Forex Medium-Term Outlook

December 24, 2021

Overview of Outlook

USD/JPY movements during December continued in the appropriate direction. The brief JPY appreciation following news of the omicron variant did not continue very long, with USD regaining strength in line with the Fed's smooth implementation of policy normalization. 2021 has been characterized by the prevalence of an "undesirable weak-JPY" trend, and the "undesirability" can be interpreted in two ways. One is in the sense that it results from a Japan avoidance, while the other is in the sense that it is unfavorable for the Japanese economy. I believe the undesirable trend will continue in the former sense in 2022. Going by Prime Minister Fumio Kishida's general policy speech, it seems quite likely that the uniquely Japanese, zero-risk approach to controlling the pandemic will continue to erode economic growth in 2022. The "Japan avoidance" theme that determined forex and stock market trends in 2021 may inevitably continue for some time to come. While the close-to-50-year-low real effective exchange rate (REER) levels seem, in theory, to suggest nominal JPY appreciation, JPY may find it difficult to appreciate without any growth in Japanese exports. It seems more likely that the REER will be raised as a result of growth in inflation following the establishment of a tourism-based economy in Japan. In this sense, perhaps the unlikeliness of JPY appreciation can even be justified. Of course, there is also the risk of USD depreciation. The Fed's swing to an extremely hawkish stance has already invited a bear-flattening of the yield curve, and we may see another setback of the kind seen during 2018-2019. Demand-led USD depreciation can also not be ruled out. However, it is important to understand that, as in 2021, a USD selling trend does not necessarily imply a JPY buying trend.

EUR movements were also lackluster in December. Although the spread of infections in Continental Europe continues to be a source of concern, infections are already showing clear signs of having peaked in Germany and some Eastern European member states where things looked quite dire as of mid-October. While acknowledging the risks from a spread in infections, the ECB went ahead and decided to end the pandemic emergency purchase programme (PEPP) more or less on schedule. The decision to ramp up purchases under the Asset Purchase Programme (APP) as part of a radical monetary accommodation was also as expected. So, while lagging behind the U.S. and the UK, the euro area is also smoothly proceeding with policy normalization. A decline in EUR/USD may be inevitable during the first half of 2022 as a result of an increasing gap between U.S. and European interest rates. However, as the prospect of the APP entering a phased reduction and eventual termination emerges in the second half of the year, the ECB may also begin discussing rate hikes for 2023 and beyond. This is bound to limit EUR depreciation. Of course, despite some sluggishness, the euro area's economic and financial performance is much better than Japan's, so EUR/JPY is bound to remain strong.

Summary Table of Forecasts

	2021 Jan-Dec (actual)	2022 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2023 Jan-Mar
USD/JPY	102.60 ～ 115.52 (114.38)	113 ～ 118 (116)	114 ～ 120 (117)	115 ～ 121 (118)	116 ～ 122 (119)	116 ～ 123 (120)
EUR/USD	1.1186 ～ 1.2349 (1.1325)	1.11 ～ 1.16 (1.13)	1.09 ～ 1.15 (1.12)	1.10 ～ 1.16 (1.13)	1.11 ～ 1.17 (1.15)	1.12 ～ 1.18 (1.15)
EUR/JPY	125.10 ～ 134.12 (129.60)	126 ～ 132 (131)	125 ～ 134 (131)	127 ～ 136 (133)	128 ～ 138 (137)	130 ～ 140 (138)

(Notes) 1. Actual results released around 10am TKY time on 24 DEC 2021. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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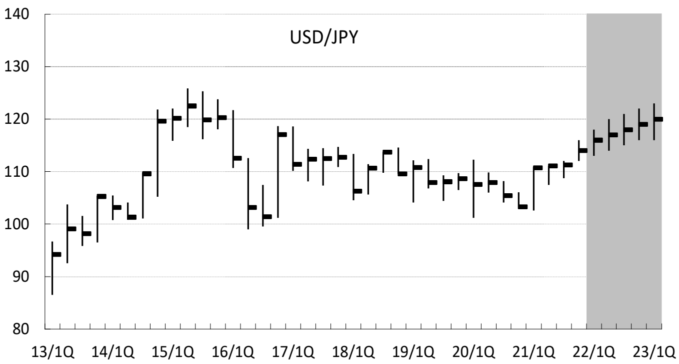
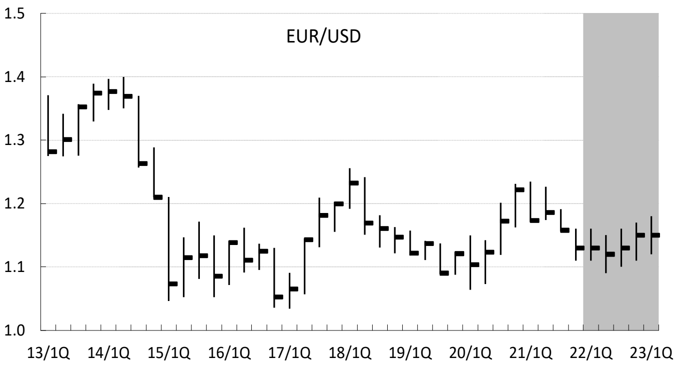
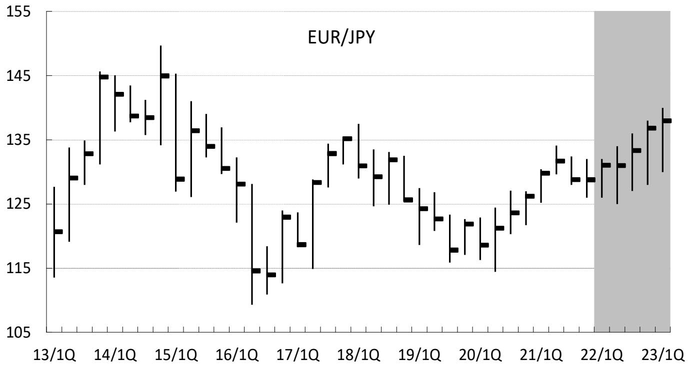
Exchange Rate Trends & Forecasts







USD/JPY Outlook – Japan Avoidance May Continue in 2022

Japanese Economy and Politics Now and Going Forward – Going by Kishida's Policy Speech, Japan Avoidance May Continue in 2022

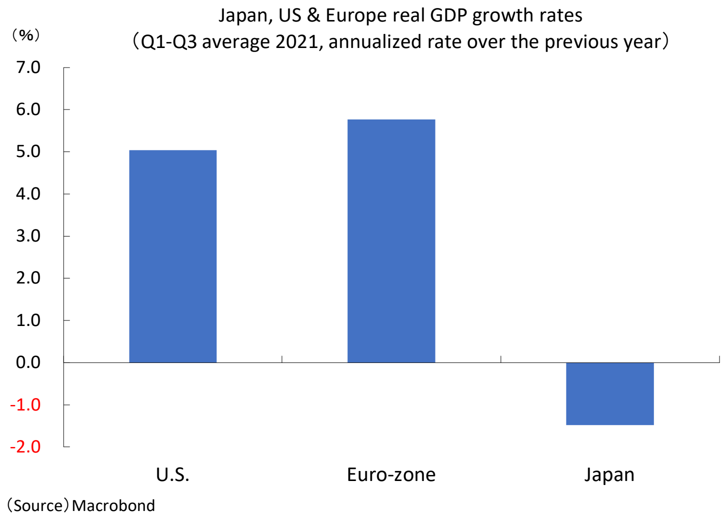
Japanese Economy May Continue to Mistake the Means for the Goal

In his policy speech on December 6, Prime Minister Fumio Kishida said, "This public finance is the result of economic activity, and we must not get that out of order," suggesting that an excessive focus on sound fiscal policy would hinder economic growth. However, with regard to economic activity, he said, "as we resume economic and social activities, we must be cautious in determining the state of affairs, and by no means merely assume optimism," indicating that measures against COVID would take precedence over normalization of economic activity. Mr. Kishida further said with regard to COVID measures on December 23 that being "too cautious" was the better option. I think it is exactly this putting of COVID measures ahead of economic growth that resulted in Japan being the only one among developed economies to post negative growth in 2021 and lagging behind other developed economies in terms of forex (JPY) and stock market performance. Given Japan's present circumstances, taking economic growth more seriously seems like the warranted course of action.

To begin with, Japan's pandemic control measures are already praiseworthy. As of December 16, the country's vaccination rate (percentage of people who had received at least one dose) was tied with Canada's at 79.43%, higher than any other country in the world. As for the number of deaths, Japan has the best outcome among G7 nations at 146 per million, which is in a different league altogether compared with the other countries including Canada (791 people/million), the distant second. Japan's attitude of still putting COVID measures ahead of the economy indicates fear of infections themselves despite having the best vaccination rates and lowest death rates. As long as this almost "discriminatory" attitude continues, it seems unlikely that people will be encouraged to consume or invest. High vaccination rates ought to be a means to achieve the goal of economic and social normalization – a strategy that is clearly being implemented in the U.S. and Europe. Japan, too, may have significantly recovered economic growth during the October-December quarter, when infections were very low, but a high price will have to be paid for spending almost all of 2021 in a state of putting the horse before the cart, and this is an important factor to consider in understanding the Japanese economy and asset prices in Japan in 2022 (details later).

Japan Avoidance May Continue in 2022

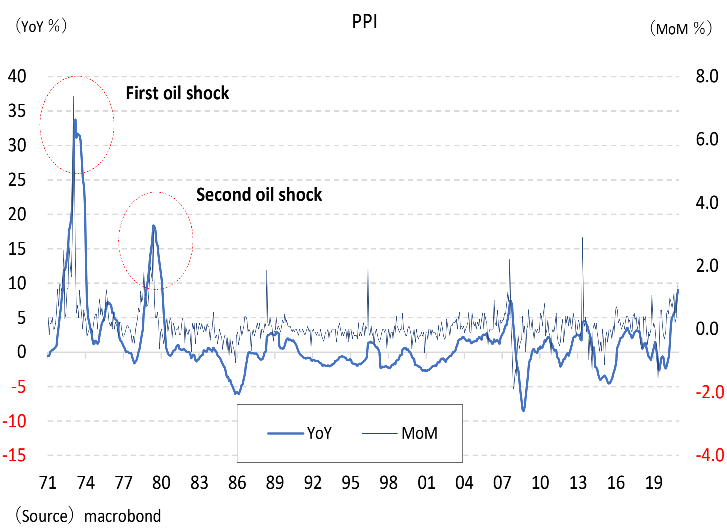
The number of new cases in Japan during the October-December quarter remained extremely low. Given this, there seems no good reason for the government to widely communicate its hesitant stance concerning economic normalization fearing the possible increase in infections at some point in the future. What one wants from administrators at a time of relatively low infections is to ensure sufficient medical resources so that yet another emergency can be avoided, not attempts to discourage the resumption of social and economic activity. I will leave an analysis of the effectiveness of Japan's pandemic control measures to the experts, but it seems very likely that Japan's unique approach to dealing with the pandemic is directly linked to the disparity in growth rates between Japan versus the U.S. or Europe. 2H of 2021 saw many challenges to economic growth, including the delta variant, supply constraints, high resource prices, and soaring inflation, but these were common to the whole world, and there is no reason they should sink only the Japanese economy. However, the fact is that Japan was the only economy that did sink. Looking at the average real GDP growth rate (annualized qoq) for the period from July through September, the U.S. saw +5.0% growth, the euro area saw +5.8% growth, and Japan posted -1.5% negative growth (see figure). This is not ordinary even taking into account Japan's originally low potential growth rate. It is the outcome of six months of movement restrictions in the shape of an emergency or measures to prevent the spread of infections since April.



It was investors' assessment of this wretched plight of the Japanese economy that, I believe, manifested as across-the-board JPY weakness in the forex markets and a lower rate of growth of Japanese equities compared with the equities of other developed economies in 2021. If Japan, instead of learning from this experience (failure), repeats its mistakes, the Japan avoidance trend is bound to continue in 2022. With regard to the weak-JPY trend in 2021, it is noteworthy that the idea that growth driven by a decline in Japan's purchasing power parity is undesirable finally gained widespread acceptance. This argument was inevitably met with criticism during the peak of Abenomics in 2013-14, but now, thanks in part to higher resource prices, people are beginning to feel a sense of crisis with regard to the undesirable weak-JPY trend. Going forward, if the government continues to give pandemic measures priority over economic growth, 2022 could well be a repeat of 2021 in terms of growth rates, and JPY may weaken further.

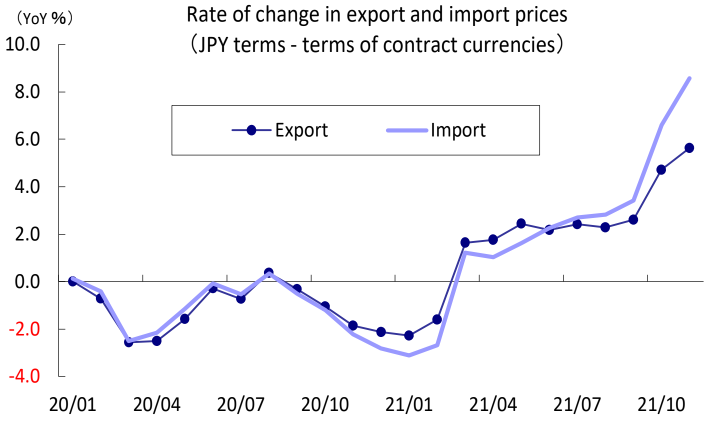
Will PPI Growth Peak at Highest in 41 Years?

Incidentally, the current level of JPY weakness is quite damaging to both the corporate and household sectors. The November Japan Producer Price Index (PPI, preliminary values) published by the BOJ on December 10 had grown by +9.0% yoy, the largest growth in the 41 or so years since December 1980, when the after-effects of the oil shock caused the PPI to soar. Mom growth was +0.6%, of which +0.17 pp are attributable to petroleum and coal products (e.g., gasoline, light mineral oil, and liquefied petroleum gas), +0.10 pp are attributable to utilities (electricity, gas, and water), and +0.09 pp are attributable to steel. Essentially, soaring commodity prices continue to raise headline figures, but obviously, this is a situation common to the whole world. However, a decline in demand with the emergence of the new omicron variant has caused resource prices to stabilize somewhat since the start of December, and it will be interesting to see if PPI growth will peak with the October-December 2021 quarter.



Import Prices in JPY to Visualize JPY Weakness and Resource Price Strength

In the case of Japan, JPY weakness adds to high resource prices. In this context, it is notable that while the import price index increased by +35.7% yoy in terms of USD and other contract currencies, it rose even more dramatically, by +44.3%, in terms of JPY. In other words, the degradation of JPY's purchasing power parity affects the import of resources, causing import prices in JPY terms to increase even more (reflecting the extent of JPY's weakness) than import prices in terms of contract currencies. Of the various producer price indexes, the import price index best helps visualize the impact of high commodity prices and a weak JPY.

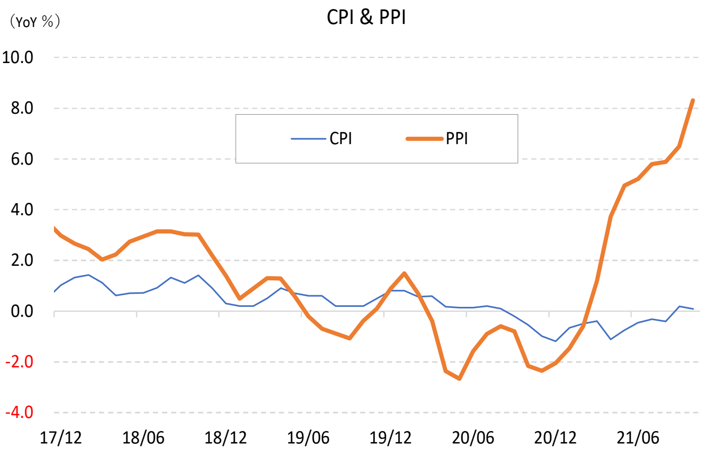


(Source) Bank of Japan

Meanwhile, as confirmed under Abenomics, rather than lower their foreign-currency-denominated export prices and increase their export volume during weak-JPY phases, Japanese exporters are more inclined to maintain sales prices and enjoy higher exchange rate gains. For instance, during 2013, when the BOJ under Governor Haruhiko Kuroda earnestly set Abenomics in motion, USD/JPY increased by approximately +20%. During this period, export prices in JPY increased by +11.6% yoy on average, but export prices in contract currencies did not fall by more than -1.7% per month on average. Despite the considerable depreciation of JPY, management decisions to lower foreign-currency-denominated sales prices were not made, and this is pointed out by many as the reason Japan could not increase its export volume in line with JPY depreciation. This time, again, export prices in JPY have increased with JPY weakness, but export prices in contract currencies have not fallen adequately. The figure on the previous page very clearly shows how JPY weakness no longer raises export volumes but only the volume of JPY outflow from the country.

Corporate Sector Suffering Under Pressure

Looking at costs by use case and demand stage, there is a very significant gap between costs during the production and sales stages. This hints at the circumstances in which the corporate sector is placed, unable to pass on the rising costs and enduring lower profits as a result. For instance, production stage costs of raw materials and intermediate goods have risen dramatically by +74.6% yoy (+8.6% mom) and +15.7% yoy (+1.0% mom), respectively. Meanwhile, the cost of finished goods has risen only modestly, by +4.6% yoy (+0.4% mom). Even among finished goods, the price of final consumer products (domestically produced), which has a greater relevance in the consumer price index (CPI), has risen by a mere +2.7% yoy (+0.7% mom), decelerating from the +2.3% yoy (+0.7% mom) recorded during the previous month (October). The inflationary pressures have not spilled over to the household sector.



(Source) macrobond

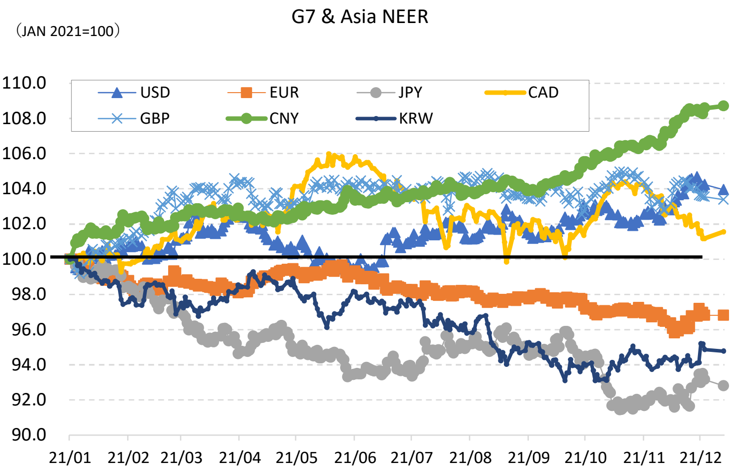
This state of affairs can be seen in the divergence between the PPI and the CPI (see figure). For instance, as of the writing of this report, the latest (October) data shows that an increase in PPI by +8.3% yoy and in CPI by +0.1% yoy, resulting in a gap of 8.2 pp. This is the biggest gap since July 1980, when the after-effects of the oil shock were quite strong, even though at that time, the CPI also grew strongly, by +7.4% yoy, posting a significant increase in growth rate compared with the average for the previous three years (January 1977 to December 1979). This time, with almost no ripple effect discernible on the CPI, the PPI alone has risen, increasing the burden on the corporate sector to that extent. If this continues for long, corporate earnings will suffer and give rise to concerns about the effect on share prices.

Why is the CPI not growing? There may be several reasons for this, but one reason is probably the delay in domestic demand recovery. As mentioned above, the Kishida administration has clearly indicated that it will prioritize pandemic control measures over economic normalization, so it seems quite likely that, as in 2021, stronger measures against the pandemic than warranted by the number of casualties will continue to be taken in 2022. Inevitably, domestic demand recovery will remain lackluster. Under such circumstances, it would be difficult for most businesses, except highly cost competitive large enterprises, to pass along any increase in costs. Theoretically speaking, the predicted path is a decline in corporate revenues leading to an adjustment in jobs or wages. If costs cannot be passed along, companies will have no choice but to cut costs in the production stage (either by reducing their staff or lowering wages). Unfortunately, the current administration's stance ("as we resume economic and social activities, we must be cautious in determining the state of affairs, and by no means merely assume optimism" – PM Kishida) is not conducive to whetting consumption or investment appetites, and companies may have to continue bearing the brunt of this cost-push inflation.

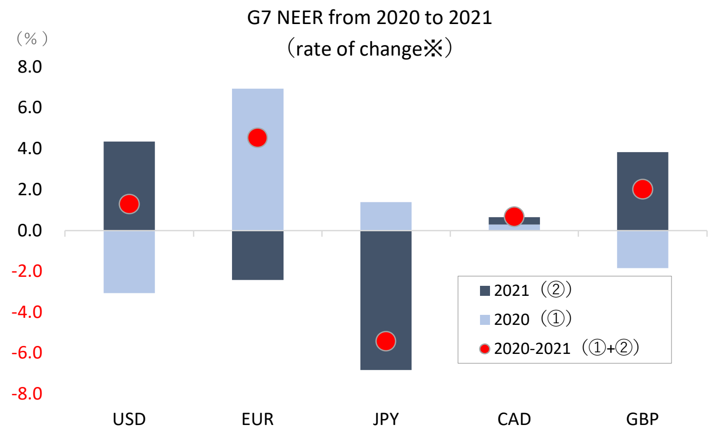
JPY Now and Going Forward – A Recap of the "Undesirable Weak-JPY" Idea that Surfaced in 2021

The "Undesirable Weak-JPY" Idea Attracted Fresh Attention in 2021

2021 has been characterized by the prevalence of an undesirable weak-JPY trend, and the "undesirability" can be interpreted in two ways. <u>One is in the sense that a lack of confidence in the Japanese economy and political decisions strengthened the JPY selling trend and resulted in "Japan avoidance,"</u> i.e., that one of the reasons investors let go of JPY in 2021 was because of the Japanese economy's dismal performance compared with other developed economies. I too think this possibility cannot be ruled out. 2021 was truly a year of across-the-board JPY weakness in the forex markets. This is quite obvious when we compare the nominal effective exchange rates (NEER) of JPY and the currencies of Japan's main trading partners. The figure to the right (top) compares the NEERs of G7 nations as well as China and South Korea, taking their levels at the start of 2021 to be 100. The currencies that lost value compared with the baseline 100, in descending order of weakness, are JPY, KRW, and EUR. Of course, EUR's depreciation was a reaction to its significant appreciation in 2020, and the currency maintained a net increase when both years are taken together (see figure to the right, bottom). This leaves JPY and KRW as the only currencies that weakened amidst the pandemic, but among G7 currencies, JPY is by far the only one that has weakened.

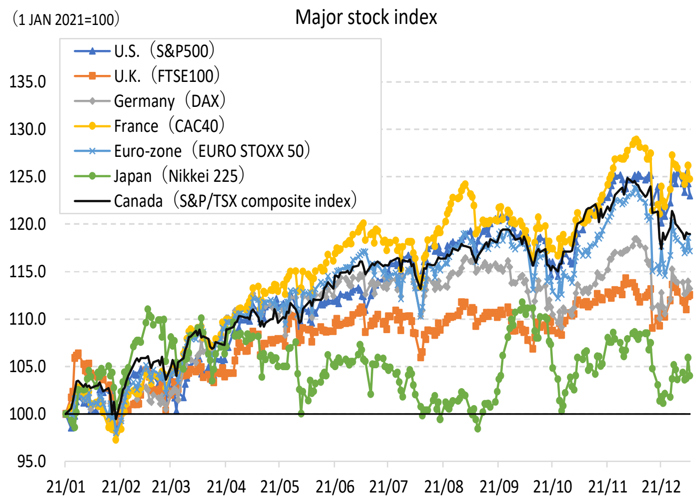


(Source) macrobond



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

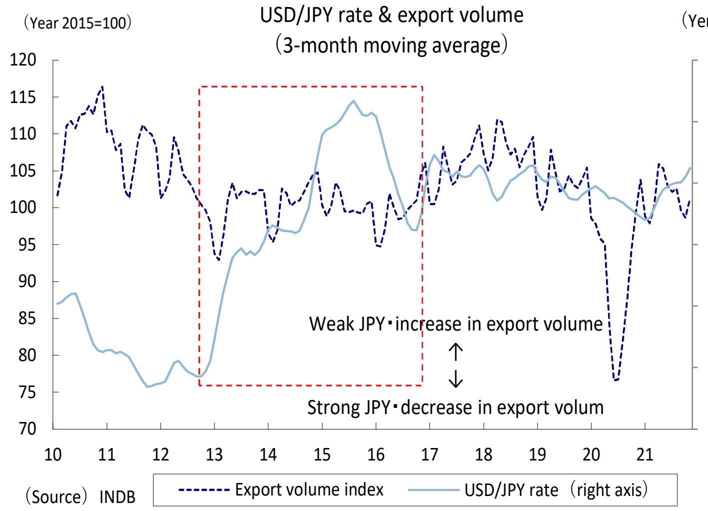
A similar structure can be seen in the stock markets, with Japanese stocks alone showing dull performance among major G7 stock indices (see figure). <u>It is no exaggeration to say that financial market investors in 2021 avoided Japan because of its weak real economy</u>. In the past, JPY weakness often progressed during phases of global economic recovery, when interest rates everywhere but Japan began to recover, and Japanese institutional investors, amid renewed confidence, sold JPY to buy foreign-currency denominated marketable securities (U.S. Treasury securities or equities, etc.). As a result, the weakening of JPY did not particularly have a negative image. However, the weak-JPY trend of 2021 was widely seen as the result of investors disliking Japan as an investment destination, and in this sense, the "undesirable" tag stuck.



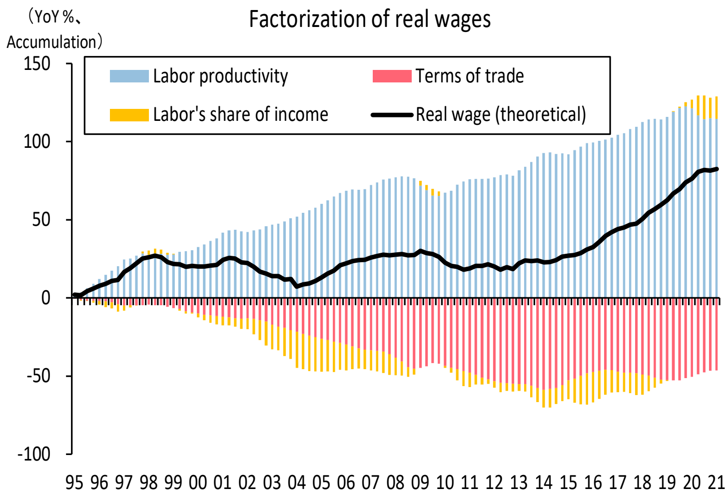
(Source) macrobond

JPY Weakness No Longer a Plus for the Japanese Economy

Yet another interpretation of the "undesirable" JPY weakness in 2021 is in the sense that it is not desirable for the Japanese economy. To be honest, this interpretation has come a bit too late. Since 2013, arguments doubting the effectiveness of reflationary policies have been repeatedly presented in light of the large-scale monetary accommodation rolled out by the Kuroda BOJ. These arguments have included the fact that a weak JPY merely invites an outflow of income, and that a weak JPY cannot result in economic recovery without an increase in exports. Despite this, large-scale monetary accommodation was continued on experimentally, based on the argument that the effects cannot be seen until prices increase. However, neither the dramatic weakening of JPY in and after 2013, nor the across-the-board weakening of JPY's NEER seen in 2021 have resulted in any marked increase in export volume (see figure) or in any recovery of the trade surplus. In the case of 2021, crude oil price rises have coincided with the JPY depreciation, making it easier for ordinary people to experience a deterioration of their real income environment via an increase in prices of imported products as a result of JPY weakness.



I received a large number of requests from September through December to talk or write about why JPY weakness is not good for the Japanese economy. This may be the first time there is so much concern in Japanese society regarding the negative effects of a weak JPY. The concern is, in fact, warranted. It is an act of self-harm for an oil importing country to actively seek a weak domestic currency in any case, but an enthusiastic attitude toward a weak JPY is quite problematic especially now, when many companies have shifted their production bases overseas and exports are failing to rise. The deterioration of the terms of trade (i.e., an expansion of trading losses) as a result of JPY weakness theoretically leads to a depression of real wages. Specifically, hourly real wages have three components – (1) hourly labor productivity (real GDP ÷ total hours worked), (2) terms of trade, and (3) labor's share of income (nominal employee compensation ÷ nominal GDP). The figure analyzes the factors contributing to the cumulative change in real wages since 1995, and it is easy to tell at a glance that a deterioration in the terms of trade has weighed down real wages. It is obvious that selling cheap and buying expensive is not the way to become affluent.



(Source) Cabinet Office "National Accounts of Japan", Ministry of Health, Labour and Welfare "Monthly Labour Survey"

Could Weakening JPY be a Target Going Forward?

As a result of fresh awareness of the "undesirability" of a weak JPY in two senses of the word, more people seem to be questioning blind deference to JPY weakness as a desirable thing. Back in 2013, few people listened to arguments against the political reverence for a weak-JPY trend as though it was a panacea, but things are different now. This change in social norms may be the silver lining of a dark cloud. For one thing, an uncontrollable weak-JPY trend is exponentially more dangerous than an uncontrollable strong-JPY trend. In theory, it is possible to implemented unlimited currency intervention (sell JPY and buy foreign currency) to correct a strong JPY trend, but the reverse (selling foreign currency and buying JPY to correct a weak-JPY trend) can only be implemented until foreign currency reserves last. Especially given that Japan is a resource importing country, any phase where the country has to protect its currency (prevent it from falling further) would be extremely frightening. However, as the new societal norm (of not desiring a weak JPY) sets in, there is a greater fear of JPY swinging toward weakness. This is because financial markets tend to swing in the direction that the authorities do not want them to.

Once it becomes widely known that a weak JPY is an inconvenience for the Japanese economy, speculators could take a predatory strategy of JPY selling. This is because, if JPY weakness is really undesirable for the Japanese economy, the government and the BOJ would, at some point, have to take some kind of action to reverse the weakness. And when that happened, it would be very easy to reverse the trade (in this case, buy JPY) and make a profit. This is what they call "buying the rumor and selling the fact." Since the collapse of Lehman brothers, Japan has frequently suffered from upside pressures on JPY, as was the case during former BOJ Governor Masaaki Shirakawa's term. Going forward, things could be reversed. If so, the present time may be a phase of transition.

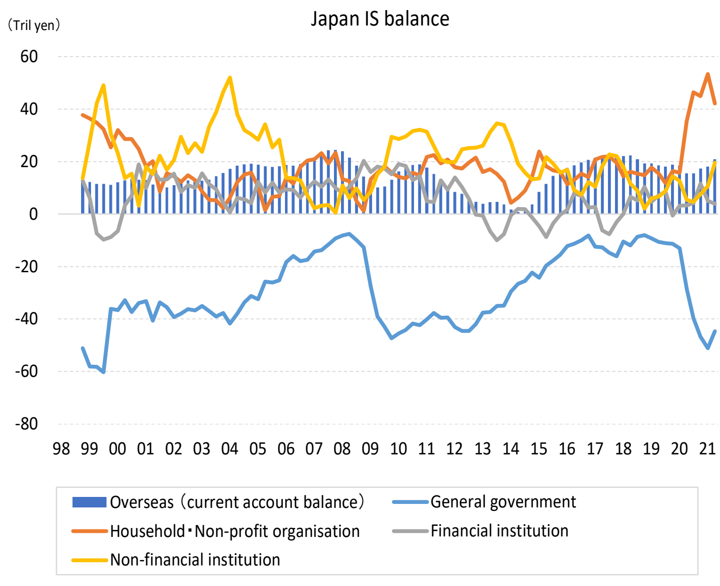
Easy to Explain Away JPY Weakness as Result of Large Government Debt

It has always been pointed out that, given the political, economic, and financial circumstances in which Japan is placed, it seems strange for the country to chronically suffer from a strong currency. Why should JPY be considered a safe asset when Japan is one of the most rapidly aging countries in the world, with rapidly declining birth rates, one of the most unfavorable growth rates in the world, and the largest government debt anywhere in the world? This is the reason behind the deep-seated fear that JPY could, at some point, suddenly go into a free fall. Specifically, one often hears admonishing speeches to the effect that Japan's enormous government debt could trigger a rush to sell off of JPY. As of 2021, Japan's government debt amounted to +256.86% of its nominal GDP (estimates as per the IMF's October 2021 World Economic Outlook), by far the largest in the world. Such figures understandably give rise to concerns of a weak JPY going forward. However, the path from large government debt to JPY weakness is not as straightforward as it seems at first glance.

Japan's enormous government debt (as a percentage of nominal GDP) even by global standards is not a recent development. Government debt had surpassed 100% as early as 1997, and the idea that the Japanese economy will, at some point, have to face a dramatic rise in prices and interest rates has been quite prevalent. However, government debt has since ballooned to over 2.5 times the level in 1997, but 10-year interest rates are now negative and prices have remained consistently low. It seems there is not much substance to arguments that focus on government debt levels. To state this more clearly – a negative interest rate on Japanese government bonds indicates a greater demand than supply of what investors consider to be an extremely safe asset. As is widely known, over 90% of JGBs issued are held domestically, so unless there is a flight of capital, with Japanese people rushing to invest their funds overseas, it would be difficult to justify the widespread reasoning that a large government debt results in higher inflation and, therefore, in a weak JPY.

Net External Assets and Current Account Balance Better Explanations than Government Debt

The current account surplus provides the most straightforward explanation of why most Japanese government bonds are bought up in the domestic market. Looking at the saving-investment (I-S) balance in the Japanese economy, it is clear that the saving surplus (excess savings) of the private sector exceeds the saving deficit (insufficient savings) of the government sector, resulting in a current account surplus (i.e., a saving deficit in the external economy sector) – see figure on next page. However, if the savings rate decreases in the coming years as society continues to age, the government sector's saving deficit could become greater than the private sector's saving surplus, resulting in a current account deficit. In that situation, the Japanese economy will become dependent on an inflow of funds from abroad. Japanese government bonds do not have a great credit rating to begin with, and the Japanese economy is not sufficiently geared toward fiscal reconstruction or growth for the rating to be raised, so the Japanese government would have to pay a higher interest rate on its bonds for foreign investors to be interested in them. How high the interest rate would have to be is a complex issue, but it is natural to worry about the potential for JGBs to crash (soaring JGB yields) and for JPY to crash alongside them.



(Source) macrobond

In other words, the statistic to pay attention to is not government debt in isolation, but the current account balance, which includes government debt. As someone who studies and analyzes the forex markets for a living, I am frequently asked, "If JPY were to crash, what could potentially trigger such a crash?" Based on my understanding as described in the previous paragraphs, I respond that if the calendar-year current account balance were to turn red, it could symbolically set off a JPY crash. Japan's net external assets are the result of its current account surplus built up over the years, and as of the end of 2020, Japan has had the largest net external asset balance in the world for 30 years in a row. This is the single biggest reason JPY is seen as a safe asset despite all the failings of the Japanese economy. The current account balance turning red could symbolize entry into a phase of decline in Japan's net external assets, the yearly growth of which has been taken for granted thus far. This could be a trigger for investors to begin questioning the safety of JPY as an asset.

Of course, in reality, a change in the price of assets owned (for instance, a change in share or bond prices or forex rate fluctuations) could also significantly affect the balance of net external assets, so the current account balance turning red may not immediately trigger a net external asset decline or JPY selling. However, the calendar year current account balance turning red is a reasonable indicator of the pulse of the times, and one must remember that forex market participants, in particular, tend to act instinctively. Should anything happen to affect Japan's current account surplus or net external assets, which they have been taking for granted, investors could turn right around and sell off their JPY holdings.

Of course, there are many other points to consider in addition to the aforementioned. However, given the consistently rising trend of fiscal deficits and, therefore, balance of government debt, on a calendar year basis, if private sector savings were to start declining as society ages and birth rates decline further, the former could naturally subsume the latter at some point. If that happens, some market participants are bound to assume current account deficit → decline in net external assets → skepticism about the safety of JPY → JPY weakness → inflation. Adhering to a path of fiscal reconstruction as though it were the Gospel is dangerous, and JPY is not going to crash as soon as the authorities stray from the path of sound fiscal policy, but chronic fiscal deficits and the resultant ballooning of government debts definitely carry the risk of a current account deficit and, therefore, JPY depreciation.
I think the new awareness of the undesirability of a weak JPY that emerged in 2021 has given us a chance to earnestly reconsider how best the Japanese economy and Japanese people themselves can protect their domestic currency going forward.

U.S. Monetary Policy Now and Going Forward – Inflation may not be "Transitory"

QT Could be in the Offing, but Dialog with Markets Seems to be Going Well
The FOMC decided at its December meeting to accelerate tapering (a phased reduction of quantitative easing or QE), with Committee members' projections of the federal funds (FF) rate (the dot plot) also indicating an earlier start of rate hikes. The pace of tapering was doubled from -USD 15 billion per month (-USD 10 billion in U.S. Treasury securities and -USD 5 billion in mortgage-backed housing loans) to -USD 30 billion (-USD 20 billion in U.S. Treasury securities and -USD 10 billion in mortgage-backed housing loans), bringing the expected end of tapering forward from June 2022 to March 2022.

Given that interest rates can be raised only after exiting QE, bringing the end of QE forward amounts to laying the ground for rate hikes, and this backs the changes seen in the dot plot described in the next section. Having laid out a quick roadmap for exiting both QE and interest-rate-based easing, the focus of the Fed's policy normalization process will now enter its final stage, i.e., quantitative tightening (QT). The next critical juncture will be to see how and when the Fed hints at suspending the reinvestment of marketable securities, with some members already calling for this to begin as soon as tapering ends, indicating the presence of a significant number who say QT is possible before the start of rate hikes. In fact, Fed Chair Jerome Powell admitted at his press conference that long-term balance sheet management had been discussed at the meeting. During the previous phase of policy normalization, QT began in October 2017, approximately two years after the first rate hike was implemented, so the speed will be unprecedented this time if QT is implemented before rate hikes even begin. At any rate, it is notable that market turmoil has been avoided despite this rapid pace of policy normalization – perhaps evidencing the Fed's skillful dialog with the markets.

No More Improvement After Reaching Full Employment in 2022
Looking at the Summary of Economic Projections (SEP) by FOMC members (see figure), the unemployment rate projections all the way from 2022 through 2024 were projected to be 3.5% (down from 3.8% in September). Given the long-term unemployment rate (4.0%), aka the natural unemployment rate level, one could say the projections indicate that a state of full employment will continue starting 2022, with unemployment rates no longer improving from that point. As for inflation, the core personal consumption expenditure (PCE) deflator is projected to remain higher than +2.0% throughout the forecasting period from 2022 through 2024, indicating that both the mandates of the Fed (employment maximization and price stabilization) are expected to be fulfilled from 2022 onward. It is quite natural and justified, therefore, for the Fed to end tapering, start rate hikes, and perhaps even implement QT taking into account this employment and price situation. Going by the dot plot, three rate hikes each in 2022 and 2023 and two rate hikes in 2024 are expected, which, if realized, will result in 8x25 bps i.e., +200 bps worth of rate hikes.

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

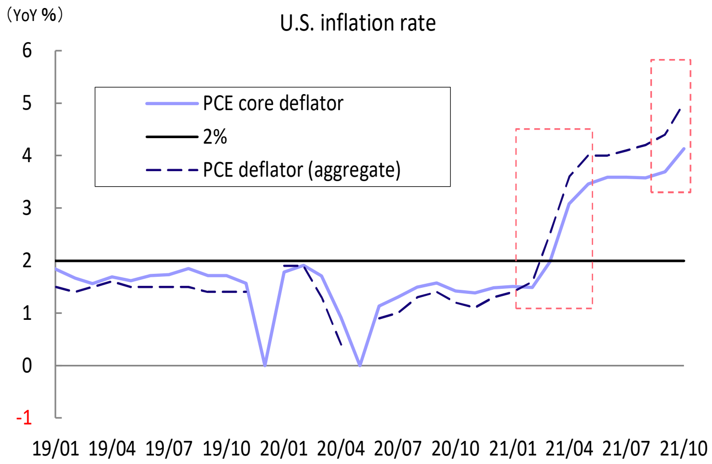
	2021	2022	2023	2024	Long term
Real GDP Growth rate	5.5	4.0	2.2	2.0	1.8
as of SEP	(5.9)	(3.8)	(2.5)	(2.0)	(1.8)
Unemployment rate	4.3	3.5	3.5	3.5	4.0
as of SEP	(4.8)	(3.8)	(3.5)	(3.5)	(4.0)
PCE inflation rate	5.3	2.6	2.3	2.1	2.0
as of SEP	(4.2)	(2.2)	(2.2)	(2.1)	（2.0）
Core PCE inflation rate	4.4	2.7	2.3	2.1	
as of SEP	(3.7)	(2.3)	(2.2)	(2.1)	

（Source）FRB

In other words, the recent FOMC meeting indicates plans to raise interest rates to the neutral interest rate level of 2.50%, but as explained below, it is important to consider whether share prices can withstand this, given that the inflation curve could undergo a sudden bend from mid-2022 onward, causing the yield curve to bear-flatten. Considering that the flattening has already begun, the hawkish mood may have to be changed if there are rumors of an inverted yield curve just as rate hikes are about to begin. Significantly, some are beginning to observe that the decision to begin shrinking the balance sheet earlier than expected was taken in an effort to prevent this.

Risk of a "Transitory" Inflation this Time?

The normalization process appears to be going smoothly, but there are many risk factors. One of these is the inflation trend, which Powell revised his opinion on, saying it was no longer "transitory." However, there still remains the possibility that the high rate of change will end up being transitory. It is true that inflation has been persistently high recently, but a close look reveals that there have been two jumps in 2021, one in spring and one in the fall. Not much attention is paid to this because inflation has continued growing at extremely high rates of 3-5% yoy since spring, but looking at the PCE deflator as an example, growth jumped twice – once in March-April and then again in October (see figure). In other words, price levels (not rate of change) jumped at those points – the first time because of the rapid rise in demand following the relaxation of movement restrictions, and the second time as a result of crude oil and other resource prices soaring, among other things. The sharp rise in used car prices, one still remembers clearly, was in the headlines at the time of the former. This time around, used car prices have settled down, but crude oil prices have increased instead.



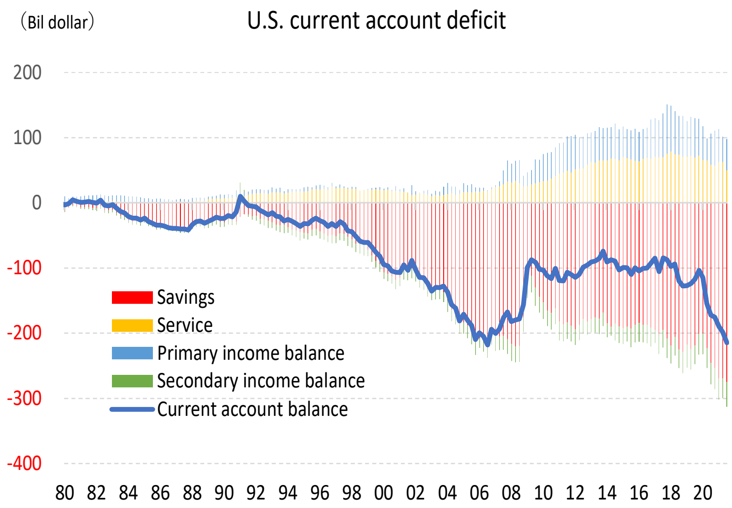
(Source) Bloomberg

Unless a similar seasonal rise in inflation takes place in the spring and fall of 2022, it seems very likely that the rate of change of inflation will inevitably fall. Spring 2022 is when tapering is scheduled to end and rate hikes may begin, while the fall of 2022 would coincide with the second and subsequent rate hikes. If inflation sinks right when the next step of the normalization process is due to begin, the Fed may find it difficult to proceed with its policy. In this sense, in trying to predict the Fed's operations from 2022 onward, it seems reasonable to take into account the significant risk of inflation being transitory, but at the present time, I believe this may not be sufficient to derail the scheduled June and September rate hikes.

Risks to My Main Scenario – "Supply-Demand-Related USD depreciation Risk" and "Tourism-Related JPY Depreciation Risk"

USD Depreciation Risk due to Supply-Demand Trends

I anticipate that USD/JPY will continue to be driven upward by JPY selling, but it should be noted that USD selling factors are also emerging. The July-September current balance of payments figures announced by the U.S. Department of Commerce on December 21 suggest that USD selling could become a dominant trend with respect to the supply-demand situation. The U.S. current account deficit for the July-September quarter amounted to USD214.8 billion – the highest level in about 15 years, since the 2006 July-September quarter. As a share of nominal GDP, the current account deficit rose to 3.7% – the highest level seen since the 2008 October-December quarter. As the U.S. current account deficit primarily reflected the country's trade deficit (see graph), which has a strong influence on forex supply-demand trends, the risk that supply-demand factors will cause USD depreciation cannot be ignored.

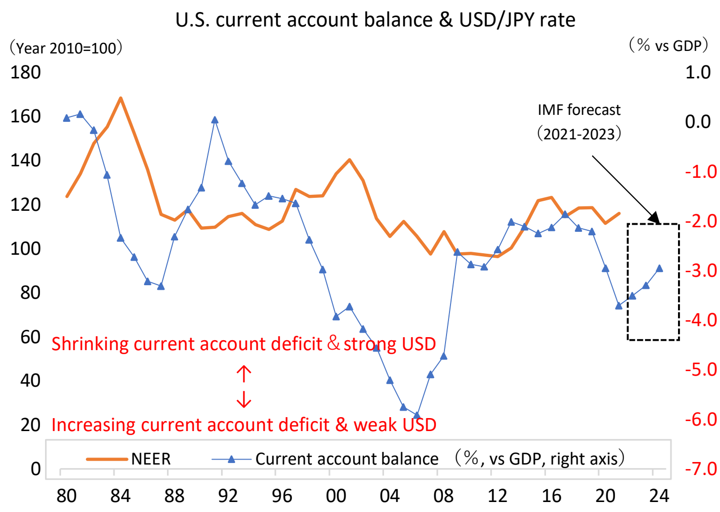


(Source) macrobond

Taking a look at the U.S. trade deficit's components, one finds that U.S. exports attained a record high level of USD441.6 billion due to increases centered on natural gas and petroleum products, but U.S. imports also reached a record high level of USD716.4 billion, reflecting increased imports of such items as petroleum and chemical products. Amid shortages of various items due to supply constraints, the United States' July-September quarter GDP was boosted by inventory investment (up 2.1 percentage points yoy following a 2.0 percentage point yoy rise in the previous quarter), and this suggests that companies' moves to replenish their diminishing inventories promoted the import surge.

Landmark Current Account Deficit Level of "Around 6% of GDP"

If the U.S. current account deficit continues to grow, it will be necessary to consider its prospective impact on USD. As can be seen from the graph, there is a fairly consistent relationship between movements in the U.S. current account balance (as a percentage of nominal GDP) and in USD's nominal effective exchange rate (NEER). As mentioned above, the U.S. current account deficit has reached its highest level since 2006, and it appears that the country's current account imbalances have reflected excessive consumption and investment proclivities following the subprime and Lehman shocks. As a percentage of nominal GDP, however, the U.S. current account deficit has recently reached only about half its size in 2006 – the current level of 3-4% of nominal GDP is not remarkably high. It is important to note that focusing on the current account deficit's nominal size alone may promote a distorted perception of the underlying trend.

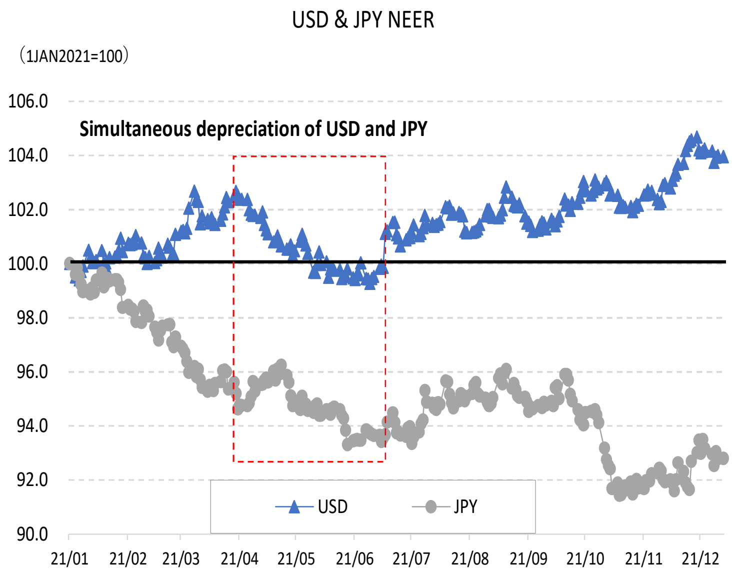


(Source) macrobond & IMF (Note) 2021 NEER is as of November

As USD NEER can be seen to move roughly in parallel to current account deficit changes after a time lag, however, it is quite possible that this year's current account deficit will place downward pressure on USD NEER during 2022. As mentioned above, it is highly possible that the recent increase in U.S. imports largely reflected companies' temporary inventory replenishment moves owing to supply constraints, and this suggests that the trend of current account deficit expansion seen during the July-September quarter will not persist. If the 2021 scenario of economic growth rates in the United States being relatively higher than growth rates in other countries continues, however, there remains a possibility that the U.S. current account deficit will continue expanding (largely reflecting an increasing trade deficit) against the backdrop of disparate economic conditions within and outside the United States. The U.S. economy is undoubtedly serving as the global economy's primary growth locomotive, but there are grounds for concern that playing that locomotive role to an excessive degree may directly generate supply-demand factors that cause USD depreciation. My view is that one should be prepared for the possibility of significant USD depreciation if the U.S. current account deficit shows a potential to grow to about 6% of nominal GDP – the level seen immediately before the subprime shock.

USD Depreciation Not Necessarily Linked to JPY Appreciation

Besides these supply-demand issues, there is growing speculation that the Fed will not be able to smoothly elevate interest rates during its normalization process, as is already suggested by the yield curve's bear-flattening. USD/JPY movements during 2022 appear likely to reflect a tug of war between "USD selling pressures stemming from both supply-demand and interest rate factors" and "JPY selling pressures based on the 'Japan avoidance' theme". If the Japanese economy's inferior performance and the associated 'Japan avoidance' theme promote JPY selling, it is quite possible that JPY may not strengthen even in the case of across-the-board USD depreciation – as was the case in the April-June 2021 quarter (see graph) – owing to a large number of forex market participants who seek to sell USD but see no rationale for JPY buying. As mentioned above, it seems unrealistic to expect the emergence of Japanese domestic policies during 2022 that could significantly change the "avoid Japan for the time being" trend.



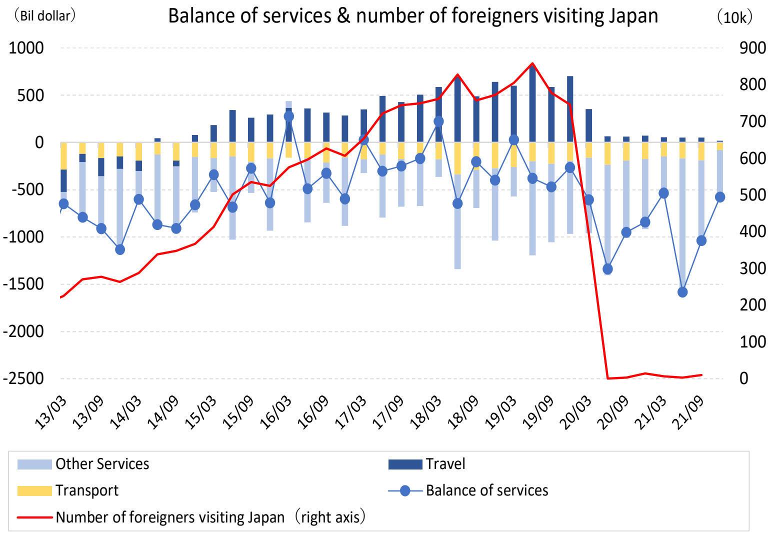
(Source) macrobond

Corporate Behavior Reflecting the "Cheap Japan" Concept

On December 14, the electronic version of the Nihon Keizai Shimbun posted an article entitled "Increased Overseas Labor Costs and JPY Depreciation Spur World Co., Ltd., Etc., to Resume Domestic Production" that overviews moves by major Japanese apparel companies to once again begin production operations in Japan. The article notes that the resumption of domestic apparel production operations is apparently in response to JPY depreciation and rising labor costs overseas, and it goes on to explain that increasing acknowledgment of the "cheap Japan" concept is beginning to affect the corporate sector's behavior in various ways. The apparel industry as well as other industries impacted by pandemic-induced supply chain disruptions are beginning to face supply constraints, so moves to bring production operations back to Japan are partly aimed at promoting greater business stability. Going forward, one of the major apparel companies covered in the article is seeking to boost its domestic production ratio to 50%, from the current level of 10%. <u>With JPY's real effective exchange rate (REER) reaching its lowest level in about 50 years, it may be natural that we are seeing some Japanese corporate behavior patterns beginning to resemble their forms 50 years ago</u>.

"Cheap Japan" Already Boosting "Services" Exports

If one focuses on production costs alone, production operations are still relatively expensive in Japan, but the broader scenario is that returning production operations to Japan enables shorter time frames for ordering, production, and delivery processes along with a consequential reduction of opportunity losses. However, if the current situation – that overseas wages and prices rise while Japanese wages and prices do not – continues, we can envision a future in which Japan will inevitably become the relatively cheap locale for production operations even as measured by production costs alone. <u>It is striking that there are signs that Japan (despite being a G7 member) may be returning to the format of its earlier economic growth stages – taking advantage of the "cheapness" of its domestic business operations to profitably sell (export) Japanese-made goods overseas</u>.

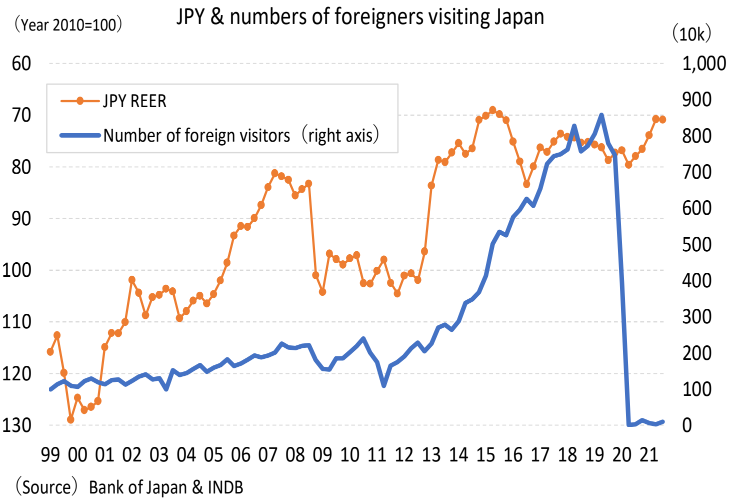


(Source) Bank of Japan

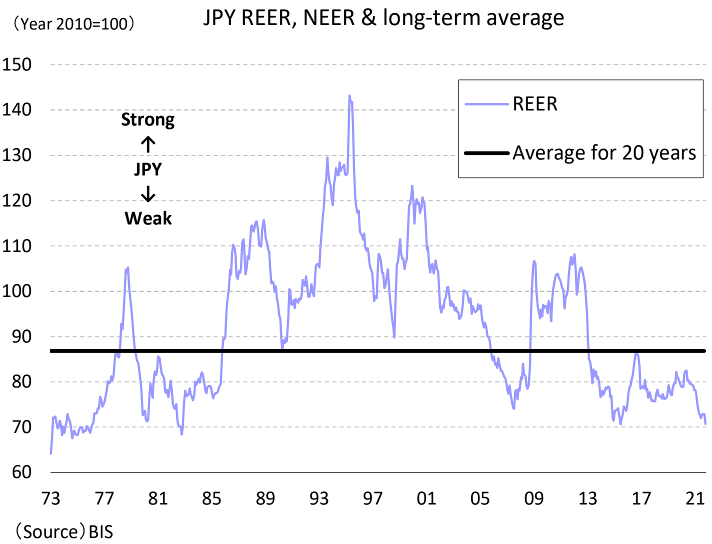
Besides product exports, Japan's "cheapness" can also be leveraged to export services. Unlike goods that entail complicated manufacturing processes, the appeal of "cheap Japan" experiences or services can be offered to foreigners directly and quite easily, and the uptrend in providing such services to foreigners was already confirmed during the initial period of the Abenomics era. Even in the wake of the considerable JPY depreciation seen during that era, Japan's manufacturing industry's exports (the "goods" portion of the current account balance) did not increase significantly, as the industry had already shifted the bulk of its operations to overseas production bases. <u>On the other hand, the "services" portion of Japan's current account balance, which had previously been in the red each year, began regularly recording surpluses centered on a large surplus in the travel balance</u>. As foreign currency is acquired from so-called inbound tourists (foreigners visiting Japan), such inbound tourism can effectively be considered an export sector of the Japanese economy from the forex perspective. While Japan's service balance had historically been in the red, it has been in the black since mid-2014. Rather than boosting goods exports, the most significant direct impact on Japan's real economy from Abenomics era JPY depreciation was on service exports, particularly on travel balances.

Making Japan a Major Tourism Destination and JPY REER's Adjustment Potential

The disappearance of annual travel balance surpluses of over JPY2 trillion due to the covid-19 pandemic has been painful for Japan's food and beverage industry, which had been expecting the surpluses to continue, but as the graph on the next page shows, JPY's REER reaching its lowest level in about 50 years clearly had been promoting a surge in inbound tourists and that JPY REER level is still positioned to sustain that surge when the pandemic-related travel restrictions end. If the pandemic had not intervened, it seems likely that the number of foreign visitors to Japan would have continued to reach record highs. It may take a long time before the incipient repatriation of Japanese manufacturing operations reported by Nikkei will begin in earnest, but if domestic and international people movements become renormalized, the "cheap Japan" situation can be expected to restore and expand the country's travel balance surplus. Over time, there is likely to be considerable talk about Japan's potential for becoming one of the world's major tourism destinations.



As disparities between domestic and foreign prices and wages are significantly widening, it is rational to anticipate that, when the post-pandemic era arrives, there may be a surge of foreign visitors who have significantly improved their purchasing power from the perspective of Japanese people. A trend of increase in the prices of meals at renowned sushi restaurants and other traditional Japanese restaurants in city centers that are popular with foreigners has been evident for some time, and it stands to reason that such goods and services price rises reflect foreign visitors' budgets and consumption propensities. While there will be a lag before such a price rise trend becomes more widespread in Japan, there is a possibility that prices of many tourist-related goods and services may become set at relatively high levels, as can be seen in such leading global tourist destinations as the Italian city of Venice.



A general rise in prices initiated by tourism-related prices would promote a rise in JPY REER, which is perceived as having fallen excessively – it is a mechanism for promoting appropriate JPY REER adjustments. However, it is debatable whether transforming Japan into a major tourism destination would be a happy outcome for people living in Japan. While being a major tourism destination sounds appealing, tourism destinations' economies must do their utmost to cater to the needs and desires of inbound visitors, and there may arise problems related to how an economy structured in this way can realize growth in domestic residents' consumption and investment along with a general increase in a tourism destination country's social welfare. After overviewing the state of tourism destination countries in the real world, one does not get the impression that countries with tourism-based economies are likely to be influential players in global politics or economics. But Japan's ability to generate travel balance surpluses has important implications regarding future JPY trends. As mentioned above, Japan's ability to keep its services balance (centered on the travel balance) in the black raises the possibility of promoting a general trend of increase in domestic price levels along with becoming a major tourism destination in the foreseeable future. If these possibilities eventuate, it may also become possible for the JPY REER to adjust based on nominal JPY appreciation going forward.

EUR Outlook – ECB Clearly Lagging Behind the Fed Despite Some Progress toward Normalization

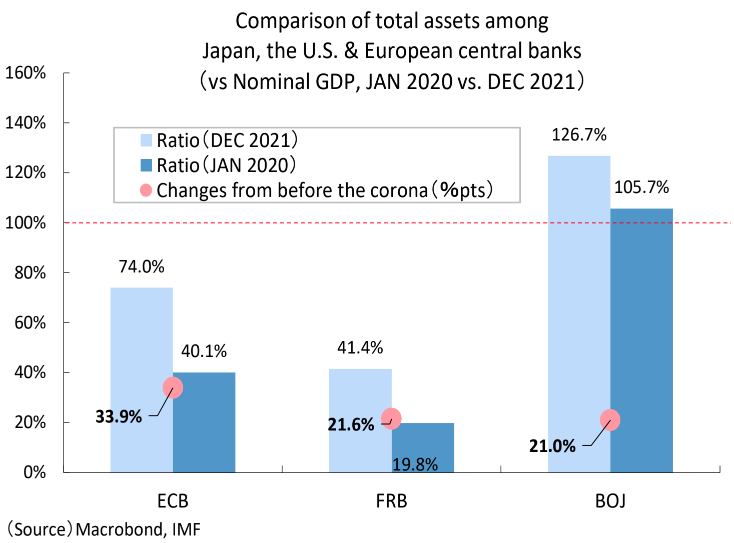
EUR Area Monetary Policies Now and Going Forward – The "Lagarde Bazooka" and the Outlook for Interest Rate Hikes

The "Lagarde Bazooka" Departs from the Limelight

As had been generally anticipated, the December ECB Governing Council meeting decided to end the Pandemic Emergency Purchase Program (PEPP) at the end of March 2022, as originally planned. On the other hand, the meeting also decided "to reinvest the principal payments from maturing securities purchased under the PEPP until at least the end of 2024", and this contrasts with the Fed, which is already giving hints about a debate regarding balance-sheet reduction measures. The meeting's statement also states that the PEPP framework will not be abolished, saying that – "Net purchases under the PEPP could also be resumed, if necessary, to counter negative shocks related to the pandemic." It seems that the ECB's basic intention with respect to the PEPP is that it will only stop the program rather than eliminating it.

As the PEPP was created as an emergency framework for pandemic response measures, however, it will finally depart from the limelight as the pandemic's emergency status diminishes, and the ECB's new asset purchases will subsequently be undertaken through a regular ECB program – the asset purchase programme (APP). The PEPP continues to buy Greek government bonds that were previously ineligible for ECB purchasing programs, and there is no doubt that the PEPP's existence has contributed to the stability of the euro area financial system. Hurriedly approved by an extraordinary Governing Council meeting on March 18, 2020, the PEPP was apparently introduced in response to the financial markets' disappointment with the Lagarde-led ECB's regular Governing Council meeting on March 12, 2020. The PEPP's overwhelming scale pacified the markets' anxieties, and its operation eventually caused the ECB balance sheet to exceed that of the Fed. Former ECB President Mario Draghi was praised as having deployed the "Draghi Bazooka" when he launched the 36-month longer-term refinancing operation (LTRO), which provided more than EUR1 trillion of liquidity during the most tense stage of the European debt crisis, and the PEPP can be considered the "Lagarde Bazooka". Although many years remain in ECB President Christine Lagarde's term, it is anticipated that the "Lagarde Bazooka" will be considered one of the ECB's major achievements during her term.

The ECB's Current and Prospective Asset Purchases



(Source) Macrobond, IMF

According to the latest Governing Council meeting's statement, PEPP purchases will be made "at a lower pace" in the January-March quarter, suggesting that the PEPP will be shut down at the end of March after a gradual reduction of purchases. As can be confirmed from the record of actual PEPP purchases, however, there has not yet been a steady decline in PEPP purchases despite hints in September that the purchases would be reduced. The value of PEPP purchases decreased to about EUR71 billion in September and about EUR63.3 billion in October, but then increased to about EUR69 billion in November. At the time this article was written, PEPP purchases had been implemented during December at a rate of about EUR18 billion a week and corresponding to a monthly purchase level of EUR72 billion, exceeding the September level. The spread of covid-19 infections and rises in inflation rates are concurrently progressing in the euro area, and it can be surmised that the ECB may find it difficult to accept the possibility of an uptrend in regional interest rates owing to a deceleration of PEPP purchases. Although the ECB may be aiming to gradually reduce its PEPP purchases, in reality it is generally expected that the purchases will be abruptly terminated at the end of March.

In light of that, considerable attention will be focused on measures taken to moderate the impact of that termination in April and subsequently. It has already been announced that the monthly pace of asset purchases via the APP (a regular ECB program that has been purchasing EUR20 billion of assets per month) will be temporarily increased to EUR40 billion during the April-June quarter and EUR30 billion during the

July-September quarter. The APP monthly purchasing pace is slated to return to its original EUR20 billion level from October, and the ECB will seek to sustain that level of purchases for as long as possible. The ECB already has the largest central bank balance sheet in the world, and as a percentage of GDP, the size of the balance sheet has expanded by more than 30 percentage points since the pandemic began. Both in terms of monetary value and in terms of GDP ratio, the ECB is the central bank that has accelerated its asset purchases the most during the pandemic period, and the scale of its purchases may become subject to greater scrutiny and debate going forward. While it is asserting that its monthly purchase pace will decrease in the future, the ECB may be anticipating that its large accumulated balance of purchases will continue exerting monetary easing effects. This is reflected in Lagarde's statement at the post-Governing Council meeting press conference – "We keep [the PEPP] dormant and effective in terms of reinvestment phase, and we maintain the flexibility." – emphasizing the significance of continuing the reinvestment of principal payments from maturing securities (including Greek government bonds) until the end of 2024.

Interest Rate Hikes Very Unlikely Until Early 2023?

ECB staff outlook（DEC2021）　(%)

	2021	2022	2023	2024
HICP	**2.6**	**3.2**	**1.8**	**1.8**
(Previous : SEP 2021)	2.2	1.7	1.5	—
Real GDP	5.1	4.2	2.9	1.6
(Previous : SEP 2021)	5.0	4.6	2.1	-

(Source)ECB (Note) EURUSD is assumed to be 1.13 year 2022 - 2024

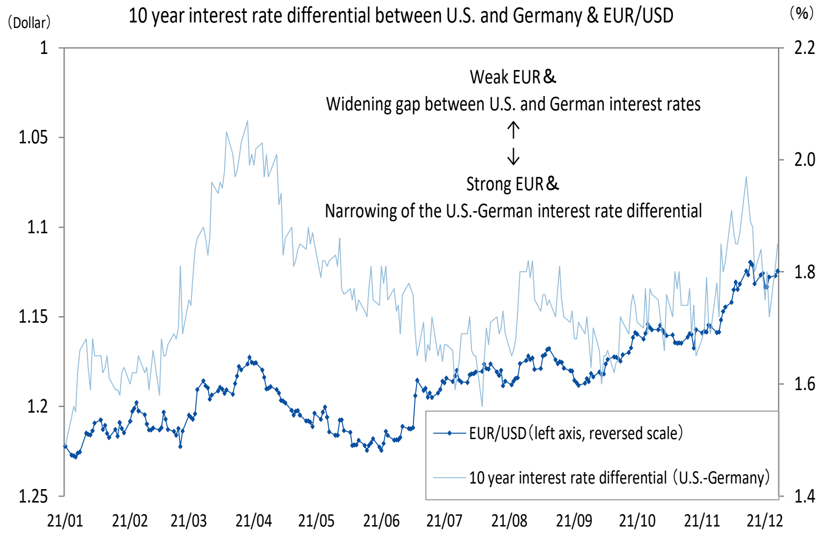
As the nature of the ECB's upcoming quantitative easing measures becomes clearer, the focus of observers' attention is naturally shifting to prospective rate hikes. The ECB normalization process is accompanied by a forward guidance statement – "The Governing Council expects net purchases to end shortly before it starts raising the key ECB interest rates" – and this suggests that immediately after the ECB completes the termination of its quantitative easing measures (including the APP) it will begin hiking interest rates. As mentioned above, it remains unclear what direction monetary policy will move toward after the APP returns to its standard EUR20 billion monthly buying pace from October 2022. In light of the plans to reduce the APP monthly purchasing rate from EUR40 billion in the April-June quarter to EUR30 billion in the July-September quarter and EUR20 billion from October, it seems reasonable to anticipate that the rate might be reduced to EUR10 billion in the January-March 2023 quarter and that the APP might be completely terminated during the April-June 2023 quarter. Focusing exclusively on the possibility of interest rate hikes, it seems that such hikes might become possible some time from the October-December 2022 quarter through the January-March 2023 quarter.

The question of when a prospective termination of the APP will come into view and a shift to rate hikes will become possible ultimately will depend on the ECB's evaluation of the price stability situation. In this regard, there appears to be a good possibility that the price stability situation will be favorable. 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" – and the price stability situation will have to be in accord with all three definitions. The recently revised Eurosystem staff projections (see table) suggest that definition (1) is likely to be realized. Regarding definitions (2) and (3), however, there is a possibility that prices will not be considered stable, as the inflation rate is expected to descend below 2% in 2023 and 2024.

However, the average Consumer Price Index (HICP) level during the forecast period is about +2.3%. If the ECB were to consider it reasonable for the inflation rate to be restrained in the year following a year with a particularly high inflation rate, it may have the requisite leeway to judge that the inflation situation is expected to be stable during the 2023-2024 period. President Lagarde said at the press conference that – "it is very unlikely that we will raise interest rates in the year 2022." – but even if such hikes are not actually implemented during 2022, it is quite possible that rate hikes will be on the Governing Council's agenda during the year. The first reporter to pose a question at the press conference noted that a year ago the staff projection HICP outlook for 2021 was +1%, less than half the current HICP outlook for 2021, and he asked, given the "high uncertainty surrounding the forecast at the moment", whether it was appropriate to state with confidence that there will be no rate hikes until 2023.

Omicron and EUR/USD

However, properly analyzing the current trend toward hawkishness requires understanding the ramifications of the Omicron covid-19 variant. It is noteworthy in this regard that U.S. Chief Medical Advisor to the President Anthony Fauci stated on December 15 that specialized Omicron booster vaccinations were not necessary, as Omicron can be sufficiently countered by moving ahead with the existing covid-19 booster vaccination program. The Fed's hawkish stance seems to be based on an anticipation that Omicron will be addressed in this manner. It is unclear whether continental Europe will adopt a similar view – ECB President Lagarde said the prospective impact of Omicron has not yet been fully evaluated. The latest Eurosystem staff projections revision decreased the 2022 real GDP growth rate by 0.4 percentage point but increased the 2023 real GDP growth rate by 0.8 percentage point, so the overall picture remains roughly unchanged. <u>While it is peculiar to see so much variation among Western authorities' basic perceptions of Omicron, the ECB appears to be shifting toward a basic perception similar to the Fed's, anticipating that the latest surge of pandemic infections will peak out during the January-March quarter. If this peaking out occurs in line with anticipations, it could be expected to give momentum to central banks' normalization processes</u>. However, <u>evaluating the outlook for EUR/USD requires attention to factors other than the timing of interest rate hikes. Particularly when one takes into consideration the debates regarding the issue of balance sheet reduction, the gap between Fed and ECB policies is still large, and it can be expected that there will remain considerable downside risk for the time being (see graph).</u>



(Source) macrobond

Appendix: Germanys' New Government Now and Going Forward – Sudden Diplomatic Challenges Regarding the Beijing Olympics

Sudden Diplomatic Challenges Regarding the Beijing Olympics

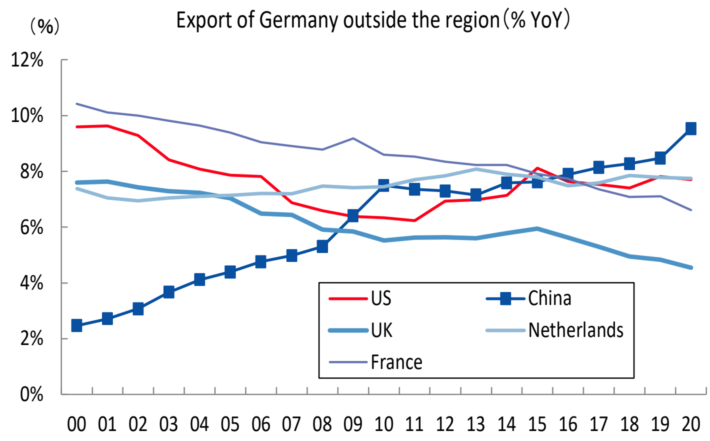
Various countries are beginning to make prominent political protest gestures regarding the Beijing Olympic Games, which are scheduled to be held in February 2022. These countries are distancing themselves from the games based on such concerns as those regarding human rights issues in the Xinjiang Uygur Autonomous Region, the oppression of democracy in Hong Kong, suppression of Chinese journalists' speech, and the disappearance of a well-known tennis player. The United States and Australia have announced diplomatic boycotts of the game, followed by the United Kingdom and Canada, and China has warned that those countries will definitely pay a price for their boycotts. China has also taken a threatening posture toward Japan, which has not yet decided on an Olympic Games-related policy, saying that the prospective policy will be a key measure of Japan's amity or enmity, but so far as can be learned from Japanese government officials' leaked remarks, it appears that it will be quite difficult for Japan to diplomatically participate in the games in a normal manner. On the other hand, France and Italy have indicated their intention not to follow this trend of criticizing China through Olympic-related gestures. Italy has already made a name for itself as the only G7 country to participate in China's "One Belt, One Road" initiative, and it appears that Italy will continue to be intent on avoiding behavior that irks China. Italy can now be considered a divisive wedge that China has deftly driven into the EU and G7 frameworks.

<u>As Germany is the G7 member with the closest political and economic ties to China, the question of what it will do regarding the Beijing Olympics has become a major focus of attention</u>. Germany's new chancellor, Olaf Scholz, has been proclaiming that there will be a shift away from the Merkel governments' approach, which has been ridiculed as excessively pandering to China. Promoting this shift is the Greens Party's co-leader Annalena Baerbock, a politician with overt anti-China and anti-Russia positions who has been appointed the new government's Minister for Foreign Affairs. Foreign Affairs Minister Baerbock has reportedly said she would not rule out a German boycott of the Beijing Olympics. While other countries have undertaken diplomatic boycotts of the Beijing Olympics, there remains a possibility that Germany might undertake a genuine boycott that precludes the dispatch of a German team to the games. If that were to happen, China would be likely to mount a very forceful response. The prospective nature of Germany-China relations is among the most important issues that will determine Germany's post-Merkel era path, and given the current depth of Germany-China economic relations, many believe that resolving this issue will be extremely difficult. In light of that, <u>Germany's decision regarding the Beijing Olympics will be a highly significant</u>

measure that will be interpreted as indicating the Scholz government's true intentions with respect to Germany-China relations. Similar to the Beijing Olympics issue, the issue of whether to permit the Nord Stream 2 natural gas pipeline's operations has emerged as a key test of Germany's intentions with respect to Germany-Russia relations, but I would like to discuss Germany's relationship with Russia at another time.

Preparing Anti-China Measures Regardless of Repercussions

While adjusting the nature of Germany-China economic relations is considered to be extremely difficult in practical terms, many observers have noted that Germany is frequently inclined to opt for impractically idealistic policies that are in reality very difficult to sustain. Germany's recent climate change-related policies are typical example of this – even if those policies create serious problems for the corporate sector's activities, the policy goal of prioritizing global warming countermeasures is likely to be maintained. In this regard also, the Scholz government has made it clear that it will seek to correct what it considers to be the inadequate measures of the Merkel government. Although Germany's current coalition government includes the Free Democratic Party (FDP), which gives a high priority to sound fiscal policies, the government has established a climate investment fund that will enable a great amount of fiscal expenditure on global warming countermeasures that is not officially included in the sound budgets that the FDP seeks to promote. It is feared that such clever accounting and policy management approaches will continue enabling the neglect of Germany's traditional dedication to sound fiscal policies.



(Source) Datastream

Going forward, there is an undeniable possibility that a similar degree of intense commitment to ideological goals will be focused on implementing anti-China policies. In fact, following Chancellor Merkel's retirement, the German government appears to feel completely empowered to implement such policies without any hesitation. At the EU level, there are already active moves to strengthen relations with Taiwan – this October 21, the European Parliament adopted a document recommending that the EU should strengthen its political relations with Taiwan. This is a clear reflection of anti-China sentiment that would have been politically difficult to express during Chancellor Merkel's heydays. Germany built extremely deep economic relations with China during the 16 years Chancellor Merkel was in power, and it will be necessary to prepare for a considerable amount of repercussions if those relations are scaled back. The concept that pro-Chinese relations are among the Merkel government's greatest legacies is not just an abstract concept – during Chancellor Merkel's tenure, China's share of Germany's international trade transactions more than doubled, from 4.4% in 2005 to 9.4% in 2020 (see graph). This rise has compensated for declines in trade with other countries. The share of Germany's trade with the United Kingdom fell from 7.0% in 2005 to 4.6% in 2020 (following Brexit), and the share of Germany's trade with France has also fallen, from 9.4% in 2005 to 6.6% in 2020. Looking at the numbers alone, it appears that Germany's growing trade with China has roughly compensated for the decline in trade with other European countries. France was Germany's largest trading partner until 2014, but it would appear to be very difficult for France to try fill China's shoes in terms of trade with Germany going forward. The high share of German automobile sales recorded in China is often referred to as a reflection of how important the Chinese market is for Germany. As the chart shows, one third of the vehicles Germany's top three automobile makers market worldwide is sold in China.

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

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

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

It is noteworthy that, while Germany is well known to be the country with the world's largest current account surpluses and trade surpluses, it has a large trade deficit with China. It is clear that China is an important market for Germany, and Germany is also an important market for China. For trading partners that are extremely important to each other, it would be most appropriate to cooperatively coordinate adjustments to their trade relations. The conspicuously high proportion of German cars sold in China makes it easy to focus on the potential damage that German-China trade frictions could wreak on the German economy, but it is also true that the loss of Germany as a principal trade partner would cause China to lose a large export market.

Human Rights Diplomacy with China Restrained by Chancellor Merkel

It is true that the Merkel governments were widely criticized for their approach of advocating an emphasis on human rights in China while concurrently strengthening Germany-China ties. Given current trends in the international community, it appears clear that Germany will have to reform its approach and harmonize it with Western nations' consensus view about how relations with China should be handled. The key question, however, is whether Germany will actually be able to undertake this harmonization with the Western international community even when it becomes evident how huge the associated economic losses will be. Reforming Germany-China relations appears to be a good example of something that is much easier said than done.

In the early days of Merkel-led German governments, Germany's emphasis on human rights led to a high-profile conflict situation with China associated with a visit to Germany by the Tibetan spiritual leader, the Dalai Lama. In September 2007, Chancellor Merkel invited the Dalai Lama to her office in Berlin for talks. Chancellor Merkel insisted on holding the meeting despite fierce opposition not only from China but also from pro-Chinese German companies and Germany's Christian Social Union in Bavaria Party (CSU), who argued that the meeting would damage German trade relations with China. Up through that time, it can be said that Chancellor Merkel was acting in accordance with her image as an activist humanitarian. The visit infuriated China, however, which presented Germany with various political and economic challenges. For example, the Chinese side publicly announced diplomatic event cancellations, such as decisions not to visit German ministers, and harassed Germans posted in China[1]. After some twists and turns, Chancellor Merkel managed to repair the Germany-China relationship, but she never met the Dalai Lama again, and she appears to have tried as much as possible to avoid behavior that would upset China.

Perhaps the easiest way for the Scholz government to clearly differentiate itself from previous governments is to discontinue those governments' China-appeasement posture, and he would not be subjected to much criticism for such a move given the tailwind of trends in the Western international community. A Beijing Olympics Boycott would also seem to harmonize with other German foreign policy moves, such as the August 2021 dispatch of the German Navy frigate Bayern to the Asia-Pacific region and the November 2021 docking of the Bayern in Tokyo. It is noteworthy that Germany also proposed that the Bayern make a port call in Shanghai, but that proposal was rejected by China. This rejection could be interpreted as a message from China that it is not inclined to embrace a half-hearted relationship with Germany. In light of these circumstances, focusing on anti-China policies may be the easiest of the options the Scholz government could take.

However, the Germany-China relationship is directly linked to trends in the German economy as well as to trends in the EU economy. It is also likely to affect the ECB's monetary policy management. A decision by Germany's chancellor to exert pressure on China would be momentous. Boycotting the Beijing Olympics is an effective way to embarrass China, particularly if Germany participates, but the consequential damage to German companies that have been expanding their presence in China could be expected to be considerable. Very soon after the Scholz government's inauguration, its mettle is expected to undergo a major test.

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[1] Nobuyuki Sato, "The Mystery of Merkel, the World's Strongest Empress", Bunshun Shinsho.