

December 1, 2021

Overview of Outlook

USD/JPY remained volatile in November. Toward the end of the month, there were phases when the currency pair intermittently renewed its year-to-date high, but it tumbled back down following news of a new COVID variant's emergence. I have no way of judging the potential impact of the new variant, but I would like to maintain my basic understanding of the situation without becoming caught up in short-term developments. 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 things are in a shambles at home, and it seems that this point remains the key to understanding the current state of affairs. Comparing the GDP growth rates (annualized qoq; average for three quarters) of the U.S., euro area, and Japan, the gap between Japan and former two is quite dramatic, with the U.S. and the euro area posting +5.0% and +5.5% growth, respectively, compared with -1.9% for Japan. This difference in real economic performance has also undeniably affected the performance of Japanese stocks and JPY in 2021, and I am apprehensive that this state of affairs may continue in 2022 also. Japan will probably recover pre-pandemic growth levels during 2022, but by that time, the U.S. is likely to already be conducting rate hikes. The spread of infections from variant strains of the coronavirus, supply constraints on both people and goods, and high resource prices are all downside risks common to the whole world and unlikely to cancel out the relative disadvantages of Japan (or JPY). With the additional risk of the U.S. policy normalization process possibly speeding up sometime in the foreseeable future, it seems reasonable to continue forecasting USD strength as the direction of USD/JPY going forward.

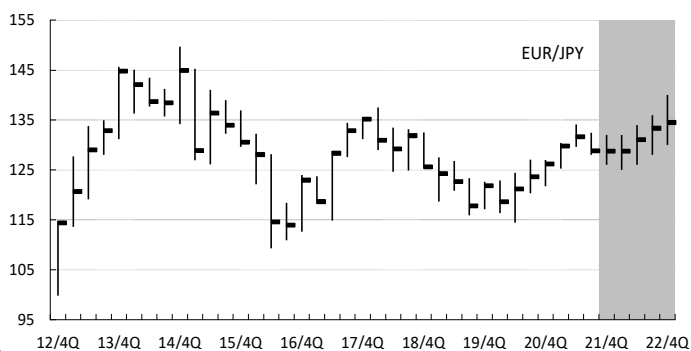
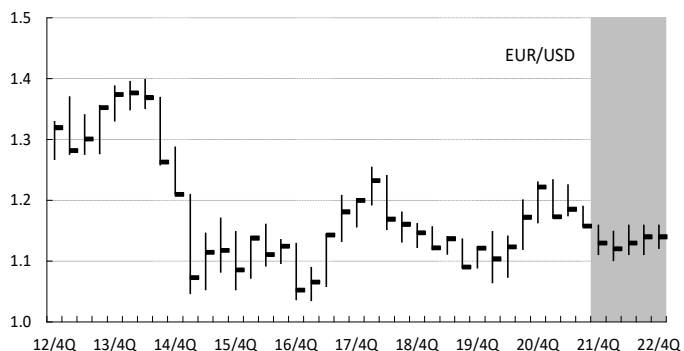
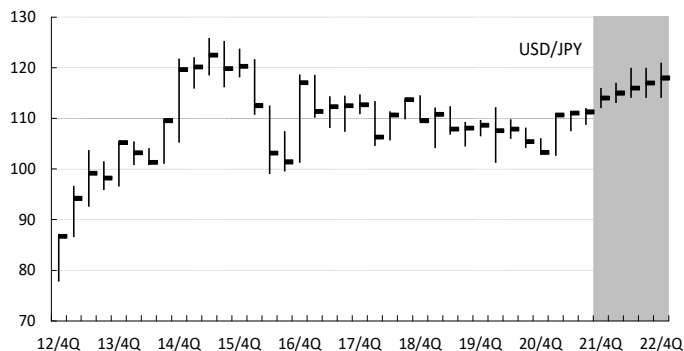
Meanwhile, EUR's lower bound decreased in November. Amid concerns of the virus spreading in Continental Europe again, forcing the ECB to delay its policy normalization process, investors appear to be letting go of the currency. Having said that, soaring inflation is also a major problem in Europe, and this is one reason for the persisting view that the termination of the pandemic emergency purchase programme (PEPP) will proceed smoothly as per schedule. However, one has to wonder whether it will really be possible for the ECB to end a program that has "pandemic" in its very title right in the middle of the pandemic, with infections surging again. It seems fairly likely that, at its upcoming December meeting, the ECB will either postpone the termination of the PEPP or emphasize continued monetary accommodation by replacing the outgoing PEPP with a substitute program. If so, this will inevitably cause regional interest rates to peak, contributing to an expansion of the interest rate gap between the U.S. and Europe, thereby causing EUR selling in exchange for USD to accelerate. Such a trend seems very likely to continue through January as the pandemic continues to spread, but going by past experience, this wave of infections is also bound to peak at some point. And once it does, the ECB could resume its normalization process sometime in the second half of the January-March quarter, potentially leading to EUR recovery at that time. However, despite deteriorating somewhat, it seems unlikely that the euro area economic or financial performance will be worse than that of Japan (JPY), so EUR/JPY is likely to maintain its underlying strength.

Summary Table of Forecasts

	2021		2022			
	Jan-Nov (actual)	Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	102.60 ~ 115.52 (113.22)	112 ~ 116 (114)	113 ~ 117 (115)	114 ~ 120 (116)	114 ~ 120 (117)	114 ~ 121 (118)
EUR/USD	1.1186 ~ 1.2349 (1.1332)	1.11 ~ 1.16 (1.13)	1.10 ~ 1.15 (1.12)	1.11 ~ 1.16 (1.13)	1.11 ~ 1.16 (1.14)	1.12 ~ 1.16 (1.14)
EUR/JPY	125.10 ~ 134.12 (128.34)	126 ~ 132 (129)	125 ~ 132 (129)	126 ~ 134 (131)	128 ~ 136 (133)	130 ~ 140 (135)

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

Exchange Rate Trends & Forecasts

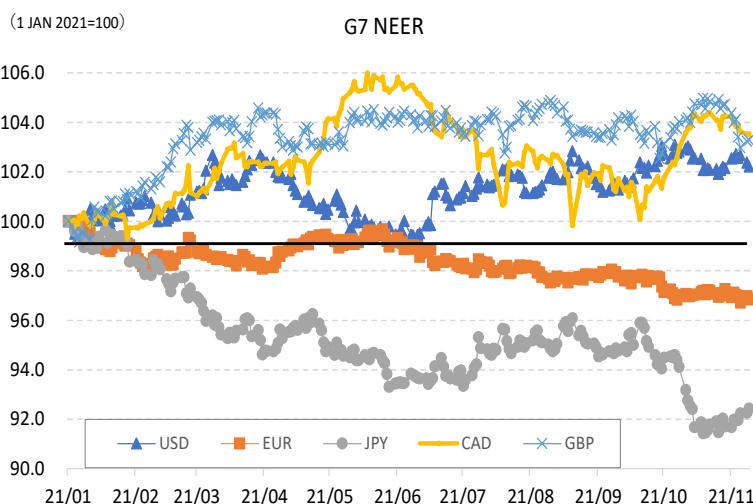


USD/JPY Outlook – “Japan Avoidance” Remains the Key Theme

JPY Now and Going Forward – Japan Avoidance Mood may Continue in 2022

JPY 115 Merely a Transit Point

USD/JPY surpassed the 115 point toward the end of November, hitting its highest in 4 years and 10 months. Some interpret this as a direct result of news of the reappointment of Jerome Powell to the post of chairman of the Federal Reserve Board, which strengthened expectations of the Fed continuing with policy normalization as planned, thereby resulting in a mutually stimulated growth in U.S. interest rates and USD, but I think this is no more than an attempt to explain something in hindsight. USD/JPY hitting 115 is an important milestone, but it was a foregone conclusion given the overall trend in the forex markets (see figure), with JPY being the only weak currency in terms of year-to-date growth in nominal effective exchange rate (NEER). If we assume that the Fed’s policy normalization process has only just begun, we can expect that the increase in U.S.

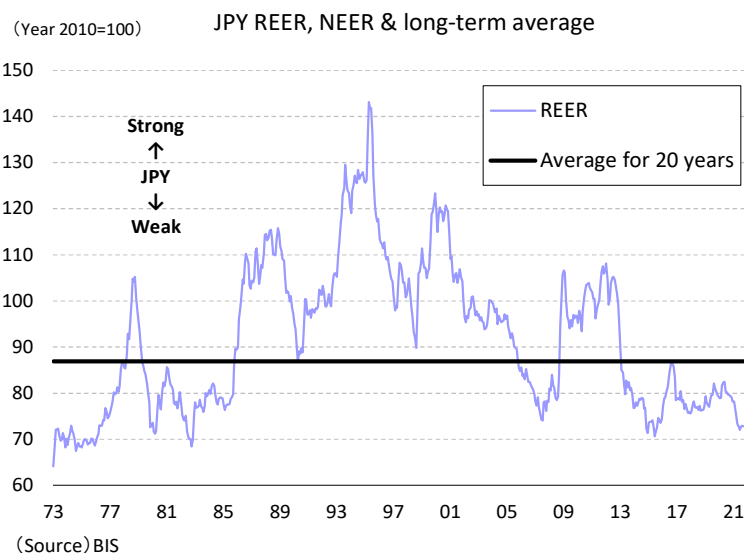


(Source) macrobond

interest rates and USD appreciation have also just begun, so JPY115 may be no more than a waypoint. In this report, until the previous month’s edition, I had already assumed an upper bound of 119 for USD/JPY, but with the Fed now seen as almost certain to wrap up tapering (phased reduction of quantitative easing) sooner, I would like to raise my predicted number of rate hikes in 2022 from one to two. Given this, USD/JPY could hit the 120 level during 1H of 2022. It may even be necessary to take the possibility of three rate hikes in 2022 into consideration as a risk scenario.

Milestone Deserving Focus May be 70.64, not JPY120

As I will explain in detail later, shortcomings in overseas economies are unlikely to change the wretched situation in which the Japanese economy is placed, and the “Japan avoidance” mood in the share and forex markets is likely to continue in 2022 and beyond. Assuming weak performance by Japan in terms of growth rates and inflation, the focus of attention going forward may be real effective exchange rate (REER) rather than USD/JPY levels. As of October this year, JPY’s REER had already fallen to 70.82, the lowest since the 70.64 trough of June 2015. June 2015 was when USD/JPY hit its high of 125.86, following which BOJ President Haruhiko Kuroda remarked that JPY REER levels seemed unlikely to fall further. It is easy to see the 120 level as the next milestone for USD/JPY, but I am more concerned about developments leading to JPY’s REER falling below 70.64. This

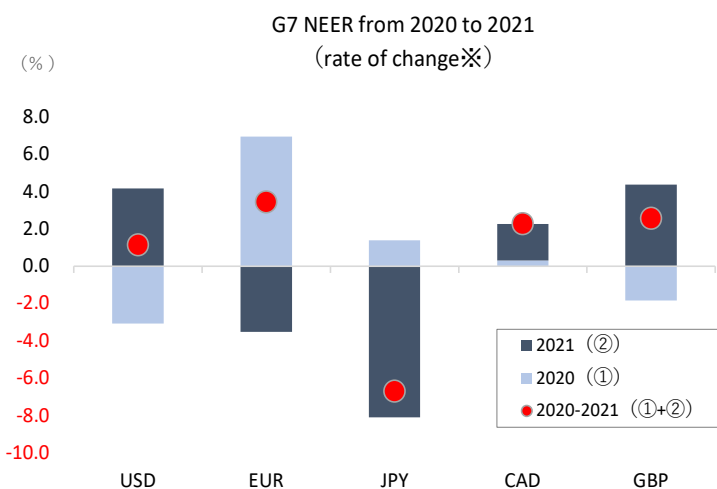


would amount to JPY’s purchasing power returning to similar levels as following the switch to a floating exchange rate system.

Even though JPY is nominally somewhat stronger now than in those days, JPY REER levels are almost as weak – this can only be explained by the fact that prices in Japan are weak by international standards. This relative weakness of prices leads directly to a drop in the real exchange rate. In theory, the price gap should be adjusted by a strengthening of JPY’s nominal exchange rate. However, with Japan no longer able to post trade surpluses and the declining ratio of securities investment in its net external assets, JPY buying factors have become scarce. Looking at the divergence of JPY’s REER from its long-term average, one is tempted to predict JPY appreciation in the process of its return toward the average, but it is difficult to find a path through which this could actually take place.

Assessing the Trend Since Early 2020 – USD Remains Level, EUR has Appreciated, JPY has Depreciated

Recently, USD has strengthened across the board, so it is not just JPY that has weakened. However, looking back at the rate of change starting early 2020, it becomes clear that USD has simply recovered the strength it lost last year. The figure plots the rates of change for all of 2020 and so far in 2021 as well as the net rate of change since the start of 2020 for G7 currencies. USD has barely recovered its -3% fall in 2020 with a +4.2% growth margin this year. Assuming that the Fed will follow through with its policy normalization following the reappointment of Powell, USD could begin to strengthen in earnest going forward as rate hike expectations drive up U.S. interest rates. As for EUR, it appreciated strongly (+6.9%) in 2020 and has fallen back by only half of that (-3.5%) this year, even though some are focusing narrowly on its recent depreciation. In terms of net change over the past nearly two years, EUR remains the strongest G7 currency. JPY meanwhile, having strengthened by +1.4% in 2020, has plummeted by -8.1% this year to become the most conspicuously weakened G7 currency.



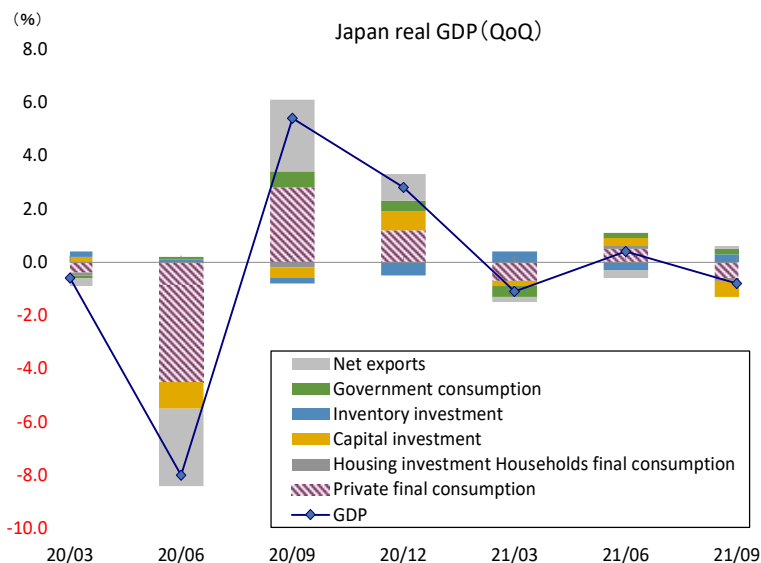
(Source) macrobond (Note) as of 23 NOV 2021

There are several things one can learn from this, but a similar weakness of Japan can be seen also in the share markets, making it difficult to deny the mood of “Japan avoidance” in the financial markets. Supply constraints, high inflation rates, and rise in COVID infections are major factors weighing down on the global, and especially the U.S. and European, economies, but JPY rates in 2021 are proof that such challenges faced by overseas economies are not sufficient to hide the wretched state of the Japanese economy. This would be a useful perspective to keep in mind when formulating my outlook for 2022.

The Japanese Economy Now and Going Forward – Too Wide a Gap Between Japan and the World

Negative Growth Not Due to Supply Constraints but Rather Insufficient Demand

The July-September quarter GDPs of the U.S., Japan, and Europe were all released in November. Japan posted a real growth of -0.8% qoq and -3.0% annualized qoq, exceeding market expectations but posting its second quarter of negative growth this year. This is natural outcome of spending most of the July-September quarter under a state of emergency, but it makes the gap between the Japanese and overseas economies far too wide (details later). Yes, the July-September quarter was plagued by problems resulting from the spread of infections due to the Delta variant, soaring inflation, and supply constraints around the world, with the result that the UK and the U.S. also saw a slowdown in growth, but the UK and U.S. had posted stellar growth during the April-June quarter, at +22% annualized qoq (+5.5% qoq) and +6.7% annualized qoq (+1.7% qoq), respectively. Japan's growth during the April-June quarter was +1.5% annualized qoq (+0.4% qoq), so the extra growth margin available to Japan is not on the same scale.

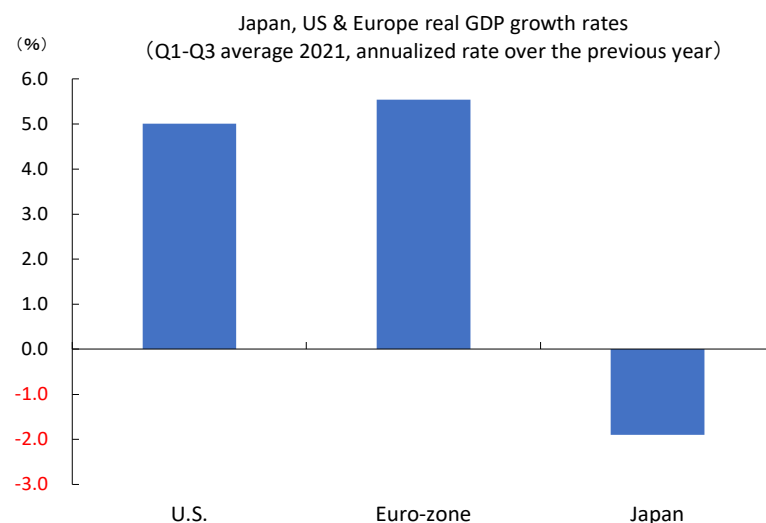


(Source) Japan Cabinet Office

Looking at growth by demand category, private demand, led by private consumption and non-residential investment, was conspicuously weak. This is natural, given that a state of emergency restricts the movement of people and, therefore, the desire to spend or invest. While the tight market in goods and components is pointed out as the reason behind lower economic growth in the U.S., in Japan, private inventory investment had built up to the extent of contributing +0.3pp to GDP growth. In other words, Japan's lack of growth is not due to supply constraints but rather weak demand. This is a good example illustrating how different Japan's problems are from those of the rest of the world. Note also that Japan's GDP growth rate for the July-September quarter is negative both in real and nominal terms, with nominal growth being negative for the third consecutive quarter, at -2.5% annualized qoq (-0.6% qoq). With this recent release, the government's goal of recovering pre-pandemic (October-December 2019) growth levels within the year has become a distant dream. In terms of real GDP, the recent quarter's results are lower than the October-December 2019 quarter by -2.2%, a gap that is impossible to close in the single remaining quarter (October-December 2021). Further, in Japan's case "recovering pre-pandemic growth levels" refers not to the October-December 2019 quarter, when the new consumption tax rate was adopted, but to the one before that, i.e., July-September 2019, which posted over 4% higher growth than the recent quarter. This makes recovering pre-pandemic growth levels difficult even within the fiscal year.

Growth Rate Gap Reflects Difference in Pandemic Measures

The figure to the right shows the average annualized qoq growth rates for the three quarters from January-March through July-September for Japan, the U.S., and Europe. The difference in the gap between the former and the latter two is obvious at a glance. This difference in real economic performance has affected the performance of Japanese stocks and JPY as discussed above, and I am apprehensive that this state of affairs may continue in 2022. The October edition of the IMF's World Economic Outlook pointed to the state of emergency and resultant movement restrictions in Japan as factors, but to be more blunt, Japan's weak economic performance is the unpalatable result of recklessly imposed pandemic measures. While it is true that the spread of infections due to the Delta variant, supply constraints on both people and goods, and high resource prices are all downside factors, these are common to the whole world.



(Source) Macrobond

I will refrain from discussing the effectiveness of human movement restrictions in preventing the spread of infections as I do not have sufficient information about this, but at least one thing is clear – the gap in economic growth rate between the U.S. and Europe, which opened up their economies unrestrained by the increase in new case numbers, and Japan, which has remained in a state of suspense. For instance, the euro area posted +9.1% annualized qoq (+2.3% qoq) growth, amounting to four times its potential growth rate, for the July-September period while struggling to contain infections from the Delta variant in populous member states including France and Spain. In Japan during the same period, media reports focused obsessively on the number of new cases while the country languished in a state of emergency for nearly the entire quarter. Naturally, the GDP (an indicator of the cumulative value added to the economy during the quarter) of the two economies are poles apart. Among advanced economies, Japan has had relatively few casualties owing to the pandemic in terms of human lives, but when it comes to economic growth, it has continued to lag behind the U.S. and Europe. This cannot be explained except in terms of the difference in pandemic measures.

Winter Will Put Kishida's Real Value to the Test

As of November 27, the effective reproduction number (the average number of cases directly generated by a single case in a population during a given period) in Tokyo prefecture is lower than 1 at 0.92, and at this rate infections are unlikely to increase rapidly. However, there are those who use the current, near-zero number of new cases to argue that infections cannot but increase going forward. There are no confirmed community infections due to the Omicron variant, but there are already ominous calls for preventive measures to be taken. Going by the conduct of past administrators, one can imagine that, if the media begins reporting on an increase in new case numbers, the Subcommittee on the Novel Coronavirus will advise some kind of movement restriction, and the government will follow past patterns of taking this advice. Some say that the correlation between human movement and the spread of infections was shown to be quite dubious in the (previous) fifth wave, but it seems likely that headline news about increasing case numbers will force the government to implement further pandemic prevention measures if only for the sake of not being seen as doing nothing. One cannot help worrying that Japan will once again be the only country to overreact to the Omicron variant and end up lagging behind the rest of the world.

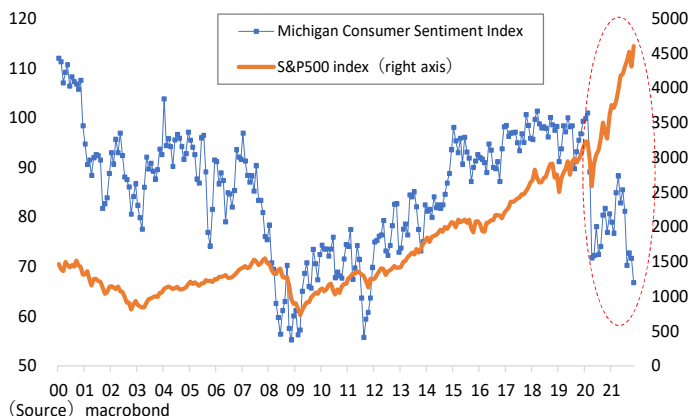
Ultimately, it all boils down to the fact that winter has arrived, and Japan still does not have a roadmap similar to the UK despite managing to get infections under control. Anxieties remain over the possibility of countermeasures similar to those during previous waves being implemented. The Second Fumio Kishida Cabinet's COVID countermeasures, which rely on making use of the previously indicated vaccine passports and increasing the number of hospital beds, inspire some hope that the Japanese economy will not tread the same path as it did in 2021. Will Japan be able to achieve sufficiently high growth for redistribution? This winter will tell.

The U.S. Economy and Monetary Policies Now and Going Forward – Could Inflation or the New Variant Unsettle the Normalization Process?

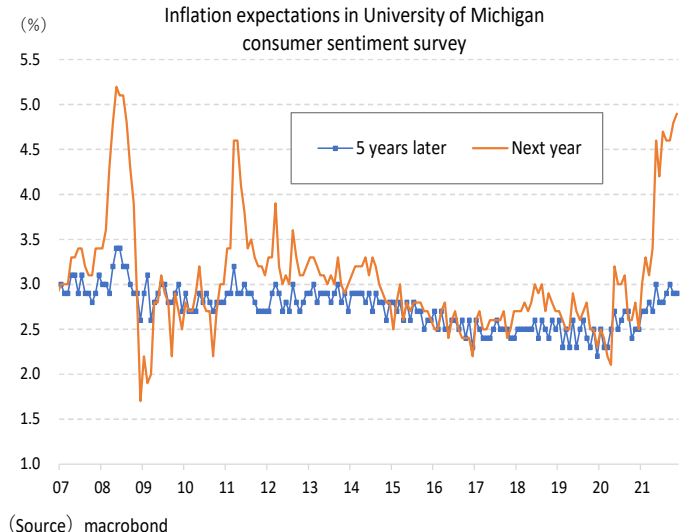
U.S. Consumer Confidence Falls to 10-Year Low

The U.S. economy is also not on entirely sound footing. Contrary to market forecasts of an increase (median forecast 72.5), the November University of Michigan Consumer Sentiment Index (released on November 12) fell from the previous month's 71.7 to 66.8. This is its lowest in 10 years, since the 63.7 posted in November 2011. As the figure to the right (top) shows, the disparity between this index and (the strong) share prices is unprecedented, and the two indicators being headed in opposite directions is of some concern. The reason for the deterioration in consumer confidence is undoubtedly the soaring inflation rates, with the chief economist of the University of Michigan Consumer Sentiment Index (Richard Curtin) commenting that it was "due to an escalating inflation rate and the growing belief among consumers that no effective policies have yet been developed to reduce the damage from surging inflation." Meanwhile, the Index of Expected Change in Prices During the Next Year (also part of the same survey) posted 4.9, the highest in 13 years since July 2008, while the Index of Expected Change in Prices During the Next Five Years remained stubbornly high at 3% or so. This damage to consumer confidence not from the rise in infections but due to soaring inflation rates clearly shows that the U.S. economy is now in the post-pandemic phase. Richard Curtin further noted that the survey revealed that one in four consumers were lowering their living standards due to the increase in prices, with lower-income consumers and seniors being the most affected. Share prices and consumer confidence moving in opposite directions could indicate that those who are not receiving the benefits of stronger share prices are suffering the greatest damage from rising prices.

U.S. stock price & University of Michigan Consumer Sentiment Index



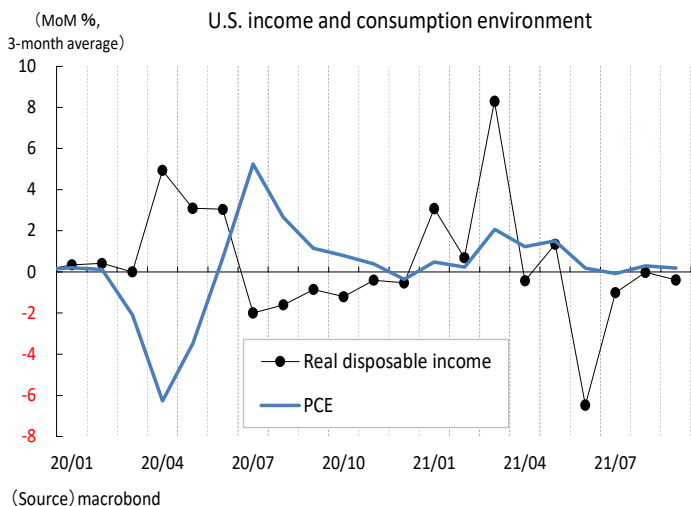
Inflation expectations in University of Michigan consumer sentiment survey



Real Disposable Incomes and Real Personal Consumption Expenditure Also Sluggish

The deterioration in consumer confidence is consistent with the combined sluggishness of real disposable incomes and real personal consumption expenditure. As is generally known, the sharp fall in the U.S. July-September real GDP was mainly owing to weak personal consumption, and in this sense, it is obvious that rising inflation and deteriorating consumer confidence are already beginning to weigh down on the real economy. In a normal year, the October-December quarter would post high growth driven by robust personal consumption during the year-end shopping season, but this year, amid supply constraints in both people and goods, not much can be expected. The +2.0% annualized qoq growth rate for the July-September quarter could be rationalized based on the average annualized qoq growth rate of +6.5% posted for the January-June period before that, but any further slowdown will result in a growth rate significantly lower than the nearly 3% potential growth rate. The most direct reason inflation is of concern is because it effectively acts as an additional tax on the household and corporate sectors. This lowers real disposable incomes and real personal consumption trends, thereby exerting downward pressure on growth. This is main risk facing the U.S. economy at the moment.

U.S. income and consumption environment



Main Difference Between Japan and the U.S. Lies in Who Absorbs the Costs

If personal consumption continues to slow down, corporate revenues will inevitably be affected. As of the current time, there seems no major discrepancy (see figure) between U.S. corporate revenues (nonfinancial corporate sector revenues released by the Department of the Treasury) and share prices (the S&P500). There is a big difference between the U.S. and Japan when it comes to the question of who absorbs the costs. In the U.S., where it is easier to pass along costs, the corporate sector is relatively more protected against damage from inflation, while the household sector perhaps bears the brunt of it. In Japan, however, it is extremely difficult to pass along costs, so that the corporate sector is forced to absorb any additional costs and respond by lowering wages (in an effort to preserve employment). Of course, another November indicator, the NY Empire

State Manufacturing Index posted an improvement from 19.8 in October to 30.9 in November, significantly exceeding the median of market forecasts (22.0), reflecting a big difference between business confidence and consumer confidence in the U.S. The prices received index, a part of the NY Empire State Manufacturing Index, had also increased by +7.3 pp to 50.8, the highest ever seen since the index began in 2001, again indicating that higher costs were being passed along quite smoothly.

In short, it is consumers who bear the burden of price changes in the U.S., while businesses do so in Japan, but it cannot be said that one is better than the other. The passing along of costs by U.S. companies also cannot continue indefinitely, and ultimately both Japan and the U.S. will face continued real economic slowdown until the root cause of the problem, i.e., supply constraints, is resolved. The Fed and the ECB are proceeding with policy normalization under the assumption that supply constraints will ease around mid-2022 and inflation will also be brought under control following that. The two central banks seem determined to see inflation as a “transitory” phenomenon until such time. However, if inflation continues to soar even after mid-2022, the focus will shift to the economic downturn, the policy normalization process would have to be reevaluated, and U.S. interest rates and eventually USD could begin to weaken. This is a currently conceivable risk scenario.

Risk of Accelerated Policy Normalization High as of Now

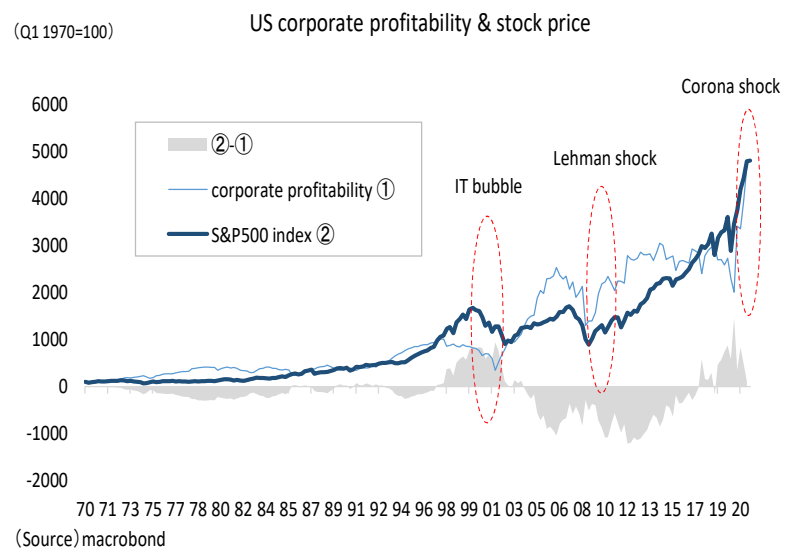
According to the minutes of the November 2-3 FOMC meeting (released in November), “Some participants suggested that reducing the pace of net asset purchases by more than \$15 billion each month could be warranted (...) in light of inflation pressures.” Further, “Various participants noted that the Committee should be prepared to adjust the pace of asset purchases and raise the target range for the federal funds rate sooner than participants currently anticipated if inflation continued to run higher than levels consistent with the Committee’s objectives.” Further, in his testimony on November 30, Powell told the Senate that he believed it would be appropriate to wrap up tapering a few months sooner than anticipated. He also said it was time to retire the term “transitory” inflation. Decisions on these issues will be formally made at the December FOMC meeting, but the possibility of tapering being wrapped up by March, followed by the implementation of rate hikes (possibly two or even up to three times as opposed to the originally expected once) has suddenly increased. As mentioned above, therefore, there is a need to take into account both the risk of a stalled policy normalization process as well as the risk of an accelerated one. Given the increased likelihood of the ECB withdrawing from its policy normalization in Europe amid rising infections, USD could strengthen not just against JPY but also against EUR.

Of course, tension has risen around the world with the emergence of the Omicron variant in late November, and there is a significant possibility of this delaying the normalization process, but as of the writing of this report, there is very little information on this new variant including vaccine efficacy, making it difficult to incorporate into my forecasts. However, Powell’s November 30 testimony was hawkish despite taking the Omicron variant into consideration, so it seems reasonable to consider a scenario in which the normalization process will proceed as per plans (or even be accelerated).

JPY Supply-Demand Climate – Weak-JPY Mood Bolstered

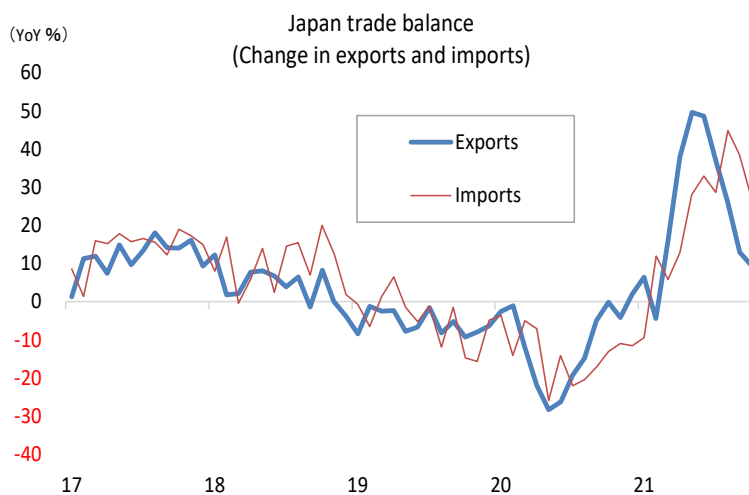
No Major Change in Trade Balance or Structure

The supply and demand climate seems to be further bolstering the probability of a weak-JPY scenario. Looking at Japan’s October trade balance, exports grew by +9.4% yoy at JPY 7.1840 trillion, while imports grew by +26.7% yoy at JPY 7.2514 trillion, resulting in the third consecutive month of trade deficit at -JPY 67.4 billion. This is a small deficit compared with the market forecast of over -JPY 300 billion, but there has been no change in the structure of imports outstripping exports (see figure on previous page). Export growth clearly peaked in early spring, and while imports have begun to slow since last month, it is difficult to categorize this as a “peaking,” given that it is the result of



commodity price trends. It seems inevitable that the structure of slowing exports and persistently high imports will continue for some time to come.

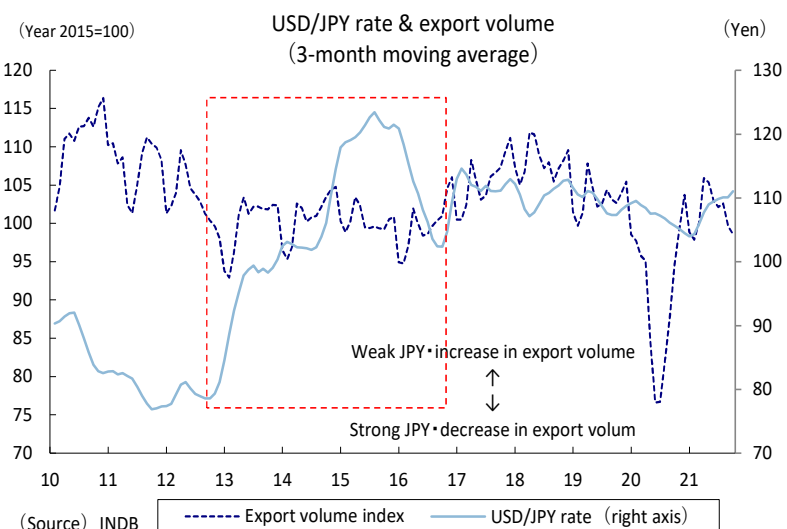
Looking at the figures by category, in the case of exports, automobile exports fell by as much as -36.7% yoy, clearly reflecting the significant production cuts by various Japanese automakers in Southeast Asia. The decline in auto exports has contributed heftily by -5.9 pp to overall export growth (+9.4% yoy). Meanwhile, imports are being boosted by mineral fuels including crude oil, coal, and liquid natural gas (LNG), with mineral fuel imports alone accounting for just under half (+12.3 pp) of the growth in imports (+26.7% yoy). Other major imports include iron ore and timber, which have contributed +3.9 pp, and chemical products including pharmaceuticals (vaccines, etc.), which have contributed +3.0 pp, showing that the rise in imports can be more or less explained by vaccine imports and the rise in commodity prices. Looking at the trade balance by product category in this way, it seems unlikely that there will be major changes in the trade balance any time soon. JPY's depreciation against USD since November is also likely to push up import prices going forward.



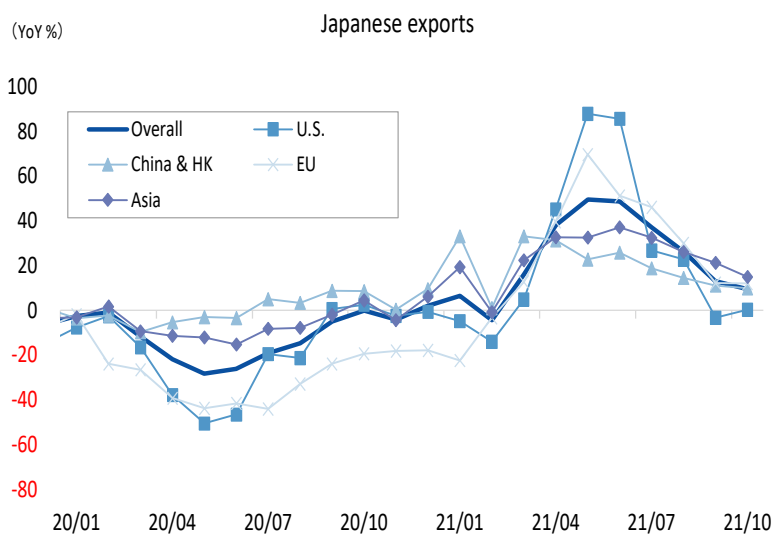
(Source) macrobond

Demand-Led JPY Selling Strengthens – Exports to the U.S. Reliant on Automobiles

As discussed also in last month's edition of this report, the failure of exports to pick up despite the weakening of JPY continues to be confirmed (see figure to the right, top). The October Export Volume Index fell for the first time in eight months to post -2.6% yoy. At this rate, it is difficult to make any sense of the widely held view that JPY weakness reflects its purchasing power parity (PPP). For that reasoning to make logical sense, the weakness of JPY would have to push up export volume, thereby boosting the trade surplus, eventually forcing export firms to buy JPY and push up JPY rates. However, what is currently happening in the Japanese economy is simply that the weaker currency is boosting import prices, thereby expanding the trade deficit, sowing the seeds for a further weakening of JPY. Of course, there is the fact that semiconductor and other component shortages have been negatively affecting automobile and other exports, but the disconnect between JPY rates and exports is not a recent phenomenon – it has been going on since 2013, when JPY weakened dramatically under the banner of Abenomics (see portion within the dotted square in the figure).



As I have repeatedly said in past editions of this report, the increase in exports we have seen since last year is led by special demand accompanying the return to normalcy of economies around the world. However, there is already a conspicuous trend of downward revision of economic growth forecasts in most of these countries/regions, making it difficult to forecast a continuation of the overseas-demand-led export growth scenario. Particularly conspicuous is the slowdown in exports to the U.S., where there has been a sizeable downgrading of growth forecasts amid supply constraints and soaring inflation (see figure on previous page). This slowdown is also partly due to the fact that transportation equipment including cars are the main category of Japanese exports to the U.S., and it seems wise to assume that this situation will take some time to be remedied. Without the ability to post a trade surplus in trade with



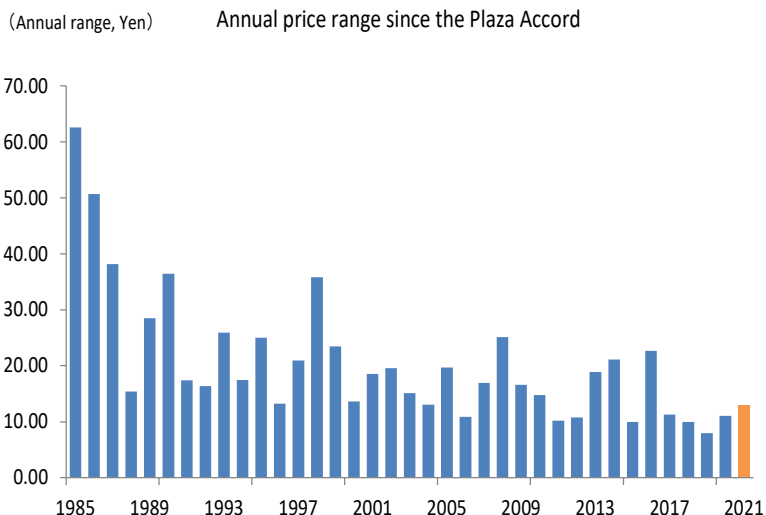
(Source) macrobond

the U.S., Japan's overall trade balance is bound to deteriorate. The expected scenario with regard to Japanese trade balance for some time to come is slowing export growth and rapid import growth, and it can be said that the trend of demand-led JPY selling will only strengthen going forward. I believe new reasons have emerged to bolster this report's weak-JPY/strong-USD forecast scenario.

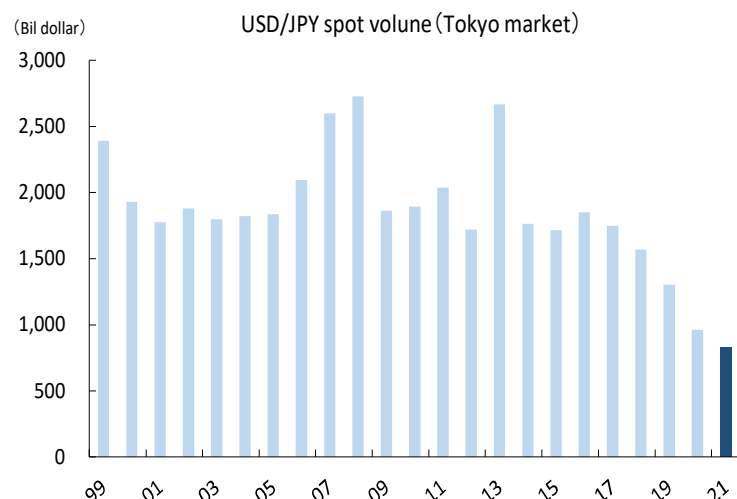
Risks to My Main Scenario – JPY Depreciation Portending a Major Market Swing?

Largest Margin of USD/JPY Movement in Five Years

Since October, USD/JPY levels have often moved by nearly JPY2 per day – the scale of daily fluctuations has continued to be relatively large compared to those seen in recent years. Since the beginning of 2021, USD/JPY levels have shifted by JPY12.93 (JPY102.59 to JPY115.52), and if current USD/JPY levels are sustained through year-end, this will be the largest margin of USD/JPY movement in five years, since 2016, when market conditions particularly volatile owing to the coincidence of the Brexit referendum and the U.S. presidential election victory of Donald Trump (see graph). Looking at the 37 years since the Plaza Accord, however, the JPY12.93 margin of USD/JPY movement is not particularly large – it is the ninth smallest margin of change during that period. Looking at the USD/JPY spot trading volume figures released by the BOJ, one finds that the total volume for the January-October period was only about USD830 billion, which is considerably less than the January-October period averages for the past 5, 10, and 20 years (approximately USD1.2 trillion, USD1.4 trillion, and USD1.6 trillion, respectively). Despite the increased margin of USD/JPY movement this year, one does not get the impression the movement reflects increased concerns about the Japanese economy or JPY – it still appears to be within the margin of error compared with margins of change seen in recent years. In 2013, when Abenomics was a hot news topic, January-October period spot trading volume was about USD2.7 trillion, three times this year's volume. At that time, there were many inquiries from overseas regarding Japan's political, economic, and financial situations, and the inflow of funds from overseas contributed significantly to a surge in Japanese stock prices. Currently, there is not much of an increase in the heatedness of market conditions to be seen.



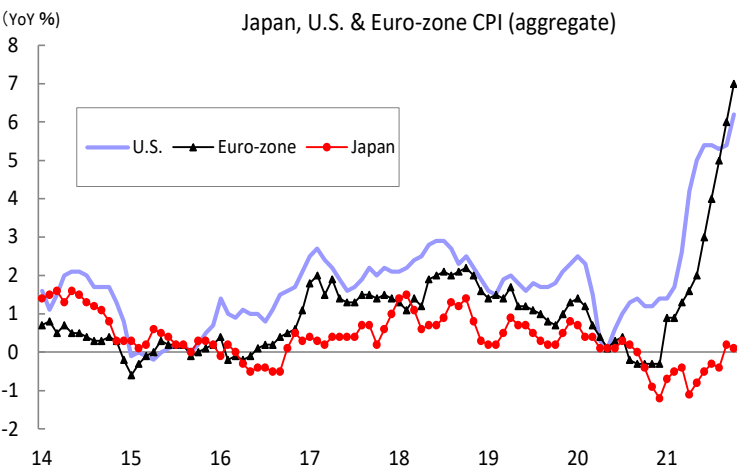
(Source) Bloomberg



(Source) Bank of Japan (Note) Total from Jan to Oct every year

Revival of Pre-2006 Situation?

However, one cannot completely rule out the possibility that this year's margin of USD/JPY movement – the largest in five years – might be a precursor to an upcoming major market swing. In the pre-2006 world, when inter-country interest rate differentials were still able to move forex rates, forex rate movements by a JPY15-20 margin were considered normal. For example, the 5-year average annual margin of USD/JPY movement for the 2002-2006 period was JPY15.68, and the 10-year average for the 1998-2006 period was JPY19.08. In the pre-2006 world, the concept that “only Japan has zero interest rates” was taken for granted, and that is why JPY carry transactions became so popular. Currently, the world's leading central banks are facing challenges from pandemic-spurred inflation surges and are showing signs of moving toward policy



(Source) Bloomberg

tightening in response (although it is admittedly too soon to confidently predict upcoming trends regarding covid-19 infections in continental Europe and their impact on ECB policies), but the BOJ remains in a different world. The difference between those worlds is apparent from a glance at recent inflation trends (see graph). If current trends are prolonged, it is not unlikely that the “only Japan has zero interest rates” concept will once again become an important element of financial market environments. In light of this, although this year’s margin of USD/JPY movement is not so wide a margin, it is possible to interpret it as being a precursor to a major market swing.

Next Major Market Swing May be One of JPY Depreciation

As mentioned above, despite the fairly wide margin of USD/JPY movement recently, the fact that “interest in Japan is low” cannot be denied, and it can be said that this situation promotes relatively low forex rate volatility. Basically, this article’s main forecast scenario anticipates that JPY will continue to depreciate gradually. However, there is no guarantee that the “interest in Japan is low” situation will continue forever. There could well be an increase in negative Japan-related trends. As noted, movements in financial markets (forex and stocks) this year suggest the Japanese economy’s inferior performance is directly promoting a “Japan avoidance” theme and, it should be remembered that financial market trends regularly show a tendency to culminate in overshooting in ways that can have painful results for relevant countries. Given that Japan is a resource importing country, it is inevitable that the continued coincidence of JPY depreciation and resource price increases will have unpleasant consequences for Japan. There are grounds for concern that market participants’ basic perception may come to emphasize JPY depreciation’s detrimental effect on the Japanese economy and that that perception will promote JPY selling. In the past, JPY appreciation under the Shirakawa-led BOJ’s policies led to such a perception of the associated negative impact on the Japanese economy, which in turn caused considerable turbulence.

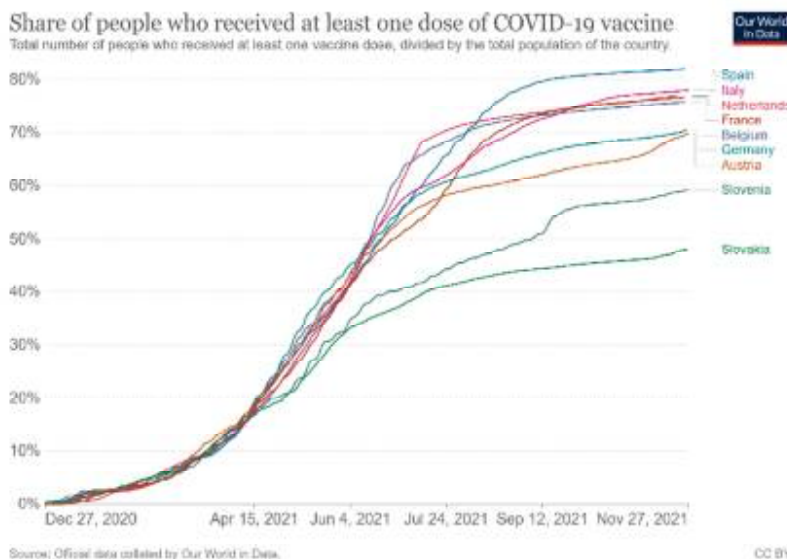
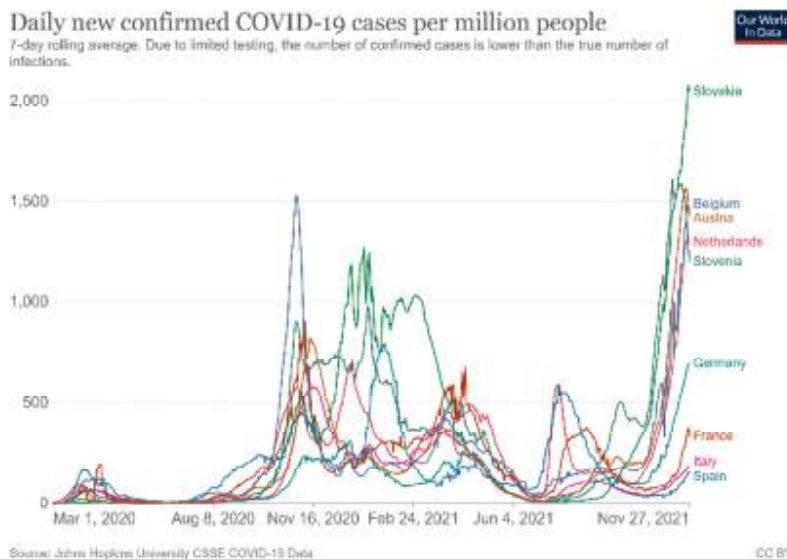
The problem is that, while it is theoretically possible for Japan to countervail JPY appreciation by infinitely undertaking the selling of JPY and buying of foreign currency, the scale of the country’s foreign currency selling and JPY buying is limited by the amount of its foreign currency reserves. When overshooting occurs, the magnitude of associated risks and the difficulty of restraining the overshooting are much greater in cases of JPY depreciation than in cases of JPY appreciation. If one calmly considers all JPY depreciation’s ramifications, however, one should note that JPY depreciation will also increase Japan’s world-leading net foreign asset balance owing to foreign exchange gains, and that in itself will promote the strengthening of JPY’s status as a safe asset. In light of that, it is evident that that a JPY depreciation trend could not continue indefinitely, and once this point is recognized, it seems clear that JPY should probably still be considered a kind of safe-asset currency. However, the forex market is subject to wave-like trends. Recognizing that “the next major market swing may involve severe JPY depreciation” should be an important basis for corporate sector forex hedging strategies, and the eventuation of such a market swing may present forex market participants with considerable profit-earning opportunities.

EUR Outlook – Resurgence of Covid-19 Infections Promotes EUR Depreciation

EUR Area Monetary Policies Now and Going Forward – Renewed Spread of Infections Likely to Halt Progress toward Normalization?

Infection Numbers Reflect Vaccination Rates?

Since the start of November, there has been an accelerating resurgence in the number of continental Europe's covid-19 infections. In many EU countries, the number of infections has reached new record high levels. New infections per million people (7-day moving average, as of November 26) is also attaining new record highs, and one finds that this indicator for Germany, for example, has exceeded 690. The surge in infections is even more pronounced in such countries as the Netherlands, Austria, Slovenia, and Slovakia (see graph). Why is the number of infected people higher than in the past when vaccination levels were lower? The reason is not clear, but the two graphs on the right give the general impression that countries with relatively large numbers of infections have relatively low vaccination rates, and that is why behavioral restrictions focused on non-vaccinated people are currently being proposed and implemented in Germany and elsewhere. While countries with high vaccination rates, such as Italy and Spain, are having greater success in restraining the level of infections, there appears to be a clear trend of increase in those countries as well. Of course, it should be noted that, despite the rapid increase in infections, particularly in Germany, the number of serious cases and deaths has been much lower than during previous infection surges, but it seems that governments are seeking to proactively impose behavioral restrictions before the winter, which is ordinarily the peak season for airborne infectious diseases. There are rumors that the accelerated spread of infections in continental Europe may be associated with the Omicron covid-19 variant that has been causing global consternation since it was discovered in late November. If the rumors are true, it will be a quite disappointing development, and it will be important to closely monitor emerging news about how effective existing vaccines are against the new variant vaccine so as to be able to predict its future impact.

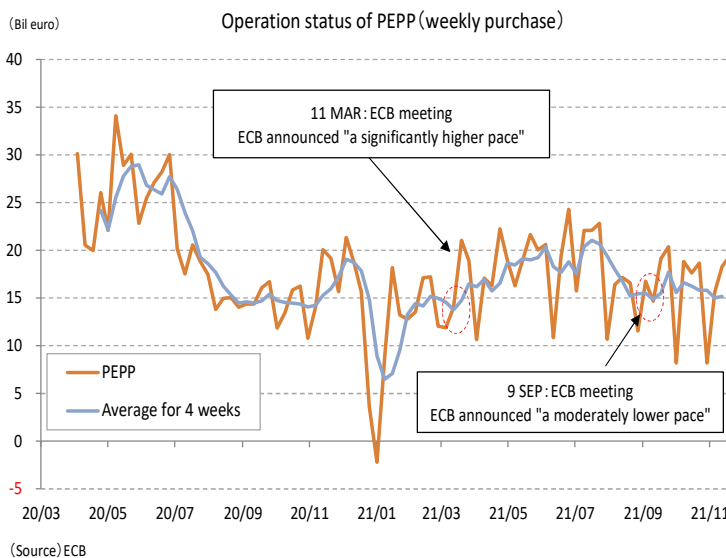


ECB Confronted with a Difficult Situation

The financial markets will be paying close attention to signs of how the resurgence of infections might affect the ECB's prospective normalization process. The ECB's last Governing Council meeting of the year, on December 16th, is expected to determine the disposition of the Pandemic Emergency Purchase Program (PEPP), which has been scheduled to be terminated in March 2022. As the PEPP's name itself makes it clear that the program is designed to respond to the pandemic emergency, one wonders whether it will be possible to discontinue the program at a time when the pandemic is resurging in terms of the number of infections. It is expected that the ECB will be positioned to make major policy adjustments following the December release of revised Eurosystem staff projections, but there is also a good chance that deliberations about such adjustments will be begun at the December Governing Council meeting with related decisions postponed to the January meeting. The exact factors causing covid-19 infection uptrends and downtrends in Europe and elsewhere remain unknown, and it has been pointed out that there are often seasonal and longer-period cycles in the incidence of infectious diseases. Given the difficulty of rationally predicting covid-19 pandemic trends at this point, postponing a decision about terminating the PEPP might be considered a wise

move. Released on November 25, the Account of the October 27-28 Governing Council meeting notes that there was general support for terminating the PEPP at the end of March 2022 but that it was also considered important to fully evaluate current and prospective economic trends before making a final decision on that issue. The account states that “the data available in December would not resolve all the uncertainties around the medium-term inflation outlook. It was seen as important that the Governing Council should keep sufficient optionality to allow for future monetary policy actions [such as not terminating the PEPP], including beyond its December meeting.” In view of this, it seems likely that, even if the PEPP is terminated on schedule, there may well be consideration of PEPP-replacement programs designed to promote a soft landing.

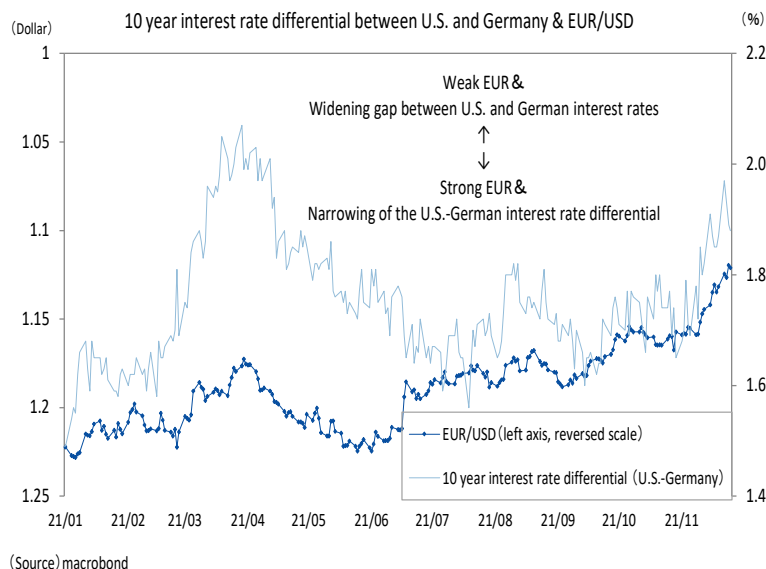
Considering the actual figures regarding ECB asset purchases, one gets the impression that the ECB will find it difficult to transition away from quantitative easing policies. The PEPP's average weekly purchases level in November was EUR17.3 billion, up from EUR15 billion in October (see graph). Although the September Governing Council meeting indicated that there would be a 'moderately lower pace of [PEPP] net asset purchases', the predicted slowdown has not been clearly evident, and it is possible this reflects the ECB's response to the resurgence of covid-19 infections, which began to be confirmed in late October. On the other hand, the rising levels of inflation rates in continental Europe are also considered problematic, and that situation makes it seem inadvisable to indiscreetly promote expectations of sustained easing going forward. The ECB is indecisively vacillating about whether to continue expanding its asset purchases or scale them down, and this appears to reflect the difficulty of the situation it is facing.



As mentioned above, Germany has focused its behavioral restrictions on non-vaccinated people, but on November 19, Health Minister Jens Spahn hinted at the possibility of a general lockdown for all residents regardless of their vaccination status. Two-thirds of the October-December quarter has already passed, so even if Germany were to immediately impose a general lockdown, the country might be able to avoid recording negative GDP growth for the quarter. But there remains cause for anxiety about economic performance in the upcoming January-March quarter, and this should be recognized as a factor contributing to the ECB's vacillation and desire to postpone major policy decisions to sometime after December.

EUR/USD Downside Risk and Potential Risk of Infection Surge in the United States

From the forex market's perspective, it is anticipated that widening monetary policy disparities between Europe and the United States will promote EUR depreciation against USD. As the United States is not facing the kind of covid-19 infection surge that Europe is, the Fed is pushing ahead with its normalization process, and it is expected that it will accelerate the pace of its quantitative easing tapering in light of rising inflation rates. Given the situation in the U.S. economy, where inflation is beginning to undermine consumer sentiment, it appears to be politically difficult to put a brake on the Fed's normalization process unless the Omicron covid-19 variant creates a fairly serious situation. Consequently, it is becoming easier to perceive the downward pressure interest rate differentials are exerting on EUR/USD, and in fact, the EUR/USD has continued to reach year-to-date record low levels during November (see graph).



Going forward, if the ECB shows signs of extending the PEPP (or creating a similar replacement program) and emphasizes that it will sustain its easing policies for the time being, it will become necessary to consider a risk scenario in which EUR/USD may fall below 1.10 during the 2022 January-March quarter. As EUR is still at a high level on a nominal effective basis, there is considerable leeway for its downward adjustment.

There are grounds for concern that the United States may also face a covid-19 infection surge going forward. In that case, the Fed will be in a more difficult situation than the ECB, given that inflation is becoming a serious societal problem in the United States. Assuming that U.S. inflation rates largely reflect supply constraints, however, the tightening of monetary policies would not be considered an appropriate countermeasure. (The Fed is continuing to move ahead with its normalization process based on the assumption that the effects of supply constraints will peak out some time before the midpoint of 2022.) A U.S. covid-19 infection surge would exacerbate supply constraints, however, so if the United States faces the kind of infection surge currently seen in continental Europe, the Fed may have to shelve its tapering plans and shift toward measures designed to support the real economy. Such a situation would likely present a risk of a temporary USD depreciation trend. The pandemic resurgences can be expected to dissipate eventually, however, and when they do, it can be assumed that the Fed will continue outpacing the ECB and BOJ in its progress toward normalization. Thus, even if there is a renewed covid-19 infection surge in the United States, it is probably rational to anticipate that it will cause only a “temporary dip” in USD exchange rates against EUR and JPY.

Appendix 1: German Politics Now and Going Forward – The Post-Merkel Era Begins

Striking a Balance between Germany's Old and New Values

On November 24, about two months after since Germany's federal parliamentary election (general election), a final agreement was finally reached on the establishment of a new German government. A ruling coalition was established among three parties – the center-left Social Democratic Party (SPD; top number of general election votes), the environmentalist Green Party (Greens; third in votes), and the liberal pro-business Free Democratic Party (FDP; fourth in votes). (This is commonly known as a “traffic light” coalition as those parties' traditional colors are red, green, and yellow, respectively).

The coalition chose Olaf Scholz, the SPD leader who has been serving as vice chancellor and finance minister, to replace Angela Merkel as chancellor. Mr. Scholz will officially become chancellor after his appointment is confirmed by a Bundestag vote in mid-December. Although it had been expected that the coalition talks might be difficult owing to disparities among the three parties' principles and policy objectives, the final coalition agreement was reached quite quickly because each party prioritized the expeditious establishment of a government.

It is worth taking a look at the main policy issues. Regarding fiscal policy, it has been confirmed that Germany's debt brake (Schuldenbremse; a fiscal debt-restriction policy incorporated in Germany's Basic Law, or constitutional law) will be preserved. It has also been reported that, while the country has recently tolerated relatively high fiscal deficits owing to the pandemic, the new government will seek to normalize those deficits from 2023. This may seem to be a defeat for the Greens, who been insisting on reforming the debt brake, but it is not. Climate change-related investments will be excluded from the debt brake's scope by taking advantage of the debt brake's pandemic-period suspension to pump considerable money into the country's climate investment fund, so the coalition is clearly showing quite a bit of consideration for the Green Party's policy objectives.

However, boosting climate change-related investment is not just a Green Party priority, as the Scholz-led coalition has given high-profile emphasis to its intention to shift away from the Merkel government's relatively passive approach to climate change countermeasures. It will be interesting to see how much fiscal spending the new government will actually implement, and it will be particularly worth seeing how much additional spending will become enabled under the 'climate change-related investment' rubric. It can be expected that there will be some resistance to the additional spending from the Green's FDP coalition partner as well as the opposition CDU/CSU. The coalition has set some specific climate change targets – including cutting greenhouse gas emissions to “net-zero” by 2045, eliminating coal-fired electric power generation by 2030 (the previous target date was 2038), and getting at least 15 million electric cars on the roads by 2030 – and these ambitious goals are tantamount to a declaration of the coalition's intent to structurally transform the German economy. Of course, this prospective transformation will be quite costly, and increased spending is expected to be focused on a wide range of investments for such purposes as the installation of electric vehicle charging stations, the subsidization of charging station purchases, and the upgrading of private homes' heat insulation. There will eventually arise a need to strike a balance between Germany's traditional emphasis on “maintaining sound finances” and the country's new emphasis on “climate change countermeasures”. While it can be argued that the climate change countermeasure spending should be in a category by itself owing to the moral imperative to protect the global climate, if that spending causes undue growth in fiscal budget deficits, the FDP and CDU/CSU are likely to begin fighting against it. Ambitious climate change spending objectives can be said to be among the most conspicuous items on the Scholz government's policy platform, along with the prospective diplomatic policy changes described below.

Problematic Portions of Both Right- and Left-Wing Policies

As the coalition government includes political parties with quite different basic principles, there is a risk that its policies may reflect negative aspects of both the right- and left-wing philosophies. For example, it is doubtful how much the new government will do to “integrate and deepen” the EU. As this article has mentioned in the past, the Merkel-led establishment of the NextGenerationEU recovery fund (NGEU) can be positively evaluated as a historical move enabling European Commission-issued bonds, but it has been confirmed to that the EC jointly issued bonds are time-limited in the EU budget for this term only and will not necessarily be continued. It is unfortunate that the traditional German right-wing emphasis on maintaining sound finances is likely to stymie efforts to make Germany promote greater EU integration. Also attracting considerable attention are leftist efforts to raise Germany's minimum

wage by 25% (EUR9.6 → EUR12). A higher minimum wage would raise concerns that the amount of employment may decrease over the medium-to-long term, and there is also fears that wage inflation would promote a general rise in prices in the short term. Boosting the minimum wage is a potentially dangerous move, particularly at a time when the potential threat of intensifying stagflation amid recessionary conditions is being keenly perceived worldwide.

The coalition's prospective distribution of ministerial posts reinforces the impression one gets that the coalition is encompassing both right- and left-wing policies. Regarding the ministerial posts allocated to the coalition's two junior party members, it is noteworthy that the foreign minister position has been given to the Greens and the finance minister position has been given to the FDP. This is particularly significant in that, while it was originally considered difficult to harmonize the FDP's policy positions with its coalition partners and the FDP is the third-ranking party in the coalition, the FDP was given the finance minister position. The finance minister position is considered the second highest minister post, so convention would ordinarily dictate that it be given to the coalition's second-ranked party (the Greens). It has been long been reported that FDP leader Christian Lindner would not keep his party within the coalition if he could not get the finance minister post, and it seems that the coalition took his threat seriously. It can be expected that the FDP control of the finance ministry will have the effect of somewhat restraining the largely leftist coalition government's desires to expand fiscal spending.

While restraining the expansion of fiscal spending may often be a praiseworthy objective, however, it also has a negative aspect in that it may suggest that Germany's finance ministry will seek to prevent the perpetuation of the NGEU recovery fund and countervail efforts to establish a euro area finance ministry and to continue issuing jointly issued EC bonds. It is impossible to deny that FDP control of Germany's finance ministry may impede further progress in EU integration. However, the other coalition partners will still be positioned to exploit the 'climate change-related investment' loophole to implement proactive fiscal stimulus policies, so it seems that the coalition's fiscal policies will include a mixture of some of the problematic portions of both right- and left-wing policies.

Germany's Diplomatic Risks in the post-Merkel era

It is also highly significant that the Greens, who have not concealed their hardline attitudes toward China and Russia, have obtained the foreign minister post. While the Merkel government prioritized economic benefits and was able to successfully bargain with China and Russia despite criticism from the United States and other countries, it seems unlikely that the Scholz government will be able to replicate that performance. Mr. Scholz has already demonstrated his willingness to address sensitive issues – announcing that his government will urge China to protect human rights and loosen control of Hong Kong and will support Taiwan's participation in international organizations. This has naturally triggered a backlash from China, and one wonders what this rocky start augurs for Germany-China relations going forward. The newly constructed Nord Stream 2 gas pipeline from Russia to Germany cannot begin operating until it is approved by the Germany government, but the government does not seem inclined to expedite such approval. One wonders whether the approval will finally be forthcoming if Germany's energy shortages become severe enough.

No Longer Positioned to Benefit from Rivals' Missteps

While the abovementioned issues are very important, however, the new Scholz government's first challenge will be deciding how to deal with the resurgence of covid-19 infections. The population would be likely to have a quite strong negative reaction to total lockdown measures, as evidenced by the violent protests that recently took place in response to a partial lockdown in the Netherlands. For the time being, it seems that a partial lockdown imposed only on non-vaccinated people in line with what the Merkel government has already proposed would be a safe response, but since Germany's vaccination rate is low even compared to other continental European countries, the new government may consider mandating vaccinations, as Austria has announced it will do.

While the lack of alternatives makes lockdowns and vaccination mandates seem to be reasonable options, it is inevitable that there will be public opposition to such measures. Although her initial covid-19 countermeasures were generally praised, even Chancellor Merkel has encountered strong opposition to her decisions to impose anti-pandemic behavioral restrictions. As he has a weaker political support base than Chancellor Merkel, if Mr. Scholz were to make the same policy decisions as Chancellor Merkel after he becomes chancellor, it may have a considerable negative impact on his voter approval rating. It should be remembered that while Mr. Scholtz's ability to become chancellor designate reflects his solid background of concurrently serving as the finance minister and deputy prime minister, it also reflects various missteps made by his leading competitors for the chancellor position – CDU party leader Armin Laschet and Greens party co-leader Annalena Baerbock. Given that he will become chancellor in large part owing to his rivals' mistakes, it may be difficult for him to gain sufficient political support for the introduction of controversial policies that clearly restrict individual freedoms, such as behavioral restrictions and vaccination mandates.

Even before officially becoming chancellor, Mr. Scholz has gotten off to a rocky start both domestically, where he faces almost insurmountable challenges associated with the resurgence of covid-19 infections, and overseas, where he has provoked a sudden deterioration of Germany-China relations. While his rivals' mistakes have helped him attain the chancellorship, he will be severely tested from the very beginning of his term in office by the intimidating challenges of leading Germany in the post-Merkel era.

Appendix 2: Current Brexit situation – Resurfacing of “No Deal Brexit” Risk

“No Deal Brexit” Risk Redux

The date of Britain’s full implementation of its withdrawal from the EU (Brexit) has been steadily approaching, although Brexit-related news has become overwhelmed by such major news themes as the pandemic, supply-chain problems, and associated rises in inflation rates. UK Prime Minister Boris Johnson’s government has been hinting that it might utilize Article 16 of the Northern Ireland Protocol to temporarily ease restrictions on trade between Northern Ireland and the rest of the United Kingdom. The EU has suggested that if the UK implements Article 16, it may impose retaliatory tariffs on imports from the UK as well as use such non-tariff barriers as increased inspections of such imports. In the worst case scenario, it has been reported that the EU might consider suspending the Trade and Cooperation Agreement (TCA) regulating its trade with the UK. If that were to happen, UK-EU trade would become subject to the ordinary regulations governing trade among WTO member countries. In short, the risk of a “no deal” Brexit that was often pointed out during the Brexit talks appears to have been revived. Below, I will summarize what is now happening in this regard using the Q & A method.

Q1: What is the Northern Ireland Protocol?

A1: The Northern Ireland Protocol was created to deal with the “Irish border issue,” which was considered the most difficult issue in the Brexit negotiations. The Irish border issue revolves around the question of how to avoid creating a physical border (a hard border) between Ireland and Northern Ireland. Northern Ireland attaches great importance being a part of the United Kingdom, but its withdrawal from the EU together with the United Kingdom has raised the prospect of creating a hard border to separate it from Ireland, which is an EU member state. Northern Ireland and Ireland would like to continue their pre-Brexit trade transactions with each other without a hard border, but realizing that goal might require Northern Ireland to give up its complete integration within the United Kingdom with respect to trade transactions. Of course, if the United Kingdom were to accept EU regulations after Brexit, then Ireland and Northern Ireland could continue trading as before (without the impediment of a hard border) without requiring Northern Ireland to give up its complete integration within the United Kingdom. That would require the United Kingdom to abandon its goal of “complete withdrawal from the EU” (exiting the EU’s customs union and the single market), but the Johnson government has promised to realize that goal.

The Irish border issue has thus come to be called the “Brexit trilemma” – as it is impossible to simultaneously achieve the three goals of “hard border avoidance”, “Northern Ireland’s withdrawal from the EU as an integral part of the United Kingdom”, and “the United Kingdom’s complete withdrawal from the EU” – and this trilemma caused delays in the Brexit negotiations. Prime Minister Johnson proposed a compromise solution that calls for Northern Ireland to remain in the EU single market but leave the EU customs union, which governs tariffs. Those are the terms of the Northern Ireland Protocol signed together with the Brexit agreement. But this protocol appears to have abandoned the “Northern Ireland’s withdrawal from the EU as an integral part of the United Kingdom” element of the Brexit trilemma.

Under the Northern Ireland Protocol, customs checks are now carried out between Northern Ireland and the rest of the United Kingdom (Great Britain, including England, Wales, and Scotland) rather than between Ireland and Northern Ireland. This has in fact prevented the emergence of a hard border, but the EU is naturally insisting on customs checks of goods moving from mainland Britain (Great Britain) to Northern Ireland, as the goods can easily move onward from Northern Ireland into the EU (Ireland). In terms of trade logistics, a distorted situation has arisen in which a kind of international border exists (between Northern Ireland and Great Britain) despite actually being a domestic border.

Q2: Why is the UK seeking to invalidate the Northern Ireland Protocol?

A2: This is because the harmful effects of actually implementing the Protocol became clear. As mentioned, instead of conducting various inspections between Northern Ireland and Ireland, it is now necessary to perform them between Northern Ireland and Great Britain. For example, Northern Irish companies that purchase supplies from Great Britain are required to obtain food safety certifications required by the EU as there would otherwise be a possibility of uncertified products flowing through Northern Ireland into Ireland (in contravention of EU regulations). Checking the regulatory conformity of various goods requires considerable complicated paperwork. For companies in Great Britain, shipping products to Northern Ireland is inefficient in terms of time and cost, as it requires procedures comparable to those required to ship products to foreign countries. As a result, shipments to Northern Ireland were sluggish and shortages of various goods began to become conspicuous. For example, the term “sausage war” has been coined to describe strife associated with the difficulty of shipping chilled meat products from Great Britain to Northern Ireland. This made the situation within Northern Ireland become unstable, principally owing to dissatisfaction among unionist residents who want Northern Ireland to remain an integral part of the United Kingdom. This past April unionist protest demonstrations led to violent rioting comparable to a civil war.

The United Kingdom argues that it has an urgent need to modify the Northern Ireland Protocol, as it is the root cause of the turmoil. Although the EU has considered this argument to be a self-serving negotiating point that it was disinclined to concede, the United Kingdom has been applying for temporary periods of exemption from EU regulations in Northern Ireland, and the EU has approved them. Rather than relying on such ad hoc temporary measures, however, the United Kingdom would like to radically revise the Northern Ireland Protocol.

Q3: What are the specific revisions sought by the UK?

A3: There are a wide variety of issues. For example, the United Kingdom is calling for measures to establish a “standstill period” of exemption from oversight by EU courts and other institutions so long as the Protocol review talks continue. However, from the EU’s point of view, the proposal is a mere pretext for suspending the Protocol and cannot be accepted. In addition, as many of the goods entering Northern Ireland from Great Britain are unlikely to move further into Ireland (the EU), the United Kingdom has requested that such goods be excluded from customs inspections. The EU has indicated that it will accept this request, and in mid-October it announced its intention to exempt various foodstuffs and animals and plants from inspections so long as there is a requirement that such items carry labels indicating they are for sale only within the United Kingdom. The EU has also indicated it will make concessions to prevent Protocol-required procedures from causing supply restrictions for such daily necessities as pharmaceutical products and hinted at its receptivity to the simplification of other procedures.

The United Kingdom is not content with these concessions (which do not require a fundamental revision of the Protocol), however, and it is continuing to hint that it may exercise Article 16 to suspend the Protocol’s application.

Q4: What kind of situation could lead to a “no deal” Brexit?

A4: The Protocol’s Article 16 states that “if the application of this Protocol leads to serious economic, societal or environmental difficulties that are liable to persist, or to diversion of trade, the Union or the United Kingdom may unilaterally take appropriate safeguard measures.” However, such safeguard measures are to be “restricted with regard to their scope and duration to what is strictly necessary”, and “If a safeguard measure [...] creates an imbalance between the rights and obligations under this Protocol, the Union or the UK, as the case may be, may take proportionate rebalancing measures as are strictly necessary to remedy the imbalance.” It is feared that the “proportionate rebalancing measures” that the EU might undertake could involve the suspension of the “Trade and Cooperation Agreement (TCA)” that the United Kingdom and the EU with great difficulty finalized on December 24, 2020.

The TCA sets zero-level tariffs on all items in compliance with the regulations of the originating country and has established a framework to ensure fair competitive conditions among companies. The still-smoldering issue of fishery rights has been tentatively settled based on a policy that requires the EU to gradually return to the United Kingdom 25% of its quotas for catches from UK waters over the five years through 2026. It has been understood from the beginning that the TCA is still subject to amendment – as it is to be reviewed every five years – but it is considered an extremely important agreement insofar as it enabled the avoidance of the “no deal” Brexit that financial markets were concerned about. If the EU were to suspend the TCA in retaliation for the invocation of the Protocol’s Article 16, the result of lengthy and difficult negotiations will evaporate and the possibility of a “no deal” Brexit will be revived. This is a potential development that the United Kingdom and EU – both of which are still in the painful process of recovering from the pandemic – want to do their utmost to avoid, yet the gap between their positions is broad enough to suggest that it might conceivably eventuate.

Q5: Is there an immediate possibility of an dire crisis?

A5: The TCA will not be immediately invalidated, leading to “no deal” Brexit, as 12 months prior notice is required before such invalidation. Any necessary dispute resolution discussions and procedures would be undertaken over a 12-month period, primarily by a joint EU-UK committee called the Partnership Council. The Partnership Council would undoubtedly striving to expeditiously find ways to avoid a “no deal” Brexit. In light of the history of EU-UK negotiations since June 2016, however, it can be expected that an agreement would not be reached until just before the end of the 12-month period. Thus, one should keep in mind the risk that the financial markets might once again have a lengthy period to renew their anxious speculation about the potential for a “no deal” Brexit. Such a situation would present an obstacle for the Bank of England (BOE), which is embarking on its policy normalization process and, while GBP has continued to be strong, such a situation would likely exert downward pressure on the currency.

Moreover, while the Irish border issue was just one of many contentious issues discussed during the original TCA negotiations, if the Northern Ireland Protocol-related problem were to threaten the TCA’s viability, the Partnership Council would have to tighten its focus on the Irish border issue. Such a focus is likely to highlight the seemingly irreconcilable positions of Northern Ireland’s Protestant residents (unionists), who insist on “unity with Britain”, and its Catholic residents (nationalists) who strongly emphasize “ethnic unity”. There are serious concerns about Northern Ireland’s societal destabilization in the wake of the April riots that took place in response to news headlines about potential compromise solutions. This difficult issue is likely to continue smoldering during 2022, six years after the 2016 Brexit referendum.

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