

March 31, 2021

Overview of Outlook

USD/JPY continued to rise in March, eventually hitting 110 for the first time in a year at the end of the month. As in February, this increase was in line with the continued rise in U.S. interest rates, so it would be accurate to say that the increase in USD/JPY represents USD appreciation rather than JPY depreciation. This higher-than-expected U.S. interest rate rise causes a shift in the “launch pad” for my forecasts, so I have upwardly revised my forecast to some extent, but the path for my main scenario remains almost unchanged. I do anticipate a path of vaccine rollouts→ slower infection rates→normalization of economic activities→normalization of monetary policy, and based on this, I think U.S. interest rates and USD will spur each other on and remain on an upward trend for the rest of this year. The April-June period, when inflation and other indicators are most likely to post yoy increases, may be the peak period for this trend. The pace of increase in U.S. interest rates during the first three months of this year has been excessive, and the brakes may have to be applied at some point taking into consideration such things as share price fluctuations. Things may slow down somewhat from the July-September period onward, slowing JPY depreciation. However, even in this case, the large U.S.-Japan interest rate differential will still remain. Regarding USD appreciation, I predict a slower pace in 2H compared with 1H, but it would be safe to say that there seems no chance of the rate trend reversing. My interpretation is that the main themes in the forex market have shifted from supply & demand in 2020 to interest rates, COVID response status, and crude oil at the current time. Sadly, JPY is unlikely to be viewed positively based on any of the above, making it safe to predict a continuation of the weak-JPY trend.

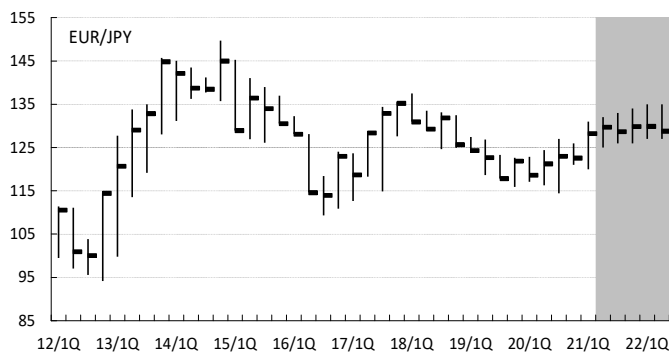
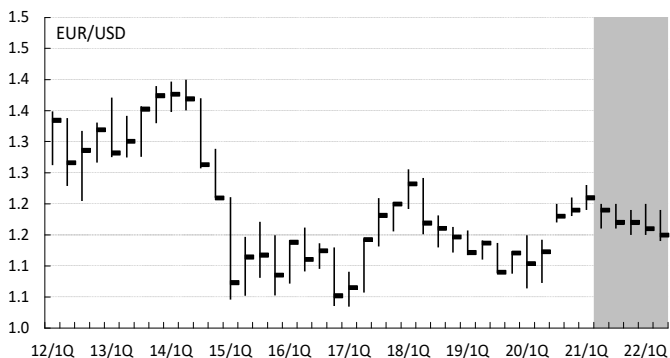
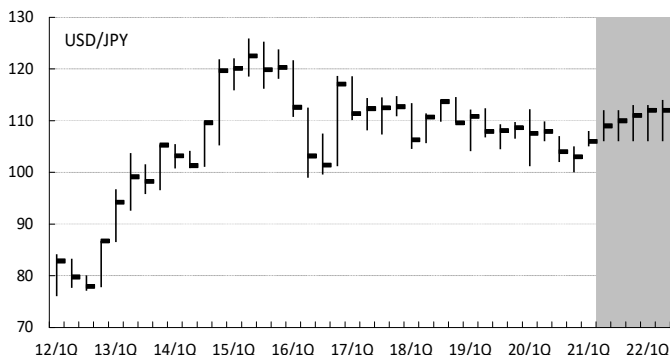
EUR, meanwhile, has clearly begun to weaken. It could be entirely the result of the across-the-board USD strengthening alongside the increase in U.S. interest rates, but I believe some part of it is also a healthy correction of last year’s voracious EUR buying. However, unlike the Fed, which seems to be more accepting of an increase in U.S. interest rates, the ECB has had a clear stance of checking any increase in regional interest rates through accelerated asset purchases and other means. Thanks to this divergence in stance between the two central banks, it must be noted that the situation is conducive to EUR selling/USD buying, which could work to weigh down EUR/USD for some time to come. Since the beginning of the year, COVID response status appears to be one of the themes dominating the forex markets, as market participants seem to be choosing currencies based on vaccination rates. In this context, EU member states are clearly lagging behind the U.S. and the UK and barely ahead of Canada, which is catching up fast. Taking into account that continental Europe is currently under threat from variant strains, it would not be surprising if the trend of investors letting go of EUR due to delays in vaccine rollout were to continue further beyond, and perhaps this is already beginning to happen. The situation does not seem likely to change any time soon.

Summary Table of Forecasts

	2021				2022	
	Jan -Mar (actual)	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	102.60 ~ 110.72 (110.70)	106 ~ 112 (109)	106 ~ 112 (110)	106 ~ 113 (111)	106 ~ 113 (112)	106 ~ 114 (112)
EUR/USD	1.1711 ~ 1.2349 (1.1720)	1.16 ~ 1.20 (1.19)	1.16 ~ 1.20 (1.17)	1.15 ~ 1.19 (1.17)	1.15 ~ 1.20 (1.16)	1.14 ~ 1.19 (1.15)
EUR/JPY	125.10 ~ 130.48 (129.75)	126 ~ 132 (130)	126 ~ 133 (129)	127 ~ 134 (130)	127 ~ 135 (130)	127 ~ 135 (129)

(Notes) 1. Actual results released around 10 am TKY time on 31 March 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

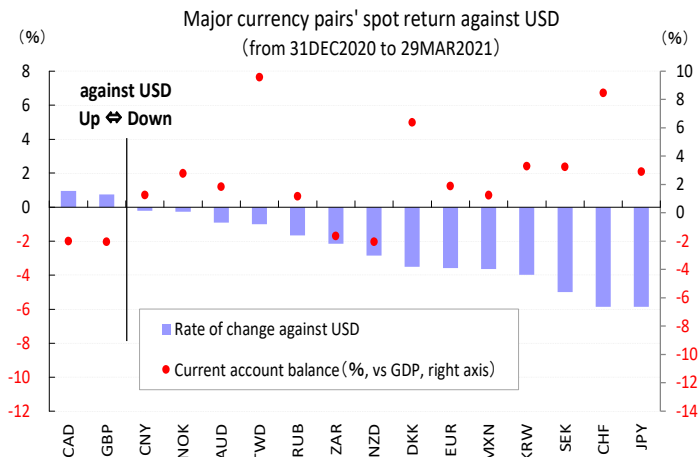


USD/JPY Outlook – New Forex Market Themes are Interest Rates, COVID Response Status, and Crude Oil

The Forex Markets Now and Going Forward – New Themes Emerge at End of 2021 1Q

Currency Buying Increasingly Unrelated to Supply & Demand

The first quarter of 2021 is already behind us. As I have said before, 2020 saw the normalization of a world without interest rates, especially centering on USD and other developed world currencies, which resulted in current account surplus, trade surplus, external credit and other supply & demand-related factors exerting a greater influence. This trend was confirmed by the fact USD's nominal effective exchange rate (NEER) was pushed down mainly by currencies that were backed by some of the world's largest current account and trade surpluses, such as EUR, CNY, and JPY. However, three months into this year, it appears that the supply & demand theme has reached its limits as an influencing factor. The figure shows the year-to-date rate of change of various currencies against USD. GBP and CAD are the only two currencies that show a confirmed rate of appreciation against USD. All the other currencies have depreciated (as of March 29). With the significant



(Source) Bloomberg & IMF (Note) Current account : Forecast for 2020

weakening of currencies such as EUR, JPY, and CHF, which boast some of the largest current account surpluses in the world, it seems clear that investors are no longer basing their currency buying or selling decisions on supply & demand factors. Even CNY, the currency of the world's second largest trade surplus country, has been flat since the beginning of the year, with no sign of the kind of momentum we saw last year. However, a simple comparison of other currencies against CNY is difficult given that CNY rates also reflect the arbitrary actions of Chinese authorities.

New Forex Market Themes are Interest Rates, COVID Response Status, and Crude Oil

What, then, is the new forex market theme? It may be difficult to narrow it down to one theme, so I would like to think that interest rates, COVID response status, and crude oil are the new themes. Not much explanation is required as to why interest rates would be an influencing factor. As shown above, USD has appreciated against most currencies, and it seems safe to assume that this was driven by investors appreciating the increase in U.S. interest rates over the past three months. Of course, there are also other currencies that have seen an increase in interest rates, but these were essentially associated with the increase in U.S. interest rates, and it is no surprise that investors would continue to buy USD as the currency driving this increase in interest rates.

The COVID response status is, simply speaking, the same as the vaccine rollout status. Looking at the year-to-date movement trends of G7 currencies based on nominal effective exchange rates (NEER), it seems quite clear that GBP is the strongest, while JPY is the weakest, and this seems to reflect the rankings of the UK (1st) and Japan (7th) in terms of per-capita vaccination rates among G7 nations.

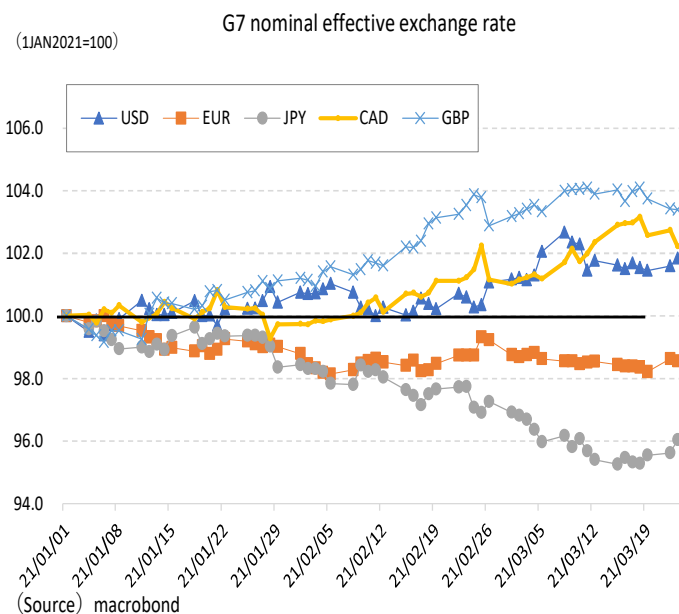
The UK has already drawn up a four-phase roadmap for normalization by the end of June, thanks to stable vaccine supplies and administration. This has improved the country's real economic forecasts, making the situation conducive to an increase in market interest rates and for GBP to be bought. Japan's per-capita vaccination rate is not even comparable to that of the UK, and it would not be surprising to see investors let go of JPY on account of this.

In the U.S., which also has a high vaccination rate second only to the UK, President Joe Biden has expressed the intent of returning to normalcy by the Fourth of July (Independence Day). The increase in U.S. interest rates can, ultimately, be attributed to the expected path of vaccine rollouts→ slower infection rates→normalization of economic activities→ normalization of monetary policy. Had it not been for the vaccines, the theme of "interest rates" pushing up USD would probably not exist either. The reason EUR is lackluster is thought to be because the region is still suffering new lockdowns due to rising infections from variant strains of the virus despite progress in vaccine rollouts. Additionally, I think that Europe's vaccination rates are not high enough to ensure bringing the pandemic under control in the wider common market area.

Crude Oil an Important Theme, but Disrupted by Noise

Then next question is – how do we interpret USD and CAD, which are backed by similar vaccination rates? Several reasons are possible, but crude oil is an important one. In early March, a large container ship made the news after it ran aground in the Suez Canal, causing crude oil prices to rise. Even before this, however, crude oil prices had been rising as a trend for the past year. Developments of this kind naturally lead to currencies of resource-based economies, such as CAD. Another factor more unique to CAD is that Canada's economy tends to be seen as interrelated to the U.S. economy, so strong U.S. economic performance may itself be seen as a factor that promotes CAD buying. Further, Canada's fundamental economic indicators are improving faster than assumed by the country's central bank, giving rise to vague expectations of an early rate hike, something not true of other advanced economies.

However, though crude oil is an important theme, it does not fully explain the developments related to other currencies of resource-based economies. For instance, BRL (Brazilian real), NOK (Norwegian krone), and MXN (Mexican peso) are also currencies of resource-based economies, but their movements are varied. MXN has weakened in view of Mexico's failure to bring the pandemic under control and BRL is being sold off due to uncertainties resulting from Brazil's structural reforms. Even RUB (Russian ruble), the currency of the world's third largest producer of oil, has been weakening since President Biden said in a televised interview (on ABC) that Russian President Vladimir Putin was "a killer," which prompted Russia to recall its U.S. ambassador. In this instance, therefore, the crude oil factor may have been set aside while the special factor of deteriorating U.S.-Russia relations spurs on RUB selling. In the case of MXN deterioration, while Mexico's failure to reign in the pandemic is one of the factors, some are pointing out that concerns of a capital drain out of Mexico due to an increase in U.S. interest rates may also be a factor. In this sense, proximity to the U.S. has the exact opposite effect on MXN compared with CAD.



Vaccination frequency per 100 people

Country	Number of times
UK	48.64
US	40.87
EU	15.07
Italy	14.94
France	14.95
Germany	14.76
Canada	12.72
Japan	0.65

(Source) Our World in Data as of 26 MAR 2021

In sum, crude oil is certainly one of the key factors for understanding the current state of affairs, but it tends to be disrupted by noise in the form of other factors that also need to be considered in conjunction for the currencies in question. Moreover, given that the U.S. itself is the world's largest producer of oil, it is always difficult to use the crude oil factor to cleanly analyze movements in the forex markets, where currency trends are mainly assessed by rate of change against USD.

Challenges Ahead for JPY and EUR in Medium Term

At any rate, as noted at the beginning of this report, it seems clear that supply & demand are not currently playing an influencing role in the forex markets. Under such circumstances, there is no reason for JPY to be viewed positively. JPY's biggest strength is Japan's rock-solid external economic position based on its status as the world's largest net external creditor for the past 29 years in a row. This is the reason JPY has been seen as a safe-haven currency despite Japan having the world's largest government debt. With regard to interest rates, the BOJ set out a wider range for long-term yield movements under its yield curve control (YCC) policy following its March FOMC meeting, which by itself could possibly be seen as a factor potentially leading to higher JPY interest rates. However, given how large the U.S.-Japan interest rate differential is, a slight increase in JPY interest rates would offer much of a reason to buy JPY against USD. As for the COVID control status factor, Japan's performance in terms of the most important factor – vaccination rates – is clearly dismal, as mentioned already, and this by itself could well prove to be a major factor eroding trust in the Japanese economy and JPY.

Of course, in a situation where supply & demand do not influence currency trends, EUR is as unlikely as JPY to be appealing, considering the normalization of negative interest rates in the euro area. Again, given the concerns over euro area credit conditions (details later), the ECB is unlikely to tolerate any increase in regional interest rates led by a U.S. interest rate increase. However, when it comes to the COVID response status, the euro area is far ahead of Japan in terms of vaccination rates, which gives EUR an upper hand compared with JPY in this regard. Neither EUR nor JPY seem in a good position to match USD, but there seems no reason for EUR to lose to JPY, so in terms of strength, it may be reasonable to rank the three currencies as USD>EUR>JPY.

However, the persistent rise in U.S. interest rates during the first three months of the year is abnormal, and it seems unlikely that the interest rates can continue rising at this pace without hurting the U.S. economy. As mentioned earlier, this mutually-aided increase in U.S. interest rates and USD is likely to continue during the April-June quarter, when inflation and other indicators are predicted to show yoy improvement, but the pace of increase is expected to fall starting from the July-September quarter, and this is expected to slow down the weakening of JPY and EUR against USD to some extent. However, even if this is the case, the interest rate differentials of JPY and EUR against USD will essentially remain significant, so I predict that pace of USD appreciation will probably slowdown from 1H to 2H, but it may be safe to assume that there will be no reversal of the trend for some time to come.

BOJ Monetary Policies Now and Going Forward – Firm Policy against Strong JPY?

BOJ Policy Assessment – Three Highlights

At the BOJ Monetary Policy Meeting (MPM) held on March 18-19, the results of the assessment of the current accommodative monetary policy were released, as announced in advance at the December MPM. Three major decisions were made as a result of the assessment: (1) the establishment of the Interest Scheme to Promote Lending, (2) a widened band around the 10-year bond yield target to 0.25% either side of zero, and (3) the abolition of the purchase targets for ETF and REIT (around JPY 6 trillion and JPY 90 billion, respectively), while retaining an upper limit (of around JPY 12 trillion and JPY 180 billion, respectively). While some of the finer details are new, the decisions themselves are within the scope of what had been expected.

Ahead of the meeting, there was greater focus on measure (3). As the worst of the pandemic seems to be behind us, it is natural to finally see a dialing down of the central bank's purchase of ETFs, which were thought to be excessive. Despite the severity of the global crisis, the BOJ is the only central bank to get involved in purchasing stocks. Going forward, the Bank will have to think of ways to process its existing balance of assets, which has ballooned up to JPY 36 trillion, but this will be a topic for post-Kuroda regime.

Moving on to measures (1) and (2), their main objectives are probably to prepare for a steepening of the yield curve in the near term and for JPY appreciation going forward. First, (2) widening the band around the 10-year bond yield target will create space for the yield curve to steepen. Although the general framework of YCC (which involves retaining short-term interest rates at around -0.1% and 10-year bond yields at around 0%) remains unchanged, the movement range for the long-term yield has been expanded from the original unwritten (no clear mention of this in the statement) 0.20bps to 0.25bps either side of zero, which a clear mention of this in the statement. This increased interest rate movement range will expand transaction opportunities for financial institutions potentially resulting in increased revenues. Naturally, some may be concerned about interest rates rising as a result of this move, but in order to prevent an uncontrolled increase in interest rates, the Bank has also simultaneously introduced a "fixed-rate purchase operation for consecutive days," which can make continual unlimited purchases of JGBs of specified maturities at a fixed interest rate as required. Going by the current situation, however, this system seems unlikely to be actually put to use any time soon.

Of the three measures, (1) the establishment of the Interest Scheme to Promote Lending may have the greatest significance when it comes to forex outlook. In Japan, as in Europe, expanding negative interest rates single-handedly damages financial institution revenues, and there is unanimous agreement that it is not a practical option. In this context, an anonymous remark that the ECB did not take kindly to market expectations of deeper negative interest rates was reported in the news in late January and made the headlines. Establishing the Interest Scheme to Promote Lending seems to be the BOJ's way of emphasizing that expanding the negative interest rate margin is not impossible. Under the Interest Scheme to Promote Lending, additional interest rates may be applied to financial institutions' current account balances, depending on the amount. For instance, if the negative interest rate is lowered to -0.20%, an additional interest rate of up to +20bps could be applied. By providing such lending incentives, the Bank's intent was probably to indicate the feasibility of further (downwardly) expanding the negative policy interest rate. A similar system, which changed the negative interest rate exemption margin for financial institutions based on their lending performance, was adopted by the ECB through its targeted long-term refinancing operation (TLTRO). One does, therefore, get the sense that the two central banks are on the same path. Credit conditions seem unlikely to improve if negative interest rates are deepened, but the move is certainly likely to have some effective on forex markets, which tend to behave based on instinct. By introducing this scheme, the BOJ appears to have laid in preparations for the eventuality of a JPY appreciation during a crisis.

Measures to Extend Life of Framework

The three measures (1) to (3) above can be seen as measures intended to extend the life of the BOJ's accommodative monetary policy under Governor Kuroda. Despite the slight change in terminology, the recent assessment can be thought of as a continuation of the September 2016 "Comprehensive Assessment," perhaps as "Comprehensive Assessment Part 2.0." No more policy assessments are expected during the rest of Mr. Kuroda's term (through April 2023), and in the coming months, the BOJ is likely to attempt guiding the 10-year interest rate down to -0.25% by hinting at a further expansion of negative interest rates (strictly speaking, since the language says "around plus and minus 0.25 percent from the target level," the lower bound could be expanded to -0.30% or so). The recent assessment, however, also tried to gauge the impact of a further decrease in interest rates on the consumer index ("people's sentiment"), and concluded that a decrease in borrowing interest rates would have a positive effect on consumer confidence, while the decline in super-long-term interest rates could have a negative effect. Frankly speaking, encouraging the 10-year bond yield downward would lower the yields for even longer maturities (super-long-term interest rates), it may be difficult to rationalize policy operation that puts too much emphasis on this. On the other hand, the recent assessment was mainly focused on encouraging an increase in JPY interest rates, which does make it a factor that could invite JPY buying, but given how wide the U.S.-Japan interest rate differential is, a slight increase in the JPY interest rate is unlikely to affect the differential much. Consequently, it is unlikely to have any major implications for USD/JPY.

U.S. Monetary Policy Now and Going Forward – Maintaining the Status Quo Somewhat Bullish

FOMC Meeting Outcome Reasonable

U.S. monetary policy was kept unchanged at the FOMC meeting held on March 16-17. There were two major points of interest this time. The first was the dot plot, which shows the federal funds rate forecasts by Committee members, and the other was Fed Chair Jerome Powell's assessment of interest rates at his press conference. With regard to the former, there was still broad agreement on maintaining zero percent FF rates until the end of 2023, and this appears to have limited the impact from the meeting on the financial markets. With regard to the latter, Mr. Powell, while acknowledging that a "disorderly" fluctuation of interest rates could threaten the achievement of the Fed's policy goals, also indicated a basic stance that it would be appropriate for the Fed to continue with its current pace of asset purchases. The message that the Fed planned to take a long view of the interest rate increases and keep its current policy unchanged is quite sensible in that it keeps the financial markets guessing as to policy direction, and the Fed will probably continue to drive home this message for the time being.

More Committee Members Predict Rate Hike before End of 2023

Taking a more detailed look at the dot plot, all 18 members expect FF rates to remain unchanged through 2021; 14 members expect them to remain unchanged through 2022, while 4 members predict a rate hike; meanwhile, only 11 members expect the rates to remain unchanged through 2023, with 7 members predicting a rate hike. The changes were not sufficient to move the median values of the forecasts, so the markets were not affected, but the fact that an increasing number of Committee members are predicting rate hikes before the end of 2023 is concerning.

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

FOMC Date	2021	2022	2023	Longer run
Mar-19	2.625%	n.a.	n.a.	2.750%
Jun-19	2.375%	n.a.	n.a.	2.500%
Sep-19	2.125%	2.375%	n.a.	2.500%
Dec-19	1.875%	2.125%	n.a.	2.500%
Jun-20	0.125%	0.125%	n.a.	2.500%
Sep-20	0.125%	0.125%	0.125%	2.500%
Dec-20	0.125%	0.125%	0.125%	2.500%
Mar-21	0.125%	0.125%	0.125%	2.500%

(Source) FRB

Committee members are predicting rate hikes before the end of 2023 is concerning. Even if this is just an aberration, such glimpses of a desire for policy normalization are still difficult to reconcile with the over 2% average target, or the forward guidance that was strengthened recently in December (to state that the current pace of asset purchases would be continued until "substantial further progress" became obvious). One of the reporters at the press conference did ask about the dot

plot's relation to the forward guidance. Mr. Powell explained in response that the dot plot was merely a compilation of individual projections by individual members, who may not have fully factored in all the uncertainties expected going forward. Although this view is reasonable, the fact remains that the financial markets cannot ignore the FF rate projections published by the Fed. Frankly speaking, therefore, the explanation is somewhat difficult to understand.

Again, Fed sources have explained several times in the past that the dot plot merely reflects the average projections of Committee members and is not a policy commitment by the Fed, but market participants have been critical of this explanation, asking what the point of releasing such projections were. This time, however, thanks to the summary of economic projections (SEP) also being significantly more optimistic, market participants had good reason to be more suspicious of the hawkish shift in the dot plot (details later). Fortunately, the upward revision of projections was not sufficient to change the median values, so they did not cause market fluctuations in ways not intended by the Fed (i.e., interest rates soaring or share prices crashing), but going forward, when tapering of monetary accommodation or rate hikes become a more realistic possibility, the markets will be watching more closely to make sure that policy decisions, dot plot projections, the SEP, and press conference by the Chair are all consistent with one another. The dot plot itself should probably have been handled as part of the Fed's revision of monetary policy strategy last summer.

Fulfilled Dual Mandate in 2022 and Onward

As for the SEP, projections for 2021 have been significantly upwardly revised, while those for 2022-23 remain largely the same – these are in line with or within the bounds of what can be inferred from projections made by other countries or international organizations. The real GDP growth rate forecast for 2021 was considerably upgraded from +4.4% to +6.5%, but those for 2022 and 2023 only saw slight changes, from +3.2% to +3.3% for the former and +2.4% to +2.3% for the later. The chart shows the range of Committee members' forecasts rather than the median value, which tends to dominate the headlines, and it is easy to see that members' perception of the current status has changed dramatically, with the 2021 growth rate forecast's lower bound jumping from +0.5% to +5.0%. Needless to say, the background to this is bound to be a decline in new cases as vaccination rates increase – something the Japanese economy is sorely lacking at the current time.

Naturally, inflation forecasts have also improved in line with growth rate forecasts. Projections for the personal consumption expenditure (PCE) deflator for 2021 were upwardly revised from +1.8% to +2.4%, although those for 2022 and 2023 remained more or less unchanged (+2.0% to +2.1%, and +1.9% to +2.0%, respectively). However, this upward revision puts the median PCE deflator forecast for the current forecasting period at over +2% (same for the Core). Again, the unemployment rate for 2022 and onward is also projected to attain the long-term unemployment rate level (4.0%). From 2022 onward, then, the Fed seems likely to enter a phase where the big question will be how

FRB economic outlook (multiple forecast, %) as of MAR 2021

	2021	2022	2023	Long-term
Real GDP Growth rate as of DEC	5.0~7.3 (0.5~5.5)	2.5~4.4 (2.5~4.0)	1.7~2.6 (2.0~2.5)	1.6~2.2 (1.6~2.2)
Unemployment rate as of DEC	4.0~5.5 (4.0~6.8)	3.2~4.2 (3.5~5.8)	3.0~4.0 (3.3~5.0)	3.5~4.5 (3.5~4.5)
PCE inflation rate as of DEC	2.1~2.6 (1.2~2.3)	1.8~2.3 (1.5~2.2)	1.9~2.3 (1.7~2.2)	2.0 (2.0)
Core PCE inflation rate as of DEC	1.9~2.5 (1.5~2.3)	1.8~2.3 (1.6~2.2)	1.9~2.3 (1.7~2.2)	

(Source) FRB

much longer can monetary accommodation be continued after having achieved the dual mandate? This seems the most important point to consider when considering what the Fed's next move will be, but it could be that retaining the status quo will be considered consistent with the idea of an "average target." In his press conference, Mr. Powell emphasized the importance of sufficient communication in advance of actually implementing tapering – perhaps the Fed has learned its lesson from its experience with QE3.

Impact on Forex Outlook – Will USD Remain Strong in 2022 and Beyond?

I base my forex outlook primarily on ongoing communication from the Fed (i.e., that there will be no change in FF rates before end of 2023), but if the U.S. employment situation, especially wages, show marked improvement, it may be wise to be prepared for the possibility of stronger hints at a hawkish adjustment to monetary policy. At his press conference, Mr. Powell denied any correlation between an improvement in the employment situation and a rapid rise in inflation (in other words, the theoretical shape of the Phillips curve). However, recent months have seen a back and forth of deterioration and improvement on a scale never seen before, and the possibility of wages rising in a non-linear manner (at least statistically) cannot be ruled out. If that happens, policy operation is also bound to be impacted. As explained in detail below, steep yoy recoveries posted during the April-June quarter this year could give rise to the mistaken belief that inflation is soaring.

Of course, such a possibility is still only a part of my risk scenario, but one must be prepared for the possibility of it gradually becoming a part of my main scenario depending on communications from Mr. Powell and other Fed officials. If that happens, it may become more realistic to predict JPY depreciation against USD in 2022 and onward. In honestly, I do think that U.S. interest rate movements will enter a lull in 2022, causing USD to swing back in a weaker direction, but it has to be said that there now seems a possibility of this not happening. While the Fed is ostensibly determined to maintain the status quo, signs of bullishness seem to be lurking in various places, and this could be an extremely important factor to take into consideration when formulating forecasts over the next year.

Contrasting COVID Response Status – Hope in the U.S., Uncertainties in Japan

President Biden Brings Hope

In March, despite significant volatility, financial markets were characterized by a triple-high in share prices, U.S. interest rates, and USD overall. In addition to the new stimulus plan, increasing vaccination rates, and hopes of a return to normalcy appear to be strongly driving the trend. In particular, many believe that President Biden's remarks to the nation on March 11 brought a ray of hope to Americans. "All adult Americans will be eligible to get a vaccine no later than May 1," he said, adding that this would allow small groups to be able to get together to mark Independence Day on July 4 – in other words, he gave a specific timeline for the return to normalcy. Of course, there is the possibility that unforeseen obstacles may crop up as restrictions on activity begin to be lifted, and if one takes into account the possibility of infections from COVID variants spreading, plans to return to normalcy by July 4 may be too ambitious. However, given the current state of affairs, there is no doubt that giving hope is one of the important duties of politicians.

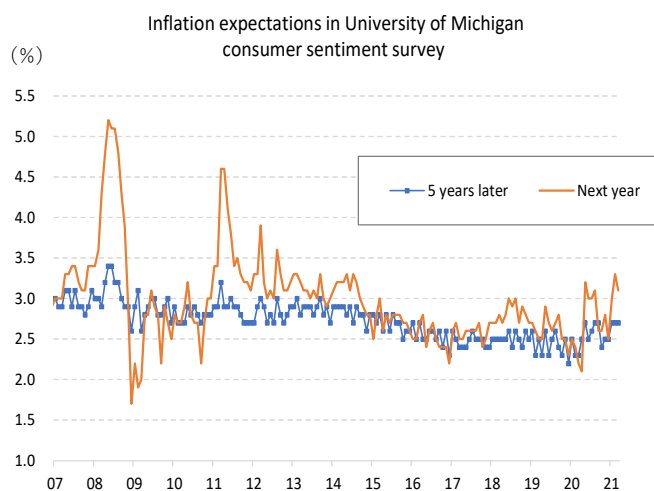
Amid rising hope for the future, U.S. 10-year bond yields in March settled at a high level of 1.60%, but this did not lead to a crash in share prices. Perhaps there is no single reason for this, but one cannot overlook the fact that inflation expectations have risen significantly. Though this has been relegated to the background, with most of the attention being diverted to the rapidly rising nominal interest rates, the 10-year breakeven inflation rate (10-year BEI), which was around 2.0% at the beginning of the year, has been gradually rising, hitting 2.2% in February, and rising to 2.3% by early March. It is not impossible this has been suppressing the pace of increase in real interest rates as well as alleviating the burden on share prices.

Survey-Based Inflation Expectations Also on the Rise

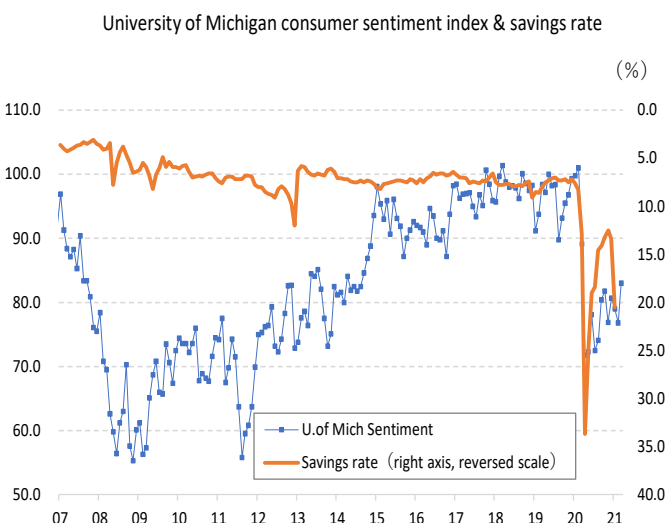
Incidentally, the surfacing of inflation expectations is not just seen in market-based indicators such as BEI, but also in survey-based indicators. The March University of Michigan Consumer Sentiment Index, which was released on March 12, showed the 5-year forward inflation expectation stable at 2.5% or so, but 1-year forward inflation expectations had clearly swung upward, exceeding 3.0% (see figure). However, 1-year forward inflation expectations had jumped also during the 2008-2011 period, which the global financial crisis and the European sovereign debt crisis. Perhaps survey-based inflation expectations simply reveal impatient optimism during phases anticipating the end of a period of pessimism. At any rate, there is no doubt of an increasing optimism regarding U.S. economic and financial conditions going forward, and this is likely the reason for the triple high of share prices, interest rates, and USD. Coming in this midst, though no more than symbolic, President Biden's remarks mentioned above, backed by a smooth supply of and preparation for the administration of vaccines, appear to have won the confidence of the nation for the moment. It is perhaps because of his providing a roadmap raising hope for the future despite present harsh conditions, rather than spreading fear while hinting at possible restrictions on activity in the midst of an uncertain situation, that inflation expectations have strengthened.

Could Expectations Turn into Magma?

Of course, it is difficult to predict whether the rising expectations will translate into strong consumption and investment in actuality. Those would have to be driven by the environment and wage situations. The household sector's savings rate (savings ÷ disposable income) was 7.3% in the 10 years from 2010 through 2019, before the COVID pandemic. By contrast, it shot up to 16.4% in 2020 and was 20.5% for the most recent month (see figure). Of course, government payouts and handsome unemployment benefits have also been contributing to this, possibly resulting in a greater increase in savings rate than there has been a dampening of consumer sentiment. As discussed in a past issue of this report,



(Source) macrobond

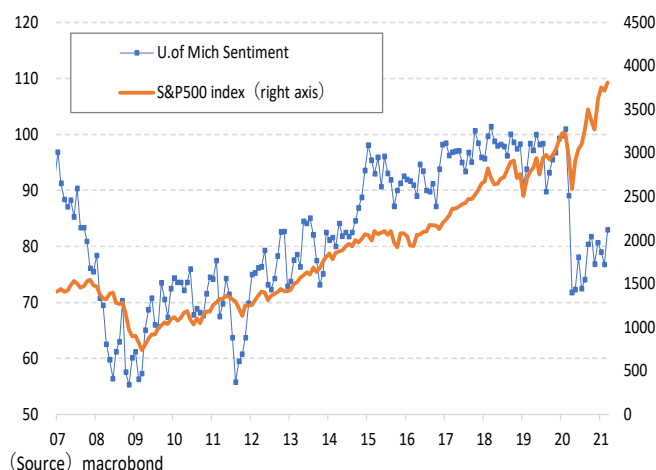


(Source) macrobond

it is difficult to say for sure at the current time whether this increase in savings will act as “magma” to drive the economy going forward, or as a burden, weighing down the economy and resulting in long-term stagnation.

However, going by U.S. inflation expectations, it appears that the U.S. is headed in a different direction than Japan or the euro area, which suffer from low interest rates and low prices as a result of chronically excessive savings in the household sector, so, perhaps the U.S. can avoid the “Japanization” phenomenon after all. I can understand the desire to bet on the “magma” theory. Consumer sentiment, which had been lacking the vitality seen in share prices, finally appears to be showing signs of recovery (see figure), and one expects that the asset price effect (which tends to be stronger in the U.S. than in other developed economies) will begin to manifest going forward.

U.S. stock prices & University of Michigan consumer sentiment index



Uncertainty Undermining Consumption/Investment Proclivities

Japan is also moving ahead toward the post-pandemic era (the state of emergency imposed on Tokyo and three neighboring prefectures was lifted on March 21), but the Japanese situation contrasts with that in the United States in that, in Japan, one does not get a sense that private-sector savings is accumulating like ‘magma’ with the potential to explode. It seems that many economic agents in Japan may not have clear hopes or expectations about what politicians might do and mainly have a strong sense of uncertainty about what will be happening in the future. As a matter of fact, the daily number of detected infections (positive test results) has been tending upwards since March 7, when the state of emergency lifting was postponed and it was decided to further extend the state of emergency,

so there is a basis for speculating about the motive for the March 21 ending of the state of emergency. The reason why this situation is so difficult to understand is that covid-19-related policies have become a focal point for political disputes in general. While Japan has had a much smaller number of infections than the United States and European countries, its yoy GDP growth rate was second lowest among G7 countries in 2021 (just slightly above that of Italy) and it is projected to be the lowest among G7 countries in 2022 (see chart).

G7 growth ratio trajectory from 2021 to 2022

	2021	2022
US	5.1	2.5
Euro-zone	4.2	3.6
Germany	3.5	3.1
France	5.5	4.1
Italy	3.0	3.6
Japan	3.1	2.4
Canada	3.6	4.1
UK	4.5	5.0

(Source) IMF “World Economic Outlook”(JAN 2021 revised edition)

Uncertainty is the biggest obstacle to making consumption and investment decisions. The outlook may appear somewhat less uncertain if one can utilize clear evaluation standards, such as figures for the number of vaccine doses procured, the number of vaccine doses administered, and the resulting increase or decrease in the number of infections. It is largely because of the smooth advances in vaccine procurement and vaccinations in the United States that President Biden has a basis for articulating his expectations and hopes. Given that vaccine procurement and vaccinations have not yet advanced much in Japan, it is understandable that one cannot yet make significant claims about the impending benefits of vaccines. However, it is disconcerting to see a rush to employ difficult-to-understand standards. When deciding to extend the state of emergency on March 7, the Tokyo Metropolitan Government suddenly cited a standard of “140 new positive tests per day” (7-day moving average), but it did not mention the figure’s denominator (the number of tests administered). Without knowing how many tests are administered per day, it is hard to understand whether “140 new positive tests per day” is in fact a high level or a low one. Prior to that, the Tokyo Metropolitan Government had indicated that a 30% reduction in the average daily number of new positive tests (7-day moving average) would be the standard for canceling the state of emergency. Yet, as the absolute number of new infections decreases, it cannot be expected that a particular rate of decrease in new positive tests can be sustained. This situation suggests that the basis for setting standards or goals was not logical or reasonable. If it were said that decisions regarding the state of emergency would be made in line with public opinion poll results, the situation would be easier to understand than it is when the decisions are said to be made based on vague and confusing standards. One may recall that the emergency was originally designed to ease excessive burdens on the medical care system’s capacity, but one cannot help getting the impression that there has been little effort to cite numerical targets or progress in that regard. When the decision to lift the state of emergency was made on March 21, it was finally decided to discuss the reasoning behind the decision. Just before that time, Prime Minister Suga stated that “The hospital bed utilization rate has improved to the point that the state of emergency can be lifted.” That can be considered a reasonable way to explain the situation

It has also been reported that, when it was decided to extend the state of emergency for two weeks from March 7, there was a dispute between the central government and the governors of Tokyo and its three adjacent prefectures regarding who would request the extension of the emergency at what time. I think that scene reflected a key element of the culture of Japan, where political considerations tend to be given a higher priority than that given to the explanation of expectations and aspirations and the provision of concrete information about associated methods and targets. Will the ‘going along with public opinion polls’ approach be continued? Throughout the past year, it seems that the news media and the local government leaders have been seeking to promote greater anxiety, and human psychology generally seems to have a natural inclination to welcome regulations that are purported to increase health and safety. An opinion poll of Japanese people conducted on March 13 by the Mainichi Shimbun newspaper and the Social Survey Research Center found that 57% of respondents wanted the state of emergency in Tokyo and its three adjacent prefectures to be extended after March 21. Of respondents resident in Tokyo and its three adjacent prefectures, the share wanting the state of emergency to be protracted was 52%. Japan has declared states of emergency for a third of the past 12 months, so it may be that people have just become accustomed to such states of emergency.

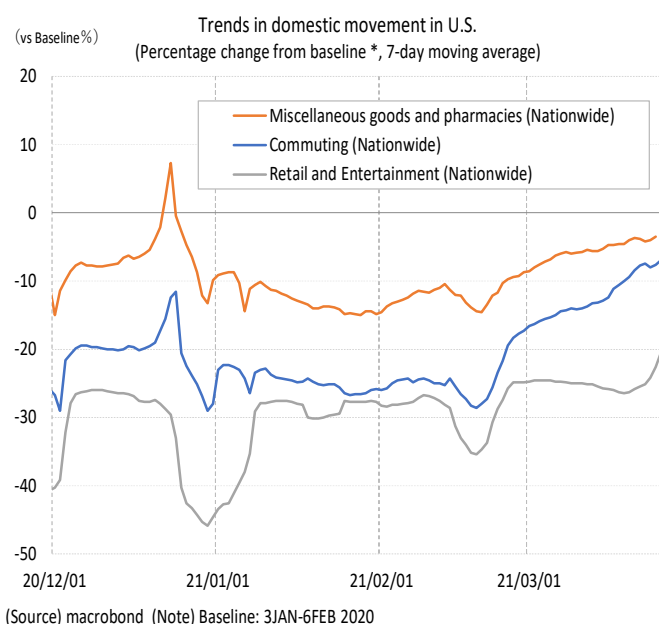
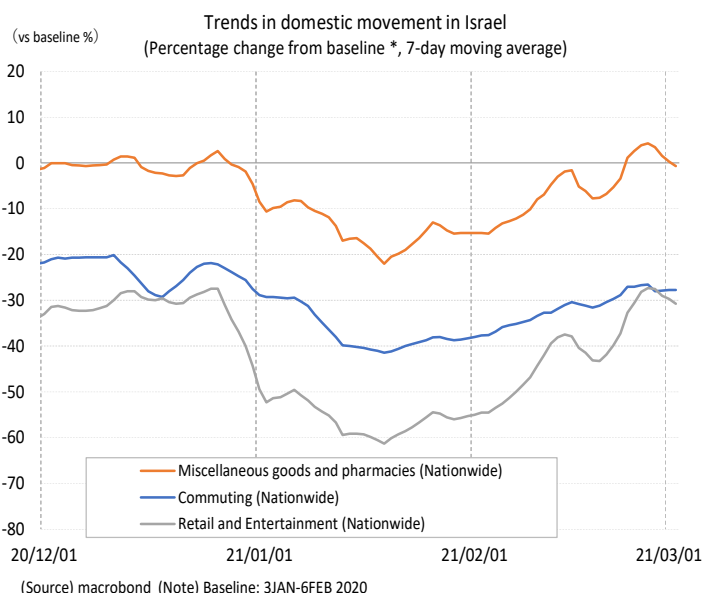
Japan’s large lag behind other G7 countries regarding the number of vaccine doses procured and administered (see chart on page 3) is depressing Japan’s economic growth rate, and this situation is unlikely to change in the near future. In addition, the repeated reimposition of activity restrictions with only weak logical bases is promoting a chronically risk-averse approach to private-sector economic activities that should not be overlooked as a factor likely to further lower the country’s economic growth rate.

Risks to My Main Scenario – What are the Upside and Downside Risks?

Downside Risk of Vaccine Vitiation

At the end of March, USD/JPY had risen to levels in the vicinity of 110. The trend of economic activity normalization against the backdrop of the vaccine effect along with the accompanying rise in market interest rates and USD largely remain as described in this section since November of last year. Of course, there have been some miscalculations about the pace of increase in U.S. interest rates and stock prices, but the pattern of trends itself is not surprising. Particularly as the scenario is proceeding smoothly as expected, I think it worth reexamining the risk factors that may be faced during the forecast period. Regarding the current year, the biggest risk factors are naturally related to the pandemic. After all, trends in forex markets as well as other kinds of financial markets will largely reflect the progress of vaccination programs (more specifically, progress toward the end of the pandemic). Accordingly, it goes without saying that the possibility of the virus becoming more virulent and vaccines becoming less effective is the greatest and worst risk factor. If such a

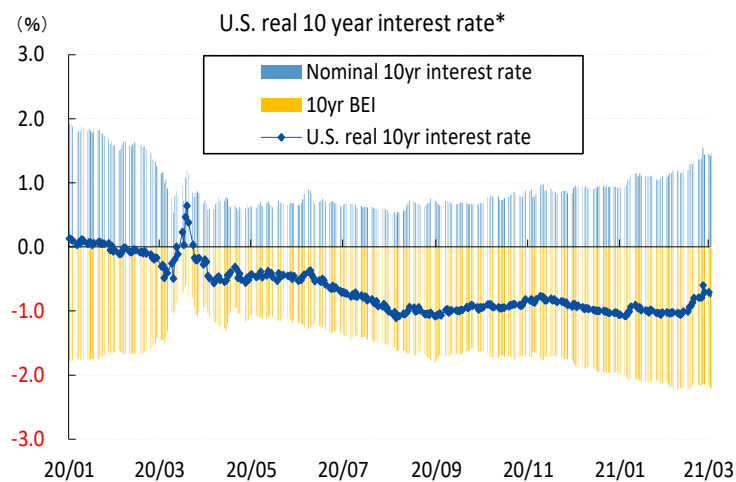
risk factor eventuates, it seems inevitable that the economic outlook’s reversal will promote decreases in U.S. interest rates and the weakening of USD. The forecasts for the next year of central banks and international organizations in Japan and overseas are based on the assumption that vaccination programs will be successful and enable the realization of herd immunity, and if vaccinations were to become ineffective, the forecast scenarios would become much gloomier. Such “vaccine vitiation” can be said to be the single greatest downside risk factor. So far, however, the pace of new infections has clearly begun declining in such highly vaccinated countries as Israel and in in developed countries where vaccination programs are rapidly progressing, such as the United States and the United Kingdom. From the economic analysis standpoint, we have no choice but to assume that such progress will continue to be achieved.



As of March 27 Israel was the world's leading country regarding the share of its population already vaccinated – with 114.70 vaccinations administered per 100 people – and there are emerging signs of normalization in that country's real economy. Google's COVID-19 Community Mobility Report for Israel shows that the country's economic activity has continued moving toward baseline levels (January 3-6, 2020) since the vaccine effect began manifesting itself in mid-January. Levels as of March 26 indicate that some business categories have already risen above the baseline and suggests that people are resuming their previous daily lifestyles (see (left) graph on next page). The situation is similar in the United States (see (right) graph on next page), which suggests that there is a sound basis for the trends seen in U.S. interest rates and USD over the past three months. There seems to be sufficient evidence to support a common sense assumption that the positive effect of vaccines will justify forex trading on the premise of progressive economic normalization during 2021, and the possibility that the vaccine effect might be vitiated clearly appears to be greatest downside risk.

Upside Risk of “Zero-Level Real Interest Rates”

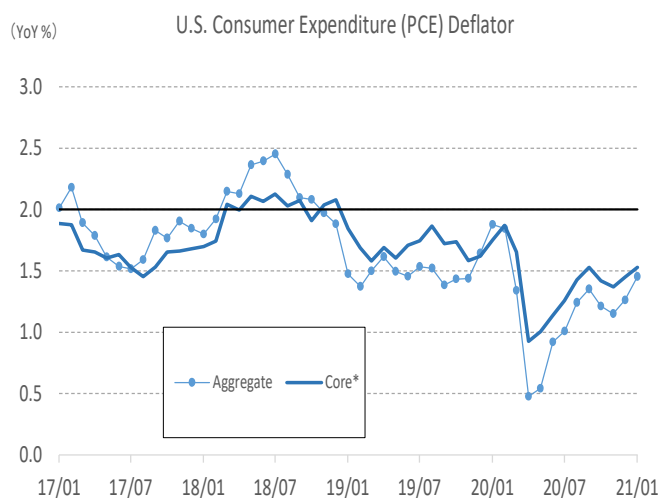
On the other hand, if expectations for vaccines become excessive there is a possibility of an increase in the associated upside risk, which might manifest itself in the form of an excessive rise in U.S. interest rates. In March, the U.S. 10-year interest rate surpassed the 1.70% level. The elevation of nominal interest rates has been accompanied by an increase in real interest rates, and there are concerns about how a real interest rate rise might impact asset prices, especially stock prices. It is said that the upper limit of the U.S. 10-year interest rate in 2021 is somewhere in the 1.50-to-1.60% range, but the rate has already surmounted several milestone levels and it is now difficult to predict its future path. The impact of the U.S. real 10-year interest rate on asset prices has been frequently discussed since last year, and the question of what specific real interest rate level would be optimal may be the next focus of discussions. At the time this article was written, the U.S. real interest rate calculated based on the 10-year break-even inflation rate (10-year BEI) was intermittently falling below -0.60% and fluctuating in the high portion of its range since the beginning of the year. It is worth noting that in January 2020, just before the pandemic shock, the real interest rate was close to zero. If the 10-year BEI stays flat, a rise of about 60bps in the nominal 10-year interest rate will restore the pre-pandemic situation with respect to the real interest rate. That corresponds to a nominal interest rate level in the 2.2-2.3% range. While this could be considered a “reasonable level” in light of the U.S. potential growth rate (slightly below 4% in nominal terms and slightly below 2% in real terms), it is not obviously reasonable given that more than 9 million jobs have been lost since the previous economic cycle peak, so there is a naturally a need to discuss the optimal level of nominal interest rates based on consideration of various situations. The Fed expects to reach full employment by the end of 2022, but it is somewhat doubtful that such a rapid recovery in the real economy will occur if real interest rates quickly return to pre-pandemic levels. In view of this, I think that a rapid return to zero-level real interest rates would be an overshoot and that the possibility of such a rapid return represents an upside risk for the U.S. economy in 2021.



(Source) Bloomberg (Note) *Nominal 10yr interest rates-BEI10yr

Concern about Second-Quarter Inflation Rate Rise

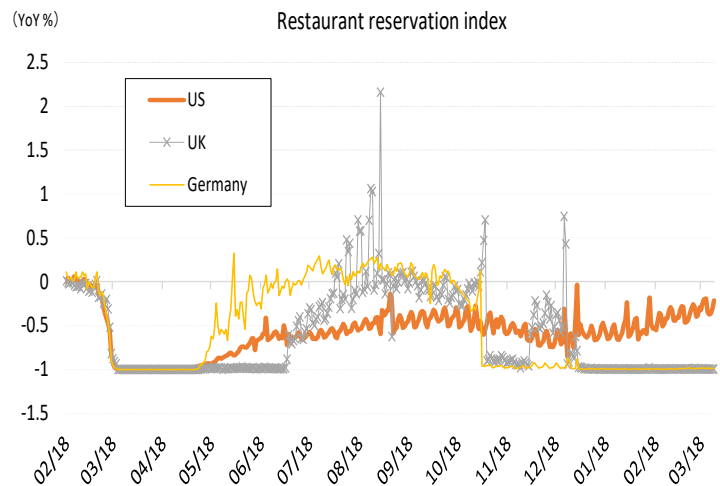
In fact, there are substantial grounds for concern about this upside risk factor. It is highly likely that the nominal interest rate will continue rising during the April-June period, aiming for a “zero real interest rate level”. This is because inflation has been largely dormant since last February, when the price of crude oil futures turned negative owing to the pandemic, but crude oil prices have been rising since last April. Consequentially, headline inflation rates are liable to surge upward during the April-June second quarter period, and the rise in BEI may well reflect a factoring in of that likelihood. While the BEI increase is just a technical rise, the Fed is expecting the inflation rate to reach 2% by the end of this year and remain stable until the end of 2023. Given that inflation rates exceeding 2% are expected to become normal in the second and third quarters of this year and in light of speculation about how the Fed will manage the new average inflation target (AIT) monetary policy it launched last September, it appears quite possible that nominal interest rates will rise along with inflation.



(Source) macrobond (Note) *Base excluding food and energy

This rise seems particularly likely to occur if a general public view takes shape that during the warmer-weather months the number of COVID infections is less liable to increase and that even if that number increases the symptoms are less likely to be severe.

Of course the increase in the inflation rate is not the only development expected from the second quarter, as year-on-year improvement in various types of economic indicators can be expected from that time. Because trends in retail sales figures and many other major economic indicators currently tend to be considered in terms of month-on-month changes, however, it seems likely they will have less powerful effects than that of the inflation rate rise. But positive trends in employment indicators might in fact have an effect on market conditions comparable to the inflation rate trend, largely because the return to work of laid-off workers is understood to be closely correlated with the general normalization of economic activities, and figures for workers returning to their jobs are expected to be particularly noteworthy with respect to such industries as restaurants and hotels. There are already clear signs of improvement in the number of restaurant



(Source) OpenTable

table reservations in the United States (see graph), and it is expected that this will, after a lag, lead to an improvement in U.S. employment statistics. U.S. President Biden has predicted that individuals' daily lives in the United States would be able to return to a semblance of normality by July 4th, and considerable improvement in the country's employment and wage situation will be required to make that prediction come true. Since the president has identified the July 4 date, one might speculate that the tone of FOMC statements could shift toward an optimistic post-pandemic mood from July.

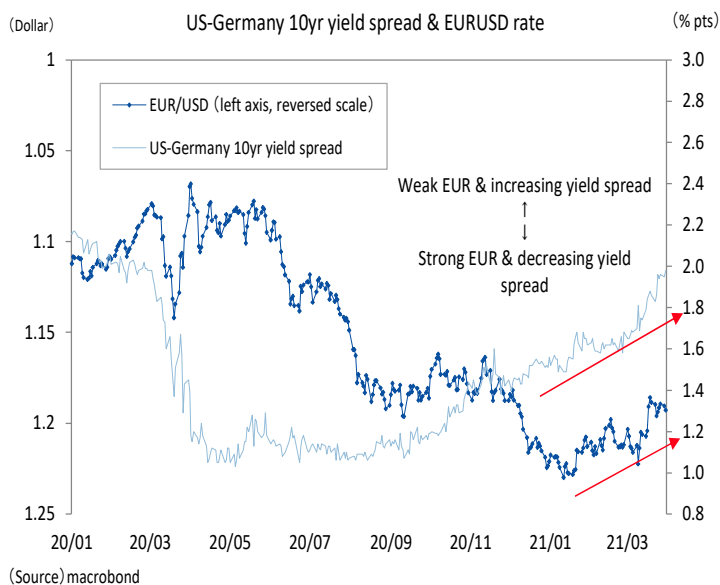
After a country attains herd immunity, it can be expected that the country's economic activity should gradually recover, so the likely outlook continues to be one of U.S. economic recovery trends accompanied a gradual rise in U.S. interest rates from the third quarter. However, it is undeniable that the second quarter is particularly likely to be a period of sharply rising economic momentum. In the absence of interest rate overshooting, if the U.S. 10-year interest rate becomes stable at levels above 2% and stock prices do not collapse, the main USD/JPY battlefield may shift to the 110-115 range. This is an upside risk related to this article's main scenario that market players should be vigilantly monitoring.

EUR Outlook – EUR Outlook – “Divergence” a Key Word Going Forward

EUR Area Monetary Policies Now and Going Forward – Interpreting the Phrase “Significantly Higher Pace”

“Divergence” a Key Word Going Forward

The ECB Governing Council meeting in March decided to maintain the policy status quo. However, the post-meeting statement included a sentence confirming pre-meeting expectations that purchases under the pandemic emergency purchase programme (PEPP) would be accelerated – “the Governing Council expects purchases under the PEPP over the next quarter to be conducted at a significantly higher pace than during the first months of this year”. I found it somewhat surprising that the PEPP acceleration would be announced in the statement (I had expected it to be mentioned during the question and answer portion of the post-meeting press conference.), and it is noteworthy that there was a sharp drop in euro area interest rates following the announcement. Given the ECB’s concerns about the euro area’s credit environment, it is understandable that the ECM would not consider it possible to emulate the Fed in tolerating a trend of rising interest rates, so the basis for its announcement is clear.



Moreover, although it is mainly the above-cited sentence that is attracting attention, when considered along with the sentence at the beginning of the next paragraph – “The Governing Council will purchase flexibly according to market conditions and with a view to preventing a tightening of financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation” – it is clear that the ECB is doing its utmost to tell the financial markets not to underestimate the PEPP’s effects. The statement said that PEPP purchases would be accelerated “over the next quarter”, but the pace of those purchases had already been accelerated at the time this article was written (late March), so it is not difficult to get the ECB’s message that it is firmly intent on curbing rises in interest rates. Since the Fed has been implicitly tolerating the uptrend in U.S. interest rates, the prevention of such a trend in the euro area can be expected to cause the Europe-U.S. interest rate differential to widen. I think it worth paying close attention to whether, by restoring the Europe-U.S. interest rate differential, the contrasting policies of the ECB and the Fed will continue to support a rise in EUR/USD following the following the sharp drop in that rate seen from last November (see graph). Understanding the “divergence” of the two central banks’ policies is likely to be a key concept in the forecasting of EUR/USD trends going forward.

Interpreting the Meaning of “Significantly Higher Pace”

The ECB explained that the biggest reason for accelerating of PEPP purchases is to prevent an unintentional tightening of the financing environment. If government bond yields were permitted to considerably and continuously increase, it would promote a rise in the interest rates on corporate bonds and bank loans, which are determined with reference to government bond yields, causing the overall financing environment to become tight. As that would impair price stability, the ECB’s strategy is to employ PEPP purchases to depress government bond yields. In this regard, some reporters posed questions about the possibility of reviving yield curve control system proposals that had seemed to have been hinted at in the past, but ECB President Lagarde repeatedly insisted that the ECB is examining the entire yield curve in a “holistic” and “multifaceted” manner without focusing on any particular segment of the curve. Given that the president herself has specifically denied using a yield curve control system, it is probably reasonable to conclude that there is no longer a possibility that such a system will be introduced in the near future. In fact, the risk of the central bank indicating a peg to a specific interest rate level would not be small given the numerous fluid factors the bank currently faces, such those related to the pace of vaccinations and progress toward herd immunity attainment along with the timing and strictness of lockdowns and other restrictions going forward. Of course, some reporters at the press conference posed questions seeking a more-precise definition of “significantly higher pace”, but it was also clear that they are not so concerned with the specific purchasing amounts given that those amounts will not be associated with the promotion of specified interest rate levels. Although the statement states that the pace of PEPP purchases will be significantly higher “over the next quarter” (the April-June period), an acceleration of the purchasing pace was already evident during the week following the meeting. It will probably be useful to wait about a month from after the meeting to analyze the nature of the purchasing pace acceleration at that point.

If one optimistically expects a scenario of smoothly advancing vaccination programs leading to the expeditious acquisition of herd immunity and normalization of economic activities, however, it may be that the “significantly higher pace” of purchases will be limited the next quarter (the April-June period) as explained in the statement.

“Holistic” and “Multifaceted” Evaluation of Financing Conditions

It is noteworthy that the latest revision of the staff projections indicate that the euro area Consumer Price Index (HICP) will not reach the targeted 2% level during the forecast period (see table), but this outlook was already indicated by the December staff projections. Given that, some reporters questioned why the pace of PEPP purchases slowed in January. In short, it seems that there may have been a tentative decision in January to accelerate PEPP purchases but, as mentioned above, the ECB's greatest concern relates to the deterioration of the funding environment in the real economy. It appears that the ECB's decision making process begins with the consideration of how much support the financing environment requires based on consideration of the main forecast scenario – the economic and inflation forecasts of the staff projections. Thus, when the staff projections are revised, the ECB evaluates financing conditions based on that forecast scenario, and if support is deemed necessary, initiates a “determining the risk-free policy interest rate level → determining the government bond yield level → determining the corporate bond and bank loan yield level” process. President Lagarde has repeatedly emphasized the importance of maintaining a holistic view of policy management that encompasses this decision-making process flow and a multifaceted perspective that considers multiple indicators.

	2020	2021	2022	2023
HICP	0.3	1.5	1.2	1.4
(Previous: DEC 2020)	0.2	1.0	1.1	1.4
Real GDP	-6.9	4.0	4.1	2.1
(Previous: DEC 2020)	-7.3	3.9	4.2	2.1

(Source)ECB (Note) EURUSD is assumed to be 1.21 for year 2021-2023

President Lagarde has repeatedly emphasized the importance of maintaining a holistic view of policy management that encompasses this decision-making process flow and a multifaceted perspective that considers multiple indicators.

In other words, when making PEPP management decisions, the ECB will first evaluate the financing environment in light of the latest economic and inflation outlook. If government bond yields are deemed too high, it will accelerate PEPP purchases, and if government bond yields are deemed too low, it will decelerate PEPP purchases. Since the staff projections are revised on a quarterly basis, it follows that the reevaluation of PEPP management decisions will also be undertaken on a quarterly basis. While this summary may be oversimplified, it does seem that the flexibility touted as a major strength of the PEPP may be somewhat impaired owing to the financial markets' assumption that PEPP management will be reviewed quarterly.

Benefits of PEPP's Total Envelope Structure

In response to the ECB's latest PEPP management decision, I had the feeling that the PEPP concept – initially establishing a huge purchasing envelope without prior specification of monthly purchasing amounts, not imposing an obligation to use the entire envelope, and then accelerating or decelerating purchases depending on changes in circumstances – is a very easy-to-use method for avoiding constraints stemming from market expectations. For example, if PEPP purchasing was initially set at EUR60 billion per month, raising the monthly purchasing amount to EUR110 billion would be a big decision. Once the figure is raised, it will be difficult to adjust it downward owing to concerns about sending the wrong signals. Moreover, it is inevitable that even initial determinations of spending amounts will be complicated by the seemingly trivial issue of “whether or not that particular figure is above or below market expectations, and by how great a margin”, yet while the issue seems trivial, it is also apparent that interest rates do in fact tend to fluctuate considerably when central bank decisions deviate from market expectations. The ECB was able to employ the ambiguous expression “significantly higher pace” because the PEPP's total envelope structure obviates the need to specify purchase amount figures or describe those figures precisely in the Governing Council meeting statements. The ambiguity the PEPP's total envelope structure enables may also be considered beneficial in that it probably facilitates the promotion of consensus decisions within the Governing Council.

While the latest Governing Council meeting decided to accelerate PEPP purchasing, the ECB is positioned to quickly adjust that decision in the case that interest rates were to decrease by an unexpected margin for whatever reason might emerge. If actual interest rates were to decline, the pace of purchases might be maintained or decreased, but the financial markets will probably not care so much about either of those possibilities. Given how conveniently flexible the total envelope system for asset purchasing programs created by the Lagarde-led ECB is, it would not be surprising to see it become a standard tool of developed countries' central banks going forward.

German Politics Now and Going Forward – Spotlight Shifting from Immigration to the Environment

Chancellor Merkel's Frank Apology

It has been widely reported that German Chancellor Angela Merkel cancelled plans for a strict lockdown during the Easter holiday period and apologized, admitting the lockdown plan was a “mistake”. This is an unprecedented situation in which public criticism of a government approved lockdown has forced the government to back down. The German government was asking the public to stay at home and reduce social contact during a five-day Easter holiday period, but after the sudden announcement of tightened restrictions increased the crowding of stores prior to that period and began impacting manufacturers' production plans, Chancellor Merkel cancelled the lockdown and announced that – “This mistake is mine alone”. It is very uncharacteristic of Chancellor Merkel to flexibly back down regarding confirmed policy decisions, and it appears that the public's aversion to strict anti-pandemic regulations is becoming an increasingly powerful force countervailing such restrictions. Going forward, the idea that vaccination

programs should be given higher priority than lockdowns is likely to become dominant in every country. Such activity restrictions as lockdowns and limits on facilities' operating hours are considered time-buying tactics that mainly delay inevitable developments, but the public is seeking fundamental solutions. The global trend is likely to be one in which the goal of elevating vaccination rates comes to be uniformly given top priority.

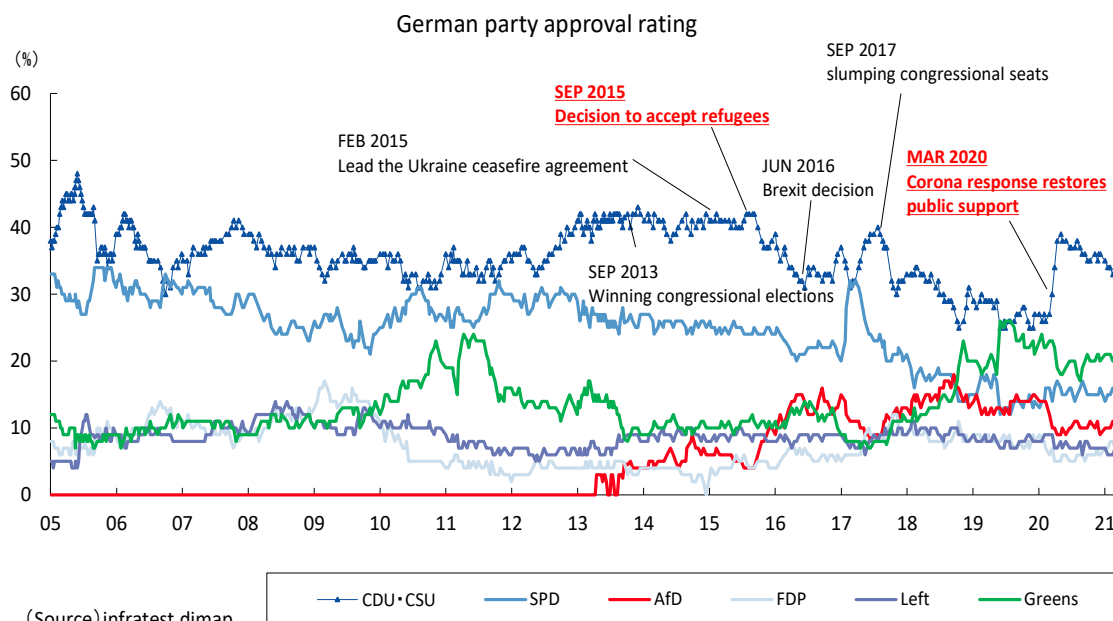
German Parliamentary Elections' Potential Impact on EU Evolution

One reason Chancellor Merkel may have taken personal responsibility for the "mistake" may be that she plans to retire in September and wants limit any potential impact the mistake might have on her political party in the upcoming elections. In fact, Chancellor Merkel's ruling Christian Democratic Union (CDU) is not in a strong position. The latest public opinion poll (conducted on March 19) found that the share of respondents supporting the CDU had fallen below 30% for the first time in a year.

It has been reported that the CDU was suffered defeats in elections in two western German states on March 14, and as I have received multiple inquiries about their implications, I would like overview the results of those elections here. Although German elections have been largely overshadowed by pandemic-related issues, Germany will hold state legislative elections in six of its states (including the abovementioned two) this year, and the country's federal parliamentary election (general election) is scheduled to be held on September 26. That is why Germans refer to 2021 as a Superwahljahr (super election year). While the level of interest in German local elections is not high in Japan, Chancellor Merkel's impending retirement and other situations will make this year a milestone transition year with respect to German politics (as well as EU politics), and many Japanese will have seen intermittent reports about what kinds of changes are likely to happen going forward. Among the world's countries considered major economic powers, Chancellor Merkel is currently the longest serving leader, and her retirement this year is a highly significant event that will have a large influence on the future of Germany as well as the EU.

Looking back at recent history, one finds that German state parliamentary elections have often led to major political changes. After the CDU suffered historic defeats in two state parliamentary elections in October 2018, Chancellor Angela Merkel decided that it was necessary to refresh the CDU's leadership and, accordingly, she announced that she would immediately resign from her position as CDU leader (while continuing to serve as chancellor) and retire from politics in September 2021. Her decision to ease herself out also reflected her responsibility for the September 2015 decision to accept an unlimited number of refugees as well as the CDU's devastating defeat in the September 2017 general election – when the CDU retained its position as Germany's top party but lost a significant number of parliamentary seats while the right-wing populist Alternative for Germany (AfD) party won many additional seats – but it was directly triggered by the poor results in the state parliamentary elections. Her successor as CDU Chairwoman, Annegret Kramp-Karrenbauer, served for only somewhat more than a year before announcing her resignation in February 2020, and the direct cause of that resignation appears to be Kramp-Karrenbauer's inability to defuse controversy regarding the CDU's apparent acceptance of rightwing parties' support in the state premier election in the eastern German state of Thuringia. (Prior to that, Kramp-Karrenbauer had made numerous questionable statements that caused many to question her qualifications for the post.)

This year, Germany's state parliamentary elections have been a kind of rehearsal for the country's general elections in September, and it should be understood that the September elections are likely to determine the leadership and government policies of Post-Merkel Germany as well as the Post-Merkel EU. Having begun in 2005, the Merkel era has lasted for 16 years. The end of that era has the potential to bring great changes to German politics and it is also likely to have noteworthy widespread effects on international politics, economics, and finance in Europe as well as elsewhere in the world.



Gains by Greens and SPD

Chancellor Merkel's center-right CDU party performed poorly in the state parliamentary elections held in Baden-Württemberg and Rhineland-Palatinate on March 14, receiving its lowest-ever shares of voter support in both those states. It is worth examining those election results in greater detail. Since the previous election in 2016, Baden-Württemberg's government has been a coalition led by the Alliance 90/The Greens ("the Greens") party, which has been gaining popularity in recent years owing to its emphasis on environmental issues, and its junior coalition partner, the CDU. In the March 14 election, the Greens increased their share of votes by 2.3%, to 32.6%, while the CDU suffered a 2.9% decrease in its share of votes, to 24.1%. The state's minister-president is Winfried Kretschmann, a member of the Greens. Rhineland-Palatinate has been governed since 2016 by a three-party coalition led by the center-left Social Democratic Party (SPD), which increased its share of votes by 0.5%, to 35.7%, while the CDU suffered a 4.1% drop in its share of votes, to 27.7%. The state's minister-president is Malu Dreyer, a member of the SPD. The incumbent ruling parties' leaders have shown strength in both Baden-Württemberg and Rhineland-Palatinate.

Based on those election results, the Baden-Württemberg coalition government to be formed might be either (1) the Greens + CDU or (2) the Greens + SPD + the Free Democratic Party (FDP). This choice had not yet been made when this article was written, but in the case of coalition (1), it will represent the maintenance of the status quo. If coalition (2) were to be formed, it would be evidence of how broad the Green Party-CDU policy gap is, and the size of this gap is likely to be an important consideration affecting the formation of a federal government coalition after the September general election. Moreover, the formation of coalition (2) could be interpreted as evidence of a general trend of increasing support for leftist parties in Germany. On the other hand, the prospective government of Rhineland-Palatinate is expected to be a continued coalition of SPD, the Greens, and FDP. In German states, priority is no longer being given to the formation of centrist coalitions between CDU and SPD, largely because the SPD is averse to being dominated by CDU within such coalitions.

Questions about Laschet's Ability to Unify and Strengthen the CDU

Armin Laschet, the Prime Minister of North Rhine-Westphalia, became CDU leader at the party's convention this past January and is considered the most likely candidate to replace Chancellor Merkel in the post-Merkel era, but do the recent election results suggest that he will in fact become chancellor? Factors related to the CDU losses in the abovementioned two states include (1) the strength of the incumbent minister-president of each state, (2) a scandal in which CDU members are alleged to have been obtaining large commissions for brokering mask procurement deals, (3) accumulating dissatisfaction with the government and ruling party associated with protracted anti-pandemic lockdowns. Many media editorials have been asserting that the CDU's weak showing reflects such factors and does not suggest that CDU Leader Laschet will not be effective in his efforts to unify the CDU and promote its electoral success.

However, it is still unclear whether CDU Leader Laschet will be the CDU's candidate for chancellor in the September general election, as there are those who do not believe he has the ability to fill Chancellor Merkel's shoes. There is intermittent speculation that Bavaria's Minister-President Markus Soeder – a member of the CDU's Bavarian sister party, the Christian Social Union (CSU) – would be a better candidate given his relatively high level of national support. If CDU Leader Laschet is the candidate, it would increase expectations of the continuation of Chancellor Merkel's policy positions, which would be comforting to financial markets, but one cannot take it for granted that the CDU can win the upcoming general election. Preliminary forecasts suggest that the Greens are likely to deprive the CDU of a certain share of its support.

On June 6, prior to the September general election, a state parliamentary election will be held in the eastern state of Saxony-Anhalt, where there is a high level of support for the right-wing populist AfD, and it is expected that that election's results will also be considered to offer hints about who the CDU's candidate for chancellor should be. There are other regional elections that will be held soon – such as those in the eastern state of Thuringen (where there is also a high level of support for AfD), the northeastern state of Mecklenburg-Vorpommern, and the capital city of Berlin – but those are scheduled to be held on September 26, concurrently with the federal parliamentary election. Consequently, the Saxony-Anhalt election is likely to be given a particularly large amount of attention as a source of hints about the federal election.

Spotlight Shifting from Immigration to the Environment

It is worth noting that the right-wing populist AfD was not able to increase its share of votes in the Baden-Württemberg and Rhineland-Palatinate elections. Emphasis on the immigration issue was seen to increase the AfD's support in previous state and federal parliamentary elections, but that support declined in the March elections. In contrast, the increasing attention being focused on climate change and other environmental issues has appeared to be providing a tail wind for the Greens. This trend of declining support for right-wing populist parties is a phenomenon seen not only in Germany but also in other EU countries.

While it is not yet certain at this point, the current situation suggests that there has been a major shift of the German political spotlight during the past five years, with the focus shifting away from immigration and toward environmental issues. It seems likely that consciousness of the immigration issue has been decreased owing to the restriction of people's movements during the pandemic.

After the September federal parliamentary election, it appears highly likely that consideration will be given to the formation of a coalition government centered on the Greens. Although it remains a mere risk scenario, if CDU support continues to decline, there is a non-zero possibility that the Greens and SPD might establish a left-wing coalition government and that the CDU will become an opposition party upon Chancellor Merkel's retirement. While such a development would clearly demarcate the beginning of the post-Merkel era, it is uncertain how sustainable such a left-wing coalition government would be, and some observers are predicting that such a development would indicate the beginning of a period of destabilization within German politics.

From the perspective of the EU, which has numerous reform proposals on its plate, the possibility of German political destabilization after 16 years of outstanding stability is not a welcome prospect. For example, it is said that it was only possible to finalize the July 2020 agreement to establish the Next Generation EU recovery fund because the presidency of the Council of the European Union was held by Merkel-led Germany at that time. Currently, there are not many EU politicians who rival the level of leadership that Chancellor Merkel has demonstrated. In light of all this, it should be understood that the German state parliamentary elections have greater global significance than most local elections, as they offer very important hints about the prospective nature of the post-Merkel era. At this point, however, there is a widespread feeling that no one is likely to truly fill Chancellor Merkel's shoes, and there is a great deal of anxiety about the possibility that her leadership will soon be sorely missed.

Daisuke Karakama
Chief Market Economist
Derivatives & Forex Department
Mizuho Bank, Ltd.
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.”