# Forex Medium-Term Outlook

**March 1, 2021**

## Overview of Outlook

In February, there were phases of USD/JPY pushing its upper bound – reflecting the strengthening of USD rather than the weakening of JPY. This is in line with the consistent rise in U.S. interest rates since the beginning of the year. Taking into account that U.S. interest rates have risen more strongly than predicted in this report, I am compelled to upwardly revise my USD/JPY outlook to some extent. However, there seems not much scope remaining for a desirable rise in interest rates unaccompanied by a share-price correction. At the very best, U.S. 10-year interest rates can rise to 1.70%, but even at that level, USD will be the only major currency with a decent interest rate, resulting in a scenario of across-the-board USD appreciation for 2021. However, it is impractical to expect that the U.S. interest rate increase will maintain its momentum of January and February (even from the perspective of maintaining share price strength), so the USD/JPY upper bound is also likely to rise to no more than 110 or so over the next year. Any risks, one could say, would be on the up side. In the U.S., there is already debate about inflation. I think concerns of runaway inflation as a result of current indiscriminate macro-economic policy measures are far-fetched, but if COVID vaccines are effective, there is the possibility of inflation expectations overheating toward the middle of the year. This could affect nominal interest rates and boost USD more than expected. Such a development is a not-insignificant risk scenario for this report's main forecast.

EUR appears persistently strong despite even the ECB suggesting a possible weakening. There were phases of EUR/USD falling below 1.20 dollars as USD appreciated across the board, but EUR did not weaken significantly in the end. As restrictions on economic and other activities continue amid a rise in infections, neither the current state nor future prospects for the euro area economy are bright, and inflation seems likely to remain stagnant for the time being. Further, major national elections are scheduled to be held in Germany and several other EU member states during the current forecasting period, and there are concerns whether the EU will be able to smoothly implement its policies (pandemic recovery fund, etc.). However, there are no signs of EUR weakening as a result of such political and economic uncertainties. The fact that the euro area has the world's largest current account and trade surpluses seems to be preventing a crash of EUR. Under such circumstances, the ECB may be attempting to guide EUR downward by hinting at further rate cuts, but given the poor credit conditions facing the region's financial institutions, a policy that would further eat into profitability in the financial industry may be impractical. My main scenario assumes a further increase in U.S. interest rates and a weakening of EUR against this, but perhaps not to the extent of JPY, given the strong actual demand for EUR.

**Summary Table of Forecasts**

| | 2021<br>Jan (actual) | Feb-Mar | Apr-Jun | Jul-Sep | Oct-Dec | 2022<br>Jan-Mar |
|---|---|---|---|---|---|---|
| **USD/JPY** | 102.60 ～ 106.69<br>(106.48) | 105 ～ 108<br>(106) | 105 ～ 110<br>(107) | 105 ～ 110<br>(108) | 106 ～ 111<br>(109) | 106 ～ 111<br>(110) |
| **EUR/USD** | 1.1952 ～ 1.2349<br>(1.2093) | 1.19 ～ 1.23<br>(1.21) | 1.17 ～ 1.22<br>(1.20) | 1.17 ～ 1.22<br>(1.18) | 1.15 ～ 1.21<br>(1.17) | 1.15 ～ 1.21<br>(1.17) |
| **EUR/JPY** | 125.10 ～ 129.94<br>(128.77) | 125 ～ 131<br>(128) | 124 ～ 131<br>(128) | 125 ～ 132<br>(127) | 126 ～ 133<br>(128) | 126 ～ 133<br>(129) |

(Notes) 1. Actual results: until 26 FEB 2021, (): as of 10AM 1MAR2021 . 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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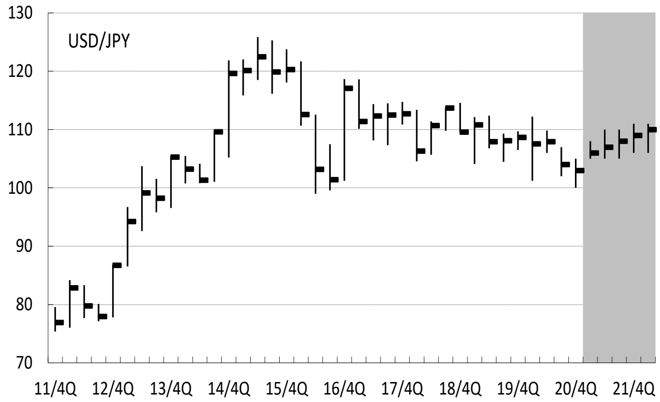
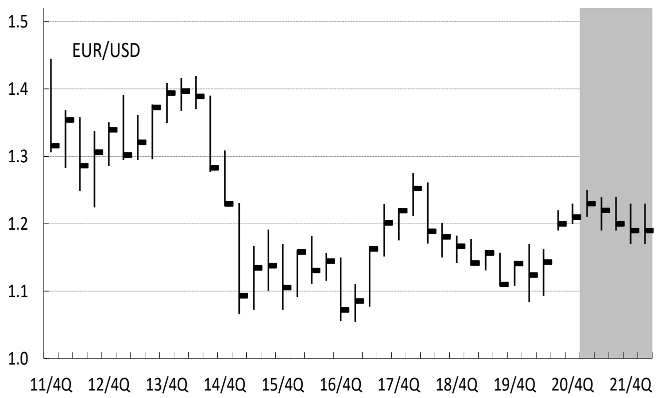
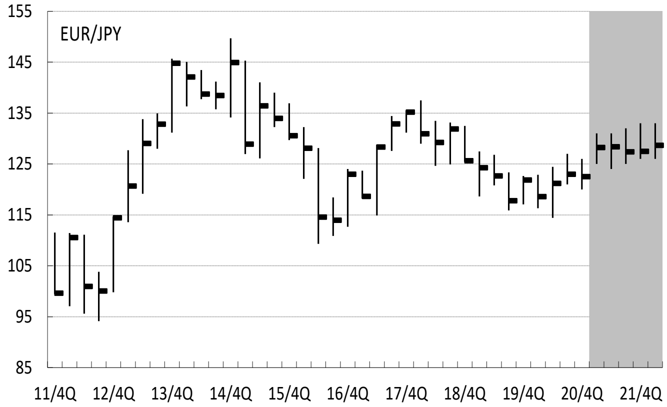
**Exchange Rate Trends & Forecasts**




# USD/JPY Outlook – U.S. Interest Rate Gathers Momentum; Upside Risk from Inflation

### U.S. Monetary Policies Now and Going Forward – Focus on Bond Yield Attractiveness Relative to Share Prices

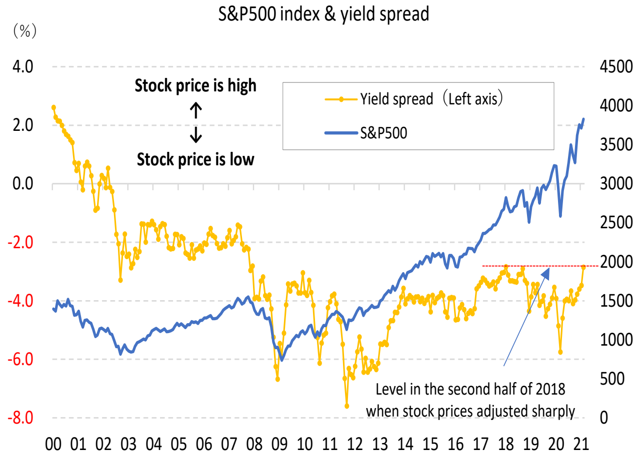
*At the Current Rate, USD/JPY Could Surpass 110 by Yearend*

In February, USD/JPY closed at a high of 106, having pushed up its upper bound. This was the side effect of across-the-board USD appreciation in line with the consistent rise in the U.S. 10-year yield since the beginning of the year. The November 2020 issue of this report assumed regarding the U.S. 10-year yield (which was around 0.9% at that time) that it would stabilize at the 1.0% level during the January-March 2021 quarter, rise to 1.20% during April-June, and then to 1.50% by the end of the year. I remember thinking at the time that this was a fairly hawkish prediction, but as it turned out, the 10-year yield shot past 1.50% to the 1.60% level in late February. Of course, it fell back to the 1.40% level right away thanks to share-price corrections, but the fact remains that U.S. interest rates have rebounded more rapidly than expected. Given my reasoning that the rebound in U.S. interest rates in 2021 will cause USD also to recover, an upward revision of my USD/JPY forecast becomes essential.

*Limited Scope for Further Desirable Rise in Interest Rates*

Will the rise in yield maintain its momentum in March and onward? I discussed the predicted upper bound for the U.S. 10-year yield in last month's issue of this report and considered a 1.50% upper bound to be reasonable given the potential growth rate, and the status of the yield curve and yield spread. As explained above, it may be necessary to raise the upper bound somewhat taking the current yield level into account, but even so, I strongly feel that a 1.60% or 1.70% level may be as high as it gets.

There are other ways to predict interest rate levels apart from using the potential growth rate and shape of the yield curve. In focus right now is the yield spread (U.S. 10-year yield – stock yield), which compares bonds with stocks in terms of attractiveness as investment options. For instance, in recent history, share prices underwent a major correction during a phase of rising interest rates in October 2018 or so. The yield spread around that time (July-September 2018) was -3.00%. Taking the current U.S. 10-year yield to be 1.60%, we get a -2.80% or so yield spread (which is an indicator of the relative attractiveness of bonds vs. S&P500 index stocks). This is a similar yield spread as that seen around October 2018, close to the end of the previous phase of rate hikes, when U.S. stock prices were forced into a major correction. The share price correction following the 10-year yield hitting 1.60% in late February was as expected. It has to be said that there is very little scope left for a “desirable” rise in interest rates unaccompanied by a share price correction. Moreover, one must not forget that the previous phase of rate hikes began during a state of full employment, under economic and financial conditions dramatically better than current conditions.

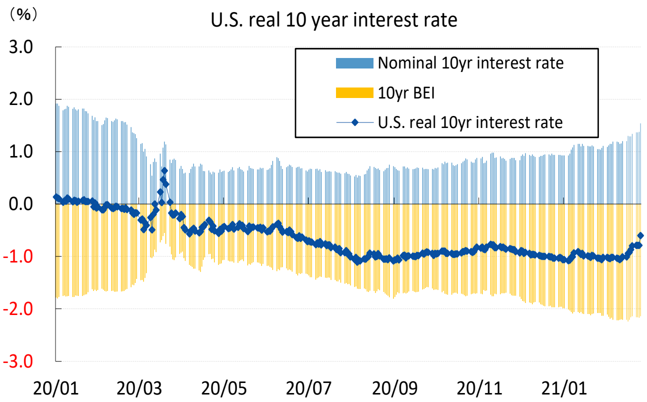


（Source） macrobond
（Note） Yield spread (U.S. 10-year yield – stock yield)

Of course, there is something to the argument that earnings per share (EPS) could increase in a non-continuous manner, in line with the non-continuous suspension of economic activity due to the pandemic and the interest rate and inflation expectations arising from hope given by the vaccine, and this is adding to the difficulty of formulating a forecast. It is not easy to come up with specific numbers, but as of the writing of this report, it makes sense to consider a path for USD/JPY assuming a 1.50% U.S. 10-year yield by the end of June, 1.60% by the end of September, and 1.70% by the end of December.

*Real Interest Rate Trend*

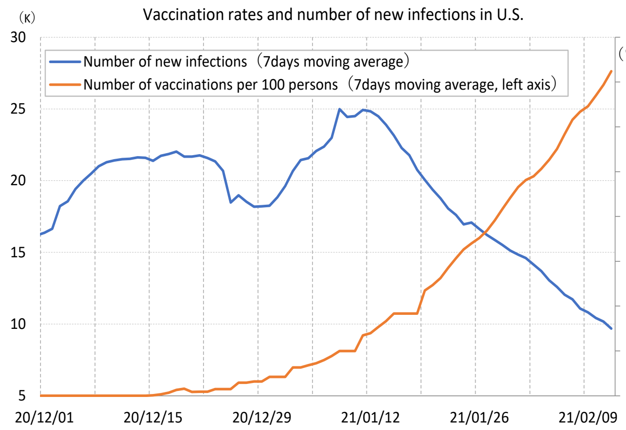
In February, another interesting development was the rise in real interest rates. Even though the U.S. 10-year yield has been soaring since the beginning of the year, the U.S. 10-year real interest rate has remained more or less unchanged since August 2020 at a historically low level (-1% or so). Many consider this to be the reason share prices remain strong despite the rise in nominal interest rates. The 10-year real interest rate, which is calculated based on the U.S. 10-year Treasury yield and the 10-year break-even rate (10-year BEI), has been normalized at the level of -1.00% or so since last summer (see figure). It rose slightly to the level of -0.90% after voting began in the Georgia Senate runoff elections early this year, and remained at that level for seven business days (January 8-18), but fell back to the -1.00% level subsequently. However, real interest rates have been rising steadily since February 16 and were hitting the -0.80% level intermittently by the end of the month. Taking into account that share prices have also not been consistent in their rise, it seems likely that the rise in the U.S. 10-year yield will be more tempered after around the level of 1.50%. Having said that, my USD/JPY outlook will have to be upwardly revised to the extent that the U.S. interest rate level has risen.



（Source）Bloomberg
（Note） Real 10yr interest rate=nominal 10yr interest rate--10yr BEI

*Dramatic Change in Expectations Anticipating End to Pandemic*

It is not clear why U.S. interest rates began to rise in February. Some say it is because the new economic stimulus package is closer to being implemented, but if so, it seems like a late reaction. Perhaps there is a non-linear change in market expectations as a COVID exit looms into sight. As I will elaborate later, heated debates are already taking place in the U.S. about inflationary concerns resulting from excessive macroeconomic measures. <u>Leave alone influenza, of which there have been very few cases this season, new COVID cases are also clearly peaking out (see figure) thanks to wider vaccine rollout. At this rate, it would not be surprising to hear of an end to the pandemic by summer</u>. It seems logical to assume that hopes of COVID ending are being reflected in higher nominal interest rates and inflation expectations. In this context, the minutes of the January FOMC meeting responds to the market's concerns of inflation by dismissing it as temporary and not likely to last very long. However, as vaccines reach more people and the number of new cases obviously begins to taper out, the FOMC statement will have no choice but to address the issue. In his Congressional testimony on February 23, Fed Chair Jerome Powell said inflation was a sign of market expectations of economic reopening and growth, but there is an undeniable possibility of a concrete effect on monetary policy operation when expectations begin to turn into reality. When that happens, market participants may see it as signalling the start of monetary policy normalization, similar to the May 2013 Bernanke Shock.



(Source) macrobond

## CNY Rates Now and Going Forward – Can CNY Drive USD Depreciation Again this Year?

*Factors Contributing to CNY Appreciation Peel Away*

As I have discussed in past issues of this report, USD's nominal effective exchange rate (NEER) fell by -4.1% in 2020, of which -1.6 pp were contributed by the rise in CNY. JPY also contributed by a not-insignificant -0.4 pp, but it was far outstripped by CNY and EUR. In the case of China, in particular, its diplomatic ties with the U.S. will be in focus this year, the first year of a new administration in the U.S. Also already in the news are debates surrounding whether or not the Winter Olympics can be held in Beijing, so the financial markets are likely to be paying attention to even the smallest China-related developments yet again this year.

A major reason for the strengthening of CNY in 2020 was the expectation of an improvement in the political climate surrounding China in terms of (1) abundant current account and trade surpluses (supply and demand), (2) the expansion of the U.S.-China interest rate differential (interest rates), and (3) the inauguration of the Biden administration in the U.S. (politics). In other words, supply and demand, interest rates, and politics all contributed to CNY buying in 2020, but I believe that these factors will gradually begin to change in 2021. <u>And without help from CNY appreciation, it would be difficult for USD to continue depreciating</u>.

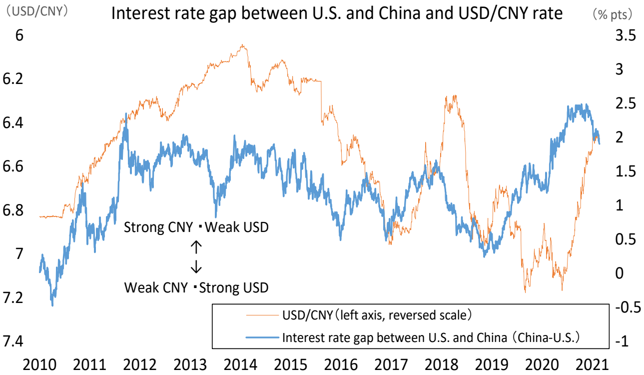
USD NEER rate of change & contribution since the beginning of the year

| 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

Let us begin with factor (3), politics, which is bound to fade away in significance going forward. America's China policy is unlikely to show a clear softening, even if it loses some of the stridence of the Trump era. In his first speech after being inaugurated, President Joe Biden spoke about the U.S. foreign policy at the State Department on February 4. In his speech, having said "We are ready to work with Beijing when it's in America's interest to do so," he also described China as "our most serious competitor." He spoke of China and Russia in the same breath, saying, "American leadership must meet this new moment of advancing authoritarianism, including the growing ambitions of China to rival the United States and the determination of Russia to damage and disrupt our democracy." He even went so far as to say, "<u>We'll also take on directly</u> the challenges posed by (sic) our prosperity, security, and democratic values" by China through its aggressive territorial ambitions and attacks on human rights and intellectual property.

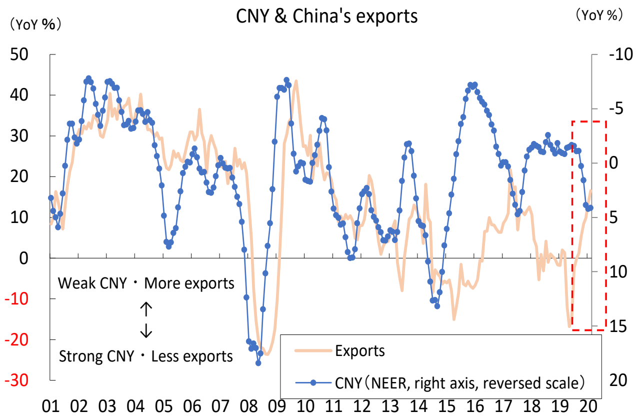
It is difficult to quantify the extent to which expectations of a softer U.S. policy on China contributed to last year's CNY appreciation, but it is clear that this factor will gradually cease to function in the same way going forward. As for factor (2), interest rates, I agree with the rumors that nominal interest rates will rise as the U.S. and other developed economies recover in 2021. The U.S.-China 10-year yield differential, which was 250 bps in September last year, has already shrunk to around 190 bps, weakening CNY's advantage over USD in this regard. This trend is likely to become more prominent as the year progresses, serving to deter CNY appreciation.



(Source) macrobond

*The Real Test for "Dual Circulation"*
As with factors (2) and (3), I believe factor (1), CNY appreciation due to supply and demand, is also likely to weaken in 2021. The 5th plenary session of the 19th Central Committee of the Communist Party of China (an important meeting for the party), held in October last year, formulated a new policy called "dual circulation," which aims to switch to a domestic demand-led development model. The transition was hailed as a once-in-a-century revolution. The "dual" in dual circulation stands for both domestic and external demand, and the idea is to guide them into a virtuous cycle to achieve high growth. It is thought that this new approach was conceived in the wake of the risk to the export-led growth model from U.S.-China trade frictions, but the Chinese government's seriousness toward this approach will be put to the test based on the authorities' actions with regard to CNY appreciation. If domestic demand is really to be given greater importance, the authorities are likely to switch to a stance of greater tolerance for CNY appreciation (or even guide CNY higher) in order to boost domestic purchasing power.

In this context, given CNY's appreciation since last year, perhaps the transition is indeed being promoted. However, the real test for the domestic demand-led dual circulation policy will come when exports begin to tangibly fall as a result of CNY strength. As of the current time, there are no signs of negative impact on external demand due to CNY strength. China posted its second largest ever trade surplus at USD 535 billion for 2020, and exports recorded an all-time high, at USD 1.5906 trillion and a yoy growth rate of +3.6%. In other words, China has not suffered at all from CNY strength over the past year. However, this was the result of an increase in demand for Chinese exports both as a direct and indirect result of the spread of COVID infections, or in other words, special demand. In addition to goods directly related to the pandemic, such as masks and protective clothing, a large percentage of electronic devices purchased for work-from-home purposes, such as laptops, were also from China. This special demand is thought to have cancelled out the punitive tariffs imposed by former U.S. President Donald Trump's administration (although the tariffs were not applied to medical products to begin with).



(Source) macrobond

Again, aside from special demand for certain products, China was the first both to be hit by the pandemic as well as to recover from it, and the rest of the world ended up depending on exports from China as their own economies came to a standstill. In this way, "substitution demand" of sorts also contributed to special demand for Chinese products in 2020. Going forward, however, such special demand factors are very likely to peel away. Even otherwise, it is too early to say that the recent CNY strength has had no impact on China's exports. As the figure shows, the impact of CNY strength on Chinese exports tends to be manifested with a time delay of six months to a year. Experience tells us, therefore, that the export-dampening impact of CNY strength during the past year is likely to start being felt starting around now. The real question, therefore, is whether the Chinese authorities, faced with weaker exports due to CNY strength, will tolerate it as being favorable to their new model of domestic demand-led growth?

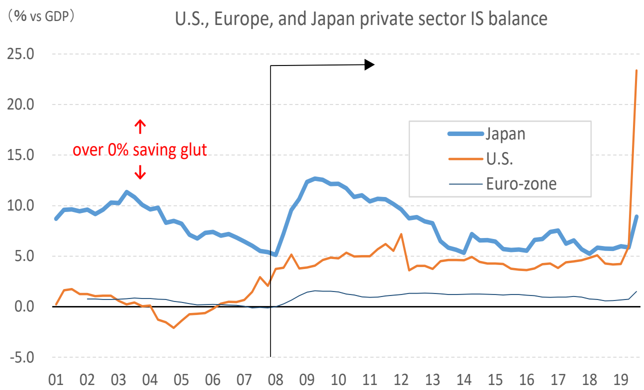
*Impossible to Transition to Domestic Demand-Led Growth Model Overnight*
As the dual circulation policy gives importance to both domestic and external demand, I do not believe an excessive strengthening of CNY will be tolerated. It is quite possible, of course, that over time, the structure of the economy will become more resilient to a stronger domestic currency. However, simply because the authorities called for a domestic demand-led growth model last October does not imply a structural transformation overnight. October last year was when the People's Bank of China (PBoC) abolished restrictions on CNY selling for the first time in two years and also announced that it would reconsider the counter-cyclical factor in the pricing mechanism of CNY (an investment measure aimed at inhibiting CNY weakness). If the authorities really had no problem with CNY appreciation, they would have no need for such policies (however, it must be noted that these developments preceded the 5th plenary session).

There have been many calls to switch to a domestic demand-led model even in Japan, which has suffered from phases of chronic JPY strength. However, even now, when a weak JPY does not necessarily lead to greater exports, JPY strength is a source of anxiety for many. Of course, one has to be cautious when comparing Japan with China, where it is easier for government administrators to unilaterally implement their desired policies, but even so, there is bound to be a limit to the extent of CNY strength that can be tolerated. As mentioned above, the U.S.-China trade friction will receive close attention even under the Biden administration, and if periods of friction increase and a slowdown in exports is confirmed, it seems natural that CNY appreciation will checked, and that itself could invite a reversal of the USD depreciation trend.

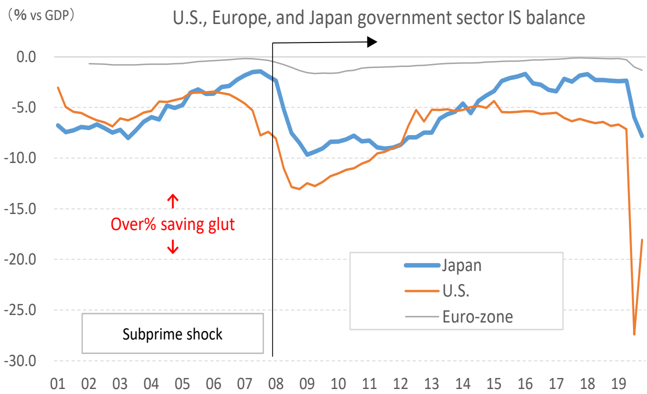
**The Global Economy Now and Going Forward – Could Savings Be the Magma of the Future?**

*Private Sector Saving Glut vs. Government Sector Savings Deficit*

The G7 Summit meeting of the seven key global economies, including the U.S., Europe, and Japan, was held online on February 19. The Leaders' Statement published following the meeting committed to concerted action "to make 2021 a turning point for multilateralism" and to tackle climate change, attracting attention for the marked contrast with the Trump administration's policies. With regard to economic measures against the current crisis, the statement declared, "We have provided unprecedented support for our economies over the past year totalling over $6 trillion across the G7. We will continue to support our economies to protect jobs and support a strong, sustainable, balanced and inclusive recovery." In formulating an outlook for the post-COVID global economy, therefore, it may be important to pay attention to whether the government sector is going to be driving the economy for some time to come. Since last spring, I have repeatedly argued that saving will come to be seen as a good thing in the pandemic-affected global economy, and stressed that the household and corporate sectors (together "private sector") will emerge as excess saving entities in the saving-investment (I-S) balance. As per macroeconomic principles, the saving glut in the private sector can be balanced by a saving deficit in the government sector (i.e., a fiscal deficit) to prevent the economy from crashing. In 2020, we did indeed see this combination of a private sector saving glut and government sector saving deficit emerge in the world's leading economies (see figure). However, this is a trap – one that Japan fell into following the collapse of its bubble economy and the euro area fell into in the wake of its sovereign debt crisis, and it leads to stagnant prices rooted in insufficient actual demand, which then also results in stubbornly low interest rates.



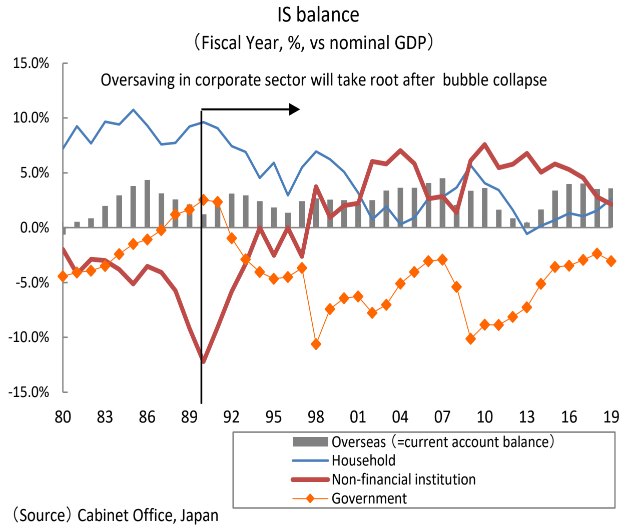

(Source) macrobond、
(Note) Sums the ratio of "Private sector + household sector" to nominal GDP calculated by the average of 4 quarters




(Source) macrobond、
(Note) Sums the ratio of "Private sector + household sector" to nominal GDP calculated by the average of 4 quarters

Zero interest rate policies adopted by central banks, persistently low government bond yields, quantitative easing, and stagnant inflation can all be cited as signs of "Japanification," but it must be understood that their root cause is a private sector saving glut, which causes interest rates to fall (the natural interest rate, which is also an approximation of the potential growth rate) so as to sufficiently whet consumption and investment appetites. Note that, among the three key economies of the U.S., Japan, and Europe, the combination of a private sector saving glut and government sector saving deficit was most pronounced in the U.S. in 2020 (see figure on the previous page). In 2020, the U.S. implemented a fiscal package amounting to as much as 20% of its GDP. Moreover, the package consisted mainly of direct payouts in the form of handsome unemployment benefits that some were concerned would dampen the desire to find work and increase the number of long-term unemployed. An inevitable outcome of this fiscal expansion was an I-S balance characterized by a private sector saving glut and government sector saving deficit.

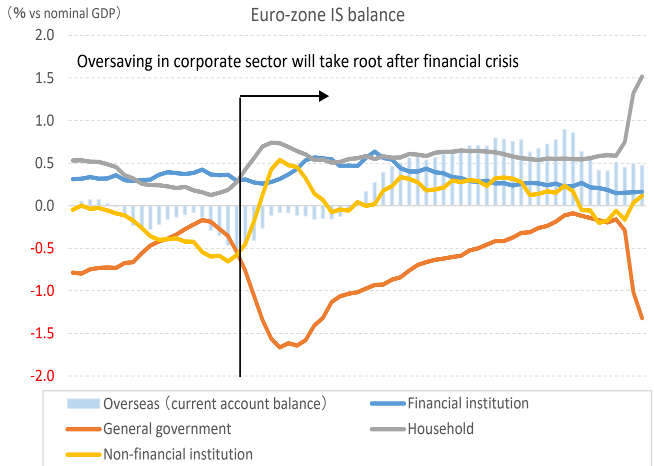
*Could Savings be Compared to Magma?*
Increasingly, there are comparisons of this saving glut to magma that could serve as fuel once the global economy has exit its current stagnation period. As I will discuss in detail later, there is lively debate over concerns of runaway inflation in the U.S. in the post-COVID period, but even with regard to other countries, one increasingly hears concerned-yet-hopeful predictions of the built-up private sector savings boosting consumption and investment in a non-linear manner going forward. The February 21 Online Edition of the Nikkei Shimbun featured an article titled “U.S., Japan, and Europe See Savings Rates with Potential to Cause Consumption Rebound.” The article compared savings to an “elastic force.” Given that the current enormous accumulation of savings is the result of artificial restrictions on economic activity, it is unlikely that the I-S balance structure seen in 2020 will continue over the long term.



(Source) Cabinet Office, Japan

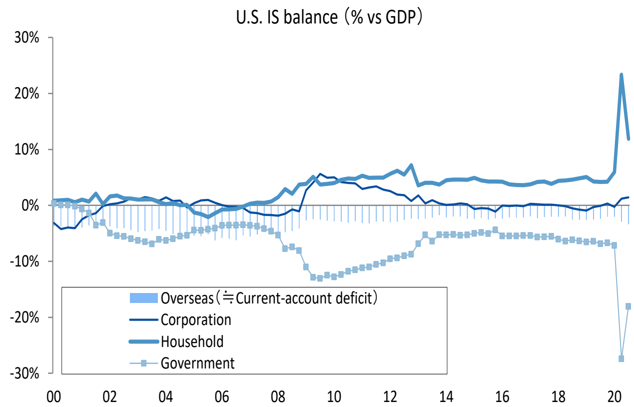
However, looking back at the Japanese economy of some time ago, one must take note of the fact that the severe shock from the collapse of the bubble caused the corporate sector to lose its risk-taking ability and resulted in a saving glut in the private sector overall. As the figure shows, the Japanese corporate sector suddenly went from being a savings deficit entity to a savings surplus entity with the start of the 1990s. This was the result of the lack of promising investment opportunities amid low expected growth rates due to a real-demand shortage after the collapse of the bubble. Let me rephrase that more accurately – promising investment opportunities probably existed, but the loss of financial resources and confidence as a result of the shock had sapped the ability of companies to find these investment opportunities, or their ability to act on such opportunities even if they were able to find them. At any rate, it is well know that, in the wake of the bubble’s collapse, Japan’s growth rate went into chronic stagnation, prices refused to increase, and monetary policy fell into the liquidity trap.

The euro area is now following the path of the Japanese economy described above. Around a year after the global financial crisis that began with the collapse of Lehman Brothers in September 2008, Europe was hit by a sovereign debt crisis. The region was plunged into political, economic, and financial misery that lasted all of four years, until around 2013, when the sovereign debt crisis stopped featuring in financial market news. As a result of this, the euro area’s corporate sector (“Non-financial corporations” in the figure) turned into a savings surplus entity in September 2008, and this situation became normalized subsequently. Strong shocks change corporate behavior – this is a reality that was experienced first in Japan and largely reconfirmed in the euro area. The European sovereign debt crisis was more or less resolved by 2013, but the region’s wages and inflation situation remained stagnant, and in June 2014 (ahead of Japan, which had been experiencing this problem longer), Europe introduced negative interest rates. The European corporate sector showed signs of becoming a savings deficit entity again in 2018 through 2019, but then fell back to its previous state as a result of the current crisis. Going by the climate in the euro area, it seems unlikely that the corporate sector can drive the economy any time in the near future.



(Source) macrobond (Note) Calculated on a 4-quarter average

*Can American Companies Stand Firm this Time Again?*
Will the U.S. also traverse the same path? Unlike Japan and Europe, inflation expectations are quite strong in U.S. even under present conditions. Moreover, this is a country that could afford to hike interest rates a few times even after the global financial crisis began. It is possible, therefore, that the U.S. is still far from “Japanification” that starts with a private sector saving glut. Looking at U.S. I-S balance trends, the household sector turned into a savings surplus entity following the subprime mortgage crisis, while the corporate sector turned into a savings surplus entity following the collapse of Lehman Brothers. Subsequently, the household sector has remained a savings surplus entity, but the corporate sector revived sufficiently to drive the economy as either a savings neutral or savings deficit entity. One gets the



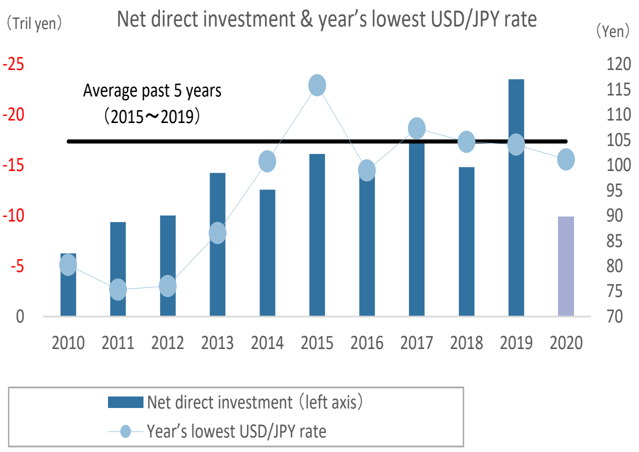
(Source) FRB

impression that the U.S. was able to overcome “Japanification” pressures because its corporate sector stood firm. However, at the start of 2020, the corporate sector once again turned into a savings surplus entity. Of course, what happened in 2020 was beyond human control, but whether or not the corporate sector returns to being a savings deficit entity this year will be a key point in predicting the medium- to long-term future of the U.S. economy.

### JPY Supply and Demand Now and Going Forward – Is a Neutral Trade Balance the New Normal?

*Scale of Direct Investment Smallest in Nine Years*

In February, Japan’s December Balance of Payments were released, so we can now take a look at the JPY supply and demand for the whole of 2020. In last month’s issue of this report, I discussed the dramatic decline in overseas direct investment by Japanese companies (i.e., Japanese companies’ acquisition of foreign companies) in connection with the current trends of and future prospects for USD/JPY. Net direct investment for the entire year 2020 was the smallest in nine years (since 2011) at -JPY 9.9 trillion, which is almost half of the average of the past five years (around -JPY 17.3 trillion or so). Perhaps the dramatic decline in overseas corporate acquisitions, which involve an outright selling of JPY, contributed to USD/JPY remaining in the 101.18~112.23 range in 2020, which is somewhat on the strong-JPY side when compared with recent years.

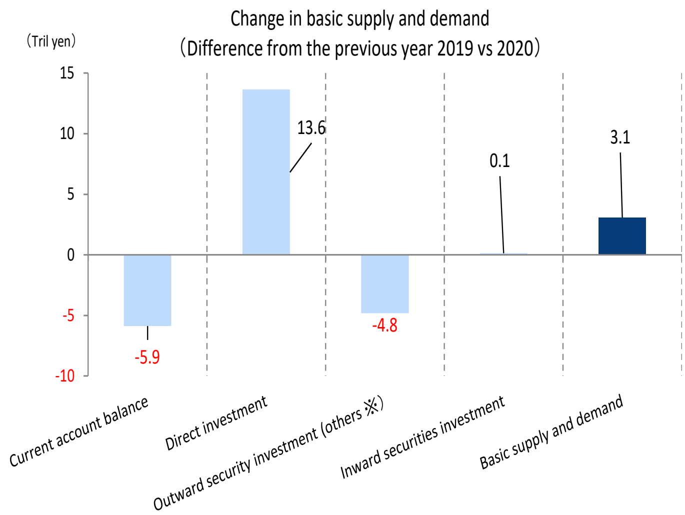



(Source) INDB

Of course, it is unlikely that USD/JPY trends are dictated by the mere existence of direct investment by Japanese companies, but following several years of aggressive direct investment, it has replaced securities investment as the largest component of Japan’s net external credit. As a result, it is important to note that JPY has waned in strength as a currency that is bought back during risk-off phases amid a rollback in foreign securities investment (I will refrain from going into further detail regarding this as I have discussed it many times in the past). I believe that robust direct investment by Japanese companies, thought not a factor driving JPY weakness, has been a factor preventing JPY strength. For this reason, the dramatic decline in direct investment in 2020 will be key to forecasting JPY rate trends going forward. However, as I have said in past issues of this report, my basic understanding is that last year’s decline in direct investment was a one-off development resulting from the pandemic. Foreign direct investment is a management strategy conceived by Japanese companies concerned about the domestic market shrinking, so it is likely to recover its momentum right away once a COVID exit is in sight.

*JPY Supply and Demand in 2020*

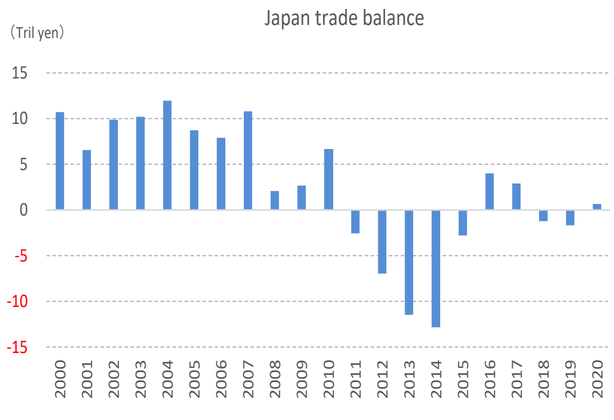
Although direct investment declined dramatically in 2020, so did the travel surplus, which had the effect of suppressing the current account surplus. Further, foreign securities investment increased. As a result, the decrease in JPY selling pressure due to a decline in direct investment was cancelled out by an increase in JPY selling pressure due to the decline in the current account surplus and an increase in foreign securities investment (see figure). If the current account surplus and foreign securities investment had been at the same level as the previous year (2019), the 2020 JPY supply-demand balance would have tilted significantly toward a net buying of JPY, but as it turned out, the two pressures cancelled each other out and resulted by and large in equilibrium at around -JPY 1.6 trillion. Still, the net JPY selling margin shrank by JPY 3 trillion or so compared with the previous year, and this itself could have contributed to the appreciation of JPY against USD.




(Source) INDB (Note) Subject: including insurers, pension funds & individuals

This year again, it seems likely that direct investment and other proactive risk-taking activities will remain suppressed, while the restoration of a travel surplus seems unlikely. Meanwhile, an increase in foreign securities investment in response to the increase in U.S. interest rates seems quite likely to drive a JPY-selling trend.

*Japan's 'New Normal' as a Country with Balanced Trade*
Taking a longer-term perspective, it seems reasonable to note the trend toward a lack of supply-demand imbalances in recent years and characterize 2020 overall as yet another year conforming with that trend. As mentioned above, while overseas direct investments are liable to be a focus of discussions and do act to countervail JPY appreciation, overseas direct investments do not appear to have enough driving force to spur a forex trend. On the other hand, it is often said that trade surpluses are capable of spurring a forex trend, since exporters' overseas sales generate a continuous JPY buying flow comprised principally of outright transactions. That is the context in which people may view the 2020 trade surplus, which has been considered significant in that it was the first such surplus to be recorded in three years, yet the magnitude of the surplus was very small at approximately JPY67 billion. Looking at the past five years, since 2015, Japan's trade balance is has averaged +JPY31.4 billion, which is roughly the same level as the 2020 trade surplus. <u>This does not seem unrelated to the fact that the margin of fluctuation in USD/JPY has hit a record low level three times in the last five years (in 2015, 2018 and 2019)</u>.



(Source) macrobond

Before the Lehman shock, Japan regularly recorded large trade surpluses. After the Great East Japan Earthquake in 2011, an export company-centered trend of progressively transferring production facilities overseas proceeded, and the large trade deficit era continued for several years after the earthquake (also reflecting increases in mineral fuel imports). <u>Since the situation settled down in 2015 to the present, Japan has been a country with a roughly stable trade equilibrium – a country with neither significant trade surpluses nor significant trade deficits. If this is Japan's "new normal", the lack of large-margin fluctuations in USD/JPY may simply reflect the fact that balanced trade has promoted the elimination of supply-demand imbalances</u>.

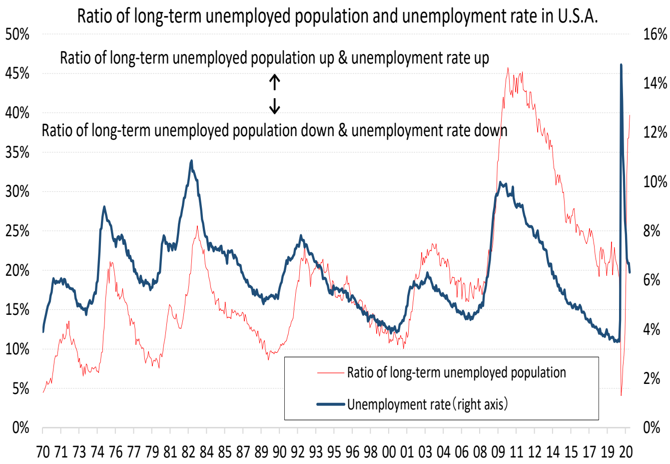
**Risks to My Main Scenario – Is it Worth Being Fearful of Inflation?**

*Professor Summers Spurs Renewed Debate about Inflation*
As vaccination programs progress and the peaking out in new infections becomes clearer, debate about U.S. expansionary fiscal policies has intensified. The debate centers on the question of whether, as the prospect of the post-pandemic era comes closer, the further protraction of current economic policies will eventually lead to problematic inflation levels. Leading economists and government officials have articulated various arguments to support their disparate views regarding this issue, and the news media's coverage of these arguments has attracted attention. As noted below, <u>emergence of the debate itself can be considered a positive confirmation of a general perception that the post-pandemic era is approaching</u>, but if inflationary pressure really rises in a non-linear manner, then it may be expected that a sharp rise in U.S. interest rates will accompanied by considerable USD appreciation. (While it should theoretically cause USD depreciation, I think USD appreciation is likely).
The recent flare-up of the controversy was ignited by a Harvard University professor, Lawrence H. Summers. In two editorials published by the Washington Post, Professor Summers wrote such alarming things as – "there is a chance that macroeconomic stimulus on a scale closer to World War II levels than normal recession levels will set off inflationary pressures of a kind we have not seen in a generation" – and – "I worry that containing an inflationary outbreak without triggering a recession may be even more difficult now than in the past." <u>Given that Professor Summers is known for repopularizing the 'secular stagnation' concept (in a 2013 speech at the IMF) to describe market economies with a secular (meaning chronic, or long-term) insufficiency of demand, his concern about a resurgence of inflation attracted a particularly large amount of attention</u>. It is also worth noting that <u>Professor Summers has been a major figure in Democratic Party presidential administrations' economic policy units</u>, having served as treasury secretary during the Clinton administration and chairman of the National Economic Council (NEC) during the Obama administration. <u>This is another reason his critical perspective on the current administration's policies has attracted so much attention</u>.

Regarding the scale of economic stimulus programs, Professor Summers has also expressed support for the Biden administration's large-scale program proposals, writing – "it is better to err on the side of doing too much rather than too little." – and he is not in a position to prevent or constrain such programs. However, his editorials are quite significant in that they represent the first opposition from a prominent Democrat party member to what seem to be plans to protract fiscal stimulus programs indefinitely regardless of actual economic conditions. In fact, the levels of both market-based and survey-based measures of U.S. inflation expectations have not been flat but have begun rising. <u>While there may be no leeway for dispute about how dire the current state of the United States' real economy is, given the surprising fact that inflation expectations are rising despite that dire condition, it is understandable that some observers feel a need to consider the possibility of incipient problematic inflation trends</u>. Professor Summers noted that – "a substantial part of the program should be directed at promoting sustainable and inclusive economic growth for the remainder of the decade and beyond, not simply supporting incomes this year and next. [...] We will be borrowing to finance sound investments rather than consumption." – and some other observers have expressed support for this view. For example, there are proposals to gradually decrease the level of supplemental unemployment insurance payments, which widely considered to be extremely generous, and to tighten the eligibility standard for receiving $1,400 stimulus checks. (The current plan would provide such checks to individuals with annual income of $75,000 or less and households with annual income of $150,000 or less.)

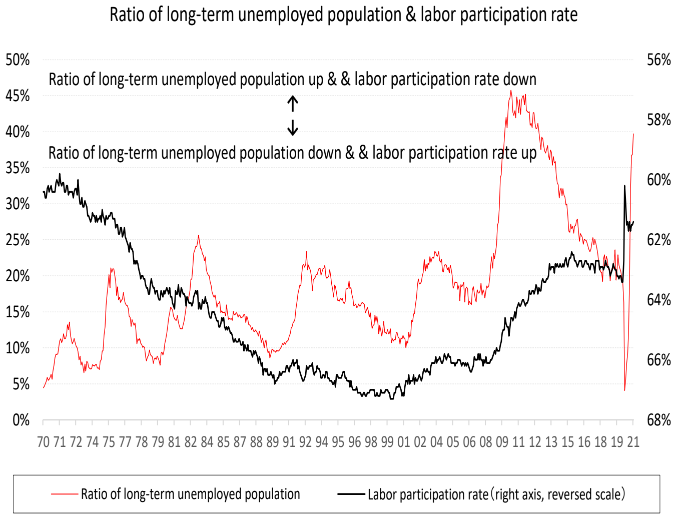
*Long-Term Unemployment Rate's Unstoppable Rise*

Many people have been quick to present arguments against Professor Summers' abovementioned views, and the most prominent of these people is probably U.S. Treasury Secretary Janet Yellen. She stated that a sufficiently large economic stimulus package could restore full employment conditions in the United States during 2022, while an insufficiently large package may delay recoveries in employment and in the economy at large. While acknowledging a potential inflation risk, she said that there policy measures that can be used to address that risk if it eventuates, and she expressed concern that a delay to the implementation of stimulus measures could delay the reattainment of full employment conditions (by lowering the unemployment rate to 4%) until 2025.




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

Given that Treasury Secretary Yellen is a high-level member of the Biden administration, it is natural that she would defend the administration's policy, but I basically share her views. In particular, the current situation should be understood to be completely unpredictable in light of long-term unemployment and labor force participation trends, which Treasury Secretary Yellen emphasized during her term as president of the Fed. The upper graph shows that the unemployment rate is currently trending downward while the proportion of the long-term unemployed (those unemployed for 27 weeks or more) is sharply rising, reaching 40% in January. The lower graph shows that a factor associated with the stubbornly high level of the long-term unemployment rate is the historically low level of the labor force participation rate. The current situation is one in which there are clearly grounds for concern about the sequential pattern of "long-term unemployment → decline in motivation and skills → exit from the labor market → decrease in the statistical number of unemployed/decrease in unemployment rate → labor participation rate decrease → potential growth rate decrease". The need to prevent that pattern from gathering momentum makes it difficult to discontinue macroeconomic stimulus policies, and it is likely that this need is particularly important from the perspective of Treasury Secretary Yellen, given that she has particular expertise with respect to labor markets.




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

*Discussion of Overheating Reflects Approach of Post-Pandemic Era*

It is unreasonable to expect the indefinite protraction of fiscal stimulus program spending that represents more than 20% of GDP (often characterized as a wartime level), however, and even those with quite different perspectives on fiscal stimulus policies could probably be expected to admit that careful consideration should be given to the targets of fiscal spending. In fact, the need to carefully consider fiscal spending targets is one of the rational bases for arguing that fiscal spending should be scaled down. For example, the argument that overly generous unemployment insurance benefits discourage employment and promote long-term unemployment is persuasive. It seems unlikely that supplemental unemployment benefits will be suddenly eliminated, but I think it is rational to consider their gradual reduction.

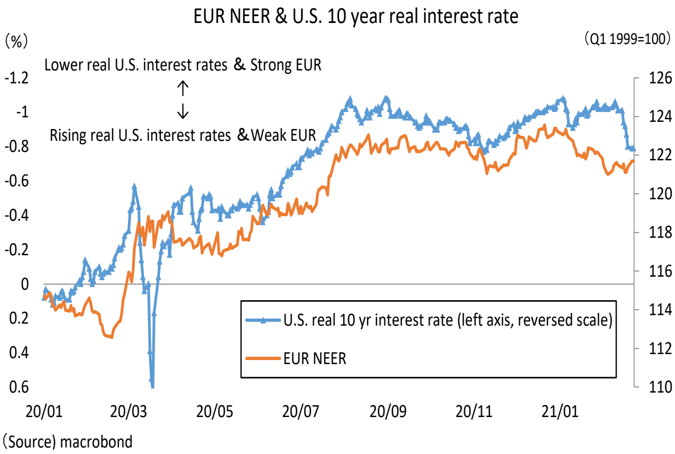
The existence of financial bubbles is generally not acknowledged until the bubbles deflate, and it seems that inflation may be similar in that the potential for a surge of inflation may not be acknowledged until it has already happened, so the current arguments about the likelihood of such a surge are unlikely to be conclusively resolved in the near future. One thing that does seem clear is that, as mentioned above, the fact that the scale of fiscal stimulus programs has become controversial in of itself suggests that we are finally approaching the post-pandemic period. The widespread panic seen immediately following the emergence of covid-19 – when people were staring into the abyss and fearing that there were no possible measures that could prevent economic deceleration – is gradually fading away, and it appears likely that a shift to greater hawkishness regarding fiscal and monetary policies will eventually become inevitable. On the other hand, improvement in the most important employment and wage-related statistics will only be fully recognized in retrospect, so it can be expected that proponents of dovish policy perspectives will continue resolutely refusing to compromise for the time being.

So long as there seems to be a general trend of improvement in the real economy, however, it seems reasonable to expect support for hawkish perspectives to gradually increase. In light of the increasing number of vaccinations and decrease in new infections, it appears possible that the covid-19 pandemic may no longer be a major theme of U.S. economy-related discussions by midway through this year. Leaving aside the issue of whether inflation pressures really increase non-linearly or not, it is quite possible that we will see an increase in inflation expectations (if not in inflation itself) that accelerates with unexpected rapidity. Through the Fisher effect, such an increase would be likely to promote a rise in nominal interest rates. Given this possibility, I think it is reasonable to prepare for a rise in the U.S. 10-year interest rate and other U.S. market interest rates along with an associated increase in USD buying.

# EUR Outlook – EUR Appreciation Already Peaked Out?

**EUR Area Monetary Policies Now and Going Forward – Reversal of EUR Appreciation Trend**

*Changed Perception of EUR Appreciation Trend*




There was no ECB Governing Council meeting January 21 Governing Council meeting did not seem to offer any market-moving information at the time it was held, but the Account of that meeting does contain some noteworthy material. In particular, the Account suggests that the ECB's perception of EUR appreciation has significantly changed. The January Governing Council meeting's statement did show some wariness of EUR's appreciation; however, the ECB's own analysis suggested that the decline in U.S. real interest rates were the main cause of EUR appreciation, and that decline was showing signs of halting at the time of the January meeting. In light of that, I wrote in last month's issue of this article that it would be worth giving special attention to how the Governing Council evaluated those signs. In her summary of economic and financial trends at the start of the Account, Executive Board Member Isabel Schnabel said that – "rising US government bond yields had interrupted the depreciation trend in the US dollar that had gained further momentum after the Governing Council's previous monetary policy meeting" – and noted that – "the euro exchange rate versus the US dollar had reversed its appreciation trend." Although the January Governing Council meeting's statement expressed some remaining concern about EUR appreciation, the Account seems to indicate that the Governing Council's perception of EUR exchange rates has significantly changed.

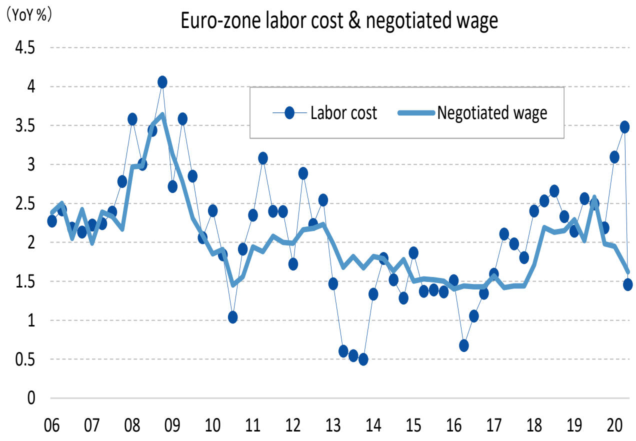
The Account also points out that – "US real rates had been a key factor boosting global portfolio rebalancing and risk-taking" – and many commenters have suggested this reflects a change in the ECB's perception of forex trends. Financial markets are currently focused on the question of whether rising U.S. interest rates may provoke a general decline in stock prices, and the Account also expresses concern about this, saying – "a more sustained rise in real rates could rapidly lower the relative attractiveness of equities and thereby pose the risk of a more broad-based repricing."

*Critical Perception of Staff Projections*

The abovementioned topic of real interest rates is an important issue for financial markets, but regarding the real economy, the Account reports that – "it was argued that the fast rebound in growth foreseen in the December staff projections might be too optimistic, with growth in the second quarter of 2021 possibly at risk from extended lockdowns. In addition, vaccination roll-outs were proving to be slow and concern was also expressed about the possible impact of the spread of new, more virulent, mutations of the virus". The protracted effects of lockdowns are closely related to the pace of vaccinations and spread of mutant forms of covid-19, so all the reasons cited can be considered interrelated. The Account also states that – "it was noted that the economic costs of containment measures were now lower than in spring 2020, as the measures were more targeted and firms had learned to better adjust to the restrictions." – but it appears the Governing Council believes the impact of covid-19 will remain even into the year's warmer months, so its default route for the time being seems likely to be maintaining (or strengthening) its monetary easing measures.

It is worth noting that the Eurosystem staff macroeconomic projections are not commissioned to meet the Governing Council's needs but are designed to present the results of independent economic analyses. Those projections are just one of numerous sources of data that the Governing Council bases its policy management decisions on. The fact that the Governing Council frankly publishes opinions regarding its data sources to the outside world indicates that the Governing Council decision-making process is properly functioning to obviate a need to speculate about Governing Council members intentions.

*Understanding the Current Inflation Situation*



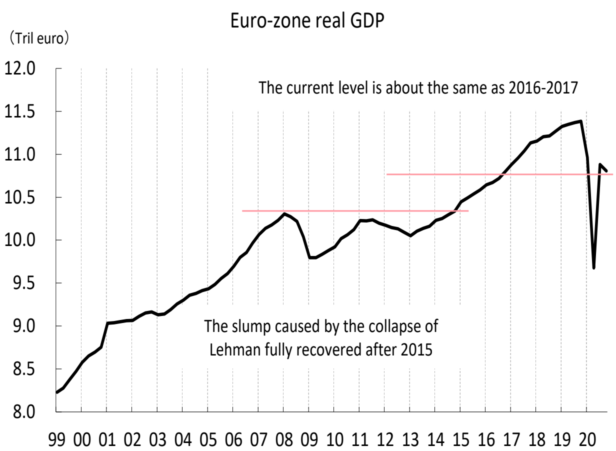

(Source) Macrobond
(Note) There are also non-agreed wages. therefore differ from actual labor cost

The Account's description of the Governing Council's discussion of the inflation situation was also noteworthy. Despite the euro area's dire situation throughout last year, the euro area Consumer Price Index (HICP) showed a non-linear uptick in January this year. The Account projected that HICP would increase from the start of 2021 owing to such factors as the phasing-out of the temporary cut in the German value-added tax (VAT) rate, the reversal of the plunge in crude oil prices, and a substantial change in HICP weights owing to changes in consumption patterns during the pandemic. However, the Account also acknowledged that aside from such technical factors – "underlying price pressures were expected to remain muted 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." The wage situation is an important basis for projecting future trends in the real economy, and the Governing Council concluded that euro area wages have not greatly deteriorated (see graph). However, the Account carefully notes that the lack of deterioration reflected the fact that – "many wage agreements had been concluded before the pandemic." Such market-based inflation expectations indicators as five-year in five years inflation swap break-even inflation movements have been showing an upturn in inflation expectations, but the Survey of Professional Forecasters (SPF) for the first quarter of 2021 found that inflation expectations were broadly unchanged, and it appears the Governing Council remains strongly concerned about disinflationary tendencies.

It is worth remembering that the ECB has repeatedly emphasized how EUR appreciation depresses HICP levels, but while reiterating that fact, the Account also mentions the possibility that – "the impact of exchange rate movements on inflation might be overestimated in standard models." There are various methods for estimating the impact of forex rate changes on inflation (the pass-through effect), and it is thought that one guideline employed by the ECB was that a 1% depreciation of EUR will boost HICP by 0.1 percentage points[1]. EUR rose 7% on a nominal effective exchange rate (NEER) basis in 2020, so the this guideline would estimate that the appreciation depressed HICP by about 0.7 percentage points. The fact that HICP was not depressed so much may be a factor causing the ECB to recognize that standard models may overestimate the impact of exchange rate movements. On the other hand, if the models are wrong, that might suggest that HICP could continue to be sluggish even after excessive EUR appreciation were corrected. For this and other reasons, there are good grounds for concern regarding the stubbornness of disinflationary pressures in the euro area.

**The Euro Area Economy Now and Going Forward – The Record-Breaking GDP Drop of 2020**

*Crumbling Away of GDP Growth Accumulated over Four Years*




(Source) macrobond

In February, Eurostat announced the euro area's GDP growth rates for the last quarter of 2020 and the full year of 2020. Real GDP declined 0.7% qoq in the fourth quarter, the first time in two quarters the euro area as a whole has recorded negative GDP growth. There is probably no need to explain that this result reflects the restrictions placed on economic activities following the pandemic's resurgence. For the full year of 2020, euro area GDP shrank 6.8%, a drop exceeding the 4.5% decrease in the year after the Lehman shock. However, the pandemic has caused rates of change in GDP and other economic indicators to fluctuate so greatly that it is difficult to grasp the underlying situation. The pandemic's economic impact is perhaps more easily understood from an examination of GDP magnitude changes, which are not usually the focus in more-normal times.

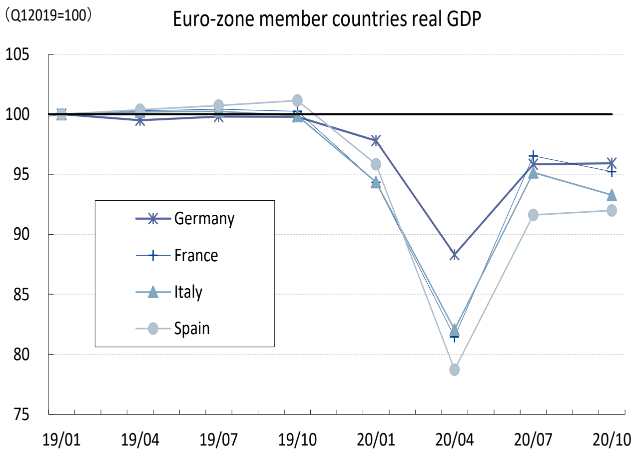
While the direction of movement in GDP levels does not ordinarily change, the pandemic's shock has decreased GDP levels to an extent that makes the impact of the Lehman shock look like an rounding error. The euro area GDP level for the fourth quarter of 2020 (approximately EUR10.8 trillion) is close to the quarterly GDP level around the fourth quarter of 2016. The results of growth that were accumulated over four years have crumbled away, and the focus going forward will be on how quickly those results can be restored. It is worth noting that, after the Lehman shock, the euro area was subjected to its own regional debt crisis, and it was not until 2015 that the euro area's GDP regained its

[1] ECB "Exchange rate pass-through into euro area inflation"

pre-Lehman-shock level. That process of regaining the pre-Lehman-shock level required seven years. This time, however, there is no actual economic problem akin to the debt crisis, as the GDP drop mainly reflects government-imposed restrictions on economic activities, so it can be expected that restoring pre-pandemic GDP levels may not take so much time once the benefits of vaccinations enable the removal of restrictions.

*Increasing Difficulty of Monetary Policy Management*

The current state and outlook of individual Euro area countries' real economies have much in common with other Euro area countries as well as with the United States, Japan, and countries worldwide, but the euro area's challenge is particularly difficult because it includes 19 different national economies. As was apparent during the process of recovering from the European debt crisis, the euro area faces medium-to-long-term challenges associated with the disparate GDP growth rates of member countries and the need to make appropriate adjustments to ECB monetary policy management in light of those disparities. As of the end of 2020, there were no large differences among the growth trajectories of the euro area's four top economies (see graph). While the economic situation is clearly dire, the seriousness of the challenge should facilitate efforts to build consensus agreement regarding the overall direction of ECB policies. (Albeit there will continue to be disagreements about specific aspects of the policies.)



(Source) macrobond

Given the euro area countries' different potential growth rates, however, it can be expected that the countries' growth rates will be disparate going forward. In particular, it is clear that Germany's growth rate is liable to diverge from the growth rates of other euro area countries, and it seems likely that the divergence will become apparent as soon as later this year or as late as sometime in 2022. At that time, it can be expected that the ECB's continued monetary easing measures will provoke concerns about economic overheating in Germany. This article repeatedly discussed such issues during 2018[2], but it turned out that the euro area economy's slowdown from 2019 along with the pandemic promoted agreement that ECB should continue implementing easing policies. In light of that history, it seems likely that disagreements regarding the direction of monetary policies will become deeper as the post-pandemic era approaches.

The current situation is already showing grounds for concern about this. The considerable negative growth rates recorded by euro area countries throughout 2020 somewhat obscure the inter-country disparities, but looking at individual countries qoq GDP growth in the fourth quarter, one finds that while those of France and Italy were -1.3% and -2.0%, respectively, Germany achieved +0.1% growth. It seems that the inter-country divergence has already begun. While the Lagarde-led ECB has faced some internal dissent regarding the scale of monetary easing policies, it has not yet been confronted with a situation in which there is internal disagreement regarding the continuation of easing measures. ECB President Lagarde is reputed to have excellent coordination capabilities, and it may only be in the post-pandemic period that she will be required to draw on those capabilities to their utmost extent to maintain a harmonious consensus regarding the optimal nature of ECB policies going forward.

## Appendix: Italian political affairs Now and Going Forward – Mario Draghi Becomes Italy's Prime Minister

*A High-Profile Government to Deal with the Pandemic*

On February 12, Italy's President Sergio Mattarella appointed former ECB President Mario Draghi to serve as Italy's Prime Minister. It appears that Draghi was chosen because his strong reputation as an efficacious technocrat fit well with President Mattarella's aim of creating a "high-profile national unity government" capable of dealing with the array of challenges Italy faces, particularly those associated with the covid-19 pandemic. As Mr. Draghi is well known in Japan, I have received numerous inquiries about the significance and suitability of his returning to the limelight about 15 months after his retirement as ECB president as well about what can be expected from him going forward. I think the number of inquiries reflects a high level of interest in Mr. Draghi as an individual, as he will be leading Italy rather than one of the top euro area countries, such as Germany or France, and as I only rarely receive inquiries about Italian political affairs that are not directly related to financial market fluctuations. In light of this, I would like to briefly overview the current and prospective situations regarding Prime Minister Draghi's appointment. In short, although the initial level of expectations for the Draghi government are high, it is undeniable that the Draghi government has many characteristics of an interim government, and it is unclear how long it may last. It is worth noting that German Chancellor Angela Merkel's term is scheduled to end this September, while French President Emmanuel Macron's term ends next May. It can thus be expected that the upcoming year will be a period of political transitions for Europe, and the creation of the Draghi-led government in Italy can be considered the starting point of that period.

[2] For example, see the article entitled – "ECB Faces a Difficult Task in Seeking to Appropriately Respond to Germany's Incipient Bubble" – that was posted on August 10, 2018, on the Toyo Keizai Online website.

*Draghi Government Supported by Diverse Parties*
The Draghi government is supported by parties comprising the previous government, including the center-left Democratic Party (PD), the left-wing Free and Equal Party (LEU; spun off from the PD), and the centrist Italy Viva Party (IV; headed by former Prime Minister Renzi). It is also supported by former opposition parties, including the center-right Forza Italy Party (FI; led by former Prime Minister Berlusconi) and right-wing League Party (Lega; the largest opposition party and strongly opposed to the EU). Thus, the Draghi government has gained a broad base of support, but as a result (or perhaps as a cost), the support is comprised of a heterogeneous mixture of leftist, rightist, and populist parties. From a positive perspective, it is a "national unity government" commissioned to deal with the pandemic's challenges, but from a negative perspective, it is a motley collection of parties that might at any moment lose its coherency.

**Major European elections scheduled for 2021 – 2022**

| Year | Month | Election | Country |
|---|---|---|---|
| 2021 | JAN | Ruling CDU leadership election | Germany |
| | MAR | State legislative elections in two western German states | Germany |
| | | Dutch parliamentary election | Netherlands |
| | APR | Parliamentary elections in Thuringia | Germany |
| | MAY | Scottish parliamentary election | Scotland |
| | | London mayoral election | U.K. |
| | JUN | Sachsen-Anhalt parliamentary election | Germany |
| | | French local elections | France |
| | **SEP** | **German federal election** | **Germany** |
| | OCT | Parliamentary election | Czech |
| 2022 | until end of FEB | Italian presidential election | Italy |
| | **Spring** | **French presidential election** | **France** |
| | | Parliamentary election | Hungary |

（Source）Prepared by Karakama from Nikkei newspaper

Given its strong opposition to the EU, the right-wing Lega finds it discomfiting to support Mr. Draghi, who is a symbol of the ECB and the EU. It may be that the Lega recognizes the wisdom of supporting a unity government to face the pandemic and of avoiding disruptive move to dissolve the government and call for general elections, but it may also be that the real intentions are still somewhat obscure. I suspect that as Mr. Draghi has high support from all directions, he can easily accept the notion that the Lega is only offering temporary support as a response to an emergency situation. It seems clear that Lega leader Matteo Salvini is harboring the ambition of becoming Italy's next prime minister after obtaining support from right-wing voters in the next general election. Although Prime Minister Draghi is launching his government fully aware of these kinds of uncertain factors, it does appear that the political situation will remain reasonably calm until next February when President Mattarella's term expires.

*Rising Expectations About What Prime Minister Draghi Can Accomplish*
Naturally, the new Draghi government's top priority is to deal with pandemic-related challenges, basically the same challenges countries throughout the world are facing. As the focus shifts from effectively preventing the pandemic's spread to efficiently administering vaccinations, it is clear that Prime Minister Draghi's evaluation will be strongly affected by how well vaccination programs operate in Italy. <u>Given his reputation, however, there are high and rising expectations regarding what other things Prime Minister Draghi can accomplish</u>. EU policy making has generally followed a pattern in which German Chancellor Angela Merkel and French President Emmanuel Macron determine the outline and then confirm those determinations in consultation with member states at the EU summit, and this pattern has generated increasingly evident resentment in such EU countries as the Netherlands. That's how the EU recovery fund agreement was intended to be orchestrated last year, yet actually confirming the agreement required a five-day extraordinary EU summit. However, <u>as the presence of Chancellor Merkel (scheduled to retire this September) diminishes, there may be greater opportunities for Prime Minister Draghi to join the elite EU policy drafting group on behalf of Italy</u>. If Italy can get its views considered at earlier stages of the Franco-German policy outlining process, Italy could play a constructive role as a spokesman for other Southern European countries.

Utilization of the Next Generation EU recovery fund will begin this year. European Commission President Ursula von der Leyen indicated on February 12 that she would like to submit a fund utilization plan by the end of April and start supplying funds by the end of September. According to the traditional pattern of EU policy drafting, Italy would be positioned only to play the role of a protesting problem child regarding certain aspects of such policies as the fund utilization plan, and it has appeared to become resigned to playing such a role. At this point, however, it can be expected that more attention will be given to Prime Minister Draghi's views, owing to the economic stimulus program-related reputation he earned as ECB president.

*Political Transitions in Germany and France*
As mentioned, Chancellor Merkel and President Macron are scheduled to serve in their current positions until this September and next May, respectively. <u>Although there are expectations that Prime Minister Draghi may be able to constructively insinuate himself into the EU's policy-drafting group, it is also thought that the political environments of Germany and France may preclude flexible compromises at this time, so it may be that Prime Minister Draghi will immediately face a severe challenge in trying to affect a consensus decision that is already liable to be extremely difficult to reach</u>. At present, the nature of Germany and France's next governments is largely unclear. For example, Armin Laschet has just become leader of Germany's Christian Democratic Union (CDU) party, the currently dominant party in Germany, but some observers consider it questionable whether the Laschet-led CDU will emerge victorious from the upcoming elections. While Italy and other economically fragile EU countries would like to make the recovery fund permanent with an eye addressing post-pandemic challenges, it seems likely that the political transitions in France and Germany will make it difficult to promote a consensus decision on such a weighty issue this year or early next year.

If so, there are grounds for concern that the disappointment of excessive expectations about what Prime Minister Draghi might be able to realize may quickly generate strong centrifugal forces within the coalition supporting him, causing him to quickly face the kind of insuperable political challenges that have been characteristic of Italy in recent years. In the case of political turmoil, it is reasonable to fear the possibility that the scapegoating of Prime Minister Draghi for his failure might promote a strong reactionary trend. The Draghi government's parliamentary term will end by June 2023, but the question of whether the government can last that long is likely to depend on whether it can produce outstanding results this year amid the pandemic. Facing an Italian political situation precariously balanced on the brinks of national unity and party fragmentation along with disagreements within the EU regarding the ideal nature of the recovery fund, Prime Minister Draghi will have only a brief period to organize his government and undertake urgent policy management tasks, yet in light of his strong eight-year record serving as ECB President and guiding the ECB through the worst of the European debt crisis, it seems reasonable to expect that he may be able to realize some noteworthy successes.

Daisuke Karakama
Chief Market Economist
Derivatives & Forex Department
Mizuho Bank, Ltd.
daisuke.karakama@mizuho-bk.co.jp