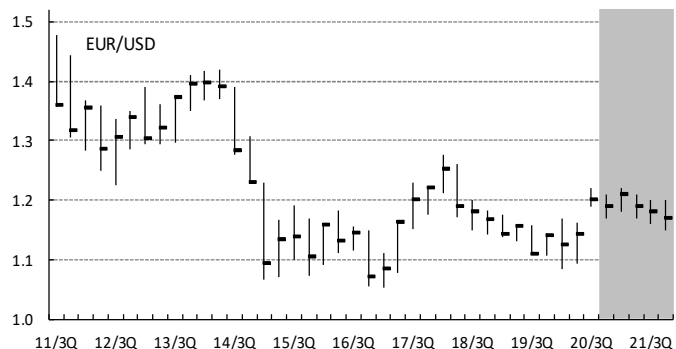
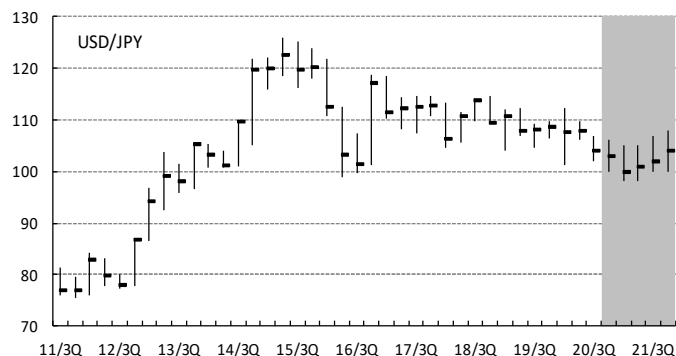
Meanwhile, EUR remains persistently strong. There are no signs of a EUR sell-off despite Europe being in the grips of a second wave of COVID-19 pandemic. Perhaps this reflects the strong sense of USD overvaluation, but it may also be because there is strong demand for the currency backed by the world’s largest current account surplus in a world without interest rate differentials. Under these circumstances, the ECB is bound to remain vigilant of the potential for EUR appreciation. A brazen additional monetary easing in response to currency appreciation is unlikely, but the woeful inflation situation in the euro area is also a reality. Service-sector inflation, especially, is conspicuously low and will be monitored as a portent of a wage slump. Looking at the bigger picture, it is clear that the Phillips curve for the region has shifted downward since the 2008 global financial crisis, indicating the “Japanization” of Europe. A stronger EUR would undoubtedly worsen these disinflationary trends, and the ECB could implement measures in response. However, reversing EUR appreciation may be difficult for the ECB, given that forex trends are dictated mainly by the sense of USD overvaluation. I would like to predict that the USD depreciation trend will change starting early spring, when the end of the pandemic comes into sight.

Summary Table of Forecasts

	2020		2021			
	Jan -Oct (actual)	Nov-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	101.18 ~ 112.23 (104.45)	100 ~ 106 (103)	98 ~ 105 (100)	98 ~ 105 (101)	100 ~ 107 (102)	100 ~ 108 (104)
EUR/USD	1.0636 ~ 1.2014 (1.1688)	1.15 ~ 1.19 (1.17)	1.16 ~ 1.20 (1.19)	1.15 ~ 1.19 (1.17)	1.14 ~ 1.18 (1.16)	1.13 ~ 1.18 (1.15)
EUR/JPY	114.43 ~ 127.06 (122.08)	119 ~ 125 (121)	117 ~ 125 (119)	117 ~ 126 (118)	118 ~ 127 (118)	118 ~ 127 (120)

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



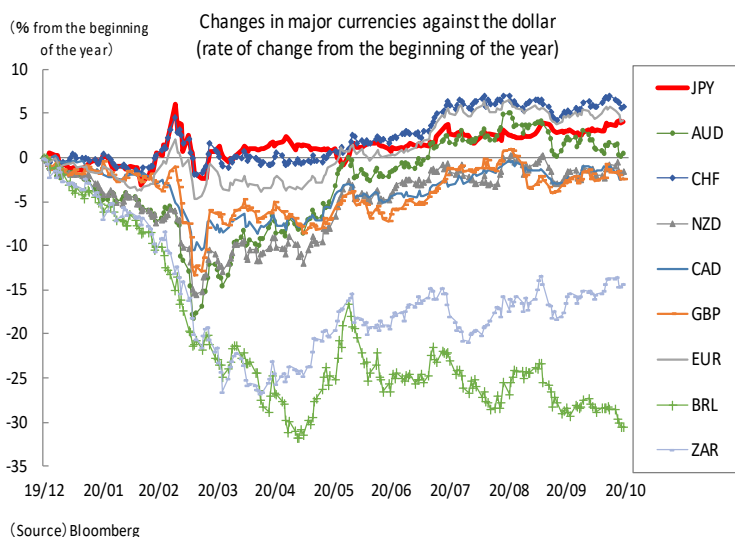
USD/JPY Outlook – Perception of USD Overvaluation Stronger than Biden Trade

Summary of Forex Markets in 2020 – What Kind of Currencies Have Performed Well?

What One can Tell from Currency Rate Trends Against USD since Early This Year

2020, a year plagued by the COVID pandemic, is almost at an end, with only two months to go. The real economy remains severely wounded, but thanks to unprecedented levels of fiscal and monetary policy response, the financial markets, especially stock markets, seem to have recovered their pre-COVID momentum. Forex market movements, meanwhile, have remained reasonable and out of the headlines. However, some points worth noting become obvious when we look back at forex market trends over the course of the year.

The figure shows the movement of various key currencies against USD. Note that CNY is conspicuously absent from this list. This is because there are too many things to say about CNY, so the currency will be discussed in detail separately in a later section. Compared with 2008, following the eruption of the global financial crisis, the risk-off buying of JPY and CHF appears to have weakened. However, after the markets became spooked by the pandemic, there was only one brief period (when USD procurement costs were being adjusted around the world in early March) in which JPY and CHF fell against USD. This phase of USD buying was a brief yet strong, knee-jerk response by the financial markets, similar to that seen in the immediate wake of the global financial crisis. It was a similar phenomenon to the rise in mask



(Source) Bloomberg

prices as customers flocked to the stores worried about a potential shortage, in that prices did not reflect the real value of the thing being purchased. Financial institutions rushed to procure USD not because the currency was actually in short supply, but because they were concerned about the possibility of a shortage. It was a transient rate

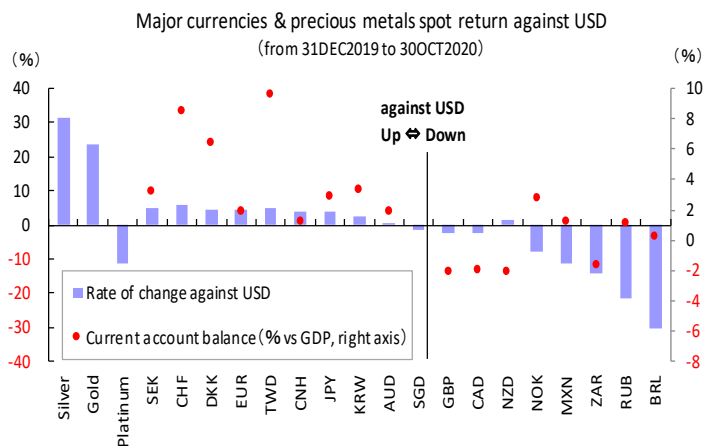
trend based on insecurities that was resolved right away.

EUR Strengthens its Position as a Risk-Off Currency

EUR began to show strong signs of recovery starting May, clearly regained its year-to-date high in June, and has continued to rise since. Through all this, the spread of COVID infections in the region has been rising and falling, and concerns regarding the real economy have risen and fallen in tandem, but EUR itself has continued strong with no significant volatility. As I have repeatedly said in this report, EUR seems to be gradually strengthening its position as a risk-off currency. The euro area has one of the world's largest current account (and trade) surpluses as well as a long-running disinflationary situation. Both are good reasons for currency appreciation and seem to be influencing trends irrespective of the real economy's strength or weakness. After all, it is obvious from Japan's case that political and economic stability are unrelated to currency strength. The euro area remains politically unstable on a near-constant basis, but because Germany continues to earn a great deal of foreign currency thanks to the perennially undervalued EUR, the currency will remain strong from a demand perspective. This is a valuable quality in a world without interest rate differentials, as evidenced by the fact that EUR continues to be bought even as Europe is in the grips of a second wave of COVID infections. Such a trend was not seen following the 2008 global financial crisis, when the euro area did not have a stable current account surplus. In those days, EUR tended to be sold off during risk-off phases.

Currencies Appreciating Against USD Have One Thing in Common

The figure showed forex movements since the beginning of the year, but the figure to the right shows the rate of change of various currencies against USD since the beginning of the year as of October 30. The currencies that have appreciated against USD include the aforementioned JPY, CHF, and EUR, as well as the Swedish korna (SEK), the Danish krone (DKK), the New Taiwan dollar (TWD), CNH, South Korean Won (KRW), and AUD. All these currencies have something in common – they are backed by a current account surplus. Australia has a strong image as a current account deficit country, but in 2019, it posted a current account equilibrium (a slight surplus), and this year, it is expected to post a bigger surplus. When current account surpluses accumulate over a number of years, they become net external credit. Japan has had the world's largest net external credit for 29 years in a row, with Germany in second position and catching up fast in recent years. The reason JPY and EUR are being bought in exchange for USD may be simply because they are currencies that are worth buying from a demand perspective.



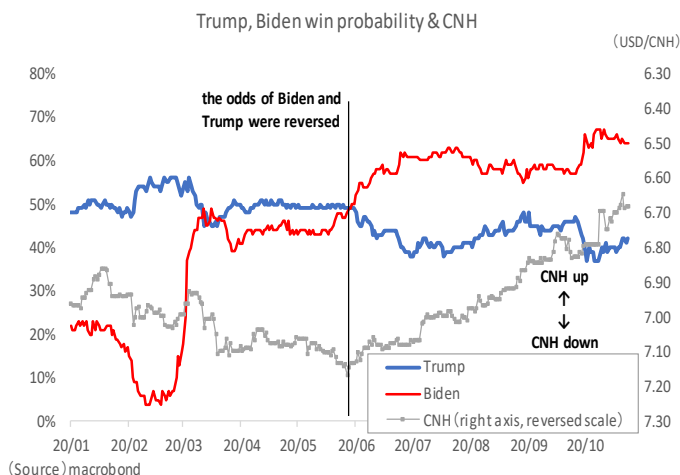
(Source) Bloomberg & IMF
(Note) Current account balance is 2020 forecast

The absolute volume of JPY trading has dwindled in recent years as a result of less interest from market participants, leading some to call it a “has been” currency. To be honest, the situation is such that this cannot be denied altogether. However, the fact that JPY's value remains stable against USD in times of crisis is positive, if somewhat boring. When it comes to the financial markets, low volatility means high predictability, which lead's JPY to be valued as a low-risk, stable-value asset. A currency with these attributes is certainly a blessing for its country, its economy, and its people. Having lost its erstwhile vigor, JPY no longer attracts much attention, but it would not be far from the truth to say that the currency remains strong in a crisis.

U.S. Presidential Election and the Forex Markets – Understanding the Biden Trade

CNH vs. Level of Support for Biden

As of the writing of this report, the U.S. presidential election results have not yet been announced, but it appears that many in the markets are betting on a win for Mr. Biden (see figure). Given that Mr. Biden supports raising taxes for corporations and the affluent classes, one would think that a win for him would be seen as a negative outcome for share prices, but the dominant view at the current time seems to be that a win for the Democratic Party will mean fiscal expansion, thereby leading to the buying up of shares. For reasons discussed in detail later, I cannot help wondering if things are really that simple. Meanwhile, in contrast to the share markets, the reaction in the forex markets is less clear. It seemed as though JPY, EUR, and CHF buying would strengthen alongside the risk-off



(Source) macrobond

mood in the case of a win for Mr. Biden, but the direction of the trend in the forex market is unclear. There is a point worth noting in this connection. The figure plots CNH against the predicted winning probability for both candidates. CNH has been rising sharply since the end of May, starting exactly when the winning probability for the candidates flipped. The list of policies on the agenda in the event of Mr. Biden winning is not yet clear, but it seems relatively certain that, in addition to increasing taxes, Mr. Biden will pursue a path of friendship with China.

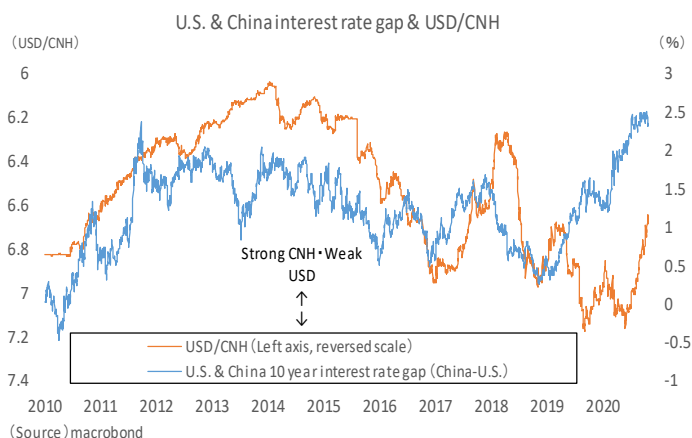
Strong Surge in CNH Buying is Based on Political Situation

Under such circumstances, CNH rates have strengthened a notch. The most convincing argument is that this is due to favorable political winds, but it may not be just that, so let us take another look at the various factors that may be at play. Even as of the writing of this report, CNH is at a two-year high against USD and the intent of the Chinese authorities is beginning to be of concern. On October 10, the People’s Bank of China (PBoC) announced that, starting October 12, financial institutions would no longer have to deposit a forex risk reserve equivalent to 20% of the principle with the central bank when buying foreign currency (selling CNH) for their customers through forex forwards. This forex risk reserve was, essentially, a penalty that financial institutions had to pay to sell CNH. It was introduced during the weak-CNH phase of two years ago, and its abolition is a move to contain the recent strengthening of the currency. CNH appreciation is thought to reflect the improvement of China’s ties with the U.S. and a positive appraisal of the Chinese economy, but recent developments seem to reflect the authorities’ view that the appreciation is approaching tolerable limits. Incidentally, China’s forex reserves have been on the rise since the beginning of this year, so the recent CNH appreciation against USD is not the result of a CNH buying (USD selling) intervention by the PBoC, but merely a reflection of the market trends. The reason the foreign currency reserve is rising is probably because of the foreign exchange gains from CNH’s appreciation against USD.

It is often mentioned that, during his tenure as vice president, Mr. Biden had approved the relaxation of restrictions on Chinese exports to the U.S. in exchange for a stronger CNH during one of his visits to China. Politically speaking, therefore, the current climate is conducive to CNH buying, but it is uncertain how much of the recent CNH appreciation is due to this fact. Meanwhile, this time last year, with the U.S.-China trade war at its height, USD/CNH rose to and became established at the 7.0-yuan level. The shift in this trend undoubtedly owes something to the political prediction of a shift from Trump to Biden.

Interest Rate Differential Also Playing a Role in CNH Buying

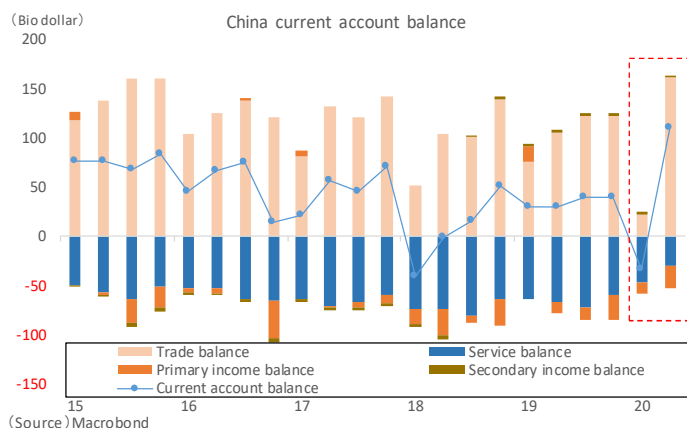
Apart from political readings of the situation, there are other reliable and quantitative factors that contribute to CNH buying. Specifically, the fundamental factors affecting forex movement – interest rates and supply and demand – also favor CNH appreciation. Take interest rates, for instance. As is generally known, the interest rates for most G10 currencies is zero (or negative), resulting in the firm establishment of a world without interest rate differentials. As a result, it has become quite meaningless to discuss the movement of a currency pair based on the interest rate gap between the countries in question. Against this background, there is the fact that China’s interest rates have been rising conspicuously due to its edge over other countries in terms of recovering from the pandemic. As the figure indicates, there is a stable correlation between the U.S.-China 10-year interest rate gap (China - U.S.) and USD/CNH, and it is not difficult to imagine that the expansion of the U.S.-China interest rate gap may be behind the recent strengthening of CNH. Another way to see this is that CNH is being bought in exchange for USD in response to the difference in the two country’s perceived economic strengths. If that is true, CNH appreciation may continue for some time to come, given that the economic situations of the U.S. and China are unlikely to change in the near term.



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Recovering a Big Surplus

CNH buying can also be justified from a demand perspective. As mentioned above, market participants positively rate China’s economic recovery from the pandemic earlier than other countries. The expansion of China’s exports, and therefore also of its trade surplus, are symbolic of this recovery, but what is worthy of special note in any discussion on CNH appreciation is the fact that the country’s current account balance, which has intermittently posted deficits in recent years, has also expanded its surplus margin. Two factors have contributed to the expansion of the current account surplus – the narrowing of the services deficit, and the expansion of



exports, both of which are obvious at a glance from

the figure. In recent years, the main reason for a decline in the Chinese current account surplus has been an increase in tourists from China to other countries, which resulted in a travel deficit that expanded the services deficit. This year, with tourism suffering in view of the pandemic, the services deficit for the April-June quarter fell by half yoy. In other words, of the services income and outgo, the dramatic decline in outgo (by around 30% to be more specific) is what caused the services deficit to shrink.

Meanwhile, the trade surplus posted a 3.6-fold yoy increase, and this is the result of a sharp rise in exports even as imports remained level (see figure). The strength of the Chinese economy, which has resumed production activity ahead of other countries around the world, can clearly be witnessed here. In this way, it is clear that there has been a sudden increase in demand for CNH against an improvement in China's trade and services balances, which, coming on top of the political and interest-rate factors mentioned earlier, seems to have set in motion a virtuous cycle of CNH buying. However, if, as interest rate levels clearly show, the current strength of the Chinese economy is head-and-shoulders above the rest of the world, one of the biggest concerns going forward is the possibility of the country "importing a recession" via its strong currency. The recent abolition of the forex risk reserve requirement can be said to indicate some of that concern of Chinese policymakers.

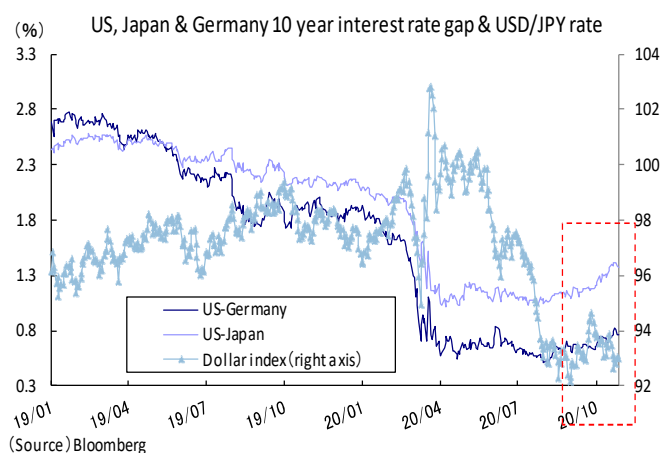


The Inscrutable Biden Trade

If we look only at the forex markets, CNH appreciation may be symbolizing a "Biden trade," but in financial markets overall, the logic of the Biden trade (at least as of the time of writing this report) seems to be (1) election win for Mr. Biden → (2) fiscal expansion led by Democratic Party administration → (3) revival of the U.S. economy → (4) increase in U.S. stock prices and interest rates → (5) sellback of USD bought during risk-off phase. As a result, hopes of a win for Mr. Biden appear to be manifesting as higher share prices, lower bond prices (higher interest rates), and a weaker USD.

However, is the above logic reasonable? The progression from (1) to (2) is not difficult to understand, but the reasoning behind the progression from (2) to (4) is dubious. To begin with, though Mr. Biden has been described as a "moderate" or "neutral" compared with other Democratic Party candidates, he is rumored to be strongly leftwing on a fundamental level. He has proposed an increase in all kinds of taxes, including income tax, corporate tax, and capital gains tax from selling shares. In view of this, the reelection of President Donald Trump has always been the more desirable scenario in the financial world. For instance, in the event of a win for Mr. Biden, the long-term (maturities over one year) capital gains tax rate for the highest earners could be raised from 20% to 39.6%. Any rational investor is bound to want to let go of shares before this takes place. Perhaps this concern, which cannot be ruled out as of the moment, is overridden by Mr. Biden's proposed fiscal expansion.

It is also quite doubtful that (4) and (5) could coexist. At first glance, it seems logical to assume that, as USD is bought during risk-off phases, it would be sold during risk-on phases, but one has to wonder – how long will USD selling continue amid a clear increase in U.S. interest rates? Going by experience, there have certainly been risk-on phases when USD was sold, but the momentum of USD selling was often lower than that of JPY selling during the same phase, leading to a rise in USD/JPY. One of the cornerstones of the forex markets is that JPY is both the weakest currency during risk-on and the strongest currency during risk-off. In particular, one of the main reasons for JPY being the weakest currency during risk-on phases is the unchangeable fact that JPY comes with a zero percent interest rate. But with USD interest rates also close to zero percent now, it is not impossible that things have changed. Still, it seems unlikely given that JPY interest rates are negative while USD interest rates are still positive. At the present time, USD continues to weaken across the board and be sold off against JPY despite the rise in U.S. interest rates and U.S. share prices. This is not something I intuitively understand the reasoning behind. The interest rate differentials between USD and both EUR and JPY are gradually expanding, but USD remains weak against both these currencies (see portion within dotted square in the figure).



Given that we are in a phase of no interest rate differentials, my basic understanding is that the rise in U.S. interest rates will not coexist with USD weakness for very long. If U.S. interest rates continue to rise, it is only a matter of time before USD begins to recover too. However, given that the Fed is at great pains to convince markets that there will be no interest rate hikes until 2024, it seems unlikely that U.S. interest rates will continue to increase. A Democratic Party administration is bound to pursue fiscal expansion for sure, but that would not be much different from the present situation, with fiscal deficits approaching 20% of GDP.

Explanations Based on Effectively Negative Interest Rates

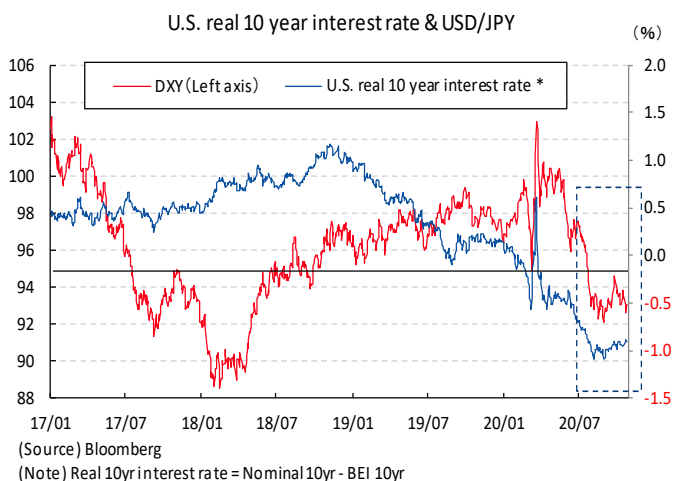
One way the markets are justifying the coexistence of an increase in U.S. interest rates and USD weakness is by suggesting that USD weakness actually reflects the decline in real U.S. interest rates. 2020 does seem to be a year of real interest rate trends seemingly dictating USD trends. Since July, in particular, real U.S. interest rates have sunk further into negative territory, and USD appears to have weakened another notch in line with this (portion within dotted square in the figure). However, one has to ask – to what extent can an event in the nominal world (USD weakness) be explained on the basis of an event in the real world (effectively negative interest rates)? A direct correlation between the two may seem apparent, but the causal relationship would be difficult to explain from a theoretical point of view (of course, it is

always possible that USD is weakening as part of a self-fulfilling prophecy as a result of the intuitive belief in the correlation between USD and real interest rates by financial and forex market participants). Based on my long years of experience surveying and analyzing the forex markets, I get the impression that theories correlating real interest rates to forex movements tend to surface when no other explanation seems to fit the bill. This seems to be the case at the present time. With the nominal interest rate trend apparently in clear conflict with forex market trends, other measures that seem to logically explain the developments are being sought. If it is difficult to explain a trend simply by substituting real interest rates for nominal interest rates, analysts will try to find the answers using real interest rate differentials, or by changing the maturity of bonds to focus on, and so on. Of course, such efforts are a legitimate aspect of serious analysis and cannot be rejected outright.

It has to be said, however, that not many forex traders refer to real interest rates when trading. Moreover, the current focus of attention is specifically on real interest rates estimated on the basis of inflation expectations, i.e., expected real interest rates. Since the size of the inflation-linked bond markets in the U.S. and Japan are different, real interest rate differentials estimated this way are inevitably unstable. They may seem to explain recent trends in the market by coincidence, but there is very little theoretical ground for such an explanation, and it is not likely to remain valid in the long term.

USD Overvaluation may be More Important than Near-Term Real Interest Rates

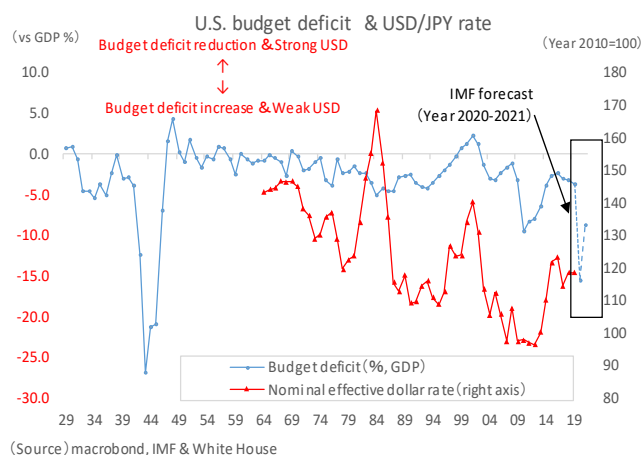
When contemplating forex movements over the next six months or a year, one would like to do so on the basis of fairly sound factors. This report has consistently taken the perceived overvaluation of USD based on the enormous U.S. fiscal deficit to be an important guidepost in this regard (details later). If a Biden administration does in fact pursue even greater fiscal expansion than current levels, as expected by the markets, one can assume, based on past experience, that USD will weaken further. Any increase in U.S. interest rates is bound to be promptly contained by the Fed as a potential impediment to the U.S. economy in the shape of an “unintended fiscal tightening.” However, considering that Mr. Biden is essentially a proponent of higher taxes, the discrepant trend of increase in share prices is bound to undergo significant correction at some point as Mr. Biden’s character comes into closer focus. However, taking into account the expected policies from the U.S. government and the Fed, it seems likely that both share prices and corporate revenues will continue to soar in spite of the contradiction from the perspective of the ground reality. The “Biden trade” is bound to change into a trend of higher share prices, higher bond prices (lower interest rates), and a weaker USD in place of the current higher share prices, lower bond prices (higher interest rates), and a weaker USD.



An Unprecedented U.S. Fiscal Deficit and the IMF's Fiscal Monitor – Perception of USD Overvaluation Refuses to Fade

The Worst Fiscal Deficit in U.S. History and Perceived USD Overvaluation Remain Key Themes

On October 16, the U.S. Department of the Treasury announced that the fiscal deficit for FY 2020 (October 1, 2019 through September 30, 2020) had reached unprecedented levels at -USD 3.1320 trillion. This is more than twice the size of the worst fiscal deficit before this, which was -USD 1.4160 trillion for FY 2009, immediately after the global financial crisis erupted. The scale of the deficit, which stands at over 15% of the U.S. nominal GDP (worth around USD 21 trillion), is literally reminiscent of wartime. In this report, I have long argued that the perceived overvaluation of USD due to this scale of fiscal deficit plays a key role in determining forex market trends, and combined with the Fed's stance of keeping interest rates from rising, makes USD a currency that is hard to buy.

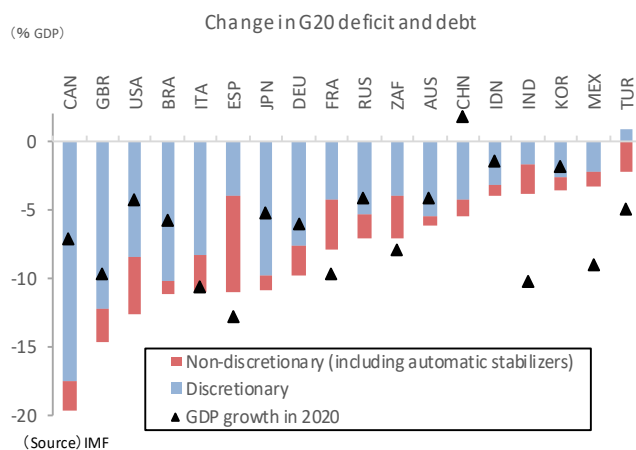


According to the IMF's revised World Economic Outlook (WEO) published in October, the U.S. fiscal deficit for the calendar year 2020 is set to reach 18.7% of GDP, but if one considers the possibility of a fourth phase of COVID stimulus (currently embroiled in debates) being added to previous packages, the deficit may expand even more. At any rate, going by past trends as shown in the figure, it is difficult to imagine that USD will appreciate.

USD Overvaluation is Conspicuous Compared with Other Currencies

Large-scale fiscal stimulus packages are being implemented in countries around the world at the present time, so it is not just USD but also other currencies that are suffering from perceived overvaluation. For this reason, it is important to see things from a relative perspective. In this context, the revised IMF Fiscal Monitor report published earlier in October is important. Ordinarily, fiscal policies get buried in reports like the IMF's WEO or Global Financial Stability Report (GFSR) and fail to be highlighted, but now that fiscal policies can no longer be overlooked in any political, economic, or financial discussion, they are worthy of special attention.

As indicated by the figure to the right, the fiscal deficits (as percentages of GDP, same below) of all the key countries, not just the U.S., have deteriorated considerably. Though diverging slightly from the main issue at hand, let me first summarize the basic points to understand when it comes to fiscal balance. Fiscal measures are of two main types – discretionary fiscal measures of various kinds that are implemented in response to economic deterioration, and fiscal adjustments (“non-discretionary fiscal measures” in the figure) implemented as automatic stabilization measures. The latter are a form of social security that automatically stabilize the economy by minimizing economic fluctuations in the natural course of things. In the context of the fiscal balance, when an economy deteriorates, not only do fiscal payouts increase, tax revenues also dwindle, causing the fiscal deficit to expand. According to the recently released Fiscal Monitor, discretionary measures are responsible for a third of the recent U.S. fiscal deficit expansion.

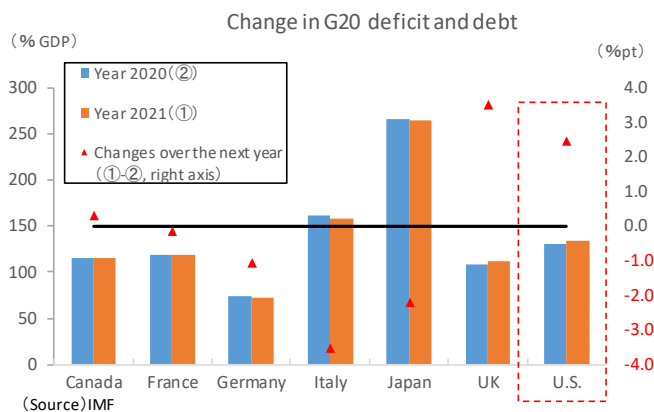


There are other factors contributing to the expansion. In finance, the balance of government debt is said to have long-term stability when the official interest rate (r) is lower than the economic growth rate (g) in a scenario where the primary balance (fiscal balance excluding interest rate payments) is in equilibrium. This “ $r < g$ ” or “ $r - g < 0$ ” is called the “Domar condition,” and is well-known as an easy tool for judging fiscal balance sustainability. However, at the present time, even though r is being suppressed through monetary policy, g is experiencing an unprecedented slump. The U.S. economy has posted significant negative growth in 2020, resulting in a situation where “ $r - g > 0$.” According to the Fiscal Monitor, $r - g$ being positive has contributed 6.6 pp of the 20.3 pp deterioration in the balance of government debt for advanced nations in 2020. This contribution is three times as large of the same in the case of emerging market economies, indicating the considerable deterioration in the growth rates of advanced economies, given that their interest rate levels are fairly low to begin with. In other words, the more advanced the economy, the worse the deterioration of its fiscal balance. In fact, in 2020, fiscal balance deterioration is the most conspicuous among the most advanced economies.

U.S. Finances Set to Deteriorate in 2021 Also

Knowing this, one could ask – if the fiscal deficits of all the advanced economies have deteriorated, would this not lessen the significance of USD overvaluation? Unfortunately, I don't think it does. The U.S. fiscal deficit deterioration is not the worst among G20 countries – the figure above shows G20 countries in decreasing order of fiscal balance deterioration for 2020, with Canada, the UK, the U.S., Brazil, and Italy being the top five (incidentally the figure for the U.S. fiscal deficit is slightly different from the -18.7% mentioned in the figure on the previous page, but this is an error arising from a slight difference in estimating method and applies to all the countries in the figure). However, if one considers the overwhelmingly large scale of the U.S. economy (worth around USD 21 trillion in 2019, and accounting for over 20% of the USD 87.5 trillion global economy), its impact on the forex markets is somewhat concerning. In contrast to quantitative easing by the central bank, fiscal policies (bond issuance) by the government tend to involve direct supply of currency to the real economy in some shape or the other. Because it directly impacts money supply rather than the base money, the importance of fiscal policy, in comparison with more roundabout monetary policy, is being reevaluated.

Even a U.S. fiscal deficit worth merely 10% of its GDP (USD 2.1 trillion) would indicate a supply of USD larger than the whole of the Canadian economy (around USD 1.7 trillion). Taking into account a further stimulus package that will probably be passed going forward, the fiscal deficit percentage could ultimately expand to around 25% of GDP. Intuitively, in such a scenario, one would not want to bet on USD. Incidentally, the IMF estimates that most countries will be able to stabilize their government debts with the resumption of economic activity and with the help of low interest rates, but a deterioration is forecast for the U.S. and UK (see figure). One could say that GBP is another of those currencies that is difficult to buy because of perceived overvaluation, but here again, looking at the scale of the deficit, the overvaluation of USD is bound to be the bigger theme in the forex markets for the time being.

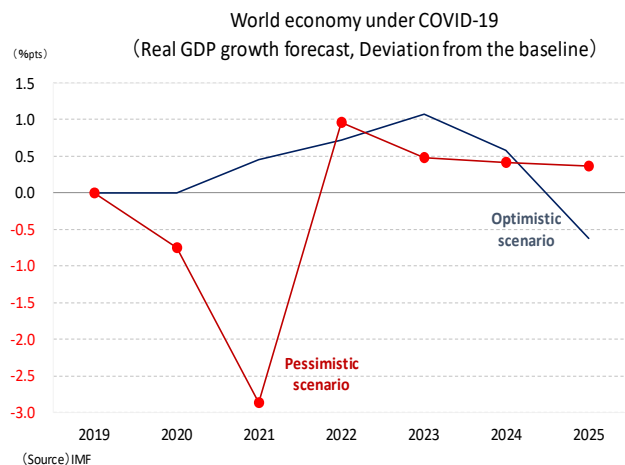


If the fiscal deficit expansion invites an increase in interest rates in the bond markets, some may seek out USD for purchase, but the Fed, which predicts zero interest rates through 2023, is unlikely to allow interest rates to rise and have an unintentional financial tightening impact. In this report, therefore, I will retain my prediction of downside risks for USD going forward.

Risks to my main scenario – “Bright Future” the Biggest Prospective Risk Scenario?

Risk Scenarios in the Autumn World Economic Outlook

The spring edition of IMF’s World Economic Outlook (WEO) presented multiple forecast scenarios based on different assumptions about prospective covid-19 pandemic trends, and the autumn WEO, released on October 13, similarly presents alternative downside and upside forecast scenarios. The spring WEO offered three alternative forecast scenarios. Scenario 1 assumes that measures to contain the spread of the virus in 2020 will last roughly 50% longer than assumed in the baseline. Scenario 2 assumes that there is a second outbreak of the virus in 2021 that is roughly two-thirds as severe as in the baseline. Scenario 3 assumes that it takes longer to contain the outbreak in 2020 and that there is a second outbreak in 2021. Taking these scenarios into account, this article’s USD/JPY forecast is as follows – (Scenario 1) USD/JPY will fall below JPY100 within the year; (Scenario 2) USD/JPY will shift to the JPY95-100 range next year; and in the worst case (Scenario 3), USD/JPY will fall below the JPY95 level.



The autumn WEO is simpler than the spring WEO in that it presents only two alternative forecast scenarios. The downside scenario assumes that containing the virus will entail a more-difficult and protracted struggle until a vaccine is widely available, while the upside scenario assumes that all dimensions of the fight against the virus go well. The different assumptions will generate divergent forecasts regarding economic and financial situations as well as various other situations, but separating the types of forecasts is particularly important with respect to economic analyses. The graph shows how much global economic growth rates are expected to deviate from the baseline scenario in the downside and upside scenarios. Looking at the cumulative effect of divergent growth rates during six-years from 2019 through 2025, one finds that the growth rates will be a total of 1.40 percentage point below the

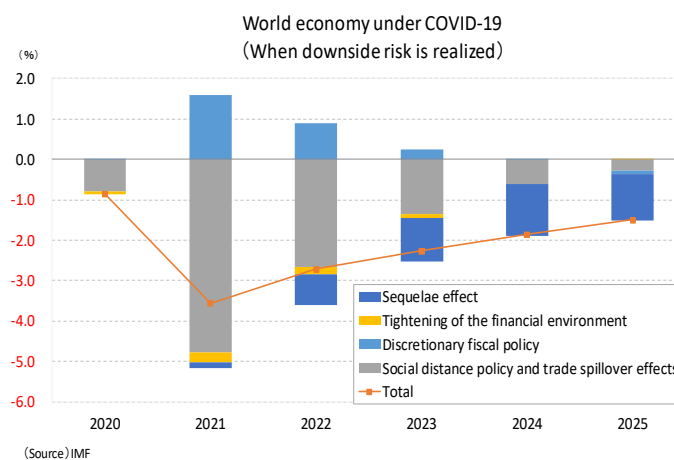
baseline scenario in the downside scenario, and a total of 2.19 percentage points above the baseline scenario in the upside scenario – the margin of difference amounts to 3.59 percentage points. The real economic situations

expected to ensue from the two scenarios are a world apart. It may be worth noting that, while discussions of up- and downside scenarios usually consider the upside scenario before considering the downside scenario, the IMF this time discusses the downside scenario first, and one wonders if this ordering might reflect the IMF’s opinion about which scenario is more likely to be realized.

Downside Scenario’s Large Scarring Effect

The downside scenario assumes that pandemic control measures will slightly increase the direct drag on economic activities in the latter half of 2020 and that, in 2021, progress in the development of vaccines and treatments will be slower than expected and the application of social distance policies more-protracted than expected. It is assumed that these situations will lead to a deterioration in activity in contact-intensive sectors, with the associated income effects spilling over to other sectors. Since the slackness of domestic demand in one country will slacken external demand from the perspective of other countries, the negative effects are expected to spread to each individual country’s economy by means of a slump in trade transactions and thereby lead to a trend of stagnation in the global economy.

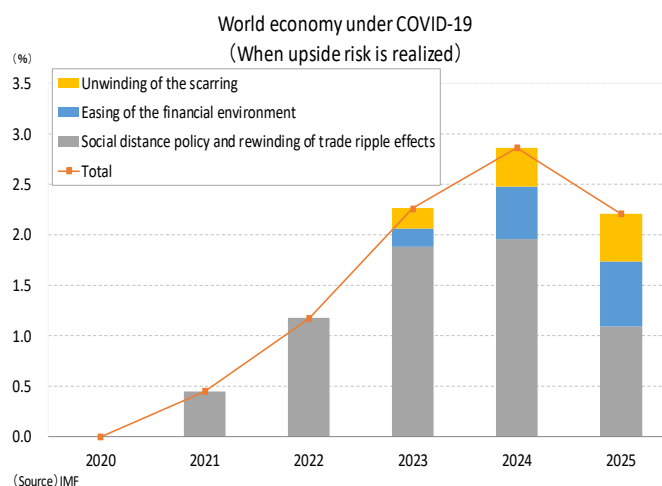
The graph shows how social distance policies and negative trade spillover effects account for most of the negative effects anticipated by the downside scenario. The graph also shows a noteworthy increase in economic scarring (negative aftereffects) beginning from 2022. It can be expected that a severe shock such as the current one will be followed by the implementation of various kinds of structural reforms – both desired reforms and undesired reforms – that may have a lasting impact on macroeconomic output. For example, companies that survive the shock will probably strive to make their workplaces more hygienic and safe, but the cost of associated measures may well dictate concurrent restructuring (rationalization or downsizing) measures. If workers leaving the labor market owing to restructuring measures cannot quickly return, the economy of the country in question will see a decrease in its labor input and a consequential decrease in its potential growth rate. In general, the longer the unemployment period, the more likely this kind of adverse effect will be generated. Moreover, as companies downsize their workforces they are also likely to seek to limit their capital accumulation by restraining their capital investment. If the proclivities to make capital investments decline, it may become impossible to establish more-efficient production systems, and this will also promote a decline in the potential growth rate. The graph shows that this scarring effect is not expected to be very noticeable in the short term but is expected to become quite large and growing factor from 2023, when it may well become referred to as the post-corona effect.



The downside scenario also anticipates a widening of corporate credit spreads in advanced countries and the possibility of a widening of both corporate credit and sovereign spreads in emerging countries. This makes it necessary to consider this kind of monetary tightening effect as a downside risk. There is cause for concern about such negative financial trends in 2021, but the IMF expects central bank measures may return financial conditions to the baseline from 2022. In any case, as it assumes greater downward pressure on interest rates compared to the baseline scenario until 2025, it seems reasonable to conclude that that the downside risk scenario anticipates relatively low interest rates over the next few years.

Upside Scenario already Tenuous

The upside scenario assumes that all pandemic control measures will be more successful than in the baseline scenario, but it is already beginning to appear quite tenuous in light of the pace of increase in Europe’s second wave of infections, which is already exceeding that of the first wave (although the rise in infections has not been paralleled by a rise in associated deaths). The upside scenario anticipates that people’s anxieties will be dispelled as the fatality rate declines and that proclivities to consume and invest will be restored. This scenario also assumes smooth progress in vaccine development and usage, enabling the gradual discontinuation of social distancing policies and thereby promoting trends opposite to those anticipated in the downside scenario described above.



The WEO points out that the differences between the upside scenario and the baseline scenario will be magnified by a “larger relative easing in risk premiums” and a “larger unwinding of the scarring embedded in the baseline” in the upside scenario and that rescinding social distancing policies will promote economic activities, with the positive effects spreading to various economic sectors (see graph). In the upside scenario, economic scarring will not be a negative factor from 2023, from which time the unwinding of the scarring embedded in the baseline will be a factor pushing growth rate upward. This scenario would naturally enable the unwinding of monetary and fiscal stimulus policies, an uptrend in interest rates, and improvement in the government sector’s fiscal situation.

A “Bright Future” Would be the Biggest Surprise

How should these IMF assumptions be reflected in forex rate forecasts? In the case of one-year forecast period such as that of this article, there is probably a need to closely monitor the potential for the upside scenario’s eventuation. This is because it is believed that financial market participants are already to some extent prepared for the possibility of the downside scenario. The Fed itself is disseminating information suggesting that interest rates will be raised sometime going forward from 2024, and this implies that the downside scenario may be akin to the main scenario in the world of those keenly monitoring developments related to central bank policies and interest rate. Even in the downside scenario, one should naturally be cautious about the possibility of a sharp drop in stock prices, but a sharp change in market conditions currently appears rather unlikely in light of the authorities’ swift policy responses and the general perception that things are progressing pretty much as expected.

On the other hand, there are probably not so many people who are basing their forecasts on the assumptions of the upside scenario. That scenario assumes that every aspect of the pandemic countermeasures go much better than generally expected – meaning that vaccine development will smoothly progress, various social distancing policies will be discontinued, private-sector consumption and investment proclivities will be restored – and that, as a consequence, efforts will be made toward normalizing fiscal and monetary policies. The post-Lehman shock experience suggests, however, that financial markets do not tend to expect or accept moves toward post-shock policy normalization, even after economic and financial conditions have considerably improved. The upside scenario perhaps just seems a bit too unrealistically optimistic. Yet that is precisely why it would probably be best to be prepared for the slight possibility of an interconnected rise in U.S. interest rates and USD/JPY in a situation akin to the upside scenario. In such a situation, the main range of USD/JPY would depend on the pace of increase in U.S. interest rates, but if the 10-year U.S. interest rate were to rise to the vicinity of 1.5% it would not be surprising to see the main range of USD/JPY shift to the vicinity of JPY110-115. It may seem sad to think that a “bright future” of progress toward normalization would constitute the most unexpected surprise development, but I think that biggest risk market participants might face is the sudden onset of the post-corona era along with moves toward normalization.

EUR Outlook – Increasingly Severe Disinflationary Trend and the Direction of EUR Appreciation

EUR Area Monetary Policies Now and Going Forward – Lagarde’s 1st Anniversary as ECB President: Threat of EUR Appreciation on a Par with that from Pandemic?

Lagarde-Style Prior Indication of Easing?

The October 29 ECB Governing Council meeting decided to maintain the status quo but also strove to disseminate information encouraging expectations of additional easing measures in December. The ECB has long had a tradition of fending off disappointed expectations regarding a given meeting by hinting at decisions that may be made at the next meeting, but this time the ECB adopted an unusual approach of distributing a separate written announcement prior to the usual statement. The separate announcement, presented as a press release titled “Monetary policy decisions”, begins with the sentence – “In the current environment of risks clearly tilted to the downside, the Governing Council will carefully assess the incoming information, including the dynamics of the pandemic, prospects for a rollout of vaccines and developments in the exchange rate.” It then states that the GC will “recalibrate its instruments, as appropriate, to respond to” information obtained from the next round of Eurosystem staff macroeconomic projections in December. The contents of the press release are excerpts from the ordinary statement, and this approach of excerpting prospective easing-related information in a separate announcement was not seen during the period when the ECB was led by former-President Draghi. (There were occasions when the content of easing packages were presented as a separate announcement at the time of their approval, but there were no separate announcements regarding such packages prior to their approval.) This could be considered to be a Lagarde-style of “dialog with the markets”.

Threat of EUR Appreciation on a Par with that from Pandemic?

Aside from the presentation format, the text – “the Governing Council will carefully assess the incoming information, including the dynamics of the pandemic, prospects for a rollout of vaccines and developments in the exchange rate.” – is surprising, in that it seems to put responses to unprecedented public health disaster (“the dynamics of the pandemic, prospects for a rollout of vaccines”) on the same footing as responses to “developments in the exchange rate” (essentially referring to EUR appreciation).

It seems that many people felt such surprise, in fact, one reporter expressed his opinion regarding that sentence rather than posing a question, saying – “I wanted to speak to you a little bit about your opening statement, where you mentioned that one of the things that you’re looking at is the monitoring exchange rates. I can’t remember a time you mentioned exchange rates so high up in your presentation.” In response, President Lagarde said that pandemic-related trends and containment measures (vaccines) as well as forex market trends were listed together insofar as they all “are exogenous factors that you cannot influence”, and hinted obliquely that they might also share the characteristic of being “driving factors”. It is true that monetary policy makers do not have perfect control over the forex markets. At the same time, however, it should be recognized that the ECB’s ability to influence the forex market by through measures that affect interest rate trends and other measures is much greater than its ability to exert influence over viruses and vaccines. In fact, the ECB’s citing of exchange rates together with the pandemic as major factors gave me the clear impression that the ECB is extremely concerned about EUR appreciation, and I strongly suspect that this impression may be correct.

The latest Governing Council meeting also indicated its awareness of the problematic deceleration of euro area service industries’ activities and associated weakness of service prices, although I will refrain from going into detail about this situation at this point since this article has discussed it repeatedly in the past. Two reporters posed questions about whether the ECB would be accepting of deflationary pressures. In her responses, President Lagarde pointed out headline inflation was being depressed by temporary factors – including falling energy prices, Germany’s temporary reduction of VAT rates, and a drop in travel-related prices – and forecast that inflation rates will rise during 2021 as these special factors disappear. The ECB’s official view is thus that there is no great need for concern about deflation at the moment. Given that the pandemic’s spread has led to restrictions being placed on the population’s movements and behavior, however, further declines in demand appear to unavoidable going forward and, theoretically, such demand declines can be expected to diminish upward pressure on prices. Although the ECB is intent on emphasizing that the current weakness of inflation trends is stemming from special, temporary factors, it would be best to maintain a skeptical attitude regarding that argument.

Meaning of “Recalibrate”

As the statement indicated that the ECB planned to “recalibrate its instruments”, several reporters naturally inquired about the specific meaning of recalibration. Many financial market participants are anticipating recalibration will include an expansion of the Pandemic Emergency Purchasing Program (PEPP), but President Lagarde avoided giving specifics, saying – “I’m not ruling in any of the tools that we have. Staff of ECB and NCBs, as I said, are already working on this to arrive at the best possible mix.” As her elaborate responses were perceived as raising hopes but avoiding pledges, a reporter frankly asked – “Just to clarify, did I understand correctly that the Governing Council has agreed that there will be action in December; that there will be more stimulus; the only question is what exactly that will look like?” In response, President Lagarde merely read aloud the third sentence of the press release regarding how the Governing Council would “recalibrate its instruments, as appropriate” and evasively emphasized that – “This is a key sentence[.]” While additional monetary easing in December is generally believed to be the ECB’s default route, President Lagarde is apparently intent on avoiding explicit confirmation of that. The last reporter to pose questions at the press conference asked whether it might be difficult for the Governing Council to reach a unanimous decision on action in December and expressed concern about the possibility that the Governing Council might become divided as it had been in the past, and President Lagarde indicated that she has a flexible attitude toward the goal of making decisions based on unanimity, saying – “[U]nanimity is not necessary to take action.” Based on observations of the Governing Council’s decision making process in the past, I think it will be wise to keep a close eye on political noise factors following the meeting.

Although only abstract information was provided about the specific easing measures likely to be implemented, President Lagarde did go into a bit more detail at one point, saying – “recalibrating means that we are going to identify what is the optimal way to use one or more of the instruments, several of them, and clearly, increase, extend, work on duration, work on volume, work on attractiveness.” Of course, she did admit that the PEPP was conveniently flexible (“instrumental”) and emphasized that she will not hesitate to utilize PEPPs flexibility to undertake measures involving deviations from the capital key if deemed necessary. As a matter of fact, however, the ECB does not have a lot of policy cards left to play, and one can expect that its decisions are likely to be within the scope of market expectations.

Extraordinary Meeting?

The next Governing Council meeting is scheduled for December 10, six weeks from now. In light of the rapid pace of the pandemic’s and the current state of governmental responses to the pandemic, however, six weeks seems to be a quite long hiatus period. It is expected that there may be considerable changes to the economic and financial situations in the near future, and the current skyrocketing of the VIX index may be a reflection of widespread concerns about such changes. At the press conference, one reporter asked about the possibility that the ECB might convene an unscheduled meeting to take policy action, as it did when deciding to launch the PEPP. President Lagarde overviewed the ECB’s use of remote meeting technologies and the potential use of those technologies to enable extraordinary meetings at short notice, saying – “if we have to meet on short notice, we will do so.” In the case of large movements in euro area stock prices, interest rates, and exchange rate trends, market participants should be prepared for the possibility that such an extraordinary Governing Council meeting might be convened.

Looking Back at Lagarde’s First Year

President Lagarde has now been ECB president for a full year. A year ago, one could not have imagine that the economic and financial situations inside and outside the euro area would be impacted by such a major disaster as the COVID-19 pandemic, but the extraordinary challenges the ECB has been facing make the past year an excellent period in which to evaluate President Lagarde’s abilities under pressure. At her debut Governing Council meeting last December President Lagarde emphasized her flexible posture regarding diverse kinds of policy responses, saying – “once and for all, I’m neither dove nor hawk and my ambition is to be this owl that is often associated with a little bit of wisdom.” Unlike former President Draghi, who was not averse to overcoming dissent by means of majority votes, President Lagarde has explained that she strongly emphasizes harmony and unanimity, and this led some to suspect that such an attitude might prevent her from undertaking flexible and bold policy initiatives.

At this point, however, it can be said such worries were unnecessary. At the post-Governing Council-meeting press conference on March 12, she made a verbal misstep, saying – “we are not here to close [government bond] spreads. This is not the function or the mission of the ECB.” – and thereby triggering a painfully sharp rise in euro area interest rates. It was very soon after that, however, on March 18, that an extraordinary remote Governing Council meeting was convened to launch the PEPP, and the ECB under President Lagarde’s leadership was subsequently very dynamic in enhancing its framework for funding with negative interest rates (TLTRO3, PETRO, etc.) and implementing other emergency response measures.

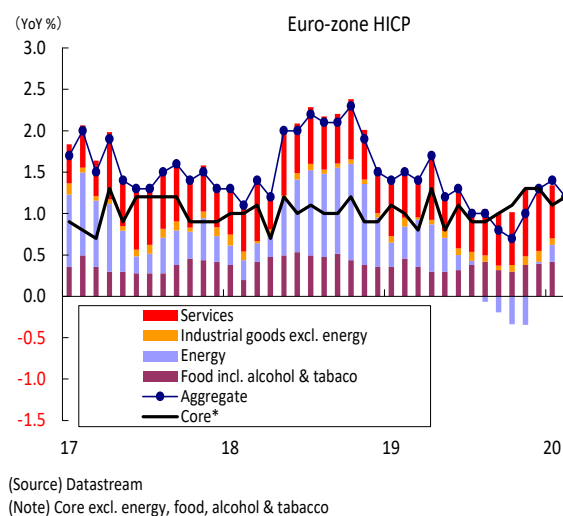
Moreover, it has been widely reported that, despite the pandemic crisis, President Lagarde has not slackened her commitment to undertaking new ECB initiatives related to such as issues as climate change responses and digital currency development. It can probably be said that President Lagarde has proven to be a successful monetary policy manager over the past year. But observing performance over a one-year period is not a sufficient basis for coming to a conclusion, as the quality of monetary policies can only be truly evaluated when the subsequently requisite exit strategies are concurrently considered. In that sense, it cannot be overlooked that the prolongation of the PEPP has caused the ECB's government bond holdings have become significantly overbalanced with regard to individual countries, which is likely to make the future exit strategy more complex than the strategies envisioned during the ECB's Draghi era. It may seem that this concern is premature as the eventual exit strategy is still a distant prospect, but I do think such medium- to long-term concerns are worth pointing out and considering.

EUR Area Inflation Trends Now and Going Forward – Increasingly Serious Inflation Situation

Serious Inflation Situation Reflected in Service Prices

The euro area's economic and financial situations have become increasingly challenging, promoting intermittent rises in expectations of additional ECB easing measures during October. There were two main reasons for this – the renewed spread of the COVID-19 pandemic in Europe and the drop in inflation rates. Major continental European countries – including Germany, France and Spain – have decided to reintroduce lockdowns following upsurges in numbers of COVID-19 infections. While the new lockdowns are said to be somewhat less rigorous than those launched in the spring, they will inevitably affect such hard economic statistics as those related to production and consumption, and the increasing weakness of consumption can be expected to further exacerbate the trend of falling inflation rates.

Announced in October, comprehensive basis euro area HICP growth rate for September was -0.3% yoy, the second consecutive month of negative growth, while the core basis HICP growth rate descended to the record low of + 0.2% yoy. Basically, the inflation rate drops can be said to reflect a decline in energy prices owing to lower crude oil prices, but as the graph shows, the contribution of service prices has clearly been diminishing – service prices grew only 0.5% yoy September, the slowest rate every recorded. As service prices largely reflect wage levels, there are concerns that a labor market slump is promoting deceleration in the real economy. In addition, two consecutive months of -0.3% yoy growth in prices of non-energy industrial goods indicate that the increasing weakness of inflation is no longer a problem that can be entirely attributed to the fall in energy prices.



As noted in previous issues of this article, PEPP was initially launched as an emergency policy designed to (1) overcome pandemic-related risks that might impair the smooth transmission of monetary policy. It was therefore initially believed by many that the PEPP's purchasing envelope might not have to be fully utilized. However, PEPP was subsequently given the additional objective of (2) promoting greater inflation by augmenting monetary easing. The ECB is currently arguing that "target (1) was successfully attained, but target (2) requires continued and expanded implementation", and that is why the above-described weakness of HICP growth figures is provoking expectations of additional easing. In any case, it is clear that inflationary pressures are clearly beginning to decline in the euro area with respect to both goods and services. From Japan's experience, it is well-known that, once established, deflationary mind-sets are extremely resilient and difficult to dispel. More than five years have passed since concerns about the euro area's Japanification process were first expressed, and since then, euro area phenomena very similar to their Japanese counterparts have become evident in such diverse areas as monetary policy management, interest rates, and currency appreciation. At this point, increasing attention is being focused on the question of whether the euro area's Japanification process will clearly extend to encompass the inflation situation that is a crucial core element of Japanification. In light of all that, it is expected the expectations of additional ECB easing measures – not restricted to measures associated with PEPP expansion – will intensify before the end of the year.

Concern about the weakness of services prices was expressed in the Account of the ECB Governing Council Meeting (held on September 8-9). The key portion of the Account reads – "Recently, momentum had slowed in the services sector compared with the manufacturing sector, which was also visible in survey results for August. Looking at the components of GDP in more detail, consumer spending had increased strongly since April, but

its recovery remained far from complete.” While service industries slump is thought to stem from the sluggishness of domestic demand – “Survey data indicated that the perceived lack of demand was increasingly becoming a drag on investment – in particular business investment” – and this was cause for concern regarding the euro area’s GDP performance in the July-September quarter.

ECB Staff vs. Governing Council Members

Newly revised ECB staff macroeconomic projections for the euro area were discussed at the September Governing Council meeting, and the Account states that – “The argument was made that the inflation outlook in the September staff projections appeared too optimistic.” These staff macroeconomic projections are provided to ECB Executive Board member and chief economist Philip Lane, who presents them to the Governing Council. In other words, the projections are presented along with an expert economist’s analysis,

and this would ordinarily preclude dissenting views from individual Governing Council members based on their own analyses. This system has generally prevented ECB Governing Council members from objecting to elements of staff projections in the past and, in this sense, the ECB’s system might be said to be significantly different from those of the Fed and the BOJ.

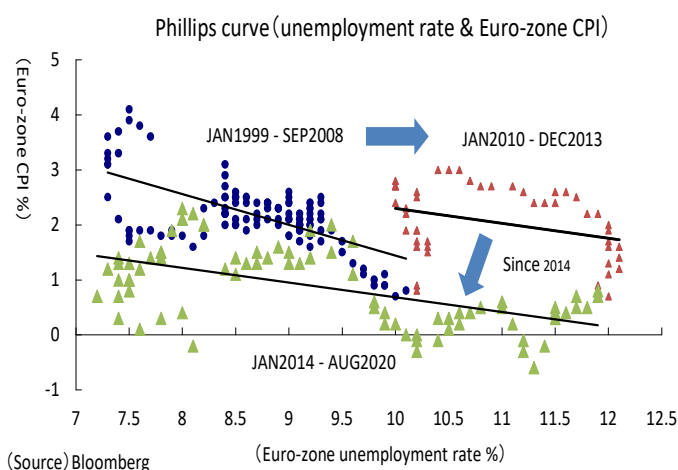
Specifically, one or more Governing Council members suggested that – “Phillips curve estimates, in particular those incorporating the output gap or using total hours worked rather than the unemployment gap, tended to show lower inflation compared with the September baseline.” The graph on the right shows Phillips curves created using a simple method based on the euro area consumer price index and the unemployment rate. While this method is different from that referred to in the Account, the graph does indicate that the Phillips curve has clearly shifted downwards over the past decade, and it can be argued that the flattening of the curve makes it more difficult for prices to rise.

The Account goes on to say that – “Inflation pressures were very low in some services sectors, and certain services sectors, such as hospitality, would probably experience a more gradual recovery than previously thought.” It appears that discussions of service industries and the sluggishness of services prices will become an increasingly important part of analyses of the euro areas real economy. It is noteworthy that, following these comments, the Account states that – “The pick-up in inflation to 1.3% in 2022 could also be considered optimistic against the background of the sharp decline in activity and high uncertainty.” – and this appears to be tantamount to a frank disagreement with the staff projection.

ECB staff outlook (SEP 2020) (%)

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

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

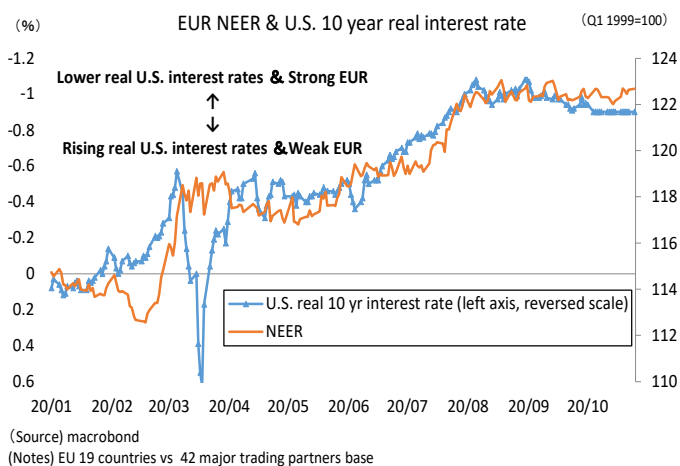


EUR Now and Going Forward – ECB Analysis of Factors Promoting EUR Appreciation

ECB’s Analysis of EUR Appreciation: Reflection of Decline in Real U.S. Interest Rates?

The Account of the September Governing Council meeting also includes interesting information regarding EUR appreciation. In her summary of economic and financial trends, Executive Board Member Isabel Schnabel basically explained EUR appreciation as being the flip side of USD depreciation. In her explanation of USD depreciation, she pointed out that – “Investors tended to reduce their holdings of US dollar-denominated debt securities when break-even inflation rates increased, and this effect was also stronger when real rates were in negative territory.” In brief, she argues that US real interest rates’ negative levels are an indirect cause of EUR appreciation, and the graph on the right is convincing evidence of the veracity of that argument (see graph). USD was preferred as a safe haven asset until March, and this probably can explain why a reaction to shift away from USD has been evident April. The graph clearly shows that the rise in EUR’s nominal effective exchange rate has intensified in step with the descent into negative territory of the US real 10-year interest rate (nominal interest rate - BEI 10 years). If this interpretation is correct, it can probably be expected that EUR appreciation will persist for the time being.

Ms. Schnabel pointed out two “main drivers” behind the EUR appreciation, the first being the “the reversal of previous safe-haven flows into the United States” accompanying the descent of U.S. interest rates into negative territory. The other driver is that, before the pandemic, the Fed had more “conventional policy space” or leeway for reducing interest rates, which was a factor promoting USD selling. This also seems to be a reasonable analysis, as the Fed has cut interest rates several times during the pandemic shock period, while the ECB has not even once adjusted its policy rates. The argument that this situation promoted the accumulation of speculative USD selling/EUR buying positions is also convincing.



Argument that EUR Appreciation’s Pace More Important than its Level

The above are the views of Executive Board Member Schnabel, but other Governing Council members also expressed their views regard EUR appreciation. It was noted that EUR appreciation reflected – “a broad-based improvement in risk sentiment and a reduction in “flight-to-safety” flows” that promoted the unwinding of USD buying and also reflected “relative changes in the monetary policy in the United States and the euro area” – (the perception that the ECB had already played more of its easing cards than the Fed), and these views are roughly the same as those expressed by Ms. Schnabel. However, the suggestion that – “it was the pace of the euro’s appreciation, rather than the level of the exchange rate, that could become a concern.” – is worth noting. In the markets, there is often discussion about the EUR reaching the “1.20” level against USD and “120-125” range in terms of the nominal effective exchange rate, and it was suggested that those levels in of themselves might not be problematic. I naturally do think that the EUR appreciation level itself is in fact worthy of some concern, but the pace of change is also quite noteworthy. EUR/USD has risen by more than 12% since March, and there is no doubt this degree of change merits being considered extraordinary.

Governing Council members are reported to have commented that further EUR appreciation constituted a risk to both growth and inflation in light of “the openness of the euro area economy”. But it was also suggested that EUR appreciation did not constitute an additional risk, as “a significant impact of the exchange rate appreciation on euro area inflation had been included in the September 2020 ECB staff projections.” This can be interpreted as suggesting that the current degree of EUR appreciation should not be considered a factor affecting the possibility of additional monetary easing going forward. It was also pointed out that the “the underlying causes” of EUR appreciation are important, and that the impact on the real economy would vary depending on the nature of the underlying causes. As EUR’s recent appreciation to a certain extent reflects expectations that the euro area economy has greater growth prospects than the U.S. economy, EUR appreciation should not be considered a completely “bad” phenomenon, but the Account of the September Governing Council meeting indicates that Governing Council members generally attributed EUR appreciation to the Fed’s interest rate cuts and the excessively poor performance of the U.S. economy. Assuming that the Governing Council considers EUR appreciation to stem from U.S. factors and has a perception that the weakening of euro area service prices and other prices has reached crisis proportions, it seems likely that, going forward, we will be seeing the ECB intermittently disseminating information reflecting its concern about EUR appreciation.

Continued Gap Between Euro Area and U.S. Growth Rates

By the way, while there was a lot of Europe-related bad news in October – such as the turmoil related to Brexit negotiations and the concerns about the second wave of pandemic infection – there was no movement away from EUR in the foreign exchange market. As this article has discussed in the past, it is thought that a factor in the background of the EUR appreciation seen since this spring may be the simple idea that the euro area will surpass the United States in terms of economic the growth rates during the period through 2021. This is evident in the newly revised IMF WEO released in October, which forecasts 2021 real GDP

Growth trajectories for major economies through 2021

	Year 2020 (①)	Year 2021 (②)	Recovery (②-①)
U.S.	-4.3	3.1	7.4
Euro-zone	-8.3	5.2	13.4
Germany	-6.0	4.2	10.2
France	-9.8	6.0	15.8
Italy	-10.6	5.2	15.9
Japan	-5.3	2.3	7.6

(Source) IMF [World Economic Outlook] (October 2020 revised edition)

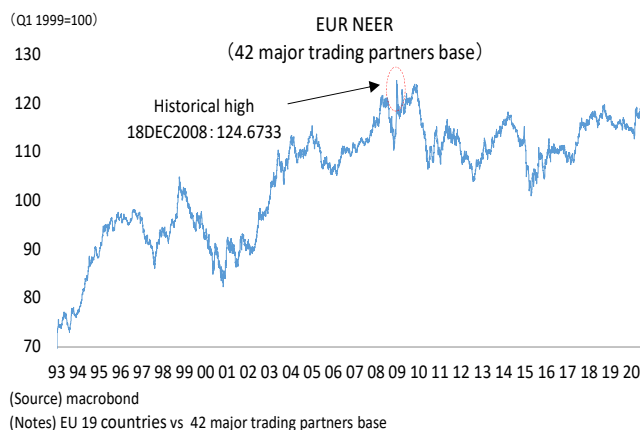
growth rates of 3.1% in the United States and 5.2% in the euro area – a significant difference of about 2.1 percentage points. The euro area celebrated the 21st anniversary of its establishment in 2019, but during the area’s history of over two decades, its economic growth rate has only seven times exceeded that of the United States. Among those seven times, the biggest margin of difference was in 2001, when terrorist attacks

restrained the U.S. rate to +1.0% and the euro area achieved +2.2% growth – a difference of about 1.2 percentage points. This time, the outlook is extremely unusual in that the prospective difference is nearly double that size. Of course, the magnitude of the 2021 rebound should not be overestimated, as euro area GDP is forecast to sink 8.3% in 2020, nearly double the forecast of a 4.3% drop in U.S. GDP in 2020. Regardless of that, it should be remembered that financial markets – particularly the foreign exchange market – have high levels of appreciation for momentum factors. It seems that the markets are inclined to give a relatively positive evaluation to the euro area in view of its real economy's superior prospective momentum.

EUR Remains Strong on NEER Basis

However, it is generally understood that the ECB is not happy with EUR's current strength. It is true that EUR/USD has been progressively adjusted upward since the beginning of the year, but the EUR nominal effective exchange rate (NEER) has remained on a plateau at close to its highest-ever level (see graph). EUR movements against USD are important for the euro area economy given its high level of dependency on foreign demand, but the significance of sustained high EUR NEER levels with respect to the currencies of major trading partners should not be overlooked. As mentioned above, the ECB Governing Council has posited that the pace rather than level of EUR appreciation is particularly

problematic, but the EUR NEER has remained relatively level since surging upward in March, so it is hard to characterize the pace itself as being the primary problem. Since the revised staff outlook released in September already incorporated the EUR appreciation through that time, it may be difficult to cite EUR appreciation as a factor justifying additional easing measures in the near future. The ECB can be expected to become even more hostile to EUR appreciation in the wake of the second pandemic wave and full-scale turmoil related Brexit negotiations, however, and it is likely to design its monetary policy "next move" in a way that countervails it.



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