

February 1, 2021

## Overview of Outlook

USD/JPY remained rudderless again through January. Some countries have begun to verify the vaccine's effectiveness, but with economic activity continuing to be restricted amid a rise in infections in the middle of a harsh winter, it is unfortunately difficult to muster up much optimism. However, the mood is likely to improve with the start of spring. As the wider distribution of vaccines and warmer weathers result in infections peaking, that itself is likely to boost the real economy. As the Fed is unlikely to change its dovish stance, an increase in interest rates seems inevitable with the recovery of the real economy, and this may result in a rollback of USD selling. Going by past experience, it seems likely that U.S. 10-year interest rates could rise to the level of around 1.50% by the end of the year. A forced correction in the accumulated USD short positions is also likely from a cost point of view. Of course, there are some risks. A weak USD would be desirable for the Biden administration not just for an economic recovery but also in view of acts by supporters of former President Donald Trump. If a weak USD is politically contrived, this report's projected scenario is unlikely to come true. Further, the decline in direct investment by Japanese companies since last year is cause for concern. Since direct investment involves outright JPY selling, it has been considered a deterrent to JPY strength from the point of view of currency supply and demand. Direct investment in 2021 seems likely to improve relative to 2020, but if it remains lackluster, it would have to be considered a risk factor for a strong-JPY trend.

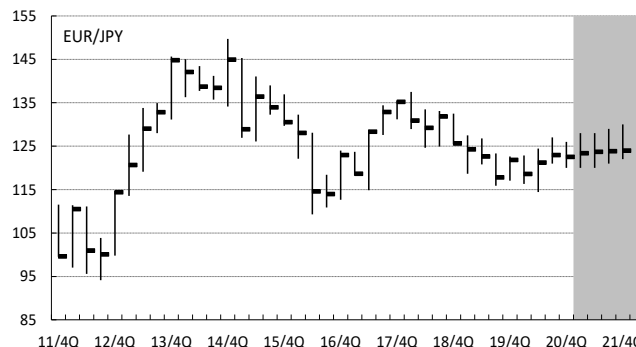
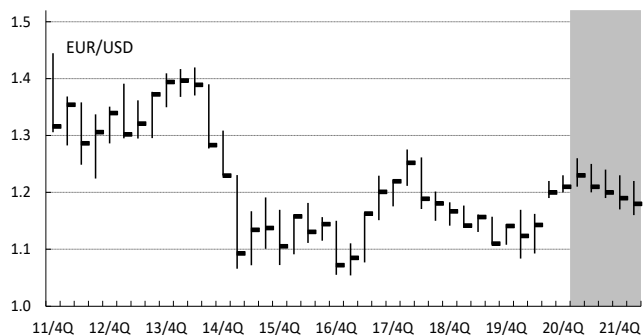
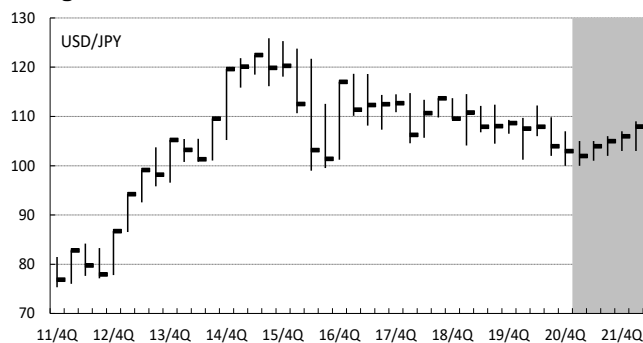
While the strong appreciation of EUR appears to have slowed down, the currency is still maintaining the benchmark level of USD1.20 to EUR. With economic activity still restricted due to the spread of infections, both current and future prospects for the euro area's economy remain unremarkable, and inflation is also showing signs of a severe slump. However, EUR itself has not seen any one-sided sell-offs, probably because it is the currency of the world's largest current account and trade surplus economy. The ECB has been frantically trying to contain EUR appreciation, but, as already seen in 2020, currency strength rooted in the fundamentals is not easily corrected by expanding quantitative easing (QE). It would be safe to assume that the ECB will be essentially ineffectual in its efforts to check EUR appreciation. However, the bank's large-scale asset purchases do help keep government bond yields low despite political instability in Italy and elsewhere, and ironically these low yields may also be preventing EUR selling. Assuming an increase in U.S. interest rates during the current forecasting period, EUR also seems likely to weaken gradually, but perhaps not to the extent of JPY, given the real demand for EUR.

### Summary Table of Forecasts

	2021					2022
	Jan (actual)	Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
USD/JPY	102.60 ~ 104.94 (104.66)	100 ~ 105 (102)	101 ~ 106 (104)	102 ~ 107 (105)	103 ~ 109 (106)	103 ~ 111 (108)
EUR/USD	1.2054 ~ 1.2349 (1.2132)	1.19 ~ 1.24 (1.21)	1.18 ~ 1.23 (1.19)	1.17 ~ 1.22 (1.18)	1.15 ~ 1.21 (1.17)	1.14 ~ 1.20 (1.16)
EUR/JPY	125.10 ~ 127.49 (126.97)	120 ~ 128 (123)	120 ~ 128 (124)	121 ~ 129 (124)	122 ~ 130 (124)	123 ~ 131 (125)

(Notes) 1. Actual results released around 10am TKY time on 1 FEB 2021. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels  
3. Forecasts in parentheses are quarter-end levels

### Exchange Rate Trends & Forecasts



## USD/JPY Outlook – To What Extent Will Key U.S. 10-Year Yield Increase?

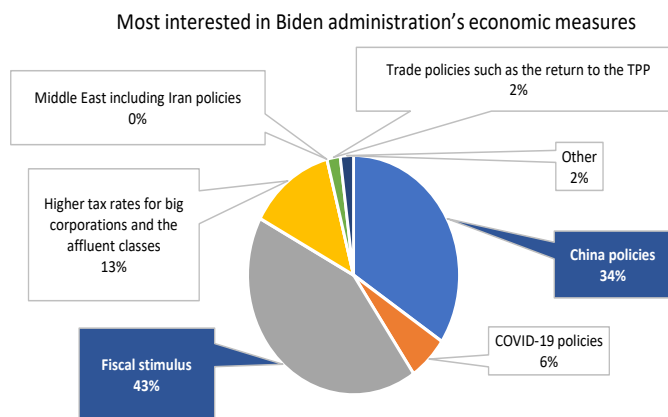
### The Financial Markets' View of the New Biden Administration – What is the Market Paying Attention To?

*Economic Measures* → *Measures Related to China* → *Tax Increases*

The Biden administration was inaugurated on January 20. While the financial markets have focused most on Biden's anti-COVID economic package, his policies overall have also attracted attention, including the U.S. return to the Paris climate accord and the reversal of the travel ban on several Muslim-majority countries. In this context, the results of a survey jointly conducted by QUICK Corp. and Nikkei Veritas (survey period January 12-13) was released on January 18. The survey asked respondents questions on their expectations regarding the overall policy operation of the Biden administration. I would like to use this timely survey to take a look at which aspects of the new administration's policies market participants are focusing on.

The largest percentage of respondents (43%) were most interested in the new administration's economic measures, mainly centering on fiscal stimulus.

During the presidential election period, the Biden administration's China policies were the main topic of focus, and it was thought that this was driving up CNY, but in the recent survey, it drew less attention than the fiscal package at 34%. This may, however, be due to the fact that the scale of the incoming Biden administration's additional fiscal stimulus was in financial market news headlines during the survey period. I think that the actual level of interest is likely to be similar for both topics. In fact, given the automatic assumption that Biden's stance toward China will be friendly, any indication even slightly contrary to this expectation is likely to come as a major shock to the financial markets and impact CNY significantly.



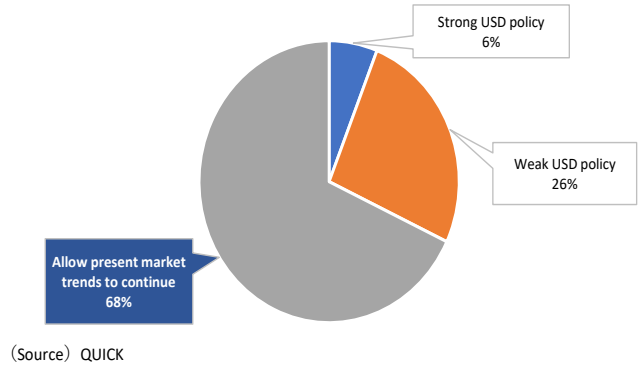
(Source) QUICK

Moving on, survey respondents' interest in the Biden administration's higher tax rates for big corporations and the affluent classes had fallen significantly to 13%. If memory serves me right, the predominant view during the Democratic primary was that Joe Biden had very little chance of winning in the primary because of his plan to raise taxes, and that share prices would crash if he did win. As of the current time, however, most market participants appear not to be taking this possibility seriously, perhaps assuming that tax rates could not possibly be raised in the current climate. Strong share prices have recently contributed to optimistic moods in the market, and any attempt by the new administration to raise taxes, including the capital gains tax, would negatively affect share buying. Market trends are directly affected by tax hike policy trends, so there is bound to be more interest in this subject than revealed by the survey results.

**The Biden Administration's Currency and Monetary Policies**

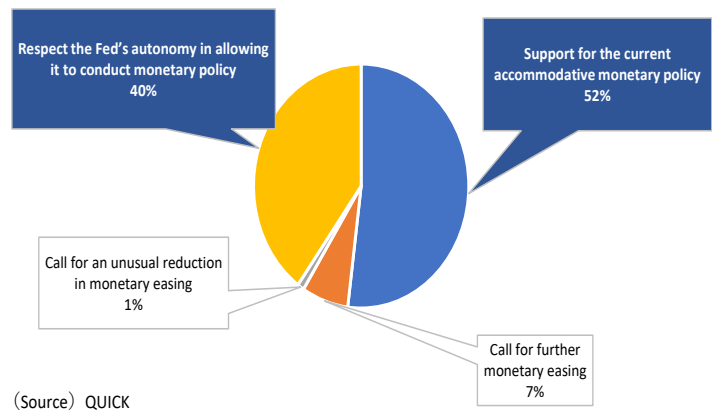
The survey also asked respondents what they expected the incoming administration's currency policy to be. Traditionally, the forex markets have held the view that USD tends to be weaker against JPY during Democrat-led administrations, and this view was also reflected in the survey responses, but a large majority of respondents (68%) thought the Biden administration would allow present market trends to continue. This indicates that market participants feel dispassionate about this issue, and I am with them. Of course, one remembers the bitter trade friction and sanctions against Japan during the Democratic Clinton administration, but that stance was the result of Japan posing a real threat to the U.S. in those days. While Japan still maintains a trade surplus with the U.S., Japan's trade balance these days tends to be in equilibrium and frequently even post a deficit as a whole. It can no longer be said that Japan uses unfair currency policies, tariffs, and other nontariff trade barriers to flood the world's markets with its own products, and there seems no reason for the U.S. to enforce strict trade policies against Japan. Any strict policies that are implemented would rather target China, and the markets are closely watching to see, not just what kind of political and diplomatic relations the Biden administration will have with China, but also what its stance will be regarding CNY rates.

What do you expect Biden administration's FX policy?



Having said all that, 26% of respondents expected the Biden administration to pursue a weak-USD policy, while 6% expected a strong-USD policy. In other words, while the markets are taking a dispassionate view of the new administration's currency policies, they see a slight bias in favor of a weak USD policy. In this context, the words and actions of former Fed Chair Janet Yellen, who has been named the new Secretary of the Treasury, will draw more attention than usual (details follow). Monetary and currency policy directions necessarily align as the two are closely related to each other, and survey respondents seemed to understand this. 52% of respondents expected to see support for the current accommodative monetary policy, while 40% of respondents expected that the Biden administration would respect the Fed's autonomy in allowing it to conduct monetary policy as it sees fit (this was in the context of the Trump administration's relationship with the Fed, which made the headlines now and again). In other words, nearly all respondents seemed to expect monetary policy operations to remain unchanged. However (though there were no questions related to this), the Biden administration's influence on the Fed will come into close focus in 2022, as it approaches the appointment of its next chair. One potential candidate as of the current time is Lael Brainard, who was not appointed Treasury Secretary despite being considered the most likely candidate for the job. However, I feel that her name has been put forward too prematurely.

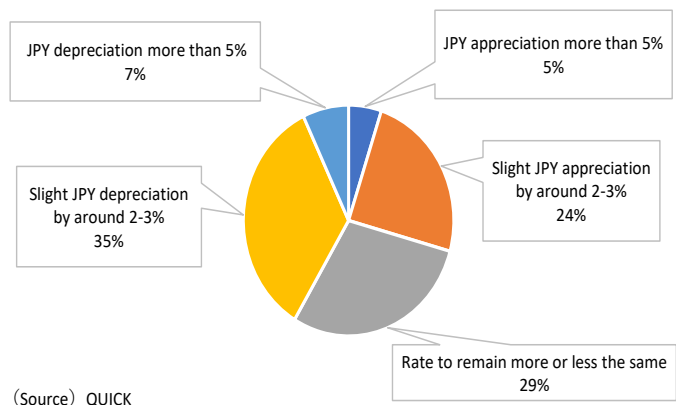
What do you expect Biden administration's monetary policy stance?



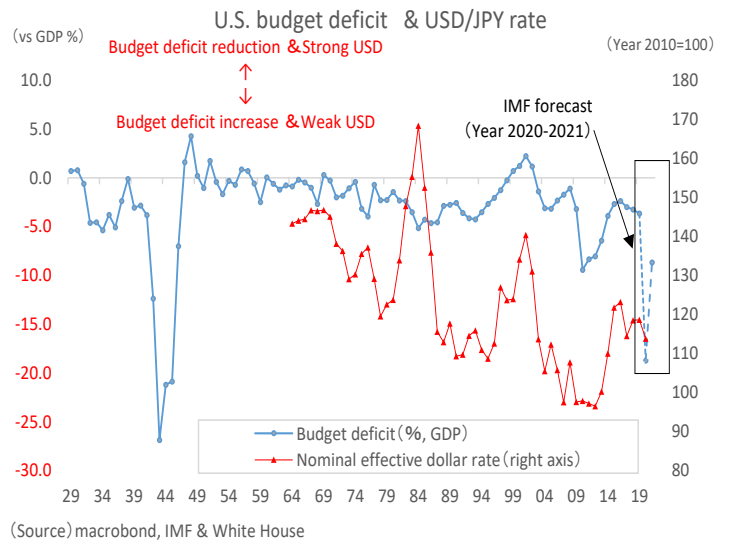
**USD's Perceived Overvaluation to Remain a Major Theme**

Let us take a look at some specific expectations regarding USD/JPY and EUR/USD trends based on the assumptions outlined in the above sections (see figure to the right). With regard to USD/JPY, 24% of respondents expected a slight JPY appreciation by around 2-3%, 29% expected the rate to remain more or less the same, while 35% expected a slight JPY depreciation by around 2-3%. The responses suggest that market participants expect USD/JPY to remain quite stable again this year despite the change in administration. EUR/USD expectations were also similar, which seems to suggest (as in the case of responses related to currency and monetary policy above) that not many market participants see a link between forex market trends and a change in administration in the U.S.

What do you expect Biden administration's USD/JPY rate?



Rather than consider the impact of the change in administration on specific currency pairs, it may be better to take into account the perceived overvaluation of USD and consider the extent to which USD is expected to weaken as a whole. As already reported, the Biden administration has announced an economic stimulus package worth a total of USD 1.9 trillion, the first round of which will target households, in a move typical of the Democratic party. USD 1.9 trillion amounts to approximately 9.5% of the U.S. nominal GDP (approx. USD 20 trillion) and roughly half the 2020 fiscal deficit. Based simply on this figure, Biden's stimulus package could exert upward pressure on USD as it will halve the perceived overvaluation of USD compared with the 2020 deficit. However, going by past experience, the fiscal deficit of any given year does not necessarily correlate to USD rate trends during the same year; it is quite possible for the impact to be manifested after a delay (see figure). As COVID infections spread, the government will likely be called upon to further expand its fiscal measures, and this is bound to intensify the perceived overvaluation of USD. As in 2020, I will use the U.S. fiscal deficit (as a percentage of GDP), which indicates the direction of USD, as a key indicator in formulating my forex outlook for this year.



### JPY Supply and Demand – Weakening Foundation a Risk to My Scenario

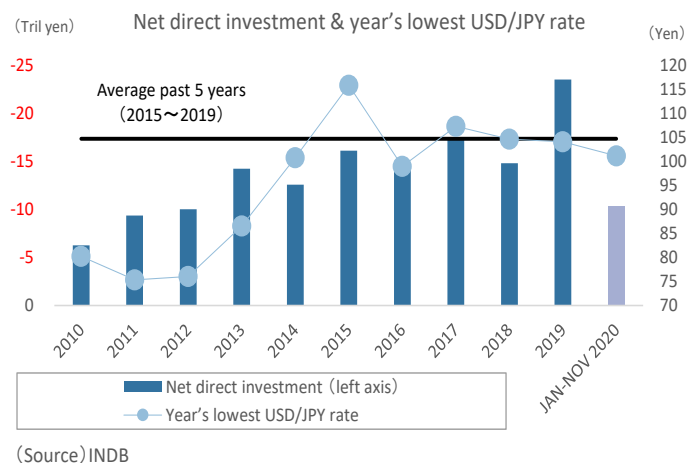
#### Pause in U.S. Interest Rate Increase

As of the end of the first month of 2021, USD/JPY has remained mostly in the 102.50-104.00 range. This is a moderate range, given that forex rates have increasingly resembled fixed exchange rates in recent years. This report has predicted that USD will weaken as U.S. interest rates stabilize at low levels during January-March 2021, as infections rise during the “dark winter,” and that USD/JPY could intermittently fall to the 100 level; then as spring approaches and temperatures rise, the end of the pandemic may come into view, leading U.S. interest rates to increase and USD to be bought back. However, as U.S. interest rates rose more than expected over the yearend and early in the new year, the prospects for USD/JPY falling below 100 have weakened. The 25-bps increase in U.S. interest rates in the one month from mid-December to mid-January, however, was quite steep, and interest rates have since plateaued. Real economic performance during February-March is likely to be worse, so one must still be prepared for U.S. interest rates falling a notch and USD rates declining as we approach spring.

#### USD/JPY Foundation Shaken by Sluggish Direct Investment

Compared with USD/JPY rate levels in recent years, the 102.50-104.00 range is definitely on the strong-JPY side. The lowest rate posted by USD/JPY each year over the last five years has been 115.86 in 2015, 99.00 in 2016, 107.32 in 2017, 104.64 in 2018, 104.10 in 2019, and 101.18 in 2020. If we take the plunge to 99.00 in June 2016 as a momentary aberration (literally lasting only a few minutes) resulting from Brexit (Britain’s exit from the EU, which came as a big shock to many market participants), the trend shows a clear decline in USD/JPY. What could be the reason for this? This is an important point to consider not just in terms of strong-JPY risks, but also in connection with this report’s view that U.S. interest rates and USD will bottom out for the time being in 2021. Of course, it is natural to assume that the USD/JPY rate trend is primarily determined by U.S. economic cycles and ultimately linked to U.S. policy interest rate movements, but the impact of JPY supply and demand must not be overlooked either. In recent years, JPY has lost some of its charisma as a safe-haven currency or a currency preferred during risk-off phases. This is thought to be because of the acquisition of foreign companies by Japanese companies (“direct investment” in the balance of payments), which involves an outright sale of JPY in the forex markets.

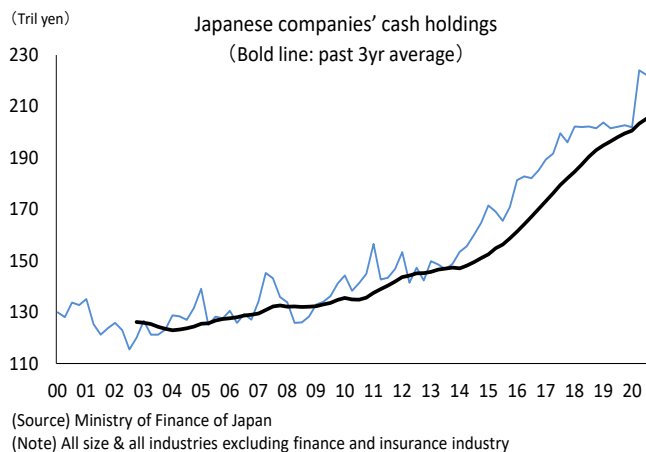
The figure plots the scale of net direct investment (hereafter, simply “direct investment”) for each year over the past 10 years against that year’s lowest USD/JPY rate. The correlation between the two is not all that clear, but one could say that an annual direct investment level of JPY 15 trillion appears to act as a bulwark against USD/JPY falling below 100, and this is something that has been mentioned repeatedly in the markets in recent years. Looking at the figures in detail, direct investment was -JPY 14.8 trillion in 2018, -JPY 23.5 trillion in 2019,



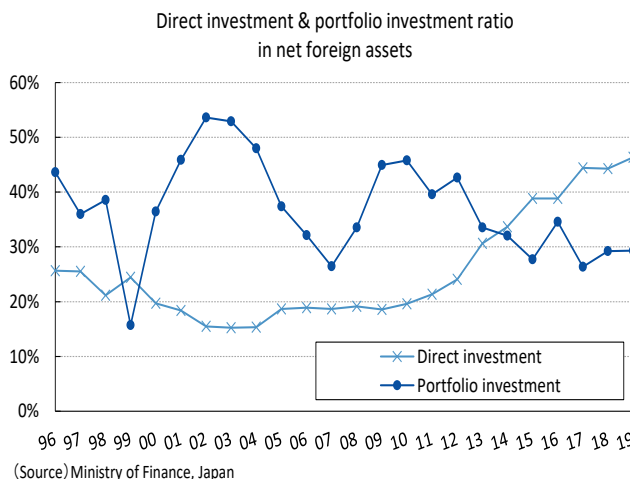
-JPY 17.3 trillion on average over the 2015-2019 five-year period, -JPY 13.6 trillion on average over the 10-year period from 2010-2019. Further, direct investment for January through November 2020 (latest data available) was merely -JPY 10.3 trillion. The final data for 2020 will be available only after the December 2020 balance of payments has been released, but it is clear that 2020 was an exceptionally bad year for direct investment compared with recent years because of the forced restrictions on corporate activity. As a result, the foundation of the USD/JPY rate trend has temporarily been shaken, and perhaps this is what has caused USD/JPY to move in the 102-103 range, which is a rare occurrence in recent years.

### *Direct Investment will Return; Thanks to Abundant Standby Funds and Japan's Ageing Population and Declining Birth Rates*

Will direct investment remain sluggish going forward? I don't believe so. Of course, the corporate sector cannot be expected to engage in the same level of proactive risk-taking through cross-border M&As as seen in the past 10 years until there is an end in sight to the pandemic. However, I would like to review the original reasons why Japanese companies began to voraciously acquire foreign companies in the first place. During the brief Democratic Party of Japan administration in Japan in 2010-11, the phrase "sextuple whammy" (representing an ultra-strong JPY, high corporate tax rates, high electricity charges, deadlocked free-trade agreements, rigid employment regulations, and strict environmental regulations) was frequently heard, and it is said that this is what forced Japanese companies to start seeking better opportunities abroad. A few of the six challenges, such as the ultra-strong JPY and the deadlocked free-trade agreements, were eventually resolved, but several remain and are expected to continue spurring on direct investment. Japan has also faced a more fundamental challenge since before the "sextuple whammy," namely that its population is ageing and its birth rates are declining faster than any other country in the world, so it is hardly surprising that companies would seek possibilities in foreign markets rather than in the domestic market. As is generally known, Japanese companies have maintained high levels of cash and deposits to begin with, and the level of these funds has only increased as a result of the pandemic (see figure top).



This is because of subsidies received in addition to investment and consumption activities being suppressed by the pandemic. Thanks to another round of ad hoc policy measures adopted following the second emergency declaration, there is a higher likelihood of the Japanese private sector (corporations and households) shutting itself in as a excess-savings entity (details follow). However, it must not be forgotten that these abundant standby funds will come in handy in the post-pandemic phase for activities that involve taking risks. As a result of robust cross-border M&A over the past 10 years, close to half of Japan's net external credit (the largest in the world) is no longer due to securities investment, but rather due to direct investment. This signifies that the structure of the Japanese economy is beginning to change starting with its external economic sector (see figure on previous page, bottom). To put it roughly, this structural change is the result of companies determining that there are no longer any promising investment opportunities in Japan, and I do not believe that such a trend will end any time soon. From the point of view of the forex markets, this signifies an increase in the outright sale of JPY, and is likely to continue playing the role of deterring JPY buying during risk-off phases or as a safe-haven currency.



## **U.S. Monetary Policies Now and Going Forward – To What Extent Will the U.S. 10-Year Yield Increase?**

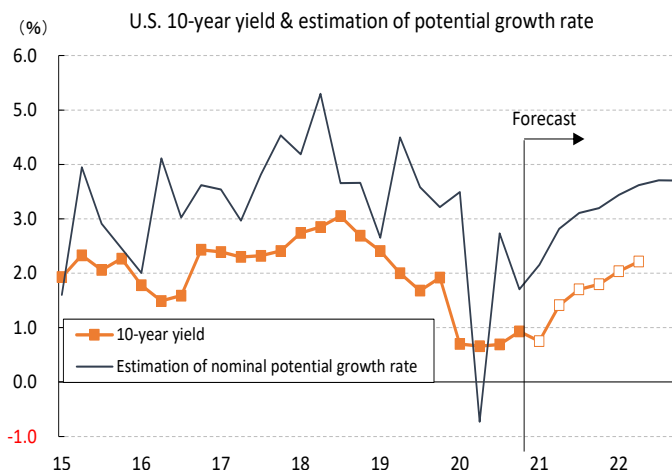
### *January FOMC Meeting*

At the January FOMC meeting, the Committee decided to keep the federal fund (FF) target range at 0-0.25% and maintain the current pace of QE (purchase of Treasury securities at the pace of USD 80 billion/month and mortgage-backed securities at the pace of USD 40 billion/month). The prospect of an additional fiscal stimulus package combined with expanding vaccine rollout has improved the economic outlook. Fed Chair Jerome Powell dismissed concerns of QE tapering that have emerged in some quarters as being premature. In fact, one of the key themes for 2021 may well be the extent to which the Fed will tolerate the increase in market interest rates as the real economy improves. Given that we are still in the middle of a "dark winter," with infections still spreading, Powell's dismissal of the concerns as "premature" may be somewhat believable, but the real test will come after the start of spring. As various economic and financial indicators show yoy improvement, the Fed will have to skillfully balance

maintaining its path of unprecedented monetary accommodation and tolerating an increase in market interest rates. How shares and forex rates respond to this state of affairs may turn out to be the biggest highlight of 2021.

*To What Extent Will the U.S. 10-Year Yield Increase?*

Financial asset prices in 2021 will depend on the extent to which U.S. interest rates rise. Both the dramatic rise in share prices relative to real economic performance and the significant depreciation of USD can be attributed to U.S. interest rates (led by the 10-year yield) stubbornly maintaining historically low levels following the Fed’s bold move to cut interest rates by -150 bps in one fell swoop last March. For instance, the 10-year yield, which is most typically used when discussing current and future economic prospects, has been in the 0.50-1.00% range since last March. This is an extremely low rate of interest given that the U.S. had a potential growth rate of over 3% before the pandemic. If we assume that there will be an end in sight to the pandemic during the current forecasting period, then all asset prices are bound to be at the mercy of the extent to which interest rates rise, which will be a key topic. The question “to what extent will interest rates rise?” can be approached in several ways. For instance, let us first tackle it from the point of view of its relationship with the potential growth rate. The figure plots the U.S. 10-year yield trend against the nominal potential growth rate trend as estimated by the Congressional Budget Office (CBO). According to the CBO’s calculations, the potential growth rate for the recent-most five years (2015-2019) has been +3.5% on average.



(Source) macrobond

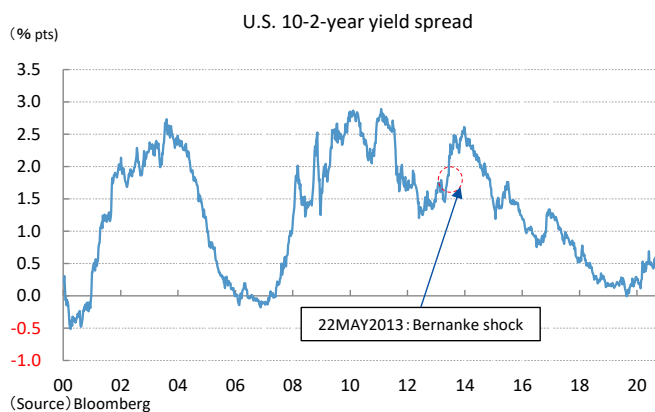
(Notes) The potential growth rate is estimated by the U.S. CBO.

The 10 year interest rate is calculated by taking an average of the difference between the potential growth rate for the past 3 years and the 10 year interest rate, and then calculating it backwards by taking this into account the CBO estimates.

The U.S. 10-year yield during the same period has been 2.2% on average. If we look at the recent-most three years (2017-2019), the potential growth rate has been +3.8% on average versus 2.4% on average for the 10-year yield. In other words, since before the pandemic, the U.S. 10-year yield has tended to be approx. 120-140 bps lower than the potential growth rate. Given the severe damage caused by the pandemic, the 10-year yield may remain below its usual level for some time to come. According to the CBO’s projections, the potential growth rate for 2021 is +2.8%, so taking away 120-140 bps from this, we get an estimated 1.4-1.6% rate for the 10-year yield, and this is one benchmark to watch out for.

*From the Point of View of the 10-2-Year Yield Spread*

It is also possible to look at things based on the shape of the yield curve. The figure shows the 10-2-year Treasury yield spread. This spread is currently approx. 100 bps, a level approaching that seen in 2017, when the Fed implemented three rate hikes. Incidentally, it was around 160 bps around May 22, 2013, when former Fed Chair Ben Bernanke gave the Congressional testimony signaling the start of the normalization process (often called the “Bernanke shock”). In other words, the spread was around 160 bps just before the normalization process began. Could this indicate, perhaps, that a 150-bps spread acts as a ceiling of sorts for the 10-2-year yield spread?

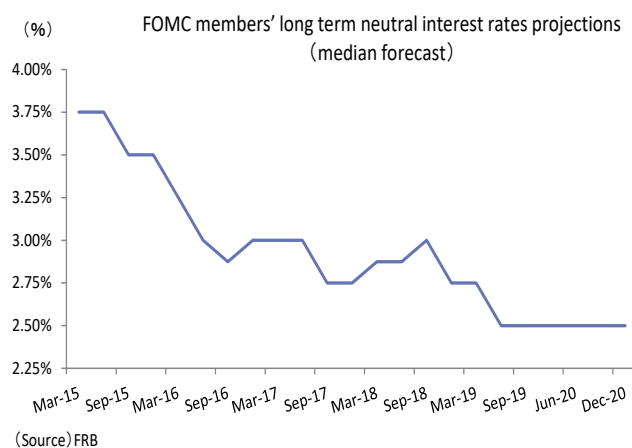


(Source) Bloomberg

Ordinarily, the 2-year yield tends to strongly correlate to the FF rate, while the 10-year yield is thought to strongly correlate to inflation expectations and future economic performance. There is consensus among FOMC members that the FF rate will be kept at zero percent until the end of 2023, so one can reasonably take this as a given. If so, the 10-year yield can only increase by 50 bps more (to 1.50% or so) before the 10-2-year yield spread hits 150 bps. Assuming that the economy is unlikely to recover to the Bernanke-shock level within the year, it is easy to believe that 1.50% would be the limit. Forex rate and other asset price forecasts assuming an upper limit of 1.50% for the 10-year yield this year to be the most likely scenario may not be far off the mark.

### Falling Neutral Interest Rate a Risk to My Main Scenario

Having said that, if we base our forecasts on the projections of Federal Reserve Board members (the dot plot), the neutral interest rate (which is considered the end point for rate hikes by the Fed) was 3.50% when the previous rate-hike phase began, but has since fallen to 2.50%. Taking into account the dramatic decline in labor participation rate as a result of the pandemic, it is unsurprising for both the potential growth rate and the neutral interest rate required for realizing it to have fallen a notch. If it is true that the upper limit for rate hikes has declined, it would be dangerous to predict interest rates based on past experiences. And if so, it is also possible that U.S. interest rates will not rise as much as expected in 2021 and that USD buying will also be accordingly limited. One of the risk factors for this report's main predicted scenario that both U.S. interest rates and USD will bottom out in 2021 is the suppression of market interest rates as a result of this decline in the neutral interest rate.



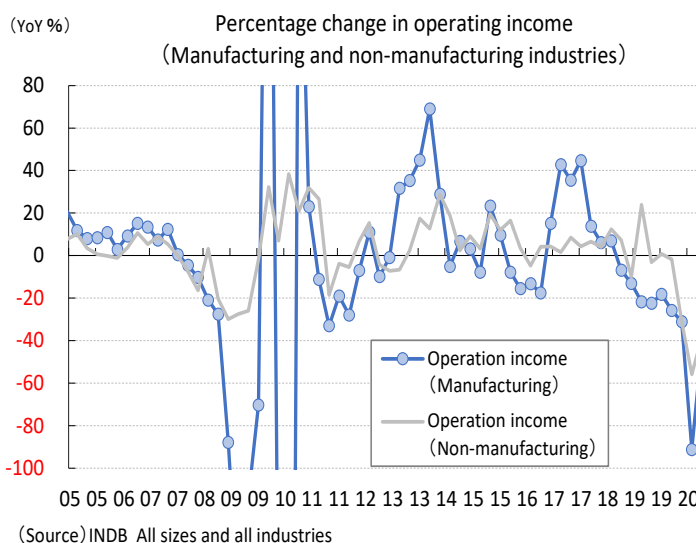
### Addendum: The Japanese Economy Now and Going Forward – The Righteousness of “Saving” Underscored by Second Crisis

#### Corporate Performance Set to Plummet Again

On January 2, Tokyo Governor Yuriko Koike and the governors of three other prefectures called on the government to declare another emergency, and the government did so on January 7. According to advance reports, the government and ruling party had doubts about the effectiveness of another emergency declaration and wanted to prioritize the revision of the 2020 special measures law on infectious diseases in the ordinary Diet session. The revised law, it was said, would include provisions for levying fines on businesses that refused to heed government calls for temporary closure or shorter business hours, thereby ensuring the efficacy of measures to curb the spread of infections – an argument that is logically convincing. The governors, then, began taking their own initiatives to call for shorter business hours. This coincided with reports of low approval rates for the Suga administration, thereby forcing the government to declare a second emergency without putting up too much of a fight. If the Suga administration had continued resisting, the governors would simply have persisted with their calls, and it seemed obvious that this would further bring down approval rates, so perhaps the governors were aware that the battle had already been won. I am not convinced that turning an important decision such as this into a political game was the right thing to do; the actions of the governors and the prime minister's response to them have left a bad impression regarding the strength of the prime minister's leadership. As anybody could have predicted, calls for emergency declaration did not stop with Tokyo and three other prefectures. Several other prefectures are calling for the same one after another. This kind of flabby policy operation is bound to cause the approval rate to worsen further. Moreover, as of the writing of this report, it is being reported that the state of emergency will be extended another month after the original February 7 end date. This was also quite predictable.

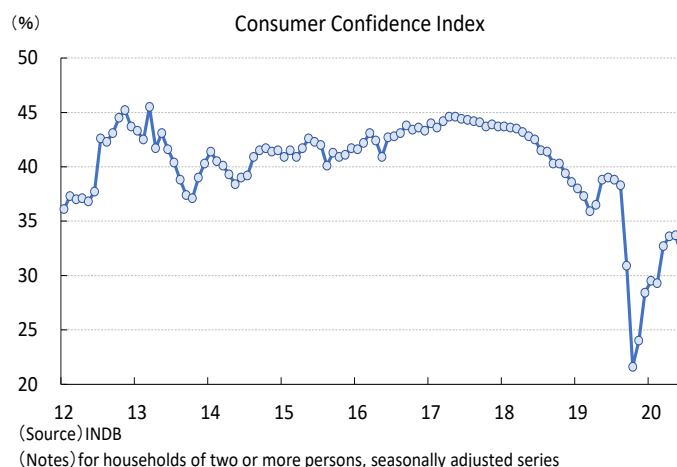
#### Leaving Behind a Festering Source of Evil in Corporate and Household Sectors

I see the recent second emergency declaration as a decision that leaves behind a festering source of evil. There were several arguments for and against the decision even at the time of the first emergency declaration in April-June last year, but at that time, there was a sense of helplessness in the face of an unknown crisis. However, the idea was that, when the spread of infections slowed during summer and the fall, the country would rush to build a more resilient healthcare system (by optimally allocating medical resources) in preparation for a new wave of infections in winter. In other words, it was already known that infections would rise again in winter, and a panel of experts had proposed the adoption of an appropriate new lifestyle to overcome the crisis, calling “living with COVID” the “new normal.” It is precisely because of this that many businesses have been putting up with the cost of meticulously implementing measures aimed at preventing infections. They have now been rewarded by being asked to shut down again because of another rise in infections (technically, a rise in the number of positive test results). Such a measure could well sow the seeds of mistrust in the minds of households and corporations (the private sector). Looking at corporate performance trends in the Ministry of Finance's Financial



Statements Statistics of Corporations by Industry, it is very clear the corporate performance slumped sharply during the April-June quarter and recovered somewhat in the July-September quarter (see figure), although performance remained negative year-on-year. Another slowdown is expected for the October-December quarter, when the rise in case numbers began to gather pace again, and performance for the January-March quarter is now expected to deliver the finishing blow to this trend.

Of course, this second lockdown differs from the previous one in the sense that it allows businesses to operate, although for fewer hours. However, from the point of view of payrolls and other operating costs, businesses could consider it better not to open at all if they have to close at 8:00 p.m. In this sense, it is quite harsh. It has been clearly pointed out that shortening business hours has the adverse effect of increasing crowding in stores, but there is no indication that the government has taken this into consideration either. Further, there are signs of household consumer confidence deteriorating again. In the December Consumer Confidence Survey released recently by the Cabinet Office, the Consumer Confidence Index (for households of two or more persons, seasonally adjusted series) fell by -1.9 pp mom to 31.8%. This was the first mom decline in four months. Confidence is likely to decline even further for January and February amid biased media reporting designed to fan public fears following the emergency declaration. Ultimately, consumer confidence seems poised to plunge to newer depths without ever having recovered to pre-pandemic levels. Naturally, personal consumption is likely to be sluggish. Meanwhile, despite a large number of hospital beds available throughout Japan, the media reports an imminent collapse of the healthcare system on a daily basis. What could the reason for this be? What could be preventing the problem from being resolved, and what would allow the problem to be resolved? With insufficient explanations in this regard, the government leaving behind a festering source of evil with its recent decisions.

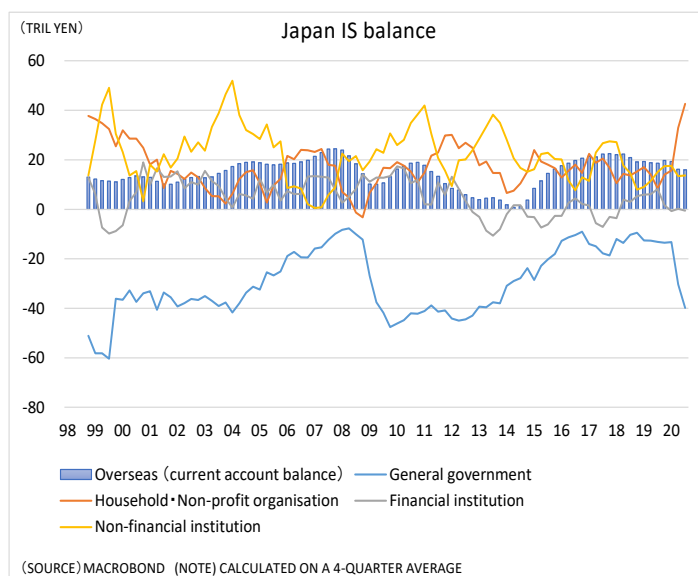


biased media reporting designed to fan public fears following the emergency declaration. Ultimately, consumer confidence seems poised to plunge to newer depths without ever having recovered to pre-pandemic levels. Naturally, personal consumption is likely to be sluggish. Meanwhile, despite a large number of hospital beds available throughout Japan, the media reports an imminent collapse of the healthcare system on a daily basis. What could the reason for this be? What could be preventing the problem from being resolved, and what would allow the problem to be resolved? With insufficient explanations in this regard, the government leaving behind a festering source of evil with its recent decisions.

*A Strengthening View that Saving is Good*

This evil that I talk about is mistrust. Mistrust of administrators will directly result in uncertainties regarding the future of the economy. If uncertainties intensify, they will suppress the consumption and investment appetites of the household and corporate sectors. This means a decline in such demand components of the GDP as private consumption, private residential investment, and private non-residential investment. To put it roughly, saving money rather than using it would become the rational choice for households and corporations in the face of uncertainty. Japanese companies have long been made fun of for their excessive internal reserves, but these reserves served as a buffer and prevented a major calamity for many companies in the face of the recent crisis. In other words, the excessive internal reserves proved to be a blessing in disguise and an unexpected tale of success. This, combined with government administrators riding roughshod over people’s personal rights with their ad hoc decisions based on no particular criteria, is feared to further suppress the consumption and investment appetites of households and companies. It is precisely this tendency toward excess savings in the private sector that leads to persistently low inflation and interest rates, which is at the core of the increasing Japanization of the world, as I have argued repeatedly since last spring.<sup>1</sup>

The figure shows Japan’s investment-savings (IS) balance for the July-September 2020 quarter. The household sector’s excess savings had increased following strict restrictions on economic activities, while the corporate sector’s excess savings remained level. The reason the corporate sector’s excess savings had not increased dramatically was because, while sales languished, costs continued to accumulate, preventing any increase in operating surplus (i.e., profits). At any rate, the excess savings of the private sector as a whole, which includes both the household and corporate sectors, increased significantly. This saving glut in the private sector is offset by a saving deficiency in the government sector, and this is the current structure of IB balance in the Japanese economy. With insufficient borrowing (demand) to offset the excess saving (supply), the cost of money (interest rate) cannot rise. Japan did maintain a similar situation during its lost two decades, but things were



<sup>1</sup> For example, please see the May 7, 2020, Market Topic titled “Signs of the Japanization of the World – Something to Watch Out for Post the Pandemic.”



not as dire then as they are now. Of course, last year's extreme situation was the result of special policy measures restricting economic activity and were at that time considered a transient phenomenon specific to 2020. However, if it turns out that emergency could be declared and measures similar to those taken in 2020 could be taken intermittently going forward, a dramatic saving glut in the private sector combined with a dramatic saving deficiency in the government sector could become the new normal. In such a world, neither wages, nor inflation or interest rates would rise, and economic activity would become permanently lukewarm as it is conducted under reckless fiscal expansion and monetary accommodation to sustain the fiscal expansion. I believe that the second emergency declaration will strengthen the view in Japan that saving is a good thing.

## Risks to My Main Scenario – Smoldering Risk of Politically Driven USD Depreciation

### Yellen Refrains from Mentioning “Strong Dollar”

In last month's edition of this report, I pointed out that a politically driven USD depreciation was the biggest risk to my forecast scenario that U.S. interest rates and USD would bottom out with the start of spring. I am still of this view. On January 19, a hearing was held to approve the nomination of Yellen to the post of Treasury secretary. Yellen's testimony touched upon a range of issues, but contrary to market and media expectations, her remarks did not include the phrase “strong dollar,” which tends to be over-used by Treasury secretaries. Perhaps her remark that “maintaining confidence in the long-term strength of the U.S. economy and the stability of the U.S. financial system is good for America as well as our trading and investing partners” hinted at a favorable stance regarding USD strength, but there was no direct mention of it. Given the call for “unity” rather than “division” by the new administration, this may have been intended as an olive branch to Former President Donald Trump's supporters, who have a strong preference for a weaker USD. Note, however, that simply bringing up “strong dollar” does not guarantee that USD will appreciate. As explained in the next section, the U.S. is known for verbally expressing support for a strong dollar while simultaneously letting USD remain weak (benign neglect).

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	6.7	-1.6
Euro-zone	17.0	8.9	-1.5
Mexico	13.3	-5.0	0.7
Canada	11.7	2.1	-0.2
Japan	7.1	5.2	-0.4
S.Korea	3.8	6.4	-0.2
Taiwan	2.2	6.1	-0.1
Switzerland	1.7	9.2	-0.2
U.K.	3.2	3.1	-0.1
Russia	0.6	-16.7	0.1
S.Africa	0.4	-4.7	0.0
Turkey	0.5	-20.0	0.1
Argentina	0.3	-28.9	0.1
Other	15.0	-	-0.7
NEER JAN-DEC2020	-	-4.1	-4.1

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

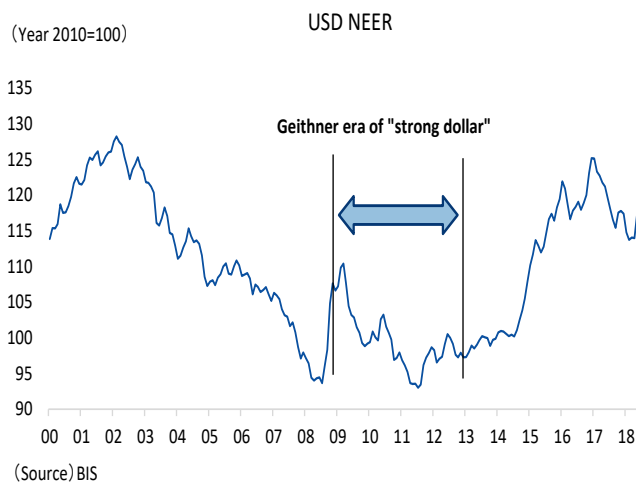
References to China were conspicuous throughout the testimony, however, and several media reports focused on this. For instance, having called China “our most important strategic competitor,” Yellen went on to directly criticize China, saying, “China is undercutting American companies by dumping products, erecting barriers, and giving illegal subsidies to corporations. It is stealing intellectual property and engaging in other practices to give it an unfair technological advantage, including forced technology transfer.” Given her remark that “the Biden Administration will make use of the full array of tools to counter China's abusive economic practices,” it will be interesting to monitor the tone of the Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States to see if it reflects this stance. Even if the U.S. were to implicitly and explicitly promote USD depreciation under Treasury Secretary Yellen, perhaps the main currency at the receiving end of this would be CNY rather than JPY. As the chart shows, CNY is the currency that contributed most to USD depreciation in 2020, followed by EUR, with JPY contributing much less.

However, to be honest, my basic understanding is that CNY is susceptible to weakening. Since the beginning of the year, the U.S.-China interest rate gap has been shrinking, and the repercussions of CNY appreciation would be a drop in exports leading to a decline in trade surplus for China. My main forecast scenario involves a rate reversal (depreciation) for CNY, which will boost USD.

### Geithner's “Benign Neglect”

Looking back at U.S. currency policy over time, there are many examples of authorities verbally expressing support for a strong USD while silently allowing it to weaken before their eyes. The most recent example of this policy, termed “benign neglect,” was seen during the term of former Treasury Secretary Timothy Geithner (January 2009 to January 2013), which coincided with the turbulent aftermath of the global financial crisis. Soon after taking office, Geithner remarked, “A strong dollar is very important in the United States,” adding that the dollar would retain that position for a very long time (Bloomberg, September 2009). Later during his term, he stressed again, “Our policy has been and will always be, as long as at least I'm in this job, that a strong dollar is in our interest as a country. We will never embrace a strategy of trying to weaken our currency to try to gain economic advantage” (April 26, 2011, Reuters). However, USD's NEER fell by 9.2% during Geithner's term. In 2011, at the peak of USD depreciation, the NEER declined even further, falling by considerably more than 10% compared with its value when Geithner took office (see figure). In other words, Geithner's words were completely contrary to the realities of the market.

The excuse given by U.S. authorities at that time was that USD had depreciated as a result of the unprecedented protraction/expansion of monetary accommodation by the Fed in order to support the domestic economy damaged by the financial crisis, and that weakening the currency was not in and of itself the goal. Therefore, they explained, there was no contradiction in expressing support for a strong USD as the currency policy. As a result of this benign neglect of USD depreciation, JPY (the currency of the world's largest net external creditor and, at that time, still backed by the world's largest trade surplus) skyrocketed. Given that the damage caused by the pandemic is even greater than that caused by the 2008 financial crisis, there are fears of a repeat performance of benign neglect, but even if that does happen, I think it likely that the currency most affected by USD depreciation will be CNY, given that China is a political adversary of the U.S. and a big trade surplus country. Note that, when JPY depreciated significantly under Abenomics in January 2013, inviting heavy international criticism, Finance Minister Taro Aso famously responded, "We never once complained about the dramatic JPY appreciation following the global financial crisis. It is unreasonable to criticize us now for simply reversing that trend to JPY depreciation." His remarks rang true to anyone who knew about the appreciation of JPY on the back of the "benign neglect" of USD depreciation by U.S. authorities.

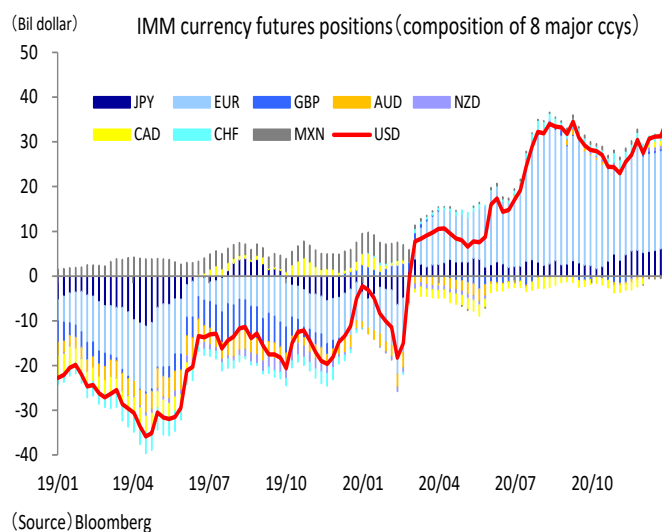


Returning to the point at hand, my main point is that it is a Treasury secretary's job to express support for a strong USD, but there is no guarantee that this outward stance will determine trends in the forex market. Even if U.S. authorities think a strong USD is desirable in the long run, they will blatantly disregard USD weakness if they consider it desirable for the real economy.

#### *Rebounding from 2020 a Key Element of 2021 Outlook*

Perhaps there is no reason to attach too much importance to the fact that Yellen did not directly mention a "strong dollar" in her testimony. However, taking into account the large volume of U.S. Treasury bond issuance expected in 2021, the Fed keeping the FF rate at zero percent through 2023, and the Biden administration's desire to take along Trump supporters, it seems likely that a significant number of market participants are forecasting USD depreciation driven both by political and economic factors. This in itself is a risk for this report's main forecast scenario of USD appreciation.

However, it is important not to forget that 2021 is the year after 2020, the year of despair. My basic understanding is that, failing to take into account a "rebound from 2020" as a key element of the outlook for 2021 will result in wrongly predicting the direction of forex trends. Those who expect the real economy three months from now or six months from now not to have improved compared to the present are likely to be in the minority. Starting from spring, real economic indicators including the growth rate and inflation are likely to show yoy improvement. More people are likely to have received vaccines as well. If the real economy begins to improve, nominal interest rates are likely to increase accordingly, and perhaps the Fed will permit an increase in this type of interest rate. If we assume a scenario of a clear increase in U.S. interest rates, it seems likely that USD, which depreciated significantly last year, will be bought back. Recent IMM futures transactions show that the USD short position is at its peak since the beginning of the pandemic. The most likely scenario for 2021 seems to be that USD will bottom out in the process of this short position being reversed.



Note, however, that my prediction of a rebound from 2020 relates only to 2021; it does not imply a continued appreciation of USD from 2022 onward. From 2022 onward, USD rate trends are likely to once again be determined by real demand in the form of current account surpluses and net external credit, while also being influenced by the Fed's back-and-forth normalization efforts, as was the case from 2013 onward. I would like to leave the discussion of the outlook for 2022 onward for another time.

# EUR Outlook – EUR Appreciation May Peak Soon

## Euro Area Monetary Policies Now and Going Forward – Could YCC be the Next Move?

### Statement Clearly Outlines PEPP Prospects

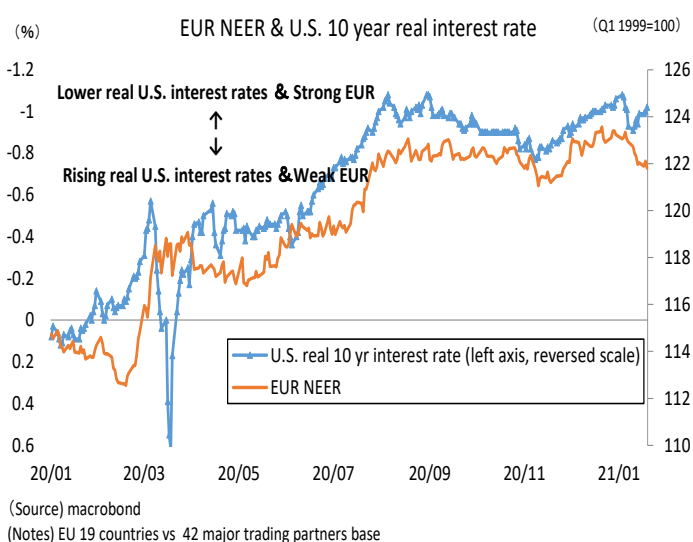
The ECB decided following its January Governing Council meeting to keep its policy unchanged. Since the Council had only in December decided to expand and extend its pandemic emergency purchase programme (PEPP) as well as to extend its targeted longer-term refinancing operations (TLTRO3), this time's decision to maintain the *status quo* was as per market expectations. As of January 15, just before the meeting, the main pillar of the ECB's monetary accommodation, the PEPP, had already used up EUR 780.7 billion or 40% of its total envelope of EUR 1.85 trillion. With over a year remaining in its implementation period (through March 2022), another expansion or extension of the PEPP is unlikely to be taken up for debate for the time being. The Account of the December Governing Council Meeting also reveals that several cautionary views were expressed with regard to expanding and extending the PEPP at that time. If the spread of infections can be controlled as envisaged by the ECB, the question of whether the entire amount set aside for the PEPP should be used may become a point of contention going forward.

In this context, the January meeting's statement mentioned two options for PEPP management going forward: (1) "If favourable financing conditions can be maintained with asset purchase flows that do not exhaust the envelope over the net purchase horizon of the PEPP, the envelope need not be used in full," and (2) "Equally, the envelope can be recalibrated if required to maintain favourable financing conditions to help counter the negative pandemic shock to the path of inflation." "Recalibrate" is a term the ECB has been using a lot lately, and seems to be synonymous with "expand." ECB President Christine Lagarde called attention to the fact that the two options had been linked with the word "equally," stressing that it indicated that the two options would be treated with equal importance.

### Paying Attention to EUR Appreciation from Next Time

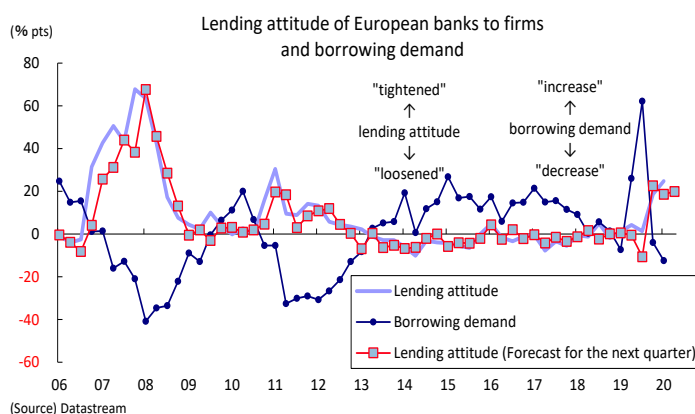
The ECB's continued wariness regarding EUR strength was also obvious. Although the policy decision itself was uneventful, the statement itself continued to stress that "underlying price pressures are expected to remain subdued owing to weak demand, notably in the tourism and travel-related sectors, as well as to low wage pressures and the appreciation of the euro exchange rate." As expected, the press conference also included questions regarding EUR appreciation, to which Lagarde responded as usual with, "we are monitoring very carefully exchange rates, very carefully, because we know that exchange rates have an impact on prices, and clearly play a part in our inflation forecast, and what we can deliver with our monetary policy." Such expressions of caution regarding EUR appreciation from the ECB have become quite common, but this situation may change going forward.

The Account of the Monetary Policy Meeting held on September 9 and 10, 2020, surmised that EUR appreciation was the result of USD depreciation, which in turn was because "Investors tended to reduce their holdings of US dollar-denominated debt securities when break-even inflation rates increased, and this effect was also stronger when real rates were in negative territory." In this context, real U.S. interest rates are recently showing signs of bottoming out, and there are accordingly signs of EUR appreciation peaking out (see figure). It will be interesting to see how the ECB Governing Council evaluates such developments going forward.



### Euro Area Credit Conditions Seen as the Biggest Problem

The high level of concern regarding the region's credit conditions was obvious at the press conference. On January 19, the latest issue of the ECB's quarterly euro area bank lending survey (BLS) was released. The survey clearly revealed the stricter credit standards applied by banks for the current quarter as well as the upcoming one (see figure). Since last year, the main economic/financial problem in the region has been shifting from one of liquidity to one of solvency. Solvency-related concerns have quietly been emerging as credit is accumulated through TLTRO3 and other operations. How to assess this regional credit climate as a real problem is likely to be the ECB's biggest worry going forward. Lagarde's response to those expressing



concern regarding the deterioration of credit conditions is to emphasize that TLTRO3 has been consistently successful in terms of take-up, and lending interest rates have declined, indicating that the policy has been successful. To be sure, Italian government bond yields did not increase despite political instability in Italy making the headlines early this year. I also think that the ECB's asset purchase program has played a role in making this possible (to put it in a different way, this may be proof that the ECB has already begun yield curve control (YCC) – details follow). Again, going by the BLS, demand for loans also appears to have simmered down, so it would appear that the series of measures taken have been successful in defusing a tense situation.

Having said that, it should be possible to ask the ECB why, despite all these accommodative measures, there has been no improvement in banks' attitudes toward lending. In this regard, Lagarde has refrained from providing specifics, merely stating that rather than focusing on specific interest rate levels, the ECB takes a composite approach based on multiple indicators to determine whether financing conditions are favorable or not. Such issues as that of whether to fully utilize the PEPP asset purchase envelope and that of how the ECB assesses the current and future state of credit conditions are likely to be important focuses for ECB watchers going forward.

#### *Start of ECB's Version of YCC?*

Since the beginning of the year, there have been rumors that the ECB may introduce YCC in its policy operations. Governor Pablo Hernández de Cos of the Bank of Spain was reported on January 4 as having said, "Yield-curve control is an option worth exploring. The experience of central banks (that have already introduced it) suggests that, if sufficiently credible, yield-curve control allows the central bank to achieve a yield-curve configuration with a lower amount of actual purchases, hence, enhancing efficiency." Further, Bloomberg reported on January 20 that "The ECB is buying bonds to limit the differences between yields for the strongest and weakest economies in the euro zone, according to officials familiar with the matter." The Bloomberg report suggests that the ECB is already implementing the policy, and confirms that the policy is being implemented based on the specific intent of appropriately controlling the yield spread between member states.

Naturally, a few reporters (fewer than expected) asked about this during the press conference. The question was very straightforward, asking what Lagarde's views were regarding reports such as the aforementioned. In response, Lagarde denied that the ECB was considering YCC, saying, "We're not riveted to any particular yield. We take into account multiple indicators that relate to the financing of the economy." However, as noted by the questioner, market participants are likely to continue suspecting that the "ECB's already doing de facto yield curve control, without saying so."

I have been discussing the possibility of the ECB introducing YCC since August 2019.<sup>2</sup> Given that the ECB already applies a -0.50% negative interest rate (-0.40% in 2019), it makes sense that any further monetary easing would have to be through quantitative expansion, and that is, in fact, what is happening. However, even if the Bank pursues QE with determination, interest rate levels will also be negatively affected. As in the case of the BOJ, appropriately controlling yields will result in increased systemic risks if sufficient consideration is not given to the operations of financial institutions. Inevitably, there are calls to maintain the interest rate level at the optimum level, and the BOJ's experience shows that YCC is an effective policy in the face of such calls. However, the euro area has 19 types of government bond yields, so it will have to take this into consideration and design the YCC policy appropriately. In this connection, I have thought that it may be a good idea to design a policy in terms of the direction of interest rates rather than in terms of the interest rate level. The BOJ's YCC currently operates in the range of  $\pm 20$  bps from the 0% target. In the case of the ECB, it could aim for a range of  $\pm 20$ bps from a certain point (say, the yield as of the date of the Governing Council meeting) for its member states' 10-year government bond yields. Since the starting point for each member state is inevitably different, there may be no choice but to aim for a specific fluctuation range from the base date.

The Bloomberg article quoted above notes that the ECB is buying bonds to "limit the differences between yields for the strongest and weakest economies in the euro zone, according to officials familiar with the matter," but when it comes to what criterion is used for establishing a permissible fluctuation range from that point, my assumption seems to be right. For instance, since November last year, the 10-year yield spread between Germany and Italy and that between Germany and Greece have been stable, so speculations and reports that the ECB has already begun implementing "de facto YCC (and/or a de facto YSC – Yield Spread Control) without saying so" are understandable. Going by Lagarde's response at the press conference, the ECB is not yet ready to publicly own up to its YCC or YSC policy, but Italy is going through a major political shakeup, and major political events are scheduled over the next year or two in Germany and France, so we may see mentions of YCC or YSC as the ECB's "next move" if the bond markets show signs of turbulence in connection with any of these events. The ECB seems to be steadily following in the BOJ's footsteps.

#### *Sudden Rumors that the ECB May Cut Rates Further*

On January 27, Bloomberg ran an article titled "ECB Officials Agree to Counter Investor Rate-Cut Skepticism," which reported on the possibility that the ECB could further cut already record-low policy rates. Among central banks that have already adopted negative interest rates, the main debate centers around how to lessen the damage from the

<sup>2</sup> For example, please see the August 21, 2019, edition of Reuters Forex Forum, entitled "YCC Abandoned by the BOJ Only to be Picked Up by the ECB."

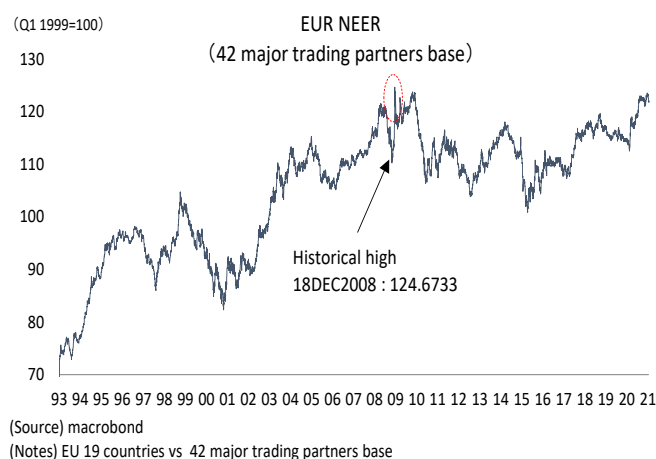
policy, so it is rare to see discussions or market predictions in favor of further rate cuts. It may, therefore, be worth exploring the reason for such a report to be published all of a sudden at this time. The article states that “European Central Bank policy makers are uncomfortable that investors appear to be largely ruling out more interest-rate cuts, and have agreed to stress that such stimulus remains a viable option, according to officials.” It is not clear who the “officials” mentioned here are, but a similar discussion reportedly took place also at the January 21 Governing Council meeting.

#### *Hints of Further Rate Cuts Have Existed Since July 2019*

To be sure, looking back at the January 21 press conference, in response to a direct question from a reporter, “Why didn’t you touch the rate?” Lagarde referenced the Introductory Statement (“We expect them to remain at their present or lower levels until we have seen the inflation outlook robustly converge, etc.”) and said “the deposit facility rate is part of our toolbox.” However, the forward guidance was changed to its current language suggesting a rate cut on July 25, 2019; it is not a new development. Lagarde is free to reference a forward guidance that had become devoid of substance, but that does not change the fact that most market participants were not expecting further rate cuts to actually take place. Two months after the forward guidance was introduced (on September 12), the ECB cut the policy rate from -0.40% to -0.50%, and market participants have since assumed that this is as far as it will go.

#### *Correcting EUR Appreciation the Primary Objective?*

Why is the debate over further cutting rates being brought up again now? My view is that this may be a strategy to counter EUR appreciation. Despite several rounds of additional monetary easing and verbal interventions, EUR remains rock solid. In particular, the currency is at its highest ever level in nominal effective terms (see figure), which is a burden for the euro area economy, heavily dependent on external demand as it is. In an interview to Bloomberg on January 27, President Klaas Knot of De Nederlandsche Bank said, “there is still room to cut (deposit facility) rates” (currently at -0.5%), if necessary in order to prevent a further appreciation of EUR. It seems blasphemous for the head of a developed economy’s central bank to make statements to the effect “We would like to cut rates to devalue our currency,” but the recent trend seems to be to allow such statements to be made by ECB Governing Council members except the president, who also serves as the chair of the executive board (the ECB’s Governing Council comprises the president, vice president, and four other members of its Executive Board as well as 19 governors of the national central banks of euro area countries). Going by recent developments, perhaps Knot is one of the “officials” mentioned in the Bloomberg report above.



The Account of a past Governing Council meeting presented the analysis that the decline in U.S. real interest rates was resulting in USD depreciation, which in turn was causing EUR to appreciate. Specifically, according to the review by Executive Board Member Isabel Schnabel, “Investors tended to reduce their holdings of US dollar-denominated debt securities when break-even inflation rates increased, and this effect was also stronger when real (U.S. interest) rates were in negative territory.” Although Schnabel mentions real U.S. interest rates, it seems more appropriate to discuss this issue in terms of the gap between real interest rates in the U.S. and the euro area. And if so, it would not be surprising to see ECB officials attempt to further cut the euro area’s interest rates overall in an effort to guide EUR lower. However, nominal U.S. interest rates have already begun to increase in recent days, causing real interest rates also to turn around, and EUR’s nominal effective exchange rate has accordingly stopped soaring. If the ECB’s intent in attempting to further cut policy rates is to deter EUR appreciation, it seems quite likely not to implement the policy right away, preferring instead to wait and watch.

#### *Rate Cut Risks Not Worth the Returns*

The ECB is facing a deterioration of credit conditions in the region. This is thought to be because of concerns that the cost of credit could deteriorate amid a regional economic stagnation. Although the ECB has been strengthening fund provisioning to the banking sector through TLTRO3 and other operations, risk aversion in the banking sector continues to intensify. The managerial decision to take a stricter attitude to lending amid a real economic deterioration is a sound one, but one cannot overlook the fact that management stamina has been waning as a result of the negative interest rate policy, which has been in place since long before the pandemic began. As it is, banking sector profitability takes a hit in a deteriorating macroeconomic climate, so further cutting rates at such a time is bound to invite an even stricter attitude to lending. In the first place, there is no need for a further interest rate cut because lending interest rates in the region are already on a steady decline. Moreover, it is unclear whether taking the risk will be worth it in terms of being able to stem EUR appreciation driven by USD depreciation. Frankly, one gets the impression that the risks are far greater than the expected returns. Based on this understanding, my view is that further cutting interest rates is unlikely to be the ECB’s first choice for additional monetary easing, and that it would only be implemented if, say, EUR’s nominal effective exchange rate were to hit an all-time high or if EUR/USD were to surpass 1.25 dollars.

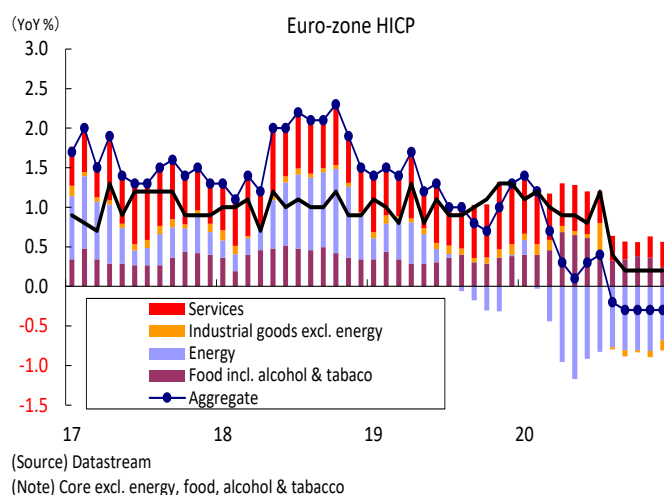
## Euro Area Economy Now and Going Forward – Inflation Situation Worse than Ever Before

### *Euro Area Inflation for 2020 at Worst Ever Level*

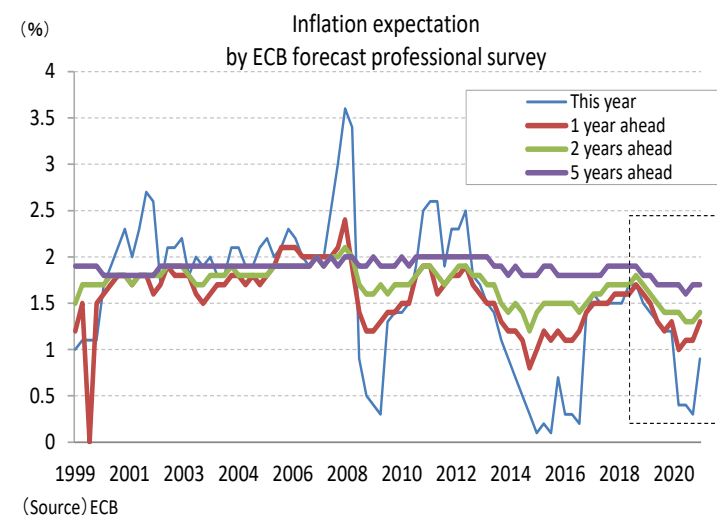
The euro area's December Harmonised Indices of Consumer Prices (HICP, final report), published by Eurostat on January 20, revealed no change from the preliminary report at -0.3% yoy. This was the fifth consecutive month of negative growth starting August, and the longest stretch of negative growth posted since June-October 2009, the year after the global financial crisis began. If the January HICP, which has not been released as of the writing of this report, also turns out negative, this will be the longest ever stretch of negative inflation. Further, the HICP for the entire year (2020) was -0.3%, topping the previous record (-0.2% for 2014). In other words, it has now been confirmed that 2020 posted the worst ever inflation for the whole year. Of course, this poor inflation performance is largely driven by the slump in crude oil prices, and if that proves to be the sole reason, we should see a return to positive inflation growth starting 2H of this year.

### *Unlikely to be a Transient Phenomenon*

However, as the figure shows, non-energy industrial goods have also been contributing negatively since mid-2020. It is rare to see negative contribution from non-energy industrial goods, and even when this component did contribute negatively in the past, it was often only a small and brief negative contribution that usually recovered within a couple of months. This time, as of December, non-energy industrial goods have posted the fifth consecutive month of negative contribution, albeit a small one. Services, food, alcohol, and tobacco have also been weak, making it quite difficult to dismiss the negative HICP growth as a temporary phenomenon attributable solely to lower crude oil prices. The January Governing Council meeting statement expressed the view that the weak 2020 HICP was caused by temporary factors including "current energy price dynamics" and "the temporary VAT reduction in Germany," and that headline inflation was likely to turn positive in the coming months as these factors faded away. It added, however, that "underlying price pressures are expected to remain subdued owing to weak demand, notably in the tourism and travel-related sectors, as well as to low wage pressures and the appreciation of the euro exchange rate," acknowledging that it may be quite difficult to achieve the expected 2% inflation target over the medium term.

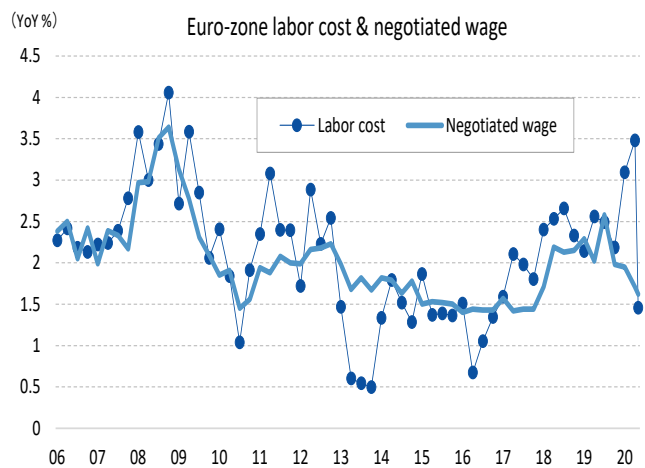
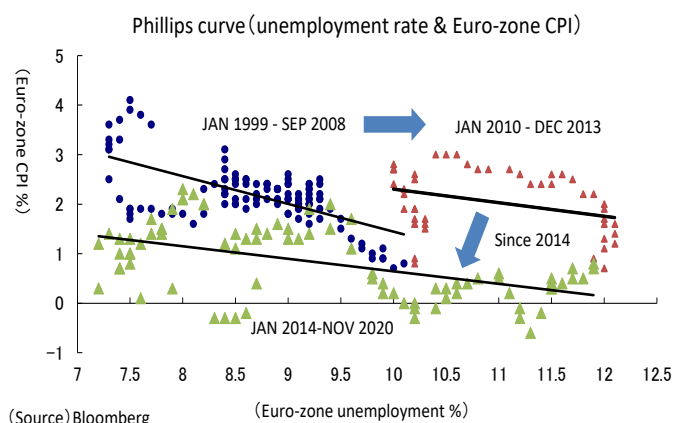


Inflation expectation trends have also been concerning. The ECB has expressed concern that not just market-based inflation expectation indicators such as the 5-year, 5-year forward inflation expectation rate (5-year, 5-year BEI), but even relatively more stable survey-based inflation expectations are weak. For instance, inflation expectations are increasingly weak in the Survey of Professional Forecasters released by the ECB once every quarter. Strictly speaking, inflation expectations for all periods, including the traditionally more stable five-year forward BEI had begun to decline in 2018, long before the pandemic struck – the pandemic was merely the final nail in the coffin. Inflation expectations in the near term (this year) may see some recovery due to volatility, but concerns will remain whether the five-year forward inflation expectation can be expected to recover to the neighborhood of 2%.



### Concern over Flattening Phillips Curve

As mentioned above, the ECB considers low wage pressures to be one of the reasons behind subdued price pressures, and low wage pressures especially in the service sector, which generally tends to drive wages, are feared to exert downward pressure on prices going forward. Services have a relative weight of 45% among HICP components, and if they continue to contribute negatively to price pressures, they will eventually cause a change in the price trend. Given that service prices remained relatively stable during the global financial crisis, the recent trends are worrisome and need to be monitored going forward. As the figure to the right (top) shows, the rate of change in wages has not slumped quite to the historical level of the HICP. However, the euro area's negotiated wage rates (wages that are agreed upon following wage negotiations) as estimated by the ECB are currently at +1.6%, which is not far from the lowest ever recorded for this statistic (+1.4%). Given that wages are a lagging indicator of the economy, the situation warrants close monitoring. Meanwhile, although the unemployment rate peaked at 8.7% in July 2020 and has since been gradually improving, one cannot be certain that wage and price trends will improve directly as a result of this. Ever since the European sovereign debt crisis, the region's Phillips curve has clearly shifted downward and has been gradually flattening (see figure to the right, bottom), so it would be risky to bet on the traditionally expected path of a decline in unemployment rate leading to an increase in wages, thereby resulting in higher prices. I am afraid the euro area's inflation rates, which were still recovering from the region's sovereign debt crisis, have been forced to take another hit and fall further as a result of the pandemic.



(Note) There are also non-agreed wages, therefore differ from actual labor cost

Daisuke Karakama  
 Chief Market Economist  
 Derivatives & Forex Department  
 Mizuho Bank, Ltd.  
 Tel: +81-3-3242-7065  
 daisuke.karakama@mizuho-bk.co.jp

These materials and the content of any related presentation are confidential and proprietary and may not be passed on to any third party and are provided for informational purposes only. Assumptions have been made in the preparation of these materials and any such presentation and Mizuho Bank, Ltd. ("Mizuho") does not guarantee completeness or accuracy of, and no reliance should be placed on, the contents of these materials or such presentation. Nothing in these materials or any related presentation constitutes an offer to buy or sell or trade and the terms of any transaction which may be finally agreed will be contained in the legal documentation for any such transaction, with such transaction being priced at market rates at the relevant time (the rates herein or in any related presentation being purely illustrative). (As a general rule you will not have a right to terminate early any transaction entered into – if you wish to do so, losses may be incurred by you.) These materials and any related presentation should not be considered an assertion by Mizuho of suitability for you of any transaction, scheme or product herein or therein. Mizuho has no duty to advise you on such suitability, nor to update these materials or contents of any related presentation. You must determine in your own judgment the potential risks involved in the transactions outlined herein or in any related presentation (taking professional financial, legal and tax and other advice) and whether or not you will enter into any transaction that may arise from these materials or related presentation. Nothing herein or in any related presentation should be construed as providing any projection, prediction or guarantee of performance or any financial, legal, tax, accounting or other advice. Mizuho shall have no liability for any losses you may incur as a result of relying on the information herein or in any related presentation. "MHBK provides this information for free. Please request for cancellation of subscription if you do not want to receive free-of-charge information from MHBK."