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Forex Medium-Term Outlook

30 June 2016

Mizuho Bank, Ltd.
Forex Division

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Overview of Outlook

USD/JPY finally dropped below 100 in June. I had envisaged the possibility of the rate falling below 100 in last month's issue of this report, and it became a reality earlier than I had predicted, what with the shock of the UK's exit from the EU (Brexit). Even in the wake of Brexit, however, there is no change in this report's main scenario. Ultimately, the basis for my prediction of JPY appreciation against USD is the fact is that I have no confidence in the FRB's normalization process, and this is not something that is affected by whether or not the UK remains a part of the EU. Rather, it is natural to assume that the FRB's position has become even more difficult following Brexit, and I believe that this increases the probability of the strong-JPY scenario even more. The game of predicting U.S. rate hikes, which has been the biggest topic over the past three years, may even be going out of fashion. The FRB has not given up its determination to normalize yet, but there is scope for examining whether or not forex rates based on the U.S. rate hike path are ideal. One feels unease at the thought that the Brexit vote may have profited the candidacy of Mr. Donald Trump in the U.S. Presidential election, but as far as USD appreciation goes, both Mr. Trump or Ms. Hillary Clinton are against it, so JPY is feared to further appreciate over the second half of the forecasting period as a result of U.S. currency policy. Extending the forecasting period to mid-2017, I envisage the possibility of USD/JPY settling down at the 90-95 level.

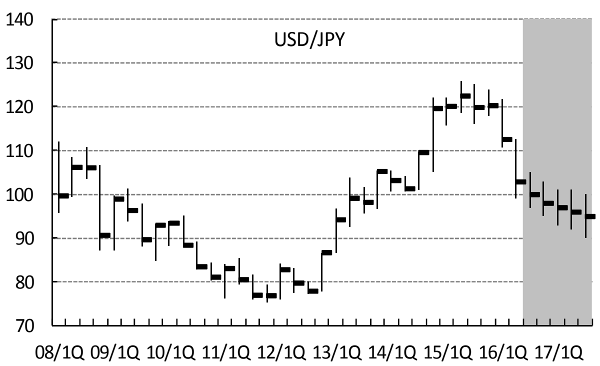
EUR weakened somewhat following Brexit, but given the magnitude of the incident, it seems appropriate to consider it rather strong. As I have argued repeatedly, EUR is the currency with the world's largest currency account surplus and a relatively high real interest rate, and these are the characteristics that must be taken most seriously when it comes to forecasting forex rates. Brexit does nothing to change these facts, and I would like to retain my forecast that EUR will continue strong following the derailing of the FRB's normalization process. I also disagree with the argument that Brexit could weaken the EU as a politically unifying force. Given the miserable conditions that await the UK going forward, it is unlikely that there will be many copycat exits from the EU. Considering that the EU was created in pursuit of peace, Brexit is undoubtably one of the biggest mistakes in history. However, it is wrong to conflate the "strategic failure of the EU as a political union" with "the underlying strength of EUR, which will continue to exist as a common currency for the remaining members." Events that affect the continued existence of the European Community may arise again going forward, but so long as the currency block exists with the support of its core members, it would be an exaggeration to predict a scenario of EUR crashing.

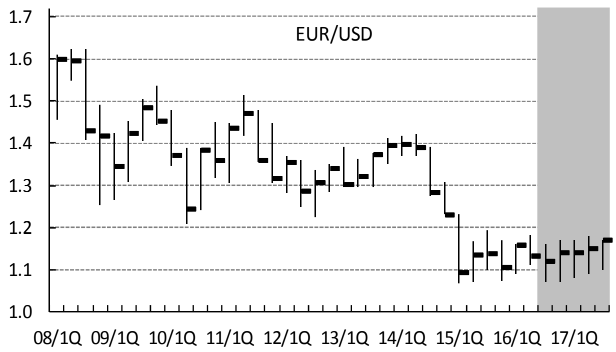
Summary Table of Forecasts

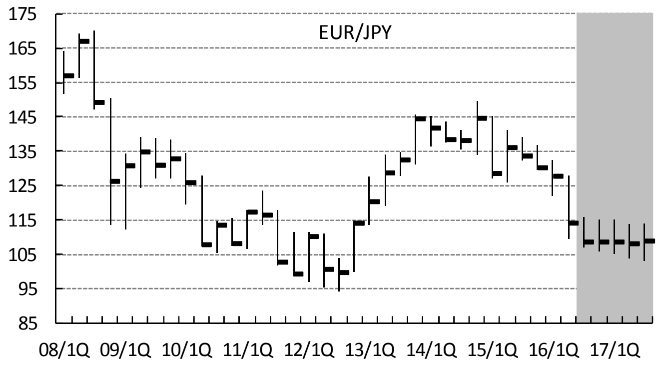
	2016 Jan-Jun (actual)	Jul-Sep	Oct-Dec	2017 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	99.00 ～ 121.70 (102.70)	97 ～ 105 (100)	95 ～ 103 (98)	93 ～ 101 (97)	92 ～ 101 (96)	90 ～ 100 (95)
EUR/USD	1.0711 ～ 1.1616 (1.1110)	1.06 ～ 1.14 (1.10)	1.06 ～ 1.15 (1.12)	1.06 ～ 1.15 (1.12)	1.07 ～ 1.16 (1.13)	1.08 ～ 1.17 (1.15)
EUR/JPY	109.30 ～ 132.45 (114.07)	107 ～ 116 (110)	106 ～ 115 (110)	105 ～ 115 (109)	104 ～ 114 (108)	103 ～ 114 (109)

(Notes) 1. Actual results released around 10am TKY time on 30 June 2016. 2. Source by Bloomberg 3. Forecast rates are quarter-end levels

Exchange Rate Trends & Forecasts







USD/JPY Outlook – We may be entering a phase of double-digit exchange rates

Examining USD/JPY Levels – Timing of Shifts between Advances and Retreats

Anniversary of the USD/JPY peak last June 10

June 10, 2016 marked the anniversary of the apex of USD/JPY last year at the 125.86 level. It has now been over a year since the peaking out of the recent trend of JPY depreciation and stock price increases, which had been a major topic of interest along with the concept of Abenomics since November 2012. It was on June 10, 2015, that BOJ Governor Kuroda told the lower house financial affairs committee that – "Going forward, further JPY depreciation on a real effective exchange rate (REER) basis is not likely to happen." It was from that moment – there are debates about the cause-effect relationship, but the timing is clear – that the JPY depreciation trend ended. Just as anticipated by Governor Kuroda, REER bottomed out in June 2015, and it is currently rising rapidly. There are two main factors in the background of the JPY appreciation/USD depreciation forecasts this report has been presenting since last year. The first is the fact that it has seemed unlikely that U.S. currency and monetary policies would be amenable to USD appreciation. The second is my emphasis on the facts that both JPY and USD exchange rates had reached excessive levels from the perspective of REER and that the rates were naturally liable to move toward the long-term average REER levels. While purchasing power parity (PPP) and REER are not suitable tools for predicting forex rate movements in the immediate future, they are nonetheless formidable means of gaining a big-picture understanding of the forex market, and my faith in those tools is an essential element of my credo with respect to forex forecasting. Based on PPP and REER, one can be confident in predicting the major market trend transitions that will inevitably occur when rates have reached "excessive levels," and was the kind of transition that happened in 2015. Overviewing the kind of adjustments called for based on REER and PPP, as noted above, JPY REER bottomed out in June 2015 and is now rising. However, the current level of JPY weakness is comparable to that in 1976 and, based on the assumption that REERs will tend to move toward their long-term average levels, as of April 2016, there remains leeway for an adjustment of about 10%. In the case that a 10% adjustment were to proceed against all currencies, a drop of USD/JPY to roughly the 95-96[1] range would be an adjustment sufficient to reduce the deviation from the long-term average to what seems to be a reasonably sustainable level. This argument has already been presented in previous issues of this report.

[1] Since the level of USD/JPY at the end of April was 106.45, a 10% reduction would bring the rate down to 95.80.

Arguments about appropriate levels

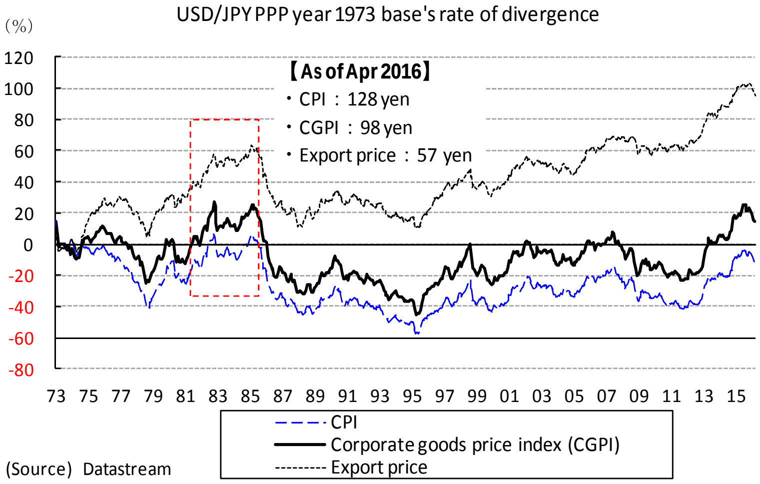
The chart on the right shows PPP indicators listed in order according to the level of USD/JPY rates they suggest. As noted in previous issues of this report, a number of relatively important PPP indicators are concentrated in the 100-105 range, and I have been referring to this range as the "PPP core zone." What is now taking place is an adjustment from excessive JPY depreciation toward the "PPP core zone," and this can be considered an appropriate market movement in light of long-term product price measures. As the chart shows, there are no key PPP indicators at levels of 110 or above, and the sustainability of the relatively high levels is quite questionable. In light of these PPP measures, in order to convincingly argue that JPY was overvalued on the stage of international economic diplomacy, one would probably have to be able to show that USD/JPY movements were clearly stable at levels below this core zone. (From the perspective of volatility, however, I think it should probably be recognized that a 20 movement in USD/JPY during the first half of this year clearly constitutes "excessive fluctuation".)

Reference points of USD/JPY rate

	JPY rate	Evaluation Standard
	56.9	Purchasing Power Parity（export prices,1973 base, Apr 2016）
	73.4	Purchasing Power Parity（export prices,1980 base, Apr 2016）
	75.1	Big Mac Parity(Economist magazine,Jan 2016)
	77.5	Purchasing Power Parity（Mid point between export prices and corporate goods prices,1973 base, Apr 2016）Note 1
	91.9	*Purchasing Power Parity（corporate goods prices,1980 base, Apr 2016）*
	94.9	Purchasing Power Parity of materials within manufactured products,etc.(METI,FY2014 survey)
Core PPP zone	*98.0*	*Purchasing Power Parity（corporate goods prices,1973 base, Apr 2016）*
Core PPP zone	103.2	Break-even rate for exporters as of Mar 2016 (Cabinet survey, FY2015)
Core PPP zone	*104.5*	*Purchasing Power Parity（consumer price,1980 base, Apr 2016）*
Core PPP zone	*104.7*	*Purchasing Power Parity（World bank, 2015)*
Core PPP zone	*106.0*	*Purchasing Power Parity（OECD, 2015, GDP base) Note 2*
	106.1	***14 June 2016***
	111.3	Purchasing Power Parity（OECD, 2014, private final consumption）
	117.5	Corporate planning rate (BOJ Tankan, Apr 2016 survey, fiscal year)
	120.9	Next year ahead forecast rate as of Mar 2016 (Cabinet survey, FY2015)
	128.1	Purchasing Power Parity（consumer price,1973 base, Apr 2016）
	130.3	Purchasing Power Parity of processing/assembly within manufactured products,etc（METI FY2014 survey）
	143.4	Overall Purchasing Power Parity of manufactured products,etc.(METI,FY2014 survey)
	258.8	Purchasing Power Parity of energy within manufactured products,etc.(METI,FY2014 survey)

(Note 1) support level more than 10 years
(Note 2) Purchasing power parity (OECD) as of Dec 2015 （revised every Jun & Dec）

It should naturally be recognized that actual forex rates only correspond to PPP levels for short time periods, and I have therefore habitually focused on the percentage of deviation from PPP levels. The graph shows that, since 1973, USD/JPY has had a fundamental tendency to converge toward the upper bound of the corporate goods price-based PPP (when the deviation in the graph is 0%). However, the graph also shows that JPY appreciation corresponding to roughly -20% deviations from the corporate goods PPP has not been rare. Since the advent of Abenomics, however, this rule of thumb has been contravened, with USD/JPY continuously staying above the corporate goods PPP. As for the explanation of this phenomenon, it is possible that USD/JPY was moved by such factors as speculation that BOJ easing measures and other reflationary policies would realize a surge in inflation and thereby adjust the PPP itself, bringing it in line with the level of JPY depreciation.



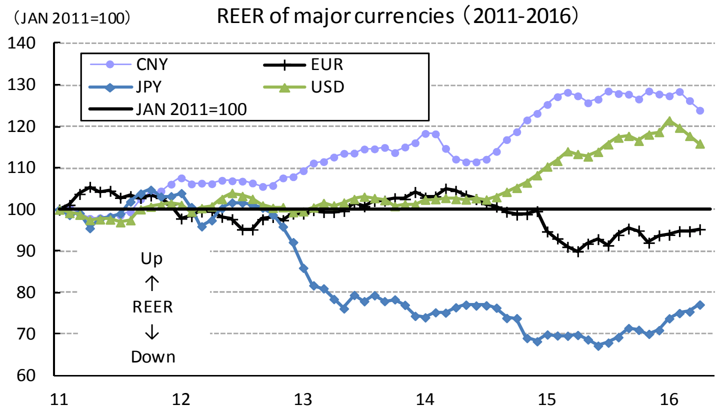
(Source) Datastream

On the other hand, a deviation of +25% above the corporate goods PPP has historically been the limit, and this pattern has also been seen in the latest JPY depreciation episode. Specifically, the corporate goods PPP has been roughly JPY100 since last year, and the previously mentioned USD/JPY peak last year was at 125.86, which is an upward deviation of about +26%. That was the greatest upward deviation seen since just before the Plaza Accord, in February 1985 (see the portion of the graph within red dotted lines), and I have maintained the view that such a large deviation was not likely to be sustainable for numerous reasons including the possibility of a political intervention akin to the Plaza Accord. In fact, I think it can be said that the correctness of that view has been substantiated since the beginning of this year by the statements of the U.S. Treasury Secretary at international conferences (G7, G20, summits, etc.) as well as the content of the U.S. Treasury Department's Semiannual Report on International Economic and Exchange Rate Policies. So what does the historical record indicate about how far JPY appreciation could proceed? In the case that the prospect of boosting inflation by means of existing policies is abandoned, the PPP returns to a JPY appreciation trend, and rules of thumb prevailing prior to Abenomics once again demonstrate their applicability, then it can be assumed that USD/JPY will return to the traditional range defined as "between the upper bound of the corporate goods PPP (0% deviation) and the lower bound of a -20% deviation from the corporate goods PPP." While it is not particularly necessary to think about this very much at this stage, a -20% deviation would correspond to a USD/JPY level in the 80-81 range. At the very least, it may not be rash to assume that we have entered a phase of double-digit USD/JPY rates.

JPY depreciation and appreciation – Shifts between advances and retreats

While most people do not think of it this way, it is true that USD/JPY at 120 and at 80 are similar in that they both represent a 20% deviation from PPP. On the other hand, the ubiquitously predominant view is that USD/JPY at 120 means rising stock prices and economic enthusiasm, and few are inclined to note any problematic aspects of the situation. (This is despite the obvious damage to real income levels.) Since the start of this year, executives of leading Japan-based automobile makers have described the past few years of highly profitable operations amid JPY depreciation as a period of "record strong tailwinds," and that is a quite accurate appraisal. Based on the rule of thumb described above, however, it is highly unlikely that a JPY depreciation/USD appreciation scenario with an upward deviation from PPP of more than +20% can be sustained. It actually was a temporary "tailwind" like a fickle wind gust. And given the nature of the floating exchange rate system, it will not be surprising to see the onset of a similarly powerful "headwind" based on a same-magnitude -20% deviation-from-PPP.

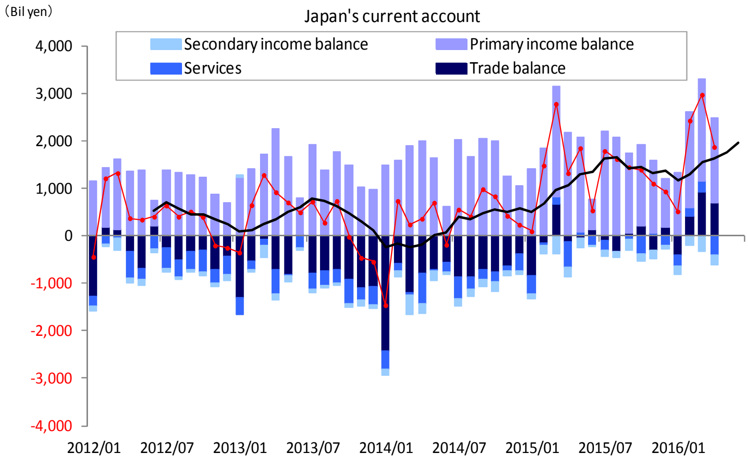
However, there are not many companies capable of calmly and objectively analyzing the forex environment as a phenomenon separate from corporate profitability issues. The predominant view throughout all sectors of Japan's economy is that "growth is fundamentally possible so long as there is JPY depreciation." This view does in fact encompass some truth, and I do not think it is a particularly mistaken view overall. The most desirable scenario is to have an optimal degree of currency depreciation so long as it can be sustained. Within the framework of the floating exchange rate system, however, this is a quixotic goal. Because of the fundamental nature of the floating exchange rate system, if there are times of JPY depreciation, then there will certainly be times of JPY appreciation. As the report has stubbornly noted in the past, the burden of currency appreciation with respect to G4 currencies during the past five years has been apportioned to and borne by USD and RMB. During this period, it is JPY and EUR that have been reaping the benefits of currency depreciation. Looking back at the cyclical nature of forex trends since 2000, one finds three years of JPY appreciation (2001-2004), almost three years of JPY depreciation (2004-2007), four and a half years of JPY appreciation (2007-2011), and four years of JPY depreciation (2012-2015). In view of these past trends, it seems natural to anticipate that shifts between advances and retreats in JPY exchange rates will occur roughly once every 3-4 years.



(Source) BIS (Note) Broad base

Basic JPY supply-demand situation – Japan’s current account surplus approaching a peaking out period

Current account surplus in first four months of 2016 already roughly half of last year’s total



(Source) Ministry of Finance, Japan
(Note) Bold line: Current account 6 months average

As usual, I would like to present a fixed-point overview of the current state of the basic supply-demand environment based on the latest international balance of payment trends. Japan’s April current account surplus amounted to JPY1,878.5 billion, below the median level of market forecasts (JPY2,303.0 billion) but still maintaining a level close to JPY2,000 billion. The trade/services balance was a JPY295.9 billion surplus, the third consecutive month such a surplus was recorded. This facilitated the continued recording of huge primary income account surpluses, as the primary income account surplus for April amounted to JPY1,780.5 billion. However, the services balance was a JPY401.2 billion deficit, the third consecutive month of such a deficit. Since the services deficit is restraining growth in the current account surplus, it may be a key factor to monitor in connection with efforts to forecast future trends (elaborated on below). As a result, Japan’s current account surplus for the January-April period amounted to JPY7,814.6 billion, which is close to half the level (JPY16,412.7 billion) for the full year 2015.

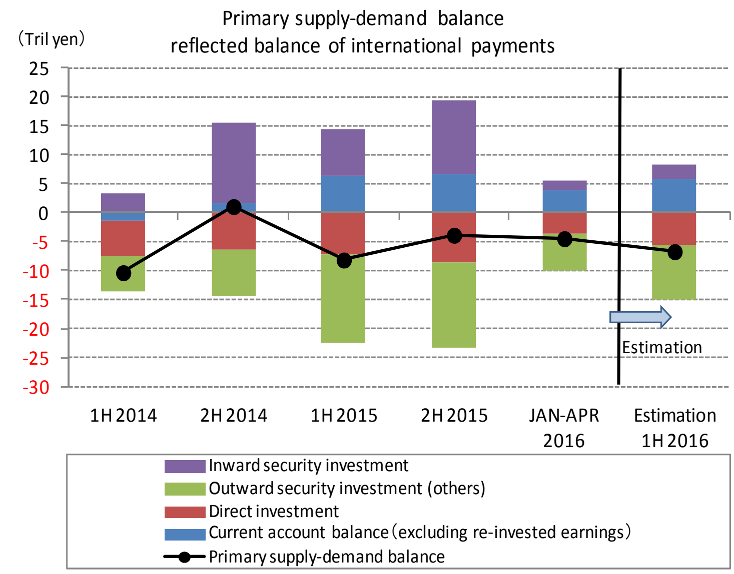
Current account surplus projected to peak out

As explained in last month’s edition of this report, however, <u>the current account balance’s improvement since the start of the year has been non-continuous and sharp, and there is concern about its sustainability</u>. The current account balance’s growth since last year has stemmed from three factors – (1) a sharp drop in imports owing to the sharp fall in crude oil prices (≈ the sharp drop in the trade deficit), (2) a rapid increase in the primary income account surplus, and (3) a rapid decrease in the services balance deficit. With respect to (1), since crude oil prices bottomed out in February, it is highly likely that the effect of this factor will progressively diminish going forward. Moreover, since JPY weakness made a large contribution to factors (2) and (3), the sharp strengthening of JPY since February can be expected to affect these factors going forward. As international balance of payment figures are reported based on ministerial ordinance reporting-use forex exchange rates – “the average effective rates in the month two months prior to the month in question” – it can be understood that the JPY appreciation trend is beginning to have an impact starting with the April figures just announced. The impact of the JPY appreciation trend is a background factor promoting the overall trend of increasingly noteworthy shrinkage in surpluses compared to the previous month. This trend will strengthen going forward.

Of course, as noted in the June 2, 2016, issue of Mizuho Market Topic entitled “Consumption tax rate hike postponement and the ‘undesirable JPY depreciation’ theory,” Japan has the world’s highest net balance of external assets and, given that the country’s domestic market is tending to shrink, it would appear unlikely that there would be a major change to Japanese corporate management strategies emphasizing business expansion in overseas markets and the acquisition of overseas companies. For this reason, it appears unlikely that there will be an overnight rapid drop with respect to factor (2). However, it is clear that there will inevitably be decreases going forward in the “portions of figures that had been increased” by JPY depreciation’s price effect. (An evaluation decrease of at least about 12% (JPY120→JPY105) will be inevitable.) Regarding factor (3), given that the “shopping sprees” of Chinese in Japan was promoted by the rising purchasing power of Chinese owing to the JPY depreciation/RMB appreciation situation, it should be recognized that the recent increasing strength of the JPY appreciation/RMB depreciation trend will to a certain extent decelerate the “shopping sprees” phenomenon. While Japan’s manufacturing sector surged during the JPY bubble period through 2007, this time the focus has shifted from product exports to service exports in the form of “shopping sprees,” and there is a possibility that a “shopping sprees” bubble has been created. In view of this, it seems possible that instead of manufacturing, the most noteworthy negative impact of JPY appreciation on this occasion will be on domestic-demand-type nonmanufacturing sectors such as retailing and hotels. In any case, <u>I am anticipating that the pace of improvement in Japan’s current account surplus will soon be diminishing</u>.

Basic supply-demand regarding JPY rates since the start of 2016

In light of the above, regarding the basic supply-demand balance (hereinafter "basic supply-demand") for JPY that this report positions as a key guiding factor for its JPY forex rate forecasts, basic supply-demand for the first four months of 2016 was characterized by approximately –JPY4.4 trillion of net JPY selling. As explained above, the background factor causing net JPY selling despite the expansion of the current account surplus is the sustained acceleration of outward securities investment. As is evident from a glance at the graph, the JPY buying pressure stemming from current account surplus expansion is roughly comparable to the JPY selling pressure stemming from outward direct securities investment expansion and, as a result, the JPY selling pressure stemming from outward securities investment expansion has been "floating" or unsettled. Moreover, as explained in last month's edition of this report, recent current account surpluses have included a growing amount of reinvestment income (included within the primary income account) that remains in the form of foreign currencies rather than being converted into JPY, and this portion of income has the effect of weakening JPY buying pressures associated with the basic supply-demand balance.



(Source) INDB (Note) Subject: including insurers, pensiom funds & individuals, excluding deposit taking finace institutions & governments

Since there has been no change to the fact that the JPY interest-rate environment is miserable, Japanese investors are maintaining their shift toward outward securities investments, and it does not appear likely that there will be a change to this scenario and its contribution to a basic supply-demand environment characterized by net JPY selling. Although there are some strongly opaque aspects of the FRB's normalization process, so long as the FRB maintains its fighting pose with respect to interest rate hikes, it seems that Japanese investors will cling to flimsy straws of hope regarding such interest rate hikes and will concurrently continue to augment their outward securities investment. In light of this continued "outward securities investment exceeding current account surpluses" scenario, it appears that the basic supply-demand environment with respect to JPY rates during the first half of 2016 will be characterized by roughly the same amount of net JPY selling as seen during 2015. As explained below, the "most realistic risk" with respect to this report's JPY appreciation scenario is the possibility of JPY depreciation stemming from accelerating growth in outward securities investment, and there continues to be deeply rooted cause for vigilance regarding this risk factor. Looking at the Ministry of Finance's "International Transactions in Securities" for May, released together with the April international balance of payments figures, one finds that there was substantial net buying in outward securities investment, amounting to JPY2,068.3 billion.

Concern regarding certain JPY appreciation greater than regarding uncertain U.S. interest rate hikes

However, as evidenced in U.S. employment figures for May, the U.S. economy is showing signs of stalling, with the situation even spurring some expectations of an interest rate reduction, and while accelerating outward securities investment accompanied by forex hedging is one thing, it is questionable how many Japanese investors there are who are bold enough to accelerate their outward securities investment while assuming the full weight of associated forex risks. In the case that U.S. interest rates are paused in line with my expectation and the JPY appreciation/USD depreciation trend proceeds, such unhedged outward securities investments will generate considerable losses. It may be true that JPY assets are completely lacking in investment appeal from an interest-rate perspective. As I have repeatedly stated, however, given such factors as U.S. currency policy trends and the history of the floating exchange rate system, I believe that the likelihood of a renewed trend of JPY appreciation/USD depreciation is quite high. It is not at all surprising that there would be an increase in investors who are more intent on preparing for a highly probable strengthening of JPY than they are on responding to U.S. interest rate hikes that are highly uncertain. My assumption is that, going forward, even if there is a continued acceleration of outward securities investments, most of those investments will be hedged, and they will therefore not be a locomotive of JPY depreciation.

BOJ monetary policy now and going forward – BOJ needs the courage to say “no” and the price to pay for surprise moves

The BOJ needs the courage to say “no”

The monetary policy was kept unchanged at the June 15-16 meeting. This turned out to be a painful decision as USD/JPY renewed its year-to-date low, but it is natural for the BOJ to want to preserve its options until the result of the UK’s referendum held a week after is known (Because, it did, in fact, succeed). However, the BOJ should have the courage to say “no” to idle market expectations in the first place as the idea of implementing additional monetary easing every time JPY strengthens is “currency policy” rather than “monetary policy,” and also a fixed rather than floating exchange rate system. In that sense, I give credit to recent decision to maintain the status quo. The Quantitative and Qualitative Easy Policy with a Negative Interest Rate (QQEN) is already not getting any support from not only financial institutions, but also households, corporations and some government sectors. Expanding it further seems rather difficult. So it is important for the BOJ to stand firm on its ground and not give in to pressure. Following yesterday’s decision, USD/JPY fell sharply to a year-to-date low of 103.56 temporarily, but only by making such repetitive decision can the heightened market expectations be restrained.

Considering BOJ’s “next move” is essentially meaningless

Even though it is logical to say that the BOJ needs the courage to say no to market expectations, there is no doubt the BOJ is under pressure to take measures against a rising JPY and falling share prices. The actualization of Brexit is an event that increasingly strengthens such opinions. Except currency intervention, monetary policy is the only quick route to weakening JPY from current level. Naturally, the forecast game begins on when the “next move” will take place. In this context, the safest assumption would be an additional easing at the July 28-29 meeting, given that the USD/JPY rate dipped below 100 following Brexit, it is also not impossible for an emergency meeting to be held before that, and an additional monetary easing to be implemented. As you may know, under Mr. Haruhiko Kuroda’s governorship, it is difficult to find any specific correlation between the BOJ’s inter-meeting communications and its “next move” (seemingly aimed to surprise). So market participants have no choice but to make their predictions based on forex and share price trends. Consequently, similarly to what happened this time and in April, whenever forex or stock markets face even the slightest headwind, market players begin to anticipate for monetary easing. And when it fails to occur, they make drastic withdrawals, and this pattern is repeated over and over again. In other words, that is the price the BOJ has to pay for making a habit of surprise moves. The BOJ is likely to suffer from this.

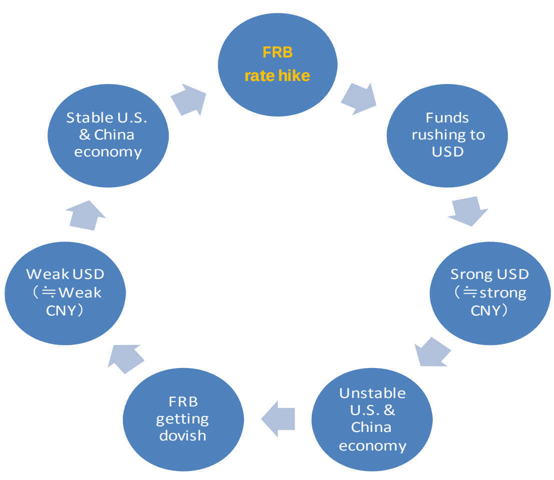
Given that FX rates and share prices are the important parameters reflecting the response to the policy, if USD/JPY were to hover at year-to-date low levels during the July meeting, that itself would be sufficient grounds to predict an additional easing. At the very least, it can be said that there is a high likelihood of an additional easing if USD/JPY falls below today’s level during the period up to the July 28-29 meeting. Also, once the July 10 House of Councillors election ended, the hurdles for an additional easing (as strongly opposed by the public) will somewhat lower. Since it cannot avoid its “next move,” the BOJ may go for a three-fold additional easing by expanding it in all three dimensions – quantity, quality and interest rates. It is difficult to imagine that the upcoming July Outlook Report would show any signs of the Consumer Price Index reaching a +2% growth rate sometime in FY 2017, hence a downward revision is unavoidable. This will also serve as an official justification for the additional easing.

Of course, it is a different story whether such measures will reverse the appreciation of JPY. As I have repeatedly said, given that the normalization process is proved difficult for the U.S., home to the world’s key currency, any attempt from the non-dollar countries to weaken their currencies would not be effective at all. This is my basic understanding. Consequently, I think considering BOJ’s “next move” is essentially meaningless when it comes to predicting medium- to long-term USD/JPY trends.

To keep an eye on the global context

I had no confidence in the FRB’s normalization process last year, and I still do not. I, therefore, predict the continuation of the JPY appreciation trend. Of course, as I also mentioned in yesterday’s Market Topic, in the event that U.S. price indicators, for instance, the Personal Consumption Expenditure (PCE) Deflator strengthen, the FRB may turn a blind eye to the weakness of the real economy and raise the Federal Funds rate. Taking present recovery in crude oil prices into account, that seems to be quite a possible scenario. However, if the FRB’s move results in higher USD, it would be against the stance

U.S. rate hike vicious circle



by Daisuke Karakama, Mizuho Bank

of the present U.S. Department of the Treasury and the Congress. Also, a large scale of capital outflows resulting in depreciation of CNY is likely to put China in a difficult condition. As a result, China may conduct another major devaluation of its currency through USD-selling interventions which in turn further reduce its foreign currency reserves. This is a scene we have witnessed several times since last year, and it is no longer necessary to explain how the international financial markets will react. As of the moment, there seems to be no escape from this "USD appreciation trap." Sooner or later, it will become clear that the safest policy is to keep a wary eye on USD weakness and the global economy (see exhibit).

Ultimately, the reality of current global economy is that the weakening of USD is imperative to the stability of the U.S. and Chinese economies, and toward this, the FRB must give up on its normalization process (in term of international coordination, Japan and Europe must halt monetary easing). It is also important to keep in mind that disregarding this international context and engaging in games to forecast the BOJ's next move will not prove too useful in terms of predicting medium- to long-term USD/JPY trends.

U.S. monetary policies now and going forward – End of the "debating whether there will be interest-rate hikes or not" stage

FRB Chair Yellen shows backbone

The June 14-15 Federal Open Market Committee (FOMC) meeting decided to maintain the status quo in line with market expectations. The meeting's statement newly referred to a deceleration in employment and, although the median level of the FOMC members' policy interest rate outlook (dot chart) maintained the twice-per-year interest rate hike pace, the number of members anticipating only one hike this year increased, and based on this and other signs, the FOMC showed an undeniable tendency toward greater dovishness. FRB Chair Janet Yellen took pains to disseminate information indicating that the FOMC's resolution made an interest rate hike possible at any time but, at this point, it simply appeared that she was seeking to display her backbone. If the employment deceleration continues, then an interest rate hike would merely represent a bet with respect to commodity inflation, but regardless of how much FRB may emphasize the importance of its dual mandate (the FRB's two main responsibilities of (1) fostering maximum employment and (2) promoting price stability), it would still require considerable courage to implement a policy of looking askance at deceleration in employment (≈ the real economy) while citing rising price levels to justify hiking interest rates. FRB Chair Yellen clearly indicated that Brexit was the cause for postponing an interest rate hike this time, but it cannot be said that she showed no concerns about her own country's economy.

Ultimately, there are strong suspicions that the FRB's normalization process is overdue for action, and it must be said that if multiple hikes were to be implemented on a regular schedule, it would have been best to implement them during the 2014-2015 period when USD was strengthening.

Statement – Undeniable impression of increasing dovishness

The introductory portion of the statement appraising economic conditions was "the pace of improvement in the labor market has slowed while growth in economic activity appears to have picked up," and this strikes a balance between mentioning deceleration in the employment market and affirming that the overall state of the economy is improving. This may well constitute a last-ditch effort to avoid giving the impression of dovishness. In the sector-by-sector economic appraisal portion of the statement, however, the employment market deceleration was mentioned a second time by changing the section reading "A range of recent indicators, including strong job gains, points to additional strengthening of the labor market" in the April statement to read "Although the unemployment rate has declined, job gains have diminished." There do not appear to be other noteworthy changes to the statement as it was presented in April, but it may be worth noting such signs of change as the support for status quo maintenance shown by Esther L. George, President of the Kansas City Fed, who had voted to raise interest rates through April. Overall, the FOMC is undeniably giving the impression of increasing dovishness

Staff economic projections essentially unchanged

Regarding the FRB staff's economic projections (see chart), compared with the projections in March, the latest projections for the 2016-2017 period show small-margin downward adjustments to the real GDP growth rate, although unemployment rate figures were not changed. Looking ahead to 2018, the real GDP growth rate projection was unchanged and the unemployment rate projection was slightly reduced, so it seems that the outlook for the real economy has not greatly changed during the past three months. On the other

FRB economic outlook (multiple forecast, %, as of JUN 2016)

	2016	2017	2018	Long-term
Real GDP Growth rate as of MAR	1.9～2.0 (2.1～2.3)	1.9～2.2 (2.0～2.3)	1.8～2.1 (1.8～2.1)	1.8～2.0 (1.8～2.1)
Unemployment rate as of MAR	4.6～4.8 (4.6～4.8)	4.5～4.7 (4.5～4.7)	4.4～4.8 (4.5～5.0)	4.7～5.0 (4.7～5.0)
PCE inflation rate as of MAR	1.3～1.7 (1.0～1.6)	1.7～2.0 (1.7～2.0)	1.9～2.0 (1.9～2.0)	2.0 (2.0)
Core PCE inflation rate as of MAR	1.6～1.8 (1.4～1.7)	1.7～2.0 (1.7～2.0)	1.9～2.0 (1.9～2.0)	

(Source) FRB

hand, while inflation trends are becoming the last resort hope for justifying the FRB's normalization process, the personal consumption expenditure (PCE) deflator for 2016 has been adjusted upward on both comprehensive and core bases, and this is believed to be directly linked to FRB Chair Yellen's stance of asserting that an interest rate hike is possible at any time. Since the unemployment rate projections throughout the projection period are below the natural unemployment rate, it is naturally incumbent on a central bank to indicate the possibility of interest rate hikes. In the case that the employment recovery is already maturing and slackening, however, then it is impossible not to be concerned about the possibility that the timing of any interest rate hike implemented going forward may coincide with a period when the unemployment rate is beginning to rise.

Halting interest rate hikes without excessive obstinacy

As of June, the median figures of the high-profile dot chart for the three years from 2016 through 2018 are 0.875%, 1.625%, and 2.375%, respectively (see chart). Compared to the March dot chart, the 2016 figure is unchanged, while the figures for 2017 and 2018 have been reduced by 0.25 and 0.625 percentage points, respectively. Consequently, the dot chart is still implying two interest rate hikes within 2016, but the overall trend of the dot chart figures suggests a strengthening dovish tendency. Looking at the distribution of dots for 2016, one finds that the number of FOMC members anticipating a single interest rate hike during 2016 is sharply rising. Specifically, through March, only one of 17 members was anticipating a 2016 year-end rate of 0.625% (corresponding to a single interest rate hike) but, by June, the number of members anticipating the 0.625% year-end rate had risen to six. The median level narrowly avoided a downward adjustment owing to the fact that the number of members anticipating a 2016 year-end rate of 0.875% (corresponding to two interest rate hikes) has remained unchanged at nine. However, the number of members anticipating a 2016 year-end rate of 1.125% (corresponding to three interest rate hikes) has decreased from three to one, and the number anticipating a rate of 1.375% (corresponding to four interest rate hikes) has decreased from four to one. It can be assumed that those abandoning the 1.125% and 1.375% figures have shifted to 0.875%, while some of those who anticipated 0.875% in March may have shifted to 0.625%. (Naturally, it is possible that there may be members who shifted from 1.375% to 0.625%, but it seems more likely that there have been gradual adjustments.) What is undeniable is that there are an increasing number of members who are losing confidence in the upcoming pace of interest rate hikes. In addition, it is noteworthy that the members' median perception of the longer-run level of the policy rate has gradually descended to 3.00%. (As is also explained below, the longer-run rate was considered to be 4.00% as of May 2013, when then-FRB Chair Bernanke announced tapering.) The process of seeking to normalize the policy rate has proceeded for three years against the backdrop of a decrease in the perceived level of the neutral policy rate along with the perceived level of the potential growth rate. Since the neutral policy rate essentially represents the end point of interest rate hikes, it has a strong effect on the perception of whether progress toward that end point may be too slow or whether the end point is not yet in sight, but at this time it can be said that it is becoming accepted that the goal line itself has been moved to a closer position. In light of this, it appears that it would be advisable to refrain from excessive obstinacy and simply stop running toward the goal line (pause the normalization process).

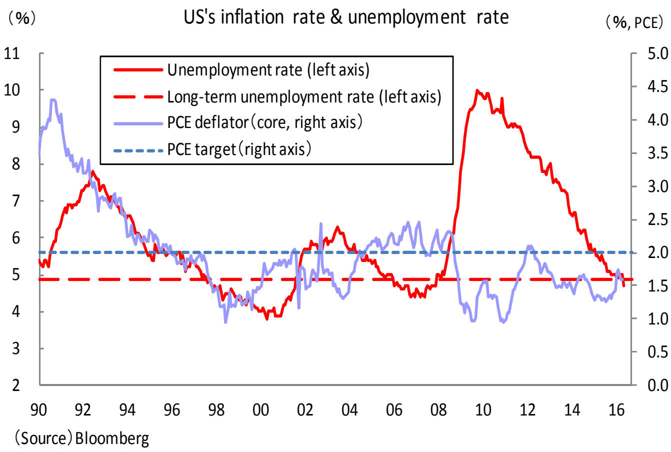
Policy interest rate outlook as of each year end (median estimate)

FOMC Date	2016	2017	2018	Longer run
Jun-13	n.a.	n.a.	n.a.	4.00%
Sep-13	2.00%	n.a.	n.a.	4.00%
Dec-13	1.75%	n.a.	n.a.	4.00%
Mar-14	2.25%	n.a.	n.a.	4.00%
Jun-14	2.50%	n.a.	n.a.	3.75%
Sep-14	2.875%	3.75%	n.a.	3.75%
Dec-14	2.50%	3.625%	n.a.	3.75%
Mar-15	1.875%	3.125%	n.a.	3.75%
Jun-15	1.625%	2.875%	n.a.	3.75%
Sep-15	1.375%	2.625%	3.313%	3.50%
Dec-15	1.375%	2.375%	3.250%	3.50%
Mar-16	0.875%	1.875%	3.000%	3.25%
Jun-16	0.875%	1.625%	2.375%	3.00%

(Source) FRB

Implications for JPY rates

Thus, this report is positioning the zero U.S. rate interest rate hike within 2016 scenario as its main forecast scenario and, based on the assumption that U.S. currency and monetary policies will not be accepting of USD appreciation, it appears that JPY appreciation will continue. It is true that the current situation is one in which the dual mandate could be used to justify monetary tightening (see graph), and it is also noteworthy that financial markets react more strongly to employment figures than inflation figures. FRB Chair Yellen has adopted the position that there is no need to be upset simply because of negative employment trends during the past month



(Source) Bloomberg

or two, but the markets' interest rate hike anticipation has already completely taken May employment statistics into account, and the mention of those statistics in the June FOMC statement led to additional JPY appreciation. The U.S. corporate goods price index (PPI) figures for May, announced on the same day as the FOMC statement, were higher than expected, yet those figures did not at all have the effect of promoting anticipation of interest rate hikes or progressive USD buying. While the FRB may be responsible for giving due attention to both inflation and employment situations, the markets' interest in employment is incomparably greater than their interest in inflation. Going forward, in the case that employment (economic conditions) are decelerating while inflation is beginning to rise, it is questionable whether the FRB would proceed with interest rate hikes.

If an interest rate hike was undertaken, it would be exerting its effect several months later, and there is a danger that inflation could be starting to decrease at that time. Essentially, it cannot be denied that the June FOMC's policy management may be falling behind the curve. Ultimately, if there is a clear-cut deceleration in employment figures then, regardless of how strong the inflation figures might be at that time, the FRB (as it just did) will probably pause any moves it might have been considering to raise interest rates. Given the fact that the macroeconomic situation is already becoming progressively more mature, it appears extremely likely that we are seeing a process of moving toward calling a halt to interest rate hikes. The problem is associated with the risk of an upcoming interest rate reduction along with subsequent moves such as those to reinitiate quantitative expansion (QE). At this point, I would like to draft a forex forecast focused on the period following the "debating whether there will be interest-rate hikes or not" stage that has been playing out over the past three years.

Risks to my main scenario – "What is impossible" is impossible?

Review of risk scenarios – "What is impossible" is impossible?

The secession of EU member countries is the first situation of its type to eventuate, and it greatly complicates the task of projecting future developments. Regarding U.K.-related situations that may occur going forward after the secessionist victory in the Brexit referendum and the overall outlook for G3 currencies, I have written articles – including the June 24, 2016, edition of Reuters Forex Forum, entitled "Dissolution of U.K.? No grounds for expecting EU breakup," and an article posted on the Toyo Keizai Online website entitled "Accelerating USD depreciation to JPY95 while EUR is robust – "U.K. Dissolution" more realistic than "EU breakup" – and I invite readers to refer to those articles. In brief, Brexit has further increased the solidity of this article's JPY appreciation forecast. To employ a phrase that has been popular since the financial crisis, Brexit can be called "the biggest black swan event since the Lehman shock." Currently there is considerable speculation about BOJ extraordinary monetary policy meetings and market intervention by the Japanese government and the BOJ, and I am anticipating that there will be efforts to prevent unidirectional JPY appreciation/Japanese stock price decrease trends but that, even given intermittent adjustments (JPY reselling), there will be a moderate trend toward new lows in USD/JPY going forward.

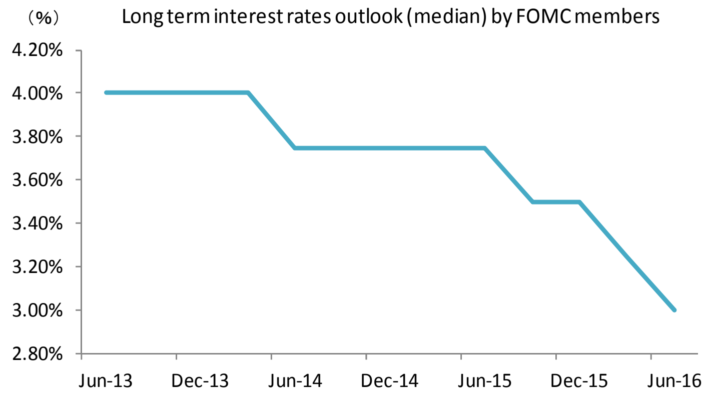
All the same, following the Brexit vote, there is a need to reexamine the various assumptions about risk scenarios that have been made up to now. At this point, regarding USD/JPY trends over the next year, I am anticipating a JPY appreciation scenario in which USD/JPY has the potential to descend to as low as 90. The chart shows the risk scenarios associated with that main scenario. The colored scenarios involve JPY appreciation risks, and the remaining items are JPY depreciation risks. One gets the feeling that the JPY appreciation risks that have existed to date have suddenly become greater.

Potential Risks to the Main Scenario

		Risk Factors	Remarks	Direction
US	①	FRB monetary policy normalization	・Successive interest rates hike after unexpectedly high economic growth, B/S reductions also affected.	Weak JPY Strong USD
US	②	Potential monetary policy adopted by new President	・Regardless of new President, Hilary or Trump, Strong USD will be perceptibly capped. Focusing on new Secretary of the Treasury nominstion.	Strong JPY Weak USD
US	③	Additional FRBs easing	・Interest rate cut in the wake of U.S. sudden recession & QE4 pondering?	Strong JPY Weak USD
Japan	④	Risk-taking by Japanese investors	・Changing main policy from currency hedges to increasing open positions?	Weak JPY Strong USD
Japan	⑤	Japan officials strong JPY curbing	・BOJ's continuous negative interest rates expansion. ・Buying USD/JPY intervention (or rumor)	Weak JPY Strong USD
Europe	⑥	Ruckus over the breakup of the EC intensifies	・Northern Ireland and Scotland seek independence from the UK. Possible concerns about something similar happening in continental Europe?	Strong JPY Weak USD

First, with respect to downside risks, there is the possibility that USD/JPY will descend to the 90-95 range and stabilize there. It is not a scenario that I want to anticipate, but it is worth thinking about. In the chart, risk factors (2), (3), and (6) are associated with this possibility. An issue that is beginning to attract greater attention is the risk that Donald Trump may become the next U.S. president (risk factor (2)). Mr. Trump's statements are replete with indications that he is biased against free trade and toward currency depreciation, the expansion of fiscal spending, and the use of monetary expansion policies, and none of these tendencies are likely to promote JPY depreciation or USD appreciation. In addition, it is noteworthy that Mr. Trump has repeatedly posited such moves as those to withdraw U.S. military forces from Japan and abrogate the U.S.-Japan security treaty (The Treaty of Mutual Cooperation and Security between the United States and Japan). As we approach the end of the summer, the Trump-related risks are likely to be attracting increasing attention. While Brexit reflects sentiments similar to Trump's and may generate some tailwind support for him[2], at this point, his opponent Hillary Clinton has greater support among voters, so the likelihood of a Trump presidency still appears to be low. On the other hand, market participants should probably be prudent in maintaining their vigilance regardless of trends seen in public opinion polls prior to the actual U.S. presidential election, particularly in light of the fact that both "the advent of a Trump presidency" and "the advent of a Brexit" had previously both been similarly positioned as tail risks. Currently, Boris Johnson (sometimes referred to as "the U.K.'s Trump") is considered a strong candidate to become the U.K.'s next prime minister and, given that Johnson's image (including his appearance) corresponds to that of Trump in many ways, if Johnson were to succeed David Cameron as prime minister, the potential for a surge in Trump-risk should not be casually dismissed. Trump quickly responded to the Brexit vote results by saying – "there are great similarities between what happened here [the U.K.] and my campaign" – and it appears that he is eager to leverage the Brexit situation as means of augmenting his own political support. It may be that we should not over hastily assume that "what is impossible" is impossible.

"U.S. interest-rate-hike guessing game" outdated?



(Source) FRB

Another potential JPY appreciation risk is that the FRB could reverse its normalization process and move toward monetary relaxation (risk factor (3)). While this report has occasionally mentioned this risk, the realization of Brexit may have increased its likelihood. In short, the risk –involving a shift to assumptions about interest rate cuts rather than interest rate hikes – can be described as a risk that the "U.S. interest-rate-hike guessing game" that has been the greatest theme in forex markets for the past three years has now become outdated. The existence of this risk requires a reexamination of the definition of "normal" that encompasses a reconsideration of the meaning of "normal" in the phrase "normalization process". In June 2013, immediately after then-FRB Chair Bernanke promulgated his tapering policy, the assumed neutral level of the policy interest rate was 4.00%. At this time (June 2016), three years later, the level is 3.00% (see chart). As the height of the goal that is being pursued (≈ restoring the U.S. economy's underlying strength) progressively descends, questions arise regarding what should be considered normal and how such a normality should be attained. It is impossible to deny the possibility that the FRB is facing a situation in which, rather than debating the timing and number of interest rate hikes, it should expeditiously promote a reexamination of the optimal direction of its monetary policies. This is particularly true in light of the excessive number of unforeseen things that have already happened. During the three years since May 2013, the Chinese bubble has popped, crude oil prices were halved, the "impossible" event of Donald Trump winning the Republican Party candidacy for the U.S. presidential election has taken place, and the U.K. has voted to leave the EU. All of these situations are huge risk situations that people assumed three years ago were "impossible." It would not necessarily be a mistake to guess that we may be witnessing the beginning of a reversal in the optimal direction (away from tightening and toward loosening) of the pendulum of U.S. monetary policy.
Moreover, following Brexit, there is an array of associated JPY appreciation-related risk factors that are becoming more potentially realizable (risk factor (6)). Already, it has become possible that there will be referendums on the independence of Scotland and Northern Ireland, and right-wing populism is strengthening in continental Europe. During the forecast period, I do not expect a prospective exit from the EU by a second or third country to become a reality, but if other unexpected risk factors do in fact become more likely, then they can be expected to be JPY appreciation risk factors.

[2] In response to the Brexit vote, Donald Trump is reported to have made such comments on June 24 as – "I think it will be a good thing." – and – "People want to take their country back. They want to have independence, in a sense, and you see it with Europe, all over Europe."

Overview of JPY depreciation risks

There are also JPY depreciation risk factors (although I do am not overly concerned about them). With U.S. employment reaching a full-employment situation and signs of budding inflation beginning to be confirmed, it cannot be said to be impossible that the FRB might boldly implement an interest rate hike despite Brexit-generated headwinds (risk factor (1)). The potential scenario of full-scale inflation requiring sharp interest rate hikes in a short period of time is the situation that the FRB would most strongly like to avoid, and this can be considered a reasonable motivation for calmly proceeding along the path of interest rate hikes. However, given that the advent of Brexit has the potential for spurring a downturn in the global economy, there is a high likelihood that inflation within the United States will progressively cool down, so I do not think that the U.S. inflation situation is a very realistic risk factor.

A more-worrisome situation that this report has focused on each month is the realistic risk that Japanese investors facing a miserable fund management environment owing to the low level of JPY interest rates will accelerate the growth of their outward investments (risk factor (4)). However, as noted above, it has become conceivable that the FRB will respond to Brexit by reversing its normalization process and moving toward monetary relaxation. In this kind of situation, it would appear that circumstances may make hiking interest rates quite difficult not just within this year, but also during 2017. In view of this, I do not expect that a majority of investors undertaking JPY investments would venture to make those investments while assuming the associated forex risks. Among the risk scenarios, the most realistic would appear to be such scenarios as those in which a JPY depreciation trend were to take root despite a lack of progress in the FRB's normalization process, but I am still doubtful about whether such scenarios are actually possible.

In addition, a more direct JPY depreciation risk scenario is that in which the policy responses of the Japanese government and the BOJ (specifically, forex market intervention and additional easing) were to elevate USD/JPY, and this risk is always latent. Naturally, if USD/JPY breaks below the JPY100 level and stabilizes there, there will probably be some consideration of policy responses encompassing market intervention measures. It is generally understood that JPY20 appreciation against USD in a half year is a fully sufficient volatility-based ground for asserting that there is "excessive fluctuation." It would not at all be surprising if there was consideration of possible measures that could be taken to stop the JPY appreciation. However, as this report has stubbornly argued, the direction of U.S. currency and monetary policies have overwhelming power within the floating exchange rate system and, given that the FRB could easily swing to a more dovish stance amid the current scenario, a Japanese policy response could probably not be effective for more than a short period of time. Looking back at the long history of JPY exchange rates, it is not difficult to imagine such a situation.

EUR Outlook – How to assess the impact of Brexit

ECB monetary policy now and going forward– Two years since the introduction of negative interest rates

The real battle is from July onward

At the June ECB Governing Council Meeting, the key ECB interest rates were kept unchanged at 0.0% for the interest rate on the main refinancing operations (MROs), 0.25% for the interest rate on the marginal lending facility, which is the upper limit of market interest rates, and −0.40% for the interest rate on the deposit facility, which is the lower level of market interest rates. With this, the interest rate corridor (the difference between the upper and lower limits of market interest rates) also remained unchanged at 0.65 pp. As there are some new monetary easing measures going into effect from June (second round of targeted long-term refinancing operations – TLTRO-II, and the Corporate Sector Purchase Program – CSPP), the general sentiment discernible from the introductory statement and the press conference was that there was no need to act hastily at this point. For instance, the statement noted that “additional stimulus, beyond the impetus already taken into account, is expected from the monetary policy measures still to be implemented and will contribute to further rebalancing the risks to the outlook for growth and inflation.” Again, it seems that the bottoming out of crude oil prices and the signs of recovery in inflation expectations are giving the ECB more room for policy operations. However, the problem now is whether inflation and inflation expectations will really improve as a result of new measures going into effect and crude oil prices bottoming out, and in this sense, the main battle for the ECB will be from July onward.

Monetary policies that do not make a difference

As there were no major points, this time a lot more attention than usual seemed to be focused on the revised [3] staff macroeconomic projections. Since downward revisions of staff projections have become a more-or-less established pattern, it is rare to see an upward revision like this time. Specifically, the Harmonized Index of Consumer Prices (HICP) forecast for 2016 was raised from +0.1% to +0.2% against the recovery of crude oil prices, while the 2017 and 2018 forecasts were kept unchanged at +1.3% and +1.6%, respectively. The real GDP growth rate forecasts for 2016 were also upwardly revised from +1.4% to +1.6% following the news of a stronger than expected performance for the January-March quarter. The GDP forecast for 2017 was kept unchanged at +1.7% while that for 2018 was lowered from +1.8% to +1.7% (see chart).

ECB staff outlook（June 2016） (%)

	2015	2016	2017	2018
HICP	**0.0**	**0.1～0.3**	**0.6～2.0**	**0.7～2.5**
（Previous : MAR 2016）		(-0.2～0.4)	(0.6～2.0)	(0.8～2.4)
Real GDP	1.6	1.3～1.9	0.7～2.7	0.5～2.9
（Previous : MAR 2016）		(1.0～1.8)	(0.7～2.7)	(0.6～3.0)
Private consumption	1.7	1.9	1.7	1.5
Government consumption	1.3	1.5	0.8	0.9
Gross fixed capital formation	2.7	3.2	3.4	3.3
Exports (goods and services)	5.2	3.2	4.2	4.4
Imports (goods and services)	6.0	4.7	4.7	4.8

(Source)ECB (Note) EURUSD is assumed to be 1.13 year 2016 & 1.14 year 2017-2018

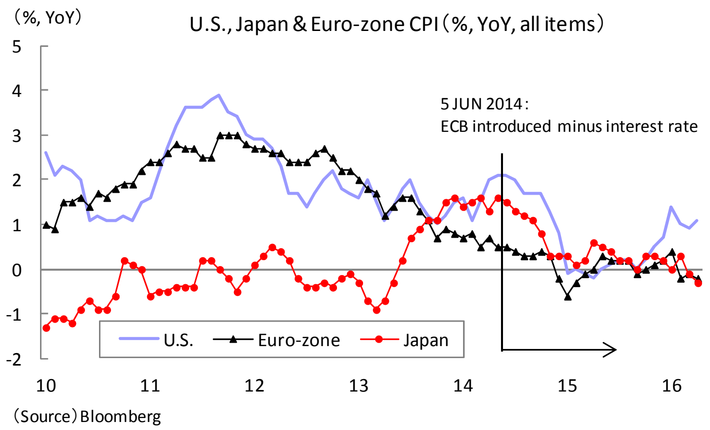
In response to such projections, there was a perceptive question from a reporter: “Looking at the forecasts, at the end of the forecasts horizon, on the inflation side they are the same; on the GDP side they're even worse. So I'm wondering, can you only sustain the very gradual recovery at the sluggish growth pace you've described with the help of ever-increasing stimulus, in which case are you prepared to keep that going as long as – maybe indefinitely? Or is the fact that your growth and inflation forecasts haven't improved after the March measures, is that a sign that basically any additional easing will not be effective and will essentially be pointless? Is that underlining your call for structural reforms, in a way? In which case, why are you saying you're going to do more and more and more, if you know that it's not going to make a difference?”

To be sure, even though the economic and price projections were upwardly revised this time, the improvement was not all that remarkable taking into account the bottoming out of crude oil prices and the various monetary easing measures implemented so far. Mr. Draghi’s response to the question naturally was, “It's pretty clear that in the presence of a faster pace of structural reforms our measures would be showing their positive effects faster, but even in its absence they have been effective.” He also remarked that “the March package has been instrumental in avoiding a severe deterioration of financial conditions after the turbulences around the end of last year, and certainly has supported the recovery.” His remarks constitute the kind of argument that policymakers typically make,

[3] Precisely speaking, the staff macroeconomic projections are prepared through a joint effort by the staff of the ECB and the various national central banks (NCBs) twice a year (June and December), and by the ECB staff alone the remaining two times (March and September). The GC meeting this time was held in Vienna, and in this connection, one of the questions asked was, “Since you are also here to celebrate the 200-year anniversary of OeNB, why are national central banks still needed today, and what will possibly be the role of Österreichische Nationalbank in 2216?” In response, ECB President Mario Draghi mentioned that the March and September forecasts were created using the “greater” or “more detailed” knowledge of the NCBs. Of course, the difference between the two kinds of projections is not obvious enough for the markets to be aware of it.

namely that things would have been much worse if the measures had not been implemented. As I have argued in this report before, it is impossible for anyone to verify what the results would have been had a certain measure not been taken. Consequently, criticizing the authorities for a policy that has already been implemented simply ensures that the discussion does not go anywhere. However, the fact is that the recent staff forecasts have factored in the effects of the two special measures yet to be implemented, and they are still lackluster, so the reporter's question "can you only sustain the very gradual recovery at the sluggish growth pace you've described" is bound to have hit a nerve.
A similar question was, "You repeat after every Governing Council session that there's of course a problem that the political side doesn't help by structural reforms and so on. Do you, does the Governing Council, have any idea how such a process of structural reforms channeled by the political side could get on the move?" Naturally, Mr. Draghi's response was merely to state that structural reforms were outside the scope of the ECB's mandate, but he did emphasize that it was "very, very important" to restore competitiveness in the products and services markets through structural reforms.

Two years since the introduction of negative interest rates



The June 5, 2014 ECB Governing Council Meeting of two years ago was a historical meeting at which the introduction of negative interest rates was decided (in addition to negative interest rates, TLTRO was also introduced at this meeting). Two years have passed since this historical decision. Let us review what happened at that time. The ECB watched for an opportunity and introduced its negative interest rate policy at a time when the markets were expecting a quantitative easing (QE). This took the forex market greatly by surprise, and EUR crashed and remained weak until March the following year. Following the introduction of the negative interest rate, the ECB also introduced a government bond-purchase driven QE (the Public Sector Purchase Programme, better known as PSPP), even though the two policies were thought to be incompatible with each other. Subsequently, the negative interest rate margin has been expanded several times and QE has been expanded once so far. Of course, the QE targets not just government bonds but also covered bonds and asset-backed securities (ABSs) – all these various programs put together constitute the expanded Asset Purchase Programme (APP). In addition to the above, funds with negative interest rates will be provisioned under the TLTRO-II and corporate bonds will be purchased through the Corporate Sector Purchase Programme (CSPP) starting this month. Despite all these policy measures, however, the HICP has shown absolutely no improvement compared with its decreasing trend of two years ago (see graph). Granted that the fall in crude oil prices has been an adverse factor, but considering that negative interest rates are only possible by sacrificing the profitability of financial institutions, I believe it is necessary take a step back and review all the measures that have been taken.
Of course, the recent introductory statement notes that "the monetary policy measures in place since June 2014 have clearly improved borrowing conditions for firms and households," arguing that things have changed for the better since that day. However, realistically speaking, the effects of the ECB's monetary easing efforts really do not measure up to their unprecedented scale in terms of the ECB's mandate of guiding the HICP to the 2% level. On the other hand, while some may say it is "already two years" others could say it is "still only two years." The history of the negative interest rates policy is still only two years old, and it is unclear what the result of the accumulated damage to financial institutions so far will be going forward (not to mention that the margin of negative interest rates is being expanded at intervals). Mr. Draghi already hinted at the March 10 Governing Council Meeting that there was a limit to how low the negative interest rate could go, and apart from the press conference following the Governing Council Meeting yesterday, he said at a different lecture in Vienna,[4] "while our mandate is symmetric, and our commitment to our mandate is symmetric, there is an asymmetry in the tools we can use to achieve it, which stems from the existence of a lower bound for interest rates," (*Bloomberg*, June 3), again covertly hinting that negative interest rates cannot be lowered indefinitely.

Two years since its introduction, the following five things have become clear regarding negative interest rates: (1) that it cannot be expanded indefinitely, (2) its power to reverse USD weakness is limited, (3) it is difficult to raise the

[4] June ECB Governing Council Meeting was held in Vienna, not Frankfurt. The ECB Governing Council Meeting is usually held in Frankfurt, but twice a year since 2000, it has been held in some other city in a Euro member country.

HICP (this relates to (2)) with negative interest rates, (4) the profitability of financial institutions is definitely injured, and (5) lending can be expected to improve to some extent. It must be noted, however, that the causal relationship between negative interest rates and improvement in lending (the only positive effect) has not been verified. Going by intuition, points (4) and (5) are in conflict with each other, and given that there is a confirmed causal relationship between negative interest rates and point (4), one would like to wait for more serious analyses regarding (5) going forward. The ECB appears to be summarizing the developments over the past two years in a positive way, but in reality, the interest rate path seems to have run into a dead end. The next move is very likely to be related to quantity, including the strengthening of fund provisioning schemes like the TLTRO. Under such circumstances, and taking into account the lackluster HICP trend and overseas economic climate, I think it is very likely that the ECB will extend the deadline for the APP currently set at March 2017.

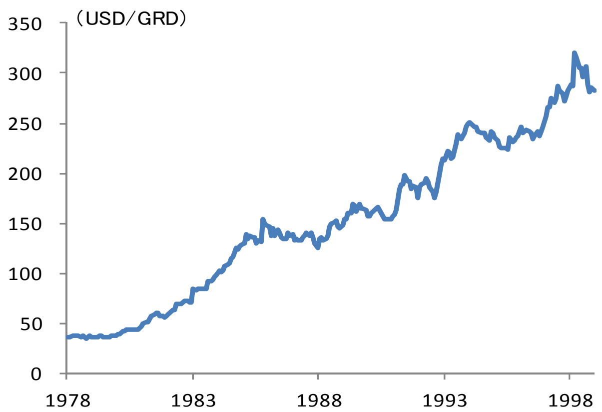
Brexit and EUR – Assessing the impact

A historic event indicating changes in the post-war order

In the U.K.'s June 23 national referendum on the Brexit issue, 48% of participants voted to remain while 52% voted to exit, and the victory of the Brexit supporters was a great surprise in light of the predominant projections of a "remain" win prior to the referendum. The U.K.'s exit will be the first case of a country leaving the EU during the almost 50 year period since the 1967 founding of the EU's predecessor, the European Community (EC). During that time period, the EU has undergone expansion a total of six times, bringing the number of member countries to its current level of 28. The U.K. has remained in the EU since becoming a member in the earliest expansion project, implemented in 1973. Since the financial crisis in 2009, the EU has been considered by many to have paused its expansion and deepening process, but the EU has never previously experienced an event that represents a clear-cut "retreat." With respect to European unification project launched with the objective of promoting peace, Brexit is unquestionably the greatest historical defeat, and from a global perspective, it would not be an exaggeration to say that Brexit is a historical event second only to the 1989 fall of the Berlin wall in terms of its importance in changing the post-war order. The EC will celebrate the 50th anniversary of its founding next year, and various events[5] are likely to be organized on a scale in line with the momentousness of the EC's founding. To have an EU member dropping out at the time of this major milestone in the EU's history is extremely regrettable. Brexit will mark the beginning of a period in which the solidarity and cohesion of the EU's remaining 27 members will be tested.

EUR after Brexit

What is the best approach to reading the EUR market in the post-Brexit era? Brexit may seem to be directly linked to a weakening of the EU, but this is not necessarily true. There is some basis for projections that Brexit may promote a weakening of the EU's political centripetal force. However, that is only in the case that the prospect of a second and third country's exit begins to appear somewhat realistic. Moreover, that case is only conceivable if the U.K. is clearly doing well following its exit, in which case Brexit could represent a "good example" for other exit country candidates to emulate. As argued in the June 15, 2016, issue of Mizuho Market Topic entitled "Q&A on the U.K.'s exit from the EU (Brexit)," however, there is no logical reason to expect the EU to go easy on the U.K. after Brexit. While it is reasonable for Brexit supporters to plan to compensate for post-exit trade-related disadvantages by undertaking bilateral negotiations aimed at restoring advantageous trade situations, there is no compelling reason for the EU to make it easy to realize such plans. Further, post-exit outflows of capital (as well as of companies) are generally viewed as inevitable, and it is feared that such outflows may wreak considerable damage on the U.K.'s real economy. In short, even if the U.K. decides to exit the EU, the EU can be expected to do its best to ensure that the exit does not directly promote a weakening of its political centripetal force, and it is highly likely that associated efforts will put the U.K. economy in a disadvantageous position.



(Source) CEIC

On the other hand, since the U.K. has frequently demanded special preferential measures and otherwise tended to slow the pace of EU decision making processes, it may well be that Brexit will have the effect of strengthening the EU's political centripetal force in the long run. Similarly, it is possible that Greece and other southern European EU

[5] I was working at the European Commission in 2007, when the European Commission organized events to celebrate the 50th anniversary of the Treaty of Rome signing in 1957.

member countries may employ pro-Brexit arguments to promote their own exits from the EU, and this may seem to raise the prospect of growing internal strife and eventual collapse for the EU, but from the perspective of creating a strong shared currency zone, such exits could be viewed as a process of discarding burdensome deadwood. In fact, roughly a year ago (during the first seven months of last year) when there was much talk of a potential Greece exit (Grexit) crisis, many observers were predicting that EUR would drop immediately after a Grexit but ultimately rise after the passage of a certain amount of time. Given that, prior to the introduction of EUR in Greece, the Greek drachma was a currency that continuously depreciated against USD (see graph), it would seem that such expectations were natural. The presence of Greece within the EU places a burden on EUR exchange rates.

In the same way, the U.K.'s presence within the EU has placed a burden on efforts to promote European integration. From the EU's perspective, the U.K. has been setting a bad example for other EU members through its chronic efforts to obtain special benefits and demands for special treatment, and the U.K.'s EU membership has always had the potential for decisively undermining EU cohesiveness. In a page-two article in the June 21 Nihon Keizai Shimbun morning edition, the French economic and social theorist Jacques Attali argued that the EU had made concessions to keep the U.K. as a member but that the U.K.'s presence within the EU had hindered the progress of unification. He went on to say that retaining the U.K. within the EU had the effect of paralyzing the EU, and I am in full agreement with that view. It bears remembering that the European unification project was originally focused on promoting peace rather than forming an economic union, and if a member of the project no longer shares that ideal, then the retention of such a member would not be meaningful. In any case, I do not believe there is enough correlation between Brexit and EUR depreciation to merit a large amount of analysis and speculation.

EUR's approach to Deutsche Mark status

What is liable to happen in the unlikely event that EU-exit campaigns in certain southern European countries gather momentum following a Brexit? Would that actually mean the Euro zone was disintegrating and that people should therefore be selling EUR? Although one might be instinctively inclined to answer in the affirmative, a bit of clear-headed thought should lead to anticipation of a different chain of events. If the momentum of exit campaigns were to gather momentum, it seems likely that the strongest such campaigns would be found in such countries as Greece and Italy – countries with particularly shaky government and or export sectors (countries that are accumulating government debt and tend to record current account deficits). However, the departure of such countries would promote an increase in EUR's characteristics of being a currency supported by government bonds with high credit ratings and a huge current account surplus. In other words, it can be said that such a situation would make EUR approach Deutsche Mark status. The departure of relatively weak countries would be likely to instantaneously spur considerable EUR selling, but such selling would not necessarily persist over the medium-to-long term. Viewed from an objective perspective, such situation would actually appear to be grounds for expecting EUR to become increasingly solid and robust.

Of course, the preceding is just a consideration of the outlook for EUR. As noted earlier, prior to the economic union, the EU and EUR were considered to be parts of a political union building project. For this reason, I do concur with the opinion that the incidence of exiting countries must be considered to represent a failure with respect to the pursuit of the ideal of a political union. Ultimately, it may be reasonable to conclude that the approach of employing economic and financial policies in place of security guarantee policies was not an approach likely to succeed. However, the "EU's strategic failure as a political union" should not be conflated with the outlook for "the underlying strength of EUR as the currency of remaining EU members." When one considers the long-term outlook, it appears that there may well continue to be some incidences of confused conditions related to the survival of the EU, and yet so long as a currency area centered on core countries (Germany, France, Italy, and Spain) is sustained, it would be extravagantly excessive to promote fears regarding the potential for such extreme developments as a dramatic plunge of EUR depreciation. In forecasting the outlook for EUR exchange rates, I believe it important to maintain a flexible acceptance of the concept that each instance of a country departing from the currency union that may occur will tend to promote EUR's progress toward Deutsche Mark status.

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