Forex Medium-Term Outlook

December 25, 2020

Overview of Outlook

USD/JPY remained weak in December. The eagerly awaited vaccinations have begun, but increased restrictions on economic activity in light of the ongoing spread of infections are keeping U.S. interest rates low. Weak USD forecasts are predominant among forex forecasts for 2021. I, too, am of the view that USD depreciation will inevitably continue against the backdrop of low interest rates during this “winter from hell,” primarily during the January-March period. However, several positive developments are forecast for the coming months, including the development, approval, and administration of vaccines, and the resultant economic normalization. In considering forecasts, therefore, one has to take into account a gradual shift in perception from that of a “winter from hell” to a “spring of hope.” U.S. inflation expectations, which have now recovered to pre-COVID levels, are probably based on such a hope for the future. Alongside these developments, nominal U.S. interest rates are also expected to be buoyed up in theory, and it is quite possible that this could pull USD out of its slump. Of course, even if the interest rates and USD do gradually strengthen, it may not be as easy for this strengthening trend to gain momentum. My impression is that both the interest rates and USD will undergo an L-shaped bottoming-out from 2020 rather than achieve a V or U-shaped recovery. 2021 could well be a year of USD and U.S. interest rates both flatlining in what can neither be described as a strong-JPY or a weak-JPY phase.

Meanwhile, EUR has remained strong and has finally become stable at the level of 1.20 to the dollar. The political and economic situation in the euro area is, frankly, not stellar, with inflation remaining slumped, a second wave of COVID infections raging through the continent, a new strain of the virus discovered in the UK, and many other problems, but there are no indications of EUR appreciation ending. The ECB is desperate to correct EUR appreciation, but all its efforts appear to be in vain. As I point out every month, investors are likely to continue favoring EUR due to its status as the currency boasting the world’s largest current account and trade surpluses so long as USD’s perceived overvaluation and the flatlining of U.S. interest rates form the major backdrop. Over the medium- to long-term, the increase in purchasing power as a result of disinflation has also been incorporated into the collective consciousness, which is making EUR increasingly similar to JPY. The currency has remained at an all-time high both in nominal as well as real terms, and not just against USD, so concerns of a negative impact on the real economy are bound to emerge going forward. So long as there are no big changes in U.S.-side factors, such as U.S. interest rates bottoming out and the Fed being somewhat permissive of this, it would be difficult to see a switch to a EUR-selling trend. As in the case of JPY, such a development may be possible starting next spring, but during the January-March period, EUR could post new highs that top 2020.

Summary Table of Forecasts

	2020 Jan-Dec (actual)	2021 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2022 Jan-Mar
USD/JPY	101.18 ～ 112.23 (103.55)	98 ～ 105 (101)	98 ～ 105 (102)	100 ～ 107 (104)	100 ～ 108 (106)	102 ～ 111 (107)
EUR/USD	1.0636 ～ 1.2273 (1.2182)	1.19 ～ 1.24 (1.21)	1.17 ～ 1.22 (1.19)	1.15 ～ 1.20 (1.17)	1.13 ～ 1.18 (1.14)	1.12 ～ 1.18 (1.13)
EUR/JPY	114.43 ～ 127.06 (126.15)	121 ～ 130 (122)	120 ～ 129 (121)	119 ～ 129 (122)	118 ～ 128 (121)	116 ～ 126 (121)

(Notes) 1. Actual results released around 10am TKY time on 25 DEC 2020. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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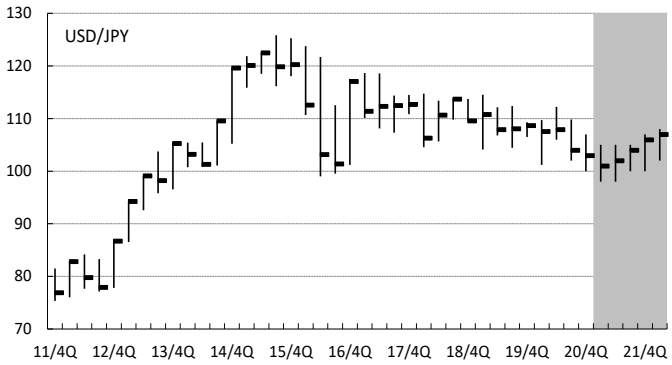
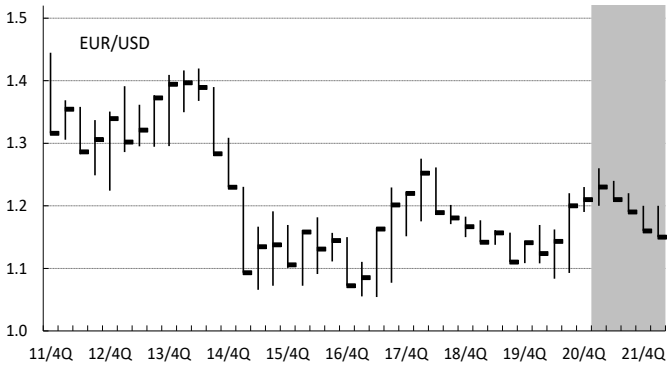
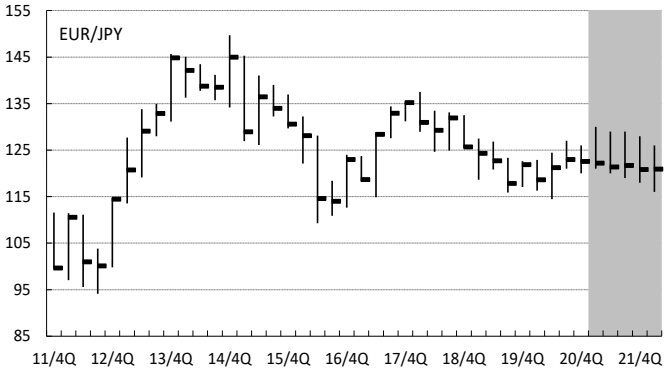
Exchange Rate Trends & Forecasts





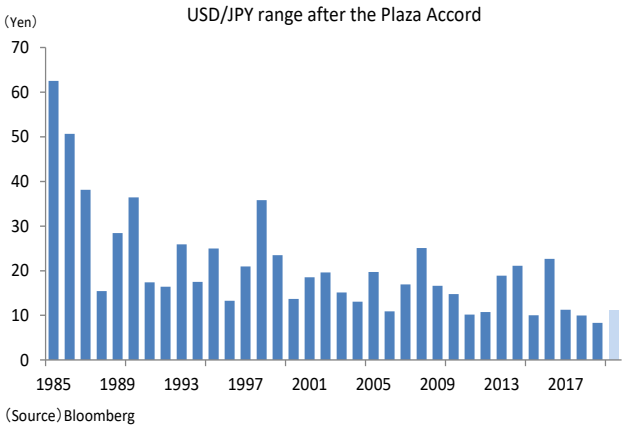


USD/JPY Outlook – The True Nature of USD Weakness and the 2021 Outlook

USD/JPY Unmoved by Turbulent 2020 – The Reasons and Future Prospects

A Year-end Ritual – Noting Yet Another Year of Narrow USD/JPY Rate Range

USD/JPY posted an annual rate range larger than the past two years at 11.05 (peak: 112.23, lowest point: 101.18), but it was the seventh narrowest range posted in the 36 years since the 1985 signing of the Plaza Accord. Given that the all-time record narrow was renewed for two years in a row in 2018 and 2019, it is unremarkable that the 2020 range was wider than that of the previous two years. However, noting that the USD/JPY rate range was narrow seems to have become something of an annual year-end ritual in recent years. There are many factors causing this rate phenomenon – (1) the vanishing of domestic vs. foreign interest rate differentials around the world, (2) a neutral JPY supply and demand climate, and (3) a general waning of interest in the Japanese economy. None of these is the determining factor, but each of them has a role to play.



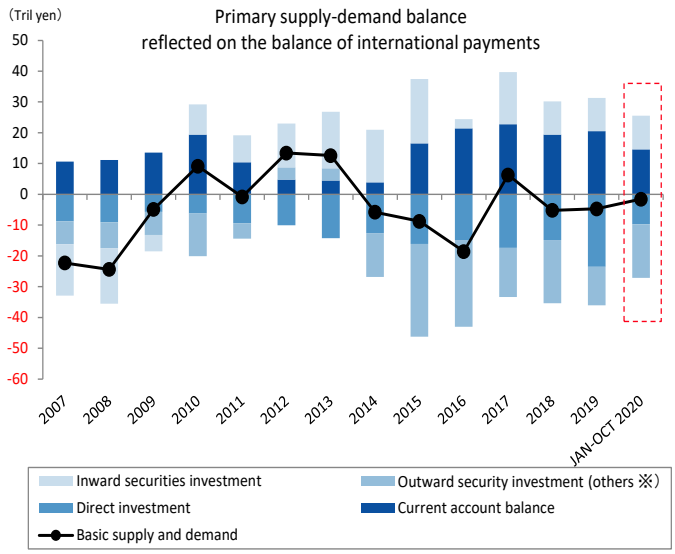
Vanishing Interest-Rate Differentials is an Obvious Factor

From a theoretical perspective, (1) is a fairly obvious factor. Speculation surrounding the next moves of the relevant central banks is undeniably the top factor influencing forex trading. However, with the policy interest rates of all the major central banks converging around zero percent, the marginal changes in interest-rate differentials have become smaller than ever, naturally resulting in a dwindling of forex transaction volume. The main focus of forex markets is on the combined effect of fundamental economic indicators, such as job data and consumer price indices, and political factors, such as the U.S.-China trade war or Brexit, on the next move of a central bank. With zero interest rate policies (ZIRP) established as the default stance of most major central banks, starting with the BOJ and including both the Fed and the ECB, the forex markets are bound to lose interest in the next moves of central banks.

Again, the fact that the policy interest rates of the world's major economies are more or less level at zero percent signifies that these economies will no longer suffer from inflation, but rather disinflation (or deflation in the worst-case scenario) concerns. In that sense, the major economies are now part of a world that is lacking not just in interest-rate differentials but also price differentials. This would, naturally, lead to more stable forex rates, even when seen from the perspective of PPP theories. 2020 witnessed the dramatic process of U.S. interest rates falling to zero, but there will be a large number of ZIRP currency pairs right from the start in 2021, and it seems quite likely things will remain this way for the rest of the year. As a result, forex market volatility may decline even further.

A Neutral JPY Supply-Demand Climate

Although USD/JPY remained relatively unmoving in 2020, EUR/USD increased significantly. What could this be owing to? Point (2) mentioned above plays a role here. Looking at the 2020 Japanese trade balance, for instance, the trade deficit expanded to post a total of -JPY 2.2 trillion for 1H (January-June), but a tendency toward a surplus was recovered during 2H, with the total for the year amounting to an almost neutral figure at -JPY 73 billion as of November. The euro area, meanwhile, is expected to retain the world's largest current account surplus in 2020, although posting a yoy decline compared with 2019. Moreover, the euro area's current account surplus is made up primarily of a trade surplus, which results in outright EUR buying. This difference between the two economies seems likely to have a not insignificant impact on the difference between JPY and EUR performance. As I repeatedly point out in this report, a currency with real demand is inevitably more valued in a world without interest rate differentials.

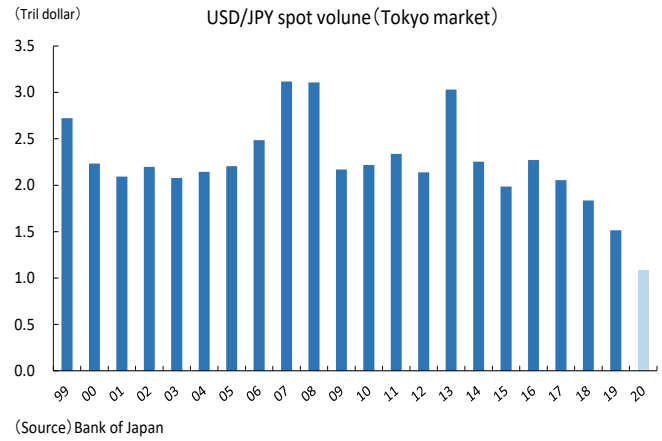


(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government

The figure to the right shows the JPY supply and demand balance calculated based on the balance of payments as a whole, including the trade statistics. The data reveals a net selling of JPY to the tune of -JPY 1.5 trillion for the period from January through October 2020. A JPY1.5 trillion bias for a period of 10 months is extremely small. As one can tell from the figure, 2018 and 2019 also posted very small net JPY selling biases, indicating a continuation of the trend. I do not believe it is a mere coincidence that the two years in question also successively posted all-time narrow USD/JPY rate ranges. It is true that Japan has the world's second largest current account surplus, but most of this is due to a primary income surplus, which does not contribute to forex trading (JPY buying). There may, therefore, be a very simple explanation for the narrow annual USD/JPY rate range – namely that JPY selling and buying are equally matched.

No Longer Interested in Japan? Spot Trading Hits Rock Bottom

The last point must also not be overlooked. In 2019, the second consecutive year of record-narrow rate ranges, the USD/JPY spot turnover in the Tokyo Foreign Exchange Market was around USD 1.5 trillion, an all-time low. This was half the recent peak of ≈USD 3.0 posted in 2013. However, the volume has further dwindled in 2020, at approx. USD 1.0 trillion as of the writing of this report, portending a second consecutive year of all-time low. On the other hand, I have to admit that the causal relationship between the decline in transaction volume and the narrow USD/JPY rate range is not all that clear. One could consider the decline in transaction volume to be the cause and the narrow rate range to be the effect, but there is also the fact that small transaction volumes often lead to rate volatility, which would not be conducive to a narrow rate range. However, large transaction volumes also contribute rate changes, so there seems no clear correct answer as to the causal relationship between the two.



(Source) Bank of Japan

One thing that can be said, however, is that the current state of affairs would not exist had the Japanese economic and financial conditions been more interesting to market participants. 2013, the year that saw transaction volumes close to the record high, was the peak of Abenomics and a phase of JPY weakness and share price strength that was globally acknowledged. A similar volume of trading was seen in 2007-2008, when there was a sudden rollback of JPY carry trade with the eruption of the global financial crisis. Before that, in 2005-06, Japan became the first country in the world to adopt ZIRP, which triggered a massive wave of JPY carry trade strategies globally. Leaving aside the question of good or bad, the fact is that there was a reason at that time to trade in JPY.

BOJ Moves Away from the Limelight with YCC

However, the BOJ moved away from the limelight with the introduction of its yield-curve control (YCC) policy following the publication of the September 2016 Comprehensive Assessment. I think this was the fate imposed by the YCC policy on the BOJ, which had exhausted all its options in trying to achieve its grand target of "+2% inflation rate at the earliest." In fact, the USD/JPY spot turnover has been in continuous decline since 2016, making 2020 the fourth consecutive year. Never before has the turnover declined for four years in a row. As a result of YCC, market participants' interest in the BOJ, and consequently also in the Japanese economy driven by Abenomics, vanished completely. The theory that this led to a decline in JPY trading volumes and further resulted in a narrow USD/JPY rate range may have considerable credibility. Incidentally, according to the triennial foreign exchange survey conducted by the Bank for International Settlements (BIS), the Tokyo forex market, which ranked third in the world with a trading share of 8.0% in 2004, has been outranked by Singapore and Hong Kong and fallen to fifth place with a share of 4.5% as of 2019. The decline in trading share was particularly steep during the 2016-2019 period, when it fell by 1.6 pp from 6.1% to 4.5%, evidencing the loss of interest in JPY and the Japanese economy as a result of YCC.

The above was a simple overview of the various factors that may be contributing to a small USD/JPY rate range. As stated earlier, all the factors from (1) to (3) are true and relevant, but none of them is solely responsible. In 2021, there may be some fluctuation in JPY rates based on factor (2) JPY supply and demand, but factors (1) and (3) seem unlikely to change significantly. Factor (1) unmoving interest rates, in particular, seems to be the premise on which all financial asset transactions are taking place, to say nothing of the Fed's dot plot. First on this list is "share price strength far removed from real economic performance," and the biggest risk for the financial markets in 2021 may be intermittent stock market turbulence.

The True Nature of USD Weakness – The Current State and Future Prospects for USD Weakness Driven by CNY and EUR

L-Shaped Bottoming Out Seems Likely

Weak USD forecasts seem predominant among forex forecasts for 2021. This report, too, has been predicting a mutually correlated decline in both U.S. interest rates and USD during the October-December 2020 and January-March 2021 periods, at the peak of the pandemic. However, thanks to positive news, including the development, approval, and administration of vaccines, U.S. inflation expectations are beginning to indicate light at the end of the tunnel, and U.S. nominal interest rates seem very likely to gradually recover (the Fisher effect). It will be interesting to see what kind of policy the Fed uses to suppress this increase in nominal interest rates in 2021. However, although both U.S. interest rates and USD are expected to move in a generally upward direction, it seems likely that there will be both ups and downs. My impression is that both U.S. interest rates and USD will undergo an L-shaped bottoming-out rather than achieve a V or U-shaped recovery. 2021 could well be a year of USD and U.S. interest rates both flatlining in what can neither be described as a strong-JPY or a weak-JPY phase.

Current Account Surplus Giant Driving USD Weakness

In addition to continuing low interest rates, the perceived overvaluation of USD based on the country's enormous fiscal deficit is often used as the main grounds for predicting USD weakness, and there is good reason for doing so. However, forex rates always involve currency pairs, and USD weakness is driven not just by USD-side factors but also by factors pertaining to the other currency. The chart to the right shows the contribution of each currency comprising the basket of currencies used to calculate USD's nominal effective exchange rate (NEER). As of December 21, USD's NEER had fallen by -3.1% compared with its level at the start of the year, and it is obvious from the chart that CNY appreciation contributed -1.5 pp and EUR appreciation contributed -1.6 pp of the 3.1%. In other words, most of the downward pressure on USD came from these two currencies. Although JPY's contribution is not comparable to the above two currencies, it too contributed about -0.4 pp. One thing China, the euro area, and Japan have in common are their large current account surpluses. In fact, they have the world's top three current account surpluses, with the euro area and China also boasting the world's largest and second largest trade surpluses, respectively.

USD NEER rate of change & contribution since the beginning of the year

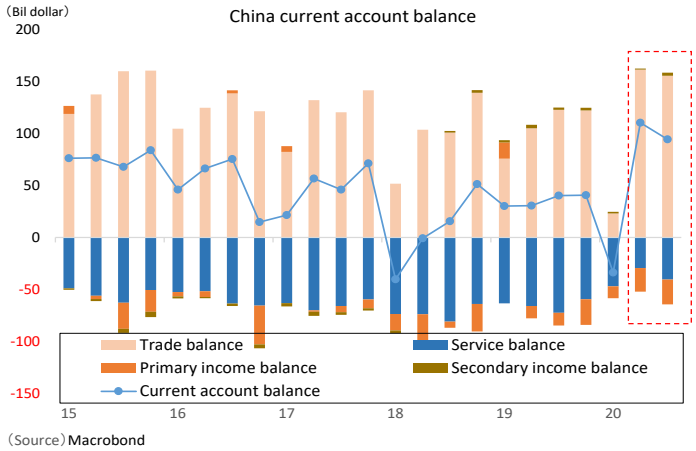
Country	Share (%)	USD from the beginning of the year vs. each currency (%)	Contribution (%pts)
China	23.3	6.3	-1.5
Euro-zone	17.0	9.2	-1.6
Mexico	13.3	-5.3	0.7
Canada	11.7	1.0	-0.1
Japan	7.1	5.1	-0.4
S.Korea	3.8	4.8	-0.2
Taiwan	2.2	6.0	-0.1
Switzerland	1.7	9.1	-0.2
U.K.	3.2	1.6	-0.1
Russia	0.6	-17.1	0.1
S.Africa	0.4	-4.1	0.0
Turkey	0.5	-22.2	0.1
Argentina	0.3	-28.0	0.1
Other	15.0	-	-0.1
NEER JAN-DEC2020	-	-3.1	-3.1

(Source) BIS & Bloomberg. (Notes) NEER: Broad base
Currency rate of change : from 31DEC2019 to 21DEC2020

Ever since the Fed introduced ZIRP in spring this year, I have repeatedly emphasized in this report that real demand for a currency should be paid attention to in a world without interest rate differentials, and going by the above contribution to USD's NEER, my basic understanding seems to be more or less correct. Forex market trends tend to be driven mainly by U.S.-related factors, but one cannot rule out the possibility that the strong external balances

possessed by the euro area and China may have contributed to the appreciation of their domestic currencies. With regard to CNY, in particular, the switch to a more friendly relationship with China proposed by the Biden team is also likely to have been factored in and resulted in the major contribution from CNY to USD's depreciation.

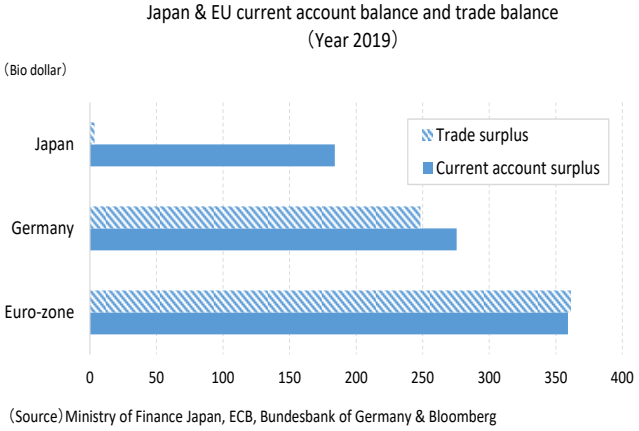
The Future of China's Current Account Surplus



In this sense, the current account surplus trends of China and the euro area will play an important role in determining USD rates going forward. Let us take a look at China first. CNY appreciation is bound to slow down exports to some extent. There is also the possibility that Chinese exports filled in for exports from other countries this year, given that China was the first both to be affected by and recover from the pandemic, and one must take into account that this special factor will not apply going forward. In other words, there is a possibility of Chinese exports slowing down in 2021. Moreover, rumors coming out of Washington indicate that the upcoming Biden administration may be more moderate than the Trump administration, but it is doubtful whether the U.S.'s China policy will soften all that much. China's territorial designs in East Asia and its lack of human rights awareness are unlikely to be politically acceptable to the U.S. even following a change in administration. That being the case, one hesitates to predict the abolishment of the additional tariffs leading to an increase in Chinese exports. Under such circumstances, the Chinese authorities may begin contemplating an intervention to weaken CNY if exports begin to decline markedly in 2021.

The above are some reasons to worry about China's trade surplus declining. In 2020, China's current account surplus was also boosted by the decline in its service deficit (strictly speaking, travel deficit), which seems very likely to expand going forward. Once the end of the pandemic is in sight globally, Chinese tourists to foreign destinations will also, naturally, increase. Rather, it would be difficult to consider the pandemic to have ended unless that happens. At any rate, the expansion of the service deficit will chip away at China's current account surplus, and the possibility of this suppressing CNY appreciation cannot be overlooked. Taking the above arguments into account, it may be wise to be prepared for the possibility that the downward pressure on USD will be relieved in 2021 as CNY peaks out. The most likely timing for this is the April-June period or later.

The Future of the Euro Area and Japanese Current Account Surpluses



What about the euro area's current account surplus? The euro area's current account surplus is made up predominantly of a trade surplus, 70% of which is from Germany. EUR's NEER has recently trended at all-time high levels, indicating that its exports could become less competitive than those of its major trading partners. This may lead to an inevitable slowing of exports from the region, but Germany's trade surplus is driven by a perennially undervalued EUR relative to its own economic strength, so EUR appreciation may only have a modest shrinking effect on the region's obscenely large current account surplus. However, even if a modest decrease in exports results in a slight decline in surplus, I do not believe there will be any fundamental change in the euro area's status as the region with the world's largest current account and trade surpluses, which are EUR's strengths. Additionally, the euro area's continued state of disinflation relative to the U.S. will also justify EUR strength against USD from the perspective of PPP. Going by Japan's experience, a currency backed by an enormous current account surplus and chronic disinflation tends to be stubbornly strong, so the situation seems unlikely to change unless there emerge clear factors for a reversal of trend from the U.S. side.

Finally, there is not that much to say regarding JPY, the third largest contributor to USD weakness. Although Japan's current account surplus is enormous, the bulk of it comprises a primary income surplus, a large portion of which may never be converted to JPY. Even if we assume that JPY has strengthened against USD as a result of stronger demand for JPY, this demand is not due to the trade balance, which results in outright JPY buying/USD selling, but rather due to Japan's position as the world's largest net external creditor. Consequently, as reaffirmed in 2020, JPY buying during risk-off phases has also become less dramatic than it once was. Further, because Japan's trade balance has become less sensitive to JPY rates, I think it would be prudent to assume no dramatic yoy change in Japan's trade balance in 2021.

Analyzing USD weakness in this way, from the point of view of factors other than those originating in the U.S., it becomes clear that this report's emphasis on supply and demand in a world without interest rate differentials will be extremely important in discussing the forex outlook for 2021. While the current account and trade surpluses of the euro area and Japan are not expected to change dramatically, CNY appreciation (a major contributor to USD weakness in 2020) seems very likely to undergo correction, a trend that I think will accelerate starting spring, when moods brighten.

U.S. Monetary Policy Now and Going Forward – USD Still Obviously Seen as Too Strong

Final FOMC of the Year Uneventful

The final FOMC meeting of the year introduced a stronger forward guidance by stating that the Fed would "continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month until substantial further progress has been made toward the Committee's maximum employment and price stability goals." However, this was already anticipated, so that the market reaction was extremely limited. Further, Committee members' projection of interest rates (the dot plot) remained unchanged, with 12 out of 17 members predicting the retention of ZIRP through 2023 (see figure). Some predicted that the Bank would purchase longer maturities of Treasury securities, but given the overall upward revision of the summary of economic projections (SEP), it was understandable why the Fed did not go to that extent.

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

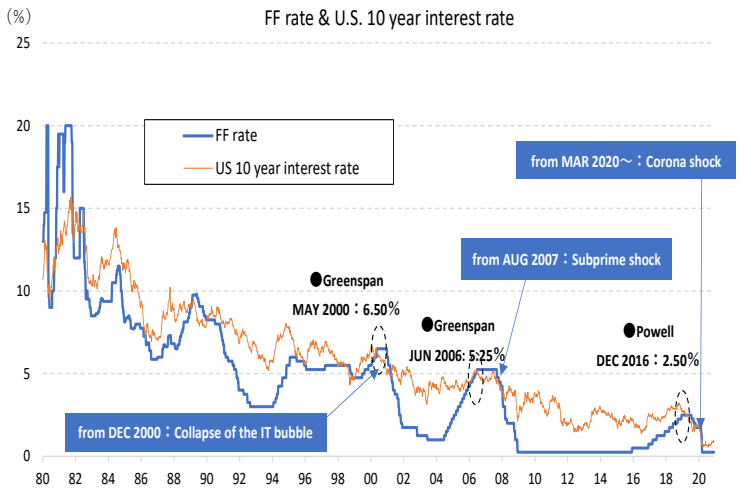
FOMC Date	2021	2022	2023	Longer run
Mar-18	n.a.	n.a.	n.a.	2.875%
Jun-18	n.a.	n.a.	n.a.	2.875%
Sep-18	3.375%	n.a.	n.a.	3.000%
Dec-18	3.125%	n.a.	n.a.	2.750%
Mar-19	2.625%	n.a.	n.a.	2.750%
Jun-19	2.375%	n.a.	n.a.	2.500%
Sep-19	2.125%	2.375%	n.a.	2.500%
Dec-19	1.875%	2.125%	n.a.	2.500%
Jun-20	0.125%	0.125%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

(Source)FRB

Peak FF Target Rate on the Decline

Details follow in a later section, but the main indicators to pay attention to in the coming months are bound to be job and wage data. There were hints of the recent strengthening of the forward guidance in the minutes of the previous meeting released in November, but one cannot help feeling that the decision was hastened following the unexpected slowing of job growth in the November Employment Situation Summary Report released on December 4. Of the 2 million jobs lost in early spring, not just have nearly half not yet been recovered, the pace of recovery is also slowing. Given that the labor participation rate has fallen to historically low levels, there are concerns of a decline in the potential growth rate over the medium- to long-term as a result of a decline in labor input.

A decline in the potential growth rate would be consistent with a decline in the neutral interest rate, i.e., the "desirable policy interest rate level." The figure plots the federal funds (FF) rate against the U.S. 10-year interest rate since 1980. It clearly shows that the peak FF target rate has declined following every major crisis, with the 10-year interest rate also following the same trajectory. With this gradual decline in U.S. interest rates, which are the world's cost of capital, interest rates in other countries have followed suit, resulting in the situation we are in today. The FF rate was a mere 1.75% when the COVID crisis erupted, causing it to be lowered to the level of zero almost instantaneously. Although hindsight is 20/20, the Fed's overkill with four rate hikes in 2018, which forced it to conduct three rate cuts in 2019, now seems regrettable. At any rate, the peak FF target rate over the past 20 years has been on a continuous decline from 6.50% → 5.25% → 2.50%, so it will certainly be interesting to see whether the next peak FF target rate can exceed 2.50% once economic and financial conditions improve. Given that the peak FF target rate has tended to coincide with the U.S. 10-year interest rate level, this will also be an important factor to take into account when formulating a forex or share price outlook.



(Source)Macrobond
(Note) the chairman's name and the year and month indicate the highest point and the level of interest rates in the interest rate increase phase

Reaching 2.50% Took 10 Years

Of course, this is not the first time that the FF rate has been at the zero percent level. The rate was previously lowered to zero percent in December 2008 and it took seven years for the Fed to resume rate hikes (in December 2015), and the rate finally reaching the 2.50% level after a period of ten years (the most recent rate hike was in December 2018). However, in all, the utmost that could be recovered even over the space of 10 years was less than half of the pre-crisis rate of 5.25%.

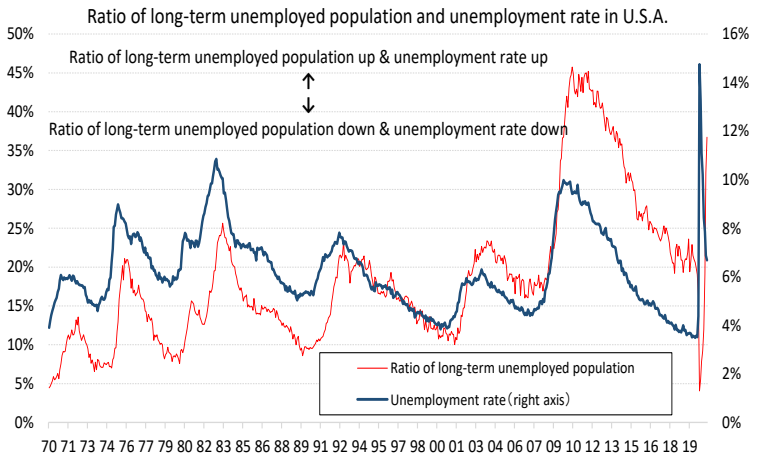
How long will it take for the rate to recover this time? The dot plot projects the continuation of a zero percent rate until the end of 2023, which I take to mean “at least until the end of 2023.” I would like to base my reading of the situation on this understanding. Labor market conditions are the reason for this. The pandemic has brought the labor participation rate crashing to its lowest ever rate of 61.5%, and one of the lessons learned from the 2008 financial crisis is that it is not easy to raise the labor participation rate after it has fallen significantly (figure displayed later). In fact, the labor participation rate had not recovered at all from the 2008 crisis when COVID hit. Under such circumstances, there are concerns of a decline in the neutral interest rate, which is intuitively analogous to the labor participation rate. This signifies the emergence of a world where interest rates become even more upwardly rigid. It also signifies that the condition of a world without interest rate differentials will remain a fundamental reality when forecasting forex rates for some time to come. Of course, interest rates will still fluctuate within a small range, so the forex markets will display movement consistent with these fluctuations, but as the marginal change in interest rates becomes smaller, forex market rate movements will also inevitably become smaller. This is greatly evidenced by the fact that the USD/JPY rate range for 2020 was no more than 10.05 despite everything that has been taking place. One point of interest in 2021 will be whether such a phenomenon can be observed for currency pairs other than USD/JPY.

U.S. Economy Now and Going Forward – Concerns of an Increase in the Long-Term Unemployed

The Harsh Reality of an Increase in the Long-Term Unemployed

Non-farm Payrolls (NFP) in the November U.S. Employment Situation Summary Report fell considerably short of market forecasts at +245 K mom. Many say that this was what pushed the Fed to take action at what would otherwise have been an uneventful December FOMC. The unemployment rate derived from the Household Income survey had declined mom by -0.2 pp to 6.7%, and this decline is consistent with the decline in labor participation rate (from 61.7% to 61.5%), resulting in what can be seen as an “undesirable” decline in unemployment rate. The labor participation rate is calculated by dividing the labor force (employed population + unemployed population) by the working age population (those who are 16 years of age or older). However, in order to be recognized as an “unemployed” person, one has to have engaged in job seeking during the survey period. Those who lose the desire for employment and leave the labor force are not counted as “unemployed” persons. If the number of such people increases, the unemployment rate (unemployed population divided by the labor force) may decrease, but so will the labor participation rate. This is what results in an “undesirable” decline in unemployment rate. On the contrary, an increase in the unemployment rate with an increase in the labor participation rate is sometimes termed a “desirable” increase in unemployment rate. When the labor participation rate continues to decline, the labor input into a country’s economy decreases, pushing down its potential growth rate. The category of people on the verge of leaving the labor market are mainly those who have been unable to find jobs despite active job-seeking over a long period. It is in this context that it is important to monitor the trend of the long-term unemployed, defined as those who have been seeking work for 27 weeks or longer.

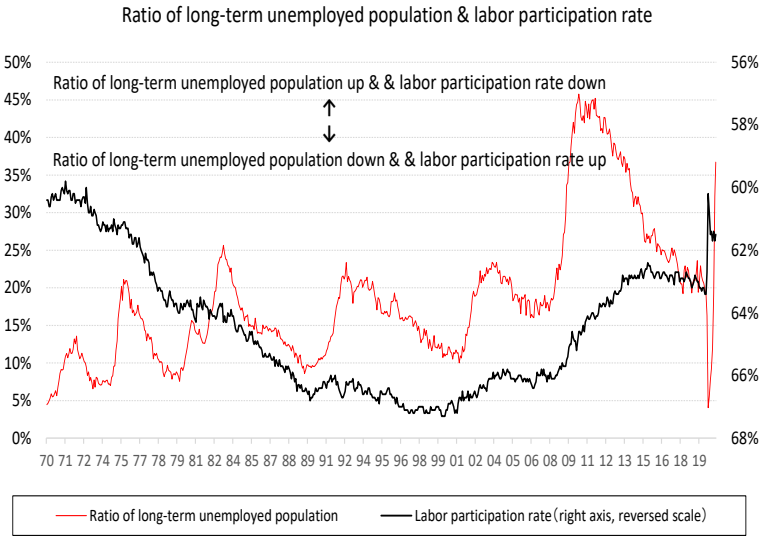
The figure plots the relationship between the unemployment rate and the ratio of the long-term unemployed population within the unemployed population (long-term unemployed rate). It is obvious that the long-term unemployed rate has increased significantly in recent months even as the unemployment rate has declined significantly. The November long-term unemployed rate is approaching 40% of the unemployed population, which is almost as high as that seen in the aftermath of the 2008 financial crisis (when it was 45% or so). As the figure shows, the trend so far has been that the long-term unemployed rate essentially declines in tandem with the unemployment rate, but this is not true of the current time. This is due to the impact of lockdowns, which have caused the unemployed population parameters themselves to fluctuate wildly. Although the long-term unemployed rate plunged in early spring, when the unemployed population (i.e., the denominator) increased sharply, in recent months, the long-term unemployed rate has increased sharply with a sharp decline in the unemployed population, making for a unique curve.



（Source）macrobond （Note）The definition of long-term unemployment is "a person who has been unemployed for 27 weeks or more"

Labor Participation Rate May Not Recover Soon

Going back to the issue of labor participation rate decline, this is something even the Fed was fervently concerned about in the wake of the 2008 financial crisis. Over the past 10 years, even as the U.S. approached a state of full employment, the labor participation rate, while not deteriorating, never recovered to its pre-crisis level (see figure). This inability to return to normal following a major crisis is a characteristic of the labor participation rate – this is easy to understand in light of the fact that, once long-term unemployed persons leave the labor market, they lose both the desire and the skill to resume economic activity. There is, therefore, a correlation between an increase in the long-term unemployed rate and a decline in the labor participation rate (with the decline in the labor participation rate being the cause of the decline in potential growth rate). The sharp decline in the labor participation rate as a result of the pandemic is likely to be a gloomy thought for the Fed and other U.S. policy-making authorities.

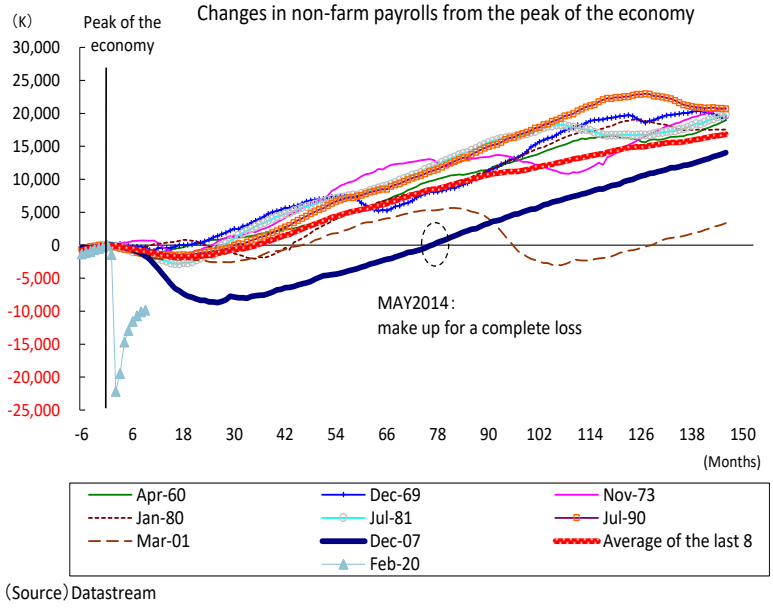


(Source)macrobond (Note)The definition of long-term unemployment is "a person who has been unemployed for 27 weeks or more

The Weight of 10 Million Lost Jobs

This is something I have repeatedly explained before, but the reason consumer confidence fails to improve despite the soaring of share prices is because of this deterioration in employment (and, therefore, wage) conditions. The November Employment Situation Summary Report was depressing no matter which way you looked at it, but share prices continued to soar in the financial markets due to policy-related hopes. This abnormality of the share price trend is almost perverted. Taking a step back from the financial market trends to look at the real economy, one cannot help being very concerned about the future of the U.S. employment, and therefore also economic, situations. Having recovered a mere half (10 million jobs) of the 20 million lost in March-April 2020, the trend of a sharp increase in employment stopped abruptly. 10 million jobs, which is an extremely large number, remain unrecovered. Compare this with the loss of jobs during the worst phase of the previous recessionary phase. In February 2010, 26 months into the recession that began in December 2007 with the financial crisis, the number of jobs that remained unrecovered was around 8.7 million.

In other words, the current number of jobs lost is worse than that recorded during the worst phase of the 2008 financial crisis (see figure). Incidentally, it was only in May 2014, 77 months into the recession, that the 870 million jobs lost in the wake of the financial crisis were fully recovered. Meanwhile, November 2020 is still only nine months into the current recession, and the U.S. is already facing a loss of 10 million jobs (9.93 million to be more precise). How long will it take to fully recover these lost jobs? Of course, the jobs lost this time are the result of deliberate restrictions on economic activity, so depending on the trend of infections and the judgment of authorities in line with the trend, the pace of recovery is likely to be rapid (in fact, it is extraordinary to have recovered 10 million jobs within the space of 9 months). However, even if it takes half the time it took to fully recover jobs following the 2008 crisis, that would still amount to just under three years.



(Source)Datastream

Current Situation Seen From the Yellen Dashboard

Under these circumstances, it seems likely that the Fed's policy operation will be increasingly restricted by the realities of the employment situation. It was thought that the December FOMC would retain the status quo (details follow), but in the event, the Fed strengthened its forward guidance. This was clearly a decision taken in light of the November job data released the week before the meeting. Amid renewed restrictions on economic activity, the opportunities for predicting fiscal and monetary policy operation based on job data will increase going forward. In last week's edition of this report, I argued that the long-term unemployed population (of those who have been seeking jobs for 27 weeks or

more) and the labor participation rate trends are the key indicators to pay attention to in the medium/long-term. The Employment Situation Summary Report tends to provide mainly three data points, namely NFP growth, unemployment rate, and average hourly wages, but my basic understanding is that it is important not to be limited by these, but rather analyze the current state and future prospects for the labor market in a more multifaceted manner. In this context, it is said that former Fed Chair Janet Yellen, who has been named for the post of the Secretary of the Treasury, considered monetary policy operation based on nine employment indicators that form what is called the "Yellen Dashboard." The nine indicators are NFP, unemployment rate, labor participation rate, U6 rate, long-term unemployed rate, turnover rate, job openings rate, hires rate, and quits rate. Note, however, that this dashboard is not something Ms. Yellen herself has talked about, but rather something that has been put together by those observing her work.

The chart below plots the average values of these nine indicators during (1) the two years leading up to the resumption of the last round of rate hikes by the fed (2014-15), (2) the quarter during which rate hikes were resumed (October-December 2015), (3) the three years before the COVID pandemic hit (2017-19), and (4) since the beginning of 2020 (January-November). To get a more accurate image of the present situation, it also includes recent-most values (for November 2020). It is obvious at a glance how grave the labor participation rate and long-term unemployed rate currently are. Apart from this, the U6 rate is also conspicuously high. Given that the loss of desire or skills for resuming economic activity among those who have been unemployed over a long period contributes to the increase in U6 rate as well as the decline in the labor participation rate, I believe that the long-term unemployed rate holds the key to understanding the current state and future prospects for the U.S. job market.

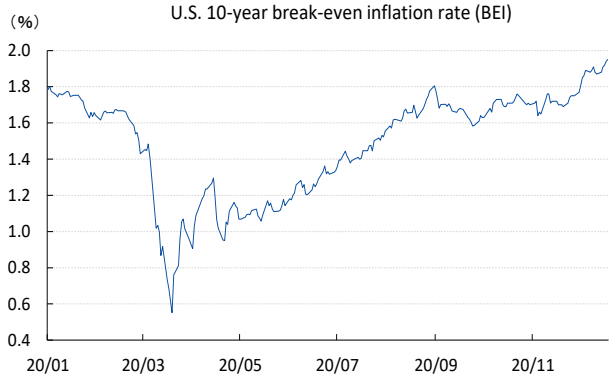
Yellen dashboard: current situation and the past (The rate hike was launched in December 2015. The number of employees: ten thousands. Share%)

	Non farm payroll	Unemployment rate	Labor participation rate	U6 rate	Long-term unemployed rate	Turnover rate	Job openings rate	Hires rate	Quits rate	Number of lost jobs *
Year 2014-2015 average	23.85	5.7	62.8	11.2	30.7	1.9	3.6	3.6	1.3	470.5
OCT-DEC 2015 (start raising interest rates)	27.20	5.0	62.6	9.9	26.6	2.0	3.8	3.8	1.3	
Year 2017-2019 average	18.21	4.0	62.9	7.8	22.2	2.2	4.4	3.8	1.2	1,360.6
JAN -NOV 2020 average	-85.17	8.2	61.8	13.8	16.5	1.9	4.2	4.1	2.4	-983.4
Latest (as of NOV 2020)	24.50	6.7	**61.5**	12.0	**36.7**	2.1	4.3	4.1	0.9	

(Source) macrobond (Note) Jobs lost from the peak of the economy, from top to bottom: as of DEC2015, as of DEC2019 & as of NOV2020

Using the Dashboard to Quell Concerns of Fed Turning Hawkish in 2021

As of the writing of this report, U.S. inflation expectations have clearly begun to surge thanks to the development, approval, and administration of vaccines. The 10-year break-even inflation rate (BEI) is approaching 2%, which is higher than the pre-COVID level (see figure to the right). If we take into account the Fisher Effect, it seems unlikely that the nominal 10-year interest rate can be kept effectively pegged to its current level (of around 0.90%). My belief is that some Fed officials will begin to show an interest in rate hikes starting the April-June 2021 period, as though to ratify the nominal interest rate growth trend.



(Source) macrobond

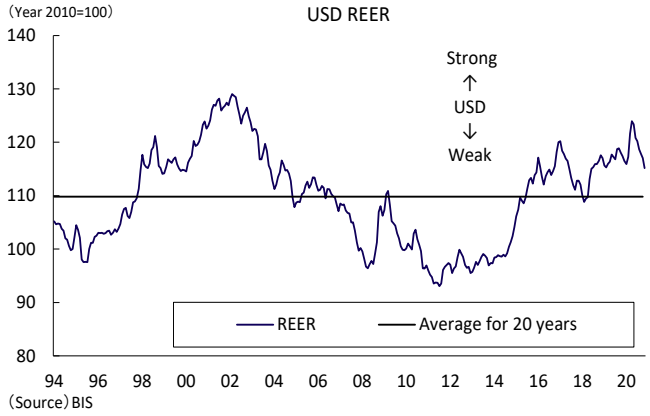
Meanwhile, employment indicators, which are lagging indicators of the economy, are unlikely to show clear improvement. For instance, as already mentioned, the long-term unemployed rate and labor participation rate are both at historically concerning levels, with the latter in particular being quite difficult to revive if it falls significantly. Taking such circumstances into account, the Fed in 2021 may not be able to keep down concerns about the "employment maximization" aspect of its dual mandate even as it feels a sense of relief over the "inflation stabilization" aspect. Speculation of the Fed turning more hawkish in its "inflation stabilization" mandate as the BEI or interest rates surge may cause share prices to fluctuate during some phases, but I believe such phases will be temporary. Meanwhile, given the wretched state of employment, it may be quite some time before the Fed can judge its "employment maximization" mandate to have been fulfilled.

Off and on in 2021, there may be phases of market sentiment being negatively affected by concerns of the Fed turning more hawkish, but one would do well in those times to take fresh stock of the situation based on the Yellen Dashboard. As the new treasury secretary, Janet Yellen herself may feel a sense of peril at the market's anticipation of a hawkish Fed as she goes through the indicators that once formed her dashboard. Another point of interest in 2021, therefore, will be to see whether this directly or indirectly impacts U.S. currency policy in 2021.

Risks to My Main Scenario – Political USD Depreciation Risks

Potential Effects of Janet Yellen Becoming U.S. Treasury Secretary
As already noted, the majority of forecasters are projecting USD depreciation in 2021 and generally cite two principal reasons for their projections – stable low levels of U.S. interest rates, reflecting Fed policies, and the perception that USD is overvalued, reflecting the government's huge fiscal budget deficit. However, many observers are still wondering what to expect from the incoming Treasury Secretary, Janet Yellen, and it seems that many people are concerned that she has the potential to promote higher risks of both USD appreciation and USD depreciation. Having received numerous inquiries about this, I think it is worth briefly discussing how incoming Treasury Secretary Janet Yellen might affect forex rates. Basically, it seems unlikely that Ms. Yellen would take initiatives to manipulate forex rates, but given that the political responsibilities of the Fed chairman and Treasury Secretary positions are quite different, one should not be overly confident in making assumptions based on her past record. Regarding particularly significant risks, I think it is probably very important to consider how to evaluate risks associated with the variant covid-19 strain that suddenly emerged near the end of the year. I will return to that issue at the end of this section.

Mistaken Expectations of USD Depreciation when Yellen Became Fed Chair
Returning to the question of how incoming Treasury Secretary Janet Yellen might affect forex rates, I basically do not think treasury secretaries have a significant influence on major trends in the forex market. While the financial markets will undoubtedly focus considerable attention on Treasury Secretary Yellen's words and deeds during 2021, there is a taboo on explicit efforts by developed countries' policymakers to seek to influence the direction of forex trends – such efforts are considered uncouth. I would definitely not expect Ms. Yellen – known for her irreproachable conduct – to arbitrarily seek to move forex trends, and the forex market as a whole probably shares that view. Looking back, it may be remembered that when Ms. Yellen became Fed chairperson in February 2014, it was widely noted that she had been strongly dovish in her previous post as governor of the Federal Reserve Bank of San Francisco, and USD weakened. Ultimately, however, it turned out that the Fed under her leadership calmly assessed the economic and inflation situations while moving ahead with a difficult normalization process, promoting a sustained trend of USD appreciation. It should be remembered that the most recent USD appreciation period (see graph), began with the inauguration of Fed Chair Yellen.



By February 2018, when she was succeeded as Fed chair by Jerome Powell, the difficult policy decisions had already been made, and many consider the four interest rate hikes implemented that year to have simply confirmed the status quo she established. While some observers have severely criticized the interest rate hikes as being overkill with respect to U.S. economic conditions and necessitating consecutive interest rate cuts in 2019, the majority of people consider her to have been a Fed chair with outstanding skills. In any case, predictions that Ms. Yellen's inauguration as Fed chair would cause USD depreciation turned out to be completely wrong, and it would probably be wise to keep that in mind when anticipating her performance as Treasury secretary.

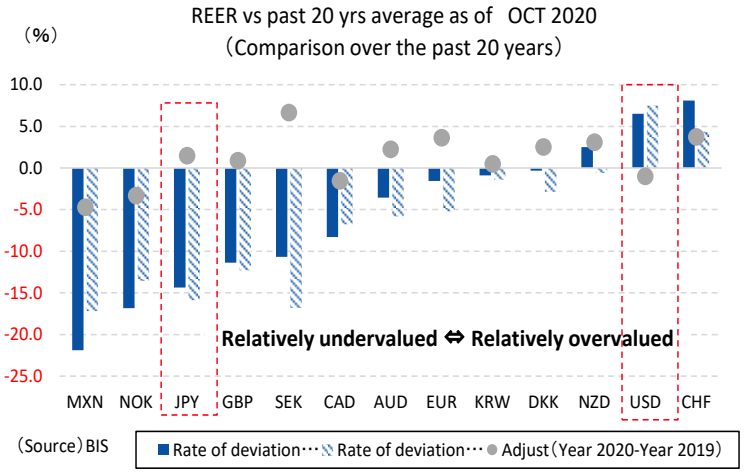
USD Beginning to Depreciate from a High Level
Of course, the position of a central bank chairperson independent from political pressures is different from that of someone in a top cabinet post that is fully within the realm of politics. While central banks are in principle not allowed to make decisions and disseminate information based on consideration of forex rates, Treasury secretaries sometimes do those things. There is a possibility that Ms. Yellen's behavior and expressed views may change after she assumes a post that is more-political in its basic nature. In the case that USD appreciation is perceived to be exerting a negative impact on the real economy, a Fed chair is only permitted to discreetly influence USD forex rates by such indirect tools as interest rate adjustments, but a Treasury secretary may sometimes use such various and sometimes direct methods such as foreign exchange intervention moves as well as information dissemination initiatives in the form of foreign exchange policy reports and direct statements. While there is a general belief that Ms. Yellen's record indicates that she would not actively undertake such foreign exchange intervention moves, it would be prudent to recognize that the existence of that general belief is liable to intensify the impact and power of whatever foreign exchange intervention moves she might eventually make.

In any case, USD's real effective exchange rate (REER) rose as a result of the normalization process during Ms. Yellen's term as Fed chair, and it is still above the long-term average level (see above graph). Fed Governor Lael Brainard once said that the rise in REER from June 2014 to January 2016 would raise the FF rate by 200 bps, and it is worth noting that the REER level has not changed much since January 2016. (It was 117.12 in January 2016 and 117.01 in October 2020.) While it is true that USD has been depreciating in 2020, it should be recognized that it has

begun descending from a high level. As explained below, the United States' desire to promote USD depreciation is reflected in the latest edition of the U.S. Treasury Department's semiannual Report on Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States (released on December 16).

USD Still Overvalued – JPY is ...

Theoretically, REER levels are expected to converge to their long-term average levels. Of course, the pace and degree of convergence cannot be accurately predicted, but in today's foreign exchange world, which is said to have become largely disassociated from the "fair value" concept, REER-based estimates of currencies' over- and undervaluations are often used in international comparisons. The graph shows the degree of deviation from the long-term average for REER for major currencies as of October 2020, the degree of deviation a year previously (October 2019), and the margin of adjustment during the year through October 2020. One can easily see from the graph that, after CHF, USD is the currency that has been allowed to rise by the greatest margin with respect to its long-term average (allowed to be overvalued), and this makes it easy to theoretically justify moves to promote USD depreciation. (As explained below, this point is emphasized repeatedly in the Treasury Department's semiannual report.) EUR appreciated significantly compared to other major currencies during 2020, almost eliminating the approximately 5% downward divergence from the long-term average (undervaluation) seen a year ago, and it is now approaching its long-term average (proper valuation).



On the other hand, the leading currencies that are the most undervalued are MXN, NOK, and JPY. However, MXN and NOK are currencies of oil-producing countries and appear to have been somewhat depressed by the sharp drop in crude oil prices in the first half of this year, making it difficult to accuse Mexico and Norway of inappropriately promoting the depreciation of their currencies. Compared to the 2014-1015 period when JPY was allowed to depreciate more than 30% below its long-term average, JPY has a smaller degree of undervaluation and has been making progress toward its long-term average, but it still is a prominent example of a leading currency that 'should be appreciating'. In fact, the Treasury Department report has continued to employ this logic to point out JPY's undervaluation. Japan's trade structure has changed significantly since the financial crisis, so that even when JPY's value becomes excessively low compared to previous levels (in this case, compared to the long-term average) it cannot really be expected to promote the previously seen "export increase → trade surplus" pattern. It can therefore be said that the theoretical expectation that "the currency should appreciate because it is undervalued compared its previous levels" ignores the underlying reality, but the Treasury Department report does not recognize the validity of such discussions of structural economic changes.

In any case, the question of how the Yellen-led U.S. Treasury will behave with respect to individual countries' currency situations will definitely be a major focus of interest in 2021. The Trump administration has undertaken highly frank information dissemination campaigns regarding exchange rates, and the Treasury Department's semiannual foreign exchange policy reports have been arbitrarily incorporated into those campaigns (mainly to target RMB). Partly because of this, the original publication dates of the reports (in April and October) have been significantly shifted. However, the "Monitoring List" that attracts particular attention every time a new edition of the report is released was actually established by the Obama administration in April 2016. It should be noted that it is a system initiated by the Obama administration rather than the Trump administration. In fact, there are historical grounds for deep-rooted concerns about the correlation between U.S. Democratic Party presidential administrations and JPY appreciation trends, and I think it is worth paying attention to whether that pattern will recur.

First Forex Policy Report in 11 months – Barely Preserving "Semi-Annual" Status

The risk of forex rate fluctuations related to a U.S. presidential administration transition and the appointment of a new U.S. Treasury secretary is essentially a kind of "political risk." Perhaps the clearest reflection of the nature of this political risk can be found in the U.S. Treasury Department's semiannual foreign exchange policy reports. This year's second such report was released on December 16, and I think it is worth discussing its content. While the report was originally released every April and October, the Trump administration has begun arbitrarily using it as a political tool with an eye to spotlighting currency manipulator countries, and it is now published at irregular intervals. As the last edition was released on January 13, the December edition was the first new edition in 11 months. It is noteworthy that the January edition was released just before the U.S.-China Phase One trade agreement was realized, and that edition's removal of China from the list of currency manipulator countries appears to have been be a kind of political move made as a 'reward' for China's acceptance of that agreement. It is unclear why the latest edition of the report was released on December 16, but one can speculate that it was the latest possible date at which it could be released as a 'semi-annual' report (if the year-end holiday period was to be avoided). As the inauguration of a new U.S.

president is expected in January, there may also be those who believe the Trump administration made a point of issuing the last foreign exchange policy report it is in a position to issue.

Switzerland and Vietnam Designated Currency Manipulators

The latest report designates two countries – Switzerland and Vietnam – as currency manipulators, and ten countries – China, Japan, South Korea, Germany, Italy, Singapore, Malaysia, Taiwan, Thailand, and India – were placed on the monitoring list (see table on next page). Regarding Switzerland, Bloomberg reported on December 10 that an anonymous official had said that the Swiss authorities' intervention to curb CHF appreciation meets the U.S. standards for being designated a currency manipulator, and that report turned out to be true. Major U.S. trading partner counties are designated currency manipulators if they meet two of the following three criteria – (1) a significant bilateral trade surplus with the United States (annual levels of USD20 billion or more), (2) a material current account surplus (2% or more of GDP), and (3) engaged in persistent one-sided forex market intervention (net foreign currency purchases conducted repeatedly, in at least 6 out of 12 months, and amounting to 2% or more of GDP over a 12-month period).

Although China meets only criterion (1) above, it is included in the Monitoring List because it "accounts for a large and disproportionate share of the overall U.S. trade deficit." If the 'large and disproportionate share' Monitoring List inclusion standard is maintained, there is probably a potential for such countries as Mexico to be added to the Monitoring List at some point. At present, Switzerland and Vietnam have not had sanctions imposed on them due to their currency manipulator designations, but such small countries could argue that forex rate manipulation has been a matter of economic survival for them, and it seems likely that they will present such arguments and otherwise do their utmost to resist any eventual imposition of sanctions that might happen. Given the Trump administration's general "America First" philosophy, countries designated currency manipulators or placed on the Monitoring List might have some justification for feeling that the United States was somewhat hypocritical.

Monitoring list 3 conditions (Highlighted countries are on the monitoring list as of DEC 2020)

		Current balance			Buying USD & selling own ccy intervention
	Trade surplus vis-à-vis the U.S. (Bil dollar)	vs GDP (%)	Change in last 3 yrs (% pts)	Amount (Bil dollar)	vs GDP
China	310	1.1%	-0.3%	157	-0.1%
Mexico	96	-0.2%	1.9%	-2	0.0%
Germany	62	6.8%	-0.9%	253	-
Vietnam	**58**	**4.6%**	**6.5%**	**15**	**5.1%**
Japan	57	3.1%	-0.8%	158	0.0%
Ireland	55	-5.5%	6.4%	-22	-
Switzerland	**49**	**8.8%**	**-0.3%**	**64**	**14.2%**
Italy	30	3.0%	0.4%	55	-
Malaysia	29	2.5%	-0.2%	9	1.1%
Taiwan	25	10.9%	-1.5%	68	1.7%
Canada	24	-1.9%	0.7%	-31	0.0%
Thailand	22	6.3%	-3.1%	33	1.8%
India	22	0.4%	1.6%	10	2.4%
S.Korea	20	3.5%	-1.3%	57	-0.6%
France	15	-1.6%	-0.7%	-41	-
Singapore	-1	16.1%	-1.1%	56	21.3%
U.K.	-8	-2.8%	1.9%	-76	0.0%
Belgium	-11	0.6%	0.9%	3	-
Brazil	-13	-2.8%	-1.9%	-47	-2.3%
Netherland	-18	9.4%	-0.2%	83	-
Euro-zone	152	2.1%	-0.5%	271	0.0%

(Notes) Trade surplus vis-à-vis the U.S., current balance & intervention amount cover for 1 year until June 2020 (4 Quarter)
For countries where quarterly data is not available, use 19 annual data.

U.S. Treasury Truly Seeking a Strong Dollar?

Within the U.S. Treasury Department's latest foreign exchange policy report, the Foreign Exchange Markets section overviews USD-related forex trends and, overall, readers of this section are likely to get the impression that the Treasury Department's real view is that USD had depreciated somewhat this year but continues to be overvalued. It states – "In the early months of 2020, the spread of COVID-19 set off a dash for safety to the dollar. Dollar funding markets tightened and the dollar experienced a sharp appreciation, with the nominal trade-weighted dollar spiking 10.2% from the beginning of the year to a recent peak on March 23. The dollar strengthened against the currencies of

nearly every major trading partner[.]" Subsequently, USD depreciated during 2020 as the "rush to the dollar" lessened. On this point, however, the report states – "The nominal trade-weighted dollar weakened 7.9% from March 23 to the end of October, leaving it 1.6% stronger for the first ten months of the year." – and this gives the impression that the Treasury Department is still dissatisfied with the overvaluation of USD.

Furthermore, the report states that – "Sustained dollar strength is concerning given that the IMF continues to judge that the dollar is overvalued on a real effective basis[.]" – and this indicates that the Treasury Department is not fully satisfied with the direction of the USD depreciation trend as the level of USD overvaluation is perceived as excessive. Specifically, the report notes that USD's real effective exchange rate (REER) – "remained elevated at roughly 7% above its 20-year average." USD's REER is indeed well above its 20-year average, being above that average by 6.5% as of October. Despite some progress in downward adjustment from USD's peak level, it appears that the period of USD appreciation that began in 2014 has undergone only a partial correction.

JPY Really Still Considered Undervalued?

The report included some noteworthy statements regarding the valuations of individual currencies. Regarding JPY, which has been appreciating recently, the report states – "After appreciating close to 1% against the dollar in 2019, JPY appreciated an additional 4.0% against the dollar through end-October[...][.] On a real effective basis, JPY rose 1.5% through end-October, after appreciating 1.5% in 2019." – basically recognizing that JPY appreciation has been progressing. But these sentences are followed by – "Despite the recent appreciation, the real effective yen remains weaker than average historical levels." – suggesting implicitly that JPY is still perceived as insufficiently strong. In June 2015, when JPY reached its peak level of depreciation against USD, JPY's REER was more than 30% below the 20-year average. During the subsequent five years, the margin of JPY REER undervaluation compared to the 20-year average has been progressively decreasing, reaching 14% as of October 2020, and it seems that this may be deemed a sufficient degree of adjustment. The report also notes that – "the deterioration in global risk sentiment sparked by the spread of COVID-19 drove flows into traditional safe haven currencies" – and that this promoted JPY appreciation. The fact that JPY and CHF are strong currencies liable to be bought in response to crises has been generally accepted since the Lehman shock, and there has controversy regarding speculation in recent years that JPY might no longer be a full-fledged safe haven currency, but it appears that the incorrectness of such speculation has been confirmed during 2020.

RMB Strength Associated with High Interest Rates and Trade Surplus

As discussed earlier, a large share of USD depreciation in 2020 was driven by RMB and EUR appreciation, making the report's evaluations of those two currencies particularly noteworthy. Regarding RMB, the report states that – "In the first half of this year, the RMB remained relatively stable. More recently, the RMB has strengthened 5.6% against the dollar since the end of June through the end of October supported by favorable interest rate differentials, increased investment inflows, and positive economic data, including a substantial trade surplus." This article has been arguing that China's high interest rates and trade surplus have contributed to RMB appreciation and USD depreciation, and it appears that the U.S. Treasury shares that view.

However, the report points out that there are still many uncertainties regarding China's exchange rate management regime and expresses concerns that structural issues preceding issues regarding RMB valuation levels have not been addressed. As this article has previously argued, it appears likely that a deceleration of China's export growth and an increase in the country's travel balance deficit during 2021 will cause supply-demand-based RMB buying to fall below the 2020 level. From the forex market's perspective, however, gaining an understanding of the degree to which the incoming Biden administration will relax the United States' China-related policies will be even more important than such analysis of fundamentals.

Unusually Positive Evaluation of Germany

Regarding EUR, which strongly appreciated against USD during 2020, the report states – "On net in 2020 the euro is stronger against the dollar (3.7% through end-October), having gradually strengthened since late April. The euro has strengthened somewhat more on a trade-weighted basis, rising 6.6% and 5.0% on a nominal and real effective basis, respectively, over 2020 though end-October." After acknowledging the large degree of EUR appreciation, the report notes that – "The IMF's most recent assessment judged the euro area's external position to be moderately stronger than warranted by medium-term economic fundamentals and desirable policies." – and this appears to hint that the EUR appreciation has been caused by the euro area's huge trade surplus. This causal relationship is an indisputable fact. It is generally understood that most of the trade surplus is attributable to Germany, and the report's discussion of that country includes the statement – "Germany's large current account surplus has narrowed somewhat in 2020 as the shock to global trade has weighed on exports. The current account surplus stood at 6.8% of GDP over the four quarters through June 2020 (down from 7.2% of GDP in 2019). Nonetheless, Germany's current account surplus remains the largest in the world in nominal terms" – pointedly referring to the existence of a huge imbalance.

However, the report also praises the German government's fiscal stimulus measures, noting that – "There are signs, however, that the current crisis is accelerating the shift of Germany's growth composition toward domestic demand, which has held up well in recent months amid fiscal stimulus measures, compared to the precipitous drop in exports."

Of course, Germany's current fiscal stimulus measures are a temporary response to the pandemic, and the country's consumption tax reduction is also positioned as a temporary measure. The report therefore goes on to recommend that – "For this shift to take hold beyond the current crisis, Germany will need to implement economic policies to address the structural factors that contribute to high domestic saving and low consumption and investment." While the report may feature conspicuous one-sided demands, this portion of the report should be acknowledged as being appropriate, and it will be worth keeping a close eye on what kind of fiscal policy management post-Merkel Germany will undertake – particularly regarding the possibility that the country will move away from its traditional dogmatic adherence to fiscal austerity.

Biden Administration Should Address Trump Supporters' Concerns

As mentioned above regarding the next U.S. presidential administration's currency policy, the default expectation is that Ms. Yellen is a kind of person who would never do something so uncouth as explicitly working to promote USD depreciation. As demonstrated during the recent presidential election, however, there are a great many Americans who support President Trump and his policies. In particular, the President Trump's promotion of intensified protectionism has a persistent appeal, and some political analysts have cogently argued that President Trump's election four years ago was attributable to the United States' chronic inability to address problems associated with its steadily expanding trade deficit. If the incoming Biden administration truly seeks to ameliorate the United States' political polarization and promote unity, it would be beneficial to address the concerns of the Trump supporters who account for roughly half the country's population. In doing that, it is quite conceivable that the Biden administration may seek to appeal to such demographic segments as manufacturing industry workers by promoting depreciation of USD, which has been overvalued for several years. While incoming Treasury Secretary Yellen can be expected to strive to manage policies in line with extremely high ethical standards, she may not be able to completely ignore various kinds of political pressures. Looking back over many decades, one gets the impression that United States' Democratic Party has a tendency to promote USD depreciation more than the Republican Party. Given that, the possibility of "politically driven USD depreciation" should be retained as a risk scenario for 2021.

Main Forecast Scenario Altered by Emergence of COVID Strains?

Although rising concerns about spread of new variants or strains of covid-19 in late December have depressed interest rates, the effect of risk-off USD buying has continued to promote a trend of USD appreciation. Among the various patterns characteristic of risk-off mood periods, the "USD appreciation" pattern is often seen to accompany the most severe risk-off sentiment periods, yet that pattern has not been much in evidence since early spring. It will be important to determine whether the growing awareness of potential challenges associated with "mutant corona virus strains" seen in the final weeks of 2020 might spur a new trend. I do not see a need to alter the main forecast scenario at this point, given that many authorities have indicated that the existing covid-19 vaccines are equally effective for the new covid-19 strain. (For example, U.S. Secretary of Health and Human Services Alex Azar stated on December 22 that the existing covid-19 vaccines are effective against new covid-19 strain.) However, if speculation that the new strain might be "70% more infectious or transmissible" were to turn out to be true, there may be grounds for concern about whether the protective benefits of vaccine administration can prevent an acceleration in new infections. Could such negative developments regarding the pandemic become grounds for altering the main forecast scenario, which anticipates that U.S. interest rates and USD will begin an interrelated trend of increase beginning sometime in the April-June 2021 period? I think it will be important to revisit and confirm or reevaluate that situation soon after the start of 2021.

EUR Outlook – Continued Challenges from EUR Appreciation and Sluggish Inflation

EUR Area Monetary Policies and EUR – EUR Appreciation Cannot be Countervailed with "Halfway Measures"

Unimpressive "Halfway Measures"
The ECB Governing Council meeting held on December 10 decided to expand and extend the pandemic emergency purchase programme (PEPP) and extend the third series of targeted longer-term refinancing operations (TLTRO3). It appears that the financial markets consider these to be unimpressive "halfway measures". The centerpiece measure was to expand the scale of PEPP by EUR500 billion (from EUR1.35 trillion to EUR1.85 trillion), and extend the PEPP period by nine months (from the end of June 2021 to the end of March 2022). The EUR500 billion PEPP expansion had been anticipated since the October GOVERNING COUNCIL meeting, so it was not surprising. The majority of previous expectations were that the period might be extended by 6 months, and the 9-month extension does exceed those expectations, but a portion of forecasters had been expecting a 12-month extension, so the 9-month extension does not comprehensively exceed prior expectations. Ultimately, it is undeniable that the ECB's unnecessary prior notice of the upcoming expansion of easing has caused market expectations to surge upwards even more during the six weeks since the last Governing Council meeting. It therefore seems clear that the measures were of no benefit regarding the true objective of countervailing EUR appreciation – not even of 'a drop in the ocean'-type benefit. As this article has repeatedly emphasized, it is a bad idea to give prior notice of prospective easing measures to the forex market.

First of all, based on the monthly PEPP usage record so far (about EUR80 billion per month), many forecasts were expecting an additional EUR500 billion of purchases over an additional 6 months. In fact, that was my basis for expecting the six month extension. Accordingly, the "additional EUR500 billion over an additional 9 months" entails slowing the monthly pace of purchases. Even if the PEPP period is extended, the ECB has no obligation to use the entirety of the authorized envelope if the economic and financial situation improves, so it seems that it would have been more effective to increase the envelope by EUR700-750 billion and extend the period by three months. Following the announcement of the ECB's latest measures, EUR has remained strong and is showing no signs of incipient weakening. If one acknowledges that the real goal is countervailing EUR appreciation, one gets a clear impression that ECB has played its monetary policy cards in the form of unimpressive "halfway measures".

Creating a Supportive Environment for Providing Loans
In addition, the end of TLTRO3 has been delayed by one year (to June 30, 2022). While the preferential interest rates applied to liquidity supply operations have been maintained, the maximum amount that counterparties will be entitled to borrow has been raised from 50% to 55% of their stock of eligible loans. ECB Governor Christine Lagarde has cited a downtrend in loan interest rates and growth in loans as evidence that TLTRO3 has been effective, but it has already been pointed out that a survey of euro area bank lending attitudes found signs that banks' lending postures were becoming stricter. The recent strengthening of credit related policies is designed to countervail such disturbing trends. At the post Governing Council meeting press conference on December 10, a reporter posed a question about whether the risks faced by households and companies were shifting from liquidity risks to solvency risks, and whether there were additional risks associated with the central bank's decision to further increase lending. In this regard, President Lagarde explained her view that TLTRO3 would promote the alleviation of potential repayment problems, indicating that addressing the liquidity problem would also help ameliorate potential repayment problems. Another reporter asked a similar question regarding the possibility that the ECB's provision of inexpensive liquidity might exacerbate the problem of non-performing loans in the euro area. President Lagarde responded that – "it is obviously for banks who are ultimately the lenders to assess and to manage risks and to take the appropriate provisions and to request the appropriate guarantees." – and went on to say the ECB's job is to provide a supportive environment for banks by – "mak[ing] sure that financing is available and can flow to banks".

Those exchanges suggest that interest rate incentives may be augmented if deemed necessary, and President Lagarde did not deny that interest rate cuts may be implemented for that purpose.

Governing Council Division Regarding Optimal PEPP Envelope Size
The series of Governing Council decisions were made not unanimously but by majority votes. Certain reports indicate that some Governing Council members asserted the PEPP envelope should be expanded by EUR600 billion and some suggested it should be by EUR400 billion, resulting in the compromise figure of EUR500 billion. On the other hand, those reports suggested that the approval of the nine-month extension period was unanimous. Regarding the nine-month period, President Lagarde said – "based on what we know today we have good reasons to believe that the end of 2021 will likely signal the herd immunity" – so the ECB is extending PEPP through March 2022 assuming that the euro area economy may not become normalized until a full two years after the start of the pandemic. While there

may be some minor disagreements and counterarguments about this, it seems that Governing Council is gathering a consensus of its members on this point. President Lagarde suggested that herd immunity was likely to be attained by the end of 2021 several times during the press conference, and that projected timeline appears to have become an important premise on which ECB policy management decisions are based.

The suggestion that the Governing Council was divided regarding the PEPP envelope size but unanimous regarding the PEPP period indicates that there was a certain amount of difference of opinion about the pace of monthly asset purchases. It can be calculated that a EUR600 billion envelope roughly corresponds to a EUR66.6 billion per month pace (EUR66.6 billion x 9 months ≈ EUR600 billion), while a EUR500 billion envelope roughly corresponds to a EUR55.6 billion per month pace (EUR55.6 billion x 9 months ≈ EUR500 billion). It is worth noting in this regard, that the average monthly level of purchases during the eight months from March through October was EUR78.6 billion, so even a EUR600 billion envelope expansion would entail a deceleration of the pace of purchases. While it is necessary to account for the special market mood that promoted an accelerated pace of purchases during the April-June 2020 period, it appears that the pace of purchases in 2021 will be lower than it was in 2020.

However, it was pointed out in the Account of the October Governing Council meeting that future additional measures are likely to produce diminishing returns, indicating that there is concern that the additional asset purchases may not necessarily have the same impact on financial markets and the real economy that previous purchases did. If that is the case, it might be considered logical to assert that the pace of purchases must be either maintained or increased in order to achieve the same effect. That may be the argument of those Governing Council members who proposed increasing the PEPP envelope by EUR600 billion. In any case, it seems apparent that there are emerging divisions among Governing Council members regarding the prospective effect of additional asset purchases and regarding the appropriate scale of purchases calculated based on different forecasts of that prospective effect. However, it also seems likely that most Governing Council members share a common sense of relief about the fact that it may not be necessary to sustain the pace of purchases seen in 2020. This is because it appears that EUR20 billion of asset purchases per month will continue to be implemented through the expanded asset purchase programme (APP), but it has been discreetly decided that the APP will be allowed to expire when the additional EUR120 billion envelope allotted to it in 2020 is used up. If this eventuates, then the ECB will have succeeded in discontinuing one of its plethora of monetary easing programs.

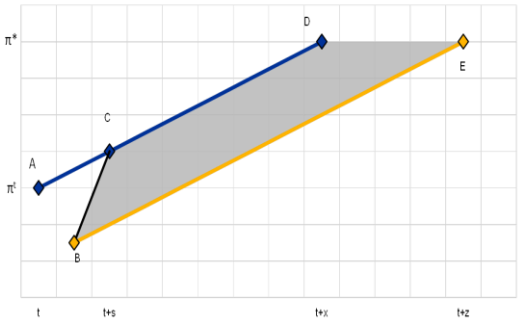
Arduous First Stage of the ECB's Two-Stage Approach

During 2021, ECB will face the challenge of figuring out the optimal means of dealing with the sluggishness of euro area inflation rates and the stubbornness of the EUR appreciation trend. However, since inflation rates reflect prices within the euro area and EUR forex rates reflect prices of items outside the euro area, they are essentially the same phenomenon. Since EUR has been appreciating for a long time, it is no wonder that the impact of EUR appreciation on ordinary price levels in the euro area is being discussed. Particular attention is being paid to how much euro area prices react to EUR forex rate movements (the so-called pass-through effect). At the post-Governing Council-meeting press conference, President Lagarde noted that – "We do not target exchange rates. But clearly the exchange rate, and in particular the appreciation of the euro, plays an important role and exercises downward pressure on prices, so we monitor it." Regarding the disappointingly low level of euro area inflation rates, she pointed out that it – "is rooted in some specific factors that have to do with the very low cost of energy, it has to do with the German VAT and in that respect it is conjunctural. But it is also caused by weak demand, it is also caused by lower wages and it is also caused by the exchange rate appreciation."

Previously published ECB studies have estimated that EUR appreciation by 1% will push down the euro area Consumer Price Index (HICP) by -0.07 percentage point a year later. In terms of the nominal effective exchange rate (NEER), EUR has appreciated 7.7% since the beginning of 2020 (as of December 22), which suggests an eventual reduction of HICP by 0.5 percentage point. Of course, the ECB will have updated its method for estimating the effect of EUR appreciation on inflation since the aforementioned studies were published, so the 0.5 percentage point HICP reduction is not necessarily the effect that the ECB may be considering, but unless the EUR appreciation trend weakens, it would be reasonable to assume that the relationship between EUR appreciation and euro area inflation will be a major topic of discussion within the ECB during 2021.

At this point, I will attempt to identify what the ECB's "next move" might be in light of the ECB's current two-stage approach to monetary policy management. The graph on the right, shown during a lecture presented by ECB Executive Board member and chief economist Philip Lane, illustrates that the ECB is aiming to raise the inflation rate from point B (to which the pandemic has depressed it) to point C, after which the ECB will strive to attain point D. Plans call for PEPP along with TLTRO3 to propel the first stage process of moving from B to C, but there is currently concern that the playing of those policy cards will not countervail the EUR appreciation trend and that, as a result, the inflation rate will continue to slump. The process of traversing the first-stage path from B to C has come to seem like a very long and arduous journey.

Image of "Two-stage approach" by ECB management



(Source) ECB

Since the true cause of EUR appreciation is thought to be the euro area's huge current account and trade surpluses, quantitative easing that merely expands base money should not be expected to have any effect, as the BOJ proved when it was led by Governor Masaaki Shirakawa. But it seems that the ECB is not yet ready to acknowledge that.

Continued Debates Regarding Climate Change

The last question posed by a reporter at the press conference was – "your colleague, Governing Council member Jens Weidmann, said in his speech recently that there is no mandate for an active role of the ECB in the fight against climate change. He said an active role in climate change policy could undermine our independence and ultimately jeopardise our ability to maintain price stability. Would you agree with his view?" Choosing her words carefully to give due consideration to Weidmann's position, President Lagarde responded that, "we have to bear in mind those risks and the direct and indirect impact that risk has on the natural interest rate, that it has on the price stability objectives and the impact on inflation of, for instance, major weather circumstances, or drought, or carbon tax if and when it comes, and so on and so forth. So, we have great debates ahead and they will come." I plan to delve deeper into this issue and discuss it in another section of this article during 2021.

The Euro Area Economy Now and Going Forward – Euro Area Faces Unprecedented Slump in Prices

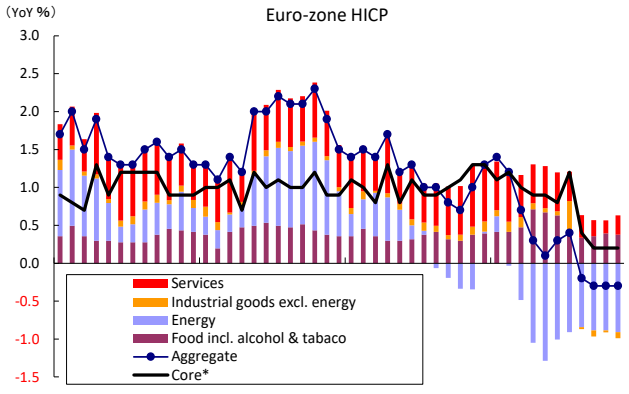
EUR Appreciation Sustained Despite Various Countervailing Factors

EUR continued to appreciate in December, and ended the year fairly stable somewhat above the USD1.20 level. The "EUR1 euro = USD1.20" level is close to the purchasing power parity level and has basically functioned as a prospective upside limit of EUR appreciation since the ECB's June 2014 introduction of negative interest rates, yet the EUR appreciation trend is not showing signs of weakening. EUR appreciation persisted during 2020 despite various situations that could be expected to weaken EUR – such as the ECB's building of the world's largest central bank balance sheet, the stormy progress of Brexit negotiations, the lack of significant progress toward the EU medium-term budgetary objective, and the opaque management of the EU recovery fund – and this seems to indicate that the EUR appreciation trend has stronger sustainability than ever.

Inflation Situation Continues to be Dire

In addition, a number of negative economic indicators for the euro area were announced on December 1. That day Eurostat released the euro area Consumer Price Index (HICP) for November, which was -0.3% yoy and was the fourth consecutive month in which that statistic was negative. Moreover, the negative margin of HICP in November exceeded the market forecast (a decrease of 0.2%). The core basis HICP figure (excluding food, tobacco, alcohol, and energy), which tends to show greater fluctuation, was + 0.2%, the third consecutive month in which record low levels were recorded. Such weak inflation indicators suggest a need for the monetary easing measures announced at the December ECB Governing Council meeting as well as additional easing measures during 2021, but as mentioned above, EUR buying does not seem to be abating.

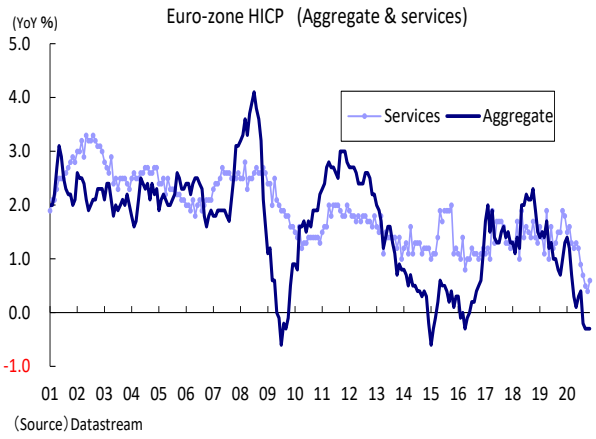
As this article has repeatedly argued, monetary easing measures may be powerless with respect to the fundamental basis of EUR appreciation, which is an overwhelming amount of real demand. There is a possibility that ECB may take a number of steps aimed at halting EUR appreciation, but they seem likely to end up being nothing more than some insignificant drops in the ocean. The persistence of this dire price situation is likely to induce some EUR selling in the short term due to speculation about additional easing, but Japan's experience seeking to control JPY appreciation demonstrated the general rule that "deflationary currencies will appreciate", and that can be considered sufficient grounds to justify EUR buying over the medium to long term.



(Source) Datastream
(Note) Core excl. energy, food, alcohol & tabacco

Wave of Weakness in Service Prices

The general inflation slump seems even more serious when you examine the underlying details. Basically, the decline in energy prices is promoting a general decrease in inflation, and the main forecast scenario is that inflation will begin strengthening again in 2021 when the temporary impact of the energy prices slump diminishes. However, yoy growth in non-energy industrial goods prices has been negative for four consecutive months – for the first time in history. Plunges in crude oil prices have indeed been experienced in the past, and each such plunge has been seen to depress non-energy industrial goods prices, but there has never been such a lengthy period of negative yoy growth in non-energy industrial goods prices.



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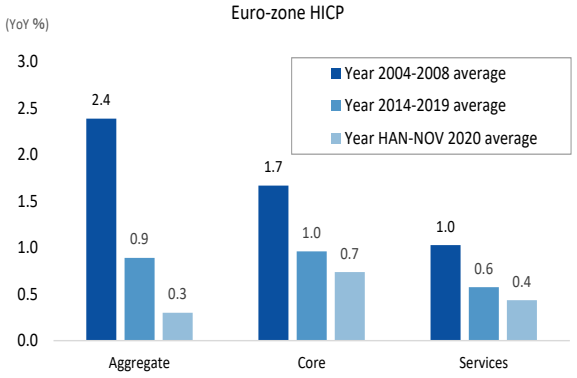

(Source) Datastream (Note) Base excl. energy, food, alcohol & tobacco

A situation that is particularly worrisome regarding future trends is that energy and non-energy industrial goods production activities factor prices may fall, raising the possibility that the trend of stable low inflation rates may extend to labor costs. Since the financial crisis, there has been growing concern about the sluggish rates of growth in wages in Europe and the United States, and the issue of how the pandemic will affect growth in wages is considered to be quite important. To discern labor cost trends within in inflation statistics, one should focus on service prices. Because of the nature of service industry operations, service price trends can be considered fairly accurate reflections of wage trends. The ECB Governing Council has already given particular attention to and expressed particular concern regarding the sluggishness of service industries and service prices, and that is because euro area service prices are undergoing an unprecedented decline (see graph on upper right). Comparing average growth rates in comprehensive basis HICP, core basis HICP, and service prices during three time periods – the five years through 2008 (prior to the Lehman shock), the five years through 2019 (prior to the covid-19 pandemic shock), and the first 11 months of 2020 (see graph on lower right) – one finds that the rate of growth in service prices has recently been less than half that recorded before the Lehman shock, and it seems evident that weak growth in service prices has been promoting decreases in comprehensive basis and core basis HICP growth rates. Of course, service prices are also being affected by special situations, such as temporary consumption tax cuts in Germany and other pandemic-period tax policies that are promoting widespread decreases in prices in general. Given the stubborn persistence of deflationary trends experienced in Japan, however, it is impossible to be sure whether the downward pressure on prices in the euro area will be fully eliminated after the global economy enters the post-pandemic era.

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