

October 1, 2021

## Overview of Outlook

USD/JPY continued strong again in September. With concerns of rapidly rising inflation in the U.S. and Europe and the debt problems of some Chinese real estate companies making the headlines, the mood overall was somber, but the Fed is going ahead with its policy normalization process as planned. While there are problems in various parts of the world, JPY still remains the weakest currency. This is, as I explained in last month's report, very simply a manifestation of how investors perceive the Japanese economy. My firm opinion is that there is no need to concern oneself much with overseas risk factors when considering the future of JPY, because Japanese economic deterioration is too severe for anything else to make much of a difference to the overall JPY trend. The U.S. and Europe have taken advantage of higher vaccination rates to realize the goal of normalizing social life, which is reflected in their economic growth rates. Japan, however, despite having overtaken the U.S. in terms of vaccination rates and entered the league of most highly vaccinated nations, is aimlessly continuing with movement restrictions. It is confusing the means for the end, and as a result, the country's economy languishes at a rate that is dismally low among advanced economies. If the past is any indication, barely justifiable movement restrictions will continue to strangle the real economy again this winter, further expanding the gap between the domestic and international economic performance, making it quite likely that investors will begin to let go of JPY at some point. Given this catastrophic domestic situation irrespective of anything going on elsewhere, I see no grounds for changing my weak-JPY scenario unless the situation in Japan improves, and my prediction is that JPY's REER will stabilize at its present weak level, which is similar to levels seen in the early 1970s, and remain there.

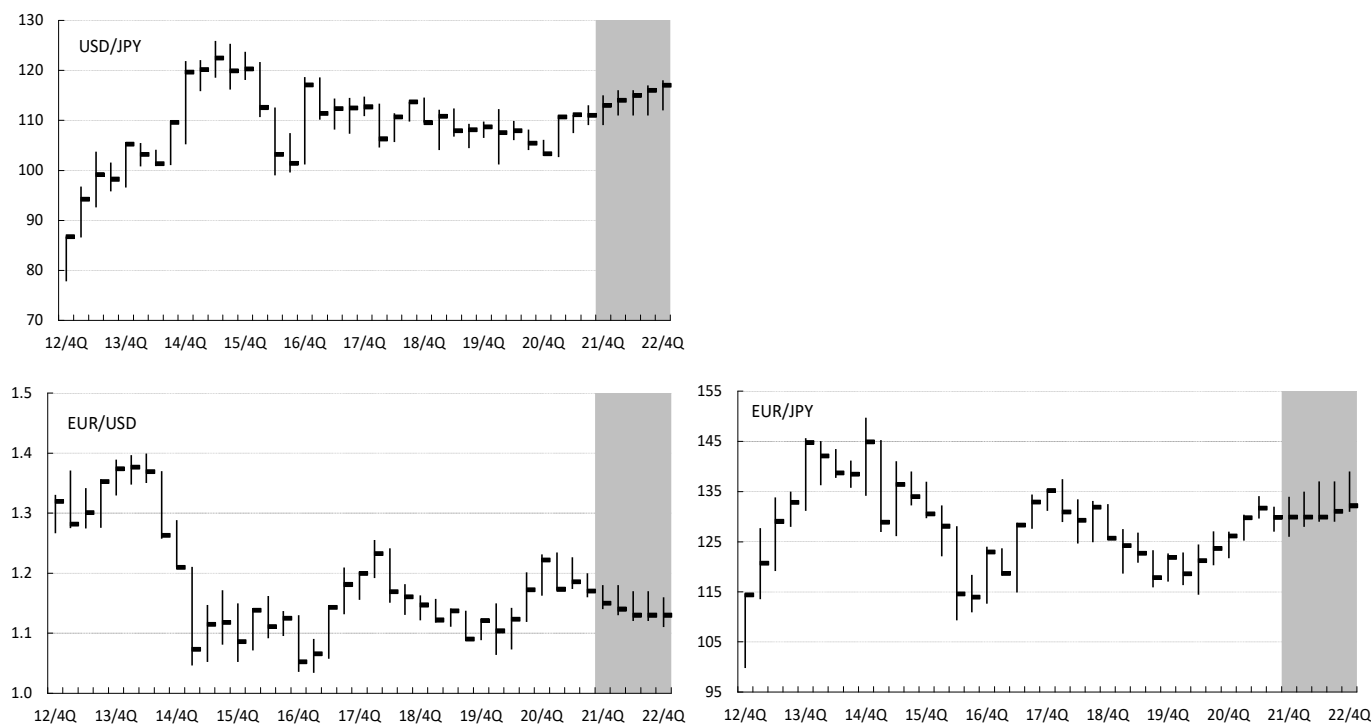
EUR also weakened in September. This was not because of any internal reason prompting EUR selling – rather, the ECB's Governing Council made a move to begin policy normalization in September. One gets the impression EUR was sold off in tandem with an increase in U.S. interest rates. Having said that, if we assume that the pandemic emergency purchasing programme (PEPP) will be terminated at the end of March 2022, euro area interest rates can also be expected to increase going forward. This, along with the euro area's rock-solid current account and trade surpluses (the largest in the world), make it unlikely that EUR/USD will crash. Inflation in the region is also rising rapidly for non-energy goods and services, and it may be difficult for the ECB to overlook this in the near-medium term. Compared with JPY, EUR has the upper hand in that it is backed not just by a large trade surplus but also significant progress in living with COVID-19, so EUR/JPY is expected to remain strong. The German federal election turned out to be a close contest, as expected. Going forward, regardless of which coalition forms the government, one can expect the post-Merkel regime to work on mending relations with China and reconsidering regional reallocation policies. The latter, in particular, is a theme that directly causes turmoil in the financial markets once in a while, making it important for market participants to follow it closely.

### Summary Table of Forecasts

	2021	Oct-Dec	2022	Apr-Jun	Jul-Sep	Oct-Dec
	Jan-Sep (actual)		Jan-Mar			
USD/JPY	102.60 ~ 112.08 (111.40)	109 ~ 115 (113)	111 ~ 116 (114)	111 ~ 116 (115)	111 ~ 117 (116)	112 ~ 118 (117)
EUR/USD	1.1563 ~ 1.2349 (1.1567)	1.14 ~ 1.18 (1.15)	1.13 ~ 1.18 (1.14)	1.12 ~ 1.17 (1.13)	1.12 ~ 1.17 (1.13)	1.11 ~ 1.16 (1.13)
EUR/JPY	125.10 ~ 134.12 (128.85)	126 ~ 134 (130)	128 ~ 135 (130)	129 ~ 137 (130)	129 ~ 137 (131)	131 ~ 139 (132)

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

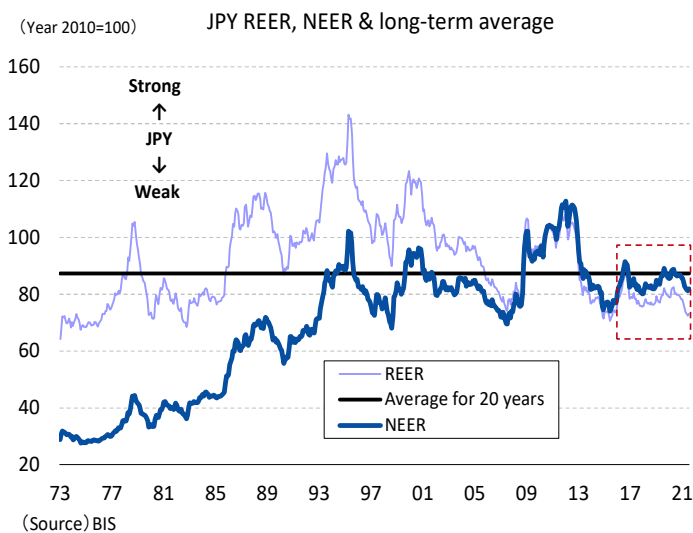


## USD/JPY Outlook – JPY Value Continues to Fall; No Recovery in Sight

### JPY Rates Now and Going Forward – JPY Value Falls to Levels Seen in Early 1970s

#### JPY REER Falls to Levels Seen in Early 1970s

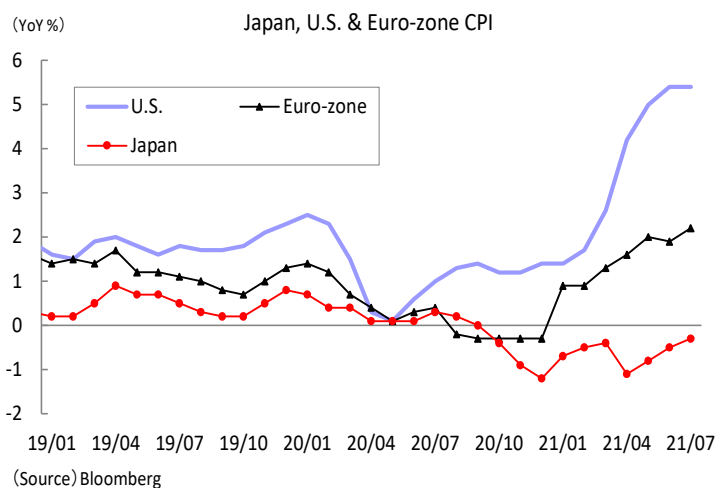
Once again in the forex markets, JPY is the sole weak currency – not just against USD, but conspicuously in terms of its real effective exchange rate (REER), which is a currency’s overall strength, calculated based on trading volume and price levels. As of July 2021, JPY’s REER was down to around 73.15. In June, it was even lower, at 72.44. In recent years, JPY made the headlines when, in June 2015, the accommodative monetary policies of the BOJ under Governor Haruhiko Kuroda led to share price appreciation and JPY depreciation to the extent that the currency’s REER hit 70.66 for the first time since Japan introduced the floating exchange rate system (in the first half of the 1970s). The REER seems to be approaching that level yet again (see figure). JPY hit its weakest in recent years under Abenomics on June 10, 2015, at 125.86 to the dollar. On that day, Governor Kuroda said in his statement before the House of Representatives Committee on Financial Affairs, “Given how low JPY’s REER has fallen, it seems unlikely that JPY will weaken any further under normal circumstances.” This led to a spate of JPY buying in the forex markets, causing USD/JPY to plummet. JPY has never weakened beyond 125.86 to the dollar since.



#### Mainly Driven by Slumping Prices

Thanks partly to the fact that USD/JPY is stable around 110 yen, people in Japan are probably unaware how dramatically JPY’s REER has fallen. For most residents, the exchange rate is synonymous with USD/JPY, so there would be no reason for them to worry about a change in the value of JPY so long as USD/JPY is stable. However, REER changes depending on (1) a currency’s nominal exchange rate, and (2) the relative change in price levels. So, even if JPY’s exchange rate remains unchanged, its REER will decline if prices in Japan fall in comparison to those in its trading partners. Looking at the figure above, it is clear that, since 2017, JPY’s REER has fallen more and more relative to its nominal effective exchange rate (NEER), and the trend has only intensified since the start of the pandemic. This indicates that (1) the situation is conducive to JPY selling on a nominal basis and (2) prices in Japan are slumping more than they are in elsewhere.

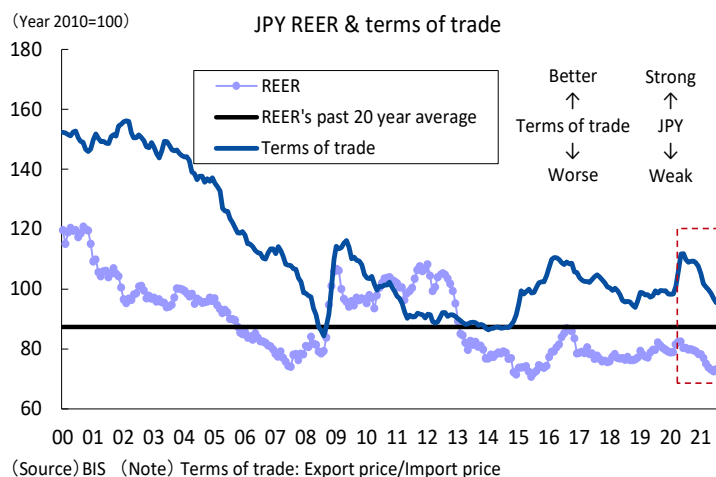
Since the beginning of the year, Japanese price levels, which were already quite bad, have become much worse than in the rest of the world (see figure). While prices in Europe and the U.S. have risen to the extent of giving rise to inflation concerns, prices in Japan have fallen. In theory, this gap in inflation would be corrected by an appreciation of JPY in NEER terms, but this has not happened for various reasons. I will discuss these reasons on another occasion, but some causative factors may include the rise in foreign direct investment by Japanese companies and the decline of Japan as an export base. The fact that the REER has fallen to this extent despite no appreciation in the nominal exchange rate of JPY indicates how conspicuously, relative to the rest of the world, Japan's prices have fallen. And this is, in fact, the case.



The sharp decline in international travel opportunities makes this more difficult to experience first-hand, but such a sharp fall in JPY's REER significantly raises the hurdles for Japanese people to travel abroad and spend or invest there. By contrast, foreign tourists can now buy a lot more for their money when they visit Japan. In other words, Japan is now cheap for everybody except those who live here.

**Deterioration in Terms of Trade and JPY Depreciation**

Let us discuss JPY devaluation from the perspective of prices a bit more. In theory, REER is synonymous with the terms of trade (export prices ÷ import prices). The terms of trade signify the ratio of export prices relative to import prices, which can also be described as the ratio of exchange in the trade between two countries. When a currency's REER correctly reflects the country's competitiveness, REER and the terms of trade move in close tandem with each other. For instance, if export prices rise and import prices fall, the terms of trade improve, meaning that more goods can be purchased than previously. This amounts to a real improvement in the domestic income environment, which leads to an improvement in economic and inflation environments – factors that cause REER to increase.



To understand this more simply, under a floating exchange rate system, forex market movements level out each country's terms of trade, so to the extent that the terms of trade improve, REER increases to offset the gains. In short, the terms of trade have always been closely correlated with REER, as the figure shows. The portion within the dotted square shows the movements in the past year – Japan's terms of trade have deteriorated sharply (as the increase in import prices has outpaced the increase in export prices since last year), and this is in line with the deterioration in REER.

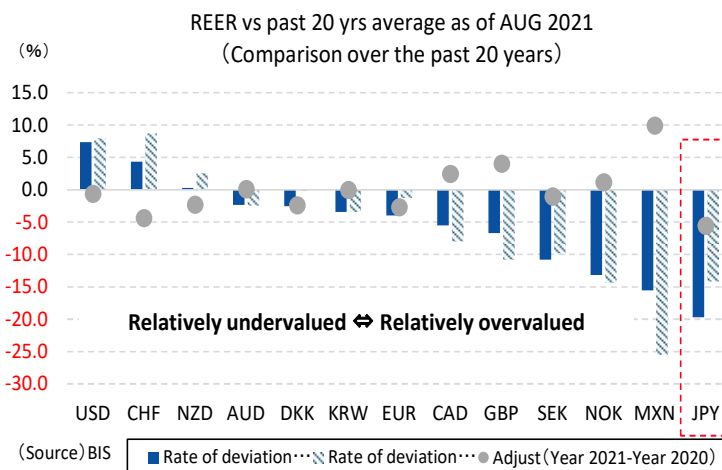
Supply constraints, such as those in the semiconductor industry, are now expected to continue until early next year, as import prices remain stubbornly high. If so, the deterioration of the terms of trade and the accompanying decline in REER also seem likely to continue for now. Even just focusing on price levels during the pandemic, the weak-JPY trend seems likely to continue for some time.

**International Comparison of REERs**

Symbolizing this fall in JPY's REER to early 1970s levels, the September 16 edition of the Nikkei Shimbun ran an article titled "iPhone Price Triples in 10 Years to JPY190K – 60% of the Average Japanese Monthly Income," revealing how expensive iPhones had become for Japanese consumers. Not just the iPhone, imported luxury cars, luxury watches, and other branded goods have also become clearly more expensive than they used to be for Japanese consumers, and it is no longer rare to see special features about "Cheap Japan" in the media. Of course, there is also a recognizable trend in terms of an increase in list prices globally speaking, but the extent to which this increase is keenly felt by consumers in any country depends in part on the macroeconomic conditions of that country. As discussed below, the margin by which JPY has depreciated in the past year is significantly larger than the margin of depreciation of any other major currency, and this signifies a dramatic decline in purchasing power.

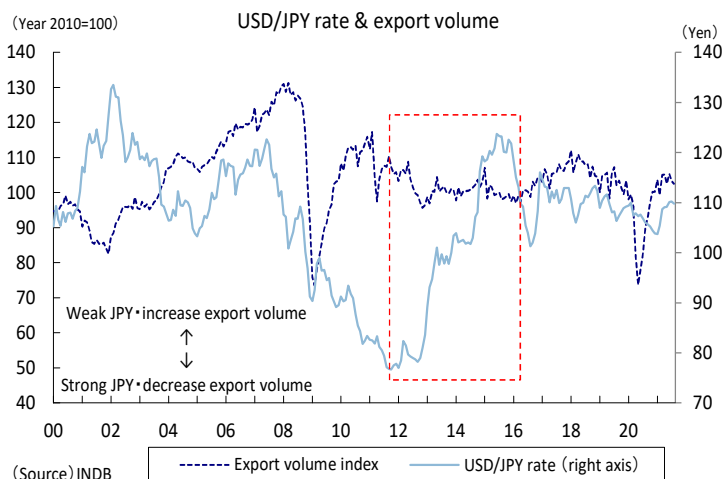
### JPY Has Diverged the Most from Its Long-Term Average in the Past Year

The figure shows the rate of divergence from the long-term (20-year) average of the August REERs of different currencies as published by the Bank for International Settlements (BIS). For reference, the figure also shows the difference in margin of divergence compared with REERs one year ago (August 2020). As of August this year, JPY was showing a divergence of -19.7% from its long-term average. The second most divergent currency, MXN, follows at a distance (-15.5%), not to mention that MXN has actually improved +10 pp from a year ago, when it was -22.5%, while JPY has deteriorated by -5.5pp from -14.2% a year ago. As the figure shows, Japan's margin of deterioration is also quite conspicuous relative to other key currencies. The second largest margin of deterioration is for CHF, at -4.3 pp, but CHF deteriorated from a place of strength (+8.7%) a year ago, and is now down to +4.3%.



### Path for Correction of JPY Weakness Broken

In other words, in the past year, MXN has improved from its excessive weakness and recovered some of its strength; CHF has undergone a healthy correction from being excessively strong last year, but JPY has gone from being already very weak to even weaker, which is not a healthy development in any sense. Incidentally, USD has maintained its strength relative to the long-term average at +6-7% this past year, making USD/JPY a pairing of the strongest and weakest currencies relative to their long-term averages right now. Given that the REER tends to return to the long-term average, it ought to be theoretically safe to predict JPY appreciation against USD, and this would have been my inclination in the past.



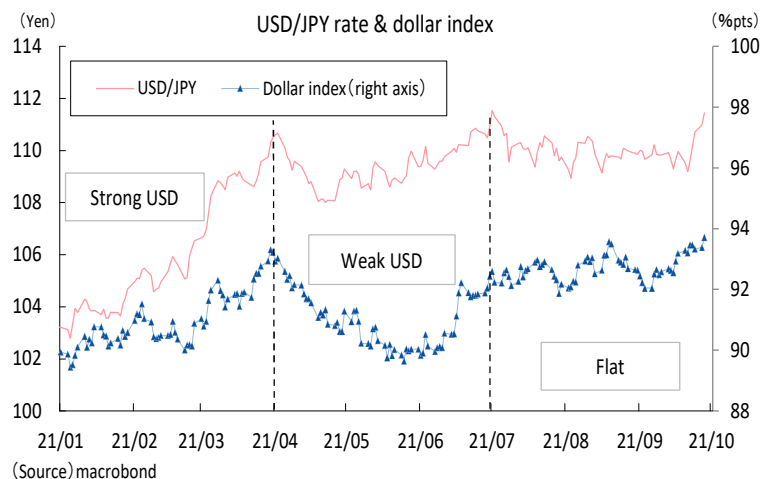
However, it may be time to reconsider this view. For one thing, Japan is no longer a country that can benefit from a weak JPY by increasing its exports. If a weak REER does not lead to an increase in Japanese export volume, and therefore to an increase in the trade surplus, the path by which a decline in REER causes an increase in JPY's nominal exchange will remain broken. As the portion within the red dotted square in the figure to the right shows, the rise in exports was quite gentle even at the peak of Abenomics, when USD/JPY increased by 50 percentage points. For JPY to be seen as excessively weak, it would first have to result in trade surpluses. This would then invite an appreciation of the currency in order for the undervaluation to be corrected. However, given that many Japanese companies have already shifted their production bases overseas, disabling the mechanism by which JPY weakness leads to an increase in exports, there is no guarantee that an excessively weak REER will result in higher nominal rates for JPY. Further, this weakness of REER arises from the fact that inflation in Japan is lagging behind other countries, a well-known chronic problem with the Japanese economy, but if prices remain perennially slumped, REER weakness will continue to be overlooked. Therefore, the view that the REER tends to return to the long-term average level, while true in theory, becomes a risky assumption on which to base JPY's forex outlook.

### New Kishida Administration and USD/JPY – Up to Japan in a Rare Turn of Events?

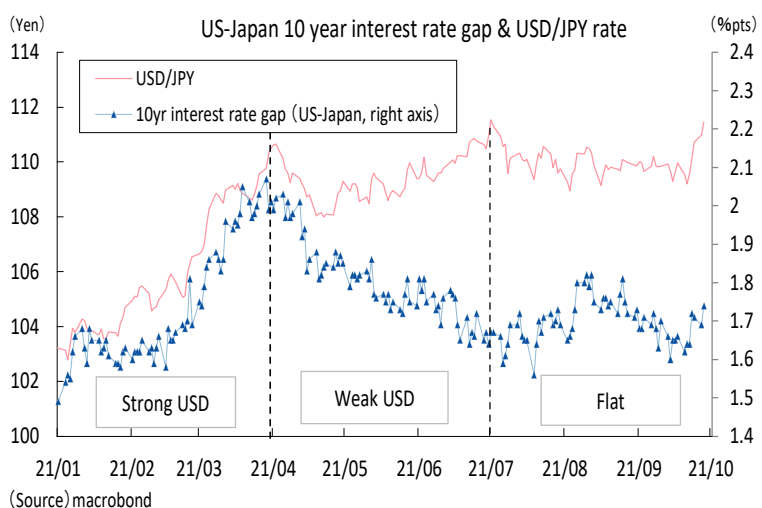
#### JPY is Weak Regardless of USD Rates

At the end of September, USD/JPY temporarily rose to the 112-yen level for the first time in a year and seven months. This movement was directly linked to the strong resurgence in U.S. interest rates, which is a natural development considering the gap between the U.S. and Japan in terms of economic and financial conditions. Since last year, this report has been predicting that 2021 would be a year in which the global economy, particularly the U.S. economy, begins to recover in anticipation of the end of the pandemic, prompting the Fed to consider starting its policy normalization process, thereby triggering a mutually stimulating rise in U.S. interest rates and USD. Following the September FOMC meeting, with a Fed rate hike already in sight, one must be prepared for market trends resembling those during January-March this year.

The figure to the right (top) looks back at USD rates versus USD/JPY on a quarterly basis since the beginning of the year. To paint a rough picture, JPY depreciated amid USD appreciation (rising of the dollar index) in January-March, USD/JPY remained more or less level despite USD depreciation (fall in the dollar index) in April-June, and in July-September, USD/JPY remained level against a level USD (no change in the dollar index). In other words, regardless of what the dollar trend was, investors were clearly not interested in JPY. As is obvious from the figure, the dollar index rose sharply during January-March and plunged during April-June, but USD/JPY has remained more or less level after



rising sharply in January-March. Further, the bottom figure to the right shows USD/JPY against the U.S.-Japan 10-year interest rate gap. The U.S.-Japan 10-year interest rate gap shrank dramatically in April-June as U.S. interest rates fell, but USD/JPY showed no response to this. This seems to be the result of investor perception that there is no reason to buy JPY even if U.S. interest rates fall, because, unlike in the U.S. and Europe, where interest rates may temporarily rise or fall, but the monetary authorities are on track to beginning policy normalization within the year, in Japan's case, the BOJ has completely removed itself from the picture. Also, most importantly, while Europe and the U.S. were seriously working to lift movement restrictions starting April, Japan had at that time just declared its third state of emergency, and some form of restriction or other has remained in place in Japan continuously since then. This is reflected in the difference between Japan's GDP and those of Europe and the U.S., and I believe, is directly related to Japan avoidance (selling off of Japanese shares and JPY).



#### *Conditions in Other Parts of the World Irrelevant to JPY Outlook*

Could this trend of Japan avoidance end this October-December? For that to happen, the new administration led by Prime Minister Fumio Kishida will have to move away from being excessively concerned about new case numbers. We will continue to receive previews of the new administration with media reports going forward, but one thing is clear – the U.S. and Europe are no longer taking the safe approach of locking down the economy simply because of an increase in the absolute number of new cases. This is the reason their economies have been able to grow at twice or three times the pace of the potential growth rate at the start of the year. If the new administration continues to make emergency declarations at similar risk levels as the previous administration, investors will once again move to sell off Japanese shares and JPY as they did early in the year. As I will explain later, Japan's preventative policies in response to the pandemic have amounted to confusing the means for the end. Though the drain on medical resources has been alleviated through the “means” of high vaccination rates, the government is continuing to impose movement restrictions in pursuit of zero risk, thereby disregarding the main objective of “social normalization.” This is the result of blindly deferring to nothing but new case numbers. I believe this deficient strategy is what has resulted in low growth rates, a weak JPY, and fall in Japanese share prices.

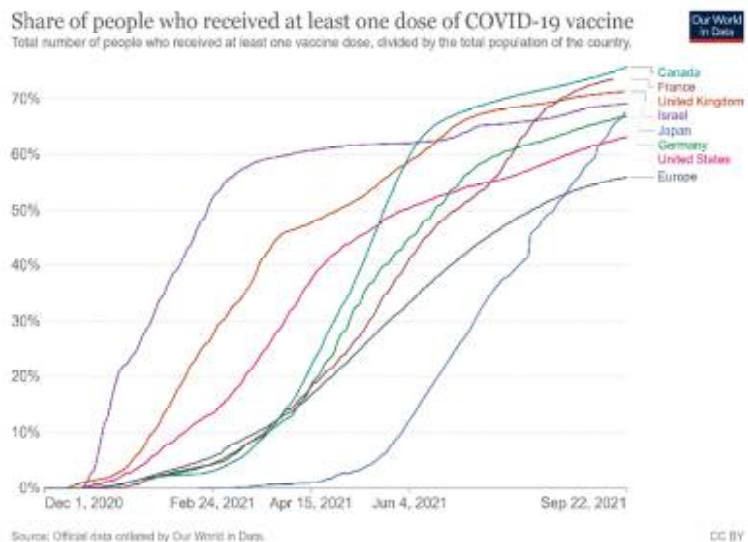
Going forward, unforeseen problems are bound to arise in the U.S., Europe, and China, but these will not be sufficient to hide the wretchedness of the rudderless Japanese economy. In formulating the JPY outlook, my basic understanding is that conditions in other parts of the world are irrelevant, and that the key factor will be whether the new Kishida administration can extricate itself from a new-cases-led approach or not. In that sense, the issue of electronic vaccine passports for use in various situations as part of the new administration's pandemic response, as included in its “Four Pillars,” gives hope. Thinking of it this way, it seems that the USD/JPY outlook is going to be dependent on the actions of the Japanese authorities in a rare turn of events.



## Japan's Economy Now and Going Forward – Rudderless and Adrift

### *No Point Overtaking the U.S.*

On September 10, it was widely reported that Japan's partial vaccination rate (percentage of people who have received at least one dose of the vaccine) had caught up with that of the U.S. Further, Japan is among the most rapidly vaccinating countries in the world in terms of the number of vaccines per 100 people being given per day (as of September 9, it was the fastest in the world at 0.95 shots per 100 people). As Vaccine Minister Taro Kono recently said, "Thanks to the hard work of local governments and medical institutions, which have sped up vaccinations, we have now caught up with the U.S. in terms of vaccination rates," major credit goes to frontline staff working at vaccination centers. However, as is widely known, the gap between U.S. and Japanese economic/financial conditions have, far from shrinking, actually widened even further. And as far as one can tell



from Japan's pandemic preventative strategy based on curtailing economic vitality at every step citing "slackness," we are unlikely to see any major change for the July-September or October-December quarters either in this pattern of Japan being left behind by the U.S. and Europe as they surge ahead. In the U.S. and Europe, high vaccination rates are well understood to be no more than the means to the ultimate goal of resuming economic activity, which they have been steadily doing. By contrast, the Japanese government seems to view a high vaccination rate as an end in itself, while economic self-restraint continues as usual. To be very honest, it is not clear what the government is trying to do. This problem of viewing the "means" as the "end" continues even after Japan has surpassed the U.S. in terms of vaccination rates. In other words, the U.S. and Europe had clear strategies – achieve high vaccination rates early, remove movement restrictions, and then normalize social activity. Speedy vaccine rollouts were positioned as the means to the end. In the case of Japan, confusing the means for the end and lacking clear strategies and tactics have been the main factors behind the dismal performance of the Japanese economy since the beginning of the year.

For instance, the UK, which had the highest vaccination rates among G7 nations from the start, was the first (in late February) to reveal a roadmap for the removal of movement restrictions targeting all of England. At that time, a four-step plan was indicated, with the aim of opening the country up by June 21 at the earliest. A roadmap is a "strategy" for returning to normalcy. The UK then went on to utilize vaccination as the "means" to achieve the ultimate "goal" of the strategy. Each country has its own strategy, i.e., way to utilize the "means" efficiently. In the case of the UK, the country took measures including early training of volunteers for specific tasks, with a view to preventing a slowdown in vaccine rollout due to a shortage of hands. As a result, the UK maintained its status as the most vaccinated country through the first half of the year, and is still among the most highly vaccinated countries in the world. In the event, the early deadline of June 21 was unable to be met as a result of a spike in infections due to the Delta variant, but on June 28, the government announced the removal of most movement restrictions starting July 19. In line with this, both the 2021 Wimbledon Championships as well as the 2021 UEFA European Football Championship were held in the UK with spectators.

Even now, the English Premier League football matches are being held with spectators as usual (incidentally, most spectators are unmasked). Taking into account this move toward economic normalization, the Bank of England (BOE) has also devised a way to exit from quantitative easing (QE) within the year, with the result that GBP has been maintaining an even stronger performance than USD in the forex markets. The UK, it can therefore be said, has been more or less successful in following through with its original strategy against the murky risks associated with a pandemic. Similarly, in the U.S., it was on March 11 that President Joe Biden announced his goal of "independence" from the Coronavirus by July 4<sup>th</sup> (U.S. Independence Day). This too has gone more or less as per plan, as evidenced by one of the strongest growth rates and employment recoveries among advanced nations.

The above are examples of how speedy vaccine development, procurement, and rollouts are the means to achieving ends such as lifting movement restrictions and normalizing social activity. Comprehensive strategies based on an understanding of the means and the end involved achieving high vaccination rates as early as possible, removing movement restrictions, and normalizing social life. Although with some variation from one country to the next, the pace of vaccinations in the UK, the U.S., and euro area since the beginning of 2021 has been dramatically quicker than in Japan, and this success was what allowed the U.S. and UK economies to revive starting the January-March quarter, and euro area economies to revive starting the April-June quarter like fishes that had been put back in water.

### *Japan's Present Vaccination Rate Higher than the UK's in April*

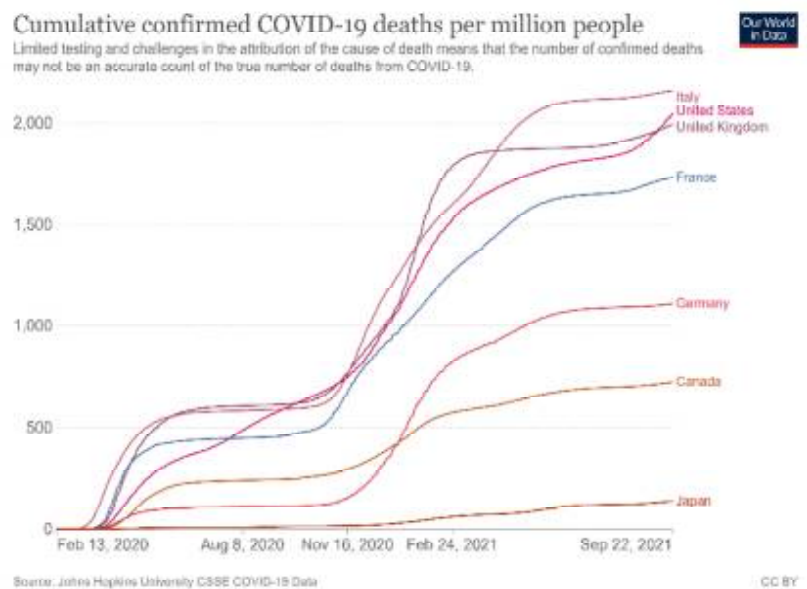
Around the time Europe and the U.S. began discussing roadmaps to return to normalcy, Japan was making its third emergency declaration. Voices of disappointment that wondered how many times the government would repeat this charade given it seemed to have no effect were already beginning to be heard, but because Japan's vaccination rates were dismally low among developed nations (0.71% as of April 1), it was easier to convince people to be patient until

the vaccination rates improved. There was even some hope that Japan may be able to achieve recovery similar to Europe or the U.S. by the July-September quarter.

However, in the event, the state of emergency continues even after Japan has surpassed the U.S. in terms of vaccination rates, and the country has endured some form of restriction or the other continuously for the nine months since the beginning of the year. Looking back at the recent-most quarter (April-June), for instance, the U.S. and the euro area have achieved annualized qoq growth rates of over +6% and +8%, respectively, amounting to a pace of growth twice or three times higher than their potential growth rates. This is thanks to their removal of movement restrictions starting early spring, but vaccination rates in the UK, U.S., and Europe were 45.92%, 29.60%, and 13.05%, respectively, as of April 1, i.e., much lower than the current rate in Japan (69.52% as of the writing of this report on September 27). In other words – exactly what is Japan’s purpose in desperately striving for high vaccination rates? Appeals to remain patient until vaccination rates increased, it turns out, were not based on a hopeful strategy along the lines of the U.S. and Europe, but rather just a vague idea that good things come to those who wait.

### *Great Tactics Cannot Make Up for a Failed Strategy*

As one can tell from the figure at the start, the trend in terms of the pace of vaccination in Japan compares favorably with Europe and the U.S., and this is undoubtedly an achievement for the Yoshihide Suga administration. One has the image of Japan as a country that can show its strength once it begins attempting to make things efficient through inventive workflow ideas on the ground, and that image was proved correct again. If we compare the pandemic to a war, and a larger strategy for overcoming the pandemic to a battle plan, then battle tactics would be the lower-level strategies aimed at leading individual engagements on the battlefield to success (one can get back on track even if miscalculations are made once in a while in terms of battle tactics). It is famously said about war that good strategy can cover for bad tactics, but good tactics can never make up for the lack of a strategy, which



perfectly describes the current state of the Japanese economy. Regardless of how brilliantly frontline vaccine workers achieve high vaccination rates within short periods, the Japanese economy currently has no strategy for putting this battlefield victory to good use. As already explained, the rapid rise in vaccination rates has contributed almost nothing to the Japanese economy. Despite the major medical victory in terms of being able to dramatically reduce serious cases of or death from COVID, the pandemic subcommittee continues to repeat its warning to the people not to let their guard down, and there is no sign of a return to normalcy. Every time there is an increase in human movement, the news is full of critical reports citing some percentage of increase in case numbers. This is not the way to bring back consumption appetite or return to normalcy.

As a result, the real economy continues to be slowly strangled to death. Perhaps it is not my place to comment on this as someone who is not a medical professional, but even from the perspective of a lay person, it seems that COVID casualty figures in Japan (number of deaths per million people) is lower than other G7 countries by one, or in some cases, two digits (see figure to the right). And now, with vaccination rates also higher than the U.S., what more does the government want? By late September, new case numbers in Tokyo had fallen dramatically, yet Tokyo Governor Yuriko Koike called for a further curtailment of the spread. The series of preventative measures taken by the Japanese government are bordering on the eccentric and seem to leave no hope from the perspective of economic growth. In this situation, where nobody seems to have the slightest idea what the government’s strategy is, different sites, including vaccination centers, restaurants and bars, hotels, and schools, are battling valiantly with great tactics, but it seems extremely likely that their efforts will continue to be restricted and strangled going forward.

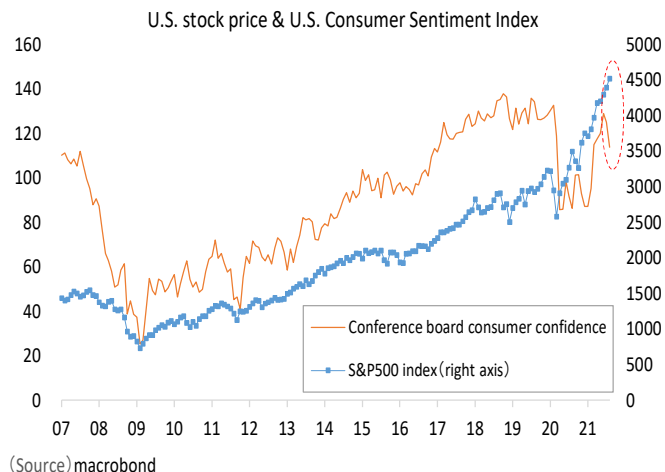
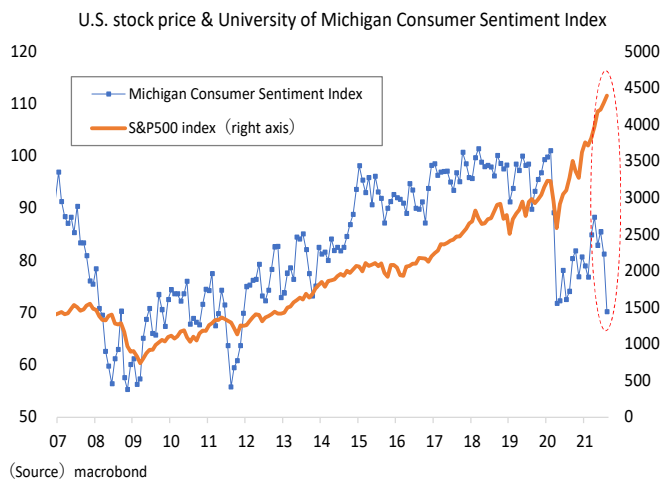
Things are very different now than they were a year ago, when no one could see a way out of this pandemic. Now there already exist exit strategy models in other countries, so it should be natural to focus on following them, but Japan’s extremely low tolerance for risk is coming in the way of its doing so. This is now a question of political decisions to be made by the Japanese authorities, and there is nothing to do but to wait, but in the forex markets, which permit a free flow of capital, no rational investor wants to buy the currency of such a country (economy). If things continue this way, Japan will probably catch up with countries like the UK and Israel, the original leaders in terms of vaccination rates, but for an economy without a strategy, this is a wasted accomplishment.

## The U.S. Economy Now and Going Forward – Consumer Confidence Begins to Fall

### Ominous Signs for U.S. Consumer Confidence

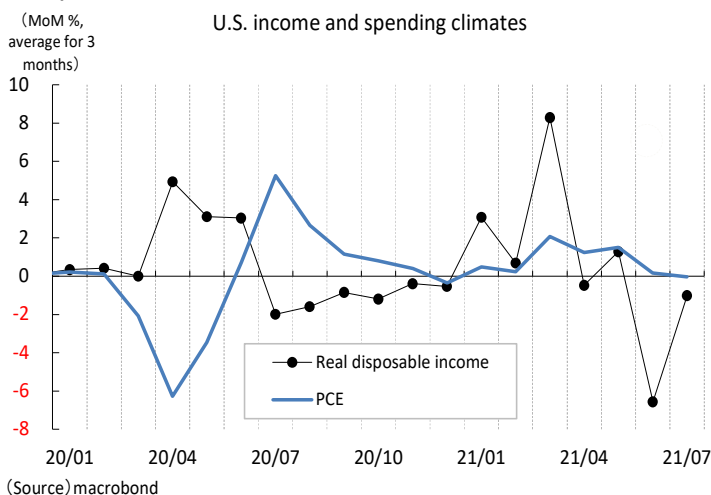
U.S. economic indicators, specifically, U.S. consumer confidence, have been unstable since August. Will this trend continue, and how will it go on to affect personal spending? These are important points that need to be considered. As I have argued in past issues of this report, it will be important to see whether the U.S. economy can enter a virtuous cycle of (1) accommodative monetary environment → (2) increase in share prices → (3) wealth effect leading to an increase in personal spending → (4) increase in corporate revenues. In particular, it will be important to see whether the link from (2) to (3) functions as intended. Even if shares appreciate beyond their intrinsic value, so long as the wealth effect can kindle consumption and investment, the real economy will be boosted. For instance, the August University of Michigan Consumer Sentiment Index level deteriorated for the first time in 10 years, indicating the possibility of the disruption of the link between (2) and (3) (see figure to the left on the next page).

Having said that, given the small sample size of this survey, it should probably be analyzed together with the results of other consumer confidence indices such as the Conference Board index. In this connection, the August Conference Board Consumer Confidence Index, which was released on August 31, posted 113.8, the lowest in eight months, since February this year (see figure, right). It seems that the improvement in business sentiment achieved over the past six months has been wiped off, with a dissonance from the high share prices beginning to be obvious now. If this situation continues unchecked, the real economy will undoubtedly slow down. The Conference Board senior director of economic indicators, however, commented that “While the resurgence of COVID-19 and inflation concerns have dampened confidence, it is too soon to conclude this decline will result in consumers significantly curtailing their spending in the months ahead.” In fact, what would be truly concerning is if the spread in infections lead to the imposition of movement restrictions yet again, but we are not at that point right now. Rather, I feel that the concerns are mainly surrounding the risk of rapidly rising inflation.



### Worsening Real Incomes a Source of Concern Apart from Spread in Infections

Roughly 60% of the U.S. economy ( $\cong$  GDP) comprises personal spending, so it is no exaggeration to say that personal spending is the one indicator that can make or break the U.S. economy. In this context, though the markets rarely concern themselves with it, it is important to take stock of the income climate, which is the source of consumption and investment. Currently, nominal incomes are rising, but thanks to prices, which have been stubbornly high since the beginning of the year, real incomes are deteriorating as a trend. Since early spring, the real U.S. income and spending climates have not been great, with the personal consumption expenditure (PCE) deflator's growth trend remaining quite suppressed for the past year. As the Conference Board official above said, the deterioration in U.S. consumer confidence is not just owing to the resurgence of the pandemic, but also to inflation concerns. While it is true that the rise in infections is more threatening due to its unpredictability, the concern is more or less in the mind so long as there are no effective restrictions on movement.





However, the real deterioration in income climate is clearly weighing down on household budgets. If Delta variant infections can be kept in check at current levels, the main threat for the Fed will be the persistently high inflation. If that happens, the central bank's traditional role of tightening monetary policy in an effort to suppress inflation – a task that has rarely been required since the start of the global financial crisis in 2008 – could make an appearance once again. Naturally, in a world where low interest rates have become the norm, this could easily become cause for USD appreciation.

## U.S. Monetary Policies Now and Going Forward – Rate Hikes in 2022-23 Disguised as Established Policy Path

### Extremely Smooth Policy Normalization Process

Monetary policy was kept unchanged at the September 21-22 FOMC meeting, but at his press conference following the meeting, Fed Chair Jerome Powell hinted that QE tapering would be decided in November and would likely be completed by mid-2022. Further, the dot plot of federal fund (FF) rate projections by FOMC members indicated that rate hikes would begin not in 2023 or later, as previously thought, but earlier, in 2022. Regarding the Evergrande debt problem in China (details later), while admitting that “you would worry that it would affect global financial conditions through confidence channels and that kind of thing,” Powell ultimately

concluded that it “seems very particular to China” and that “there’s not a direct United States exposure.” The problem has, therefore, not resulted in any revision of the basic scenario. As I will explain in greater detail later, the Evergrande problem is expected to cause damage to the Chinese economy over the long run, rather than cause any immediate damage as in the case of the collapse of Lehman Brothers. It is not a positive development one way or other, but given that the Chinese government is already moving to lead a public bailout, there is no reason for the U.S. government to revise the monetary policy it has been finalizing since before summer.

Going forward, several patterns are possible for the Fed to bring its (currently USD 120 billion per month) asset purchases to zero by the end of June 2022 – it could reduce the pace of asset purchases by USD 20 billion a month starting in January 2022, or in four installments of USD 30 billion each to coincide with the January, March, April, and June 2022 meetings, or distributed over six FOMC meetings including the November and December 2021 meetings. It has not been specified that tapering will begin next year, so a starting point of November or December this year is also possible, and strictly speaking, the process could even end before the end of June next year. Having said that, the exact timing is a trifling issue – the important thing is that, despite major unforeseen developments including the rise in infections from the Delta variant and the Evergrande problem, the Fed is proceeding with its normalization process in an extremely time-bound manner.

### Rate Hike in 2022-23 Disguised as Established Policy Path

The pace at which the normalization process is proceeding, as confirmed from the dot plot, is also extremely smooth. As before, 18 FOMC members projected no rate hikes within the year (0.00~0.25%), but the number of members who predicted no rate hikes before the end of 2022 (0.00~0.25%) had declined from 11 to 9, while those who predicted one rate hike (0.25~0.50%) had increased from 5 to 6, and those who predicted two rate hikes (0.50~0.75%) had increased from 2 to 3. As a result, the median forecast for 2022 changed to 1 rate hike, which was the big development following the recent FOMC meeting. Having said that, this is still the median forecast value, and there is still contention between those who predict a rate hike in 2022 and those who do not. Perhaps the prospects of a rate hike in 2022 are not as solid as the headlines make them seem.

Meanwhile, with regard to 2023, the number of FOMC members who project no rate hikes until the end of 2023 (0.00~0.25%) has dwindled down from 5 to 1. In other words, it is no longer a mainstream view to project no rate hikes until the end of 2023, and rate hikes in 2022 or 2023 has now become the expected policy. This is the most important takeaway from the FOMC meeting this time. Further, the number who project one rate hike (0.25~0.50%) by the end of 2023 has increased from 2 to 4, while those who predict two rate hikes (0.50~0.75) remain unchanged, and the number who predict three rate hikes (0.75~1.00%) has decreased from 3 to 1. It seems likely that the 9 members who predict a 0.00~1.00% range for FF rates by 2023 are nine members who expect to see no rate hikes in 2022. Reading deeper into it, 8 of these 9 members seem to expect rate hikes in 2023, of which 4 expect a single rate hike, 3 expect two rate hikes, and 1 more expects three rate hikes. It is interesting to see that there are as many as 4 members who believe that, even if there are no rate hikes in 2022, there will be a need to raise the rates more than once in 2023.

The remaining nine members are those who predict rate hikes both in 2022 and 2023, with 6 predicting an FF rate of 1.00~1.25% by the end of 2023 and 3 predicting a 1.50~1.75% rate. In other words, the most hawkish members predict two rate hikes in 2022 and four in 2023, making for a total of six. Since there are eight FOMC meetings each year, this means that even the most hawkish members expect a rate hike to be implemented once every two meetings in 2023. This is quite similar to the pace of rate hikes seen during the previous rate hike phase. What seems plausible to me is a single rate hike in December 2022 and one rate hike every two meetings with the start of 2023.

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

FOMC Date	2021	2022	2023	2024	Longer run
Jun-20	0.125%	0.125%	n.a.	n.a.	2.500%
Sep-20	0.125%	0.125%	0.125%	n.a.	2.500%
Dec-20	0.125%	0.125%	0.125%	n.a.	2.500%
Mar-21	0.125%	0.125%	0.125%	n.a.	2.500%
Jun-21	0.125%	0.125%	-0.625%	n.a.	2.500%
Sep-21	0.125%	0.250%	1.000%	1.750%	2.500%

(Source) FRB

*Impact on USD/JPY outlook – Policy Focus Shift from “Quantity” to “Interest Rates”*

I do not expect this will have any impact on this article’s main forecast scenario. Since the August employment statistics were released, this article’s tapering-related forecast has been “November decision, December start, June 2022 completion” (prior to the August employment statistic release, I had expected a September decision), and it appears that actual events will turn out to be quite closely in line with that forecast. The Fed may have various reasons for preferring to start tapering in November, December, January, or at some other time, but it probably is most intent on avoiding a scenario in which it is forced to modify its chosen schedule owing to financial market overreaction to unforeseen situations (such as Delta variant infection trends and debt problems in China). I presume that the Fed has a strong desire to start tapering while it is still in a position to start it. Chairman Powell is emphasizing that the pace and timing of tapering will not necessarily indicate the timing of prospective interest rate hikes, but rate hikes cannot realistically be discussed until tapering is complete. Reflecting that, when Powell mentioned the possibility of completing tapering midway through 2022, the dot plot was suggesting a 2022 rate hike commencement, but some FOMC members are now anticipating four hikes in 2023, so it can be said that the focus of the Fed’s “next move” has already been shifted from “quantity” to “interest rates”. Looking at the forex market, it would take quite a bit of courage to predict a trend of USD depreciation.

Although the Fed’s normalization process is proceeding smoothly, USD/JPY levels have not shown a strong reaction to that because the rise in US interest rate levels has been sluggish. However, if the Fed’s expectations that conditions in the real economy will continue improving as Fed bond purchases are progressively scaled down turns out to be true, it is safe to bet that there will be a trend of increase in US interest rates. In addition, the PCE deflator is expected to consistently exceed 2% on a core basis over the forecast period – a situation that has not been seen for many years – so it is possible that it could become necessary to raise interest rates in order to stabilize economic conditions. In any case, the difference between the U.S. situation and that of Japan – which is still discussing whether or not to maintain movement restrictions – is very large, and I think that difference will be clearly reflected in the USD-JPY value relationship over the next year.

**Risks to My Main Scenario – Perception of “Chinese Lehman Shock” Exaggerated?***Two Key Points for Understanding the Evergrande Situation*

Since late September, the debt problem of the Evergrande Group – the second largest property developer in China by sales – has been attracting considerable media attention and causing nervousness in financial markets. At the time this article was written, things had settled down somewhat regarding Evergrande, but there remain lingering concerns about the possibility that additional cases of major Chinese companies with serious debt problems may emerge. In light of currently available information, the two main points that need to be considered in order to understand the Evergrande situation are (1) whether the Chinese government intends to use its own funds to rescue the company and (2) the degree to which the company’s debtholders are dispersed or concentrated. As explained below, examination of the Evergrande crisis with respect to those two points seems to indicate that one should not be too quick to promote exaggerated perceptions of associated risks by calling the Evergrande crisis a “Chinese Lehman shock.”

Regarding point (1), one reason why the “Chinese Lehman shock” phrase became so widely used were reports suggesting that the Chinese government had no intention of bailing Evergrande out. Hu Xijin – editor-in-chief of the Communist Party tabloid Global Times, which is considered to strongly reflect Chinese government’s intentions – attracted considerable attention from financial markets when he made a social media posting saying – “when the state needs to carry out standardized adjustment to an industry, it will not accommodate and protect an enterprise just because its problems are serious.” Many media reports have indicated that the Chinese government has begun emphasizing the view that widening economic inequality promotes social unrest, and the government has declared that from this summer it will focus on income redistribution policies to better distribute wealth that it believes should be considered to be commonly held among Chinese citizens. This rich-to-poor redistribution policy focus has important ramifications regarding a prospective Evergrande bailout, since such a bailout would likely be perceived as a poor-to-rich income redistribution move. As Evergrande has a history of selling high-yielding financial products to wealthy Chinese (including investors, home buyers, and others) as a means of raising funds for its real estate development projects, a bailout of Evergrande would be seen as a move to aid wealthy people and deny the concept that China’s wealth should be commonly held among ordinary citizens.

However, the Evergrande problem is causing actual turmoil in financial markets. The key question is whether the Chinese government will give priority to living up to its domestic wealth redistribution promises or to alleviating financial market turmoil, and it appears that financial markets are anticipating the former scenario. The 1997 bankruptcy of Sanyo Securities in Japan and the 2008 bankruptcy of Lehman Brothers in the United States led to financial crises after financial market players quickly perceived that government policymakers believed that bankruptcies could be controlled and that investors were responsible for independently dealing with their own exposure to bankruptcy-related risks. Many people consider government decisions made with respect to both cases to be obvious mistakes, and financial market players are fearing that the same kind of mistake will be made this time.

*Likelihood of Successful Loss Absorption by Chinese banking sector*

The question of whether the Evergrande situation will promote contagious fears among financial market players leading to a major financial crisis largely depends on point (2) – the degree to which the company’s debtholders are dispersed or concentrated. In this regard, it is widely believed that most of Evergrande’s interest-bearing debt is distributed among banks and non-bank companies in China. According to the Bank of China’s major banking supervision and management indicators for the 2021 April-June period (released in mid-August), the balance of Chinese banks’ allowances for doubtful accounts at the end of June was RMB5.4 trillion (≈ JPY92 trillion at RMB1/JPY17 rate), while Evergrande’s total debt is currently reported to amount to about RMB2 trillion (≈JPY34 trillion). Thus, even if Evergrande were to default on all its debts, the associated losses apparently could be absorbed by the Chinese banking sector. It has been reported that the company’s corporate bonds are also held by major institutional investors outside China, but the scale of those bondholdings (so far as is currently known) is not large enough to significantly impact the international financial system. For example, Reuters reported on September 21 that BlackRock from January to August this year purchased 31.3 million Evergrande corporate bonds, which comprise 1% of its \$1.7 billion Asian high yield bond fund. This scale of bond holding is not nearly enough large enough to cause a crisis comparable to the Lehman shock.

As it currently appears extremely unlikely that the Evergrande situation will impede financial transactions in the manner seen following the Lehman shock, I think one should refrain using the provocative “Chinese Lehman shock” phrase. This is particularly true given that Evergrande is a real estate development company rather than a financial institution. It is fundamentally unlikely that the bankruptcy of a business corporation will generate a shock of a magnitude comparable to that caused by the bankruptcy of a financial institution that spreads exposure to its debt worldwide through the sale of financial products. Since real estate transactions are primarily bilateral transactions, however, it will take some time to gain a good grasp of the entire Evergrande situation, so it is likely that the situation will continue impacting market sentiment for a somewhat protracted period.

*Anticipated Future Developments*

Of course, market players are continuing to be fearful of the Evergrande situation. As mentioned above, it is generally hoped that it will prove possible to limit the situation to the bankruptcy of Evergrande alone. The bankruptcies of Sanyo Securities and Lehman Brothers had repercussions promoting management instability among other companies in the same industry. The European debt crisis began in Greece and then spread throughout Southern European countries. Such impact-spreading processes have eventually reached even companies and countries with relatively low risk levels. For example, Spain and Ireland were impacted by the debt crisis despite being countries with fiscal budget surpluses that seemed unlikely to be compared with Greece, which was noteworthy for its lack of fiscal discipline and misrepresentation of statistics. Once the impact begins spreading, it takes time to stop that spreading process. Declines in financial institutions’ credit capacities and in consumption and investment proclivities in the real economy due to such an impact-spreading situation may eventually lead to a decline in prices and thereby promote a decline in interest rates.

In this way, rational fears regarding prospective bankruptcy processes can be magnified by mistakes made in initial countermeasures that promote self-fulfilling suspicions among market players that pick up momentum and snowball. When multiple cases of refraining from executing payments because of a lack of confidence in transactional counterparts take place at the same time in various places, the financial system – the heart of the real economy – will stop pumping. Companies and countries do not always go bankrupt owing to the recording of losses, they can also go bankrupt when they cannot obtain the requisite amount of liquidity. In other words, even companies and countries able to generate stable surpluses may go bankrupt if their access to liquidity (financing) is interrupted. The need to prevent such accidental liquidity interruptions often makes it best to undertake state-funded bailouts to deal with cases that are likely to generate systemic risks.

Going forward, financial market players will be seeking to identify companies in China with the potential to become second and third cases of bankruptcy on a scale comparable to that of Evergrande. They should be striving to expeditiously examine companies in the Chinese real estate development industry and related industries that have been offering high-interest financial products similar to those offered by Evergrande. It is fundamentally best to extinguish the fire of risk contagion completely before it spreads to make sure that initial problems do not snowball, but it must be recognized that such quick fire extinguishing policies will be difficult to implement insofar as they clash with China’s current emphasis on income redistribution policies designed to better distribute the nation’s wealth.

*Evergrande Situation May Promote Economic Deceleration*

I do not think that the Evergrande problem is likely to spur an acute economic slowdown like that following the Lehman shock, but I consider it a factor with the potential to promote chronic economic deceleration. Financial markets will be paying close attention to the handling of Evergrande’s upcoming corporate bond interest payments, but regardless of what associated problems may emerge, they are not likely to have a widespread impact on the real economy for some time. Until then, the situation basically just poses a potential problem for the financial markets.

Apart from such financial market problems, however, one should note that when a real estate developer runs out of funds, its current development projects may fail. For example, it is quite possible that condominium units already purchased and paid for will not ultimately be delivered. It is well known that people in China generally prefer to invest the bulk of their savings in housing assets, so it is assumed that the Evergrande bankruptcy will directly impact personal consumption in China to some extent. Also, even if the Evergrande situation does not impact the financial system to the extent the Lehman shock did, it seems almost certain that it will cause some degree of damage to China’s banking sector and thereby promote deterioration of the credit environment for daily economic activities. This

---

might also have a negative effect on economic conditions. In light of these factors, even if the “Chinese Lehman shock” phrase is acknowledged to be a greatly exaggerated characterization of the situation, it should be recognized that the Evergrande situation does seem highly likely to promote a slowdown in the Chinese economy.

*Possibility of Impact on Western Monetary Policies*

When considering the outlook for asset prices, it is worth noting how the Evergrande situation might possibly necessitate revisions to Western monetary policies, particularly to the Fed’s basic policy stance. As discussed above, the September FOMC has successfully come to the point of making a decision on tapering, and Fed Chairman Powell has described the Evergrande problem as a situation likely to impact China alone. It should be remembered, however, that when such phrases as “subprime shock” and “Lehman shock” were newly minted, it was generally believed that the associated impact would mostly affect the United States alone or the financial markets alone and that the impact on the real economy would be limited. Of course, the financial system’s resilience level at that time was lower than it is today. Over the last decade, strict capital controls that can even be characterized as excessive have been put in place with an eye toward preventing individual financial shocks from causing global reverberations. In short, one should refrain from using the overly dramatic “Chinese Lehman shock” phrase since the main forecast scenario is that a crisis worthy of being called a “Chinese Lehman shock” is quite unlikely to eventuate.

On the other hand, if the Chinese government were to make mistakes in its initial response measures and cause a situation comparable to that of Japan in 1997 or that of the United States in 2009, it might possibly affect the Fed’s normalization process enough to necessitate the revision of this article’s main forecast scenario. In fact, observers are already beginning to make scattered reports regarding additional Chinese companies that might possibly suffer debt problems comparable in severity to those of Evergrande and, going forward, I think it will be necessary to carefully examine data related to such problems and create risk scenarios to reflect those data.

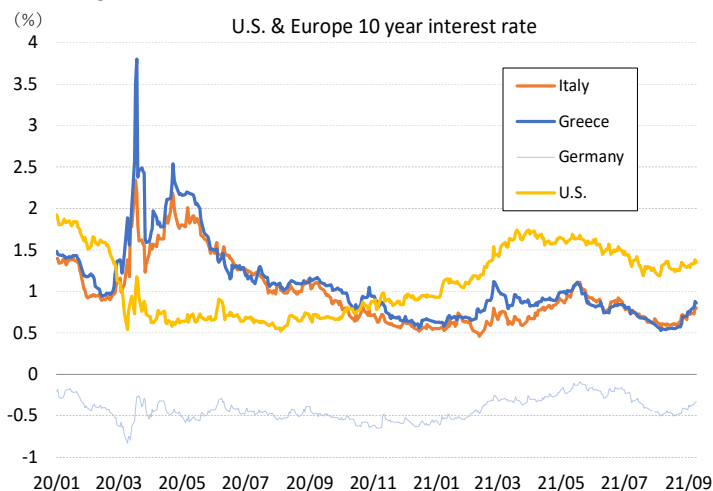


## EUR Outlook – ECB also to Move Toward Normalization?

### EUR Area Monetary Policies Now and Going Forward – Decision about PEPP Termination likely in December

#### Financing Environment Conditions the Key Policy Determining Factor

The September 9 ECB Governing Council meeting revised the official description of the current pace of Pandemic Emergency Purchase Program (PEPP) asset purchases – from “a significantly higher pace” to “a moderately lower pace” – and also clarified the policy regarding the future reduction of those purchases. This article had already anticipated the nature of these moves and the reasons for them prior to the meeting. The ECB has since the end of August begun hinting at a deceleration of PEPP purchases in line with the plans of euro area country central bank governors. The ECB has explained that the PEPP’s purpose is to employ the tool of quantitative expansion in order to attain the goal of maintaining a favorable financing environment – having judged that it can maintain those favourable financing conditions with a slower pace of purchases, the ECB does not



(Source) macrobond

see a need to seek to maintain the quantitative expansion pace. The Governing Council meeting statement clearly explains that the slower purchase pace is justified by calm conditions in the interest-rate environment, stating – “Based on a joint assessment of financing conditions and the inflation outlook, the Governing Council judges that favourable financing conditions can be maintained with a moderately lower pace of net asset purchases under the pandemic emergency purchase programme (PEPP) than in the previous two quarters.”

While euro area interest rates had been trending upward before the meeting, they did not show much reaction to the decisions made at the meeting, partly because those decisions had generally been anticipated and factored in in advance. Currently, euro area interest rates’ level is about the same as their level in mid-March when the Governing Council began employing the “significantly higher pace” phrase. Since current and prospective conditions in the real economy have improved dramatically since March, however, the fact that nominal interest rates remain at the March level is interpreted as indicating that the degree of monetary easing is actually increasing. At the post-meeting press conference, ECB President Lagarde repeatedly cited the positive conditions in the financing environment as reasons for the decision to decelerate PPP purchasing, and the meeting’s statement explains that the current slowdown in bank lending merely reflects a slowdown in demand for loans stemming from the fact that companies borrowed heavily during the early stage of the pandemic and remain well funded. President Lagarde also emphasized that the decision to decelerate PEPP purchases was a unanimous one.

#### Clear Upward Revisions in Staff Projections

Since June, the Eurosystem staff projections have been clearly revised upwards. The latest projections have boosted the anticipated 2021 consumer price index (HICP) and real GDP growth rate by 0.3 and 0.4 percentage points, respectively, making it reasonable to anticipate moves toward monetary policy normalization. It might have been possible for the ECB to justify policy status quo maintenance in light of uncertainties regarding the prospective impact

ECB staff outlook (SEP 2021)

	2021			2022			2023		
HICP	2.2	1.7	1.5	1.9	1.2	1.4	1.9	1.2	1.4
(Previous: JUN 2021)	1.9	1.2	1.4	1.9	1.2	1.4	1.9	1.2	1.4
Real GDP	5.0	4.6	2.1	4.6	4.7	2.1	4.6	4.7	2.1
(Previous: JUN 2021)	4.6	4.7	2.1	4.6	4.7	2.1	4.6	4.7	2.1

(Source)ECB (Note) EURUSD rate is assumed to be 1.18 year 2021-2023

of covid-19 Delta variant infections but, given that 2021 is the only year during the forecast period during which an inflation surpassing 2% is expected, it seems natural that it would take the opportunity to reduce the pace of PEPP purchases at this point. The latest staff projection anticipates that EUR/USD will average 1.18 in 2021, an approximately 3% lower level than the June projection (1.21), and this is another factor that can be expected to contribute to euro area GDP growth by promoting greater external demand. Given that the euro area’s potential growth rate is around 2% and that its actual GDP growth is projected to exceed this rate for the next couple of years, it seems reasonable to anticipate that the ECB’s “next move” should toward policy normalization. It is also worth noting that euro area real GDP is projected to surpass its pre-pandemic level (October-December 2019) by the end of 2021 and, as explained below, this situation can be expected to affect PEPP management. In fact, one reporter at the press conference posed a question about whether euro area real GDP’s reattainment of its pre-pandemic level is a sufficient condition for terminating the PEPP.

### Considering PEPP Scaling-Down Measures during the October-December Period

As expected, the September Governing Council meeting did not seem to consider how the PEPP framework might be adjusted in light of the program's scheduled termination at the end of March 2022. Throughout the press conference, President Lagarde reiterated that PEPP re-calibration is a routine quarterly process and that the latest adjustment does not necessarily indicate additional asset purchase pace reductions (or the discontinuation of the PEPP framework) in the future. In fact, it is understandable that it would require considerable optimistic boldness to terminate the PEPP (the Pandemic Emergency Purchase Program) prior to the winter, at a time when the nature of prospective pandemic trends remain unclear. (In this regard, President Lagarde said – “We’re not out of the woods. We are not on the green, as the golf players will appreciate.”) President Lagarde said that PEPP’s terms and conditions will be discussed based on the December revision of the staff projections, and that seems to indicate that there will be no bold decision made with respect to the terms and conditions at the October 28 Governing Council meeting. It appears that the October-December period will be one during which the disposition of the PEPP will be considered in light of ongoing changes in pandemic-related trends.

A key issue that will have to be considered in the future is that, while PEPP management is of utmost importance, there must also be discussion about how to manage the Extended Asset Purchase Program (APP; the ECB’s regular asset purchasing framework) after the PEPP’s termination. The PEPP is a framework that does not require compliance with the ECB’s ordinary asset purchasing rules and regulations – PEPP purchases have not been constrained by such regulations as those specifying the upper limit of ECB government bond holdings. When the PEPP is terminated, the application of the ordinary rules and regulations will be recommenced. It is not clear what the ECB’s view is regarding the subsequent regulation of the enormous volume of government bonds it has already purchased via the PEPP. For example, do plans call for separately managing bonds purchased via the PEPP and continuing to consider those bonds exempt from the ordinary rules and regulations going forward? It seems that there will probably be a need to create a rationale for continuing to separately manage assets purchased through the PEPP.

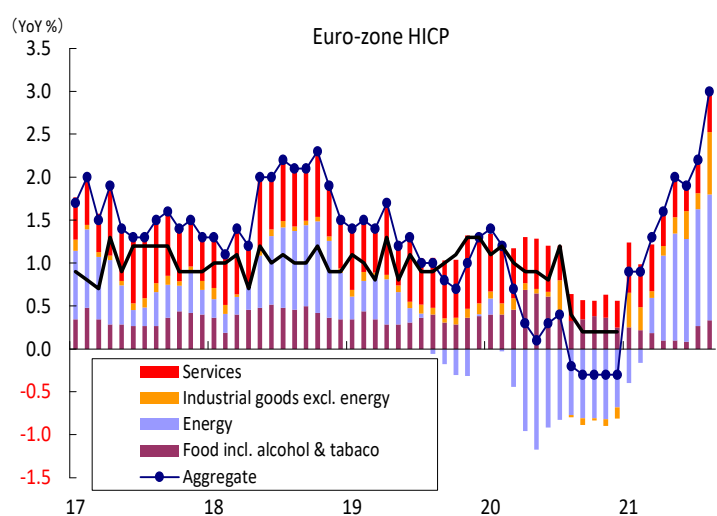
### The Challenge of the relationship between APP and Rate Hikes

Another issue is that the relationship between APP management and interest rate hikes is still unclear. The new forward guidance applied from July allows overshooting of the 2% inflation rate target, but it is focused on interest rates and does not directly relate to quantitative easing measures. The lack of forward guidance on quantitative easing is a problem that cannot be left unaddressed. PEPP-related quantitative easing is subject to the guidance “until [the ECB] judges that the coronavirus crisis phase is over”, and this end point is already in sight, but there continues to be no forward guidance with respect to the APP; the regular asset purchasing program. For the time being, the sequence of policy normalization measures appears to be – “first wind down quantitative easing measures, and then address interest rate levels” – but planning the full-scale winding down of quantitative easing measures is major task that the ECB will have to address from next year. Assuming that smooth progress is made toward improvement in economic conditions, it appears that the earliest dates the ECB might begin addressing this task might be when revised staff projections are released in March 2022 or June 2022.

## The Euro Area Economy Now and Going Forward – Inflation Rates Begin Rising in Europe

### Significant Rise in Inflation Rates

Released on August 31, the comprehensive-basis euro area Consumer Price Index (HICP) for August was +3.0% yoy, the highest level seen in about 10 years (since November 2011). Although this can still be considered a temporary rise amid exceptional circumstances, the height of the rate cannot be ignored as it exceeds the upper limit of economists’ expectations as surveyed by Bloomberg. Moreover, the core basis HICP (excluding energy, food, alcoholic beverages, and cigarettes) was below +1.0% yoy through July, at which time it was still possible to attribute much of the inflation to rising energy prices, but the core basis HICP also increased considerably in August, reaching +1.6% yoy for the first time in about 9 years (since July 2012). It would be difficult for the ECB to completely ignore these trends, and it is probable that the trends were considered as part of the basis for the above-described decision to decelerate PEPP asset purchases.



(Source) Datastream

(Note) Core excl. energy, food, alcohol & tobacco

### The Inside of Prices that Are Difficult to Read

Looking at factors contributing to the HICP rise, one finds that half (1.5 percentage points) of the +3.0% comprehensive basis figure was attributable to increases in energy prices, and it is basically assumed that this was a temporary factor that cannot be expected to continue in the future. However, mining and industrial goods other than

energy also made a large contribution of +0.7 percentage point. For that item alone, the HICP figure was +2.7% yoy, the largest such increase ever recorded, and it appears to reflect that fact that global supply constraints are impacting a wide range of goods beside energy. In addition, reflecting upward pressure on wages, the HICP figure for services was +1.1% yoy, and the contribution of services to the comprehensive basis HICP figure was +0.5 percentage point. The rise in service prices may also reflect a recovery in tourism-related demand in the euro area. By country, conspicuously large overall basis HICP figure mom changes were recorded by France (+1.5% → +2.4%), Italy (+1.0% → +2.6%), the Netherlands (+1.4% → +2.7%), Belgium (+1.4% → +4.7%), and Ireland (+2.2% → +3.1%), indicating that upward pressure on prices is spreading throughout region.

It is worth noting that Germany temporarily reduced the rate of its value-added tax (corresponding to Japan's consumption tax) for half a year from July 2020, and this is clearly a technical factor promoting greater margins of yoy increase in HICP during months in the latter half of 2021. It can be said that the ECB faces considerable challenges in separating such temporary factors from non-temporary factors to attain a realistic assessment of the HICP rate that can serve as a sound basis for making decisions about the PEPP asset purchasing pace. Some observers are expecting supply constraints to be protracted at least through the remainder of 2021, and not everyone would agree about whether such a lengthily protracted situation should be considered an exceptional temporary situation. In any case, the September GC meeting has determined the PEPP purchase pace for the next three months, and given that inflationary pressures are likely to remain strong during those months, it can be said that the decision to decelerate purchases was fully justified.

## Appendix: After Germany's General Election – Two Key Post-Merkel-Era Issues

### *Outcome as Expected*

The results of Germany's September 26 federal parliamentary election (general election) were as expected. According to the election commission's preliminary final results, which became available when this article was written, the Social Democratic Party (SPD) won the most votes (25.7%), Chancellor Angela Merkel's Christian Democratic Union Party and Christian Social Union in Bavaria Party union (CDU/CSU) had the second most votes (24.1%), and the Greens environmental party, which was leading the polls until early spring, remained in third place (14.8%). The CDU/CSU union has been Germany's runner-up party in terms of votes since 2002, and its share of votes in the latest election was the lowest recorded since it was formed. In addition, the industry-supporting Free Democratic Party (FDP) won 11.5% of the votes, the right-wing populist Alternative for Germany (AfD) party won 10.3%, and the formerly Communist Party-affiliated Left Party (Die Linke) won 4.9%. While discussions about the formation of a ruling coalition had not yet been finalized when this article was written, observers generally think it likely that a SPD/Greens/FDP coalition (commonly known as a "traffic light" coalition as those parties' traditional colors are red, yellow, and green, respectively) will be formed, in which case the most promising candidate to become the next chancellor appears to be SPD leader Olaf Scholz, who is currently serving as vice-chancellor and finance minister in the Merkel administration. If a traffic light coalition is established and Chancellor Merkel retires from politics, her political party (CDU/CSU) can be expected to disappear from Germany's political spotlight.

### *Two Key Challenges Facing the Next Government*

No matter what kind of ruling coalition may be formed, the next government will face numerous challenges in the post-Merkel era. As it would be impossible to list all those challenges in this short article, I would like to focus here on two particularly important challenges – the political/diplomatic task of "reforming relations with China" and the economic task of "reexamining wealth distribution within the euro area". There is a particularly high level of global interest in how Germany will address the first of those tasks. Since Merkel's prospective retirement was first reported in October 2018, there has been a lively debate about how Germany's next government should deal with China. Germany-China relations have progressively deepened during the 16 years of Merkel-led governments, and Germany has often been criticized for diplomatically currying favor with China during that time period. On the other hand, this approach has generated benefits for Germany's economy, particularly its automobile industry, and many consider Germany's closer ties with China to be the Merkel-led governments' greatest legacy. However, it cannot be denied that managing Germany-China relations going forward may become one of the next government's most burdensome tasks.

### *Criticism of Germany Regarding the EU's CAI Agreement with China*

At this point, I would like to discuss some aspects of the Germany-China relationship in greater detail. Many of Merkel-led governments' diplomatic policies have placed heavy emphasis on human rights issues, but as the EU and China moved ahead with discussions of their Comprehensive Agreement on Investment (CAI) it became clear that such issues were not necessarily paramount with respect to China. The EU and China had been engaged in protracted negotiations regarding the CAI since early 2014, and they suddenly reached a general agreement in principle at the end of December 2020. The CAI talks, held online, brought together top-level China and EU leaders, including Chinese President Xi Jinping, European Council President Charles Michel, European Commission President Ursula von der Leyen, German Chancellor Merkel, and French President Emmanuel Macron. This participation by such top-level figures makes it obvious how important a comprehensive investment agreement to improve the investment environment for European companies in China is for both the EU and China.

However, the CAI has been criticized by the international community for a variety of reasons. The worst aspect of the CAI appears to be the explicit significance of the timing of its finalization – just before the January 2021 inauguration of the Biden administration in the United States and just before the end of Germany's six-month term holding the

Presidency of the Council of the European Union at the end of 2020. It is widely considered indisputable that the CAI was quickly finalized based on a political calculation that strengthening EU-China relations after the inauguration of the Biden administration (expected to emphasize human rights) would be more-difficult owing to US-China frictions. It is also considered possible that the EU wanted to finalize the CAI while pro-China Germany was holding the EU Council Presidency. After its sudden finalization, the CAI was criticized as being an agreement that was railroaded in a rushed manner by Chancellor Merkel to avoid US input.

**Questionable Sustainability of Emphasizing Money over Human Rights**

Besides the background of CAI-related negotiations, there are numerous other factors that reflect the depth of Germany-China ties. For example, Germany-China intergovernmental talks have been held once every two years since 2011, the leaders and ministers of both countries undertake visits to the other country every year, and many business talks are concluded in connection with those visits. China’s forceful approach to such issues as those associated with Hong Kong and the Xinjiang Uygur Autonomous Region have been drawing growing attention, however, making it increasingly difficult to maintain close diplomatic ties with China, as the maintenance of such ties has been criticized for reflecting a diplomatic stance that emphasizes money over human rights. The fact that Germany has been able to successfully orchestrate such a diplomatic stance despite US-China frictions is largely attributed to Chancellor Merkel’s skills and power, and it is expected that Germany’s next chancellor may lack the requisite political resources to easily sustain such a stance. The European Parliament has indicated that, emphasizing human rights issues, it will maintain a strict attitude toward China while suspending its ratification of the CAI. While Chancellor Merkel will soon retire, the European Parliament has adopted this posture while she is still in power.

The Merkel government has seemed to be gradually distancing itself from China in recent years, but it will not be easy to make substantive changes to Germany-China relations owing to the countries’ close economic ties centered on the automobile industry. In 2020, more than one in three luxury cars produced by German automobile companies was sold in China (see chart), and it would clearly be quite painful for those companies to scale back their presences in the huge Chinese market. Ideally, Chancellor Merkel might have set some strict limits to Germany’s relations with China during her 16-year tenure so that she could hand over an optimally balanced relationship to her successor, but that did not happen. Germany’s post-Merkel leaders are expected to face considerable challenges working within the rather narrow leeway she left behind with respect to the negotiation of the country’s relations with China.

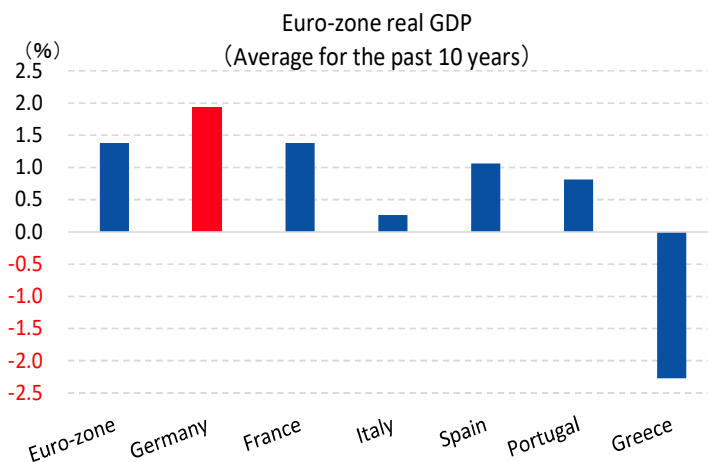
Sales by Germany's 3 largest automakers in 2020 (10,000 units)

	Mercedes-Benz (※)	VW	Audi	BMW
Worldwide sales	220.26	911.52	169.28	232.52
China	77.94	384.47	72.74	77.84
Ratio of China (%)	35.4%	42.2%	43.0%	33.5%

(Source) Prepared by Karakama from each company’s materials  
 (Note) Mercedes-Benz: passenger cars

**Risks of a German “Winner-Takes-All” Approach**

While Merkel-led governments have faced a series of serious crises (debt, refugees, pandemics) during the past 16 years, those governments’ promotion of the theory that individual EU countries should take responsibility for their own economic and financial problems was particularly significant in that it promoted turmoil in financial market during the European debt crisis in the early part of the previous decade, and those governments have also been widely criticized for promoting a rightward shift in regional politics. There has been a considerable economic performance gap between Germany and other euro area countries over the last decade, and it seems quite dangerous to allow a trend of increasing inequities to proceed within a group of countries that share the same currency and the same monetary policies. While much of Germany’s economic success can be said to be a justifiable result of steady structural reform implementation by Gerhard Schröder-led governments from 1998 through 2005, the continued widening of disparities within the euro area is generating a strong perception of unfairness and intra-regional discord. It generally acknowledged that such disparities have promoted the popularity of increasingly extreme political positions in other EU member states. In light of that, it can be said that, ideally, Germany should moderate its stance regarding EU member states’ self-responsibility obligations and adopt a more-positive attitude toward intra-regional resource redistribution measures.



(Source) Datastream (Note) Average from 2009 to 2019



However, Chancellor Merkel did not ultimately remain opposed to intra-regional redistribution measures. In 2020, she personally became involved in efforts to convince the “Four Frugal Countries” (the Netherlands, Austria, Sweden, and Denmark) to go along with the establishment of the EU reconstruction fund, a joint fund for promoting post-pandemic economic recovery throughout the euro area. In May 2020 Chancellor Merkel stated that “the most serious crisis of the EU’s history” required an appropriate response (the reconstruction fund) and, as she had consistently promoted the principle of self-responsibility up to that time, some news media reported that her promotion of the reconstruction fund represented a 180-degree change in her position on self-responsibility.

The key question is whether Germany’s next government will be able to sustain this 180-degree change. As a euro area member, Germany has greatly benefited from an undervalued currency, inexpensive labor from Eastern Europe, and easy access to markets throughout the euro area. If other euro area countries were to adopt the kind of austerity measures that have been instituted in Germany it would greatly decrease euro area sales of German products. That would be a terrible situation for Germany, as more than half the country’s exports are sold in EU markets. This illustrates the truism that “Germany can be Germany because other countries are not Germany”, and it is hoped that the next German government will fully take into account the significance and ramifications of that truism. It is to be hoped that Germany will play a leading role in promoting EU reforms that augment intra-regional redistribution systems, such as initiatives to authorize euro area joint bond issuance and the establishment of a euro area treasury department – promoting such reforms will also be beneficial to Germany itself as they will reinforce its position as the leader among euro area countries in both name and reality.

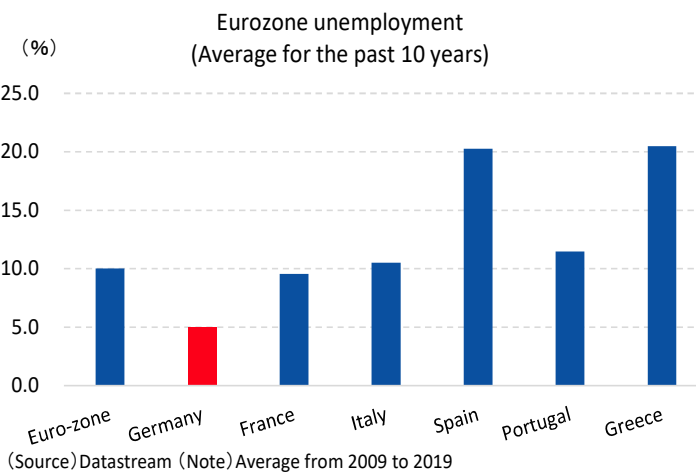
#### *Merkel’s Retirement Marks the Start of a New EU Era*

This article has focused on just two of the challenges the next German government will face – relations with China and intraregional resource redistribution – but the next German government will of course have to address many other challenges, such as “how to promote economic de-carbonization despite being a powerhouse automobile manufacturer”, “how to transform the country’s industrial structure going forward”, and “what kind of business models can Germany build that will be suitable for the upcoming new era”.

Germany also has to consider how to deal with widening domestic disparities, which have been regarded as an increasingly serious problem in recent years. In light of the turmoil in Afghanistan, Germany cannot ignore its smoldering domestic problems associated with refugees. Given that the Merkel government’s popularity was progressively impacted by its problematic refugee-related policies, the transition to a new government should be considered an opportune time to carefully reconsider such policies.

On the other hand, many EU leaders are concerned that the loss of Chancellor Merkel’s powerful presence will have a negative impact on the EU’s ability to expeditiously make decisions. Her political power has been conducive to the consolidation of support for important EU decisions in the past, and there is a possibility that individual EU members will become less inclined to coordinate their policy positions in the future. The departure of the United Kingdom’s has increased centripetal forces within the EU, and a decline in Germany’s ability to play a leadership role is likely to further undermine the EU’s cohesiveness. The results of Germany’s recent election should be leveraged as an opportunity to signal the beginning of a bright new era for Germany as well as for the EU as a whole.

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.”