Forex Medium-Term Outlook

July 30, 2021

MIZUHO

Overview of Outlook

USD/JPY lacked movement again in July, but if one were to have to find a trend, perhaps it would be reasonable to say that "USD/JPY remained weak as before." Both during USD depreciation in the April-June period and USD appreciation since the start of July, JPY has remained stably weak. Some in the markets tend to forecast JPY strength against USD weakness on the grounds of supply and demand factors, primarily the U.S. fiscal and current account deficits. Their arguments are theoretically correct, but if one assumes that the Fed will carry on with its normalization process, the idea that U.S. interest rates will decline and USD will continue to be sold seems somewhat implausible. It is usually during risk-off phases that the supply-demand factor gains persuasive power. Of course, depending on how the pandemic progresses going forward, the likelihood of another risk-off phase cannot be ruled out, but I do not believe it should be part of the main forecast scenario. It must be noted that the current market sentiment is one in which interest rates ultimately drive USD buying. In terms of the fundamentals, there is not much to commend JPY. In the IMF's revised growth forecasts published in July, Japan was the only G7 nation for which the forecast had been downwardly revised. Looking at the financial markets, it is clear that in both the stock and forex markets (nominal effective rate basis), Japan is the only country to post weak year-to-date performance. Although the economic and financial situations in the U.S. and Europe are important when considering JPY forecasts, one has to ask the fundamental question – given the state of the Japanese economy, is there any real reason to buy JPY regardless of the state of other economies? Based on this fundamental understanding, I would like to retain my prediction of USD strength against JPY in this report.

EUR, meanwhile, weakened somewhat in July. Rather than having something to do with euro-side factors, this is the flip side of the coin from the overall strengthening of USD against strong U.S. economic and financial performance. The changes seem to be rather muted given the interest rate gap between the U.S. and Europe, perhaps due to the conflict between Europe's deep negative interest rate margin and the fact that it boasts the world's largest current account and trade surpluses. The new monetary policy strategy announced in July indicates a more dovish stance than before, and an expansion/extension of the pandemic emergency purchase programme (PEPP) can no longer be ruled out. However, according to current ECB staff economic projections, the euro area's GDP is expected to have fully recovered to pre-pandemic levels by early 2022, with even ECB President Christine Lagarde saying so. Even assuming that the PEPP will continue beyond April 2022, it may be very difficult to explain any obvious expansion of its scale. A weakening of EUR/USD may be inevitable given the gap between the ECB and the Fed, which is steadily moving toward a rate hike, but given the rock-solid demand for EUR, the currency may avoid a crash. On the other hand, the new strategy seems to suggest an approval for the creation of policy space, so the ECB may embark on policy normalization sooner than the markets expect, and this must be taken note of as an upside risk.

Summary Table of Forecasts

	2021 Jan -Jul (actual)	Aug-Sep	Oct-Dec	2022 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	102.60 ～ 111.63 (109.49)	109 ～ 113 (111)	110 ～ 115 (113)	111 ～ 116 (114)	111 ～ 116 (115)	111 ～ 117 (116)
EUR/USD	1.1704 ～ 1.2349 (1.1883)	1.16 ～ 1.20 (1.17)	1.15 ～ 1.20 (1.16)	1.14 ～ 1.19 (1.15)	1.14 ～ 1.19 (1.15)	1.13 ～ 1.19 (1.14)
EUR/JPY	125.10 ～ 134.12 (130.09)	128 ～ 133 (130)	129 ～ 136 (131)	129 ～ 136 (131)	130 ～ 137 (132)	131 ～ 139 (132)

(Notes) 1. Actual results released around 10 am TKY time on 30 July 2021. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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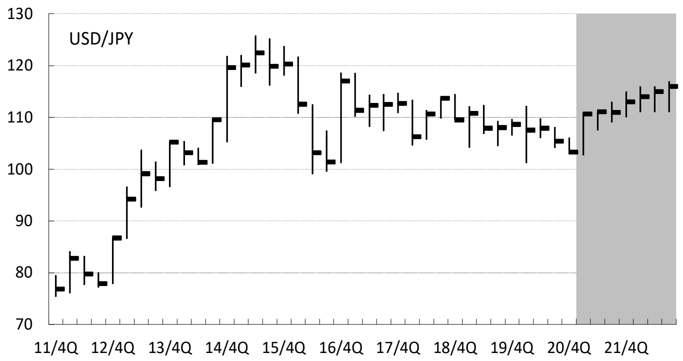
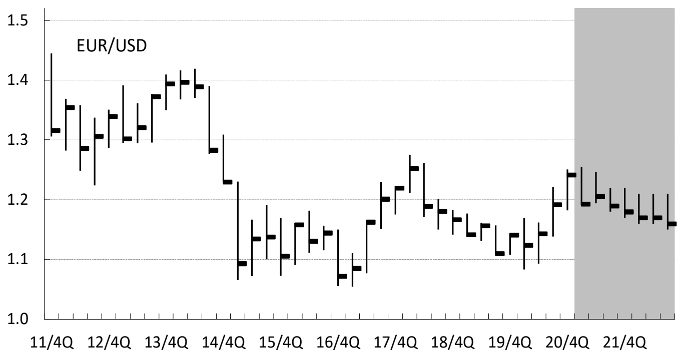
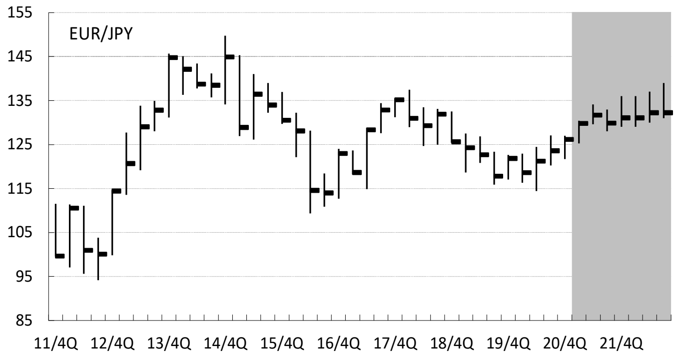
Exchange Rate Trends & Forecasts







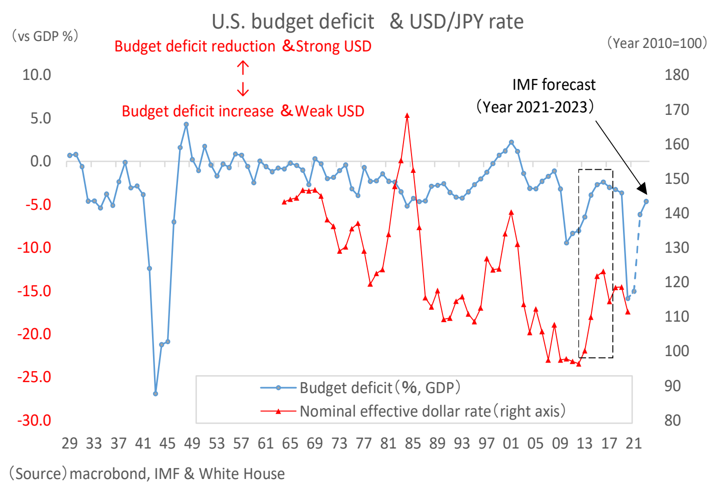
USD/JPY Outlook – Japanese Economy and JPY Show Clear Signs of Subordination

USD/JPY Now and Going Forward – Supply & Demand Factors Point to USD Weakness

No Change in My Basic Scenario Focusing on Interest Rates

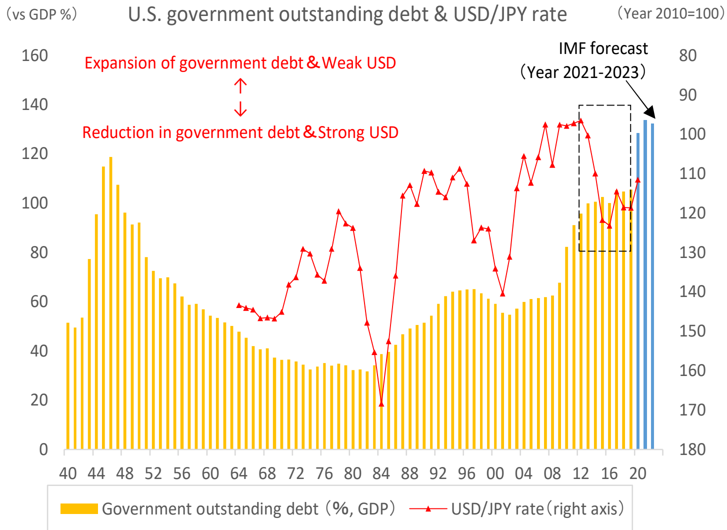
In this report, I have staunchly maintained a relatively simple forecast that, thanks to strong vaccination rates, the U.S. economic and financial situations will improve early, leading to predictions of an early monetary policy normalization and rise in U.S. interest rates, thereby inevitably making it easy to buy USD. This basic understanding of mine has not changed at all. Of course, my scenario will not hold if the virus continues to mutate, making the vaccines ineffective and leading to lockdowns being reinstated in major U.S. urban centers, but at the current time, there seems insufficient reason to make this my main forecast scenario (there are some signs, but not enough to reverse my forecast scenario). Given these circumstances, my main scenario (especially for the U.S.) is focused on interest rates, so to speak.

The Rationale Behind Predicting USD Weakness Based on Supply/Demand



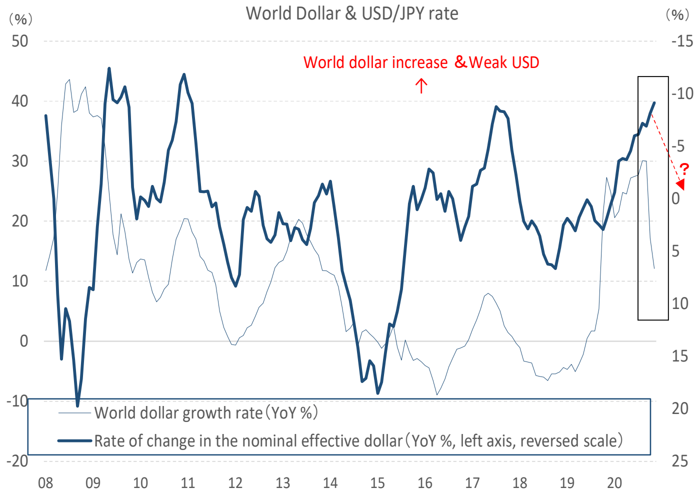
<u>Some in the markets are predicting a scenario of USD depreciation. Most such forecasts appear to be focusing not on interest rates but on supply and demand factors</u>. Supply and demand factors here relate to the enormous fiscal and current account deficits, and the forecasters in question appear to be predicting USD devaluation based primarily on a perception of USD being overvalued. Last year, this was my position too. In particular, <u>I predicted USD weakening in 2020 taking into account the stable correlation between U.S. fiscal deficit as a percentage of GDP and the nominal effective exchange rate (NEER) of USD, and my prediction did, indeed, come true</u>. USD's NEER fell by around -6% for the whole of 2020. Of course, it would not have been surprising to see an even more dramatic fall given a fiscal deficit at par with right after World War II, so it is not irrational to believe that the currency has scope for a further depreciation. However, <u>as the figure shows, there are signs that the fiscal deficit will rapidly shrink starting 2022, and under these circumstances, it takes courage to bet on a weak USD</u>.

The argument that USD should, in theory, weaken further given the scale of the U.S. fiscal deficit is centered more on the "stock" variable of the balance of government debt rather than on the "flow" variable of fiscal deficit. Of course, government debt (stock) does build up as a result of fiscal deficit (flow), but the correlation between the stock variable and USD rates is unstable. For instance, during the previous normalization process, USD appreciated sharply (see portion inside dotted square in the figure) despite government debt remaining high ever since the 2008 global financial crisis. Meanwhile, the flow variable of fiscal deficit was on the mend during this period, causing USD to appreciate in reality (see portion inside dotted square in the figure). Therefore, in connection with USD and government deficits, it would be fair to say that USD's NEER responds more sensitively to the direction of the flow variable rather than the stock variable.



(Source) macrobond, IMF & White House

Significance of Considering the World Dollar
If one insists on focusing on the stock variable, it can be said that the NEER of the "world dollar" does appear to have a stable relationship with U.S. government debt as a stock variable. The world dollar is the sum of the base money supplied by the Fed and the balance of U.S. Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of foreign monetary authorities (in custody accounts), and amounts to the total USD in circulation globally. In other words, the world dollar is itself a stock variable. However, the Fed is an entity that makes large-scale asset purchases in order to finance the aforementioned enormous fiscal deficit, which is related in a way to an increase in the base money. As the figure shows, there is a stable correlation between the rate of change in world dollars and USD's NEER, but the former is also strongly driven by an increase in the base money, which is not unrelated to the scale of QE conducted by the Fed or the scale of the fiscal deficit (flow) behind the Fed's monetary policy. To say that the rate of change in world dollar suggests an increase in USD's NEER is to say the same thing as the (top) figure on the previous page. In other words, the flow variable seems more effective than the stock variable in terms of determining the direction of USD's NEER, and if so, it seems safe to bet on USD's NEER rising in the coming months.



(Source) macrobond (Note) "World dollar" is the sum of the Fed's monetary base and the outstanding amounts of the custody accounts

Importance of Supply/Demand Waning in a World with Interest Rates
Having said that, there is no correct answer when it comes to choosing between supply/demand and interest rates as the main predictive indicator of USD rates. It is not wrong to predict USD depreciation based on the existence of an enormous fiscal deficit and government debt. The bigger question is whether forex markets will disregard rising interest rates and continue selling USD because of the fiscal deficit in the event that interest rates rise alongside the expansion of the fiscal deficit. I do not think so. The supply/demand factor is more persuasive in a "world without interest rates," as was the case in 2020. In other words, the supply/demand factor seems to me something one can fall back on in the absence of other choices. CNY, EUR, and JPY were the most bought currencies against USD in 2020, and I think it could not be a coincidence that these three currencies are backed by the world's three largest current account surpluses. 2021 and 2022 constitute a phase of return to normalcy, and also a phase of transitioning from a "world without interest rates" to a "world with interest rates." Assuming that the global economy is on the mend and that the investment appetites of the private sector will return, it is natural for investors to choose a currency that offers relatively more returns on investment, and given the Fed's normalization process, that currency is likely to be USD.

The Japanese Economy Now and Going Forward – Stocks and Forex Rates Reflect Signs of Japan's Subordination

Japan's Subordination All Too Clear

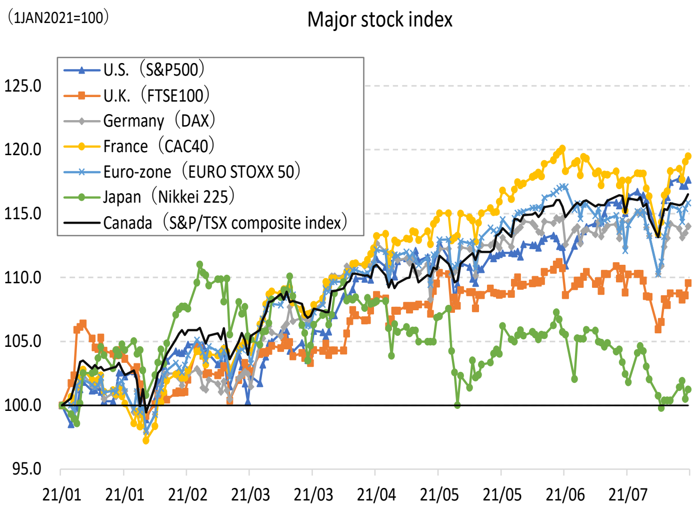
On July 27, the IMF published the revised version of its April World Economic Outlook (WEO). The subtitle "Fault Lines Widen in the Global Recovery" describes the current state and future outlook of the global economy well. The July revision reconfirms the April WEO's simple scenario that a path of "increase in vaccine rates → relaxation of activity restrictions → enlivening of consumption and investment activities → higher growth rates" will determine global economic performance, and that this is unlikely to change in the foreseeable future. Comparing the 2021 growth rate forecast of all G7 countries, it is clear that Japan, which has dismally low rates of vaccination, is the only country for which the outlook has been downwardly revised (see chart). Moreover, the margin of downward revision is significant at -0.5 pp. This is a clear numerical reflection of the side effects of suppressing consumption and investment appetites through spending half the year in a state of emergency. Although, perhaps "side effects" are not the right description, given that the emergency declaration has not effectively slowed down infections. There need to be verifications of whether the economic sacrifices were worth it.

G7 growth ratio trajectory from 2021 to 2022(YoY%)

	2021		2022		Vaccination rates (*)
	As of APR	As of JUL	As of APR	As of JUL	
US	6.4	7.0	3.5	4.9	56.74
Euro-zone	4.4	4.6	3.8	4.3	58.29
Germany	3.6	3.6	3.4	4.1	60.88
France	5.8	5.8	4.2	4.2	59.06
Italy	4.2	4.9	3.6	4.2	62.63
Japan	3.3	2.8	2.5	3.0	38.17
Canada	5.0	6.3	4.7	4.5	71.22
UK	5.3	7.0	5.1	4.8	68.77

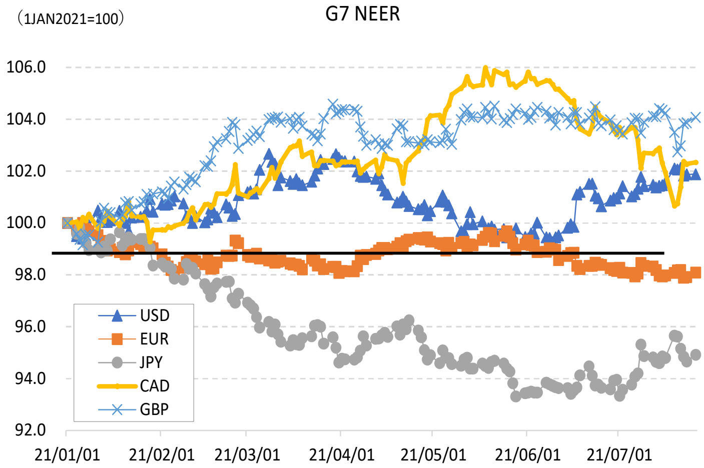
(Source) IMF "World Economic Outlook" (JUL 2021)
(Note) Percentage of population vaccinated at least once as of 28 JUL

This understanding of Japan's actual economic performance has permeated through to the financial markets. Take the forex market, for instance. The figure to the right compares the year-to-date performance of the stock price indices of the world's major countries. While most of the countries have achieved a 10-20% increase in share prices since the beginning of the year, Japan alone has achieved no more than a 1-2% increase. Looking at the price trends, it is clear that Japan's performance began markedly lagging behind the rest starting April – this coincides with when activity restrictions began to be lifted in Europe and North America. Around that time, Japan had just declared its third emergency and begun to discuss prohibiting the sale of alcoholic beverages. The resultant gap between the Japanese economy and its European and American counterparts is bound to be reflected in the April-June GDP figures of each country, which will be released going forward, and it seems likely that Japan alone will be posting negative growth. This can be guessed also going by the aforementioned graph, in which Japanese share prices alone continued to fall through the April-June quarter. At the current time, the rumors are that share prices are stronger than warranted by real economic performance thanks to the investment of surplus funds, but Japanese shares alone are being avoided even in this midst.



(Source) macrobond

Incidentally, this is true not just of the stock markets but also of the forex markets. Among the currencies of G7 countries, JPY alone has fallen conspicuously year-to-date in terms of NEER (see figure), revealing investors' avoidance of JPY buying. There is no longer a strong sense of JPY as even being a currency that is bought during risk-off phases. Of course, the economic and financial situations in Europe and the U.S., especially the actions of their central banks, are important in formulating a JPY outlook. However, irrespective of the situation in other countries, given the circumstances in which the Japanese economy is placed, there remains the fundamental question of whether there is any value in buying JPY. In light of this, I will maintain my position of continuing to predict an upside risk for USD/JPY in this report.



(Source) macrobond

Note that interest rates (bond market) are more stable, unlike the stock and forex markets. This is because the government, the BOJ, and the banking sector are working together to manage government bond investments, making this the only area in which market speculation does not work as expected. Of course, the BOJ's purchases/holdings do make a not-insignificant contribution even in the stock markets, and this may be what has prevented the stock markets from falling as much as they might otherwise have (the purchases (flow variable) have dwindled since March, but the holdings (stock variable) have expanded). The effectiveness of various policies has muffled the warning signals from the markets regarding the Japanese economy so far, but given the IMF's forecasts as well as the relative strength of the Japanese stock and forex markets, one cannot help feeling that it has become increasingly difficult to hide the subordination of the Japanese economy, and I believe this is something that must be reflected in my JPY outlook.

BOJ Monetary Policies Now and Going Forward – Status of Restrained Climate Action Operation

Climate Action Operation Could Continue At least Until 2050?

At its Monetary Policy Meeting held on July 16, the BOJ outlined a new system (hereafter: climate action operation) for encouraging investments and financing aimed at promoting action against climate change by financial institutions. This came right on the heels of the ECB revealing its action plan against climate change, for the first time in 18 years, following a revision of its monetary policy strategy, suggesting a sudden rise in environment action by central banks. As I have argued in the past, my basic understanding is that it is a waste of policy resources for the central bank to be involved in climate action. The questions "what can the central bank do?" and, even more fundamentally, "should the central bank do anything?" appear not to have been thought through, and I think it is pointless for the BOJ to be led on by the ECB and draw up a system for climate action in haste.

However, if one has to (be half-coerced to) get on board this trend based on the understanding that it is an unavoidable duty for all citizens of the world to take climate action, I can understand why the BOJ would feel that it has to do something as a central bank. The language at the start of the statement released, "In order to address climate change, various entities in society and the economy need to actively play their roles," seems to suggest a mood of partial surrender. Taking the BOJ's position into account, the recent response by the BOJ appears relatively balanced. Meanwhile, the ECB's move of going so far as to change its rarely changed mission statement, which reflects policy strategy, to include climate action seems excessive, and I believe has closed the gap between the central bank's authorities and politics too much.

Moreover, climate action operations will be begun within the year, with the policy's deadline being FY 2030. As is generally known, 2030 is the year by which the government aims to have reduced its CO_2 emissions by 46%, so the recent actions have clearly been taken in concert with Prime Minister Yoshihide Suga's administration. Incidentally, the Japanese government's climate action target is to realize a decarbonized society and reduce greenhouse gas emissions to zero (become carbon neutral) by the year 2050, so the climate change operation may have no choice but to continue until then.

Details Reveal a Sense of Balance

In this section, I would like to review the details of the climate action operation. While the details are still quite skeletal, one gets the impression that a deliberate effort was made to maintain balance so that the central bank's neutrality would not be affected. The effort is reminiscent of the hard work of clerical staff.

First, the lending interest rate will be zero percent, and twice as much as the amount outstanding of funds counterparties receive will be added to the macro add-on balances in their current accounts at the Bank (portion for which zero percent policy rate applies). Both the above provisions conform to those of the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19) (hereafter: COVID operation). It seems befitting that some view the climate action operation as the tacit successor of the COVID operation. Meanwhile, the handling of interest rates applied was more surprising. Market participants were curious to know which of categories I-III of the Interest Scheme to Promote Lending would be applied to the climate action operation. In other words, what would be the reward (interest rate applied) based on amount of funds outstanding.

To give an overview of the interest rates applied, as is generally known, the BOJ set up the Interest Scheme to Promote Lending in March this year in order to offset the negative effects of negative interest rates, under which all operations that contribute to increased lending are classified based on their characteristics into categories I-III. Financial institutions can receive interest rates on their current account deposits with the BOJ, which are equivalent to the outstanding amount of funds they receive through these various operations, based on the category of the operation. Specifically, the interest rates are +0.2% for Category I, +0.1% for Category II, and 0% for Category III. I will refrain from going into the details, but financial institutions can receive interest rates of +0.1-0.2% under the COVID operation, depending on the internal conditions of financing, but the interest rates for the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth and Funds-Supplying Operation to Support Financial Institutions in Disaster Areas are 0%.

Given this system, there was speculation that the climate action operation, which is being touted as something critical for the survival of the nation, would begin as a Category II (or perhaps even a Category I) operation. It, therefore, came as a surprise that this operation was designated as a Category III operation, i.e., for which a 0% interest rate would be applied. However, in the sense that the climate action operation is ostensibly designated as a successor to the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth, it seems logical that it would be classified under the same category as the latter, i.e., as a Category III operation. Moreover, in the sense that it endangers the central bank's neutrality, it is a risky operation to begin with, so the thinking may be to start it cautiously as a Category III operation, rather than springing it on the nation as an interest-earning Category I or Category II operation. There may also be the reasoning that adding twice the outstanding amount to the macro add-on balances is in itself a reward, and anything over that would be too much.

The cautiousness of intent was also apparent in the provisions related to duration of fund provisioning. Many predicted that the duration of fund provisioning would be at least four years, in line with the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth. Given that these funds are allocated to address climate change, it would be natural for them to be lent for longer durations, say five or 10 years. In this context, while a short duration of one year was set, it was also decided that “until the end of the implementation period of the measure, rollovers can be made within the amounts outstanding of eligible investment or loans for an unlimited number of times.” Additionally, the monetary policy statement also stated, “Effectively, counterparties can receive long-term financing from the Bank for their eligible investment or loans.” In other words, the funds are recognized to be long-term in effect, but the provision for assessing progress and extending as required shows that caution was exercised.

Take Care of Inflation Before Worrying About Climate Change

One of the things about the BOJ’s climate action operation is that it leaves a great deal up to private financial institutions’ judgment rather than enforce direct measures such as targeting “green bonds” for quantitative easing or giving them preference over other kinds of bonds as acceptable collateral. In this sense, it can be commended for being more commonsensical than the ECB’s response, which has excessively narrowed down the gap between the political establishment and the central bank. Going forward, information disclosure rules for users of the fund provisioning measure and other infrastructure will have to be established.

Though I repeat myself, I think it is important not to stop questioning the new sensibility that it is natural for a central bank to be involved in addressing climate change. Many media outlets reporting on the BOJ’s new operation take it upon themselves to mention that European initiatives in this regard are more advanced. None of these reports, however, question whether “being advanced” is a desirable thing. It has originally been taboo for the central banks to interfere in resource allocation in connection with private sector economic activity. Measures that favor specific fields, industry sectors, or companies for fund provisioning are essentially injecting political value judgment into the act of resource allocation. Because central bankers do not receive their mandates from the people through elections, they are appointed as a team of financial experts with a collective mandate to contribute to the furtherance of values that are publicly beneficial and universally desirable, such as price stability. Something like the relationship between economic activity and global warming would be better discussed, researched, and legislated by the government or private sector players.

Of course, I do not intend to suggest that climate change is unrelated to price stability, but the fact is that things affecting price stability are as numerous as the stars. If one believes that robust economic activity is the cause of climate change, specifically global warming, then the central bank could simply raise interest rates to stifle the economy. If aiming for economic growth is considered a direct cause of globalization, then measures to stimulate the economy are in direct conflict with climate action. Again, in a world where central banks are committed to fine-tuning the relation between climate change on the one hand and economic/financial conditions and price stability on the other, and where market participants trust in this commitment, one can conjecture that every time the average annual temperature rises or abnormal natural disasters occur, market participants will begin to expect some sort of policy change. Perhaps, then, we should pay close attention to weather forecasts in order to predict the “next move” by the central bank. In fact, it would not be surprising for central banks to being partnering with meteorological agencies.

However, it is unlikely that any such thing will happen. The reason being that market participants do not believe that monetary policy could have any impact on climate change. The flash-flood disaster that unfolded in Germany in July was truly painful, but nobody expects the ECB, which is headquartered in Frankfurt, to have sent out warnings or to take policy measures in response. The effectiveness of any measures to address climate change implemented by the central bank are bound to be too circuitous to be useful. A path such as the one that involves suppressive consumption/investment appetite through rate hikes, thereby leading to economic stagnation, which in turn lowers prices is easy to imagine. On the other hand, what could possibly be done by the central bank in response to natural disasters that unfold in front of one’s eyes? Will the central bank have to take responsibility now for trying to explain policy effect paths that are beyond the imaginations of market participants? It seems unnecessary for central banks to take on a whole range of policy issues simply based on the reasoning that they affect price stability.

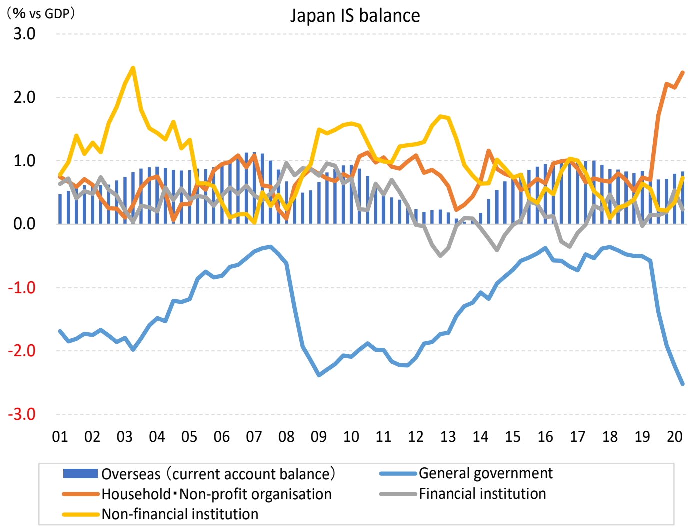
The BOJ has not yet ended its large-scale monetary easing begun in April 2013, which promised a 2% inflation target to be achieved by working on market expectations. The inflation target of “stably over 2%” has not been met even after eight years of this policy, despite paying an enormous price in terms of causing the government bond market to dysfunction and raising financial system stability concerns through the introduction of negative interest rates. I have never believed that monetary policy alone can raise inflation rates as a trend, but at least this is a somewhat more straightforward topic for the central bank to tackle when compared with temperature or climate-related goals. It seems to me that there will be plenty of time for the central bank to work on monetary policies to address environmental issues *after* it has achieved its heavily touted price stability mandate.

The Japanese Economy Now and Going Forward – Crocodile's Mouth Opens Wider, Fourth Emergency Declared

Crocodile's Mouth Opens Wider

The Japanese government has officially announced its fourth emergency declaration, effective starting July 12. The emergency was originally said to last a total of 42 days, through August 22, but on July 30, an extension until the end of August was reported (a specific date has not yet been announced as of the writing of this report). The latest emergency declaration comes three weeks after the end of the previous one, which lasted around two months from April 25 to June 20. Note that the emergency before that lasted from January 8 to March 7. Even during the intervening non-emergency periods, strict measures to prevent infection were in place. In other words, the Japanese economy has been continuously in shackles so far in 2021. Meanwhile, elsewhere in the world, the EURO 2020 Final match was held in the UK on July 11 in a stadium that accommodated 60,000 spectators, and the Wimbledon was also held to a packed stadium. What is more, going by video footages of the events, most spectators were unmasked. Similar scenes are evident at the Major League matches held across the U.S. While it is true that Japan's vaccination rates are significantly lower than the U.S. and UK, one is astonished to note that the infections as well as incidence of severe illness and fatalities are exponentially higher in the U.S. and UK. The difference is so staggering as to be on a different plane altogether, making it more appropriate to say that they are in two separate worlds rather than that there is a gap.

During the first emergency declaration of the year in January, I wrote a Market Topics report titled "Saving Increasingly Justified Amid Re-Declaration of Emergency" (January 7, 2021). In this report, I used the investment-savings (IS) balance to argue that if the gap between the super savings surplus of the private sector and the super savings deficit of the government sector, so wide as to be reminiscent of a crocodile's open mouth, became normalized and saving was increasingly seen as desirable, the economy would eventually rigidify to the extent that, leave alone wages, even interest rates and prices are unable to rise over the long run. The figure shows Japan's IS balance for the January-March 2021 quarter, and it appears that the "crocodile's mouth" has opened even wider, led by surplus savings in the household sector.

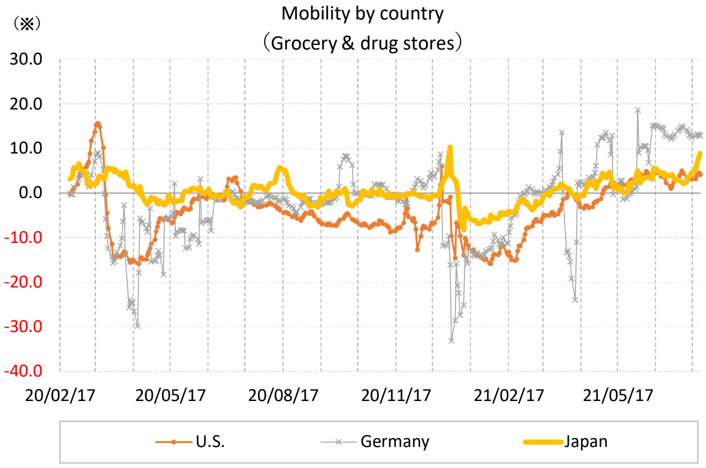


(Source) macrobond (Note) Calculated on 4-quarter average

I never imagined that the situation would have worsened half a year on, but it is true that commensurate measures have been formulated at least domestically. The fourth emergency, which was originally slated to last 42 days from July 12 to August 22, is the longest emergency so far (and has been extended to boot). As usual, measures mainly target specific industry sectors (especially the restaurant industry) based on unfounded assumptions that they are mainly to blame for the spread of infections. The Tokyo Olympic Games, which have coincided with the emergency, are being held mostly without spectators – something that is difficult to understand given that soccer, baseball and other professional sports are allowing spectators. Further, proposed measures (including some in which the financial institutions play a role) aimed at putting pressure on non-complying restaurants and bars from some cabinet members recently gave rise to strong public backlash (these proposals, however, were immediately withdrawn). Whichever way one looks at it, society as a whole has grown more suspicious of the authorities' motives compared with half a year ago – to put it simply, there is an air of mistrust. Vaccinations, seen as the trump card to beat the pandemic, had been progressing rapidly, but it soon came to light that the government did not have sufficient supplies, resulting in more disappointment.

Mistrust Inviting Surplus Saving Trend in Private Sector

Under these circumstances, private sector consumption and investment appetite seem more likely to slump than to recover. The only reward the private sector has got for cooperating with efforts to curb the spread of infections is repeated demands to close their business and refrain from holding events because of a "rise in infections" (strictly speaking, an increase in the number of cases testing positive). As a result, a majority are beginning to feel suspicious of the authorities' intent, given that there is no clear sense of what will happen going forward. There is no reason, under such circumstances, why consumption or investment appetites should recover. The surplus savings of the private sector can, therefore, be seen as the result of a rise in mistrust. For instance, when the government declared its previous emergency at the end of April, it originally said that the measures would be "short and intensive," but that period of emergency dragged on for around two months. This time again, most people are probably skeptical that the current emergency will end on August 22. This being the case, it is quite rational for people to hold off on consumption and investment and take the defensive move of building their savings. The example of the UK should be enough to show that even vaccinations cannot keep down infections, even though it lowers the incidence of severe illness and fatalities. The medical system of Tokyo, the capital city, with a population of just under 14 million, is reportedly on the brink of collapse as a result of a mere 60 or so serious cases. Unless something is done to improve this situation, Japan alone will be forced into economic stagnation on a near-permanent basis. One wonders what came of talks to optimally allocate medical resources.



(Source) macrobond (Note) ※ The baseline is zero (from 3JAN2020 to 6FEB2020)

Japan, where the pandemic has been relatively mild when compared with Europe and North America, has continued to restrict activities in a chronic manner. This is very clear when we look at the COVID-19 Community Mobility Reports. The graph appears to show that daily life during periods of activity restriction in Japan has remained more or less normal even compared with pre-pandemic levels. Neither the duration nor the intensity of the periods of activity restriction seem as great in Japan as in the U.S. or Europe. Regardless, the private sector has accumulated surplus savings, while the government sector is working desperately to offset them, resulting in a widening of the "crocodile's mouth." Perhaps activity restrictions were kept slight in an effort not to hurt economic activity, but the results show that the effort was completely off the mark. Some critics say that it is the minimal level of activity restriction that is preventing the curb of infections and causing the protraction of restrictions, but I am not convinced. In the U.S. and Europe, where normalcy has largely been restored, the status of infections is exponentially worse than in Japan under its state of emergency. For instance, the number of infections per 100K persons (as of July 20) was 10,323 in the U.S. and 8164 in the UK, as compared with 671 in Japan. If Japan's rate of infections had been much worse than the rest of the world due to the minimal level of restrictions, there would have been reason to believe this was what was causing the private sector to save excessively, but that is not the case.
Ultimately, it is not that the spread of infections could not be curbed, but rather that activity restrictions have been imposed under the pretense that the spread of infections have not been able to be curbed, and this is the problem. Administrators have been responding to the status of infections resulting from the various policies at times strictly and at other times more leniently with no apparent rationale behind any of it. For instance, school sports events are not okay, but the Tokyo Olympic Games are fine; rush hour on trains is okay, but restaurants are required to ensure appropriate distancing – who could rationally explain this state of affairs? Naturally, then, households and businesses are unable to figure out on what basis to plan their consumption and investment activities. Even though the COVID-19 Community Mobility Report shows not much change in mobility since before the pandemic began, a rise in skepticism and an increasing sense that saving is desirable are the reasons behind the relentless expansion of the private sector's surplus savings.

Impact Could Continue After End of Pandemic
Going by global developments, it seems clear that increasing vaccination rates, reducing serious illness and fatalities (although curbing the spread of infections seems difficult), and relaxing activity restrictions is the only possible exit strategy from the pandemic. Frequent emergency declarations with minute activity restrictions each time will only increase the suspicions of the private sector, making Japan more obviously a savings-driven economy. At the very least, this has been the case over the past year. The problem is that the private sector's mistrust of administrators will remain even after the pandemic has fully ended, potentially hindering the full revival of consumption and investment appetite as well as reflation efforts. Given that the Japanese economy is already characterized by a permanent state of private sector surplus savings, the intensification of this trend is a matter of considerable concern.

U.S. Monetary Policy Now and Going Forward – Fed Continues on Expected Path

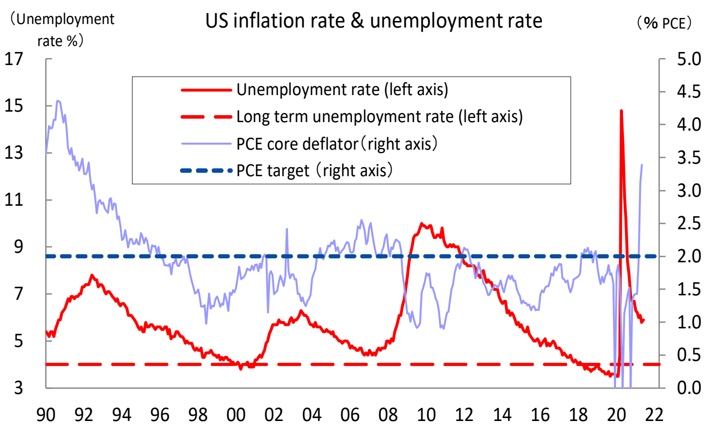
Fed Confirms Expected Path
The Federal Open Market Committee (FOMC) decided to keep the federal funds (FF) rate and quantitative easing (QE) unchanged at its July meeting. However, the statement reflected an overall upward revision, even hinting at the possibility of a phased tapering of QE. For instance, the starting paragraph, which says that the economy is on the mend thanks to progress on vaccinations and assesses the economic condition based on this, has not changed much in terms of meaning, but the word "COVID-19" has been removed. With regard to the economic outlook, again, the statement now says "The path of the economy continues to depend on the course of the virus," whereas it had previously said "The path of the economy continues to depend significantly on the course of the virus." One could read this as suggesting that the path of the economy depends less on the course of the virus now than it did before. Recently, the delta variant has been casting a shadow over efforts to curb infections going forward, and it is clear that the path of the economy will continue to depend on the course of the virus, but the Fed appears to have decided to continue on its expected path by assessing economic recovery based on progress on vaccinations in a straightforward manner.

No Change in View that a Decision will be Made in September at the Earliest or by October at Any Rate

As a result of an improvement in conditions, the statement has consistently been hinting at the Fed's intent to implement tapering. In December last year, the Fed strengthened its forward guidance, with the statement saying, "The Federal Reserve will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month until substantial further progress has been made toward the Committee's maximum employment and price stability goals." <u>This time's statement included the language "Since then (December 2020), the economy has made progress toward these goals, and the Committee will continue to assess progress in coming meetings" right after its forward guidance</u>. Of course, the phrase "coming meetings" is ambiguous, but perhaps a decision will be made at one of the three remaining meetings for this year (September, October, December) following the August Jackson Hole Symposium. My view in this report is that a decision will be made in September at the earliest or by October at any rate, with tapering itself starting in December, and there is unlikely to be much divergence from this. <u>Given the clear prospects for developments going forward, it would be difficult to explain any unilateral decline in U.S. interest rates, so I will retain my prediction of an earnest increase in U.S. interest rates starting 2H of the year, and a market climate conducive to buying USD</u>.

Fed Can Tweak Dual Mandate to Suit Own Convenience

It must be noted, however, that Fed Chair Jerome Powell's press conference gave the impression of there being risks to the assumed schedule of tapering decision and implementation. <u>Asked about any dramatic new developments, Mr. Powell said that the Fed was not yet at that stage, and that it would be some time before that stage was reached</u>. Perhaps the time required is for achieving the dual mandate (employment maximization and price stability), though the Fed has recently been moving the goalposts of its dual mandate to suit its convenience.



(Source) Bloomberg

For instance, there is no quantitative target to determine what constitutes employment maximization. Theoretically, perhaps it means a state of full employment (at the natural unemployment rate). In this context, the revised Summary of Economic Projections (SEP) by Fed staff released in June held the long-term unemployment rate, which indicates the natural unemployment rate, to be at 4.0%. Against this, the projected unemployment rate is 4.5% for 2021, 3.8% for 2022, and 3.5% for 2023, so this could be interpreted to mean that employment maximization will be reached within the next year. However, given that the estimated long-term unemployment rate itself is seen as a rough figure with a margin for error, it can be assessed loosely to suit one's convenience. If so, the Fed could continue with QE until the unemployment rate falls to 3.5% in 2023. As employment and wages are lagging economic indicators, they tend to warrant monetary tightening fairly early, and this is, in fact, the way monetary policy is conducted. It is, however, quite possible for the Fed to revise its assessment of employment and wage figures in the more dovish direction.

Price stability targets can also be interpreted flexibly. At his press conference, Mr. Powell indicated his view that inflation pressures would recede when the supply constraints were relaxed, which is the most orthodox view to take. However, the SEP's 2021-23 projections for the personal consumption expenditure (PCE) deflator on a core basis are 3.0%, 2.1%, and 2.1%, respectively. Even assuming a natural upswing in 2021, the next two years are also expected to see growth exceeding 2%, so it would seem reasonable to assume that the Fed's price stability mandate will also soon be achieved. However, the specific duration for which "averages" are taken are not defined for the "average target" concept that was introduced last year. As inflation will have to recover at least enough to make up for its sharp slump last year, it is easy to see that the *status quo* will be retained in terms of the average target, but unless the acceptable length of the period of "inflation over 2%" for considering price stability to have been achieved is made clear, the Fed could continue monetary easing even after 2022 for ostensible reasons such as that inflationary pressures are insufficient.

My basic scenario involves interpreting the SEP figures at face value and assuming that the Fed will achieve its dual mandate in 2022, and if so, that it will begin tapering in the near future and complete it in 2022. <u>In 2022, in addition to tapering, the Fed is likely to begin considering rate hikes and putting out communications in that regard, so it seems safe to assume that there will be at least one or two rate hikes in 2023</u>. This is my basic forecast scenario, but as mentioned above, the Fed has considerable discretion in terms of how it interprets the dual mandate. It could, therefore, aimlessly extend its QE using stock market fluctuations and other factors as excuses, so I cannot completely rule out my risk scenario either. If, for instance, the tapering decision and implementation are put off to beyond the year, U.S. interest rates may not rise as much as expected, and my USD/JPY outlook will also have to be downwardly revised.

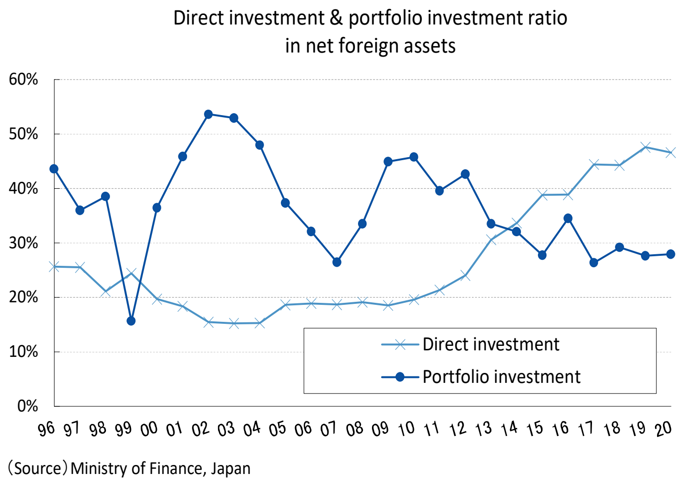
Risks to My Main Scenario – Time to Consider the Risk of a Lack of JPY Appreciation Trends?

Potentially Worrisome Developments in the Year's Latter Half
During July, financial markets' risk-off mood suddenly intensified due to concerns about the increase of covid-19 Delta variant infections in Europe and the United States, promoting selling of such risk assets as stocks and crude oil, and the U.S. 10-year interest rate level seemed likely to fall below 1.2% at one point. Editions of this article through last month have noted emerging concerns about existing covid-19 vaccines' efficacy, and it was also noted that that the protraction of behavioral restrictions in Europe and the United States may fundamentally undermine the main forecast scenario. The Fed's normalization process has not yet been affected by the Delta variant, but major scenario revisions may be required if adjustments are hinted at in such Fed-provided information as FOMC statements and Fed Chairman Powell's press conference statements. I have not yet decided whether such revisions are called for, but I will be closely monitoring the Fed-provided information.

End of JPY-Appreciation-Avoidance Era?
Despite the typical risk-off market mood, however, USD/JPY has not appreciated as it has amid such moods in the past. While one should not jump to conclusions in light of the possibility of time lags, it does appear that the power of "risk-off JPY buying" is diminishing and is already significantly below its previous level. In fact, I am worried about the level of confidence in JPY. While Japan's expected GDP growth rate had already been adjusted downward at the start, after monitoring the country's policy responses to the pandemic disaster over the past year, I see an increasing array of reasons to pose the question "is Japan really okay?" and consider various pessimistic theories about how Japan's situation might drastically deteriorate. While the highly difficult situation of hosting the Olympic games amid the pandemic can be attributed to bad luck, Japan mustered a performance inferior to other countries regarding its confused rush to repeatedly begin and end states of emergency, and one gets the impression that the country does not have a solid basis for consistently making related policy decisions.
In this regard, I am concerned about how Japan has been accustomed to the "problem of currency appreciation (JPY appreciation) at times of rising crisis moods" and how uncomfortable the country will be if this seemingly problematic pattern progressively diminishes over time. Basically, there are reasonable arguments being made that JPY may no longer be prone to appreciate or that we may have already entered an era in which we should be relatively more concerned about JPY depreciation trends. When considering the upcoming 10 years, I think the time has come to get used to these new ideas. In addition to being influenced by such basic economic fundamental factors as interest rates, supply and demand, and price levels, currency exchange rates sometimes show considerable fluctuations that reflect individual countries' political situations and day-to-day news items, and it is always difficult to accurately predict such fluctuations. Forecasting exchange rates over 10-year periods is even more difficult. However, I think it is beneficial to calmly and objectively consider what is likely to happen over such a time span in light of fundamental factors.

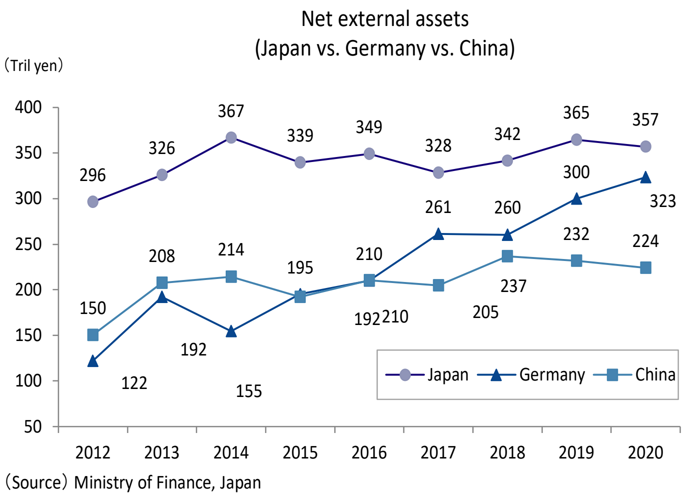
JPY's Safe-Asset Status Supported by Supply-Demand Situation
In particular, I would like to point out the ongoing changes in the supply-demand and inflation situations. Often cited among the reasons for considering JPY to be safe asset are the currency's rock solid supply-demand situation and lack of inflationary trends. Given that, I think it worth considering whether there are likely to be any prospective changes in those situations as a basis for forecasting long-term trends in the level of confidence in JPY. The first situation is the supply-demand situation. Despite Japan's having the world's worst government-debt-to-GDP ratio (over 250%), JPY has always been considered a "safe asset" and has been chosen as a safe-harbor destination during risk-off moods. Why is that? The most important factor affecting this assessment is the supply-demand situation. The biggest reason why JPY is considered a safe asset is the fact that Japan has recorded high levels of current account surpluses for many years and has consequently maintained its status as "the world's largest net foreign asset country" for more than a quarter of a century. (Leaving aside the issue of asset price fluctuations, a country's net external assets are roughly equal to the cumulative total of its annual current account surpluses.) At the end of 2020, Japan had JPY357 trillion of net external assets and had maintained its position as "the world's largest net external assets country" for 30 consecutive years.
In other words, Japan has a higher net level of foreign currency-denominated assets than any other country in the world, and that is a good reason for JPY appreciation. A country's foreign currency holdings can be considered to be a kind of ammunition that can be used for defending that country's currency (selling foreign currency and buying one's own currency) in emergency situations. When intense crisis moods take shape in light of such situations as the Lehman shock or the covid-19 pandemic, it is reasonable for market participants to seek safe harbors in the currencies of countries with a lot of such defensive ammunition. While it may not be practically feasible to sell all kinds of assets amid a country's net foreign assets, there are countless currencies that should logically be sold before the currency of "the world's largest net external assets country".

Changes in Japan's Supply-Demand Structure



However, Japan's net external asset structure has been changing in recent years. Securities investment accounted for more than half of Japan's net foreign assets in the early 2000s, but the share of the country's net foreign assets accounted for by direct investment has subsequently more than doubled, reaching levels just below 50% (see graph). Direct investment represents the acquisition and establishment of companies overseas. Direct investment's share of Japan's net foreign assets has risen steadily since 2010, and was considerably higher (47%) than that of securities investment (28%) at the end of 2020. It has been frequently noted that the power of "risk-off JPY buying" in the forex market has been diminishing in recent years. It can certainly be said that such bouts of sharp JPY appreciation as that following the Lehman shock have become much fewer, and I think this is owing to changes in Japan's net external asset structure. "Risk-off JPY buying" primarily refers to the movement of Japanese assets that were invested overseas and then return to the domestic market. Since securities investments in overseas stocks and bonds are highly liquid, one can expect a portion of the related funds to return to Japan during risk-off periods. However, while it is not difficult to cash-in (sell) foreign securities during risk-off periods, it is not easy to sell the ownership of overseas companies. Consequently, although the current magnitude of Japan's net foreign asset level seems to indicate the ownership of a large amount of repatriate-able foreign-currency denominated assets, the feasibility of repatriating much of those assets as JPY-denominated assets has decreased. It can thus be said that JPY has become less likely to appreciate and that it is more likely that responses to bouts of JPY depreciation will be relatively limited.

Incipient Loss of "World's Largest Net External Assets Country" Status

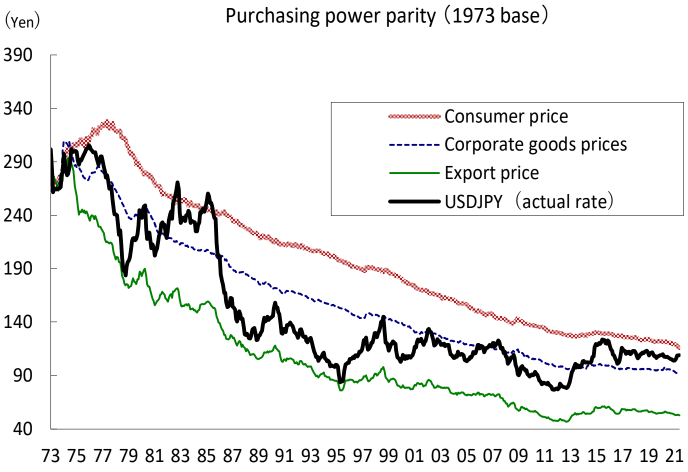


Moreover, Japan's "world's largest net foreign assets country" status is becoming shaky. As discussed in previous editions of this article, I have been closely monitoring Japan's net foreign assets situation in comparison with that of Germany. Germany continues to leverage the perennially undervalued currency it utilizes as a euro area member to generate huge trade surpluses (and consequently current account surpluses), causing the Japan's lead over Germany in net foreign assets to shrink to a record low level of JPY34 trillion as of the end of 2020 (see graph). In light of the gap's small size, it would not be surprising to see German attain "world's largest net foreign assets country" status at any time. Germany can be expected to continue rapidly accumulating net foreign assets, as EUR will not strengthen enough to undermine Germany's competitiveness regardless of how large the country's trade surplus become. Of course, even if Japan becomes "the world's second largest net foreign asset country", JPY will still have a strong basis for being considered a safe asset. Given that the forex markets are prone to straightforwardly responding to the latest theme of the moment and that Japan has maintained "world's largest net foreign assets country" status for 30 years, however, it seems possible that the financial markets might muster a strong reaction when Japan loses that status. While trade surpluses are directly linked to the purchase of exporting countries' currencies, Japan has already stopped regularly recording large trade surpluses, thereby causing a decrease in JPY appreciation pressures.

JPY Appreciation as a Deflationary Currency

Another point that must be considered in long-term forex rate forecasting is the issue of price levels, or inflation rates. As the graph shows, USD/JPY's history since the transition to the floating exchange rate system has been a history of JPY appreciation, and it should not be overlooked that the history of JPY appreciation was a history of deflationary trends. Theoretically, the currencies of countries with relatively low prices should tend to be strong and appreciate. Assuming that prices will fall over five years, one should be able to purchase more goods in five years for JPY1,000 than one can purchase today for the same sum. That means that the currency's value (purchasing power) is rising. In this regard, JPY's purchasing power moved only upward, given the Japanese economy's history, in which price increases have proceeded significantly more slowly than in other countries. This purchasing power parity theory has long been used to reaffirm the rationality of JPY appreciation. Purchasing power parity levels of USD/JPY have long suggested that rationality of JPY appreciation against USD, and actual exchange rates have often moved in line with that suggestion.

In recent years, however, the United States and the euro area have also found their inflation rates stubbornly refusing to rise above low levels, and the Fed and ECB have therefore begun revising their monetary policy strategies with an eye to boosting those inflation rates to above the 2% level. They are almost desperate to boost the pace of their inflation. The upshot of this is that the relative degree of Japan's deflation compared to that of other countries has diminished. If this trend of decrease in the relative degree of Japanese deflation proceeds, the purchasing power parity theory should eventually stop suggesting the rationality of JPY appreciation. In fact, from around 2013, the various purchasing power parity theories have stopped suggesting JPY appreciation, and it seems that JPY has accordingly begun depreciating against USD. From the perspective of price levels or inflation rates, I get the impression that JPY appreciation is less likely to occur going forward.



(Source) Datastream

Extreme JPY Depreciation More Fearsome than JPY Appreciation

When floating exchange rates shift, they often do not stop at the "just right" point – once they start moving, they often retain a clear sense of direction. Since JPY has long been valued as a safe haven currency based on supply-demand and prices/inflation situations, the "clear direction" in question has long been oriented toward further JPY appreciation. As mentioned above, however, there are structural changes proceeding that could greatly change that scenario. While JPY has been tending to mysteriously appreciate for a long time – despite Japan experiencing the fastest rates of birthrate declines and demographic greying among the world's developed countries, boasting the world's highest level of government debt, and being the world's only country with deflationary trends – I think we should all be aware that JPY may finally be starting to collapse. Japan has retained deep-rooted societal norms that make people more inclined to fear JPY appreciation than JPY depreciation. However, it is theoretically possible (leaving aside the question of political feasibility) for a country to countervail its currency's appreciation by infinitely undertaking the selling of its own currency and buying of foreign currency, but the scale of that country's foreign currency selling and own currency buying is limited by the amount of its foreign currency reserves.

In short, Japan has a finite quantity of ammunition for fighting against extreme JPY depreciation. Until now, Japan did not have much reason to worry about the obvious fact that — when considering the potential for out-of-control extreme JPY depreciation or extreme JPY appreciation scenarios – it is the out-of-control extreme JPY depreciation scenario that is much more intimidating. In light of recent market trends and structural changes, however, I think we must gradually give greater attention to the possibility that a sharp JPY depreciation trend may begin at some point going forward. This possibility should be positioned as an important risk scenario that has important ramifications not only for forex rates but also for the Japanese economy as a whole.

EUR Outlook – What Will the ECB Do Under its New Strategy?

EUR Area Monetary Policies Now and Going Forward – What Will the Consequences of the Momentous Strategy Revision Be?

ECB Undertakes Momentous Strategy Adjustment

The July ECB Governing Council meeting was the first Governing Council meeting following the strategy review (the strategy review itself will be discussed in the next section of this article), so it was the first time the new strategy was actually reflected in policy management. The forward guidance regarding the key ECB interest rates has been revised as follows. As the ECB was created as a central bank that draws on the Deutsche Bundesbank's tradition of dedication to fighting inflation, this change is a historic one.

- (Through June) We expect them to remain at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2 per cent within our projection horizon
- (From July) the Governing Council expects the key ECB interest rates to remain at their present or lower levels until we see inflation reaching two per cent well ahead of the end of our projection horizon and durably for the rest of the projection horizon

ECB staff outlook（JUN 2021） (%)

	2021	2022	2023
HICP	**1.9**	**1.5**	**1.4**
（Previous：MAR 2021）	1.5	1.2	1.4
Real GDP	4.6	4.7	2.1
（Previous：MAR 2021）	4.0	4.1	2.1

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

The key change is that the old strategy targeted inflation rates "close to, but below, 2%" while new strategy targets inflation rate levels "up to or exceeding 2%" – the old strategy set 2% as the target and ceiling, while the new strategy allows for some degree of deviation both below and above the targeted 2% level. ECB President Lagarde explained the meaning of the newly added "well ahead of the end of our projection horizon" timeframe, saying – "[...] what is well ahead? Well ahead first of all is determined by judgement of the Governing Council but it is essentially the midpoint in our overall horizon." For example, the latest (released in June) Eurosystem staff macroeconomic projections cover a 2.5-year period (30 months) through the end of 2023, so the midpoint could be understood to be 15 months from now, or September 2022. However, the staff projection anticipates that the euro area consumer price index (HICP) will only rise to a 1.4% level even as late as the end of 2023. So it appears that the key ECB interest rates are to remain unchanged in the absence of "inflation reaching two per cent well ahead of the end of its projection horizon and durably for the rest of the projection horizon", but it is not clear whether plans call for maintaining the pandemic emergency purchase programme (PEPP) status quo (deciding it is not necessary to expand it).

In fact, there were reporters who pointed out the inconsistency with the June outlook. In this regard, President Lagarde said that she was not actually setting a specific time period, as the staff projections would begin covering an additional year beginning from near the end of this year, and that she used the phrase "the midpoint in our overall horizon" to indicate it was not a specific time period. This is reminiscent of the situation in which BOJ Governor Kuroda set a "2% in two years" inflation target and then annually extended the time frame. Of course, it is not always ideal or necessary to set a strict time frame from the beginning, but it may well be that the phrase "well ahead of the end of our projection horizon" really only has the meaning "I will do my best".

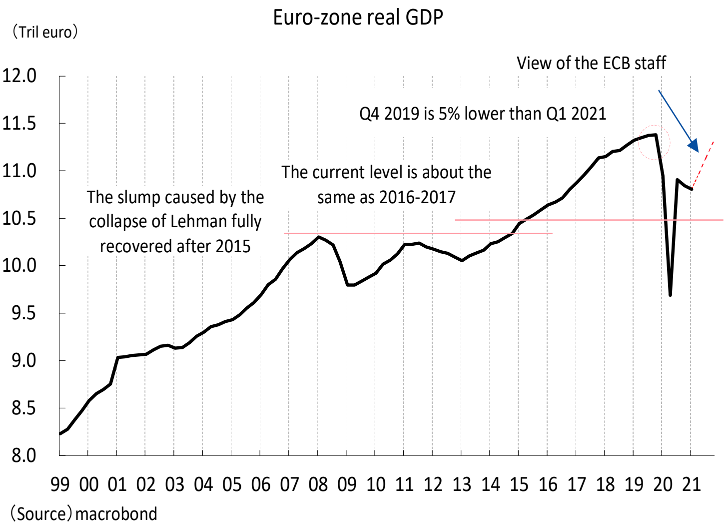
Possibility of Tapering Not Completely Eliminated

It also emerged that the forward guidance revision was not approved unanimously but by an overwhelming majority – there was some disagreement. After the Governing Council meeting, Bloomberg reported those opposed included Deutsche Bundesbank President Jens Weidmann and National Bank of Belgium Governor Pierre Wunsch. President Lagarde said the revision was opposed by "a very, very small number of Governing Council members", but it seems that she may have been referring to these two members. President Lagarde's response to the reporter who asked for a summary of the dissenting members' key arguments was noteworthy. She said – "I think you will be better off asking them. I don't want to put words in their mouth, and everybody is free to say what they want to say." – but this seems to be an overly dismissive response to what is a legitimate question. The reporter was not asking who the dissenters were, but he wanted to learn what the dissenters' arguments were, and it seems reasonable to expect the ECB president to answer that kind of query.

The ECB is recognizing the spread of covid-19 Delta variant infections as a downside risk, but the situation has not yet become serious enough to overturn the main projection scenario, so it seems that giving the message that current level of easing measures would be continued beyond September 2022 is somewhat excessive. However, the abovementioned Bloomberg report stated that the Governing Council members who approved the forward guidance revision did so with the condition that the guidance was understood to only apply to the key ECB policy interest rates and that it did not apply to asset purchasing programs (particularly the PEPP). In fact, since the post-Governing Council-meeting statement begins with the phrase – "the Governing Council today revised its forward guidance on interest rates" – it should perhaps be clear from that point that the forward guidance is focused on the key policy interest rates.

If so, there is a possibility that discussions about the issue of decelerating PEPP purchases (which the financial markets are keenly interested in) and the gradual reduction (tapering) of those purchases will proceed separately. Just as in the case of the Fed, it appears that the ECB's normalization process would begin with "quantity" and then proceed to "interest rates", so even if the ECB pledges to continue easing with respect to interest rates, it does not preclude the possibility of moving toward quantitative normalization. Given that the ECB has a huge balance sheet value now approaching $10 trillion, it would seem well worth considering the option of quantitative tapering to reduce the challenges associated with future exit strategies.

GDP Expected to Overcome Pandemic Impact in First Quarter of 2022



However, President Lagarde strongly denied the basis for tapering speculation, saying – "any particular exit would be absolutely premature." That may be quite true and, although the PEPP is set to expire in March 2022, the program has from its inception had the condition that it could be continued until the end of the pandemic. If one factors in the existence of the Delta variant and other mutant variants that may emerge, it is clear that the PEPP might never have to end, and it is true the pandemic is causing a deep scarring in the real economy. In this regard, one reporter asked a rather somewhat aggressive question – "what is the level of knowledge of pandemics about central bankers that would allow them to say one day that the pandemic is over? Which criteria will you use to assert that, yes, it is over?" – and the answer President Lagarde offered was that the ECB would determine when the pandemic ends – "by the observation of facts when it comes to employment, manufacturing, services, trade in the economic translation of what the crisis is about." In light of the current situation, it remains doubtful whether the pandemic will end by March 2022, and the Fed will be in the process of tapering at that time, so it would seem to be very difficult for the ECB – which is giving top priority to restoring the strength of the euro area economy – to end the PEPP before that time.

That said, the June staff projections anticipate that the euro area's real economy will fully recover in terms of GDP by early 2022, which may be before the pandemic's end. At the EU summit meeting in June, President Lagarde herself said that the ECB predicts that euro area GDP will return to pre-pandemic levels by the first quarter of 2022, one quarter earlier than had been expected in the spring. If so, then even if it is assumed that PEPP may be maintained after April 2022, the program could either be (1) expanded and protracted or (2) protracted at its current scale and, based on the tentative premise that the pandemic is heading toward its end-point, the latter of the two options would seem more likely. In fact, it would not seem possible to choose the (1) option without clearly changing the ECB's evaluation of the current situation by means such as the release of a downward revision of the staff projections in September. It might be argued that the strategy review could be used to justify PEPP expansion, but it would be difficult to make that argument in light of the fact that the symmetrical inflation target concept has already been included in ECB statements for more than two years. It would seem somewhat awkwardly unconvincing to cite the symmetrical inflation target concept as an excuse for expanding PEPP.

Decision Postponed until December Revision of Projections?

President Lagarde said the issue of the pace of PEPP purchases would be considered in light of the September staff projections. Since the only big change between June and September would probably be the spread of covid-19 Delta variant infections, it seems likely that the September staff projections would either be basically unchanged or revised downward somewhat. In the case of a slight downward revision, there would appear to be a possibility that the revision would be used to justify an expansion of the PEPP's total envelope and a protraction of the program's time period. On the other hand, the global uptrend in interest rates has settled down compared to mid-March, when it was decided to increase the PEPP purchasing pace, so it would seem reasonable to decrease the weekly purchase pace from the current level of EUR20 billion to about EUR10-15 billion. That is particularly true in light of the expressed purpose of PEPP, which is not to enable quantitative easing but to create a favorable financing environment. The purchase pace should theoretically be adjusted in line with financing environment conditions. Decelerating purchases could also be greatly advantageous if it enabled the retention of a portion of the PEPP envelope for use after April 2022. Given the difficulty of projecting the Delta variant's impact on the real economy, it is not possible at this point to make a rational decision on whether to accelerate or decelerate PEPP purchases, so it seems most likely that the ECB will seek to get by with status-quo-maintenance in September and postpone major decisions about the disposition of PEPP until the revised staff projections are available amid falling temperatures (and the onset of the flu season) in December.

Appendix: Interpreting the Significance of the ECB's First Monetary Policy Strategy Revision in 18 years – Elevating the Inflation Target

First New Strategy in 18 years
On July 8, the ECB announced the results of the strategy review process it had been engaged in for a year and a half. Officially started in January 2020, the review was scheduled to be completed by the end of 2020, but it appears to have been delayed for half a year owing to the pandemic. The only previous monetary policy strategy review was in 2003, so this is the first revision in 18 years. While there are several interesting aspects of the review, the most important change is that to the definition of inflation targets, and this change is the focus of most related media reports. As the changed inflation target definition will have both negative and positive effects on efforts to anticipate the ECB's "next move" going forward, I think it worth focusing on this point first.

ECB Affirms "Policy Space" Theory
The euro area consumer price index (HICP) continues to be cited as an appropriate measure of price stability, and going forward it will also take into account imputed rent, which was previously excluded. Imputed rent in Europe and the United States (the notional value of rent that would be paid for owned housing if it were to be rented housing) is believed to be more prone to upward movement than imputed rent in Japan, so there is a possibility that including it in HICP will make it somewhat easier for the ECB to achieve its inflation target. It appears that part of the rationale for revising the definition of the inflation target (which is keenly monitored by financial market players) is that, by broadening the leeway for inflation uptrends, the ECB will gain additional leeway for monetary policy responses even when the policy interest rates are close to their effective lower limits. This rationale can be considered generally valid. The fewer remaining monetary easing policy cards the ECB has left to play, the more desirable higher inflation rates become (the lower the inflation rate, the more need there is for some sorts of monetary easing measures). However, this could also be considered an affirmation of "policy space" theories dictating that measures should be taken in advance to ensure leeway for the future use of monetary policies – for example, that interest rates should be raised now to create the leeway for future interest rate reductions – and it is somewhat dangerous to officially admit that some measures may be primarily aimed at creating additional policy space. Of particular importance is the issue of whether average citizens will agree that promoting inflation is worth doing if the main goal is merely to facilitate the ECB's future policy response measures. While the strategy review has successfully undergone discussions in public hearings, I get the impression that it is really being utilized to create additional policy space.

Real Meaning of "Inflation Target Hiked" Headlines
Various news media headlines have all tended to focus on the point that the strategy review has elevated the inflation target level. The real meaning of this is difficult to understand at a glance, so I think some additional explanation is warranted. In short, it is important to understand the concept of "symmetry". As we all know, the ECB's inflation rate target was originally defined as "below, but close to, 2% over the medium term" – a phrase that is very familiar to most financial market participants. The "below, but close to, 2%" portion of the phrase implicitly suggests that "it is better not to actually reach 2%", and it also suggests a perception that inflation rates higher than 2% may be dangerous. Nowadays, in developed countries, however, the emphasis has been shifting toward greater awareness of problems associated with the difficulty of boosting inflation rates. In light of that, it can be argued that the "below, but close to, 2%" portion of the phrase is outdated and not in line with current conditions.
Accordingly, the strategy review has revised the price target to make it a "symmetric" target. The key aspect of the symmetric target is that it explicitly states that "2% is not the ceiling of the target range" and that "2.5% and 1.5% are equally risky (in the sense that they both deviate from 2.0% by 0.5 percentage point)". The ECB's official statements have clearly explained this as – "Symmetry means that the Governing Council considers negative and positive deviations of inflation from the target to be equally undesirable." In practical terms, symmetric targeting means that, even if the inflation rate exceeds 2.0%, it will not immediately necessitate monetary tightening responses. In its official statements, the ECB has inserted a sentence – "This may also imply a transitory period in which inflation is moderately above target." – that makes its acceptance of temporary inflation surges even more clear. Since the previous inflation target definition implied that it was better not to actually reach 2%, the media headlines have generally summarized the gist of the new target using such expressions as "will tolerate higher inflation levels" or "have increased the inflation target".
It is worth noting, however, that former ECB President Mario Draghi emphasized the importance of "clarifying the symmetry of our aim" at the ECB Annual Meeting in June 2019 as well as at the July 2019 Governing Council meeting and that the ECB has continuously been referring to its employment of a symmetrical targeting concept since that time. ECB President Lagarde has also admitted that she has purposely been referring to symmetry in her statements. One therefore get a strong impression that this strategic review is largely an official confirmation of a pre-exiting situation. In this regard, during the special July 8 strategy review press conference, a reporter posed the question – "in what way does this review really change the way you will conduct monetary policy? In a way, symmetry was already in place so is it simply a clarification, in effect, of what you were already doing?" President Lagarde emphasized the importance of the strategy review in her response, saying – "On your other question, "this strategy is really not much". I am very sorry, but I don't believe so. I think it is quite a lot." Objectively speaking, it can be said that the ECB's intentions were clarified by the strategy review's clear statement that the Governing Council considers negative and positive deviations of inflation from the target to be equally undesirable or risky. But in reality, this clarification cannot be expected to lead to dramatic changes in the ECB's policy management.

Increased Emphasis on Monitoring Bubble Formation/Collapse Processes?

Another noteworthy feature of the strategy review not so extensively reported is that it has modified the ECB's analysis method. Previously, the ECB made policy decisions based on a "two pillar approach" that included economic and monetary analysis pillars. Previous Governing Council meeting statements included paragraphs with bold subtitles indicated that they were focused on economic analysis and monetary analysis. Following the strategy review, those two analysis items are supplemented by a financial analysis item. Strictly speaking, there are still two pillars – (1) economic analysis and (2) monetary and financial analysis. So what is financial analysis? Specifically, statement says it will examine "possible risks to medium-term price stability from financial imbalances and monetary factors", and this seems to indicate that the ECB plans to pay close attention to the effects of financial imbalances as they affect price stability and thereby promote the creation and collapse of asset bubbles. Of course, the ECB's monetary analysis can be assumed to have been monitoring asset price trends in the past, but it has now been made clearer that asset price trend monitoring is an important focus. It seems likely that this change would have been supported by hawkish Governing Council members led by those from Germany and, in light of recent financial market conditions, it is probably suitable to consider the upgraded attention to potentially problematic asset market trends to be a "hawkish" adjustment.

Difference Between "Tolerating" and "Targeting"

At the post-Governing Council-meeting press conference, a reporter posed the question – "You said you may tolerate a transitory period of moderately higher inflation [...] How much of an overshoot is the ECB willing to tolerate, and over what time frame?" In response, rather than offering new information, President Lagarde basically just summarized the – "The Governing Council confirms the medium-term orientation of its monetary policy strategy. This allows for inevitable short-term deviations of inflation from the target, as well as lags and uncertainty in the transmission of monetary policy to the economy and to inflation." – portion of the meeting's statement, emphasizing the "medium-term" nature of the target. The next reporter then asked – "tolerating and targeting are two very different things. Could you just confirm that, after periods of low inflation, the ECB will not seek a higher inflation rate but merely tolerate if that happens but that's still not the target to overshoot?" Again, Lagarde responded by just repeating the above points and did offer any additional useful information. The revised inflation target is somewhat confusing if one tries to understand what its exact meaning is. The fact that similar questions were posed by two reporters, one after another, is probably evidence that the exact meaning of the revised inflation target has not yet been sufficiently explained. The two similar questions were posed and were met with similarly vague answers, suggesting that further questions would be equally futile.

Overall, however, it seems safe to characterize the strategy review's results as dovish. The previous "below, but close to, 2%" inflation target did not allow for acceptance of higher inflation rates – regardless of whether the acceptance is characterized as "tolerating" or "targeting" – while the new inflation allows for acceptance of higher inflation rates, so the essential gist is that the ECB has become a central bank that is more tolerant of higher inflation rates. Although President Lagarde's explanations were generally rather vague, her statement during the press conference that – "We went from below, but close to, 2% to 2%. It is simple to communicate, it is solid [...]" – seems to indicate that she herself believes she was sufficiently clear.

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