Forex Medium-Term Outlook

October 29, 2021

MIZUHO

Overview of Outlook

USD/JPY rose significantly in October. In this report, including in last month’s edition, I have maintained that the weak-JPY scenario will not change until the situation in Japan improves, and that there is no point analyzing the situation elsewhere while the situation at home is in a shambles, and it seems that my understanding is correct for the time being. It is true that the global economy is dealing with such post-pandemic challenges as supply constraints and rapid rise in inflation, with even the trusty U.S. economy forced to downgrade its economic growth forecasts. However, Japan is still struggling with the pandemic, having not yet entered the post-pandemic phase. There are no signs of Japan closing its growth rate gap with its international counterparts, which is resulting in monetary policy gaps and, therefore, interest rate gaps. All this is creating a situation conducive to JPY selling, which, when combined with the trend of selling Japanese shares, is indicative of investors deserting Japan in view of its wretched growth rate. Further, the combination of a weak JPY and the rise in resource prices is beginning to give rise to concerns of a new JPY-depreciation factor, namely trade deficits. If high resource prices become normalized amid the new decarbonization trend, expanding trade deficits could further contribute to the weak-JPY trend. There is not much Japan can do to counter this situation, but if the Kishida administration were to follow in the footsteps of the U.S. and European nations in deciding to “live with” the pandemic and focus on recovering growth rates, the markets’ appraisal of Japan could change for the better. Another factor that could help contain JPY depreciation is the BOJ hinting at policy normalization on the pretext of preventing inflation. As of the writing of this report, however, neither of these seem highly probable.

Meanwhile, the EUR rate trend saw a reversal in October. It is difficult to pinpoint any one reason for this, but perhaps investors are reevaluating EUR amid an overall increase in euro area interest rates alongside the increase in U.S. interest rates. Moreover, the ECB is steadily promoting policy normalization (though slightly lagging behind the Fed), and there is rock-solid demand for EUR backed by the world’ largest current account and trade surpluses. Take these factors together, and the underlying strength of EUR is not very surprising. While it is necessary to pay attention to how the European mainland responds to the rise in infections in the UK as winter starts, regional inflation has been persistently high, and the ECB is expected to make a decision before the end of the year to terminate its pandemic emergency purchase programme (PEPP). Of course, some other asset purchase program could replace the PEPP, which means that rate hikes may be a long way away even if exit from QE is successfully achieved. In this respect, the ECB’s policy normalization process is significantly inferior to that of the Fed, and the resulting policy gap is likely to exert downward pressure on the upper bound of EUR/USD. Meanwhile, compared with Japan (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 the pandemic, so EUR/JPY is expected to remain strong. In Germany, the fiscal policy actions of the new administration, to be inaugurated within the year, will be worth paying attention to.

Summary Table of Forecasts

	2021 Jan -Oct (actual)	Nov-Dec	2022 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	102.60 ～ 114.69 (113.44)	112 ～ 116 (114)	112 ～ 117 (115)	113 ～ 118 (116)	113 ～ 118 (117)	114 ～ 119 (118)
EUR/USD	1.1522 ～ 1.2349 (1.1682)	1.14 ～ 1.18 (1.16)	1.13 ～ 1.17 (1.15)	1.12 ～ 1.16 (1.15)	1.11 ～ 1.15 (1.14)	1.10 ～ 1.15 (1.13)
EUR/JPY	125.10 ～ 134.12 (132.59)	130 ～ 136 (132)	130 ～ 136 (132)	130 ～ 137 (133)	131 ～ 138 (133)	132 ～ 139 (133)

(Notes) 1. Actual results released around 10 am TKY time on 29 October 2021. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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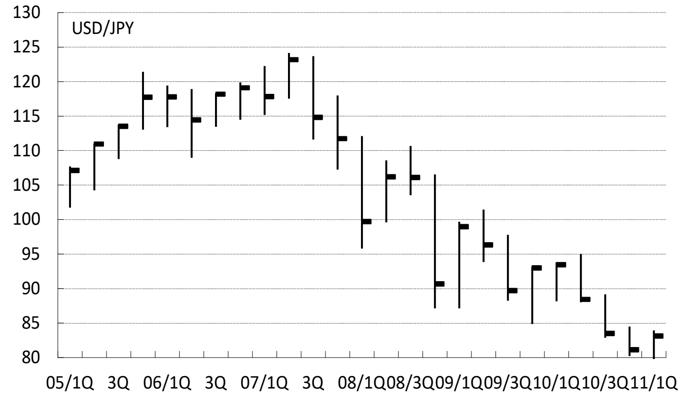
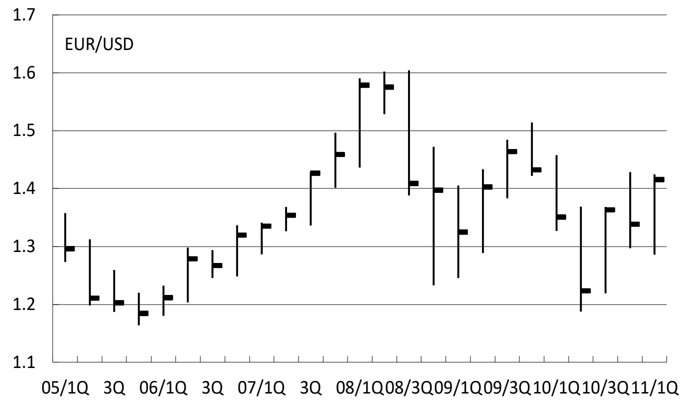
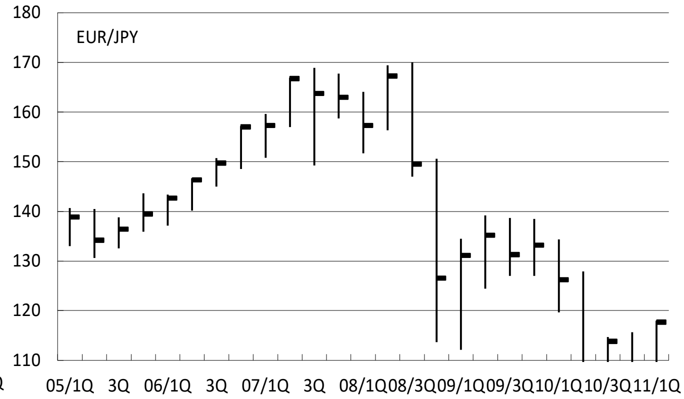
Exchange Rate Trends & Forecasts







USD/JPY Outlook – Overcoming Undesirable Weak-JPY Trend Requires Shifting Focus Away from New Case Numbers

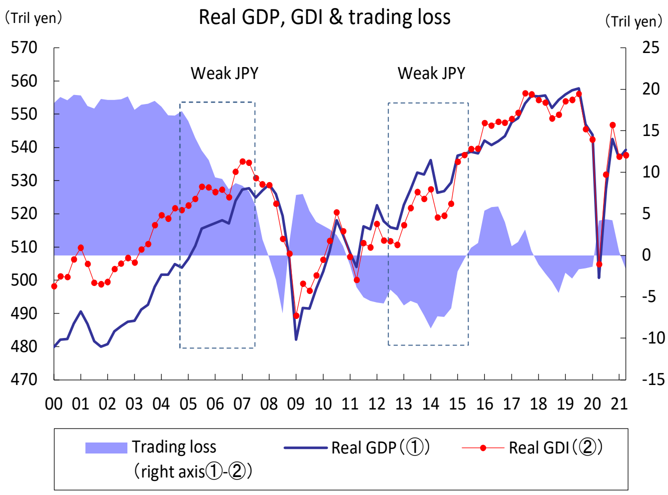
Japanese Economy and JPY Now and Going Forward – Undermined by Weak JPY

JPY Weakness – Undeniably Undesirable

USD/JPY rose to 114.54 at one point in October. This recent JPY depreciation is an undesirable trend no matter how one looks at it. In this report, I have been stressing right since 2013, when Abenomics was at its peak, that JPY depreciation without a commensurate increase in exports would have no sustainable positive impact on the economy. This is because economic recovery led by JPY weakness and share price strength often accompanies an outflow of income and results in what is ridiculed as “an economic expansion without any tangible benefits.” This was true both of the 71-month economic expansion phase under Abenomics (from November 2012 to October 2018) and the 73-month, longest unbroken phase of postwar economic expansion (the “Izanami boom”) before that under Prime Minister Koizumi Junichiro (from February 2002 to February 2008). It is somewhat vague what allows the general public to feel the benefits of an economic expansion, but perhaps the employment and wage situations are the most tangible indicators. Under Abenomics, there was a remarkable recovery in the number of new jobs, but income recovery (wages) was disappointing.

The Real Nature of an Economic Expansion Without Tangible Benefits

In this context, the real gross domestic income (GDI) is an indicator of the domestic income situation in real terms. Real GDI is a concept that adds (subtracts) trading gains (losses) to the real gross domestic product (GDP). Trading gains arise when the terms of trade (export prices ÷ import prices) improve, and trading losses arise when the terms of trade deteriorate (the change in margin is computed with reference to a base year). A deterioration in the terms of trade indicates that companies are unable to pass on any increase in purchasing prices through sales prices, thereby resulting in lower corporate profits. For the macroeconomy as a whole, this is equivalent to the outflow of income from the country. There is no need to explain how this situation might make it difficult to generate sustainable improvement in employment or wages.

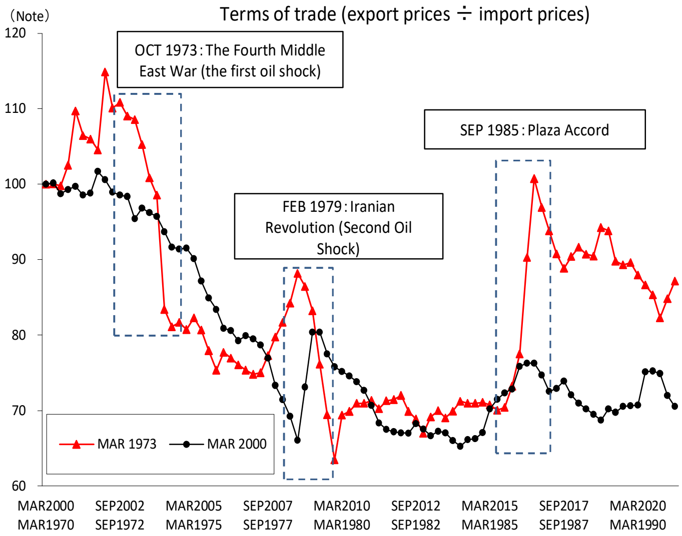


(Source) Cabinet Office

For instance, during weak-JPY phases since the 2000s, trading gains shrank (during 2005-07) and/or trading losses expanded (2013-15). The increase in import prices as a result of a weak JPY caused the terms of trade to deteriorate and depressed the growth of real GDI. In particular, from 2012 onward, during the peak of Abenomics, the income indicator, real GDI, was clearly seen to be lagging behind the economic production indicator, real GDP. <u>The gap represents trading losses and is, I believe, the main reason for the lack of tangible benefits despite apparent economic expansion</u>. One cannot ignore the fact that one of the factors of an economic expansion without tangible benefits is a deterioration in the terms of trade (i.e., trading losses).

Trading Loss Expansion Follows Expected Path

On the other hand, as the figure above shows, JPY rates did not change much during the pandemic starting spring 2020, and the steep fall in resource prices led by crude oil significantly improved the terms of trade, resulting in trading gains. For countries that import natural resources, even if forex rates remain unchanged, the terms of trade can improve or deteriorate depending on commodity prices. <u>In other words, Japan's terms of trade deteriorate when either JPY depreciates or crude oil prices increase</u>.



(Source) Cabinet Office

(Notes) MAR1973 & MAR2000=100
Estimated from the seasonal adjustment series of nominal and real GDP from 1955 to 1979

The figure uses two starting points (March 1973 and March 2000) to analyze terms-of-trade index trends, and confirms that forex rate and crude oil trends have played key roles. Trading losses, which expanded during the two oil shocks of 1973 and 1979, were absorbed by JPY appreciation following the Plaza Accord. Of course, we are looking only at the terms of trade here. As is well known, the extremely strong JPY following the Plaza Accord resulted in a range of shocks to the economy, and it would be incorrect to conclude that the strong JPY was a great thing. However, its one beneficial effect was that it led to a recovery in the terms of trade (of course, the strong JPY was not the only reason).

We have not experienced any dramatic changes in the terms of trade since the turn of the century similar to the oil shocks or the Plaza Accord, but if we were to take the recent decarbonization trend to be a turning point in mankind's energy revolution, it would not be surprising to see a similar dramatic change in the terms of trade happen again. Looking at things from this point of view, <u>the recent combination of JPY depreciation and crude oil price increase – both factors leading to a deterioration in Japan's terms of trade – is alarming, and it may be wise to assume that the trading losses are sure to expand for some time to come</u>. And as described above, an expansion in trading losses translates to lower real GDI, so it seems an economic expansion that results in greater life satisfaction will be further delayed. Already, there are economic phenomena signaling this – such as the increase in JPY prices of imported goods such as the iPhone, foreign cars and watches. Going forward, one cannot rule out the possibility of a similar rise in prices of everyday products – typically gasoline prices. Prices at gasoline stands in the city are already close to twice what they were a year ago. This is effectively an additional tax when it comes to real economic performance.

Good Opportunity for BOJ to Normalize Policy

It is impossible to significantly correct a situation closely linked to commodity and forex market developments through domestic macroeconomic policy (all one can do is attempt to lessen the damage to specific industry sectors through government subsidies). However, that does not mean nothing can be done. I think this would be a good opportunity for the BOJ to hint at the possibility of policy normalization, even if only as a pose. Historically, the BOJ, while pointing out the adverse effects of excessive monetary accommodation, has never brought up policy normalization, mainly for fear of JPY appreciation. This is because the BOJ's monetary easing decisions have often gone hand-in-hand with strong JPY and weak share price phases. Such decisions were, in fact, appropriate in times when Japan's export volume was positively correlated with JPY weakness. However, under Abenomics, exports remained mostly unchanged even though USD/JPY increased by over 50%. This indicates a lack of improvement in the trade balance despite JPY weakness, with the only result being an outflow of income. In recent years, the correlation between USD/JPY and the Nikkei Stock Price Average has also become unstable, so that the wealth effect of a weak JPY is also milder than it used to be. If the BOJ has to exit its current policy at some time, then the present time seems like a good opportunity.

In the past year and a half, the Japanese economy has fallen significantly behind the European and America economies. Key central banks around the world are already a step or two ahead of the BOJ in terms of policy normalization. At such a time, especially given the low focus on the BOJ in the financial markets, a hysterical reaction to the BOJ hinting at monetary austerity (something that might have happened in the past) seems unlikely. I think it might be worth taking some action, even if it is simply to indicate that policy normalization is being considered, if there is a possibility of helping contain JPY depreciation even slightly. Policymakers are given a hard time when they take action after the markets have sensed their impatience. If JPY begins to weaken after market participants become aware that this could be a blow to the Japanese economy, the authorities may be faced with aggressive bulk selling of the currency. Once that happens, there is very little that can be done. The authorities, not limited to the BOJ, must begin to consider small ways to contain excessive JPY depreciation now, while the damage is still slight. That is how precarious the position of the Japanese economy is.

The Japanese Economy Now and Going Forward – The Need of the Hour is to Shift Focus Away from New Case Numbers

A Reasonable Pace of Slowing May Actually be Good News

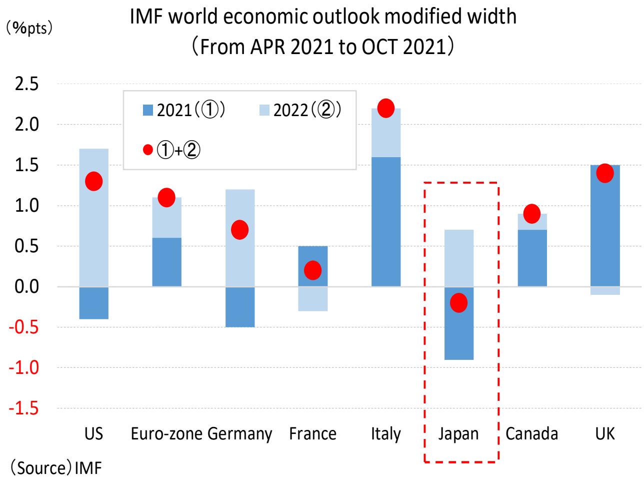
The fall edition of IMF World Economic Outlook (WEO) published in October downgraded growth forecasts for the world economy as a whole. This edition of the report was subtitled "Recovery During a Pandemic – Health Concerns, Supply Disruptions, and Price Pressures," neatly listing the current risk factors. Note that the three risk factors mentioned are mutually correlated in that the spread of the Delta variant could disrupt global supply networks, resulting in demand in excess of supply, thereby pushing up prices. No region in the global economy is immune to these risks – even the U.S. and UK, which have so far been unstoppable, had their growth rate forecasts for 2021 downgraded (from +7.0% for both to +6.0% and +6.8%, respectively). Nevertheless, both these economies are powering ahead at twice their potential growth rates, and given the concerns of rising inflation, a slight decrease in the pace of growth may actually be good news for them. The growth rate for the world economy as a whole has been downgraded from +6.0% to +5.9%, but even at +5.9%, it is still the highest growth rate recorded since 1980, the first year for which data is available. There seems no need for excessive pessimism, therefore.

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

	2020	2021		2022	
	Actual	As of JUL	As of OCT	As of JUL	As of OCT
US	-4.7	7.0	6.0	5.2	5.2
Euro-zone	-6.6	4.6	5.0	4.3	4.3
Germany	-4.9	3.6	3.1	4.1	4.6
France	-8.2	5.8	6.3	4.2	3.9
Italy	-8.9	4.9	5.8	4.2	4.2
Japan	-4.8	2.8	2.4	3.0	3.2
Canada	-5.4	6.3	5.7	4.5	4.9
UK	-9.9	7.0	6.8	4.8	5.0

(Source)IMF "World Economic Outlook"(OCT 2021

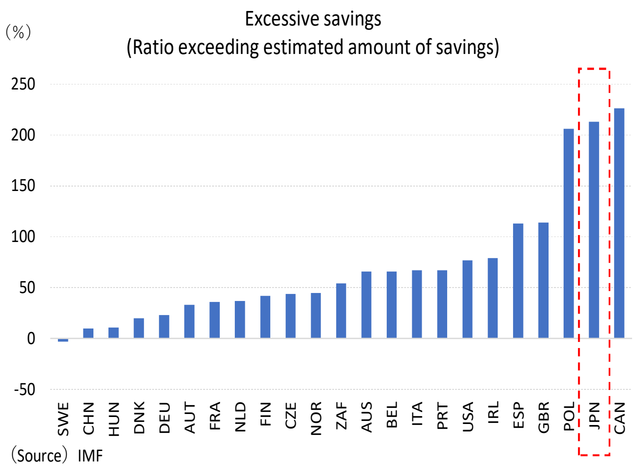
Japanese Economic Deterioration on Another Level



(Source) IMF

The 2021 growth rate forecast for developed economies overall has been downgraded from +5.6% to +5.2%, but the large part of this is due to the -1.0pp downward revision of the U.S. economy's growth prospects. Other significant downward revisions include forecasts for Germany and Japan, the former downgraded by -0.5 pp from +3.6% to +3.1%, and the latter downgraded by -0.4pp from +2.8% to +2.4%. As for the reason for the downgrades, in the case of the U.S., the large inventory drawdowns during the April-June quarter and softening consumption in the July-September quarter have been pointed out. In Germany's case, the shortage of key inputs has impacted production activity overall – as always, its domestic manufacturing industry is Germany's strength as well as weakness. <u>In the case of Japan, meanwhile, the "effect of the fourth State of Emergency from July to September" has been pointed out, indicating that the deterioration of the Japanese economy is on a different level altogether compared to the risks faced by other world economies</u>. The uniqueness of the Japanese position is obvious even from the trend of forecast revisions. The figure on the previous page compares the margin of 2021 and 2022 forecast revisions for G7 nations (from April to October). <u>Taking the margin of revision of the 2021 forecast to be (1), and that of the 2022 forecast to be (2), the sum of (1) and (2) is negative only for Japan</u>. In other words, twists and turns notwithstanding, most developed countries have been powering ahead at a better pace than expected since early spring, but not Japan.

As World Faces Post-Pandemic Challenges, Japan is Still Struggling with the Pandemic



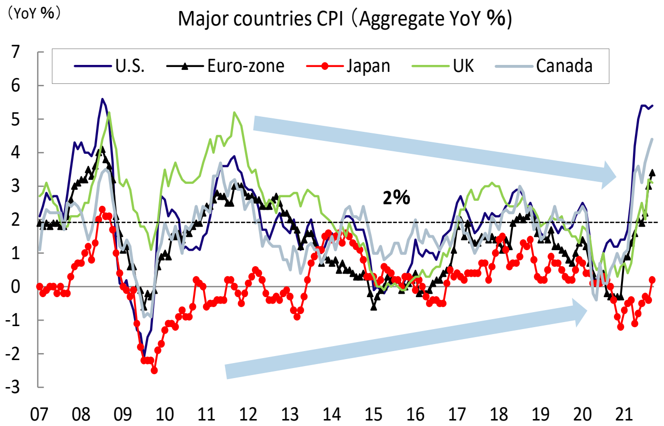
(Source) IMF

If infections are not expected to rise further, the focus for the world economy going forward will be on the extent of supply chain recovery. The resolution of the supply chain disruptions and the extent to which this can absorb the excess demand will determine inflation trends going forward. The recent edition of the WEO predicts that inflation rates will settle within the pre-pandemic range by mid-2022. Even taking into account that the IMF's predictions tend to be on the conservative side, it seems likely that the current situation will continue at least for the next half a year. Incidentally, the excess savings accumulated by the private sector during the pandemic are fueling recent inflationary pressures. Supply constraints are a problem, but unfortunately, it is the explosion of demand, rooted in these excess savings, that is compounding the problem and increasing inflationary pressures.

As the figure shows, developed countries have a significant level of excess savings, and to that extent, there is scope for an increase in demand. Further, if we use the IMF's estimates of excess savings by country, Canada is at the top, with Japan in second place, with around twice (approx. 200%) the level of excess savings recorded in the past. However, <u>the difference between Japan and the rest of the world is that the former has not yet reached the phase where people want to use their savings</u>. Despite the high level of savings in Japan, there are no signs of robust growth in consumption/investment; rather, the growth rate seems to be spiraling down. What could be the reason behind this? There could be several reasons, but the bottom line is that there seems no hope for growth. It seems symbolic that the IMF, having pointed out the disruption of supply networks and the rapid rise in inflation as risk factors for the world economy, points out the "effect of the fourth State of Emergency from July to September" in the case of Japan alone. <u>In contrast to the rest of the world, which is facing post-pandemic challenges (supply chain disruptions, rapidly rising inflation, excess demand, etc.), Japan is still struggling with the pandemic</u>. This is ironic considering that Japan has now overtaken the UK in terms of vaccination rates and entered the league of the most vaccinated nations. It has also maintained extremely low death rates. It seems undeniable that Japan's characteristic pandemic-prevention strategies have been self-defeating.

Administration's First Move to Revise Distance from Subcommittee will be of Interest

Looking back at the forex markets this year, JPY is the only currency to remain weak throughout. I believe the biggest reason the Nikkei Average is conspicuously lagging behind in the stock markets is because of investors avoiding Japan in view of the aforementioned real economic situation. Given how synchronized the economic cycle in the rest of the world seems to be, Japan's weak performance stands out all the more. Growing concerns that a weak JPY could undermine the Japanese economy make the recovery of economic growth rates imperative for Japan. The uniqueness of the Japanese situation is quite obvious when you compare inflation trends, for instance. While Europe and the U.S. are experiencing such rapid rise in inflation for it to be seen as a risk factor, prices in Japan remain sluggish (see figure). Even after factoring in the lowering of mobile phone charges, the gap between prices in Japan and elsewhere is still too stark. As I explained in last month's edition of this report too, it would seem that this situation is the result of conflating/mistaking the means (high vaccination rates) for the end (economic normalization). <u>Efficiently ending this conflation of means and end and putting the economy on a growth track similar to the U.S. and Europe will be the first challenge for the new Kishida administration</u>. Income redistribution and taxation of financial income as a means to achieve this tend to make the headlines, but as most people will understand, pandemic policies have to be the main focus in the near term.



(Source) Bloomberg

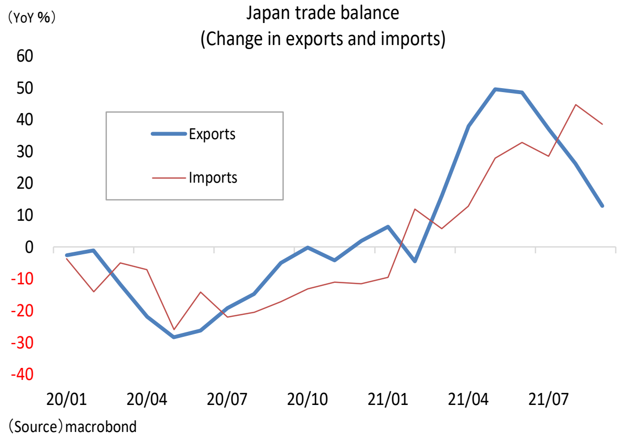
Specifically, the touchstone for the Kishida administration will be to see until when the emergency restrictions, which were fully lifted in late October, remain lifted (or rather, will it be possible to avoid declaring yet another emergency going forward). <u>The secret to not sliding back into emergencies is to shift the focus away from new case numbers</u>. If an administration's approval rate hinges on new case numbers, no administration can remain stable, regardless of who the prime minister is. Former Prime Minister Yoshihide Suga's administration may have received a new lease of life he had waited two more weeks to resign, because new case numbers would have dramatically declined by then. The subcommittee on the novel coronavirus (hereafter "Subcommittee") exists to advice the government on COVID policies and prevent political turmoil, but its proposed solutions have consistently been to impose movement restrictions based on the logic that human movement must be restricted if new case numbers are to be contained. If it were true that movement restrictions were key to containing the spread of infections and, therefore, to reviving the economy, how does one explain the powering ahead of the U.S. and European economies at over twice their potential growth rates since restoring normalcy in early spring?

Although the Subcommittee will not openly admit this, it has acknowledged that the reasons for the rise or fall in infections are not entirely clear. <u>Given that reasons are not clear, the Subcommittee must revise its fundamental stance of sacrificing the economy by putting the responsibility for the rise in infections on human movement. Otherwise, the Japanese economy will remain depressed as a result of its proposed strategies</u>. A lack of overarching strategy cannot be made up for with great tactics on the ground. A country may have the best tactics imaginable in the form of the world's fastest pace of vaccinations, but the prospects for recovery in growth and prices are bound to be nonexistent if it stubbornly insists on strengthening movement restrictions based on the notion that human movement is to blame for the spread of infections, while refusing to even consider a roadmap for an exit from this state of affairs. Taking all this into account, <u>it will be important to see how the new administration post the general election revises its distance from the Subcommittee as part of its pandemic countermeasures</u>. Depending on how this relationship changes, the government's pandemic countermeasures could be steered in a direction more conducive to realizing economic growth. This could result in a more positive evaluation from the stock and other financial markets, thereby slowing the trend of JPY depreciation, which is considered a part of the Japan avoidance trend.

JPY Supply-Demand Balance – New JPY-Selling Factor

Increase in Imports has just Begun

As described above, one of the factors behind the recent JPY depreciation seems to be JPY avoidance by investors disappointed in the Japanese economy, but another clear factor promoting JPY selling has recently entered into the equation – JPY supply and demand. Japan's September trade statistics revealed a growth in exports by +13.0% yoy (at JPY 6.8412 trillion), but imports had grown by +38.6% yoy (at JPY 7.4640 trillion), resulting in a trade deficit for the second month in a row at -JPY 622.8 billion. Export growth was affected by the fall in the pace of car exports, while import growth was boosted by the increase in crude oil, coal, and other resource prices. Over 30% of the extremely large, +38.6% increase in imports was owing to mineral fuel prices (contribution +13.2 pp). Taking recent developments into account, the structure of the September trade balance seems to be just the beginning of a trend (details later).

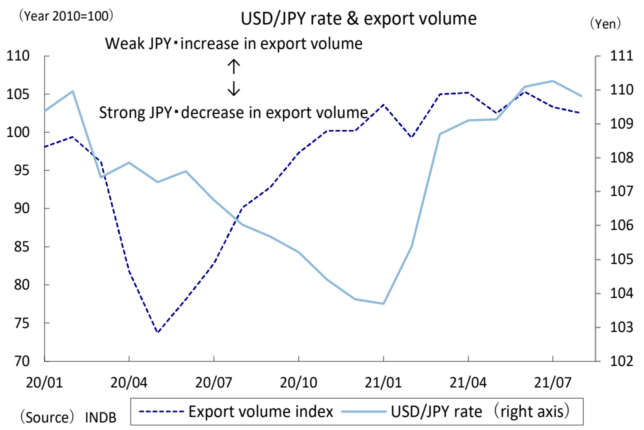


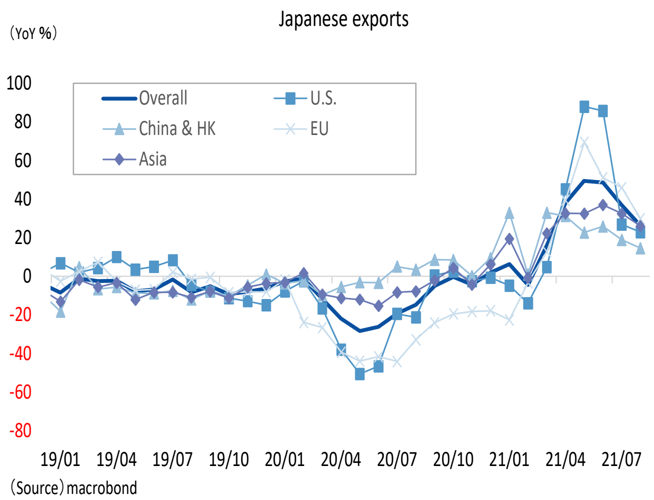
Since early this year, Japan had been posting trade surpluses. This was because of an increase in exports, driven by robust overseas demand, combined with slow import growth amid sluggish domestic demand. This reflects the difference between Japan and other countries – while other nations' pandemic policies involved using vaccination rates as a means to achieve their goal of normalizing social activity, Japan lost sight of the final goal even as it focused excessively on raising vaccination rates. <u>Looking back at the past year or so, the export growth rate has been significantly larger than the import growth rate, resulting in trade surpluses (see figure)</u>. The trade surpluses were not great news, as they were posted on the back of shrinking domestic demand. <u>However, having peaked in April, the gap between the export vs. import growth rates began to shrink, with import growth overtaking export growth in August, and the trend continuing in September. Meanwhile, USD/JPY and crude oil prices began to rise sharply in late September and further accelerated in October</u>. Now, forex and commodity price trends are reflected in trade statistics with a delay of two to three months thanks to forex and commodity hedges, so, any change in crude oil prices, for instance, gets reflected in mineral fuel imports with a delay of two months or so. Therefore, <u>one can expect that Japan's imports will increase extremely sharply during the October-December quarter, reflecting the recent forex and commodity price trends</u>.

Peaking of Exports, JPY Supply & Demand Tilting Toward JPY Selling

If exports were to be revived by the weakening of JPY, the deterioration of the trade balance could be limited, but it is doubtful whether that will happen. As I have repeatedly said in this report, <u>Japan is no longer a country that can increase its exports through a weaker domestic currency. USD/JPY has increased by close to 10% since the beginning of the year, but exports have remained flat and even show subtle signs of peaking</u> (see figure to the right, top). The increase in exports seen since last year were a transient development owing mainly to the recovery of overseas economies, so growth in exports going forward is bound to be more modest (the way it is to begin with). Looking at it by country/region (figure to the right, bottom), the pace of exports has fallen with respect to all regions, but the slowdown is most marked in the case of exports to the U.S. This is against the backdrop of a significant cooling of the U.S. economy thanks to supply disruptions and other factors. Going by the IMF's projections, this situation will continue until mid-2022, so this fate of Japanese exports can be expected to continue until then at least. A similar trend is observable with regard to the EU, even though not to the same extent. Meanwhile, with the Chinese economy in turmoil, the growth in exports to China is already conspicuously lower than elsewhere.

To summarize <u>Japan's trade balance prospects for the time being, it seems a given that growth in exports will continue to slow while growth in imports increases sharply, thereby continuing a deteriorating (expansion of trade deficit) trend. Too many factors are contributing to JPY selling. The trade surplus was one of the few factors contributing to JPY appreciation, but it is also beginning to collapse. These are all important points to take into account when formulating the JPY outlook</u>.





U.S. Monetary Policies Now and Going Forward – How to View Policy Normalization in Midst of Supply Constraints

The Malaise (Supply Disruptions) vs. the Prescription (Rate Hikes)

On October 22, San Francisco Federal Reserve Bank President Mary Daly said that the rapid rise in inflation rates were being driven by global supply chain disruptions, and that not raising interest rates was the right course for monetary policy at the present time. "Just because we are standing pat, being patient, is not the same as being asleep," Daly said, explaining that raising rates at the present time would not resolve global supply-chain issues but could stand in the way of economic growth in 2022, as it would cost the economy in terms of both output and jobs. This point, namely that there is a slight disconnect between the malaise (supply disruptions) and the prescription (policy normalization), is increasingly clear to many. It is true that raising interest rates is not going to boost the production of semiconductors, or make up for the shortage of truck drivers, or unclog the ports and make them usable again.

Raising the interest rates will, however, cause demand to contract, thereby lessening the damage from supply disruptions (i.e., demand in excess of supply) by helping to keep inflation in check. <u>However, this strategy amounts to a balanced contraction, which comes at the cost of job and wage growth. The question then is – is policy normalization so urgent as to warrant the price</u>.

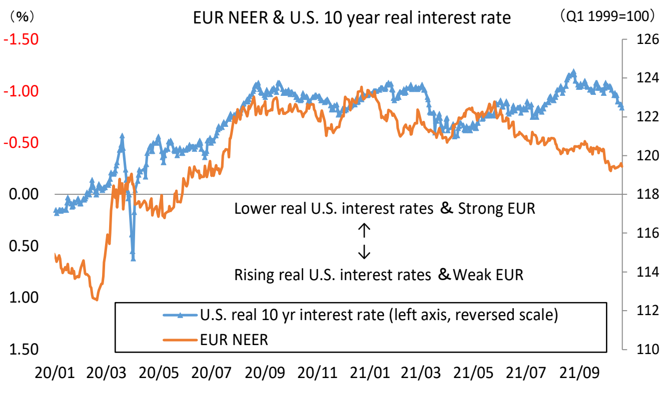
Will Powell Back Daly?

<u>If Fed Chair Jerome Powell backs the remarks by Daly, U.S. interest rates will fall, and forex and other financial asset price outlook scenarios will change</u>. However, the normalization process seems likely to continue. As indicated by the IMF in its WEO, supply disruptions are expected to be resolved after peaking in mid-2022. Assuming the resolution of supply disruptions by mid-2022, a variety of other risks should also be alleviated after that point, making it quite easy for the Fed to end its tapering of quantitative easing (QE) by the end of 2022 and begin rate hikes around the same time, as per the currently expected scenario. Based on this assumption, the IMF predicts a +5.2% growth for the U.S. in 2022, which is over 1.5 times the assumed potential growth rate. <u>If such high growth rates can be achieved, it seems somewhat unnatural to maintain monetary accommodation at the current level. Moreover, the tapering envisaged until mid-2022 is a shrinking of monetary accommodation, not a monetary tightening. That in itself seems unlikely to give rise to strong concerns.</u>

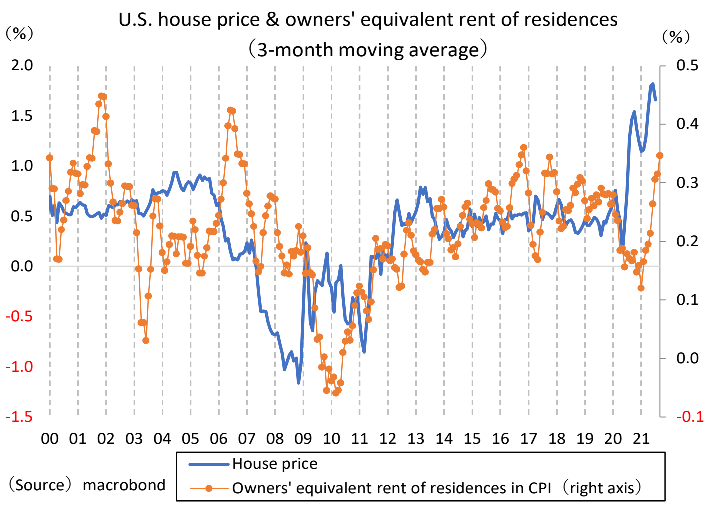
Meanwhile, it is quite possible that rate hikes, which are a true indication of monetary tightening, may be delayed beyond the currently expected December 2022 schedule. As discussed in past issues of this report, U.S. labor market challenges arising from a shortage of labor supply are related to the values of laborers (whether or not they want to get vaccinated, return to their workplaces, live in the middle of cities, and so on), and could require more time to solve than anticipated. Assuming that the trend of slow growth in employment as seen in August and September may continue, the Fed could decide to postpone rate hikes to 2023 and beyond as it monitors the situation. However, given that the corporate demand for labor (desire to hire) is strong, the normalization process itself is justified on a fundamental level.

Inflation Expectations and Imputed Rent Serve as Tailwinds

There are also other immediate factors justifying policy normalization. One is that inflation expectations are stubbornly high, resulting in effectively low real interest rates. This may be the reason share prices did not crash despite the soaring of U.S. 10-year interest rates in October. With inflation expectations being persistently high, the argument that soaring inflation is a transient development lacks persuasion, making it difficult for Powell to overtly adopt a dovish stance. However, <u>USD remains strong despite real interest rates not rising (see figure), so that one gets the impression that the stock market movements reflect real interest rate movements, while forex market movements reflect nominal interest rate movements</u>.



(Source) macrobond
(Notes) EU 19 countries vs 42 major trading partners base



(Source) macrobond

Another reason being pointed out for why it is difficult to see the rise in U.S. inflation as temporary is the rise in housing-related prices. In particular, the focus is on imputed rent trends in the consumer price index (CPI). Imputed rent (Owners' equivalent rent of primary residences) is an indicator that estimates the potential rent of owned homes, which do not actually generate any rent, by viewing them as providing a similar service as rented properties. This statistic has an expenditure weight of 40% in the U.S. CPI basket. In the September CPI, Owners' equivalent rent of primary residences increased for the first time in around 15 years, since May 2006, posting +0.43% mom. The rise in housing prices is not directly reflected in CPI, but after acquisition (posted as "investment" in the GDP statistic), it is reflected in the CPI in the form of Owners' equivalent rent of primary residences with a time delay. With housing prices soaring, the rise in Owners' equivalent rent of primary residences and, therefore, in CPI was to be expected.

It is true that monetary policy normalization cannot be a direct prescription for the supply bottleneck problem, and it is true that the supply disruptions are bound to be resolved by and by, but even so, it seems worthwhile to contain the secondary impact from the supply disruption in the form of persistently high inflation expectations. In this report, my view as of the current time is that the Fed will continue its normalization process in a matter-of-fact way with a view to beginning rate hikes at the end of 2022 as indicated by the dot plot (federal fund rate projections by FOMC members). In line with this, I would also like to retain my prediction that USD will remain strong in the forex markets for the next year or so.

Risks to My Main Scenario – Expansion of Japan's Trade Deficit in the New Energy Era

Rise in Inflation No Longer Temporary

As pointed out in the IMF World Economic Outlook, aside from risks related to pandemic spread, the world economy is facing risks associated with rising inflation rates against the background of supply constraints, and there are a growing number of observers who see a growing likelihood of stagflation going forward. While the world's major central banks currently consider the upsurge in inflation rates to be a temporary trend, financial market participants are gradually beginning to show skepticism about the banks' diagnoses. For example, supply shortages of various goods are said to stem from a worldwide semiconductor shortage. There were widespread expectations that the semiconductor shortage would be resolved in early spring 2021, and those expectations were then shifted to the end of 2021. Currently, however, semiconductor shortages are expected to last through the first half of 2022. It has become impossible to make predictions about the timing of the semiconductor shortage with a high level of confidence. Inflation expectations remain high in Europe and the United States, and in the United States, rising house prices are likely to continue pushing up the CPI via increases in imputed rents.

It should be recognized that it is difficult for central banks to conclude that higher inflation rate levels are a permanent, rather than temporary, trend in a timely manner. Inflation trends tend to lag behind other cyclical economic factors and, once autonomous uptrends in inflation rates have become established, it is highly likely that the trends will very difficult to curb with monetary tightening measures. The effects of monetary policies are manifested with a time-lag, and central banks are structurally disinclined to fully recognize nascent inflation concerns at early stages of those concerns. Financial market participants need to anticipate the upcoming policy measures central banks are likely to undertake when they finally conclude that the surge in inflation can no longer be considered a temporary phenomenon.

Inappropriateness of Calling Trends "Transient" Simply Because they Stem from Energy Prices

Following the Lehman shock, low inflation rates became the norm worldwide, and when the rates rose, such rises could often justifiably be described as transient trends due to rising energy prices. Recently, energy prices have once again become a main cause of the rise in inflation rates – more than half of the rise in inflation in Europe and the United States is attributable to energy prices. However, it has become more difficult to conclude that inflation is a transient phenomenon owing to that situation.

The situation requires careful analysis because the relevant issues are intertwined. First of all, one basic approach to understanding the inflation situation involves focusing on the energy supply-demand situation. Regarding demand, the essential issue is that energy supply has been unable to keep up with growth in demand for energy accompanying the rapid recovery of the world economy. Crude oil futures traded at sub-zero levels in the spring of 2020 when the world economy entered a deep valley, and it stands to reason that similarly peculiar trends can be expected to result from the world economy's attainment of new peaks.

It is necessary to look at supply trends in light of such demand trends. Many observers are arguing that recent energy shortages are stemming from energy supply side situations. There is a wide variety of energy supply issues, and the most important of these include (1) the fragility of clean energy technologies and (2) intentional supply restrictions by hydrocarbon exporting countries. Factor (1) is long-term situation, while factor (2) is a short-term situation. Regarding factor (2), it is not only the behavior of OPEC Plus but also the influence of Russia on natural gas supplies that is drawing attention. In Europe, peculiar price movements have been seen in Dutch TTF Gas Futures (November contract) several times since the beginning of 2021, and this has inspired suspicions that the movements reflect deliberate moves by Russia, which is in a dominant position regarding European gas supplies. Russian President Vladimir Putin has denied the suspicions and attributed the price movements to the expansion of demand, but it is noteworthy that a sharp price decline occurred in October when President Putin mentioned the possibility of an ahead-of-schedule start of operation of the newly constructed Nord Stream 2 gas pipeline. It seems undeniable that Russia is semi-covertly exerting its influence.

There are some cautious people in the EU warning that relying on Nord Stream 2 may threaten the security of EU gas supplies, but they may ultimately have to face the reality that Russia already has decisive power over those supplies. Liquefied natural gas (LNG) imports from the United States can be considered to be an alternative supply source, but natural gas shipped overland from neighboring Russia is still cheaper and, ultimately, the EU may have no choice but to rely on it. Despite widespread opposition and the generally bad state of the EU's relationship with President Putin, German Chancellor Merkel has strongly promoted the completion of the Nord Stream 2 project, and her efforts may well reflect her advance knowledge that there would be no realistic alternative to it.

Emerging Conflict between "Current Life" and "Global Warming"

In addition to the above, one must recognize that factor (1) is a very important issue. As previously discussed, the entire world has begun seeking to reduce its fossil fuel consumption while shifting to renewable (clean) energy sources. (Although Russian natural gas is still quite attractive in that it is cheap and relatively clean compared to other fossil fuels.) This shift is entailing myriad shifts from old era energy systems to new era systems, and it has proved impossible to maintain completely adequate supply capacity during the course of those shifts. It continues to be highly difficult to store clean energy, so if the pace of the shift away from fossil fuels is too fast, it will naturally disrupt energy supply-demand balances while provoking volatility in energy prices. Not personally being an expert on energy issues, I will refrain from excessively elaborating on this point, but I do think one should anticipate intermittent energy-supply-demand-balance disruptions going forward until the pace of the shift away from fossil fuels is optimally harmonized with the pace of increase in dependable clean energy production. When that optimal harmonization is achieved, there are concerns that the rises in energy prices seen since October may become acknowledged to be the new normal in the new energy era – they may well not be transient rises. Such a new normal would represent a risk with respect to forex levels as well as the prices of many financial assets. When considering JPY exchange rates, there are indications that Japan's trade deficit – which begun becoming significant in August and September – will further expand, and this is an issue that cannot be ignored as a JPY depreciation risk factor.

In a very general sense, it seems that much of the current turmoil in the world economy is reflected in the view that "there is no alternative to doing whatever it takes to counter global warming." One wonders whether or not political decisions could possibly be made based on a balancing of the goals associated with "current life" and "future global warming". On a micro-economic level, for example, would it be politically acceptable to tell voters – "You may lose your job tomorrow, but you can take consolation in knowing that the air will eventually be cleaner." – for example, if internal combustion cars are completely replaced by electric cars? Similarly, one wonders if it would it be acceptable to tell people – "The value of your pension assets has been halved, but the temperature of the earth has dropped." – as a result of shifting public pension assets toward Environmental, Social and Governance (ESG) investment goals.

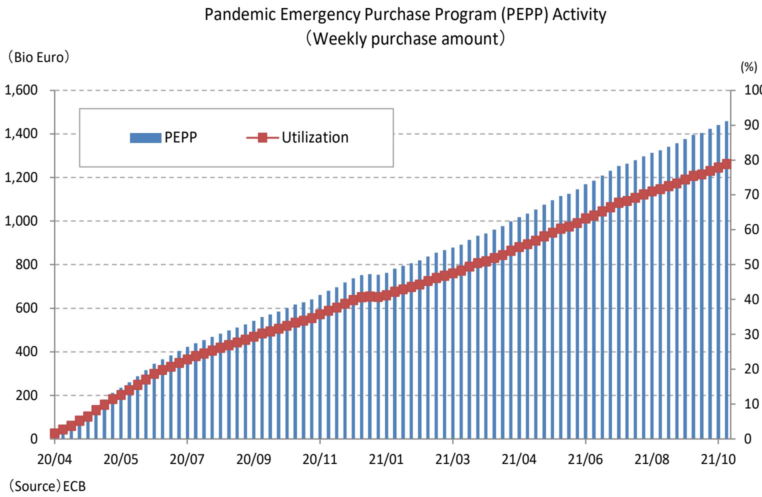
Can Policymakers Only Aim for a Balanced Contraction?

While the momentum of the shift away from fossil fuels appears to be overwhelming, the recent upsurge in inflation may be a precursory signal to humanity that the costs of the shift (as it is currently being implemented) may be somewhat greater than originally anticipated. If one believes that democratic political systems will generally strive to stabilize the lives of ordinary people, one's main outlook scenario would anticipate that effective measures will be taken to restrain resource price rises stemming from the shift away from fossil fuels, but that does not appear to be the case at this point. If the pursuit of decarbonization ideals is not modulated and balanced with other goals, there is a fearsome possibility that a general trend of sharp rises in inflation rates has only just begun. Is it feasible for macroeconomic policy authorities to curb inflationary pressures by decreasing demand through the tightening of fiscal and monetary policies with the goal of achieving a balanced economic contraction? It goes without saying that such an approach is not likely to make people happy. The European Commission began mentioning the possibility of increasing the use of nuclear power in late October, and I hope this is a sign that the European Commission is finally beginning to realize that will be extremely difficult to overcome current challenges by relying only on clean energy sources as defined to exclude nuclear power.

EUR Outlook – ECB Seeks to Restrain Rising Expectations of an Interest Rate Hike

EUR Area Monetary Policies Now and Going Forward – Serene Analysis of Inflation Factors and Many Decisions Slated for December

President Lagarde Acknowledges PEPP Termination
As expected, the October ECB Governing Council meeting did little but discuss decisions to be made in December. The Eurosystem staff projections are an extremely important basis for the new strategy the ECB has been implementing since July, and no major policy changes are expected until the December revision of those projections has been released. However, during the post-meeting press conference ECB President Christine Lagarde did confirm the upcoming termination of the pandemic emergency purchase programme (PEPP), saying – "This [PEPP] is at this point in time, in my view, going to end at the end of March '22." – and that – "I have every reason to believe that it will come to its end in March '22." Since the PEPP termination was repeatedly mentioned during the press conference, it seems safe to assume at this point that it has become the default route. In addition, it appears that the decision about whether or not to use the PEPP's entire EUR1.85 trillion envelope will be made in December, and this issue is considered particularly noteworthy insofar as it offers hints about the management of the PEPP's successor programs. It seems quite likely that the PEPP will be terminated at the end of March with a some portion of the envelope remaining unused (see graph).



Given that, the financial markets are inevitably expecting the ECB to move ahead with policy normalization process involving a shift of emphasis from "quantity" to "interest rates". In fact, the markets have already begun factoring in interest rate hikes, although it cannot be said that the markets have a clear understanding of the forward guidance associated with the ECB's new monetary policy strategy. In this regard, President Lagarde's statement at the press conference, that – "our analysis certainly does not support that the conditions of our forward guidance are satisfied at the time of lift-off, as expected by markets, nor any time soon thereafter." – is noteworthy. As discussed in yesterday's edition of this article, if the 2021-2022 period Eurozone Consumer Price Index (HICP) outlook in the December staff projections is raised by 0.3-to-0.5 percentage points, it will promote greater discussion of normalization measures – such as those to shrink or terminate the asset purchase programme (APP) and then hike interest rate levels – but the situation is not yet one in which one can realistically anticipate such measures.

ECB Inflation Analysis – Three Key Factors
Of course, there were several reporters at the press conference who posed questions about inflation, and it seems safe to say that inflation was a chief topic of the Governing Council meeting. President Lagarde strongly emphasized that in her answer to the first question asked at the press conference, saying – "Actually, we talked about inflation, inflation, inflation. That has been a topic that has occupied a lot of our time and a lot of our debates." President Lagarde then explained the ECB's inflation analysis, saying the factors driving inflation fall into – "two key categories. One is related to pandemic and recovery, and the other one is related to energy." She pointed out that the recovery of demand previously suppressed by the pandemic is creating diverse kinds of shortages along with a "supply-demand disconnection". She went on to explain that the energy factor similarly reflects the expansion of demand accompanying economic recovery but also reflects – "other factors having to do with inventory, with the wind, with maintenance in Norway, with demand in China, with the supply by Russia." Furthermore, she noted the significance of the base effect of the German value-added tax (VAT) reduction implemented in the second half of 2020, which will continue affecting HICP levels through the latter half of this year
In short, the ECB believes current inflation levels are being supported by three key factors: (1) excess demand accompanying economic recovery, (2) rising energy prices, and (3) the base effect of Germany's VAT tax cut. President Lagarde argues that the impact of factors (1) and (2) will diminish in 2022. (The effect of factor (3) will disappear completely from January 2022.) She reasoned that the impact of factor (1) will gradually diminish as pent-up demand is met and that the impact of factor (2) will be reduced as energy prices at least stabilize (if not decline), and thus concluded that – "We have every reason to believe that [the inflation-driving factors] are going to gradually fade over the course of 2022."

Supply Chain Bottlenecks Protracted Throughout 2022?

Another reporter posed a question about how long materials shortages and supply chain bottlenecks should be expected to last. In response, President Lagarde argued that additional semiconductor plants were being constructed and additional ships being built, and consistently expressed the view that the various supply constraint problems “will fade away”. It appears that the ECB’s position emphasizes that, while solving the problems is taking longer than expected, the problems are not a permanent problems, and this perspective seems appropriate for a central bank focused on attaining medium-to-long-term price stability. In addition, President Lagarde noted that the ECB has made efforts to gain a better grasp of the situation by conducting a telephone survey of large as well as medium-sized enterprises, asking them when they expected to receive their needed supplies. She said the survey results are – “telling us that it will be settled and it will be sorted out in the course of '22, but not in the first quarter of '22, and some of them have been saying it will take the whole year.” Her analysis of the survey results is that there will be a gradual resolution of problems – “but overall it will take a good chunk of '22 for it to be sorted out.” In this respect, I get the impression that the ECB is making a somewhat more cautious projection than that of the IMF World Economic Outlook, which anticipates that the problems will be largely resolved mid-way through 2022, but this may reflect differences between euro area situation that the ECB is focusing on and the global situation that the IMF is focusing on.

That same reporter expressed particular concern about the downward adjustment of Germany’s economic growth outlook. President Lagarde argued that this adjustment stemmed from supply bottlenecks, and that demand that could not be met in 2022 would be shifted to 2023. Reflecting this postponing of the meeting of demand, Germany has lowered its projected rate of economic growth in 2022 but has actually elevated its projected rate for 2023. Overall, the ECB believes the situation reflects current problems that will be resolved over time and does not represent the start of a longer-term trend of uncontrollably rising inflation rates. The ECB did present many convincing explanations about the nature of the current inflation trend and the supply constraints that are driving that trend.

Issues to be Decided at the December Governing Council Meeting and the ECB’s Price Stability Definition

As mentioned above, once the PEPP is terminated, the focus of attention will shift to the management of the APP, the ECB’s remaining program for quantitative monetary policies. So long as the ECB’s forward guidance suggests that interest rate hikes may be undertaken immediately after the APP’s termination, APP management will be seen as an indicator of the timing of prospective rate hikes. At the latest press conference, a reporter did ask a question about how APP would be managed following the termination of the PEPP, but President Lagarde simply responded that what comes next will be debated at the December Governing Council meeting. Thus, in addition to evaluating the newly revised staff projections, the December meeting will be considering several important issues, including (1) the termination of the PEPP, (2) the handling of the remaining PEPP envelope, (3) the management of the APP (purchase pace, termination target date, etc.), and (4) the outlook for interest rate hikes associated with (3). On top of that, the ECB will have to work to calm the financial markets’ expectations regarding prospective interest rate hikes.

As discussed in yesterday’s edition of this article, the ECB’s new monetary policy strategy has three definitions of price stability – (1) inflation reaching 2% well before the projection horizon (midway through the forecast period), (2) inflation being sustained at that level for the remainder of the forecast period, and (3) underlying inflation performance consistent with “stability at 2% over the medium term”. President Lagarde has stated that the full set of three definitions will not be met by the end of 2022, implying that rate hikes will not begin until sometime in 2023 or subsequently. President Lagarde has postulated two possible reasons for rising rate hike expectations in financial markets – either the markets do not properly understand the above-described price stability definition with respect to the current situation or the markets consider the ECB’s inflation projections to be mistaken – but believes that the former factor is the actual reason. However, since the market thinks that the latter factor is the actual reason, the key issue is whether one should have confidence in the ECB’s inflation projections or not. Given the emergence of this situation, it should probably be acknowledged that the ECB’s new strategy’s price stability definition is somewhat “difficult to understand”, and it seems that some improvement is needed in this regard. This is probably a problem that ECB will have to gradually improve over time rather than trying to hastily rectify.

Weidmann’s Retirement Reflects Germany’s Isolation

On October 20, Germany’s central bank (the Bundesbank) announced that its President Jens Weidmann will retire this December 31. After taking office in May 2011, he completed his first eight-year term and will retire after somewhat more than five years of his second term, about two and a half years before the end of that term. The Bundesbank’s statement included the text of President Weidmann’s letter to Bundesbank staff, in which he wrote – “I have come to the conclusion that more than 10 years is a good measure of time to turn over a new leaf — for the Bundesbank, but also for me personally.” While Weidmann has described the reason for his retirement as “personal”, there is abundant speculation about whether his departure may have been spurred by such factors as the ECB’s inability to respond flexibly to inflation-related risks as well as the ECB’s Lagarde-led moves to address climate change issues.

This is the fourth time that an apparent protest resignation of an ECB Governing Council member from Germany has become a widely discussed issue, and it cannot be said that there is no basis for suspecting that Weidmann’s resignation was also designed to express his disagreement with certain policies. No other euro area central bank has seen high-ranking officials leaving his or post mid-way through his or her term in office. Weidmann has become the second Bundesbank president to resign mid-way through his term, following the 2011 resignation of his predecessor, Axel Weber, and this constitutes an unusual pattern. In 2011, former Bundesbank President Weber and ECB Executive Board Member Jürgen Stark announced their resignations one after another to protest the re-commencement of the securities market program (SMP). While some media reports at that time speculated that President Weidmann might also resign, he denied those rumors, saying that he saw no reason to follow Executive Board Member Stark's example as he was confident that the ECB would promote financial stability and independence as a central bank. In 2019, ECB executive board members Sabine Lautenschläger resigned halfway through her term over the restart of the APP. While ECB executive board members normally serve eight-year terms, Stark resigned after five years and six months and Lautenschläger resigned after five years and nine months.

In December 2013, ECB executive board member Jörg Asmussen (also from Germany) resigned mid-term after in just two years in office, but this resignation was considered to be for genuinely personal reasons – he himself said that it was difficult for him to work in Frankfurt leaving two small children behind in Berlin and there was no other reason. <u>However, there have now been three mid-term resignations of German ECB executive board member and two Bundesbank presidents since 2006, and those resignation appear to reflect Germany's isolation in its opposition to ECB policies that are generally supported by other euro area countries</u>. It bears repeating that there have not been such mid-term resignations by ECB officials from other euro area countries.

New Monetary Policy Strategy and Climate Change Measures

The Governing Council meeting's statement suggests that the new monetary policy strategy entails rejecting inflation target overshooting and emphasizing that it is important to not only to focus on deflation risk, but also keep an eye on the threat of future inflation trends. <u>Overall, it has been emphasized that agreement has been reached on the new strategy itself although there remain questions about how to implement the strategy. Besides tacitly suggesting his personal strong opposition to certain prospective means of implementing the strategy, President Weidmann's resignation may suggest a need to give more thought to the features of the new monetary policy strategy, which has often been critiqued as being somewhat accepting of inflation</u>. Even before the revision of the ECB's monetary policy strategy, President Weidmann was often relegated to somewhat ineffectively expressing a minority opinion within the ECB Governing Council, and it may well be that he decided to retire in light of the likelihood that his inability to effectively promote his minority views within the Governing Council may have become increasingly clear going forward.

It is also well known that the Lagarde-led ECB has become intent on mustering policy responses to climate change issues, which President Weidmann did not approve of. The new monetary policy strategy stipulates that inflation targeting should be symmetric (allowing for overshooting of the 2% target) and also take impact on climate change responses into account. <u>Weidmann has been controversial in warning against central bank adoption of greening policies even before President Lagarde took office at the ECB</u>. In an October 2019 speech, he stated that climate change measures – "are political questions for elected governments and parliaments to answer. They are decisions which are not for central banks to take, because they lack the requisite democratic legitimacy." In that same speech, he stated that – "Our mandate is to preserve price stability, and policy implementation needs to be in line with principle of market neutrality. Skewing asset purchases to green bonds, say, would run counter to this principle, which is anchored in Article 127 of the EU Treaty." It is noteworthy that the speech was given just before ECB President Lagarde took office in November 2019. This led to concerns about prospective disagreements between the two, as Lagarde had been enthusiastic about promoting climate change countermeasures even before joining the ECB. Although his retirement statement includes a portion reading – "Weidmann thanks his colleagues in the ECB Governing Council under the leadership of Christine Lagarde for the open and constructive atmosphere in the sometimes difficult discussions of the past years" – it may well be that the conflict with President Lagarde regarding climate change measures played a role in causing Weidmann to resign.

Next Bundesbank President a Woman?

Weidmann's successor as president of the Bundesbank will be chosen by Germany's new government led by the Social Democratic Party (SPD), which is currently in discussions with its prospective coalition partners. As explained below, it is highly probable that the SPD and the Greens environmental party will be joined by the Free Democratic Party (FDP) to form a coalition government that can be expected to be somewhat to the left of the previous Christian Democratic Union Party and Christian Social Union in Bavaria Party union (CDU/CSU) government coalition. It is anticipated that the new government will promote expansionary fiscal policies, and that is another issue on which conflict could have been expected with Bundesbank President Weidmann. <u>In light of this, one can see that Weidmann decided to retire at a time when he saw clear indications that his isolation would progressively increase both inside and outside Germany</u>. (It has been reported that the news of his resignation was conveyed to SPD leader Olaf Scholz, who is generally expected to become Germany's next chancellor, just before the official announcement.)

Currently, it appears that the leading candidates to become Weidmann's successor as president of the Bundesbank include Claudia Buch (the Bundesbank's vice president) and Jens Ulbrich (the Bundesbank's chief economist), <u>but there are also people promoting the candidacy of ECB Executive Board Member Isabel Schnabel, who was just appointed to her ECB position in January 2020. As both the SPD and the Greens strongly emphasize gender balance, it seems quite possible that Schnabel might be given the Bundesbank presidency</u>. As there is currently no female among the central bank governors of the 19 euro area countries, the new German government is likely to enjoy a particularly high-profile PR effect from selecting a woman to be the Bundesbank's president. If Schnabel is chosen, however, she will have to resign from her ECB executive board member position that she has served in only since January 2020, and the new German government will have to find a candidate to fill that position. In light of current trends, one can expect that female candidates for that position will be given preferential consideration. However, Schnabel's departure from the ECB would mean that four consecutive German ECB executive board members (Stark, Asmussen, Lautenschlager, and Schnabel, respectively) have been unable to complete their term due to personal situations*, and this is a pattern that has hindered the German government's projection of power within the ECB.

* While resignations from ECB executive board member positions due to personal situations (such as situations in the member's home country) are rare, there are numerous cases in which such resignations are required owing to the ECB's own conventions. For example, there is an unwritten rule that executive board members cannot be of the same nationality as that of the ECB president, and since President Lagarde is French there is currently no other French executive board member. When former-President Draghi assumed his post in November 2011, it became necessary for his Italian compatriot Lorenzo Bini Smaghi to terminate his executive board membership midway through his term. (He was replaced by Benoît Cœuré, from France.)

European Commission's Green Bond Issuance – Raising Funds on Whose Behalf?

European Commission Akin to a Dog Chasing Its Own Tail?

On October 12, the European Commission announced that it had issued EUR12 billion worth of NextGenerationEU green bonds as a source of funds for the NextGenerationEU recovery fund (NGEU). The 15-year bonds are due on 4 February 2037 and have a yield of 0.453%. Including this issue, the European Commission has issued EUR68.5 billion of long-term bonds and EUR14 billion of short-term bonds associated with the recovery fund. As is generally known, the European Commission-issued bonds have been in strong demand, and the first green bond issue was more than 11 times oversubscribed, with books exceeding EUR135 billion. European Commissioner for Budget and Administration, Johannes Hahn, said the bond priced with a "greenium" (a green premium of higher prices/lower yields compared to comparable ordinary bonds) of 2.5 basis points and that the strong demand for the bond reflected financial markets' strong commitment to sustainability (as achieved through such measures as those to decrease fossil fuel consumption, also referred to as decarbonization). <u>Given the strong promotion of the bonds by EU countries' governments and the European Commission, however, it should be noted that one aspect of the bonds' popularity reflects a self-fulfilling prophecy in which investors assume the popularity of the bonds will cause them to appreciate, then the appreciation of the bonds promotes additional buying. In this sense, the European Commission is somewhat akin to a dog chasing its own tail.</u>

Clear Political Intent

The EU's initiatives related to green bonds are highly political in nature. As previously reported, the recovery fund currently is authorized to issue EUR750 billion in bonds and is scheduled to increase that figure to EUR800 billion by the end of 2026 in consideration of future price increases, and plans call for procuring about 30% of that figure (as much as EUR250 billion) via the issuance of green bonds. The green bond policy, which has been extolled since the recovery fund's establishment, is a clear indication of the EU's political intention to establish a solid position in the sustainable finance market.

The European Commission announced its "Renewed EU Sustainable Finance Strategy" this past July 6, and at that time, the Commission also put forward a proposal for a "European Green Bond Standard" (EU GBS). The Commission has stated that private investments will account for much of the investments needed to attain its 2030 greenhouse gas emission reduction target and that its green bonds are positioned as an important means of promoting such private investments. The strategy's concept is to realize a flow of "decarbonization target setting → private investment-led measures → sustainable finance market needs → government-led sustainable finance market development", and the recovery fund framework is to serve as the starting point for this flow. EUGBS is said to be designed to eliminate deceptive "greenwashing" activities that superficially emulate actual environmental protection measures, and it appears clear that the Commission would like to make EUGBS a global standard. <u>As the EU already accounts for half global green bond issuance (in 2020), it is apparent that the EU is strongly positioned to become the de facto rule maker regarding green bond issuance. It is natural for the EU to be enthusiastic about this prospect, as establishing fund procurement systems facilitates the generation of employment and profit-making opportunities.</u>

Government also Responsible for the Stability of Daily Life

As already discussed, however, the rapidly progressing decarbonization trend is promoting commodity price increases and, in response, central banks are beginning to consider ways to tighten their monetary policies (ultimately entailing the hiking of interest rates). <u>Even if one is able to utilize green bonds' "greenium" to realize low-interest fund procurement, if central banks' key policy interest rates (the original cost of capital) are raised as a result of decarbonization, one will be back where one started from</u>. For example, euro area interest rates steadily rose during October, and it goes without saying that the rise was in response to inflation-related concerns. For ordinary people living in the real economy, the prospect of a central bank tightening its monetary policies to curb harmful inflationary pressures is not appealing. <u>While it is theoretically reasonable to allow for such short-term adverse effects insofar as they ensure a long-term positive effect in the form of a prospective drop in average global temperatures, one must seriously consider the question how to find a proper balance between those adverse and positive effects</u>. While there may be no doubt about the extreme importance of curbing global warming, the key objective should be finding the optimal pace to proceed with global warming curbing measures in light of that proper balance. If a rigid commitment to a non-optimal pace causes the price of natural gas to rise 700% yoy and causes corresponding surges in electric power prices, the ordinary people who happen to be living at this particular time may suffer a dramatic deterioration in the quality of their lives that causes them to be skeptical about whether the authorities are truly taking the short-term adverse effects on their lives fully into account.

The funds the European Commission raises through green bond issuance will not be dedicated to stabilizing ordinary people's day-to-day welfare. The European Commission's Green Bond framework specifies nine eligible green expenditure categories[1] – including Research and innovation activities supporting the green transition, Digital technologies supporting the green transition, Energy efficiency, etc. – but does not provide for measures to be taken to alleviate the negative impact of decarbonization processes on people's day-to-day lives. Moreover, the lack of information dissemination regarding that negative impact does not seem to suggest that the government authorities (≈the European Commission) are behaving as a responsible representative government should ideally behave. All this begs the question of whether or not it is reasonable to ask that green plans affirm a need to accept a certain amount of dependence on fossil fuels in the short term and affirm the legitimacy of utilizing a portion of the resources procured from green bonds to alleviate the impact of green plans on the real economy. (At this time, there is a particular need to consider the impact on commodity market conditions.) It is certainly important to idealistically give due attention to future global warming trends, but I think that the lives of people living in the present are also important.

Appendix: Germany's New Government – Coalition Agreement by Christmas?

New Coalition Government Formed by Christmas?

About a month has passed since Germany's federal parliamentary election (general election), which has attracted considerable attention worldwide. On October 7, exploratory discussions about the formation of a ruling coalition were begun among three parties – the Social Democratic Party (SPD; top number of general election votes), the Green Party (Greens; third in votes), and the Free Democratic Party (FDP; fourth in votes) – and on October 15th, the parties announced their intention to start formal coalition negotiations. It has been reported that SPD leader and finance minister Olaf Scholz, who is a candidate for the chancellor position, is confident about the outlook for the formation of a new government by a SPD/Greens/FDP coalition (commonly known as a "traffic light" coalition as those parties' traditional colors are red, green, and yellow, respectively). Steady progress is being made toward the establishment of a coalition government, which will be undertaken after the prospective partners work out an agreement on their platform of basic policies. It had been thought that the significant gap between the policy positions of the SPD and Greens (relatively left-wing) and the FDP (closer to the business world) would create problems, but as explained below, it seems that the partners' policy coordination efforts have been proceeding well so far. As noted below, there remain some concerns about the allocation of ministerial posts and associated policy discrepancies, but it is expected that the coalition government negotiations will be more expeditious than those for the previous government, which took a half year, and it appears possible that the negotiations will be completed before Christmas.

On the other hand, Chancellor Merkel's Chancellor Angela Merkel's Christian Democratic Union Party and Christian Social Union in Bavaria Party union (CDU/CSU) won its lowest-ever share of votes and became only the second-ranked party by that measure, and it has been reported that the resignation of CDU party leader Armin Laschet is close to inevitable. Until the traffic light coalition government is formed, however, Chancellor Merkel will continue extending the record-long length of her term in office.

What about Discrepancies among Coalition Partners' Policy Stances?

As mentioned above, there are significant differences among the traffic light coalition partners' policy stances that make it fundamentally difficult to harmonize those stances. While the CDU/CSU and SPD have been sharing power via a grand coalition (Große Koalition), both partners have denied the possibility of protracting such a grand coalition, however, so there are no feasible alternatives to making the requisite compromises needed to form a traffic light coalition government. Consequently, the coalition discussions are proceeding quite rapidly, with each of the three parties apparently prepared to accept their share of painful compromises.

Currently, the tentative policy platform compiled during the preliminary coalition discussion includes the SPD priorities of raising the minimum wage and maintaining pensions' current value and eligibility ages along with Greens priorities of accelerating decarbonization measures (eliminating coal-fired electric power generation by 2030 rather than by 2038) and requiring the installation of solar panels on new commercial buildings. As both the SPD and the Greens support left-leaning policies, it has always been expected that realizing compromises between them would be relatively easy. The key issue is the kind of concessions that will be granted to the FDP (the third-ranking coalition partner based on its fourth largest share of votes), which supports business-friendly policies. The FDP generally opposes tax increases and fiscal stimulus policies, and it has been reported that concessions to the FDP include the postponement of the introduction of an asset tax on wealthy people along with the postponement of increases in personal income tax, corporate income tax, and VAT tax rates. During the election campaign, both the Greens and the SPD insisted on the need to introduce an asset tax on wealthy people, and it seems such a tax may be ultimately inevitable. The FDP is in a position to somewhat moderate German politics' shift to the left, and it seems reasonable to assume that the FDP joined the coalition for that very purpose.

Compromises regarding Germany's debt brake (Schuldenbremse; a fiscal debt-restriction policy incorporated in Germany's Basic Law, or constitutional law) are another important challenge, as the Greens have been insisting on reforming the debt brake with the goal of increasing financial resources for climate change countermeasures, while the SPD, despite promoting fiscal stimulus policies, has maintained a rather conservative position of proposing that

[1] European Commission "COMMISSION STAFF WORKING DOCUMENT Next Generation EU - Green Bond Framework", September 9, 2021

such policies be implemented within the scope of the debt brake. The FDP has been strenuously promoting the normalization of the current situation, in which fiscal stimulus policies are made possible through the temporary suspension of debt brake restrictions. (The debt brake provides for the exceptional loosening of restrictions in the case of natural disasters or severe recessions.) <u>One can thus see clear differences among the coalition partners' positions on the debt brake and fiscal stimulus policies, with Greens being most intent on boosting borrowing and spending, the SPD being somewhat less intent on those goals, and the FDP being the most fiscally conservative. In this regard, it seems that the FDP has agreed to go along with the desire of the SPD and the Greens to undertake greater fiscal expenditures on climate change measures so long as borrowings to fund those expenditures are kept within the scope of the existing debt brake (albeit while extending the debt brake's emergency suspension period</u>).

Outlook for the Key Finance Minister Post

Going forward, ministerial post allocations will be particularly high-profile coalition-related issues. While it is assumed that SPD leader Scholz will become the next chancellor, considerable attention is being focused on who the next finance minister will be. The German finance minister post is important not only in Germany, but also with respect to the rest of the euro area and the EU. Given the EU's propensity to experience finance-related problems, Germany's finance minister plays a conspicuously important policy-making role at euro area finance minister meetings (Eurogroup meetings). Convention ordinarily would dictate that the finance minister post goes to a representative of the coalition's top or second-ranking parties (SPD or Greens), but this time FDP leader Christian Lindner is actively seeking the post. The coalition negotiations could be stymied without the FDP's cooperation so it is possible that Lindner could become finance minister if the Greens are willing to go along with it. <u>As Lindner is unabashedly hawkish regarding fiscal spending, however, his accession to the finance minister position could be said to constitute a risk for the EU, particularly for the euro area. In particular, he could possibly undermine the flexibility of the EU recovery fund's management, and he might impede progress toward certain reform measures considered necessary over the medium to long term, such as the establishment of a euro area finance ministry and the issuance of euro area joint bonds</u>. There are important expectations and concerns about how effectively Germany can play a leading role in promoting EU reforms in the post-Merkel era. The finance minister post allocation is also likely to affect who gets the foreign ministership. If the finance minister post is given to the FDP (the coalition's third-ranked party), it is more likely that the foreign minister post will be given to the Greens (the coalition's second-ranked party).

However, the Greens are known to have somewhat hardline stances toward China and Russia, and there are grounds for concern that a Greens foreign minister might exacerbate frictions with those countries. For example, the Greens have been resolutely opposing the operation of Russia's Nord Stream 2 natural gas pipeline. Although the Greens could conceivably relent on this issue in light of the current tightness of fuel supply-demand relationship, it bears keeping this kind of situation in mind as an indicator of the kinds of diplomatic risks the traffic light coalition might engender. The traffic light coalition's formation may have an important impact on a wide range of issues.

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