Forex Medium-Term Outlook

2 MAY 2016

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Forex Division

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Overview of Outlook

USD/JPY has once again renewed its year-to-date low. Violent fluctuations aside, the bigger trend is exactly as predicted in this report. An adjustment is inevitable for USD, which has seen an excessive and rapid appreciation, so this year (2016) is likely to be different from the previous four years in terms of U.S. economic and monetary policies. As investments relying on the expanding U.S.-Japan monetary policy gaps inevitably follow, it will become difficult to maintain the strong JPY / weak USD trend. Again, the weakness of JPY is clearly excessive when seen from the perspective of purchasing power parity (PPP) and the real effective exchange rate (REER), so from a theoretical point of view, one has to expect a significantly large adjustment. The developments triggered by the release of the U.S. Semiannual Report on International Economic and Exchange Rate Policies at the end of April were also within the scope of our House view, and do not warrant any change in this report's basic scenario. There has been no change in this "extremely ordinary forex outlook" since April either. For the current forecasting period, I predict that movements in USD/JPY will have a lower limit of 100, with a risk of the rate dropping even lower. Having said that, the fact is that there is an excessive accumulation of the JPY long position at the present time, and moves to dissolve this position will probably take place during the April-June period, causing a temporary rebound in USD/JPY. This must not be mistaken for the yearly trend, however. It is important to remember that any "bazookas" on the part of the BOJ, speculative transactions, and other similar developments are mere noise, not determiners of the real trend.

Meanwhile, EUR continues strong. As this article has repeatedly noted, being the currency of a region that boasts the world's largest current account surplus and a relatively strong real interest rate, EUR has an underlying strength and is liable to recover it at the first sign of a shadow over the FRB's normalization process. After all, EUR weakness is merely the result of an "epic speculation" that relies on the domestic-foreign interest rate gap, and one must not place too much confidence in its sustainability. Understanding this basic fact is likely to be rewarding in the year ahead too. EUR has been continuing to strengthen and, despite the drop of inflation expectations to historically low levels, the April ECB Governing Council Meeting decided to maintain the status quo. This indicates that ECB policy management has reached an impasse and, going forward also, it seems likely that the ECB will continue facing difficulties in artificially depressing the value of a currency that is strengthened by large current account surpluses and relatively high real interest rate levels. It is quite possible that the EUR/USD range will shift upward to 1.15-1.20 during the forecasting period. Having said that, during the May-June period, events related to Brexit could trigger a selloff of EUR, and the currency could easily weaken to new low sometime around June, when the referendum takes place.

Summary Table of Forecasts

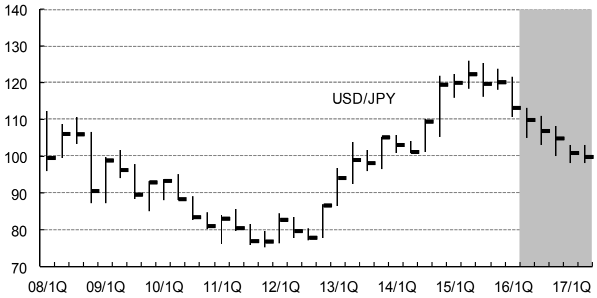
	2016 JAN-APR(Actual)	MAY-JUN	JUL-SEP	OCT-DEC	2017 JAN-MAR	APR-JUN
USD/JPY	106.27 ~ 121.70 (106.41)	105 ~ 113 (110)	103 ~ 111 (107)	100 ~ 108 (105)	98 ~ 103 (101)	98 ~ 103 (100)
EUR/USD	1.0711 ~ 1.1465 (1.1472)	1.10 ~ 1.18 (1.12)	1.10 ~ 1.18 (1.14)	1.11 ~ 1.19 (1.15)	1.11 ~ 1.20 (1.16)	1.11 ~ 1.20 (1.17)
EUR/JPY	121.71 ~ 132.45 (122.06)	119 ~ 127 (123)	118 ~ 126 (122)	117 ~ 125 (121)	115 ~ 123 (117)	115 ~ 123 (117)

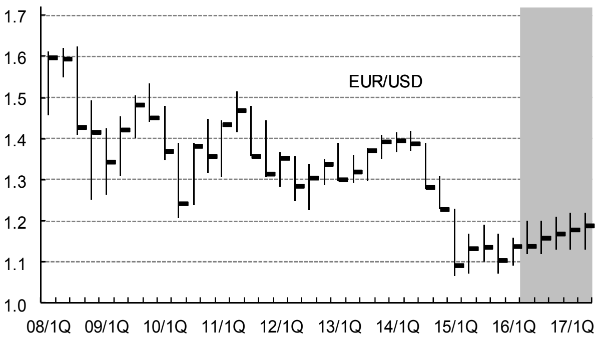
A. The exchange rates under "Actual" column are the actual trading ranges as of 29APR2016 ; those in parentheses are the rates as of 10AM on 2MAY2016.

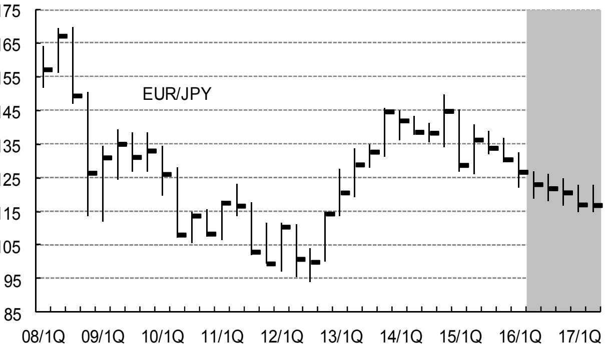
B. For actual figures, refer to sources such as Bloomberg and others.

C. In the forecast columns, the exchange rates in parentheses are quarter-end forcasts.

Exchange Rate Trends & Forecasts



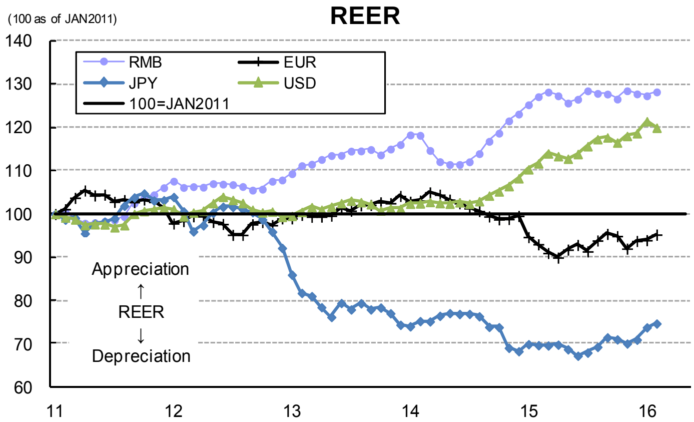




USD/JPY outlook – No change in assumption that USD/JPY may sink below 100 yen

Global context now and going forward – Looking for potential JPY depreciation factors

Formulating JPY outlook based on the global context



Sources : BIS, Broad Based

This year, in formulating the forex outlook, it has become important to take into account the international context. Since the beginning of April, the phrase “avoiding competitive currency devaluation” has often been heard in the forex markets. If efforts to avoid competitive currency devaluation have to be stressed so strongly, one cannot help feeling that the present international climate has sunk to a state of affairs very much like competitive currency devaluation. Needless to say, the forex market is a zero-sum game – one person’s gain is another’s loss. So, the weight of countries suffering as a result of currency strengthening coincides with the weight of countries profiting from currency weakening. This is difficult to understand intuitively, but the real effective exchange rate (REER) calculated by the Bank of International Settlements is the single common measure used in the area of international economic diplomacy. Over the past five years (2011 to 2015), the U.S. and China have been the two countries that have suffered the most from currency strengthening (see exhibit), while the Euro zone and Japan have enjoyed the benefits of currency weakening. The recent developments, therefore, can be explained as the reversal of those trends.

<u>The global economy at the present time clearly seems to need concerted global action based on the depreciation of USD, and this is also a factor that favors the scenario of strong JPY / weak USD.</u> The FRB’s stubborn pursuit of rate hikes and repeated monetary easing by the ECB and BOJ will only invite further unilateral appreciation of USD, which will inevitably cause CNY to appreciate in tandem with it. The result of this could only be a sudden major devaluation of CNY one fine day, and what this would do to the financial markets is hardly necessary to explain at this point. The optimal solution in view of such circumstances is obviously for the FRB to halt is rate hike process, for the ECB and the BOJ to stop monetary easing, and for the concerned authorities in China to strengthen capital regulation. This is why there are media reports[1] about the possible existence of a secret “Shanghai Accord.”

My position is that, regardless of the existence or otherwise of a ‘Shanghai Accord,’ the U.S. rate hike process is unsustainable. The FRB may continue with austerity measures due to bubble-related concerns, but to predict a continuation of USD strengthening over the next year or two at the same pace as over the past two years or so would take great courage.

Forex market concerns about “rivalry”

The G20 Finance Ministers and Central Bank Governors meeting held in Washington D.C. (April 15 locally, but April 16 in Japan) was an important event in terms of understanding what is happening in the international arena. Just as was the case at its February session in Shanghai, the meeting confirmed the stance of individually and collectively using each country's monetary, fiscal, and structural growth strategy policy tools overcome the current stagnation. While the communiqué of the meeting did not include much new, U.S. Treasury Secretary Jack Lew stated at a post-meeting news conference that - "despite recent yen strength, foreign exchange markets remain orderly." As this has been increasingly interpreted as a statement that has restrained the prospective countermeasures of the Japanese government and the BOJ, the strong JPY / weak USD trend proceeded immediately afterward (the inability of leading oil producing countries in Doha to agree on freezing crude oil production levels was another factor behind this). In this regard, while Japanese Finance Minister Taro Aso had previously been expressing concern about forex market movements, he acknowledged the yen's motion seen “wasn't that sharp” on Friday itself and emphasized that the disparity between his and Lew’s views about JPY stemmed from the fact that the two were talking about forex rate movements over different time periods. Of course, it is impossible to gain a precise understanding of the real intention of Lew’s statement. However, forex market participants have viewed the conflict between the leading figures’ statements as a significant discrepancy with respect to currency diplomacy, and this has facilitated transactions designed to understand and anticipate the key-

[1] See “Analysts point out that there may exist a ‘Shanghai Accord’ similar to the Plaza Accord,” Bloomberg (Japan), March 18, 2016.

currency trend. It should be noted that the occurrence of such statements at a time when the U.S. currency and monetary policy stance regarding USD strength is being spotlighted has caused an unnecessary amount of agitation in the forex markets. Subsequently, the fact that, in addition to China, Korea, Taiwan, and Germany, Japan was also included in the "Monitoring List" mentioned in the April 29 U.S. Semiannual Report on International Economic and Exchange Rate Policies gave impetus to such speculations. One does wonder about the decision to monitor countries that do not conduct currency interventions on a daily basis alongside those that do, but it is bound to be a matter of concern for forex market participants regardless.

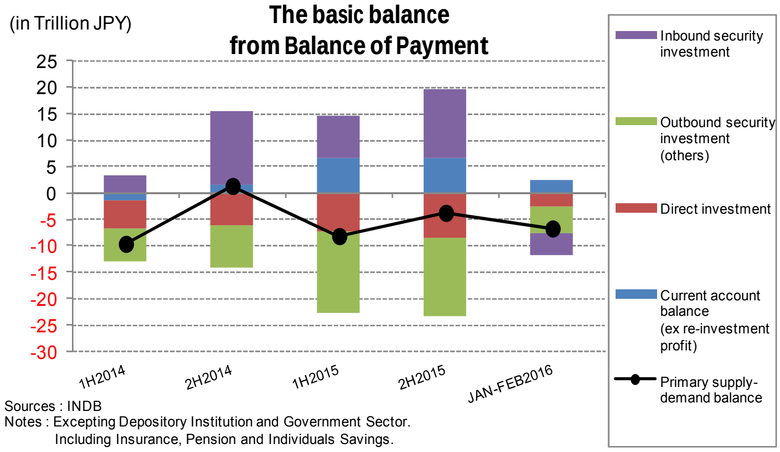
Frankly speaking, based on last year's overall USD/JPY 10yen range, it is not surprising that the G20 communique referred to this year's first quarter price action as to having adverse implications using the phrase "excess volatility and disorderly movements in exchange rates".

On the other hand, given an environment in which USD weakness is considered to be a stabilizing factor for the global economy and particularly for the U.S. and Chinese economies, while also taking into consideration that JPY weakness had steadily paced itself off over the past three years, it would be increasingly hard for a non-Japanese audience to fall for the argument that "Japan would have serious difficulties with JPY strength". Japan's situation is similar to the Euro zone's situation in this regard, and when considering the size of the Euro zone's current account and trade surpluses, the Euro zone is the least well positioned to argue against the appreciation of its currency. Since last year, this article has been predicting that U.S. currency and monetary policies will become unable to accept USD strength and that, principally for this reason, there will be a shift to a weak USD / strong JPY trend. Events from the start of 2016 through this point in time have been in accord with that forecast.

Looking for potential JPY depreciation factors – (1) Basic JPY supply-demand balance

In light of the market trends since the beginning of the year, I am often asked what it would take for a return of the weak JPY trend. This is in stark contrast to the fact that over the past three years, as JPY continued to weaken, almost no one asked me what it would take to return to a JPY strength trend. It shows how deep-rooted the subconscious notion that JPY weakness is better than JPY strength is in Japan. However, so long as the economic climate in the U.S. is intolerant of U.S. currency and monetary policies favoring USD strength, this report will continue to assume that no major change is likely in the larger strong JPY / weak USD trend. As mentioned above, USD weakness is now an adjustment that is necessary not just for the U.S., but also for the stability of newly emerging economies including China, and can, therefore, be seen also as the international economic and financial trend. I have no way of confirming whether there does in fact exist a secret Shanghai Accord, but the stability of the U.S. and Chinese economies are essential for the global economy, and if the weakening of USD is important for these, then things are likely to progress in that direction.

Against this background, I would like to consider factors that could potentially reverse the weak JPY / strong USD trend. Of course, if the FRB were to go back to its hawkish stance of late last year, that would be the quickest route. This is something I have said in past editions of this report and in my external contributions[2] – one of the lessons learned from forex market trends during January-March this year is that the intent of those governing the world's key currency is the most important factor dictating forex trends. During the said period, the BOJ introduced a negative interest rate policy and the ECB unveiled a complete monetary easing package without much effect, but USD crashed at a mere shift in dotplot projections by the FRB. Therefore, there is no question that the shortest route to a revival of the USD strength trend would be the FRB's strengthening of its hawkish stance. But are there no other factors that could cause USD strength? Well, the below ideas may be.



Sources : INDB
Notes : Excepting Depository Institution and Government Sector.
Including Insurance, Pension and Individuals Savings.

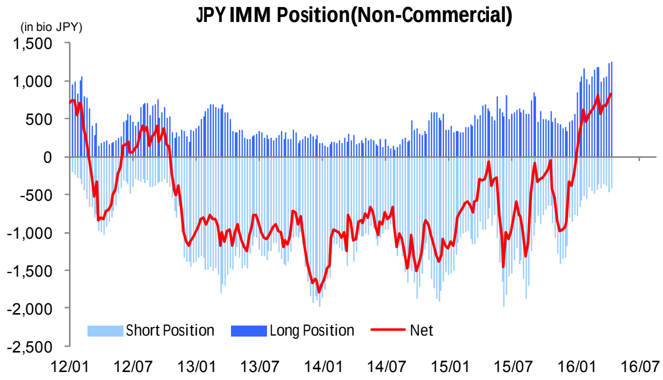
For instance, it is worth paying attention to the basic JPY supply-demand balance. Until last year, the weak JPY/strong USD trend was being driven first by the FRB's normalization process, second by the BOJ's monetary easing stance, and third by the JPY supply bias in the basic JPY supply-demand balance associated with the first two. A look at the basic supply-demand balance, which I use as a reference in this report, shows that last year's trend continued during January-February this year, with enormous foreign securities investment creating a JPY supply bias (see exhibit on previous page). Of course, there is no guarantee that the trend of the first two months of the year will continue for the remaining ten months, but given that domestic interest rates have been pared back to

[2] For example, please see article titled "U.S.-led JPY strength – USD could fall below 100 yen" in the April 8, 2016 edition of *Reuters Forex Forum*.

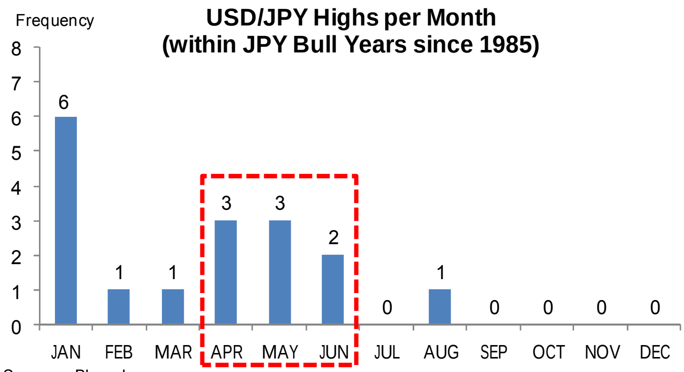
bare minimum levels, the investment climate is certainly one where investors have no choice but to look outside. And as long as the FRB's determination to normalize remains strong, this investment structure is likely to remain. What is more, crude oil prices have begun to rebound recently, and a shrinking current account surplus is bound to be added to this mix of factors, further contributing to the JPY supply bias. Looking at the March Portfolio Investment Assets, which have already been released, long-term debt securities posted a net purchase of JPY 5.2098 trillion, the largest since the current records began. At least in terms of the basic JPY supply-demand balance that I calculate, the situation seems conducive to a continuation of the weak-JPY trend.

Having said that, there is no guarantee that the statistical data pertaining to foreign securities investment will have an actual impact on the forex markets. On Page 19 of the *Nihon Keizai Shimbun* April 12 morning edition, there was an article that featured a comment from a spokesperson for a large life insurance company saying, "We're not so keen on increasing our foreign securities investment as to overlook the foreign exchange risks involved." In other words, even if net purchases in Portfolio Investment Assets show statistical acceleration, their impact on the forex markets is likely to be suppressed due to an accompanying increase in the hedge ratio. Taking into account the rising insecurities regarding the FRB's normalization process, it seems risky to place too much hope on foreign securities investment as a driver of JPY depreciation. However, as I will explain below, the fact is that an increase in Japanese investors" risk appetite for foreign investments is a major risk factor for the strong-JPY scenario predicted in this report.

Looking for potential JPY depreciation factors – (2) Rollback of speculative positions



Sources : CFTC, Bloomberg



Sources : Bloomberg

Speculative position trends, as typified by IMM currency futures transactions, offer a major clue for those predicting a JPY strength scenario, including this report. The recent-most speculative position data (as of April 26) shows (see exhibit) that the JPY long position (against USD) has been increasing while the JPY short position has been decreasing, resulting in a sharp net rise in the long position. In terms of value, this is the highest in about six years, while in terms of the number of transactions, it is the highest about in eight years. USD/JPY rebound toward the end of April is merely the result of a rollback in these positions, and the weakening of JPY in the process of these adjustments is something this report's outlook has already factored in. As I said in the previous month's edition of this report, the main theme for the April-June period JPY outlook is "to what extent will JPY weaken amid the dissolution of these speculative positions," and the recent weakening is nothing more than the start of this adjustment process. Given that the improvement in U.S. economic indicators have not been a game-changer in terms of forex rates at all recently, it was assumed that an additional monetary easing decided at the April 28 BOJ monetary policy meeting would help shift the currents, but monetary policy was kept unchanged at the April 28 meeting, prompting a further accumulation of the speculative JPY long position. In this context, this report must retain its stance of caution regarding JPY depreciation risks during the April-June period.

In the end, however, these movements are due to the liquidation of speculative positions and are not sustainable, so they will not form part of the overall trend for the year. As I said in past editions of this publication, even historically speaking, there has been a pattern of temporary JPY weakness during the April-June period even during years otherwise characterized by JPY strength (see exhibit on previous page). The reason for this is not clear, but as far as the current year goes, it may be that the present temporary break in the unilateral JPY strength trend since the beginning of the year is due to the mid-year timing. At any rate, the level of JPY weakness/USD strength reached amid the liquidation of excessive JPY long positions could well be the highest USD/JPY will post for the next eight months, and a 115 level may be the best one can hope for.

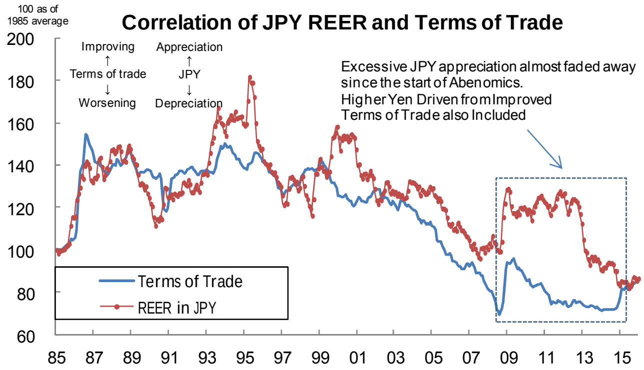
Predicted JPY Strength levels

I am forecasting that movements in USD/JPY will have a lower limit of 100, but I will not deny the risk of USD/JPY falling even lower. This forecast reflects the fact that, 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 in the vicinity of 100. Since Abenomics became a hot topic of discussion, this article has repeatedly noted that USD/JPY has been consistently higher than the corporate goods PPP and discussed how that situation should be interpreted. Based on the assumption of a "world in which 2% inflation is considered a natural state of affairs," it is natural to expect that the PPP will be adjusted by weaker JPY / stronger USD. The most logical way to explain this situation is to posit that, before the consumer price index (CPI) shows a trend of change, the forex market moves ahead with movements reflecting related expectations.

Given the current situation in which the "2% in two years" inflation target has been revised to a "2% in four years" target, however, the BOJ has become unhesitant to employ the kind of "sequential escalation of force" approach that it initially had refrained from. Furthermore, the BOJ's playing of the trump card of negative interest rates has not generally been met with a positive reception, and the negative interest rates have had no effect at all regarding the restraint of JPY strength. After all, in the forex market, where there is always another currency to consider, even if one depresses domestic interest rates within a non-negative range, so long as the interest rate on the other currency (USD) can drop by a large margin in terms of its absolute value, the interest rate gap between the two currencies will not expand so much. Since, as noted above, there are doubts about whether the FRB's normalization process may be aborted, proactively undertaking JPY selling/USD purchasing will require considerable courage. In addition, as argued in the April 6 edition of this article, entitled "Interpreting the USD/JPY dip to below 110," if one assumes that real effective exchange rates (REERs) will tend to move toward their long-term average levels, then it is clear that a fall of USD/JPY to below 100 is fully within the realm of possibility.

My impressions regarding JPY strength and the Japanese economy

Now that the USD/JPY level has become established at lower than the 110 level, there are some who express concern about its impact on the Japanese economy, but I would like to warn against those who create an excessively pessimistic sentiment. It is true that, to the extent that JPY depreciation elevated the manufacturing sector's profitability, JPY strength has considerably depressed the sector's profits. The drop in stock prices probably reflects this. This is, in fact, very seriously problematic situation. Forex movements with a range exceeding that of such movements all last year have taken place in a mere three months and, moreover, all of the movements have been in the direction of JPY strength. It is unquestionable that the associated damage to the export sector has been large, and there is concern that private-sector consumption and investment proclivities may be dampened.



Sources : Bank of Japan
Note : Export Prices / Import Prices JPY base

However, there is a need to separate this kind of discussion of directionality from the discussion regarding levels. When USD/JPY was exceeding 120, it elicited a growing amount of concern from observers including politicians, and the issue of JPY depreciation's association with the lack of improvement in real wages became a high-profile issue during BOJ Governor Kuroda's appearance before the Diet. Memories are fresh of how scattered voices from industrial circles became negative with respect to excessive JPY depreciation and the monetary easing measures that promoted such depreciation. Most importantly, it should be noted that the JPY effective exchange rate is currently at a level comparable to levels in the 1970s, so if "the Japanese economy is not OK with the current level," then there is a need to consider what other problem the economy has aside from exchange rates. In fact, a Reuters survey of companies in May 2013 found that approximately 80 of companies wanted to see USD/JPY in the 95-100 range. Even if USD/JPY is adjusted to the vicinity of JPY100 in line with this article's forecast, it seems unlikely that such a level would cause destructive damage to Japan's economy. Furthermore, crude oil prices have fallen to less than half their level in 2013. JPY strength and the plunge of crude oil prices have produced a dramatic improvement in Japan's terms of trade, and this would ordinarily be considered a highly supportive tailwind with respect to the corporate profitability environment. The JPY REER has in fact been moving in the direction of JPY strength since the start of this year, but it can be said that this movement is academic when considered in conjunction with the terms of trade improvement (see graph on previous page). It is assumed that the adoption of a floating exchange rate system will lead to exchange rate adjustments that tend to balance the levels of advantages and disadvantages in the trade environment. In very simple terms, it may be appropriate to consider the increase in costs associated with JPY strength as roughly corresponding to the decrease in costs associated with the crude oil price drop. Since 2013, even a rise of more than 50% in USD/JPY failed to spur a large increase in Japan's export volume, and the volume of voices discussing the cost of that rise in USD/JPY have gradually become quite loud. Rather than undertaking a discussion of a "JPY strength spurred recession" in a manner akin to a conditioned reflex, it will be optimal to maintain a calm attitude while seeking to accurately determine and assess the impact of JPY strength.

BOJ monetary policies now and going forward – Adjustments in line with the lack of additional easing

Psychological leeway from USD/JPY above the 111 level

BOJ Monetary Policy Meeting decided to maintain the status quo on April 28. The trends of JPY strength and stock price declines have become stably established since the January 29 introduction of the negative interest rate policy, but since the negative interest rate policy really has only been in effect for about two months, the BOJ decided to refrain from unleashing additional easing measures. While the original policy management stance emphasized acting without hesitation to prevent a back-sliding of expectations, it is impossible not to get the impression at this point that the stance has become more difficult to understand. Besides the JPY strength and stock price decline trends, the impact of the earthquakes in Kumamoto and other factors are strengthening the view that economic growth during the January-March period was negative, it and would appear that this situation could have been considered a suitable justification for additional easing. This also may be a logical basis for the decision to delay the prospective attainment period for the consumer price index (CPI) “2%” inflation target from “the first half of fiscal 2017” to “during fiscal 2017.” (This essentially presents a blueprint for attaining the target during a time-frame that encompasses the entirety of BOJ Governor Kuroda’s (five-year) term.) In light of this situation, it can be said that it was natural that many observers would assume that the BOJ would opt to introduce additional easing – leaving aside the issue of how effective the easing might be. It is thought that the forex trend – with USD/JPY rising to above the 111 level immediately before the Monetary Policy Meeting, assisted by expectations of additional easing measures – was a factor that gave the BOJ enough psychological leeway to make the decision to maintain the status quo.

Real GDP, CPI Forecast by the Majority of the BOJ Policy Board Members

y/y % chg

	Real GDP	CPI ex Fresh Food	ex Sales tax hike effect
FY2015	0.7~0.7 <0.7>	0.0	
January Forecast	1.0~1.3 <1.1>	0.0~0.2 <0.1>	
FY2016	0.8~1.4 <1.2>	0.0~0.8 <0.5>	
January Forecast	1.0~1.7 <1.5>	0.2~1.2 <0.8>	
FY2017	0.0~0.3 <0.1>	1.8~3.0 <2.7>	0.8~2.0 <1.7>
January Forecast	0.1~0.5 <0.3>	2.0~3.1 <2.8>	1.0~2.1 <1.8>
FY2018	0.6~1.2 <1.0>	1.0~2.1 <1.9>	

Notes : <> indicates board members' median.

Sources : BOJ

March statement designed to smooth the way?

The BOJ’s revised Outlook for Economic Activity and Prices indicates that the prospective rate of change during fiscal 2016 in the CPI excluding fresh foods was reduced from +0.8% in January to +0.5%. The prospective rate of change during fiscal 2017 was reduced from +1.8% in January to +1.7%. Similarly, the real GDP growth rate forecast for fiscal 2016 was reduced from +1.5% to +1.2%, and the forecast for fiscal 2017 was reduced from +0.3% to +0.1%. From an ordinary perspective, it seems surprising that such large-margin downward adjustments would not lead to a decision to undertake additional easing. While the Outlook Report’s figures have just now been adjusted downward, however, the BOJ’s appraisal of economic conditions was previously adjusted downward in a comprehensive manner at the time of the March Monetary Policy Meeting.[3] Status quo maintenance decision might be considered rational since the outlook has not changed since March. In brief, it is possible to conclude that the preparations to smooth the path for maintaining the status quo in April were begun from March. In any case, the previous outlook scenario – tightness in the employment and wage situation leading to wage increases, thereby accelerating household consumption activity and ultimately pushing product prices upward – is being maintained, and one gets the impression that the employment market will continue to represent the “lifeline” or last hope for justifying the current policies.

[3] Regarding the appraisal of economic conditions, the January MPM statement said “Japan's economy has continued to recover moderately,” and this was adjusted downward in the March statement to read “Japan's economy has continued its moderate recovery trend.” Looking at appraisals of individual economic segments, also, one finds large downward revisions to appraisals of overseas economies, exports, housing, and the inflation outlook. Based on a logical consideration of all these revisions, it would not be at all surprising if the policy decision were to have been to undertake additional easing.

Forex implications – Adjustments in line with the lack of additional easing

As has been repeatedly explained in this publication, I had expected that BOJ Monetary Policy Meeting would launch additional easing measures and that those measures would spur the elimination of accumulated speculative long positions in JPY, and it is for this reason that the previous edition (March 29, 2016) of “Medium-Term Forex Outlook” forecast that USD/JPY would rise to as high as 117 during the April-June forecast period. Owing to today’s status quo maintenance decision, however, the adjustment of speculative positions will be slower, and it appears that, with a predominant trend of small-scale (USD) short-covering transactions, USD/JPY will remain robust. The problem is that while this gradually progressing position adjustment may be sufficient to prevent a sharp drop in USD/JPY, it does not seem likely to promote a large-margin increase. Ultimately, in the case of positions being eliminated with USD/JPY at levels in the vicinity of JPY110, the next bout of JPY strength will start from that level. In light of this, a BOJ decision today to undertake more easing would have been highly significant in that it could have pushed USD/JPY upwards and thereby created greater elbow-room for subsequent policy operations. Ultimately, if the possibility of JPY strength is high whether or not a monetary easing takes place, then one is tempted to think that policy operations going forward will be easier if some action is taken this time.

As the number of playable policy cards has begun diminishing, there will be a need when planning the “next move” to consider diverse factors with an eye to playing those cards at the most significantly effective times. To use a baseball analogy, the BOJ has been like a batter in a full-count (three balls and two strikes) situation that means that the leeway for decisions has been diminished. The situation made it highly important for the batter to have a “good selective batting eye” and, this time, it appears that the BOJ batter was facing a good ball that it could have successfully hit (at least with respect to boosting the level of USD/JPY). While there are positive aspects of “keeping cards in reserve,” the cards will only be effective if they are played with the right timing. Going forward, it is unclear when another such opportune situation will present itself, so the BOJ will be required to continue doing its best to find effective ways to promote easing.

U.S. monetary policies now and going forward – The key point remains concerns over USD strength

No change in "FRB monetary policies ≈ USD depreciation factor"

At the FOMC meeting held on April 26 and 27, the Committee decided to keep the monetary policy unchanged and maintain the target range for the federal funds rate at 0.25 to 0.50 percent. Even though there were a series of remarks supporting a rate hike in April by the presidents of regional Federal Reserve Banks since the beginning of March, it was self evident that there were not enough motivation for forcefully implementing any rate hike at the meeting following which no press conference was scheduled. As a result the impact of such decision on the markets was indeed muted. If one would have had to say anything, it would have been that the language pertaining to the risks from international economic and financial conditions were deleted, which led to a somewhat hawkish interpretation of the statement causing USD/JPY to rally, albeit shyly. In a way, this has built up anticipation for a FRB hike in June but the probability of such occurrence happening remains low amongst the community. I thus believe it to be cautious in thinking that forthcoming FRB's policies to keep on being USDJPY's bear factor. At the beginning of the year, the markets had factored in a 50% probability of a rate hike at the June 15 meeting, but this probability has now halved and it directly translates into a lowering of the USD/JPY rate level too.

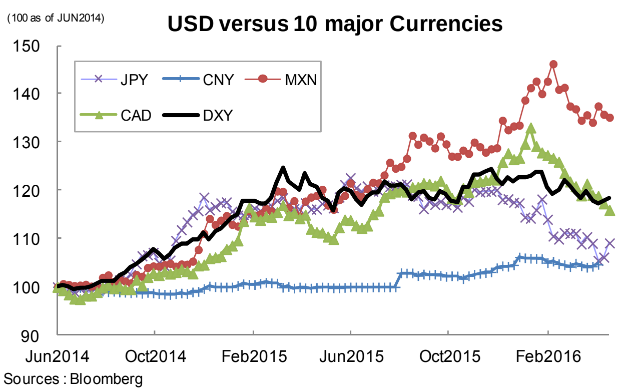
The FOMC statement reveals consideration in the finer details

Only slight changes are visible in the official FOMC statement, revealing that care was taken not to jolt market expectations. The assessment of the economy at the start of the statement was changed from "economic activity has been expanding at a moderate pace" to "growth in economic activity appears to have slowed," which is a clear downward revision from expansion to slowing. However, a look at the entire phrase "labor market conditions have improved further even as growth in economic activity appears to have slowed" shows that the emphasis is rather on the fact that labor market conditions have improved further. This makes it seem like a balanced revision including hawkish as well as dovish elements. In addition, the phrase "despite the global economic and financial developments of recent months," which had been included up to the previous month's statement, has been deleted, which gives one the impression of an overall hawkish tone if one reads just the first paragraph.

Note that the statement's handling of the phrase "global economic and financial developments continue to pose risks," which had originally been thought to remain unchanged, drew some attention. This time, the phrase had been moved to the second paragraph (which provides an assessment of the economic and price outlook) and changed to "the Committee continues to closely monitor inflation indicators and global economic and financial developments," by combining with the phrase "the Committee continues to monitor inflation developments closely" in last time's statement. In the sense that the statement did not make special mention of global economic and financial risks as a separate item, it can be seen as an upward revision. What is more, as mentioned above, the phrase concerning risks was deleted from its earlier position in the first paragraph. It, therefore, appears that the FRB's view is that the international risks have receded significantly in April compared with January and March.

Pressure Point left unchanged

Having said that concerns surrounding international economic and financial developments have receded, it still seems very unlikely that there will be a rate hike at the next FOMC meeting in June judging by the remarks (intended to check USD strength) of U.S. Treasury Secretary Jack Lew and candidates running for the office of the next U.S. president following the Washington G20 meeting. Ultimately, the key pressure point remains unchanged – will the U.S. be able to tolerate any further USD strengthening? In order to predict JPY weakening against USD, the essential precondition is that U.S. currency and monetary policies (i.e., the U.S. Department of the Treasury and the FRB) should be favorably disposed toward a continued strengthening of USD. The fact, however, is that USD has been appreciating at an unprecedented pace, and this has been weighing down the U.S. manufacturing sector's performance. In particular, USD's strengthening against North American Free Trade Agreement (NAFTA) currencies, which belong to countries that comprise over 30% of all U.S. exports (in 2014, Canada comprised ≈ 19% and Mexico ≈ 15% of all U.S. exports), has been remarkable (see exhibit). For example, USD/MXN had gained up to 50% as of February 2016 when compared with June 2014. Roughly speaking, this amounts to U.S. manufacturing sector payrolls increasing by 1.5 times compared with those of Mexico in under two years. If such conditions continue, it is natural that U.S. manufacturing sector employment will suffer significant damage. I am maintaining my view that, against



Sources : Bloomberg

increasing political and economic pressures to revise the strengthening of USD, the FRB will be forced to suspend its normalization process temporarily, resulting in a scenario conducive to JPY strengthening against USD. All these assumptions came to fruition and was revealed to the markets in the form of one development – the entry of Japan and four other countries into the "Monitoring List" mentioned in the April 29 U.S. Semiannual Report. This development does not specially affect this report's main scenario, however.

Risks to my main scenario – Importance of keeping an eye on “U.S. and Chinese need for stable USD depreciation”

Roll-back of speculative positions a minor event

Despite a bout of JPY weakening/USD strengthening during the latter half of April, there is no need at all to change my forecast’s main scenario that I have been maintaining from the past year and a half – namely, that “the weak-JPY trend will end with 2015 and the currency will begin to strengthen in 2016.” As I frequently argue, the elimination of the excessive accumulation of JPY long currency futures positions during the April-June period, expectations of GBP and EUR selling in connection with the U.K.’s potential exit from the EU (Brexit), and other factors are generating a USD-buying anticipation mood, and I think that this mood will promote a situation in which USD/JPY returns to its previous level. Regarding the futures positions – last month’s edition of this article noted that “this merely represents the possibility of a rolling back of speculative positions – it does not undermine the basis of my forecast scenario.” Accordingly, while it appears likely that there will be a return to JPY weakening during the next two months, this is completely in line with my expectations and does not undermine the forecast scenario.

Once again reviewing my fundamental assumptions, the essential point in forecasting the 2016 forex outlook is not “what Japan thinks about JPY strength” but “the U.S. and Chinese need for stable USD depreciation.” What is currently taking place is merely a roll-back of the unidirectional market trend seen during the past five years. As shown in the tables at the start of this report’s “USD/JPY outlook” section, during the past five years RMB and USD have appreciated by roughly 30% and 20%, respectively, while JPY and EUR have depreciated by roughly 30% and 10%, respectively. In order to forecast additional forex rate movements in the same direction as seen during the past five years, one would have to have quite strong confidence in the economies of the countries whose currencies have been appreciating. Since I do not have such confidence in the real economies of the U.S. and China, it follows that I am in a position where I must forecast JPY strength. As I have argued each month, assuming that the FRB, as the overseer of the world’s key currency, will show a tendency to become more dovish, it will unavoidably have the effect of promoting the appreciation of such other currencies as JPY and EUR. Rather than being a “forecast,” this is simply pointing out a “natural law” of the forex markets. Moreover, given that the BOJ is showing signs of having already played all its monetary policy cards, that Japan’s current account surplus balance is expanding, and that JPY depreciation has been excessive in light of such indicators as PPP, it appears highly appropriate to anticipate that there will be a transition from “four consecutive years of JPY weakening” to “the first JPY strengthening in five years.” Rather than attaching excessive importance to a temporary change in speculative positions or to every nuance of monetary policies, I will continue to recommend closely monitoring the international context while maintaining a large-picture perspective on the markets. Specifically, I will maintain without change my forecast scenario presented last month of JPY strengthening with a lower USD/JPY bound represented by the purchasing power parity (PPP) range of 100-105.

Risks to main scenario

Potential Risks to the Main Scenario

		Risk Factors	Remarks	Direction
US	①	FRB Monetary Policy Normalization	・Succesive Rate Hike after unexpectedly high economic growth, B/S adjustment also affected.	JPY Depreciation USD Appreciation
US	②	Potential Monetary Policy adopted by New President	・Regardless of new President, Hilary or Trumph, USD Appreciation is continuously restrained. Focusing on nomination of new Secretary of the Treasury.	JPY Depreciation USD Appreciation
Japan	③	Risk-taking attitude of Japanese Investors	・Whether Japanese Investors keep currency hedges or not	JPY Depreciation USD Appreciation
Japan	④	Official Intervention on JPY Appreciation	・BOJ's continual expansion of negative interest rate. ・USD/JPY Buying intervention(or rumor)	JPY Depreciation USD Appreciation
Europe	⑤	Official Intervention on EUR Appreciation	・ECB's incremental downward cut of negative interest rate.	JPY Depreciation USD Appreciation
others	⑥	New Accord on Internation Foreign Exchange Policy Actualized	・G4 Accord(?) ; Seize on US Rate Hike, RMB buying by Chinese Officials, QQE by EU and Japan during Iseshima Summit	JPY Appreciation USD Depreciation

Naturally, in addition to the main scenario, I also have risk scenarios. First, what is likely to happen regarding the risk (upside risk) of a continued weak JPY / strong USD trend during 2016? The greatest risk is that the U.S. economy will be unexpectedly robust, and that the FRB’s normalization process will proceed with unexpected smoothness (risk factor (1)). In this case, USD would continue appreciating in general, and we would see JPY depreciation against USD for a fifth consecutive year. The FOMC’s April appraisal of economic conditions was

adjusted downward, but the FOMC made another upward revision with respect to its characterization of the employment situation, and it clearly presented the risks related to the international economic and monetary situations as receding. Although the environment does not fundamentally appear to be supportive of consecutive interest rate hikes from June, from another perspective, it is probably becoming easier for the FRB to undertake interest hikes as prudential measures in response to the maturation or heating up of the real economy given the increasingly odd trends of rallies in stock prices and real estate prices. Amazingly enough, there are signs that such U.S. indicators as personal consumption expenditure (PCE) are beginning to bottom out, and this situation appears to present a risk that the pace of interest rate hikes may turn out to be faster than the rate assumed by this article.
Second, one must pay attention to situations that will become more clear in the latter half of the forecast period, particularly the election of a new U.S. president and the prospective direction of U.S. currency policies under that new president. Currently both leading candidates – the Democratic Party's Hillary Clinton and the Republican Party's Donald Trump – have been publicly criticizing JPY depreciation. While such criticism must naturally be somewhat discounted as it is being voiced in the context of election campaigns, it is worth remembering that the plan for doubling U.S. exports over five years presented by President Obama in his January 2010 State of the Union speech coincided with the start of a five-period of JPY strength against USD. One must keep in mind the possibility of a similar situation occurring if the new U.S. presidential administration is inaugurated during a period when USD is continuing to be strong at a high level.
Third, proactive overseas investments by Japanese investors present another risk for the JPY strength scenario. <u>Frankly speaking, this appears to be the risk factor most likely to eventuate</u>. Given the negative yields on JPY bond issues with maturities up to 10 years, the objective argument that "there are no alternatives to USD as an investment destination" is highly convincing. In fact, based on the fiscal 2016 asset management plans announced by leading life insurance companies since April, it is clear that the trend of shifting from domestic to overseas investments is becoming stronger. I have a strong visceral impression that such overseas investments are predominantly hedged, but in light of the absolute size of the domestic-overseas interest-rate gap, overseas securities investment accompanied by JPY selling and USD buying (so-called open foreign securities investment) will continue, and it could have the effect of pushing USD/JPY upward. Despite that, I believe that the shakiness of the FRB normalization process means that outward securities investment does not present much of a threat, but because JPY interest rates have descended to unprecedented levels, the number of investors willing to assume forex risks is increasing, and there is a clear risk that rules of thumb based on past experience are no longer applicable.
Fourth, there continues to be an alarming risk regarding the policy responses of the Japanese government and the BOJ. In particular, regarding monetary policies, the negative interest rate policy introduced in January has generally received a very negative appraisal. Given this, it appears that there is not much likelihood that the BOJ will adopt a "sequential escalation of force" approach to progressively expanding the negative margin of interest rates. In the period prior to national elections, it is probable that the government and ruling party will not be seeking to intensify a negative interest rate policy that has been met with negative appraisals on the part of the general public. As has become clear in light of the considerable JPY strength elicited by the April BOJ GC meeting's decision to maintain the status quo, the financial markets (particularly forex markets) are increasingly behaving as though they are addicted to easing. In light of this trend, it would not be surprising if the BOJ were to respond to the trend by moving ahead with a sequential escalation of easing going forward. In particular, it is impossible to completely rule out the possibility that the BOJ will progressively move ahead with expanding the negative interest rate margin and thereby prevent JPY from appreciating as much as it would otherwise be expected to. As already being demonstrated with increasing clarity, however, negative interest rates are not capable of halting currency appreciation and stock depreciation trends stemming from overseas factors.
In addition, while it is not included within the chart of risk factors on the previous page owing to its extreme unlikeliness, there is a conceivable risk (downside risk) to the main scenario's anticipated strong JPY/ weak USD trend stemming from the possibility that the United States' cyclical recovery will gradually peter out in a way that not only precludes monetary policy normalization but actually requires (perhaps in the fourth quarter of 2016) monetary easing policies. In this case, regardless of what monetary policies Japan adopts, it appears unquestionable that there will be an acceleration of the strong JPY / weak USD trend. Further, it is worth keeping an eye on the possibility that China – which is clearly struggling with its own inappropriate degree of currency appreciation – may suddenly decide to introduce a floating rate system for RMB. In this case, there is a possibility that RMB will sharply depreciate against other currencies and that other Asian currencies will depreciate along with RMB, causing a large rise in JPY effective exchange rates.

EUR Outlook – Need for the ECB to allow for high EUR values

ECB Monetary Policies Now and Going Forward – Draghi Ignores Inconvenient Truths

First Uneventful Meeting in Six Months

At April's ECB Governing Council meeting, the interest rate on the main refinancing operations (the policy interest rate) was kept unchanged at 0.00%, while the ceiling (the interest rate on the marginal lending facility) and floor (interest rate on the deposit facility) of market interest rates were kept unchanged at 0.25% and −0.40%, respectively, which resulted in the interest rate corridor also remaining unchanged at 0.65 pp. Governing Council meetings over the past six months have been tumultuous, starting with a warning of monetary easing last October, followed by a monetary easing that invited disappointment in December, another warning of easing this January, and another disappointment in March – by comparison, the latest meeting was uneventful. The details of corporate bond purchases via the Corporate Sector Purchase Programme (CSPP) were revealed as was the fact that the program would begin in June this year, but apart from this, there was nothing new that would interest the markets in particular. A closer look, however, throws up several points of concern and I would like to discuss them here. Specifically, Germany's criticism of the ECB, the possibility of helicopter money, and the Euro zone bank lending survey results published on April 19 were some of the bigger topics discussed. There were, of course, also questions about the future of negative interest rates, the end of which had been hinted at last month.

Questions on ECB vs. Germany confrontation stand out

Just before the Governing Council meeting, German Finance Minister Wolfgang Schäuble's strong criticism of the ECB was reported, and questions asking about the confrontation between the ECB and Germany were conspicuous. On April 20, Mr. Schäuble had remarked that the negative effects from rising financial instabilities have further given rise to uncertainties for investors and consumers, and that the ECB's policies, far from being useful, are damaging. It was reported (WSJ, Japanese edition, April 21) that Mr. Schäuble was increasingly annoyed at the ECB's policy operation. Earlier this month (April 11) the WSJ (Japanese edition) had reported Mr. Schäuble's comment that the ECB was to a large extent responsible for the rise of the anti-immigration party Alternative for Germany (AfD).

Against this backdrop, a reporter at the press conference asked, "The German finance minister was quoted as saying that the ECB's policy is to a large extent responsible for the rise of the populist party AfD. I just wanted to know how guilty you feel for that, and I guess – we all know that you met in Washington, and I guess you raised this point: I just wanted to know what your discussions have been on this issue." In response, Mr. Draghi completely denied that there was any sense of confrontation, saying, "The discussions have been very positive, fruitful, and I would say quiet, and very friendly." He went on to explain that Mr. Schäuble had himself retracted his words saying, "I didn't say the monetary policy of the ECB is to blame for the emergence of the AfD. I pointed out that the feeling of insecurity among people who have to be concerned that there will be no or negative interest rates for a long time contributes to the bewilderment that we have seen in many election results." In the end, they are both the same thing, but one was left with the strong impression that the ECB was working frantically to deny any sense of confrontation.

Apart from this, Mr. Draghi said, "criticisms of a certain type could be viewed or perceived as endangering the independence of the ECB, and therefore causing the sort of behaviour that you hinted at, namely delaying investment, delaying taking risks." He pointed out that "Any time the credibility of a central bank is perceived as being put into question, the result is a delay in the achievement of its objectives, and therefore the need of more policy expansion." Another question to Mr. Draghi was, "what would you say to the German citizens who are worried about their pensions?" – all these questions definitely led to a stronger impression than usual that the chasm between the ECB and Germany is widening. Having said that, it appears quite likely that Germany and other hawkish members of the ECB notwithstanding, the ECB Governing Council's consensus will continue to be in favor of monetary easing, as evident from Mr. Draghi's comment, "We have a mandate to pursue price stability for the whole of the Euro zone, not only for Germany."

Questions about helicopter money continue to be asked

As at the previous Governing Council meeting, there were several questions on whether helicopter money (≈ monetary finance) was being considered. Mr. Draghi once again completely denied that it was being considered – "We haven't really thought or talked about it," "it involves complexities, both accounting-wise, legal-wise," "we have never discussed it." However, he did remark (at the March press conference) that "It's a very interesting concept that is now being discussed by academic economists and in various environments."

This remark from last month's press conference seems to have triggered speculation among some people that there may be some level of interest in this idea within the ECB, which may be the reason this month's denials seem more categorical. However, the very fact that there are so many questions on this point leave one with a sense of how few options the ECB has left to it. Not too long ago, people would have been hesitant even to mention a phrase like "helicopter money" – one cannot help feeling that things have changed dramatically since then for the president of the ECB to be asked whether he may be considering it, and for the president to then go on to say it is an "interesting" concept.

What about the end to negative interest rates?

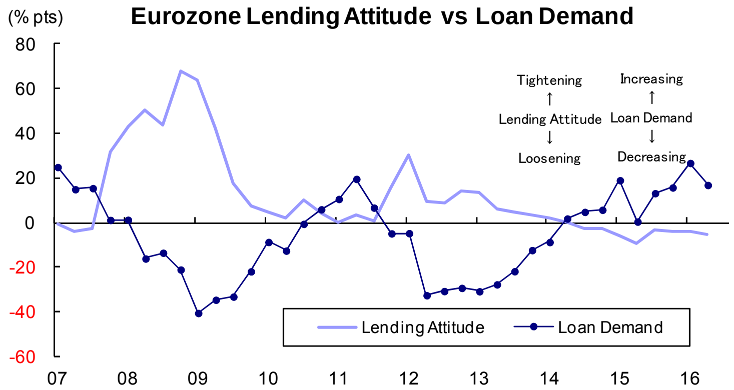
As usual, Mr. Draghi reiterated that the ECB was prepared to use all the instruments at its disposal, and a reporter asked, "Last press conference, you said that interest rates, you didn't anticipate that there'd be a need to cut them again. Has that position changed?" Mr. Draghi's response to this was quite long, but here is my summary: The problems that negative interest rates entail have many complexities. The issue of negative interest rates is not so much an issue of yes or no; it is an issue of the extent of negative rates. As of the present time, the impact of negative interest rate seems to be positive for the banking system as a whole, because one can see that lending interest rates have fallen and lending has increased against the backdrop of negative interest rates. However, even though the effect of the policy has been positive overall, it cannot be said that it has been positive for each financial institution separately, too.

The above can be seen as Mr. Draghi's and, therefore, the Governing Council's stance. In other words – given the difference in impact on different financial institutions, the ECB does not consider it wise to expand the negative interest rate margin without limits. If so, I am of the same view.

As Mr. Draghi says, the credit conditions in the Eurozone are certainly on the mend at the moment, and the latest bank lending survey results also seem to suggest that the negative interest rates have helped increase the volume of lending. However, as I will mention again later, there are also many who predict damage to bank earnings, and this may be the reason the ECB is beginning to tacitly sense a limit to negative interest rates. The markets have factored in a negative interest rate on the deposit facility of −0.50% (a further 10 bp lowering) over the next six months, but it appears that it may not be easy for the ECB to take that decision.

Inconvenient truths indicated by the bank lending survey results

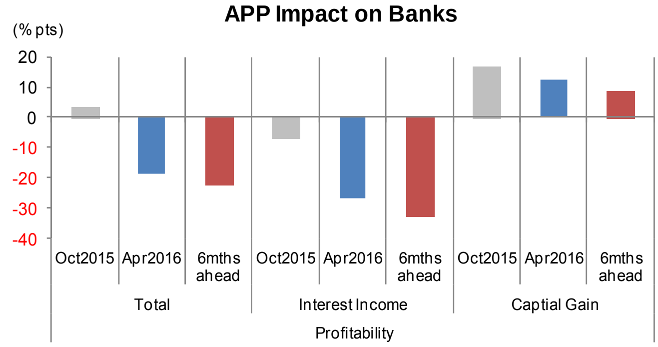
As mentioned above, the April Euro zone bank lending survey was released on April 19, earlier this week. Amid rising concerns about the side effects of non-conventional monetary policies such as the expanded Asset Purchase Programme (APP) and negative interest rates, the details of the survey results hold some extremely important hints. As Mr. Draghi keeps repeating in his press conferences, Euro zone credit conditions have been in the process of strongly recovering ever since 2014. Specifically, as mentioned on the previous page, while lending attitudes continue to ease, demand for loans is also on the mend, and one can understand why Mr. Draghi would brag about the effectiveness of the ECB's policies. However, the fact is that Mr. Draghi only mentioned the positive effects of the survey and did not touch upon those aspects of the survey results that relate to the impact of the APP and negative interest rates even though several ad hoc questions were asked about these. One can only conclude that this is because those aspects of the results hide inconvenient truths related to the ECB's continuation of its current policies.



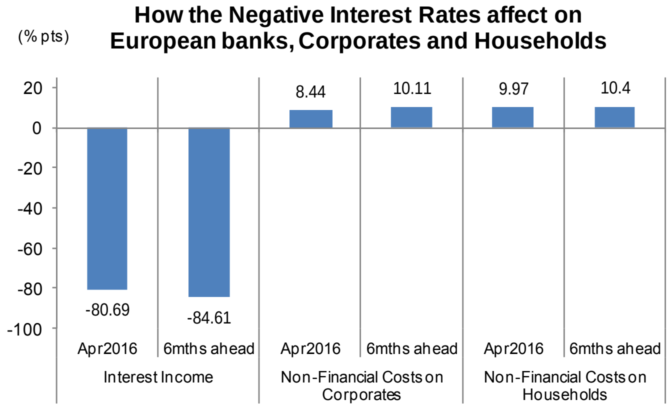
Sources : Datastream

The Euro zone bank lending survey has included questions on the impact of the APP on bank earnings and capital gains since April 2015, and this time, it also had a question on the impact of negative interest rates. In his press conference this time, Mr. Draghi mentioned that the survey included the question "What use are you going to make of the APP, the asset purchase programme, proceeds?" and positively evaluated the banks' response that "they were used mainly for granting loans." However, he has selectively chosen to focus on the positive. As the exhibit to the right (a survey of the APP's profitability) shows, a larger number of banks feel that profitability will "deteriorate" six months on. The number of banks that consider current profitability to have deteriorated is also greater compared with October last year. Even in the only category within profitability for which positive impact had been reported (capital gains), the margin of those who see an "improvement" has shrunk, with a further narrowing of this margin for six months on.

Taking a look at the impact of negative interest rates (see exhibit), which is of even greater concern, it is obvious that the majority of banks (just under 80 percent) have reported a shrinking of profit margins. Meanwhile, even though companies have reported positive developments such as the decrease in borrowing interest rates and have predicted a future increase in borrowing, they have also reported an increasing trend of non-interest charges, and these are forecast to have further increased slightly six months on. More or less similar conditions have been reported for the household sector as well (housing loans and other consumer credit – the exhibit only shows trends for the latter). While there are reports of benefits from negative interest rates in the near term, there are concerns that the credit environment will deteriorate going forward due to commissions and other charges. In this context, it will be interesting to see how the policy affects actual lending activity. At the very least, the negative interest rates impose a cost on financial intermediation functions, and those costs are not going to vanish into thin air. They are being borne by some entity within the financial system, and if that entity is not corporations or households, it simply means that banks are paying out of their own pockets to maintain the services they provide. The recent bank lending survey brought such realities into relief, but <u>Mr. Draghi simply ignored them as inconvenient truths – this was the strongest impression left by the recent press conference.</u>



Sources : ECB
Notes : above 0% on the Left Vertical Axis means improval and below 0% means deterioration



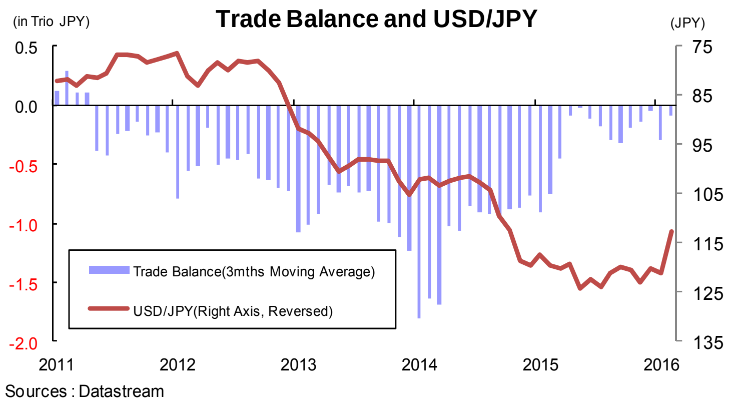
Sources : ECB, including Consumer Credits excepting Mortgage Loans
Notes : above 0% on the Left Vertical Axis means improval or rising and below 0% means deterioration or fall

Implications for EUR rates

The April Governing Council meeting's decision to maintain the status quo was in line with market expectations but, given the fact that EUR had surged and inflation expectations been depressed compared with the level on the day before the previous meeting (March 9), the policy environment was one in which, previously, it would not have been surprising to see the ECB considering additional easing measures. The March 10 Governing Council meeting announced a full package of additional easing measures, and it may be that because those policies are still in preparatory stages (TLTRO2 corporate bond purchases are to start from June) that circumstances were deemed not ripe for releasing a "second arrow" at the April meeting. Looking at the situation from a different perspective, however, since the full package's easing was not significant, it can also be said that, while up to now high EUR values would have been reduced by easing, it has become necessary to allow for high EUR values and avoid paying attention to the low level of inflation expectations. During this article's forecast period, EUR/USD is projected to rise into the USD1.15-1.20 range, and the April Governing Council meeting can be considered a foothold event on the path to that range. It seems likely that <u>the ECB will continue facing difficulties in artificially depressing the value of a currency that is strengthened by large current account surpluses and relatively high real interest rate levels</u>.

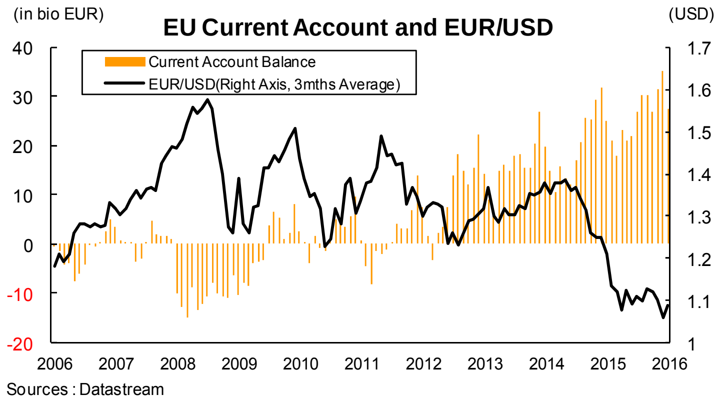
Positioning of EUR in the international context – Criticism for currency weakening competition unavoidable

Positions of Japan and Euro zone not the same



Sources : Datastream

As already noted, JPY and EUR are the most representative examples of currencies that have been providing currency depreciation benefits over the past five years. However, although it can be said that the powerful desire to promote reflation under Abenomics facilitated JPY depreciation, Japan had trade deficits in the five consecutive years from 2011, particularly in the 2013-2014 period, when it recorded annual deficits in excess of JPY1 trillion for two consecutive years (see exhibit). Furthermore, in the 2008-2012 period, Japan was subjected to five years of one-sided currency appreciation and, given the rapid pace of that appreciation, it does not seem very logically surprising that there would be a swing-back to JPY depreciation from 2013. As the graph shows, however, Japan's trade deficit has rapidly shrunk since 2015, primarily owing to the sharp drop in crude oil prices, and it appears that that situation promoted a lull in the rise of USD/JPY. While there is no doubt that the receding prospect for progress in the FRB's normalization prospect was the trigger for the current bout of JPY strength, it appears that such changes in the supply-demand environment also have a clear connection to the appreciation.



Sources : Datastream

While EUR has generally been depreciating since 2014, the graph shows that the Euro zone has been accumulating current account surpluses at a fairly rapid rate since 2013, and the area has been consolidating its position as the economy with the world's largest current account surpluses since 2014. Since 2008, EUR/USD has been greatly fluctuating against the backdrop of the European debt crisis, but the peaks showed a steady trend of decrease, and this redounded to the benefit of Germany, which had even previously boasted a high level of international competitiveness. On top of this, the ECB's efforts to guide EUR further downward with the introduction of negative interest rates enabled Germany, with its thriving export sector, to be the only advanced country with a fiscal budget surplus. <u>In view of these objective facts, it is impossible to avoid pointing a finger at the Euro zone, particularly Germany, for grabbing a disproportionate share of external demand and deriving stable benefits from that demand, and the same kind of accusation has been repeatedly made within the U.S. Treasury Department's Semiannual Report on International Economic and Exchange Rate Policies</u>. Since 2014, I have been predicting that the Euro zone's "perpetually undervalued currency" would spur trade frictions between the area and the United States[4], and one cannot help but get the feeling that the issue will surface on the stage of international economic diplomacy during 2016.

The importance of avoiding currency depreciation competition has begun attracting increasing attention within the framework of international policy coordination, and discussions of this issue will almost certainly lead to the conclusion that Japan and the Euro zone must employ monetary easing measure prudently and accept a certain degree of currency appreciation. <u>It should be recognized, however, that the positions of Japan and Euro zone regarding this issue are definitely not the same</u>. In light of the current situation, the Germany-led Euro zone is in the most disadvantageous position, and it seems likely that the area will have to find further room for compromise in policy coordination.

[4] Please refer to the May 15, 2015, edition of Reuters Forex Forum, entitled "Europe-U.S. Trade Friction Elicited by the Euro Zone's Japanization."

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