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Overview of outlook

Amid the turmoil in the financial markets that has been continuing since the beginning of the year, USD/JPY fell to the level of 110 at one point, but subsequently managed to recover. The BOJ’s introduction of negative interest rates has not been successful in changing the trend of JPY appreciation and stock price drops. Rather, it seems to have created a continuing deadlock in the markets. The FRB still seems determined to go ahead with its normalization effort, but I still think it is unrealistic to expect that the projections of the dot chart based on the assumption of four rate hikes this year will come true. Of course, JPY interest rates have been pitiful ever since the BOJ’s implementation of its negative interest rate policy, so, to some extent, the weak JPY trend will be sustained even in 2016 because of continued net acquisitions in foreign securities investment. However, if we go by this publication’s assumption that the FRB’s normalization process will become derailed, and crude oil prices will stabilize at a low level, driving a resurgence of Japan’s current account surplus, it does seem unlikely that the basic supply-demand balance will continue to be such that “leaving the situation as is will lead to JPY weakness.” As it is, JPY weakness has approached its limit going by price measures, and if “2% inflation rate” is unachievable despite the Quantitative and Qualitative Easing (QQE) policy, it seems reasonable to think, based on past experience, that USD/JPY may stabilize at the 100-105 level. Unless the FRB decides to enforce the projections of the dot chart, it would be difficult to envisage a weak-JPY scenario. Even if the FRB does enforce the dot chart, I can state with confidence that this would simply sow the seeds for upward pressure on JPY going forward. The return to fair value based on price measures is a scenario I would like to take seriously.

EUR has been stable recently. As I have said many times in this publication, EUR is characterized by the world’s largest current account surplus and a relatively strong real interest rate, which makes it a fundamentally strong currency, so it will inevitably recover if any shadow of doubt regarding the FRB’s normalization process becomes apparent. EUR depreciation is merely based on an “epic speculation,” which depends on the domestic-to-foreign interest rate gap, and its sustainability must not be overestimated. As in the past, EUR will soar strongly as a result of short-covering whenever the world economy faces a crisis or expectations of an FRB rate hike wane. However, every time EUR/USD approaches 1.15 dollars, the ECB is likely to do its best to weaken the currency again by hinting at an additional monetary easing citing negative impact on inflation expectations as the reason. During the current forecasting period, one assumes that a scenario of “CNY devaluation ➝ global economic turmoil ➝ waning of FRB rate hike speculations ➝ EUR appreciation” will continue to unfold intermittently, so I predict several additional monetary easing by the ECB. Again, any topics related to the exit of Britain from the EU (Brexit) could lead to EUR sell-off due to speculation of a decline in the politically unifying capability of the EU. I am, therefore, assuming that EUR may groove toward a new low together with GBP during the April-June period, when the British referendum is to take place.

Forecast table summary

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A. FY2016 JAN-FEB includes 29FEB2016 and ( means 10AM on 29FEB2016  B. Price data are quoted from Bloomberg.
C. ()s used in forecast indicate last price of each quarter.
USD/JPY outlook - Forex forecasting that is ultimately rewarded

Returning to the logic of purchasing power parity – Forex forecasting that is ultimately rewarded

**Oversold currency approaching inevitable adjustment**

JPY surged sharply in February, with USD/JPY reaching 110.99 at one point. While USD/JPY levels below 110 have not been seen even once since the Halloween easing of October 31, 2014, it has now become reasonable to anticipate the possibility of such levels in the near future. It appears that JPY appreciation has been accelerating as a result of the fading of speculation about further U.S. rate hikes in the wake of the Congressional testimony given by FRB Chair Janet Yellen on February 10-11, the FOMC January 26-27 meeting minutes, and remarks by senior FRB officials. Yellen strove to evenhandedly present both positive and negative perspectives in her testimony, and there were no major deviations from the January FOMC announcement. On the other hand, the markets were hoping for confidence-inspiring information and, given information that they could interpret variously, they proceeded to do so. At the present time, those who would welcome a rate hike by FRB, which would globally raise fund procuring costs, are in the minority, so with the receding of rate hike forecasts, the markets are inclined to see a straightforward strengthening of the USD sale/JPY purchase trend. As of the time of writing this publication, less than 10% of FF interest rate futures have factored in a rate hike for March this year, and it appears that the markets have stopped believing the dot chart projections (of four rate hikes this year) even at this early stage.

In February, based on the speculation that has existed from the beginning that USD/JPY will not be allowed to fall below 110, rumors about currency intervention by the authorities emerged and disappeared at the 115-yen level. The important thing, however, is not to be swayed by such unverifiable rumors. As explained below, the key big-picture perspective regarding JPY rates to keep in mind is based on the simple and generally applicable truism that “the price of things that have been oversold will eventually have to be adjusted.”

**USD appreciation “unexpected”**

In her February testimony, Ms. Yellen said that the rate hikes would, naturally, take place within the global context, adding that normalization of monetary policy for the sake of normalization was not the objective. This is the remark that appears to have triggered the market’s pessimistic view about the possibility of rate hikes going forward. I, however, would like to focus on Ms. Yellen’s remarks about USD rates. In particular, Yellen said that USD appreciation was to a certain extent anticipated and that such appreciation resulted from the fact that the U.S. monetary policy stance is different from the stance of many other countries. However, she also noted that the rapidity of USD appreciation since 2014 was unexpected, that she however, would like to focus on Ms. Yellen’s remarks about USD rates. In particular, Yellen said that USD appreciation was to a certain extent anticipated and that such appreciation resulted from the fact that the U.S. monetary policy stance is different from the stance of many other countries. However, she also noted that the rapidity of USD appreciation since 2014 was unexpected, that she was surprised at the trend, and that the USD appreciation trend had restrained domestic inflation. In previous statements by Yellen and other high officials in the FRB as well as within the U.S. Treasury Department’s Semiannual Report on International Economic and Exchange Rate Policies, descriptions of USD appreciation have been limited to citations of standard theories such as “reflecting the underlying strength of the U.S. economy” and “natural, given the differences in monetary policies” – but at this point Yellen is somewhat concerned about USD appreciation. As this article has noted in the past, the pace of the current bout of USD appreciation is quite rapid even by historical standards\(^1\) (see chart and chart on previous page). Moreover, while the U.S. had a national policy of promoting USD appreciation from the late-1970s through early 1980s and from the late 1990s through the early 2000s, the current episode of USD appreciation is different in that it is merely a side effect of the normalization process.

\(^1\) Please refer to the release entitled - “Reasons why there will be a JPY appreciation/USD depreciation trend in 2016 for the first time in five years – Now is the time in light of real effective exchange rates” – posted on December 15, 2015, on the Toyo Keizai Online website.
Given that FRB Chair Yellen is now saying that she is surprised at the unexpectedly strong USD appreciation, it would seem highly unlikely that she would undertake several additional interest rate hikes that would further promote that trend. As reflected in such indicators as the ISM Manufacturing Index, the trend of deterioration in business confidence that began among manufacturers is now spreading to non-manufacturing companies, and the softening of hard evidence figures seen in the manufacturing sector has begun to show itself throughout the U.S. economy. This publication has been arguing that "the fact that USD appreciation will place a heavy burden on the U.S. economy will lead to the abortion of the normalization process," and it is probably reasonable to believe that this major assumption is gradually proving to be correct at this time. Going forward, it can be expected that the FRB will become increasingly dovish in a clearer manner and that the wind-back of USD appreciation will continue.

**Forex forecasting that is ultimately rewarded**

While this publication has been repeatedly sounding the alarm on the following points, I will once again present an overview of milestone or landmark levels with respect to USD/JPY trends going forward. The fundamental landmark is purchasing power parity (PPP). In the history of USD/JPY rates, the corporate goods price based PPP (1973 standard) has repeatedly functioned as an upside limit, and it is currently around 100. In addition, there are the PPP levels calculated by the Organisation of Economic Co-operation and Development (OECD) and the World Bank, and those are both in the vicinity of 105. Ultimately, we should probably expect the advent of an adjustment market in which USD/JPY gradually moves toward a "100-105" range (see table). I have repeatedly emphasized that, on a purchasing power basis, the JPY depreciation seen since 2013 has been excessive, and it is important not to overlook the fact that the rewinding of that excessive JPY depreciation is already beginning. As explained below, the arguments used to justify JPY depreciation against USD to an extent greatly exceeding the PPP level have simply been based on a speculation about the future - namely, "going forward, rising inflation will cause JPY depreciation in terms of PPP also. "This reasoning is based on the assumption that we have come to a situation in which "the traditional rules of thumb no longer apply. "On January 29, however, the BOJ for the third time postponed its forecast for attaining its inflation target. One has to sympathize with the BOJ, given that some of their challenge stems from the sharp drop in crude oil prices, but in the case that the view that "inflation does not look likely to increase" once again gathers momentum, it would be best to be prepared for the advent of a "the traditional rules of thumb do in fact apply" scenario. Having long advocated the policy of avoiding being misled by elusive trends in the activities of hedge funds, speculators, and other overseas investors and of making forecasts based on due respect for the underlying theoretical logic of market trends, I am confident that this policy will ultimately pay off. At this time, I think it can be said that my approach is progressively proving to be correct.

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2 Please see the releases entitled – “Aiming for a USD-JPY PPP level of JPY100-105 – Negative interest rates provoking ‘concerns’ rather than ‘expectations’” – that was posted on February 12, 2016, on the Toyo Keizai Online website.
Japan’s monetary policy and JPY rates – The troublesome relationship between expectations and forex rates

*Traditional route of “working on expectations” has slipped into oblivion*

About a month has passed since the introduction of negative interest rates. Taking a look at the policy’s effects so far – effects on forex rates and share prices, which were the most eagerly expected, have been pitiful, with both USD/JPY and the Nikkei Stock Average renewing year-to-date lows. The fundamental cause of the current turmoil in the markets is the Chinese economic slowdown and commodity price crash, and it became freshly clear that policy operations by the central bank of a non-related country are powerless in this situation. The fact is that there is absolutely no relationship between the ECB’s or BOJ’s monetary easing policies and the Chinese economic slowdown and commodity price crash. If the malady and the prescription are mismatched, it is natural that the situation would not improve.

Other effects apparent following the introduction of negative interest rates (= side effects) include the fall in interest rates on deposits offered by financial institutions, the suspension of the sale of money market funds (MMFs) and some other financial products, and the dramatic decline in the yields of JGBs (recording the first negative-yield for long-term bonds among G7 countries), most of which are not positive for either corporations or individuals. In an unscheduled public opinion poll conducted by the Nippon Television Network Corporation and the Yomiuri Shimbun on January 30-31, in response to the question “Do you think the negative interest rate policy decided by the BOJ will lead to an economic recovery,” 24% answered “Yes,” while 47% answered “No.” It does not seem as though this policy is having any positive effect in terms of raising expectations as of the present time. I would like to relate a personal experience here – the other day (after the introduction of the negative interest rate policy), I went to the hairdresser’s and was asked by the manager, “Is it true that we will have to pay a fee for depositing our money in the bank from now on?” I have also received a number of similar queries from acquaintances who have no connection with the financial market. The recent negative interest rate policy of the BOJ was implemented taking into consideration bank revenues, so I do not believe that fees will begin to be applied to personal deposit accounts right away. However, if a lot of ordinary people are under the impression that this is the case, then one cannot help saying that the policy is a big failure for the Haruhiko Kuroda-led BOJ, which takes “expectations” as an important operating variable. Borrowing the words of the Outlook of Economic Activity and Prices, the January 29 additional monetary easing decision by the BOJ is a measure against the “increasing risk that an improvement in the business confidence of Japanese firms and conversion of the deflationary mindset might be delayed, and that the underlying trend in inflation might be negatively affected.” In other words, it is a measure intended to psychologically bolster confidence (this was also the logic behind the October 31 Halloween Easing). However, it looks like the negative interest rate this time round has been interpreted mainly as a frightening thing, and may even have triggered concerns.

To begin with, in order to explain that fees will not begin to be applied to personal deposit accounts right away as a result of the recent negative interest rate policy, it is necessary to explain the proposed three-tiered current account system, the difference between marginal cost and average cost, and the forecast trend of outstanding balances going forward. The current framework is quite complicated and takes some time even for specialists in the field to understand intuitively, so one has to say that would be nearly impossible to understand for the average person. Compared with the original, much easier to understand QQE policy of doubling the quantity of money in order to achieve a 2% inflation target within 2 years, the recently introduced QQE with a Negative Interest Rate (QQEN) policy is quite complicated, and therefore less effective in terms of working on expectations, leaving nothing but an impression of a backward-looking policy going its own solitary way. Trying to take stock of the situation right up to the most recent development, it is still difficult to tell exactly which economic entity the BOJ had in mind for aiming the positive effects from QQEN at. Could it be that the traditional route of attempting to stimulate spending and investment by working on expectations has slipped into oblivion?
“Working on expectations” and forex rates

It is important to analyze the failure of strategies aimed at “working on expectations” from the point of view of forex rate outlooks also. To begin with, as a historical trend starting 1990, the PPI-based PPP used to be the upper limit of USD/JPY (see exhibit). However, starting 2013, when Abenomics centering around the QQE policy began to be widely discussed, USD/JPY pierced through this upper limit and has remained consistently high at levels exceeding the PPP to an extent rarely seen in the past. Some strongly pro-reflationary analysts explained this phenomenon by saying that past experiences could not be applied to this situation because the sharp depreciation of JPY was the result of forex rates factoring in inflation expectations in advance. In other words, their logic was that prices would increase going forward and the PPP would change to reflect the weakness of JPY, and therefore it was not a problem.

As of the present, however, three whole years will have passed since the introduction of QQE in April 2016, and as of January 2016, the Consumer Price Index (CPI) Aggregate is 0.0% yoy while even the Core Core CPI (excluding food and energy) is only +0.7%, with no signs of a 2% growth rate. Against this backdrop, it is easy to understand the reasoning behind the idea of implementing an additional monetary easing to lower the nominal interest rate, thereby raising inflation expectations and lowering the real interest rate (nominal interest rate - inflation rate), leading to a stimulation of spending and investment, resulting in a narrowing of the demand-supply gap and causing prices to increase. However, the introduction of negative interest rates, conceived as the starting point of this chain of developments, was not received remarkably well by the public. As I described above, no increase in inflation expectations can be confirmed as a result of the negative interest rates being introduced, and since individual deposits are not being charged, there is no accelerating trend of a shift away from deposits and toward spending or investment. The impression is that this policy, as of the moment, cannot be rashly trusted to help push prices up. In other words, it would also be difficult to believe that the PPP will be pushed up to match the level of JPY weakness.

Sources: Datastream

Purchasing Power Parity since 1973

- CPI
- PPI
- EPI
- USD/JPY
- Mid btw PPI & Epi
JPY supply-demand climate now and going forward – A recap of 2015 and the outlook for 2016

2015 balance of payments depended heavily on crude oil prices

Some statistics that appear to affirm the recent appreciation of JPY are beginning to be apparent here and there. In February, Japan's December 2015 Balance of Payments were released, making the data for the whole of 2015 available (see chart). The trade and service balance for the whole of 2015 was −JPY 2,206.2 trillion, the smallest deficit in four years. This was due to factors such as the trade deficit shrinking dramatically to −JPY 643.4 billion, the smallest in four years, against the sharp fall in crude oil prices, and the service deficit (−JPY 1,5628 trillion) posting its lowest ever since records began in 1996, thanks to the increase in foreign tourists to Japan. Meanwhile, the primary income surplus posted its highest ever since records began +JPY 20.7767 trillion, resulting in the current account surplus growing by +JPY 13.9955 trillion yoy to post +JPY 16.6413 trillion. This is the highest current account surplus in five years since the +JPY 19.3828 trillion posted in 2010 — indicating that Japan's current account surplus has finally returned to the level it was at before the Great East Japan Earthquake.

However, the background to this improvement in the balance of payments does not necessarily indicate positive factors. As the yoy growth results of each component of the balance of payments shows, the large part of the improvement is due to the decline in imports caused by the fall in crude oil prices. Of course, there are also positive trends such as the steep +JPY 2.6564 trillion yoy growth in primary income surplus as the effect of Japan’s long years of foreign investment combined with the price effect of JPY weakness, and the service deficit shrank by a significant +JPY 1.5173 trillion due to the increase in foreign tourists to Japan. However, the fact remains that the import value decreased by as much as −JPY 8.6825 trillion, and one cannot help thinking that this was the main factor that regulated the current account surplus for the whole of 2015. If we assume that the fall in crude oil prices that has taken place since the beginning of the current year will be reflected in the import value over the next few months, then it seems likely that the current account surplus will continue to expand for some time to come against the backdrop of a trade balance improvement. Another way to look at this, however, is that the current account surplus may decrease once again if crude oil prices recover and lead to a large expansion in the trade deficit. The recent appreciation of JPY is also a factor that will cause a decrease in the primary income surplus, and its impact needs to be watched closely going forward.

An overview of the basic JPY supply-demand balance in 2015

Based on this result, the basic supply-demand balance for JPY (hereafter: basic supply-demand — see exhibit), which this publication uses as a guide for formulating the JPY outlook, amounted to a net supply of JPY worth −JPY 12 trillion for the whole of 2015 — the largest net sale since 2008, and is thought to have been one of the factors leading up to the fourth consecutive year of JPY weakness, making this the longest period of unbroken JPY weakness ever seen. As I mentioned above, Japan's current account surplus expanded dramatically in 2015, but this was more than cancelled out by foreign securities investments, which created a supply bias (net supply of JPY) in the supply-demand balance.

Checking to see the exact figures, the current account surplus minus reinvested earnings (which is used in calculating the basic supply-demand) grew from the previous year's +JPY 417.7 billion to +13.1 trillion, posting a yoy growth of +JPY 12.7 trillion. Meanwhile, foreign securities investment doubled from −JPY 14 trillion to −JPY 30
trillion, an expansion of −JPY 16 trillion. Putting it loosely, Japan spent on foreign investments more than it earned in terms of current account surplus — thanks partially to direct investment including cross-border M&A flows amounting to −JPY 16 trillion, the highest ever posted since the present records began to be kept, the basic JPY supply-demand balance has now become firmly biased toward JPY supply as of 2015. Domestic securities investment also expanded by +JPY 3.8 trillion from +JPY 17.1 trillion to +JPY 20.9 trillion, but it did not generate much JPY-purchasing pressure in the face of the greater expansion in foreign securities investment and direct investment. In this publication, I had consistently predicted that foreign securities investment will drive a JPY-supply bias in the basic JPY supply-demand for 2015, and this seems to have come true.

Basic JPY supply-demand outlook for 2016

Based on the above results, I would like to present my basic JPY supply-demand outlook for 2016. As I have repeatedly argued, the key to forecasting the basic JPY supply-demand is to understand which of ‘the pace of improvement of the current account balance’ and ‘the pace of acceleration of foreign securities investment’ is stronger. If the FRB’s normalization process becomes derailed in 2016 as assumed by this publication, the pace of growth in foreign securities investment will drop over the second half of the year, and a JPY net purchase trend could see a resurgence in the markets to the extent of outstripping the pace of improvement of the current account balance. As we have already confirmed, the net JPY sale of 2015 was supported by the unprecedented momentum of foreign securities investment, and had this momentum dropped, there is a high likelihood that JPY transactions would have tipped toward a net purchase.

Of course, simply because the U.S. finds itself unable to continue with its rate hikes is no reason for the Japanese investment climate to improve, and from the perspective of the U.S.-Japan interest rate gap, a robust foreign securities investment trend in Japan may continue. As a result of the BOJ’s introduction of a negative interest rate policy, JPY interest rates have been pushed down for a wide range of maturities, resulting in a large number of domestic investors left with no choice but to look outside the country for investment options. Under such circumstances, it cannot be denied that a significant net purchase of foreign securities may continue for 2016 as well. All this is based, however, on the assumption that U.S. interest rates remain at around the current levels and a considerable interest-rate gap can be maintained. If my assumption that the FRB’s normalization process will get derailed in the coming months comes true, this will inevitably cause U.S. interest rates to fall further. U.S. interest rates, which have been posting a single-track increase since 2013 seem more likely to fall significantly and attain large negative values in absolute terms compared with Japanese interest rates, which are tentatively testing the negative territory waters within a limited range. If this happens, the interest rate gap is forecast to shrink. What has been happening since the beginning of this year is a decline in USD/JPY (see exhibit) against the shrinking of the U.S.-Japan interest rate gap, and it is thought that this trend could continue further.

Taking a look at the January International Transaction in Securities published by the Japanese Ministry of Finance simultaneously with the Balance of Payments, although Portfolio Investment Assets posted their seventh consecutive month of net purchase, there is a sense that they have been losing momentum after peaking sometime mid-year 2015. The net purchase of Portfolio Investment Assets is continuing to be supported by the trust accounts, which complement the pension fund investment trends, and have been posting net purchases for the past 22 months in a row (the longest unbroken period of net purchases since records started). However, it is unclear whether the trend can continue to be maintained if a shadow falls over the FRB’s normalization process. As of the present time, the prediction that Japanese institutional investors are likely to continue selling JPY will be supported so long as the FRB keeps up with its normalization efforts, but once the difficulty of the U.S. keeping up with successive rate hikes becomes widely sensed, the assessment will probably change. I maintain this development as my forecast’s main scenario and am increasing my caution over JPY appreciation.
U.S. monetary policy now and going forward - The beginning of the end of the FRB’s normalization process

Will “unreasonable normalization” finally become a topic of discussion?
The January ISM Nonmanufacturing Index fell sharply from the previous month’s 55.8 to 53.5, the lowest since February 2014, causing USD to depreciate across the board in the forex markets. The nonmanufacturing sector was the last hope of the FRB and those in the market who were supporting the rate hikes. Now that business confidence in this sector is also beginning to show signs of weakening, it seems that the markets have also begun to feel skeptical about the FRB’s unreasonable insistence on continuing with its normalization process. This is a point I have been making repeatedly in this publication since last year – the grounds for implementing the current phase of rate hikes are very flimsy to begin with, and one gets a strong impression that it is being pushed forward mainly because of the central bank’s obstinacy. Looking at the extent to which the rate hikes have been factored in by the market as of the time of writing this publication, 10% have factored in a March rate hike, with 20% having factored in an April rate hike. Nobody seems to be taking the projections in the FRB’s dot chart seriously any longer.

The beginning of the end of the FRB’s normalization process
Despite all this, the hawkish members of the FRB continued to argue that there was no problem even if the manufacturing sector was weak, given that the nonmanufacturing sector was still strong, and because job data did indeed back their claim, the Bank implemented its first rate hike in nine and a half years last December. However, as I argued in last month’s edition of this publication, it is impossible to have an economic structure where the nonmanufacturing sector continues to recover as though decoupled from the recessionary trends in the manufacturing sector. Historically, the recessionary phases of the U.S. economy have coincided with the recessionary phases of industrial production. Even if one reluctantly acknowledges that such a decoupling is apparent as of the present time, the fact is that the nonmanufacturing sector is strongly reliant on domestic demand, and curbing domestic demand through rate hikes is likely to shake this structure. As the exhibit shows, business confidence in the manufacturing sector has clearly been damaged as a result of USD strength, and has been trending at mid-2009 levels when pessimism was at its highest. And now, business confidence in the nonmanufacturing sector has also plunged — it seems that we may be approaching the beginning of the end of the FRB’s normalization process.

“The importing of recession” must be addressed directly
Another point I have stressed in past editions of this publication is that, because USD happens to be a key currency, it is impossible for the U.S. to consider the U.S. economy as an isolated entity unconnected with the global economy in carrying on with normalization as part of its monetary policy. In the wake of the financial crisis, the FRB embarked on additional monetary easing many times, but each time, newly emerging and resource-rich economies suffered from the ripple effects of USD depreciation and were forced to implement currency intervention by selling off their domestic currencies. This time, the U.S. is facing the reverse problem – the U.S. is the only country currently following the normalization path, and this makes USD the most attractive currency for investments globally, causing USD to appreciate against all other currencies. The resulting strong USD has been destroying business confidence especially in the U.S. manufacturing sector, with prices going down as a result of the decline in import prices. Given the recent soaring of USD, import prices are likely to fall even further going forward (see chart). In other words, the U.S. is importing recession from overseas via the strong USD, indicating that there are no strong grounds for believing that
normalization of monetary policy is the obvious choice given the strength of the domestic economy even though the global economy may be doing poorly. It should be easy to give up on the normalization process because the price outlook risk is on the downside to begin with.

Precious options continue being wasted
As people begin to be conscious of the beginning of the end of the FRB’s normalization process, there are no signs of the much hoped-for effect on share prices and forex rates from the BOJ’s negative interest rate policy. In the face of major topics such as the Chinese economic slowdown, the accompanying commodity price crash, and the resultant derailing of the FRB’s normalization process, it is obvious that central banks of unrelated countries (the BOJ or the ECB) cannot do much. One month since its implementation, the side effects of the BOJ’s negative interest policy are more strongly apparent than its intended effects, with strong doubts being cast on its cost-effectiveness (to be honest, it is completely unclear as of the present time what the positive effects of this policy are supposed to be).

Of course, the cost incurred due to the negative interest rate policy has only just begun to be paid (it went into effect with the reserve maintenance period starting February 16), so it may be too early to begin discussing its effects. Still, one would think that the BOJ has had more than enough opportunities since the start of the financial crisis to learn its lesson that unless it clearly sorts out the effective and ineffective areas of its measures before implementing them, it is simply wasting its precious options. In the coming months, the FRB is likely to downwardly revise its dot chart projections and revise its official statement in accordance with the same. The BOJ’s negative interest rate policy is fundamentally incapable of fighting the resultant USD depreciation but will cause the side effects to be exacerbated. I, therefore, think it is essential to reconsider continuing with this policy. At a lecture he gave following the introduction of the negative interest rate policy, BOJ Governor Haruhiko Kuroda was asked what the “limit to measures for monetary easing” was, but he dismissed the question saying there was “something terribly wrong with that phrase.” However, the fact that some monetary easing measures may still remain does not necessarily mean they will be effective.

The current state of the U.S. economy and its impact on monetary policy - Rising concerns over the approaching economic maturity

Results help save face for FRB
In the U.S. January Employment Situation Summary report released on February 5, Nonfarm Payroll (NFP) change clearly fell short of the median of market forecasts (+190 K) at +151 K mom. On the other hand, the Unemployment Rate fell to 4.9%, a low last seen in February 2008, and was also accompanied by an increase in the labor participation rate (from 62.6% → 62.7%), confirming the tightening of conditions in the labor market. Particularly well-received was the strong growth in average hourly wages at +USD 0.12 (+0.5%) mom and +2.5% yoy — hourly wages are closely watched in connection with estimating inflation trends. As the exhibit shows, there seems to be a correlation between the unemployment rate and hourly wages trends, with hourly wages receiving a boost from the fall in unemployment albeit with a slight time-lag. It seems the results have helped to somehow keep alive the FRB’s determination to raise the FF rates (or should one say “saved face” for the FRB) for the January-March period. An increase to around +2.5% has, however, been seen many times since 2009. In the real sense, therefore, one would like to see a stable growth exceeding +3% in order to feel convinced that this is no longer the “post-crisis” phase.

How to understand the slowdown of service sector growth?
Despite the recent results, my prediction for the number of U.S. rate hikes this year remains: two at most, one in the normal course of things. As I have said repeatedly in this publication, when economic expansion has gone on for as long as it has this time, the natural analytical posture is to be concerned about the maturing of the market. The employment market recovery is no exception to the rule. The FRB went ahead with its rate hike despite low business confidence in the manufacturing sector suggesting the start of a recessionary phase on the grounds that domestic demand remains strong even though the manufacturing sector may be slowing down, so there is no
problem. Those in the forex markets who are still forecasting significant JPY weakness are also doing so largely because they subscribe to the same logic and have confidence (or rather, over-confidence) in the U.S. economy’s strength. The exhibit shows the mom service sector payroll change and its trend (six-month average). Since mid-2014, a stable growth rate of +200 K or so has been achieved, but a fall in pace has been apparent over the past three months. Domestic demand, which seemed strong in light of rate-hike expectations and/or the rate-hike implementation, may also have begun to weaken as a result of USD strength and the higher interest rate. Given that the robustness of the service sector was what justified the rate hike implementation, it seems likely that service-sector trends within NFP, confidence in the nonmanufacturing and household sectors, retail sales, personal spending and other indicators of the strength of domestic demand will become especially important for assessing the U.S. economy in the months ahead. On a more micro level, it will also be important to watch out for when the acceleration in car loans including subprime borrowers, which has been attracting attention since last year, will begin to show a clear reversal. In the ordinary course of things, the FRB’s rate hike is likely to negatively affect borrowers whose employment/wage conditions are not very good. U.S. New Car Sales posted an all-time record high for 2015, and whether there will be an adjustment in figures following the rate hikes is a matter of interest.

The most prominent interpretation of the recent sluggishness of NFP growth was that it was in reaction to the December increase resulting from mild winter conditions, but it is difficult to judge whether that was really the only reason. The one thing that can be judged from the figures is that growth in the service sector, which had been the one bright spot for policymakers within job data, fell sharply for the month following the rate hike, and is not something that can be taken lightly when trying to understand the FRB’s policy operation going forward.

Maturing employment market
I know I am repeating myself, but in the natural course of things, it would not be surprising if employment recovery were to begin slowing down in the near term. Let us take a look at the trend of NFP change starting from the recent-most economic peak, which was December 2007. By the end of 2009, 24 months following December 2007, job losses had reached just under -9 M jobs. From this point onward, the lost jobs were gradually restored, and in May 2014 (77 months later), employment finally began to increase compared with the pre-crisis peak. Historically speaking, 77 months to completely restore lost employment is a rather long period. As of January 2016, it has been 97 months since the previous economic peak, and going by past experience, the time is right to start thinking about either a slowdown in employment growth or a fall in employment. Of course, as during the phase following the economic peak of July 1990, there have been phases when employment growth has continued for a period of over 120 months, so one cannot categorically declare that the recovery has been going on for much too long. However, the period following July 1990 was the longest ever period of economic expansion (April 1991 to March 2001) experienced by the U.S. amid an increase in productivity due to the IT revolution. The question is – does the current phase have the kind of economic strength necessary to break that record?

The present economic expansion phase has continued for 80 months (counting from July 2009 as the start of the economic cycle). This is about 12 months longer than the average length of phases of economic expansion (67.3 months) seen since 1970, so concerns of a peaking in the near term are inevitable. Taking the present external circumstances into account, it would not be surprising if the U.S. economy were to enter a cyclical slowdown or
recession within the next year or two.

**China seems to be hurting toward a third large devaluation**

Even though the flow of funds tends to strongly suggest the rate of inflation, the forex markets, especially the USD/JPY market, do not seem much influenced by this factor. Concerns over the Chinese economic slowdown and the accompanying commodity price crash, which are at the root of the present turmoil, do seem hard to wish away. Hearing that the People’s Bank of China (PBoC) plans to set the USD/CNY reference rate either level or stronger, the markets seem relieved, interpreting this as meaning that the Chinese authorities are giving the greatest priority to stable exchange rates. However, as I have said repeatedly, this merely amounts to pushing the problem down the road. Even if the devaluation of CNY is put off for today or tomorrow or next week, ultimately the accounts will have to be squared at some point if the real economy does not recover momentum. At least as long as the FRB maintains its determination to raise rates and USD remains strong, China will have to put up with an undesirably strong domestic currency. This is certainly not a happy state of affairs, though. The reason China implemented a large devaluation of CNY on August 11 last year, and followed it up with another large devaluation four months later was because during those four months, expectations of a U.S. rate hike expanded and the rate hike did subsequently take place, resulting in USD appreciating (causing CNY, pegged to USD as it is, also to appreciate). The way things stand now, one cannot help feeling that China is hurting toward a third large devaluation continuing from August last year and January this year. Under such circumstances, the markets would find it difficult to gain composure regardless of what the U.S. job data results are.

Inspecting the risks to my main scenario - Biggest risk is forceful implementation of dot chart projections

**Main scenario remains unchanged**

There is no need so far to change my forecast’s main scenario since last year that "the weak-JPY trend will end with 2015 and the currency will begin to strengthen in 2016". In fact, the likelihood of the main scenario’s eventuation appears to have increased. In fact, because the pace at which JPY has been appreciating (10 yen in 2 months) is clearly too rapid, I will even go so far as to say that it would be natural for USD/JPY to temporarily attempt another recovery within the year. In particular, the fact that the IMM currency future long positions are being traded at high levels not seen in around four years is a warning sign that JPY could depreciate again in the coming months as a result of position adjustment trading. However, as I argued above, it is difficult to imagine that rate hikes, which are likely to constrict domestic demand, will continue for very long amid fears of a U.S. economic slowdown following the double-punch of USD appreciation and overseas economic slowdown – making it difficult to sustain the strength of USD based on the monetary policy gap. Taking into account the excessive weakness of JPY from the perspective of price measures (real effective exchange rate and real USD/JPY rate), I think it is safe to retain my prediction of a change from last year’s prediction of “fourth consecutive years of JPY depreciation” to “the first year of JPY appreciation in five years” for this year.”

**Risks to my main scenario: Biggest risk is forceful implementation of dot chart projections**

Naturally, in addition to the main scenario, I also have risk scenarios. What is likely to happen regarding the possibility (upside risk) of a JPY depreciation-USD appreciation trend in 2016? First, there is the possibility that the U.S. economy becomes unexpectedly robust and the FRB’s normalization process moves forward with unexpected smoothness. In this case, the steady appreciation of USD would continue, and the trend of USD appreciation against JPY would proceed for a fifth year. As I have already said, in line with the improvement in the employment situation so far, the wage situation shows signs of beginning to strengthen with a bit of a time lag. The U.S. January CPI was also stronger than forecast. It is, therefore, not altogether impossible for the FRB to boldly go ahead with its rate hikes in a proactive manner. In January, FRB Vice Chairman Stanley Fischer said that the markets were still strongly of the view that there would be only two increases this year, but that this was “too low"
and that “the market is under-estimating where we’re going to be.” Given the strong tone of his statement that the market’s expectations were “too low,” it seems likely that this may not be just a bluff. I consider the FRB’s forceful implementation of the dot chart projections citing the recent increase in wages as the biggest risk scenario of my forecast in this publication.

The second risk scenario is that the BOJ’s undertaking of additional stimulation may become a chronic phenomenon. Following the January 29 introduction of the negative interest rate policy, it may be wise to assume that the possibility of a “sequential escalation of force” in terms of monetary policy will be a given during this forecasting period. In this publication, I have so far considered additional monetary easing by the BOJ as being essentially a risk scenario, but with the introduction of negative interest rates, it seems as though the BOJ may have obtained scope for further expansion of accommodative measures, and compared with the past three years, the hurdles against further easing seem to have become significantly lower. However, as already demonstrated, negative interest rates are not effective in stopping the appreciation of JPY and decline in share prices rooted in overseas factors. The next development warranting caution, therefore, is the possibility of a currency intervention by the Japanese Government/Ministry of Finance, and in fact, there were times in February when USD/JPY rebounded as a result of speculation that this may take place. Irrespective of whether an actual currency intervention takes place, there are likely to be more occasions going forward, when the appreciation of JPY is checked merely by an unverifiable rumor.

Third, there is the possibility that the current tight USD procurement situation will continue. While the USD procurement cost surge that became a hot topic of discussion last Autumn appears to have settled down at this time, given the structural situation of diverse regulatory factors, it appears that a weakening of demand for USD will not easily happen. Amid an increase in the number of players who “are simply not inclined to release their USD,” it is impossible to preclude the possibility of USD appreciation based on scarcity value irrespective of conditions in the real economy. Meanwhile, as JPY interest rates are turning negative even for 10-year maturities (as of the time of writing this publication, i.e., February 25), the objective argument that “there are no alternatives to USD as an investment destination” is highly convincing. Ultimately, when focusing on the absolute domestic-overseas interest rate gap, it appears possible that outward securities investment accompanied by JPY-selling and USD-buying will continue and that demand for USD will remain at a high level. Despite that, I believe that the shakiness of the FRB normalization process means that one cannot count on the continuation of outward securities investment, and because JPY interest rates have descended to unprecedented levels, there is a clear risk that rules of thumb based on past experience are no longer applicable.

On the other hand, regarding the possibility (downside risk) of a JPY appreciation-USD depreciation trend greater than that anticipated in the main scenario, this situation would seem conceivable if the positive cyclical trends in the U.S. economy were to end, bringing on a need to abandon monetary policy normalization and undertake additional easing measures (such as QE4). In this case, a JPY appreciation-USD depreciation trend would probably accelerate regardless of what governmental policies Japan adopts. As has been repeatedly noted, there is no doubt that JPY depreciation has been excessive from the perspective of REER, and there is a latent potential for earthquake-sized repercussions in the case that a full-scale adjustment of this situation takes place. It is also important to be aware of the possibility of China, which is clearly struggling under the burden of a currency that is stronger than it can afford, may suddenly float CNY. If that happens, CNY will crash, taking down other Asian currencies with it and potentially resulting in a large decrease in the REER of JPY too.
EUR outlook – The taboo of EUR supply following Brexit

ECB monetary policies now and going forward – The irony of the “insurance” = the cause of turmoil

**Expression of intent to implement a preemptive easing: “Risks were predominantly on the downside”**

There was no Governing Council meeting in February, but the account of the meeting held on January 21 was published on February 18. This is the account of the meeting at which advance warning of a monetary easing at the March 10 General Council meeting was given, and the tone of the document is dovish, as expected. Overall, the message is that the policies thus far have been successful, but as risks have increased, it is time to consider making another move – concluding, therefore, that monetary easing must be considered again in March. As the heading says, the account clearly revealed the General Council’s intent to implement a preemptive easing, noting that the “risks were predominantly on the downside and new downside risks were emerging, it would be preferable to act pre-emptively, taking emerging risks into account, rather than to wait until after risks had fully materialised.”

The specific risks mentioned are the “increased uncertainty about the economic outlook for emerging market economies,” “heightened volatility in financial and commodity markets,” and elevated levels of “global geopolitical uncertainties.” Overall, there is nothing very new in the points mentioned in this connection. The main concern of the ECB seems to be that if inflation continues to move away from the target inflation rate (≈ 2%), then this could be misunderstood as a sign that the General Council has no intent of taking action or that monetary policies have been ineffective. The Account said that “repeated downward revisions of the inflation outlook were feeding through to inflation expectations, which had again increased the probability of the Euro zone economy remaining in a low inflation environment for an extended period of time.” In other words, the biggest factor prompting a reconsideration of monetary easing is the negative impact on inflation expectations posed by the current risks. In this connection, a major point of discussion at ECB General Council meetings since last year has been inflation expectations – specifically, the increasing correlation between the five-year, five-year forward inflation swap rate (five-year, five-year BEI) and crude oil prices. The Account this time also said, “Following the tight correlation recorded over 2014-15 between the five-year, five-year BEI and the spot oil price, some signs of decoupling had been observed at the end of 2015. The recent decoupling appeared to have come to a halt and the five-year, five-year BEI had moved downwards again in the wake of lower oil prices.”

As the chart shows, given the sharp fall in crude oil prices since 2014, signs of a decline are visible in the Euro zone Harmonized Index of Consumer Prices (HICP), of course, but also in the five-year, five-year BEI. Survey-based inflation expectations, as, for instance, per the ECB’s Survey of Professional Forecasters, are also not showing any increase as a result of policies taking effect, and it is not difficult to understand the impatience some are beginning to feel.

**Appearing to take another look at the lessons of the December General Council meeting, but...**

When it comes to the ECB’s advance notice of monetary easing, the one made in October last year followed by the huge disappointment in December is still fresh in the memory. In this regard, the General Council appeared to be cautioning itself by saying that “it had to be avoided, by means of appropriate communication, that markets developed undue or excessive expectations about future policy action, bearing in mind the market volatility experienced around the December 2015 monetary policy meeting.” However, even as of the time of writing this publication, with the March 10 GC meeting approaching, the markets are, unavoidably, beginning to focus on the next move. If the General Council really wanted to take the December volatility as a lesson, it should not have made an advance announcement of its additional easing intent in the first place. Perhaps it thought that, in order to rescue inflation expectations, the message had to be communicated at the earliest that a diverse range of instruments were available and there were no limits, but giving advance warning necessarily results in raising the markets’ expectations. ECB President Mario Draghi ought to be the person who best understands this. This aspect of the ECB’s policy operation is always difficult to comprehend.

The Account revealed that “a remark was also made cautioning against adopting an explicit risk-based approach to monetary policy, driven mainly by “insurance” motives” – the remark was directed at those in favor of preemptive easing, I agree. Assessing tail risks is certainly not easy, and it would become increasingly difficult for a central bank...
to vote for retaining the status quo if an attitude of “let’s relax the monetary policy because there are risks” becomes the norm.

**The irony of the “insurance” = the cause of turmoil**

The logic that action must be taken because the risks have increased, even though existing policies are already showing effect is exactly the same as that adopted by the BOJ when it recently introduced a negative interest rate or when it implemented the Halloween monetary easing on October 31, 2014. This is ultimately just another way of saying “our policies are not to blame – external circumstances are,” which is also the same as admitting that, in the face of adverse external circumstances, their policies were not as effective as expected.

The fact of the matter is that both the ECB and the BOJ, despite implementing unconventional monetary policies in quick succession, seem to find themselves in dire straits requiring unprecedented measures on a regular basis every year. Given that things have come to such a pass, what the two banks really ought to do is realize the ineffectiveness of their policies. When they fail to do that, and instead attempt to argue that the entire blame lies with external circumstances, one cannot help sensing danger. Previously, when some effect was seen in terms of forex rates and share prices, it made sense, in a way, to argue that even if the measures did not effect a cure at the fundamental level, there was some value in attempting a symptomatic treatment. However, the situation today is vastly different. Many are beginning to say that the negative interest rate is adversely affecting the health of some European financial institutions, and the same is likely to be heard in the case of Japan going forward. Most importantly, as I have been repeatedly saying in this publication, the more the ECB and the BOJ attempt to weaken their domestic currencies through monetary easing, the more inevitably CNY’s nominal effective exchange rate will increase. As a result, Chinese attempts to drastically weaken CNY will strengthen, and at such times, history will repeat itself in the international financial markets. Given that the main reason for the turmoil in the financial markets early this year was China, it is very clear that even symptomatic treatment is no longer working.

As some of the hawkish members of the ECB have said in the Account, perhaps from the perspective of the central bankers themselves, this move is simply driven by “insurance” motives. It would be nothing if not ironic if this “insurance” ends up becoming the cause of the next turmoil.

**EUR Outlook – Refraining from EUR selling on the Brexit issue**

**No basis for confidence in EUR selling despite Brexit concerns**

In February forex markets, there was a progressive plunge in such European currencies as GBP and EUR. These are trends elicited by Brexit concerns and, particularly GBP, being at the epicenter of those concerns, has at times been reaching lows not seen for about seven years. These trends have been strengthening speculation that a Brexit would decrease the EU’s governmental centripetal force and causing EUR to show a tendency to weaken against USD and JPY. (Against JPY, EUR has fallen to JPY122.47, the weakest level of EUR against JPY in about 34 months.) To date, there have been many bouts of EUR selling based on themes with potential sustainability. Each time, the selling was accompanied by speculation that EUR might fall to new record lows below parity with USD, and the current bout appears to be fitting into this pattern.

It is true that if the likelihood of a potential Brexit becomes more realistic, then it will be a scenario in which it will be worth considering the possibility of EUR/USD descending below parity. Compared to previous situations, since the trend of descent is beginning from a discounted starting point, the possibility of a descent below parity this time is probably greater than in the past. Besides the fact that the potential exiting country in this case is the U.K. the biggest issue now is the fact that an Brexit would create a “precedent” that other countries could emulate. The U.K. could become a leak in the EU’s dike that inspires concerns about the potential for similar exits of not only Greece, but of France, Italy, and other semi-core countries that have been suffering due to their use of EUR, and it is this potential that is probably the greatest cause of concern for EU authorities at this time. However, as explained below, public opinion trends in the U.K. are still fluid and unsettled, so it seems a bit early to make assumptions about such extreme scenarios. Given that the FRB’s normalization process is beginning to become shaky, it would be difficult to say that the environment is one in which EUR selling can be undertaken with confidence.

**Public opinion in the U.K.? – Still hard to read**

While there is still considerable time before the U.K general election in June, I would like to present a simple overview of the arguments related to a Brexit. The EU summit meeting held on February 19 unanimously approved a package of requests presented by the U.K. The package includes a proposal to partially restrict social security system provisions for immigrant workers in the U.K., and most observers consider this to be a major concession to the U.K. U.K. Prime Minister David Cameron has stated that he will use the approved package as a
basis for discussing the issue of whether to leave or stay within the EU during the period up to the referendum on this issue, which is to be held on June 23, and the majority of his cabinet is calling for the country to remain in the EU. However, it has been reported that London Mayor Boris Johnson and numerous other leading politicians are supporting an exit, so it the trend does not appear to be auspicious for the current government. (Mayor Johnson is a friend of Prime Minister Cameron as well as being said to be his possible successor.) The market still appears to have strong expectations that the U.K. will ultimately remain in the EU despite all the fuss, but public opinion polls are currently being greatly affected by statements of leading figures, and some polls indicate that those supporting a Brexit are in the majority. (For example, support for remaining within the EU grew in polls undertaken following the EU approval of the requests package, while support for Brexit grew in polls undertaken soon after reports about Mayors Johnson’s statements.) In light of the discrepancies among polls prior to the September 18, 2014, referendum on Scotland independence, in which it turned out that a majority supported remaining within the U.K., it appears difficult to reach any conclusions based on polling at this point.

Moreover, while the U.K. influenced the Scotland referendum by proposing to transfer authorities to Scotland and making other attractive concessions, EU Finance Commissioner Pierre Moscovici has stated flatly that there is no “plan B” prepared for use in the case that the U.K. referendum supports a Brexit. The package of reforms that the EU has just “stomached” include considerable concessions, and the official position of the EU now appears to be that there will be no more such concessions. It does not seem that additional conciliatory measures will be taken immediately prior to the referendum to promote support for the U.K.’s remaining in the EU. On the other hand, if there are major terrorist incidents or other situations heightening concerns about public security immediately prior to the referendum, it seems inevitable that those situations will increase support for the Brexit. It can be anticipated that it will be impossible to be confident about the ultimate results until the referendum takes place.

Impact? – Probably less than from the Greece situation

Going forward, there will be diverse simulations undertaken regarding the effects of a Brexit, and it can be expected that diverse effects expressed in monetary figures will be reported. The same kind of simulations were undertaken many times with respect to the Greece situation in the past and, intuitively speaking, it does not appear that there are so many non-transparent aspects of the current U.K. situation. For example, the subject of greatest concern during the Greece crisis was the issue of shifting to a different currency but, in the GBP, the U.K. has its own outstanding currency with a history much longer than that of EUR. Even if a Brexit occurs, there will be no change to financial settlement processes, and this is a great contrast to the situation during the Greece crisis. Furthermore, the U.K. is outside the Schengen area, so it has not eliminated its passport control systems. In other words, with respect to people movements, the U.K. has not completely participated in the EU integration process. While EUR single currency and the Schengen zone of passport-free travel are the two symbolic pillars of European integration, the U.K. has not opted to participate in either of them. It does not seem that a Brexit would be a major obstacle to the EU integration process. In addition, even if it leaves the EU, the U.K. could continue to enjoy tariff-related benefits within Europe based on membership in the European Economic Area (EEA) and the European Free Trade Association (EFTA) . For example, if the U.K. remains in the EEA, etc., it will continue to apply the European single-market rules. If there is no change to the U.K.’s currency, market rules, and tariffs, the impact is liable to be limited. (However, as mentioned in footnote 4, there is a possibility that remaining in the EEA will be difficult.) Overall, if compared to the cases of Greece and Scotland, one gets the impression that the magnitude of impact from a Brexit would be relatively small.

No negative impact? – Exclusion from the scope of unified rules, lower credit ratings, etc.

Naturally, this does not mean that a Brexit will not present problems. At least, if the U.K. were to leave the EU and also distance itself from the EEA and EFTA systems, it would lose the benefits it currently enjoys from common tariff and single-currency rules. If the U.K. were to leave the EU and not be a member of EEA, it would be a factor promoting an outflow of private-sector companies that have been enjoying tax system benefits, and if U.K.-based financial institutions previously recognized as being within the Europe region were to be excluded from the scope of unified rules application, it would be likely to have a large impact. Such “single rulebook” systems as the universal banking rule  and single passport rule  that have been applied to institutions recognized as being within the region since January 1993, for example, would no longer be applicable. In this case, financial institutions licensed to operate in the U.K. could shift operations to a EU member country and become authorized to resume transactions there under the EU’s common financial regulatory framework, so it can be anticipated that there would be an outflow of institutions from the U.K. In the case of Scotland two years ago, the residual support for a common destiny with the U.K. as a path to prosperity led to the situation dying down, but if a Brexit were to be accompanied by an accelerating outflow of private-sector companies, it is impossible to know whether Scotland would remain a quiet bystander with respect to the issues of its independence and EU membership. There are concerns that renewed moves toward Scottish independence might be rubbing salt into the U.K.’s wounds at that time.

Moreover, the major credit rating companies have already expressed their views on lowering ratings in the case of exits from the EU, and if there were to be a Brexit, then there is a high likelihood that it will inspire rising fund
procurement-related concerns about the U.K., which has been recording large dual deficits (fiscal and trade
deficits). Such trends could directly lead to a rise in the funding costs of U.K.-based financial institutions, and that
raises the specter of a scenario in which a Brexit could be the starting point of an international financial shock. In
addition, given the rule limiting the EU budget to 1% of member states’ GDP, it can be argued that the departure of
the U.K. – one of the EU’s four largest countries – could cause a rise in the budgetary responsibility of the
remaining countries. In this regard, however, since the size of individual countries’ budget funding responsibilities is
not so large, it seems that there is a low likelihood that this will become a major issue.

Impact on forex rates? – EUR plunge scenario not a good bet

As evidenced by the forex markets’ reaction already, the specter or eventuation of a Brexit is clearly a factor
promoting EUR selling in the short term, and this is probably why there has been a surge of chattering about the
potential for EUR to fall below parity with USD. As noted above, there are a considerable number of people inclined
to believe that a Brexit will lead to “a decline in the EU’s politically unifying capability” or centripetal force, and this is
a placing a heavy weight on EUR.

However, as this article has frequently argued, the 19 countries of the Euro zone have the world’s largest current
account surplus, and the EUR’s disinflationary tendency in the past and currently mean that real EUR interest rates
are not easily depressed. Going forward, if Chinese economic deceleration and plunging crude oil prices along with
turbulence associated with the U.K. cause turmoil in international financial markets that stymies the FRB’s policy
normalization process, then the EUR-selling/USD-buying trend based on the expanding gap between European
and U.S. monetary policies is likely to be rolled back progressively, and we may see a growing speculative trend of
buying and holding EUR. The fact that EUR/USD surged strongly when Greece-related tensions were
approaching their peak in March-August last year indicates that the progressive trend of speculative EUR selling
seen up to that time was rolled back in response to a rising risk aversion mood. Barring certainty about a
prospective collapse of the common currency area, I do not believe it would be a good bet to wager on a sharp fall
in EUR scenario.

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