Forex Medium-Term Outlook

November 30, 2020

MIZUHO

Overview of Outlook

USD/JPY remained weak in November. Spurred on by many important factors, including the U.S. presidential election and the announcement of effective vaccines, trend of high share prices, high bond prices (low interest rates), and USD weakness continued as before in the financial markets. While it is true that interest rate levels increased a notch, their rise was not as dramatic as that of share prices, and they peaked quickly. Some key factors to take into account when formulating the outlook for 2021 include share buying as a consequence of the extremely low interest rate situation, the probability of zero interest rates for the next three years to come, and the perceived overvaluation of USD as a result of the enormous U.S. fiscal deficit. As a consequence of all of these, I foresee the continuation of high share prices, high bond prices (low interest rates), and USD weakness for some time to come. As already mentioned, risks for the current forecasting period center around the COVID pandemic situation, and I will refrain from repeating myself on this subject. Apart from that, one of the biggest risks the Japanese economy and political establishment must pay attention to is the appreciation of JPY against USD in a way that seems linked to insufficient monetary accommodation by the BOJ. I would be difficult to think of an effective means to combat continued JPY appreciation arising from the interpretation that the BOJ is lagging behind the Fed and the ECB in terms of monetary accommodation. What is happening at the present time, however, is USD depreciation against JPY rather than the other way round, and the current global climate makes it difficult to show specific concern regarding JPY.

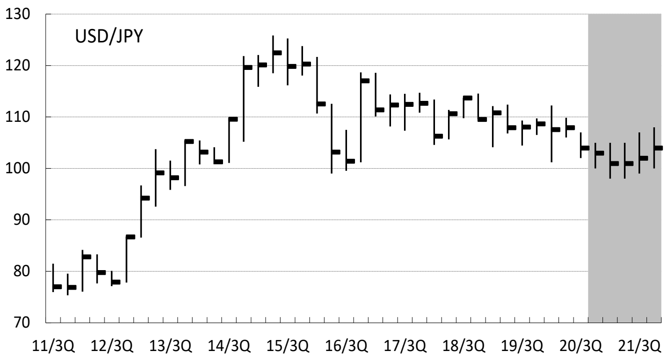
EUR, meanwhile, continues strong. Europe is in the grip of a second wave of infections and lockdowns have been imposed once again in several countries, but this has not given rise to a EUR-selloff mood. As I point out every month, in addition to the perceived overvaluation of USD, which is a significant factor boosting EUR, the euro area's enormous current account surplus (one of the world's largest) also probably works in EUR's favor in a world without interest rate differentials. EUR's real effective exchange rate stubbornly remains at an all-time record high level, and this is bound to be holding back the euro area economy, which is heavily reliant on external demand. It seems very likely, therefore, that the ECB's real desire is to check EUR appreciation, even though it pretends to be worried about inflation stability. The bank will probably choose to expand its pandemic emergency purchase programme (PEPP) as a specific tool for this purpose. Since as early as June this year, the size of the ECB's balance sheet has been greater than that of any other central bank, but EUR has continued to strengthen despite this. This is because current forex market trends are driven almost entirely by the perception of USD overvaluation. Starting early spring, if there seems an end in sight to the pandemic and U.S. interest rates and USD enter into a process of mutually-aided strengthening, the trend could be reversed, but ultimately, things will depend on factors the ECB cannot control, such as the pandemic and the U.S. economy.

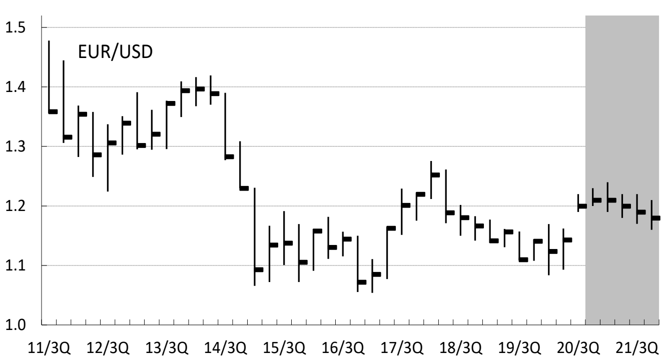
Summary Table of Forecasts

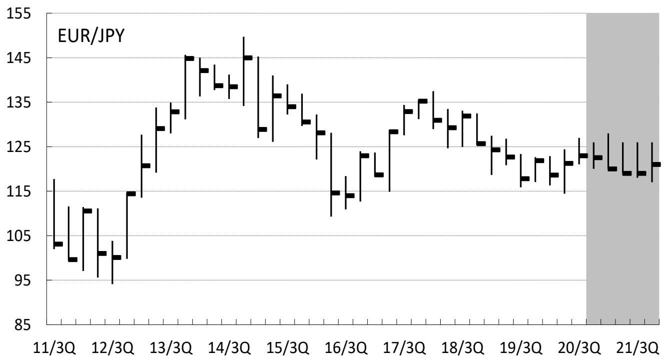
	2020 Jan-Nov (actual)	Dec	2021 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	101.18 ～ 112.23 (103.86)	100 ～ 105 (103)	98 ～ 105 (101)	98 ～ 105 (101)	99 ～ 107 (102)	100 ～ 108 (104)
EUR/USD	1.0636 ～ 1.2014 (1.1972)	1.18 ～ 1.21 (1.19)	1.17 ～ 1.22 (1.19)	1.16 ～ 1.20 (1.18)	1.15 ～ 1.20 (1.17)	1.14 ～ 1.19 (1.16)
EUR/JPY	114.43 ～ 127.06 (124.35)	120 ～ 126 (123)	121 ～ 128 (120)	119 ～ 126 (119)	118 ～ 126 (119)	117 ～ 126 (121)

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

Exchange Rate Trends & Forecasts







USD/JPY Outlook – Points to Note as We Enter 2021

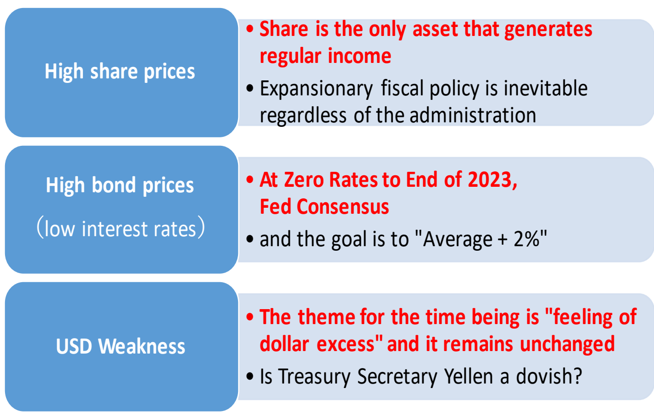
Understanding the Essence of the Financial Markets in Anticipation of 2021 – Beating the Low Visibility

Understanding the Essential Factors

Risk tolerance continued to improve in the financial markets in November as a major U.S. pharmaceutical company announced a successful coronavirus vaccine. As a consequence, share prices increased sharply, interest rate levels rose a notch, and USD depreciated across the board in the forex markets. This triggered what some called a great rotation like no other, while news of a change of president in the United States, which would ordinarily be of utmost significance, got relegated to the sidelines. The New York Dow Jones Industrial Average surging past USD 30,000 is symbolic of this trend. The announcement of an eagerly awaited vaccine combined with uncertainty regarding the outcome of the U.S. presidential election and the nature of the next administration resulted in a diversity of factors influencing key asset market trends, making them difficult to interpret.

The first thing I would like to do is provide an overview of what must be done in order to see through the current uncertainties. To begin with the conclusion, I think the trend of high share prices, high bond prices (low interest rates), and USD weakness, seen in financial markets since before the election, will continue for some time, irrespective of the election's outcome or vaccine announcements. The key points to be considered when formulating a market outlook have not changed much over the past few months (see figure). Of course, it would be a game changer if the vaccine does indeed prove effective, but it would be unwise to factor in something that is still shrouded in uncertainty (there are still many things we do not know, such as, how many times the vaccine will have to be administered in order to be effective, whether there are truly no side effects, and whether it can really generate herd immunity). I also think a change of president is not a strong enough factor to affect a market trend change. Originally, when there arose a possibility that Fed Board of Governors member Lael Brainard could be appointed Secretary of the Treasury, there was concern that Treasury Department appointments could trigger a political depreciation of USD. However, former Fed Chair Janet Yellen was

Essence of major three markets for 2021



(Source) Karakama, Mizuho Bank

eventually picked for the position, giving a greater sense of stability and no more cause for concern. (However, many believe that Ms. Brainard's appointment as the next fed chair may be on the cards in February 2022.)

A State of High Share Prices, High Bond Prices (Low Interest Rates), and USD Weakness

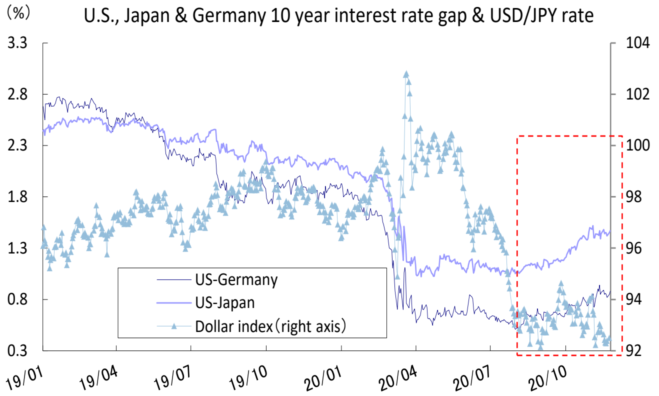
I will briefly explain the conditions behind the recent continued state of high share prices, high bond prices (low interest rates), and USD weakness. First, let us take a look at the high share prices. My basic understanding is that the political situation has very little to do with the consistent share-buying trend seen in recent years. Expectations regarding the development of a vaccine probably have something to do with the trend, but again, not in a substantial way. The key is perhaps to understand that shares are being bought as the only asset type that can provide a regular income in a situation of excess liquidity. This phenomenon, called the "securitization of shares," has been rumored since before the beginning of the COVID pandemic.

Moving on, let us look at the lower interest rates. This does not require much explanation. A consensus has already been reached within the Fed that zero interest rates should be preserved through 2023, and that rate hikes should only begin after an average 2 percent inflation rate has been confirmed. Under such circumstances, with a rate hike expected to take place only in the second half of 2024 at the earliest, there seems no need to worry about higher interest rates regardless of who the president is. In the event that a Biden administration comes to power and implements a large COVID fiscal package as previously predicted, that may result in an inadvertent increase in interest rates that could hurt the actual economy, and deliberate monetary policy measures may have to be taken to rein in the increase. So far, then, it seems that high share prices and low interest rates are the default scenario.

The forex markets are always difficult to predict, but USD has been depreciating across the board due to its perceived overvaluation since July, so it seems my reading of the situation is fairly solid. So long as the pandemic continues, a Biden administration could not afford to boldly go ahead with its proposed tax hikes without fear of an economic downturn. Ultimately, the fiscal expansion path would be pushed to the fore, and the perception of USD overvaluation would remain untended. I, therefore, think a USD depreciation forecast remains effective. In this context, the currency policy stance of Janet Yellen as Treasury Security will be of interest, but I think it unlikely that she intends to willfully manipulate forex markets.

Analyzed this way, it seems that the trend of high share prices, high bond prices (low interest rates), and USD weakness is predicted, from a wider perspective, to continue for some time to come irrespective of the outcome of the U.S. presidential elections. Of course, a cause-effect relationship between the prices of individual assets and the outcome of the presidential election cannot be ruled out absolutely, but I think it is important to get a wider and longer-term perspective on asset prices rather than focusing on highly customized interpretations for each asset as and when it moves. The essential factors as I see them include share buying as a consequence of the extremely low interest rate situation, the probability of zero interest rates for the next three years to come, and the perceived overvaluation of USD as a result of the enormous U.S. fiscal deficit, and they have remained unchanged for some time now. I believe that they will remain the most significant factors determining the gist of the outlook for some time to come.

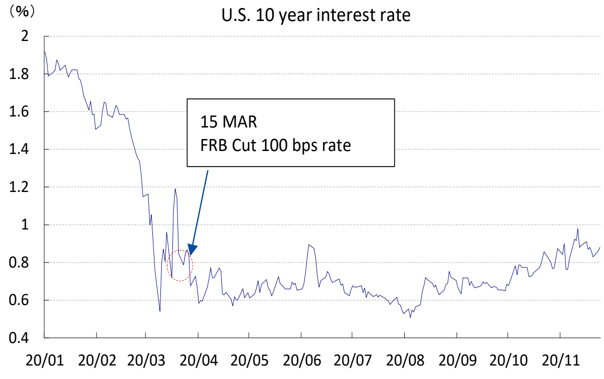
Forex Markets Unable to Keep Up with USD Buying



(Source) Bloomberg

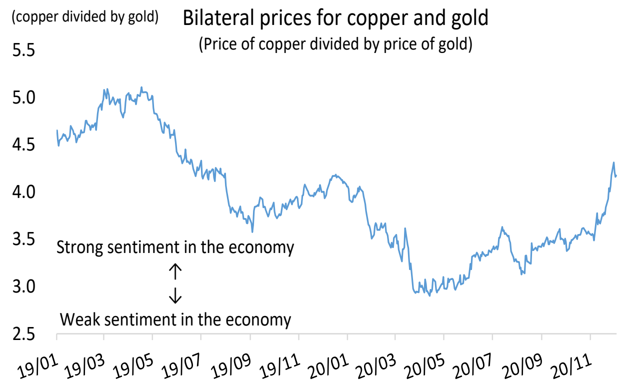
Forex market trends become easier to understand if studied on the basis of the above essential factors. USD was not significantly bought against either JPY or EUR despite high expectations regarding an effective vaccine. As the figure shows, U.S. interest rates increased to expand the U.S.-Japan as well as U.S.-euro area interest rate differentials following news of Joe Biden's possible victory coinciding with news of an effective vaccine. This did not result, however, in a corresponding trend of USD buying (having said that, the increase in U.S. interest rates also peaked out fairly soon). There may be any number of reasons for this, but ultimately, it all boils down to the universally acknowledged fact that the Fed would not tolerate a continued increase in U.S. interest rates, and investors have no reason to deliberately buy USD when there are no prospects for an increase in U.S. interest rates going forward – in other words, USD is stable at its current level of weakness.

Were Vaccine Announcements a Game Changer?



(Source) Bloomberg

With several successful vaccines being announced in a spate of positive news in November, I was asked several times at seminars and interviews if this meant we were now in the post-COVID phase. Going forward, when we look back at this time as part of the sequence of events, it is certainly possible that we might see it as a game-changing moment signaling entry into the post-COVID phase. However, going by trends in the financial markets, my impression is that it would be premature to come to that conclusion already. Below, I would like to present my reasons for believing this. It is true that the level of U.S. interest rates increased a notch in November. The equity and forex markets are prone to transient mood swings, but the bond markets, which mainly comprise more professional participants, tend to provide a more dispassionate view of the situation, and it has to be said that the message emerging from the bond markets appears to be in the process of changing. The U.S. 10-year interest rate level temporarily hit 0.97% or so following vaccine reports, and is currently trending around 0.90%. This is still historically low, but considering that the level was trending at around 0.50% in July-August this year, the increase is significant. <u>Incidentally, the 10-year interest rate level was around 0.9% in mid-March, just before the Fed cut rates by 100 bps</u>; i.e., before the U.S. adopted a zero interest rate policy (ZIRP). In that sense, it is natural for there to be a lot of interest in whether the vaccine announcement might be a game changer.



(Source) macrobond

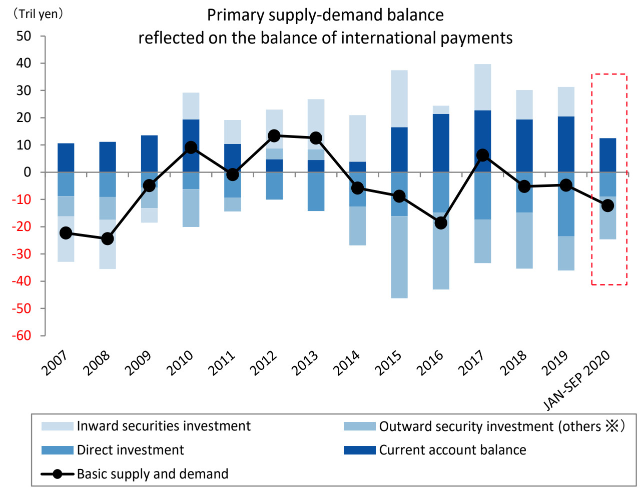
Incidentally, during the July-August period, when the 10-year interest rate was at the 0.50% level, gold prices were often in the headlines for renewing all-time record highs. In this connection, I have consistently indicated in this report that such trends are no more than a by-product of excess liquidity, and that a rise in gold prices due to the COVID pandemic would not last very long. I have also stated that a more objective view of the current situation could be obtained by comparing the ratio of copper to gold prices (the copper-gold ratio), which is a strong indicator of business confidence and also, therefore, a leading indicator of the global economy. <u>The figure shows the trend of the copper-gold ratio over the past couple of years. As one can see, it has recently continued to renew record highs not seen since the start of the COVID pandemic in March. It is, therefore, understandable that market participants want to take this as a sign that we have entered the post-COVID phase</u>.

Still No Positive Correlation Between U.S. Interest Rates and USD

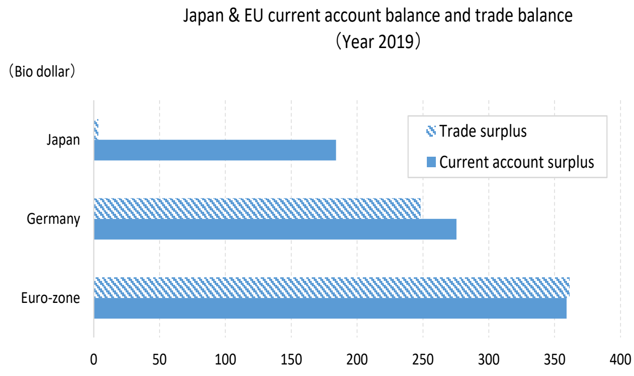
However, as mentioned above, the increase and peaking of U.S. interest rates has not triggered a corresponding increase in USD buying. Different people interpret this in different ways. <u>My interpretation is that it is possible for U.S. interest rates to be within the range of 0.5-1.0% under ZIRP, and that its current level of increase, therefore, lacks the power to change the USD selling trend</u>. If the 10-year interest rate shifts upward and rises clearly above the 1.0% level, it could bring back a trend of USD buying. As mentioned above, that would also be an indication of a return to pre-ZIRP bond markets. For this to happen, the Fed would have to issue some kind of communication regarding the rise in interest rates. However, such a communication can hardly be expected as it was only in August that the Fed issued its new “average inflation rate target of 2%” policy strategy, and the dot plot also revealed a consensus on preserving ZIRP until the end of 2023. In recent days, the mood of pessimism surrounding the rising infection rates seems stronger than the mood of optimism over vaccine availability. So, it seems unlikely that the Fed will adopt a more hawkish stance even if it refrains from adopting a more dovish one. The strong response to vaccine announcements was merely the flip side of the coin from what many consider a foregone conclusion that low interest rates and a weak USD are the future, and a rollback seen precisely because of this. As I will explain again later, a “bright future” is no more than an “upside risk” for the markets at this time.

Ultimately, <u>unless U.S. interest rates and USD rise in concert, my basic understanding is that it would be difficult to consider the vaccine announcements to be a game changer signaling the start of post-COVID rates</u>. Further, as explained above, given that share price highs have been a nearly constant phenomenon in the markets in recent years, it seems pointless to analyze them in detail to find out whether or not they signal that vaccine announcements were a game changer. I would like to reconsider my outlook path when U.S. interest rates and USD rise in tandem consistently over a period of time.

The Key to Understanding JPY Supply and Demand – Net JPY Selling May Keep USD/JPY From Crashing



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

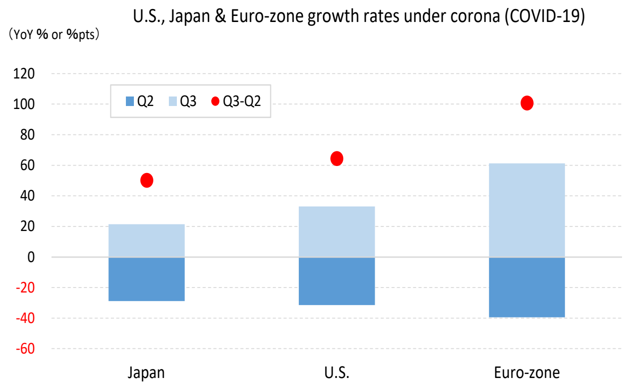


(Source) Ministry of Finance Japan, ECB, Bundesbank of Germany & Bloomberg

Keeping in mind the essential factors affecting the financial markets described above, I would also like to take a look at the JPY supply and demand in formulating my outlook for USD/JPY. In this context, it must be noted that the JPY supply-demand balance for 2020 so far is more heavily tilted toward a net JPY selling than it has been in recent years. The January-September 2020 supply-demand balance is around -JPY 12.2 trillion, which is more than twice that for the same period last year (-JPY 4.7) or the year before last (-JPY 5.2 trillion). The main reasons for this increase in net JPY selling include the higher trade and service deficits as well as a decline in inbound securities investment. My guess is that this supply-demand climate is the reason why JPY appreciation against USD has been weaker than EUR appreciation against USD in the wake of the steep fall in U.S. interest rates. In this context, it will be worth paying attention to whether the trade surplus trend seen through October 2020 will continue going forward (the latest release is the October trade balance, which revealed a surplus of +JPY 872.9 billion, the largest surplus for this year so far).
The euro area and Japan have the world's largest and second largest current account surpluses, respectively, but while the euro area's current account surplus comprises predominantly of a trade surplus (which promotes outright buying of the domestic currency), Japan's current account surplus mainly comprises a primary income surplus that is expected to be reinvested as is, in the form of foreign currency (see figure to the right). My aforementioned essential factors corroborate my forecast of a decline in U.S. interest rates and across-the-board depreciation of USD in terms of direction, but the JPY supply-demand situation indicating net JPY selling seems likely to moderate the extent of these. On the other hand, the overwhelming demand for EUR will help boost its purchasability.

U.S., Japanese, and European Real Economies Going Forward – Of Note are Yoy Comparisons

Reviewing the U.S., Japanese, and European Growth Rates



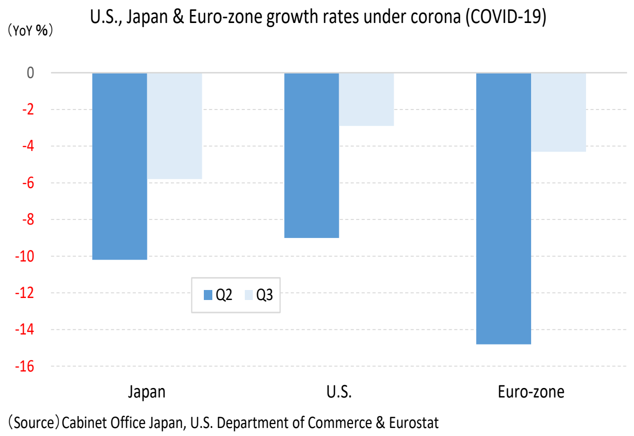
(Source) Cabinet Office Japan, U.S. Department of Commerce & Eurostat

In November, the July-September real GDP growth rates for the U.S., Japan, and Europe all became available. All three regions posted significant, headline-grabbing rebounds compared with the previous (April-June) quarter, during which lockdowns were widely imposed. For instance, Japan's July-September quarter qoq growth rate was reported to be the highest seen in 52 years. I find this trend of sensationally reporting the annualized qoq growth rates of periods characterized by very special circumstances quite discomfiting. Annualized qoq growth rates are like instantaneous wind speed. All they tell you is that you will get such-and-such figures so long as you continue at such-and-such given speed. As an indicator, they are best used during normal times. Even during normal times, it is extremely rare that the growth rate achieved during any given quarter is replicated during the other three quarters, resulting in the same level of growth for the entire year. Annualized qoq growth rates are favored for news reporting because they tend to sensationalize the figures, but my position is that they should not be used aggressively, given the potential to overestimate or underestimate the situation. If one really wants to know the extent of recovery in July-September from the severe damage incurred during April-June, a simple method is to look at simple qoq figures.

Having said that, since most news reports essentially use annualized qoq figures, this is probably the figure readers are used to. Therefore, while not considering annualized qoq figures appropriate, I still decided to use them in the figure to compare the April-June and July-September annualized GDP growth rates for the U.S., Japan, and euro area (N.B.: the figure represents them as Q2 and Q3 to save space). The euro area saw the most dramatic changes both in terms of the decline during Q2 and the recovery during Q3. As a result, the margin of recovery (i.e., Q3 - Q2) is much higher for the euro area than for the U.S. or Japan. I have argued in past reports that this relatively high growth rate reported for the EUR area may be contributing to EUR's strength. Japan's margin of recovery, meanwhile, was the lowest despite the country seeing lower COVID infection rates compared with either the U.S. or Europe. Intuitively, this seems like an extremely unhappy outcome.

The Importance of Noting that Economic Growth has Declined Yoy

The above section, however, mainly looks at qoq figures. Both the sharp decline during Q2 and the sharp recovery during Q3 were anticipated in advance, and the information did not have much added value. What is more interesting to most people is – when will the economy recover pre-COVID growth rates? In that sense, it is easier to assess the damage due to COVID and understand the distance remaining to normalization by performing a simple yoy comparison using the original data (before seasonal adjustment). As the figure shows, both Q2 and Q3 posted yoy declines as expected. In this context, the dramatic headlines over the past six months announcing sharp declines and sharp rebounds ultimately boil down, in yoy terms, to an overall negative growth. If we insist on comparing quarters for the current year, it may be best to compare the growth rates of Q1 and Q3, which would give a more honest picture.



Under such circumstances, with various policy measures having already been taken, now (Q4 and onward) is the time of real battle to overcome the winter, when infections are expected to spread in earnest. Lockdowns are already being reimplemented across Europe, but the decision to completely shut down economic activity as in early Spring this year has not yet been taken. Given that yoy decline in real economic performance has already become the standard, perhaps the authorities want to avoid a complete shutdown as a step that could irreversibly damage the economy. As effective vaccines are announced in rapid succession, they are likely to be increasingly seen as a game changer going forward. The high annualized qoq growth rates reported by the media are likely to further boost the mood of optimism. However, unless yoy growth rates consistently turn positive, could we really consider that we are now in a post-COVID phase? In addition to the continued rise in U.S. interest rates and a corresponding USD buying trend, I would like to pay attention to yoy growth rates turning positive as one of the signs that we are truly in a post-COVID phase.

Risks to my main scenario – Troublesome Aspects of "Not JPY Appreciation, but USD Depreciation"

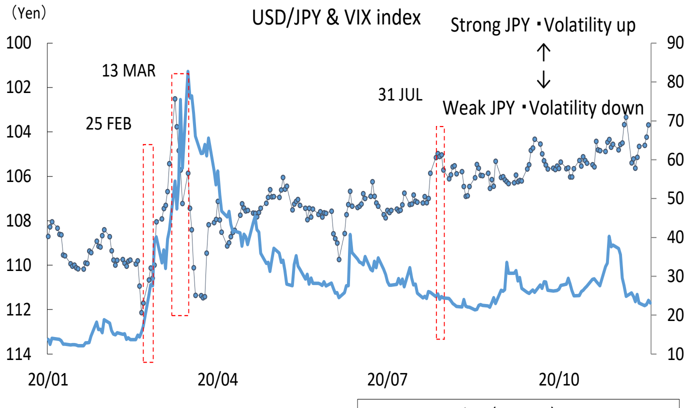
Japanese Politicians' Concern about JPY Appreciation Growing?

The greatest risks associated with this article's main forecast scenario continue to be related to the coronavirus pandemic's prospective spread and termination. However, since this article has already been discussing such risks individually each month, this time I would like to consider risk factors from other perspectives. Looking back at USD/JPY movements so far this year, the overall trend has been a quite stable one (despite considerable fluctuations in the January-March quarter) suggesting JPY has the characteristics of a "long-established safe currency". Looking ahead, it is hard to imagine USD/JPY-related turmoil in the foreseeable future. It appears that a fundamental reason for this may well be that – as the "world without intercurrency interest rate gaps" and "world without international product price differences" trends become stable – it is becoming difficult to theoretically justify the use of interest-rate parity and purchasing power parity approaches to explaining forex rate fluctuations.

However, financial markets (particularly forex markets) can be volatile for political reasons, as economic and financial conditions prompt price trends irrespective of fundamental factors. While appearing before the House of Councilors' Committee on Financial Affairs on November 20, Japan's Finance Minister Taro Aso was asked about the JPY appreciation trend, and he responded that – "It would be more-correct to call it USD depreciation, which is causing JPY to appreciate." This statement was not considered a market-moving factor in the forex market. As USD/JPY has been relatively stable in recent years, many had a sense of nostalgia about an opposition party politician (in this case, Yoshimi Watanabe, previously a Your Party House of Representatives member) asking the finance minister to respond to a question about USD/JPY, but it seems that USD/JPY is approaching a level that is eliciting concern even from Japanese politicians. Certainly, at the time of the House of Councilors' Committee on Financial Affairs meeting

USD/JPY had become stable in the JPY103-104 range, and a gradually growing number of forex market participants were beginning to notice that the rate was becoming quite close to descending into double-digits. However, Finance Minister Aso's answer is correct. As mentioned above, the U.S. 10-year interest rate began rising just before the U.S. presidential election, but the stable low level of the Japan-U.S. interest rate differential has been associated with USD weakness. As already discussed, while the U.S. 10-year interest rate is currently in the 0.5-1.0% range, it appears that the forex market is operating based on the premise that the FRB will sustain a zero interest rate policy, and it is probably unrealistic to expect that a modest interest rate increase such as that seen recently would spur greater USD buying. Some people are inclined to be suspicious of the "it's not JPY appreciation but USD depreciation" view (suspecting it to be an excuse for avoiding JPY-selling intervention to weaken JPY, etc.), but it seems that Finance Minister Aso simply stated the facts of the situation.

Current Trend Not "Risk-Off JPY Appreciation"

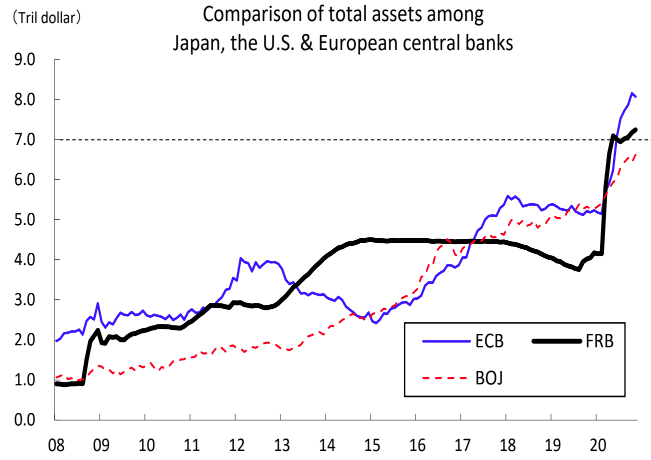


(Source) Macrobond
(Note) Dotted square indicates the date of the tripartite meeting

In November I received many inquiries about whether the Japanese government and/or the BOJ would take any actions to counter the JPY appreciation trend. I don't think they will take such actions. During the previous Abe administration, every considerable-margin drop in USD/JPY led to the convening of a meeting including representatives of three organizations – the Ministry of Finance, the Financial Services Agency, and the BOJ. These meetings were intended to restrain JPY appreciation by issuing such statements as – "We shared the recognition that market stability is extremely important and that it is important to closely monitor such trends going forward." – but were not accompanied by the launch of actual policy measures. However, they did serve as a barometer helping observers to estimate the crisis consciousness level within the government and BOJ. From the start of this year through the time this article was written, such meetings were held in February and March, and the most recent meeting was in July, but no such meetings have been convened since, and none has been held since Yoshihide Suga became prime minister. Of the three meetings this year, those in February and March were held to discuss pandemic-related "risk-off JPY appreciation" trends involving a volatility surge accompanied by hysterical price movements. If such trends were to recur, it seems almost certain that a three-party meeting will be held in response. In July, market volatility was trending downward, but toward the end of the month U.S. and European stock prices dropped sharply, while the Nikkei Stock Average fell during six consecutive days through July 31, when it closed at the lowest level seen in a month and a half. So there is no doubt that the July meeting was in response to "risk-off JPY appreciation" (although the official explanation presented in July was that the meeting enabled face-to-face interaction among new members following personnel changes).

In contrast, the JPY appreciation since early November has occurred at a time when Japanese, U.S., and European stock prices have been booming, and the JPY appreciation has been entirely a by-product of across-the-board USD depreciation driven by perceptions of excessive USD values and the continued low level of U.S. interest rates. If USD is depreciating in line with the fundamentals following the deployment of U.S. fiscal and monetary policies in response to domestic challenges, objectively speaking, it will be difficult for the Japanese government and BOJ to raise concerns about that situation. The euro area is keenly feeling the burden of its currency's appreciation against USD, so it is not just Japan facing this situation. The obvious implication of Finance Minister Aso's view that "it's not JPY appreciation but USD depreciation" is that the situation is not amenable to being dealt with through measures focused on JPY alone, and I believe that is an accurate assessment.

The Most Fearsome Prospect



(Source) Macrobond (Note) Mid-November 2020 figures

Going forward, the Japanese political and economic risk that should be most feared is JPY appreciation attributable to "insufficient easing" on the part of the BOJ. Some observers are already explaining JPY's strength in this way, but at this point, I think the thing the BOJ should strive most proactively to avert is a scenario in which a perception that "the BOJ's monetary easing is inferior to that of the Fed and the ECB" becomes widespread enough to become a self-fulfilling prophecy of JPY appreciation. There is no theoretical basis for expecting such easing inferiority to drive JPY appreciation, but if you compare the sizes of the leading central banks' balance sheets – which forex market participants like to do – it certainly does appear that the BOJ is lagging behind the others. While I personally don't agree with the argument that easing volumes are directly linked to currency values, the financial markets (especially the forex market) are indeed sometimes influenced by such arguments. Even if one focuses on BOJ easing volume "compared to the Fed and ECB," if such comparisons were to become widely made, it is probably the ECB that would be the main target of the comparisons. Across-the-board USD depreciation can be considered the default route in line with the fundamentals, and the BOJ and ECB are seeking to countervail pressures stemming from this default route with respect to JPY and EUR. As previously reported, the ECB is expected to launch additional easing measures at its December Governing Council meeting, and it already at this point is positioned to make the most of its claim to having the world's largest balance sheet. If it comes down to a simple comparison of easing "quantity", the BOJ has no chance of winning. Only the BOJ boasts a balance sheet exceeding its country's annual GDP, but if it were to modify its policies in any manner other than one promoting additional easing, the forex market is likely to unilaterally embrace a self-fulfilling prophecy of JPY appreciation. If an independent JPY appreciation trend were to begin progressing in this way, Japan does not seem to have any effective countermeasures available to it, and that is why such a trend might be considered the most fearsome prospective risk scenario from the perspective of the Japanese economy.

EUR Outlook – "Two-Stage Approach" to Countervailing EUR Appreciation

EUR Area Monetary Policies and EUR – Unstoppability of EUR Appreciation

Expectations during November Regarding the December Governing Council Meeting

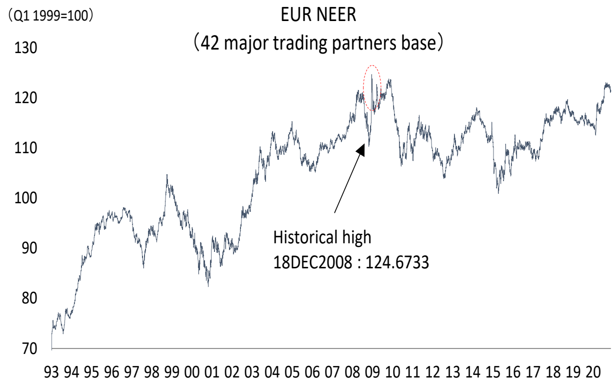
Although there was no ECB Governing Council meeting in November, expectations regarding the December Governing Council meeting intermittently became a hot forex market topic owing to the Governing Council's October announcement of prospective easing. For example, the ECB's annual meeting was held online on November 11, and many market players considered ECB President Christine Lagarde's keynote speech at that meeting noteworthy. In recent years, the ECB's annual meeting held every June in the Portuguese city of Sintra has been the focus of considerable attention, on a par with the Fed's Jackson Hole Economic Policy Symposium. This reflects former-ECB President Mario Draghi's speech at the June 2017 meeting, in which he stated that – "Deflationary forces have been replaced by reflationary ones." – and thereby spurred a bout of sharp EUR appreciation. Since then, speeches at the Sintra meetings have been considered full-fledged sources of market-moving factors. It proved difficult to hold the meeting this past June, however, and as the postponed meeting was an irregular event held online, it seems that many market participants were not aware of it in advance.

Since the November 11 meeting was President Lagarde's first annual meeting, I was among the many people who were keenly interested in reading her keynote speech. The content of the speech was largely as expected, and it reiterated the possibility that additional easing measures would be launched at the December Governing Council meeting. Specifically, President Lagarde said – "While all options are on the table, the PEPP and TLTROs have proven their effectiveness in the current environment and can be dynamically adjusted to react to how the pandemic evolves. They are therefore likely to remain the main tools for adjusting our monetary policy." This was tantamount to an announcement that additional easing measures in December was the default route and that the measures would involve adjustments to the PEPP and the TLTROs.

While this kind of frank information dissemination has been evaluated favorably at this point, it might also be considered potentially problematic in that it creates expectations that might be disappointed when the prospective easing measures are actually announced. As explained below, the ECB is currently fighting against EUR appreciation as well as against trends of weakening in the euro area's real economy and inflation rate. The forex market often responds with relentless negativity when its expectations are disappointed. Given that the forex market as well as other financial markets often factor in expectations regarding the "most extreme potential scenario", it has widely come to be considered more effective to make policy adjustment decisions suddenly while avoiding giving prior notice of additional easing measures. At the time this article was written, it was generally believed that the median of market expectations regarding the PEPP was "a 6-month extension amounting to EUR500 billion of liquidity", and one key point that can be anticipated is whether the actual PEPP adjustment will exceed or fall short of these expectations.

EUR Appreciation Unaffected by Second Pandemic Wave

At the time this article was written, a full-scale second wave of the covid-19 pandemic had commenced in Europe, and there are indications that associated restrictions of economic activities will gradually become stricter going forward. A scenario in which the euro area's real GDP qoq growth rate becomes negative again in the October-December quarter is no longer unrealistic, but there is as yet no sign that the EUR appreciation trend that has continued since May might be undercut by the weakening of the real economy. The degree of EUR appreciation that has already taken place can be understood by the fact that the EUR nominal effective exchange rate (NEER) is close to its all-time record high level (124.6733, recorded on December 18, 2008). As the euro area economy is dependent on external demand to a considerable extent, there is great concern that effective basis EUR appreciation will restrain euro area exports and thereby further depress the euro area economy's growth rate.



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

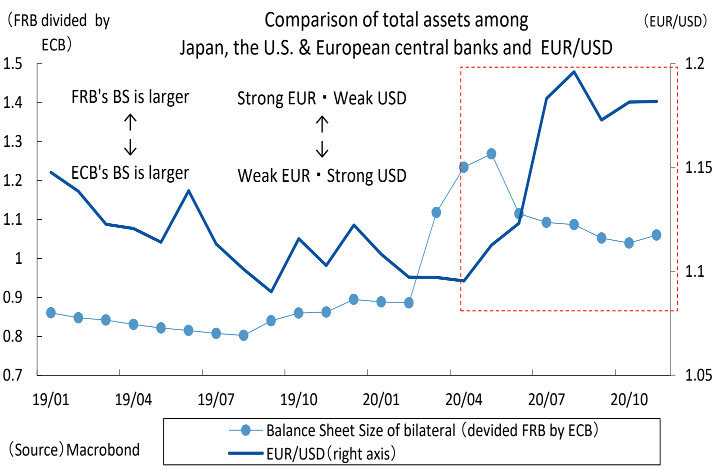
Since the end of October, growing anticipation of a second pandemic wave in Europe caused the EUR NEER to temporarily weaken, but it soon began rising again, and it is generally expected that the high level of the EUR NEER will not be adjusted downward going forward. Although the Account of the September Governing Council meeting included a suggestion that – "it was the pace of the euro's appreciation, rather than the level of the exchange rate, that could become a concern." – it is not hard to see that the EUR NEER's current sustaining of a high level following a rapid rise means the actual situation involves both a pace problem and a level problem. The September Governing

Council meeting's statement indicated that – "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 the fact that that text was retained in the October Governing Council meeting's statement (albeit expanded with the insertion of – "including the dynamics of the pandemic, prospects for a rollout of vaccines") suggests that the effect of EUR appreciation on the euro area's economic and inflation outlooks continues to be an important issue from the ECB's perspective. It seems highly likely that concern about EUR appreciation is among the factors motivating the ECB to give prior indications that additional easing measures will be launched in December.

Easing "Quantity" Incapable of Countering EUR Appreciation

Both President Lagarde, in her abovementioned speech, and ECB Chief Economist Philip Lane, in the interview discussed below, came close to confirming that the default policy route will involve PEPP extension and expansion in December. There is also likely to be an adjustment to the TLTROs. Another possible move might be to further expand the EUR120 billion temporary envelope of the asset purchase programme (APP) that was created in March. In the case that the PEPP is extended for half a year with an additional EUR500 billion envelope and that the APP is given a EUR180 billion envelope for the entirety of 2021 (Based on results so far, an addition of about EUR15 billion per month would be sufficient, and that figure for 12 months would amount to EUR180 billion.), it seems that the headline figure of additional easing quantity might be somewhat less than EUR700 billion. Would that be sufficient to impress and affect the forex market? It would be considered eminently reasonable to subsequently adjust the amount used if more-rapid-than-anticipated progress were to be made in vaccine development and deployment, so even if it is now firmly asserted that the envelopes will be fully used, there should be no problem if it turns out that the figure was a notional one employed largely to impress the forex market. The December easing measures thus appear to be extremely appealing and convenient for the ECB.

However, it does not seem likely that EUR appreciation will be curbed as a result of those measures. The graph on the right is a so-called Soros chart showing the relationship between the Fed-ECB balance sheet (BS) ratio (Fed BS ÷ ECB BS) and EUR/USD. It shows that EUR has continued appreciating against USD since June, even after the ECB surpassed the Fed's BS scale and became the central bank with the world's largest BS. This seems to strongly indicate that the expansion of easing "quantity" is not capable of curbing currency appreciation. Having presented the argument many times, I will try to state it concisely – it is quite possible that the euro area's recording of the world's largest current account surpluses and trade surpluses is an indirect cause of EUR appreciation. Over the medium to long term, the euro area's disinflationary situation may also have contributed to EUR appreciation. Seeking to fight against such legitimate currency appreciation-promoting factors by increasing base money (despite the lack of a theoretical basis for expecting that to effectively promote currency depreciation), will result in the playing of a monetary easing policy card to no avail. Although the expansion of base money may sometimes exert an effect by means of "influencing expectations," it is actually a vacuous approach incapable of independently promoting inflation or manipulating forex rates That is something that has been clearly demonstrated by Japan, a former trade-surplus leader that has been perennially plagued by the undesired appreciation of its currency. The ECB will probably muster up and display a considerable amount of easing "quantity" in December, but that unfortunately cannot be expected to curb the EUR appreciation trend.



(Source) Macrobond

EUR Area Monetary Policies Now and Going Forward – "Two-Stage Approach" a New Term for Japanification?

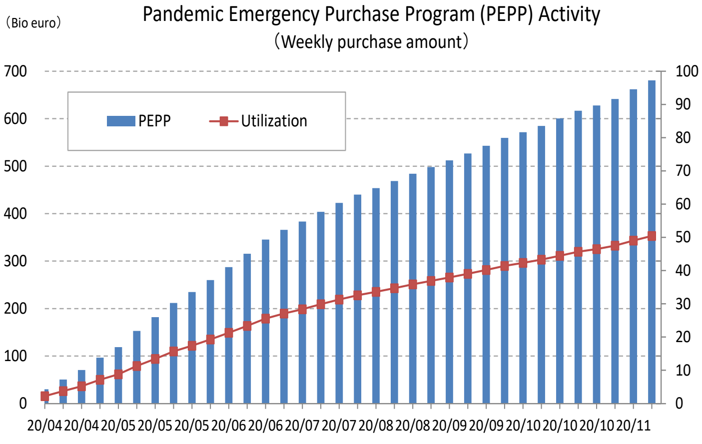
The ECB Chief Economist's View

ECB Executive Board member and chief economist Philip Lane was interviewed by the France-based newspaper Les Echos on November 22, and the interview's transcript has been posted on the ECB's website site. Many of Mr. Lane's previously presented speeches have also been newsworthy, but I would like to offer an overview of the November 22 interview here, as it offers insights into the logic underlying the policy measures expected to be approved at the December Governing Council meeting as well as other policy making decisions to be made thereafter[1]. As Chief

[1] ECB "Interview with Les Echos" Interview with Philip R. Lane, Member of the Executive Board of the ECB, conducted by Guillaume Benoit, Elsa Conesa and Sophie Rolland

Economist Lane is currently the ECB Governing Council member with the most respected theoretical expertise regarding monetary policy management, it will be very helpful to understand his way of thinking. Given that President Lagarde is not considered to have much monetary policy expertise, some observers believe Mr. Lane is the is actually the key Governing Council member with regard to policy management decisions. During the interview, the reporter posed the question – “What metrics will you look at to decide when to terminate the pandemic emergency purchase programme (PEPP)?” – and Mr. Lane responded that – “We won’t terminate the programme until certain conditions have been met.” As a forex market participant, I am eager to know exactly what the “certain conditions” are, and in this regard, Mr. Lane said– “First of all, the pandemic must no longer interrupt normal economic activity.” – and he then went on to say – “We will also have to establish other conditions in terms of economic recovery and inflation dynamics, but it’s still too early to do this.” This two-stage approach is in logical alignment with Director Lane’s speech at the Jackson Hole Economic Policy Symposium (which is important and will be discussed later).

It is important not to overlook what Mr. Lane said next – “The programme was originally designed to last until the end of June [2021], but we have always said that it would continue until the crisis phase is over.” – as it offers a hint about what to expect from the December Governing Council meeting. This can be interpreted as suggesting that the original “end of June 2021” end point will be postponed to at least the end of December 2021. (A three-month extension seems unlikely given that previous scheduling decisions have focused on mid-year and year-end dates.) In that case, it is useful to consider how much “quantitative” expansion would be required for the additional 6 months. In light of the average monthly PEPP usage so far, this article estimates that the ECB will come up with the figure of EUR500 billion. Since more than half of the PEPP’s original envelope has not yet been used (see graph), the EUR500 billion figure should be more than sufficient for a six-month extension/expansion.



(Source) ECB (Note) Utilization =Divide the cumulative purchase by the total line

PEPP Becomes an “Ordinary Policy”

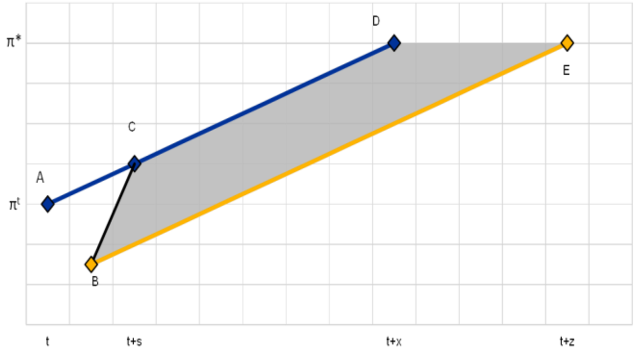
The ECB’s official view is that PEPP has a dual function, as is suggested by Mr. Lane’s statement above and as was clearly articulated by President Lagarde at a recent press conference. PEPP has been designed to achieve the dual objectives of (1) stabilizing markets and promoting the smooth transmission of monetary policies and (2) stimulating the economy and promoting an increase in the inflation rate. It has also been repeatedly emphasized that, unlike ordinary asset purchasing programs, the PEPP has the advantage of flexibility, in that it enables assets to be purchased without the need to consider such restrictions as those dictating conformance with the capital key, the credit rating of assets to be purchased, and the limiting of monthly purchase amounts. This is because, in view of the extremely great importance of objective (1), many restrictions were forgone so as not to impede the expeditious attainment of that objective. It is indisputable that the situation during the February-April period of this year was indeed a crisis requiring that kind of extraordinary countermeasures.

In light of the fact that Italy’s 10-year interest rate has hit a record low level, however, it can be said that there is no longer a need to employ PEPP to attain objective (1). While the PEPP was originally created as an emergency response measure focused on objective (1), it is now actually only objective (2) that can be cited as justification for the PEPP’s continued existence as a main monetary policy tool. This logic became conspicuous when the PEPP was expanded this past June. At the press conference following the June Governing Council meeting, a reporter asked whether the PEPP was not intended to be a short-term, emergency response measure, and President Lagarde responded by explaining the dual function/objective view as described in the previous paragraph. (She used the term “dual key” at that time.) After being launched as an extraordinary emergency measure at the extraordinary Governing Council meeting in March, the PEPP just three months later came to be casually referred to as a “ordinary policy”. It seems that Governing Council members from Germany and other relatively hawkish Governing Council members may not have supported this approach but have refrained from conspicuously dissenting so as to promote harmonious operations amid the emergency situation. There is concern that this issue might – at some future time when the economic and financial situations have become more stable – grow to become a problem that promotes divisions within the Governing Council.

"Two-Stage Approach" Logic Pervades ECB Policy Management

It is worth noting that the above-mentioned dual-objective approach is not limited to the PEPP but represents a kind of logic that has now pervaded all of the ECB's policy management. At the Jackson Hole Economic Policy Symposium this summer, Mr. Lane described the ECB's policy stance as being a "two-stage approach." Those interested can refer to the speech itself for more details, but the gist of it is that after restoring the pre-pandemic inflation trajectory during the first stage, the price target is to be reached during the second stage (by different means than in the first stage). In his speech, Lane said – "the PEPP (in combination with the other monetary policy instruments) is designed to accomplish this first-stage task." He suggested that PEPP's suspension would not be considered until after it is confirmed that pre-pandemic inflation trajectory has been restored, and this point is in line with several statements cited above. After the pre-pandemic inflation trajectory has been restored, Mr. Lane said the ECB will shift to the second stage, in which it will adopt a "post-pandemic monetary policy stance". It is not yet clear what the second-phase policies will be, but given that they should be smaller-scale policies than the PEPP it seems likely that the ECB may shift its focus to such tools as the traditional asset purchase programme (APP) and forward guidance.

Image of "Two-stage approach" by ECB management

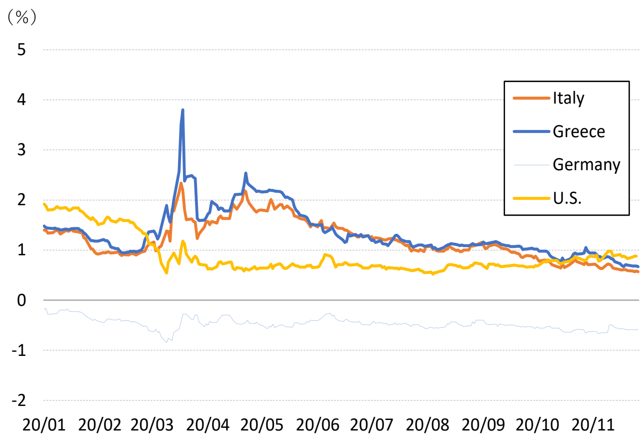


(Source) ECB

The general shape of the first-stage policy management is shown in the graph on the right. The vertical axis represents inflation and the horizontal axis represents time. The blue A-D line is the pre-pandemic inflation trajectory, and it is believed that the pandemic shock has shifted the current inflation rate downwards from A to B. In the absence of such bold measures as the PEPP, it is expected that inflation trajectory will be forced to follow the yellow B-E line. In view of this, the ECB's plan is to first restore the inflation rate from B to C through first-stage measures centered on the PEPP and then use second-stage measures to strive to raise the inflation rate along the C-D line, thereby reaching the D level at a point in time that is earlier than the E time point. The remarks made by Mr. Lane in the previously mentioned interview suggest that the PEPP is to be sustained because the ECB is currently still in the process of trying to move from B to C. All in all, this argument is quite straightforward, and it currently seems likely to be accepted by the financial markets as a reasonable portion of the ECB's "dialog with the markets". However, such explanations and charts are eerily reminiscent of the theory employed by the BOJ since soon after BOJ Governor Kuroda's inauguration, which can be concisely summarized as – "By influencing expectations, bold monetary easing measures can dispel sticky deflationary mindsets and raise inflation expectations." Given that it has ultimately been demonstrated that Japan's economic and inflation situations cannot be changed by means of monetary policies alone, it is hard to be optimistic about future developments regarding the ECB and the euro area.

Concerns about Non-Linearity and Diminishing Returns

Unusually depressed long-term Eurozone rates



(Source) macrobond

The media and the markets tend to focus on the positive aspects of additional easing, but the Account of the October 30 Governing Council meeting (released on November 26) includes some expressions of concern about negative situations. The Account notes that financial markets have remained calm despite the onset of a second pandemic wave and takes pride in that, saying that the calmness is "evidence of the effectiveness of the ECB's monetary policy measures", but it also notes that the markets remain vulnerable to such risks as those associated with a "no deal" Brexit, an increase in the severity of the pandemic, and delays to the implementation of the EU recovery fund proposal. In addition, Governing Council members expressed concerns that additional asset purchases may not generate the expected effects on financial conditions and the real economy owing to such factors as "possible non-linearities, side effects and "diminishing returns"". Non-linearities may be a concern with respect to such situations as abrupt asset price adjustments or disruptions of the real economy following a "no deal" Brexit or the reintroduction of strict lockdown regimes. Based on their experiences since this spring, market participants are probably quite well aware of how such things can happen.

It is particularly interesting to see the emergence of the phrase “diminishing returns”, which may indirectly indicate concerns that conventional monetary policy methods may be losing their effectiveness. For example, such situations as the unintended rise in interest rate levels and sharp fall in stock prices during the period from February through June could be seen as indications that monetary policies were not actually exerting all their intended effects. Currently, however, the 10-year interest rate levels of the most heavily indebted euro area countries – Italy and Greece – are intermittently hitting record lows, and that of Germany is -0.60%. Given that the 10-year interest rates of Greece are lower than those of the United States, it is not surprising that some observers are wondering what the real point is of the further augmentation of easing measures. It seems apparent that the euro area is embroiled in the kind of “liquidity trap” situation with which Japan is already highly familiar, but it also appears clear that the euro area is still quite far from officially recognizing that situation.

Returning to the above-mentioned issue of EUR appreciation, it is important to recognize that the current trend of EUR appreciation has occurred despite all the strenuous efforts made so far to prevent it. If one notes the lessons that can be learned from the BOJ’s experience, one will consider it highly likely that the ECB’s playing of additional policy cards aimed at countervailing EUR appreciation will prove to be futile. It would seem much wiser to – to the greatest possible extent – resort to “time-buying” policies (such as moves to strengthen forward guidance) that are easy to withdraw and are relatively cost-effective.

Monetary Policies Working “Hand in Hand” with Fiscal Policies

In light of the euro area’s overall situation, it should be recognized that concerns and countermeasures should not be disproportionately focused on the EUR appreciation situation – there is an urgent need to devise and implement a full range of macroeconomic policies designed to directly boost the euro area’s real economy. However, just about the only thing that the area’s central bank can do in the “liquidity trap” situation is to maintain the current interest rate environment. The Account of the October 30 Governing Council meeting emphasized the importance of ensuring that monetary policies were working “hand in hand” with euro area countries’ fiscal policies, and that can be interpreted as an indirect expression of a hope that the ECB’s maintenance of low interest rates will support and promote those countries’ efforts to make their fiscal policies more proactive. While there previously used to be a taboo on central banks’ expression of such a hope, it seems that expressing such a hope would probably be considered quite reasonable amid crisis conditions.

The ECB seems to be aware that it verging on breaking a traditional taboo, as the Account mentions a need to acknowledge that an accommodative monetary policy stance may create a present national government with a “temptation” to “increase expenditure beyond what was necessary to deal with the pandemic, exacerbating structural deficits and damaging the long-term sustainability of public finances”. But the reality is that one cannot make an omelet without breaking some eggs, and overcoming the euro area’s current challenges might require a somewhat more-lenient attitude with regard to the morality of structural deficits. This is not an issue faced by the ECB alone – it may be that the entire world will be forced to consider new attitudes toward the issue of how closely central banks and governments’ fiscal policies should be allowed to work hand in hand. It is not likely to be feasible to adopt such new attitudes on a mere temporary basis, but it seems likely that, over the next year or so, we will see a gradual increase in the attention given to the issue of the ideal extent to which monetary policies should be subordinated to fiscal policies.

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