Forex Medium-Term Outlook

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Forex Division

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Overview of Outlook

USD/JPY fell following the June 23 Brexit vote and then rose during most of July, although it was not able to muster a vigorous uptrend. As seen during the April-May period, the uptrends in USD/JPY were not able to exceed the scope of simple speculative position adjustments, and it is probably wise to view the current situation as being a temporary lull in the JPY appreciation scenario. Of course, after a 20 yen appreciation since the start of this year, it does seem possible that the lull may be protracted, but I do not feel any need to adjust the “continued basic trend of JPY appreciation” scenario that I have been forecasting since last year. While there still exists an inclination in the market to play the “U.S. rate hike related forecasting game,” it should be noted that the question of whether the FRB will hike interest rates is tantamount to the question of whether the U.S. can cope with USD appreciation, and it is questionable whether the currency policy of the U.S. government as it seeks to set up a new presidential administration would be permissive of a USD appreciation trend. Frankly, it seems that it would probably be difficult to allow such a trend. Of course, Japanese investors are accelerating their investments in foreign securities against the backdrop of the miserable JPY interest rate environment, and there is a possibility that that situation may prove to be unexpectedly effective in restraining the progress of JPY appreciation. However, the FRB is expected to have a dovish tendency during the forecast period, and it would require considerable courage to forecast the return of a JPY depreciation trend during that period. Looking at the forex trends seen since the floating exchange rate system was introduced, one may note that, once a wave of JPY appreciation has begun, it is rare that such a wave will end in a single year. In light of this, I am continuing to expect a possibility that USD/JPY may settle down at the 90-95 level during the forecast period.

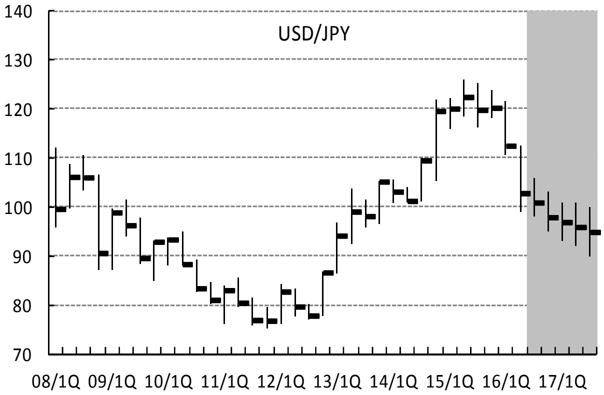
EUR has continued to be lacking in a clear-cut sense of directionality. As I have argued repeatedly, EUR is the currency with the world’s largest current account surplus and a relatively high real interest rate, and these are the characteristics that must be taken most seriously when it comes to forecasting forex rates. Going forward, I will continue basing my EUR forecasts on this reasoning. On the other hand, there is cause for concern regarding the fact that it is beginning to become apparent at this point that the EC policy responses are increasingly difficult to read. The imposition of sanctions regarding the fiscal management of Spain and Portugal has been barely avoided (postponed), but it is now doubtful whether such sanctions were being seriously considered. Moreover, the Italian domestic bank non-performing loan crisis is still in a perilous state. There is an increasingly apparent conflict between the EC’s desire to rigorously implement its new bail-in rules (creditor-funded recapitalisation rules) and Italy’s desire to use public funds to bail out the banks, and there is smoldering concern that the big event of late 2016 may be the Italy crisis rather than the U.S. presidential election. In such a case, despite the lack of a problem with the fundamentals, there is concern that EUR/USD may be forced to below 1.10.

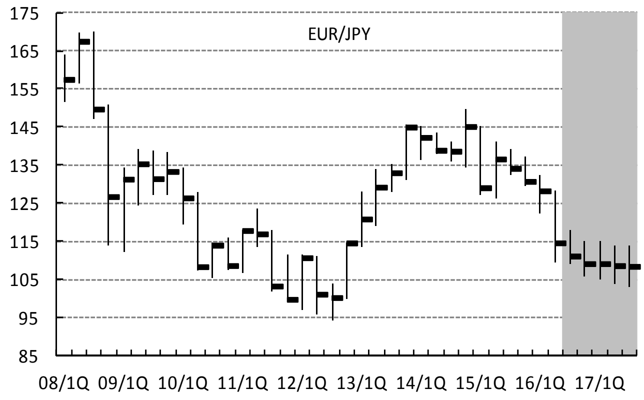
Summary Table of Forecasts

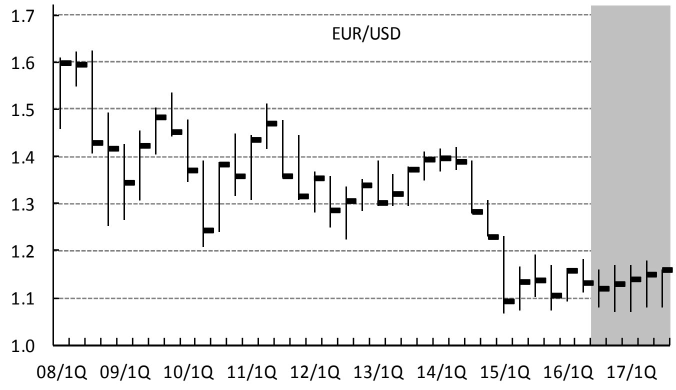
	2016 Jan-Jul (actual)	Jul-Sep	Oct-Dec	2017 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	99.00 ～ 121.70 (102.37)	98 ～ 106 (101)	95 ～ 103 (98)	93 ～ 101 (97)	92 ～ 101 (96)	90 ～ 100 (95)
EUR/USD	1.0711 ～ 1.1616 (1.1175)	1.06 ～ 1.14 (1.10)	1.05 ～ 1.15 (1.11)	1.05 ～ 1.15 (1.12)	1.06 ～ 1.16 (1.13)	1.06 ～ 1.16 (1.14)
EUR/JPY	109.30 ～ 132.45 (114.33)	109 ～ 118 (111)	106 ～ 115 (109)	105 ～ 115 (109)	104 ～ 114 (108)	103 ～ 114 (108)

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

Exchange Rate Trends & Forecasts



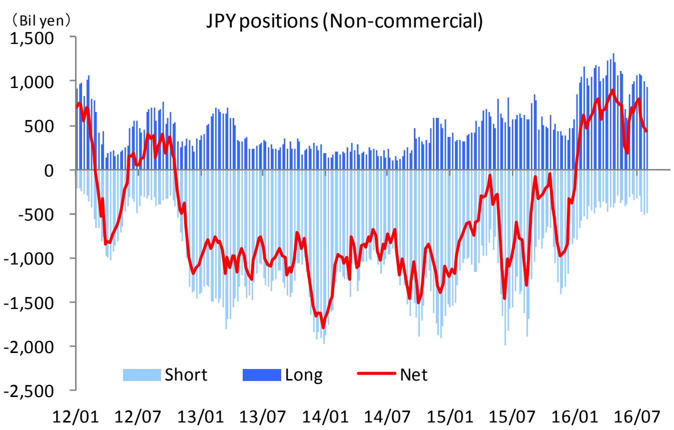




USD/JPY Outlook – USD appreciation remains a difficult prospect

Interpreting the USD/JPY trend – Must not miss the forest for the trees

Reactionary JPY depreciation is nothing more than "a temporary break" in the basic JPY appreciation trend



For the past year, I have been saying in this publication that 2016 will be a turning point for the JPY depreciation trend. The reasons for this, I have emphasized, are first, the fact that the FRB's normalization process could not be trusted to begin with, and second, that those levels of JPY weakness were not sustainable from the perspectives of purchasing power parity (PPP) or real effective exchange rates (REER). In July, USD/JPY at one point recovered to the mid-107 level, but as expected, this did not turn into a trend. There still seems no need, therefore, to change the main scenario envisaged in this paper. The increase in USD/JPY seen in July was merely a development accompanying the dissolution of the speculative JPY long position that had accumulated before then, and it was not greater than what was already expected. If we take the example of the IMM currency futures transactions as of July 5, JPY had a net long position of JPY 794.6 billion against USD. This was the second largest net long position ever posted, the largest being the JPY 898.4 billion posted on April 19, and in fact, USD/JPY did recover temporarily in May too. Given that these are speculative trends, transactions in the reverse direction become necessary at some point, so the <u>JPY depreciation against USD seen in July is likely to be no more than JPY being sold off after excess purchase</u>. Since the beginning of the year, the USD/JPY trend has been a repetition of (USD) short covering whenever the currency pair is on the rise, resulting in a new low once the rising phase is over, and by the time we realized it, we were quite far along. <u>My diagnosis is that the rise in USD/JPY in July is no more than a temporary break in the main basic JPY appreciation trend.</u>

People seem to be missing the forest for the trees

Even so, there is the view that it may be time for a reversal in the JPY appreciation trend given that JPY has already strengthened by JPY20 in the space of half a year. There is something to this argument. Even from the point of view of those who predict JPY appreciation, the changes since the beginning of the year seem quite excessive, and one does on some level feel doubtful about JPY's scope for further appreciation. This year's JPY range of 22.7 big figure is, however, not unprecedentedly extreme. If one makes a simple comparison based merely on the width of the range, then this width has been seen three times over the past twenty years (in 1998, 1999, and in 2008). All of these years have been marked by some historical development, such as a financial crisis or the introduction of a zero interest rate policy for the first time in history and so on. This year, there has been Brexit (the UK's exit from the EU), a development that hints at major changes to the world order, of a magnitude not seen since the end of WWII. That this would result in a major rate movement is not, in itself, strange. Also, historically speaking, phases of JPY strength or weakness seem to last for three to four years once they begin (see chart on previous page). If we consider the present phase of JPY strength to have begun last July, it is still only a year old. From the USD/JPY level of 124 or so as of last July, the recent level of 105 or so amounts to a change of −15% or so, but as the chart shows, there have been JPY appreciation phases in the past when the average rate of change was −33%. Of course, there is no need for such a large change to take place all at once in the space of a single year, so I do not intend to say that the current level of change is inadequate. I do, however, feel that declaring it to be adequate also requires strength of conviction (incidentally, though one does not really want to think about it, a 33% change from JPY124 would be JPY83 or so).

JPY strengthing & weakening trend since Plaza accord

Start	End	Direction	Numbers of days	Numbers of months	Rate of variability	Key phrases (some representative examples)
MAR 1985	DEC 1987	Strong JPY	1005	33.5	-51.7	Plaza accord
JAN 1988	MAR 1990	Weak JPY	790	26.3	23.5	Japanese economic bubble
APR 1990	APR 1995	Strong JPY	1826	60.9	-46.9	Collapse of Japanese economic bubble
MAY 1995	JUL 1998	Weak JPY	1157	38.6	71.0	Asian currency crisis, Japanese banking crisis, “Strong dollar a national advantage” (for the U.S.)
AUG 1998	DEC 1999	Strong JPY	487	16.2	-26.4	Russian financial crisis, Fall of long-term capital management (LTCM)
JAN 2000	JAN 2002	Weak JPY	731	24.4	24.5	Dot-com bubble and its collapse, U.S. September 11, 2001 terrorist attacks
FEB 2002	DEC 2004	Strong JPY	1034	34.5	-23.0	End of Japanese banking crisis, Japanese economic boom surpasses erstwhile Izanagi boom, Phase of U.S. rate cuts
JAN 2005	JUL 2007	Weak JPY	911	30.4	14.4	Financial bubble
AUG 2007	JAN 2012	Strong JPY	1614	53.8	-34.1	Collapse of Lehman Brothers, European debt crisis, U.S. monetary easing
FEB 2012	JUN 2015	Weak JPY	1216	40.5	51.0	FRB’s normalization process, End of European debt crisis, Abenomics
JUL 2015	?	Strong JPY	?	?	-15.2	Collapse of Chinese economic bubble, Brexit
Average (overall)			1,077.1	**35.9**	**34.7**	
Average (strong JPY)			1,193.2	39.8	-32.9	
Average (weak JPY)			961.0	32.0	36.9	

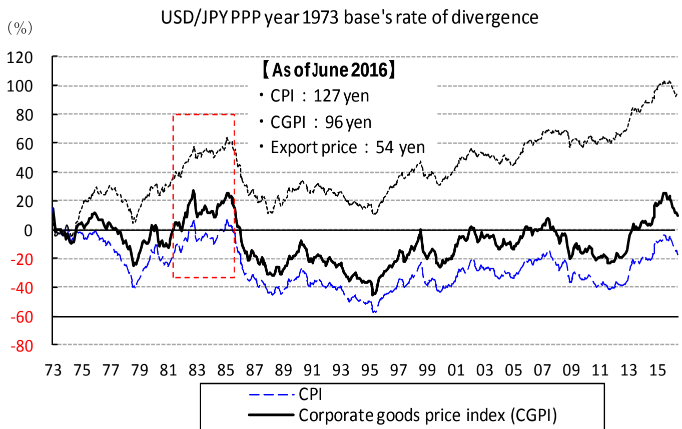
(Source) Bloomberg

(Notes) month=30 days, Classified as either trends exceeds one year. The “Average (Overall)” for the “Rate of Change” is the average of the absolute values.

As far as USD/JPY trends since the beginning of the year go, people have taken up convenient milestones and predicted reversals. These milestones have included the JPY115 point, which was thought likely to be defended because it was the assumed forex rate of major Japanese automakers, and the JPY110 point, which was thought likely to be defended because it was the rate that had been maintained since the October 2014 Halloween easing. Even the JPY105 level, some argued, would be defended as it was the assumed forex rate of major Japanese automakers. Recently, many have been predicting that the Japanese government and the BOJ would step in with policy measures if the rate falls below JPY100. In the end, however, it is simply a matter of people not seeing what they do not want to see, and it has to be said that the present rate movements reveal the tendency of people to miss the forest for the trees. USD/JPY has simply returned to a zone that is natural in terms of the PPP (100 to 105), not to mention the U.S. currency and monetary policy stances favoring USD depreciation that have been strongly felt since the beginning of the year. Under such market circumstances, there is no room for individual companies’ situations to be taken into account.

Both the JPY 80 and 120 rates are unreasonable rates

A level of 120 or 125 for USD/JPY is abnormal, and in this context, a major Japanese automobile company’s senior executive describing his company’s high profits as being “assisted by tailwinds” left an impression, and I think it was an accurate description. In the early days of Abenomics, one felt that the efforts to engineer forex rates in line with the PPP were scorned in some quarters, but it is in the nature of the forex market to forcibly adjust rates that are too far removed from price measures. Logically speaking, therefore, both the JPY80 and 120 rates, being 20% removed from the PPP, are unreasonable (although a +20% divergence in the direction of a weaker JPY is a historical rarity not seen except



(Source) Datastream

just before the Plaza Accord was signed — see graph). There is, however, an asymmetry in response depending on the direction of the divergence. At the JPY80 rate, calls for an adjustment begin to rise, but at the JPY120 rate, many deviant forecasts predicting a further rise to JPY130 or 135 are seen. If we take unprincipled short-term movements such as hedge funds to be the "trees," then long-term movements seen from the point of view of price measures are the "forest." I feel that my earnest attempt to see the "forest" when formulating my USD/JPY outlook has been rewarded over the past year.

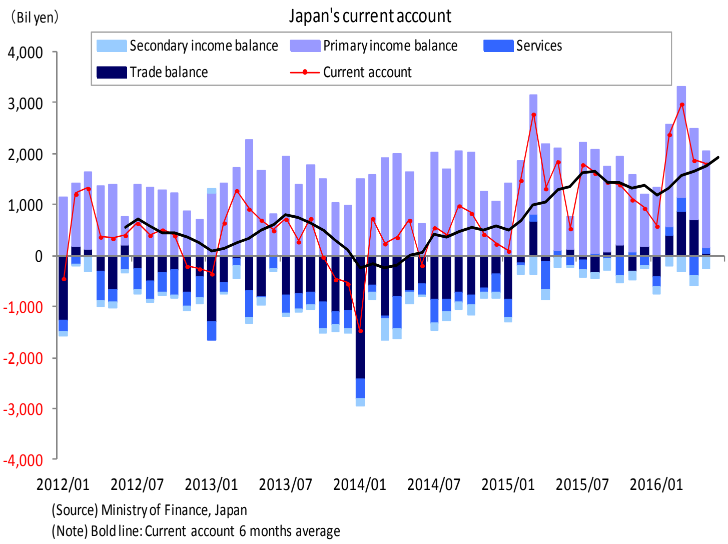
An overshoot in the strong-JPY direction is worthy of concern

Based on the above understanding, I do not feel the need to change my forex outlook. Rather, the thing that most concerns me is an overshoot not in the weak JPY direction, but rather in the strong JPY direction. Specifically, I am worried about the fact that the FRB's "next move" as of the present time is still a "rate hike" (at least as far as the externally presented stance goes). The June FOMC meeting minutes, for instance, reveal some discussions that were based on an awareness of the structural stagnation of the U.S. economy[1]. This is an indication that the rate hike process would necessarily have to be quite gentle.

Actually, a situation where a rate hike can be considered is still quite good. The U.S. economy is currently in the seventh year of its expansion phase, so one cannot ignore the possibility that the "next move" could be a rate cut. For that to happen, the first development would be a change in the language used in the official FOMC statement signaling the end of the normalization process going on since 2013. The main scenario of my outlook over the next one year is that USD/JPY will fall into double-digit rates in response to this. If there is an overshoot in the direction of JPY appreciation, it would be further down the lane from this, when it is actually suggested in the statement that the next move will be a rate cut. At that stage, the discussion would shift to whether a 90 rate can, in fact, be maintained. This risk scenario is not very likely to play out in the next year or so, but cannot be ignored either. Examples of what could trigger such an event include a confrontation between the Italian government and the European Commission over the handling of the bad debt problem of domestic Italian banks, which is slowly beginning to draw attention, and a confrontation between the EC and the governments of Spain and Portugal over fiscal reform policies (details later). The risk of Europe-related factors developing to throw worldwide financial markets into turmoil must continue to be monitored.

Basic JPY supply-demand situation – Emergence of the "most realistic risk"

Peaking of current account surplus

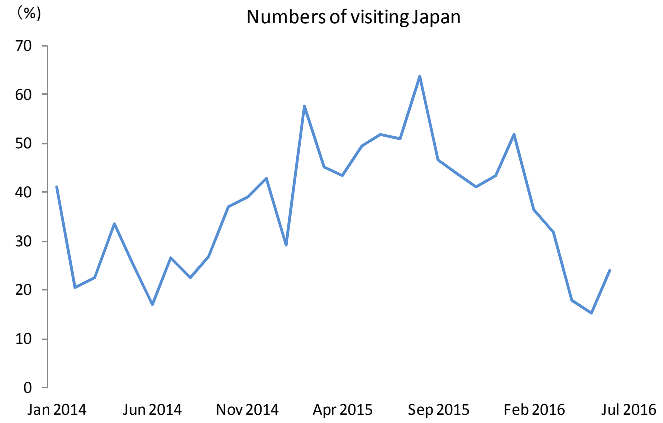


As Japan's May international balance of payment figures were released in July, I think it is worth undertaking a fixed-point overview of the JPY basic supply-demand environment. Japan's current account surplus in May amounted to JPY1.8091 trillion, higher than the median market forecast (JPY1.7512 trillion) and the second consecutive month in which the current account surplus was sustained somewhat below the JPY2 trillion level. The trade/services balance was a JPY157.4 billion surplus, the fourth consecutive month such a surplus was recorded, and this facilitated the continued recording of huge primary income account surpluses, with the primary income account surplus for May amounting to JPY1.898.2 trillion. As a result, Japan's current account surplus for the January-May period amounted to JPY9.6153 billion, which is almost 60% of the level (JPY16.4127 trillion) for the entirety of 2015. However, the trade surplus has shrunk to JPY39.9 billion, the services account does not appear positioned to generate stable surpluses, and one gets the impression from the chart that Japan's current account surpluses have peaked. As explained below, based on consideration of each individual factor, it appears highly likely that Japan's surpluses will be tending to shrink going forward.

[1] Please see the July 7, 2016 Mizuho Market Topic titled "FOMC Meeting Minutes – Fighting Pose Begins to Disintegrate"

Three factors decreasing the current account surplus

As this article has repeatedly argued through last month, the trend of sharp improvement in Japan's current account balance since last year has aspects that suggest weak sustainability. 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), however, since crude oil prices bottomed out in February, it is highly likely that the effect of this factor will progressively diminish going forward. As can be seen from the graph, the trade balance bottomed out in early 2014 and has subsequently been improving, but this improvement has occurred mainly owing to import shrinkage rather than to export growth. Going forward, it appears likely that the recovery of crude oil prices may halt the trend of decrease in imports, leading to a deterioration in the trade balance. (The trend in this regard will depend on the strength of the oil price recovery trend in comparison to the import value-reducing effect of JPY appreciation.)



(Source) JNTO (Note) YoY

Moreover, since JPY weakness made a large contribution to factors (2) and (3), the sharp strengthening of JPY since February can clearly be expected to promote a trend of decrease in the current account surplus[2]. Naturally, factor (2) (primary income account surplus expansion) can be said to reflect the fruits of Japanese companies management strategies regarding overseas business expansion and cross-border M&A transactions. Given that such structural problems as shrinkage of the domestic economy are in the background of those strategies, it would appear unlikely that there will be a major drop in the effect of factor (2) in the foreseeable future. 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 – looking at the period since the start of 2016, an evaluation decrease of at least about 20% (JPY120→JPY100) will be inevitable. Regarding factor (3), some scattered voices have begun noting the shadow falling on such inbound consumption activity as the "shopping sprees" of Chinese visitors in Japan. For example, Japan Department Stores Association figures indicate that nationwide department store sales in June were down 3.5% yoy, the fourth consecutive month of yoy declines. Moreover, figures (estimated) on the number of visitors to Japan released by the Japan National Tourism Organization (JNTO) indicate that the trend of increase has been sustained but is undergoing a noteworthy deceleration. For example, the number of foreign visitors to Japan was up 23.9% yoy this June, with double-digit growth being sustained, but this represents a large deceleration from the 51.8% yoy growth in visitors seen last June, and the trend of deceleration has become quite clear-cut since the start of this year (see graph). In the background of this trend, in addition to the price effects stemming from JPY appreciation, it is probably unadvisable to ignore the general deceleration of the global economy and associated income factors that are affecting prospective foreign visitors to Japan and discouraging them from undertaking overseas travel. Up to now, JPY depreciation has facilitated product exports, and it has been feared that a trend of JPY appreciation may lead to a deceleration of exports. However, the recent period of JPY depreciation has not actually been accompanied by a rise in exports. Instead, Japan has been benefiting from service exports in the form of inbound consumption. This has been a factor supporting Japan's strong export performance, and it can be expected that the impact of JPY appreciation on that performance will gradually emerge going forward.

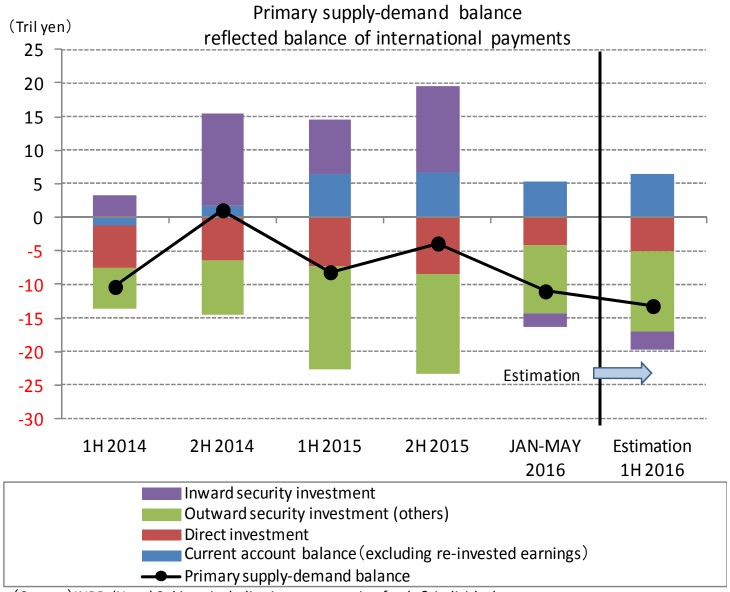
Basic supply-demand and the JPY market so far this year – Emergence of the "most realistic risk"

In light of the above, regarding the basic supply-demand balance (hereinafter "basic supply-demand"; see graph on the next page) for JPY that this article positions as a key guiding factor for its JPY forex rate forecasts, basic supply-demand for the first five months of 2016 was characterized by approximately –JPY11 trillion of net JPY selling. In the background to the situation of net JPY selling despite current account surplus expansion is an 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

[2] International balance of payment figures are reported based on ministerial ordinance reporting-use forex exchange rates defined as "the average effective rates in the month two months prior to the month in question" Accordingly, the JPY appreciation trend that began in February has been impacting international balance of payment figures for April and subsequent months.

been "floating" or unsettled. Moreover, as has been repeatedly focused on in this article, 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. Basic supply-demand is tending to indicate JPY depreciation, and it is possible that the basic supply-demand situation is having the effect of restraining the degree of JPY appreciation compared to the degree that might have occurred in the absence of the countervailing supply-demand situation.



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

Since the negative level of returns on 20-year Japanese government bonds and other situations indicate that no outlook for change in the miserable JPY interest rate environment, the momentum behind Japanese investors' investments in foreign securities is being maintained, and this can logically be expected to continue contributing to a supply-demand environment characterized by net JPY selling. These Japanese investors are literally clinging to flimsy straws of hope. This trend is representative of what this report has been describing as the "most realistic risk factor" with respect the realization of its JPY appreciation scenario. As I will explain again later, however, even though the FRB is maintaining a brave fighting pose regarding its policy normalization process, in the end it will not be able to maintain this posture unless it is prepared to tolerate USD appreciation. I personally am concerned that, the next key point with respect to the FRB's monetary policy management may possibly be an interest rate cut rather than an interest rate hike, and if this possibility actually eventuates, then it may well force a contraction of Japanese investors' investments in foreign securities. (Such a situation would be likely to be particularly difficult for foreign securities investment activity accompanied by the assumption of associated forex risks.) In any case, it is not at all surprising that there would be an increase in investors who are more intent on preparing for a strengthening of JPY for which there is still considerable leeway than they are on responding to U.S. interest rate hikes that are highly uncertain. Going forward, although JPY depreciation spurred by Japanese investors' investments in foreign securities is thought to be the most "realistic risk" factor for the JPY appreciation forecast scenario, it should be understood that that possibility is still categorized as a risk factor rather than being a basis for the main forecast scenario.

BOJ Monetary Policies Now and Going Forward – Could the next move be tapering?

Bias toward qualitative easing invites disappointment

At the BOJ Monetary Policy Meeting of July 28-29, an additional monetary easing was decided. Specifically, under the present Quantitative and Qualitative Easing with Negative Interest Rate (QQEN) policy, the annual purchase pace of stock price index linked exchange-traded funds (ETFs) was almost doubled from JPY 3.3 trillion to JPY 6 trillion. Meanwhile, the pace of annual JGB purchases was not changed, and the annual pace of change in the monetary base was maintained at JPY 80 trillion. Again, the negative interest rate on the BOJ's current account, introduced with great fanfare in January this year, was also maintained at –0.1%, and the annual pace of real-estate investment trust (REIT) purchases was kept unchanged at JPY 90 billion. The additional easing itself was as per majority predictions, but this bias toward a "qualitative" easing naturally ended up inviting disappointment. To add to this, the U.S. April-June period GDP released that same night fell considerably short of market forecasts, resulting in USD/JPY temporarily crashing from 105 before the meeting to 101. As I have been repeating in this report, unless the U.S. real economy can withstand the USD appreciation that would accompany a rate hike, USD/JPY has no choice but to fall as JPY appreciates against USD. This was true over the past year and will be true over the next year.

A worse move than retaining the status quo?

I was personally expecting the *status quo* to be retained, but the meeting ended with what could be described as an additional easing that was as close to a *status quo* as possible. Technically, a quantitative expansion targeting JGBs would have been difficult, as would expanding the margin of the negative interest rate, given the burden it would have imposed on the financial system. However, in the face of calls to coordinate with the government, which had just announced a major economic stimulus package, the Bank could not have remained unresponsive either. Consequently, it decided to implement the only kind of easing possible — a qualitative one. Everywhere in the market, this seems to be the interpretation, and there seems to be brewing a sense of impasse as never before. In the sense that the decision to implement an easing has given rise to such a mood, it may have been a worse choice than retaining the *status quo*. From the perspective of not causing further damage to the financial system, it was wise not to have expanded the negative interest rate margin, but it is quite a grave matter that the Bank's holdings of ETFs have now expanded to JPY 9 trillion (compared with its capital of JPY 7 trillion).

What does "assessment" mean? – A retreat? An "advance-notification home run"? A sayonara easing?

Major outlook by BOJ policy board members (YoY %)

	Real GDP	Core CPI (ex fresh food)	Ex consumption tax impact
FY 2016	0.8～1.0 <1.0>	0.0～0.3 <0.1>	
Outlook as of Apr	0.8～1.4 <1.2>	0.0～0.8 <0.5>	
FY2017	1.0～1.5 <1.3>	0.8～1.8 <1.7>	
Outlook as of Apr	0.0～0.3 <0.1>	1.8～3.0 <2.7>	0.8～2.0 <1.7>
FY2018	0.8～1.0 <0.9>	1.0～2.0 <1.9>	
Outlook as of Apr	0.6～1.2 <1.0>	1.0～2.1 <1.9>	

(Source) Bank of Japan (Note) < > indicate the median estimate by policy board members

The reason given for the additional easing was "Brexit and the slowdown in emerging economies." The logic is similar to the "preventative easing in response to risks" logic applied to the October 2014 Halloween Easing and the introduction of the negative interest rate in January this year. Roughly, it amounts to saying "it is unlikely that there will be a widespread impact, but we took measures anyway because we were concerned about the risks." The FOMC meeting statement released the previous day, however, had only just pointed out that the short-term risks associated with Brexit were receding, and even at the epicenter of the crisis, the Bank of England (BOE) and the neighboring ECB survived without making any changes to monetary policy. In fact, stocks and forex market conditions have also recovered, and the downward revision in the Outlook Report was limited. Taking these into account, the rationale offered for the recent easing seem unreasonable. It seems right to say that the market was more or less right to speculate that the BOJ could not ignore the political pressure to implement an additional easing.

Perhaps in light of these unreasonable pressures on the Bank to ease policy, the monetary policy statement indicated that the Bank would conduct a comprehensive assessment of the effects of the QQEN policy at its next Monetary Policy Meeting, noting that the Chairman had instructed the staff to prepare for it. As of the moment, it is completely unclear what the direction of the assessment is expected to be, but the statement is being interpreted in two main ways — as an advance notification of either (1) another monetary easing or (2) a retreat. I personally think (also including some amount of wishful thinking) it is the latter. With regard to the purchase of long-term JGBs, the statement said it would do so "in a flexible manner in accordance with financial market conditions." Considering the complaints beginning to come from the bond markets that the Bank's intentions regarding monthly JGB purchase patterns are unclear, one cannot rule out the possibility that tapering may be being considered. Domestic and foreign economic/financial market conditions being what they are at the moment, it may be possible to implement tapering while suppressing the rise in interest rates.

What kind of policy changes are possible? I would like to ponder this question over the next six weeks. BOJ Governor Haruhiko Kuroda has commented that there is no change in the determination to achieve the 2% target as early as possible, i.e., there is no change in the strategy of pursuing a 2% inflation rate itself. In that case, what could be changed is the means to achieve the target (i.e., QQEN). Frankly, I would be most comfortable with a change that involved doing away with the widely unpopular negative interest rate policy, utilizing the resultant interest rates, and tapering quantitative easing measures. Abolishing the negative interest rate policy, however, would amount to fickle policy behavior, so it is not all that likely. The only possible change may be to back off on quantitative monetary expansion on the grounds that the initially expected effects are beginning to surface.

Of course, interpretation (1) mentioned above cannot be completely ruled out. That would amount to an "advance-notification home run" style of additional easing similar to the ECB, but such a tactic would be sure to invite the disappointment of the markets – a look at what happened in the case of the ECB offers sufficient explanation. The third possibility is for the Bank to communicate that it has already implemented sufficient measures (including the recent ones) and will now take a break on easing in the quantitative dimension. This would be pattern (3), a compromise between (1) and (2). The market may call it a "*sayonara* easing." As of the present time, this possibility cannot be ruled out either.

Strong-JPY scenario upheld from both U.S. and Japanese sides

There is no change in this report's USD/JPY outlook despite the recent Monetary Policy Meeting results. It seems likely that a phase of big downside risks for USD/JPY will continue for some time in line with U.S. currency policies. USD/JPY was maintaining the level of 103 following the BOJ Monetary Policy Meeting, but crashed to the 101 level temporarily after it became clear that the U.S. April-June quarter GDP had fallen far short of forecasts. Ultimately, unless the U.S. economy is in robust health, its currency, USD, will find it hard to strengthen. Regardless of whether Hillary Clinton or Donald Trump becomes the next president of the United States, it seems unlikely that USD strength will be tolerated by the new administration, and in the end the FRB's monetary policies will also have to be brought in line with this stance.

It is unclear what shape the September assessment of the QQEN will take, but my present view is that the BOJ will acknowledge significant effects from its policies so far and shrink the scope of its monetary accommodation, especially quantitative easing (as of the moment, I do not expect any additional easing to take place at that time, but would like to gauge the situation over the next six weeks). Unfortunately, the BOJ's additional easing will not prove effective in weakening JPY, but shrinking the scope of monetary easing is likely to be effective in strengthening JPY. This report's main scenario, which involves USD/JPY falling to a double-digit rate this summer and its lower bound gradually falling over the next one year, has increasing support not just from the U.S. but also from the Japanese side.

U.S. monetary policies now and going forward – USD appreciation continues to be a difficult prospect

July FOMC meeting – Emphasizing a change in stance

At the July 26-27 FOMC meeting, no changes to the U.S. monetary policy were decided, but parts of the FOMC statement were more upbeat in tone, so the contents were somewhat hawkish if anything. Following the release of the May job data (employment change: +38 K mom, later downgraded to +11 K), the June FOMC statement was dovish in tone, but as the June job data released in July (+287 K mom) was strong, and the markets showed signs of stabilizing following the Brexit turmoil, the upward revisions in the FOMC statement were more or less within the scope of what had been expected.

Specifically, the statement began with the economic assessment: "the labor market strengthened and that economic activity has been expanding at a moderate rate." This was a clear upward revision compared with the previous time's "the pace of improvement in the labor market has slowed while growth in economic activity appears to have picked up." However, the job data for May and June were both extreme, and the sharp fluctuation in tone of the FOMC statement in response to these extremes is problematic. It would have been fairer if at least this time the statement had presented its assessment based on an average of the May and June job data (+150 K mom), and even more desirable to express concern about the slowing pace of employment change since last year. This would be closely related to the issue of the maturation of the economic cycle, which comes up every time. Other changes in the statement this time included the description of economic activity as "expanding at a moderate rate" compared with the previous time's "picked up," and the assessment of personal spending as "growing strongly" compared with the previous time's "strengthen," giving a strong impression that this time's statement was trying to emphasize a change in stance compared with June.

Minutes of the meeting will be worth reading

The statement is still not hiding the FRB's desire to raise the interest rate as its next move. The deliberate inclusion of the sentence "Near-term risks to the economic outlook have diminished" in the outlook section may be suggesting "we could not raise the rate this time, but a hike in autumn or later this year is likely." The minutes of the recent meeting will be worth reading, though, because the April FOMC meeting used the technique (?) of hiding the more hawkish aspects of the discussion by toning down the statement. The direction of both the FOMC statement, which reflects the intent of the Board (the Chair, Vice-Chair, and Governors), and the minutes of the meeting, where the actual details of the discussion are brought out in relief, tend to be the same, but the Board members at present are predominantly doves (example: Janet Yellen, Lael Brainard, Daniel Tarullo), while hawks are in the majority among the other members (example: Loretta Mester, Jeffrey Lacker, and Esther George). As a result, it is not surprising when the minutes of the meeting turn out to be surprisingly hawkish compared with the FOMC statement, as in April (the other possibility is that the Committee is intentionally balancing both sides by allowing the minutes to be in a contrasting tone to the statement). In this sense, the minutes of the recent meeting, to be released on August 17, will be worth reading. Given that Kansas City Fed President Esther George brought back her proposal for a rate hike this time, there are likely to be some rumors of earnest phrases in this connection.

Since the release of the recent statement, the financial markets have factored in a 50% chance of a rate hike within the year, but I think that level of expectation is too high. It may be politically difficult to implement a rate hike inviting

USD appreciation just before the inauguration of a new administration. There will also be a referendum in Italy (details later) to decide whether or not to amend the constitution. This referendum is also seen as a vote of confidence in Prime Minister Matteo Renzi, so the government of Italy will have to work hard to get the EC's approval on a bailout program for its domestic banks. In this context, there is quite a wide gap between the positions of the Italian government and the EC, which insists on establishing the principles of a bail in (in which private-sector holders of the bank's securities will be forced to bear the burden of rescuing a bank from failure). The October-December period is, therefore, likely to be a period of turmoil surrounding the Italian problem.

USD appreciation remains a difficult prospect

My forex outlook remains unchanged even in light of the FOMC meeting statement. The question "will the FRB will be able to implement a rate hike?" shares roots with the question "will the U.S. be able to withstand USD appreciation?" Based on my understanding that the U.S. economy cannot withstand USD appreciation, I have continued to forecast the weakening of USD against JPY, and I continue to hold the same views for the period ahead. As I have mentioned time and again, the FRB is the only central bank in the world right now that can even consider a rate hike. Because of this, as soon as the FRB even hints at an intention to raise interest rates, investment funds rush into USD-denominated assets, causing an across-the-board USD appreciation. This strengthening of USD overwhelms the real U.S. economy, especially its manufacturing sector, causing the FRB to take a step back on its normalization stance. The logic is very easy to understand. After three years on the "normalization process runway," the FRB has been able to implement only one rate hike – the reason for this is that the excessively long duration on the runway has itself strengthened USD enough to have the austerity effect of two or three rate hikes.

Meanwhile, regardless of the country, a new administration is unlikely to proactively support a strong domestic currency in its first year. Whether the new president is Trump or Clinton, going by their statements so far, the new U.S. administration is very likely to desire a weaker USD as its currency policy. No matter how strong the desire for a monetary policy normalization (belt-tightening) is; if the currency policy seems to be facing the opposite direction (currency weakness), the markets cannot trust in a rate hike and buy up USD. The markets do give importance to the words and actions of FRB Chair Janet Yellen, but they cannot afford to overlook the words and actions of the Secretary of the Treasury Jack Lew, who is assumed to reflect the political will, either. The U.S. at present seems to be adopting an unrealizable policy mix (number (7) in the chart above), and this conflict will have to be resolved at some point.

I believe that the adjustment will have to come from the monetary policy side. The U.S. currency policy is not likely to suddenly become tolerant of USD strength just because the job data for a single month was strong and the FOMC statement turned slightly more optimistic. As the sense that the expansionary phase of the economy is nearing its end becomes stronger, the U.S. policy mix seems very likely to change from the present conflicted (7) to either (1) or (3) in the chart above. In either case, the development will make USD top-heavy.

Combination of policy mix

	Monetary policy	Fiscal policy	Currency policy	Policy purpose	Japan, US & Euro zone
①	easing	easing	Weak ccy	overcome the recession, avoid deflationary spiral	Japan
②	easing	easing	Strong ccy	×	
③	easing	tightening	Weak ccy	boost economy	Euro zone
④	easing	tightening	Strong ccy	×	
⑤	tightening	easing	Weak ccy	×	
⑥	tightening	easing	Strong ccy	shrink current account surplus, prevent overheating economy	
⑦	tightening	tightening	Weak ccy	×	US now ?
⑧	tightening	tightening	Strong ccy	prevent overheating economy	

（Source）By Daisuke Karakama, Mizuho Bank

(Notes) × means unrealizable policy.

Risks to my main scenario – Potential ambush from the Italy crisis?

Review of risk scenarios – What could prevent a JPY appreciation/USD depreciation scenario?

This article's main scenario continues to be that there will be a rewinding of the USD appreciation trend that has progressed since mid-2014, and that the rewinding will be accompanied by a strengthening sharp surge in JPY. In short, rather than JPY appreciation, I am anticipating USD depreciation. As a result, I am expecting USD/JPY to decline over the next year with a possibility of reaching the 90 level. In July, USD/JPY resurged upward to pass 107 at one point, but this simply reflected the post-Brexit drawing down of speculators' JPY long positions, and vigorous JPY selling was not in evidence. The same kind of movement was seen this past May, and I do not view the situation as a factor that could shake the main scenario. Going forward, there is a possibility that the "hysterical JPY selling → reactive surge in USD/JPY →renewed JPY buying" scenario will be repeated. It can be said that this pattern is a distinctive characteristic of long-winded JPY appreciation scenarios. While undergoing periodic adjustments, USD/JPY will be progressively decreasing the level of its lows, and the rate will thereby be able to seek new lows in an effortless and sustained manner.

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

Amid this situation, I do not think this month's article needs to make a major change to the forecast scenario but, of course, the scenario is subject to both upside and downside risks. These are presented in the chart on the right. The colored scenarios involve JPY appreciation risks, and the remaining items are JPY depreciation risks. Since the realization of JPY depreciation risks would tend to directly upset this article's main scenario, it is worth briefly overviewing these JPY depreciation risks. Looking at situations during the past year, what kind of factors could possibly prevent the JPY appreciation/USD depreciation scenario during the year going forward?

Overview of JPY depreciation risks – Outward securities investment from Japan the only concern

Since the main scenario has already incorporated the abortion of the FRB's policy normalization process, a greater-than-expected strengthening of the U.S. economy enabling the normalization process to proceed smoothly would represent a major forecasting miscalculation. This is shown in the chart as risk factor (1). With U.S. employment reaching a full-employment situation and signs of budding inflation beginning to be confirmed, there does remain some logical justification for the FRB to boost interest rates. 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. However, there is not much cause for concern regarding this point. Since interest rates are being progressively eliminated worldwide at this time, a U.S. move to proceed with normalization would inevitably spark a flood of managed funds into USD-denominated assets. The resulting across-the-board appreciation of USD against all currencies would be impossible for the U.S. to cope with politically and economically. This is the "USD appreciation trap" situation that this article has discussed numerous times. As evidenced by the newly established "Monitoring List" of the U.S. Treasury Department's Semiannual Report on International Economic and Exchange Rate Policies, at least during the forecast period, I do not expect U.S. currency policy (≈political policy) to be permissive of USD appreciation. This situation will be noted again below with respect to risk factor (2).

In considering JPY depreciation risks, I think it is better to focus more attention on relatively realistic risks. As this article has repeated each month, the miserable JPY interest rate environment is spurring an acceleration of

overseas risk-taking on the parts of Japanese investors, and this (risk factor (4)) has the potential for promoting greater-than-expected JPY depreciation (or preventing the progress of JPY appreciation.) As discussed below, however, given an environment in which U.S. currency and monetary policies will not easily accept USD appreciation, it is questionable whether investors willing to invest JPY while assuming the associated forex risk will become predominant. This article is even considering the possibility that the FRB will reverse its normalization process and head toward additional easing, and it seems that a U.S. interest rate hike this year, and even next year, is an unlikely possibility. Certainly, even though there in fact may be no attractive investments within Japan, it is still hard to imagine a scenario in which JPY depreciation could take root in the absence of an FRB move to hike interest rates.
Admittedly, there is always another latent JPY depreciation risk scenario in which the policy responses of the Japanese government and the BOJ (specifically, forex market intervention and additional easing) might elevate USD/JPY (risk factor (6)). 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, and market participants are probably expecting this. As already noted, 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.

Overview of JPY appreciation risks – Might this year's last big event be in Italy rather than the U.S.?
To repeat, I do not think the U.S. currency policy stance will become permissive of USD appreciation during the forecast period. This is based on consciousness of risk factor (2). Regardless of whether the U.S. economic and financial situations are showing signs of overheating or not, the current period of economic expansion has become among the longest in U.S. macroeconomic history, and there has long been concern about when this period will end. I do not believe the U.S. currency and monetary policies have the leeway for boldly implementing multiple interest rate hikes in this kind of situation, and if this is true, then it is natural to expect the downward adjustment of USD seen over the past two years to continue for the time being. Certainly Donald Trump and even Hillary Clinton have a history of making hints that they would guide USD downward, and it is impossible to deny the possibility that the currency policy of the newly inaugurated U.S. president will place an unexpectedly heavy weight on USD/JPY. Within the rules of the floating exchange rate system, U.S. monetary policies play the most important role. In his January 2010 State of the Union speech, President Obama announced that his "export doubling plan" called for doubling exports and creating 2 million new jobs over a five-year period. The super-strong JPY scenario that took shape during the subsequent three-year period (2010-2012) is something that should be kept in mind.
Another JPY appreciation risk worth noting is that the FRB could reverse its normalization process and head toward additional easing (risk factor (3)). The current period of economic expansion has become the fourth longest (85 months long as of July) in U.S. macroeconomic history, and growth in U.S. nonfarm payrolls (NFP) have been gradually but clearly decelerating. In light of FOMC statements, the FRB's "next move" officially still appears to be an interest rate hike. If the economic expansion runs out of gas, however, it has to be presumed that there will be a scenario shift calling for an interest rate reduction rather than a hike. Essentially, while the "U.S. interest-rate-hike guessing game" has been the forex market's biggest theme during the past three years, one should make sure to keep aware of the risk that the game is becoming 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 (≈ 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. As I emphasized in the article last month, so many unexpected things have happened. 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.

Another significant JPY appreciation risk is that related to Europe (risk factor (6)). As described in greater detail below, the risk associated with Italy is beginning to sharply surge. In the case that the government of reformist Italian Prime Minister Matteo Renzi were to fall, there would be great potential dangers associated with the subsequent general election, including the possibilities of a strengthening of anti-EU parties and perhaps the organization of a referendum on whether to leave the EU. While it may be standard practice to expect the U.S. presidential election to be the last big event of this year, one should be wary of the possibility that an ambush by the Italian crisis could trigger an accelerating general shift to a risk-off mood. Moreover, while the selection of Theresa May as U.K. prime minister appears to have somewhat ameliorated the Brexit crisis, it cannot be said that the strength of the Scotland independence movement has diminished. In addition, key EU countries (the Netherlands, France, and Germany) will be holding important governmental elections during 2017. Although concerns about a second or third country exiting the EU during the forecast period may be unrealistic, since rightwing populism is strengthening in each country, there is a constant potential for the elections themselves to become considered significant risk events. In light of this, it should be recognized that JPY will constantly have the potential for a strengthening surge.

EUR Outlook – Concerns about ECB's insensitive policy management

ECB Monetary Policies Now and Going Forward – The Calm before the Storm?

Status quo maintenance but approaching a decision on parameter adjustment

At July ECB Governing Council Meeting, the policy interest rate (the interest rate on the main refinancing operations (MROs)) was kept unchanged at 0.00%, and the ceiling and floor of market interest rates (the interest rates on the marginal lending facility and the deposit facility, respectively) were also kept unchanged at 0.25% and -0.40%, respectively, resulting in the gap between them (the interest rate corridor) also remaining unchanged at 0.65 pp. About a month has passed since Brexit, and the financial markets are beginning to calm down, and the impression from the press conference was one of matter-of-fact response to the expected questions. The introductory statement included the line – "Following the UK referendum on EU membership, our assessment is that euro area financial markets have weathered the spike in uncertainty and volatility with encouraging resilience." – in one of the first few paragraphs, so it appears that the ECB's stance is that the volatility following Brexit has been successfully overcome (for now).

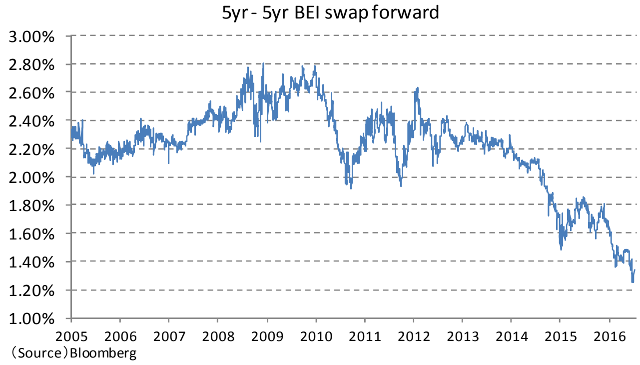
There was some speculation in advance of the meeting that there would be some relaxation of the expanded asset purchase programme (APP) parameters (such as the 33% rule, purchase ceilings for individual countries based on the share of their contributions to the ECB's capital (the capital key), etc.), but regarding the capital key, President Draghi clearly stated that – "We had no discussion about that." However, given that it would be difficult to take such initiatives as those to expand monthly purchases or extend the program after March 2017 while maintaining the APP's current framework, it appears that a decision on adjusting the parameters is likely in the near future. As discussed below, Draghi's showing a positive attitude about the use of public funds to help resolve Italy-based banks' problems with non-performing loans (NPLs) appears to be an important factor with respect to Europe's future. If an "ECB and Italy vs. the EC and Germany" scenario takes shape regarding the Italian banking problem, then internecine strife in Europe may once again become a market moving factor.

Possibility of parameter adjustment in September and additional easing in December?

The possibility of APP parameter adjustment was the issue attracting the most attention prior to the meeting, and the first question posed at the press conference was about this possibility. In response, Draghi said that – "we concluded that we didn't have yet information to take decisions." He went on to say – "over the coming months when we have more information, including new staff projections, we'll be in a better position to reassess the underlying macroeconomic conditions." – and this has laid the basis for expectations that a decision may be made at the next meeting in September. In very general terms, I believe it highly likely that the kinds of changes that may be made going forward may include a repeal of the 33% rule at the Governing Council Meeting on September 8 along with an expansion of monthly APP purchases as soon as October 20 and as late as the December 8 Governing Council Meeting. In addition, other parameters with leeway for adjustment include the purchase ceilings for individual countries based on the capital key and the use of the deposit facility interest rate as a lower limit on the yields of bonds eligible for purchasing. Since there is a strong perception that the latter parameter is impeding the APP's smooth implementation, it would not be surprising to see that parameter eliminated. (At the time this article was written, this parameter made it impossible to purchase German government bonds with maturities up to seven years.) Since, for instance, the BOJ is naturally unconstrained by a 33% rule and faces no lower limit on the yields of bonds eligible for purchasing, it would not be surprising to see the ECB consider the elimination of those parameters as a means of promoting the APP scheme's sustainability and expandability.

However, there are believed to be high hurdles on the path toward eliminating purchase ceilings for individual countries based on the capital key. Already, Reuters has quoted an anonymous Governing Council member as saying – "we'll amend the rules if necessary but it's not on the agenda now. I would expect such changes to be quite technical. The capital key would be political, however." – and this kind of statement suggests that capital key-related changes will not be easy to implement. The concept of allocating profits (as well as losses) in proportion to percentage shares of capital invested is a fundamental part of diverse systems, including those of the euro area, and rigorous compliance with the concept plays an important role in helping prevent perceptions of unfairness. If the capital key rules were to be relaxed, it is possible that there would be a perception of a bias toward the purchasing of core countries' bonds going forward and that the overall structure of the ECB's portfolio would become disproportional. Given that the ECB is the central bank for the 19 countries that have adopted EUR, such a situation would be a highly significant distortion, and it therefore appears unlikely that gaining approval of changes to the capital key rules would be a simple process.

Implementing the "next move" based on inflation expectations



(Source) Bloomberg

Trends in inflation expectations are an important basis for forecasting the ECB's "next move." In this regard, there is considerable attention focused on whether Brexit has changed the ECB's perspective, but ECB President Draghi has denied any such change, stating – "What I know is that on inflation outlook, Brexit didn't seem to have any major impact at this point in time." Of course, there has been some deviation between the survey-based inflation expectations obtained from the ECB's survey of professional forecasters and the market-based inflation expectations expressed in terms of five-year in five years inflation swap break-even inflation (BEI) levels, with the former measure of expectations being anchored while the latter measure of expectations often being unstable. Although Draghi's view is that market-based inflation expectations are showing a tendency to rise, he also stated that – "we can't say much about this at this stage. We need a little more time to assess what is the state of the market-based inflation expectations." As a matter of fact, although there has been some recovery, five-year in five years inflation swap BEI is moving at historically record low levels, and it is becoming increasingly difficult to assert that inflation expectations are anchored. It seems likely that decisions about the "next move" may be based on inflation expectation-related factors

"ECB and Italy vs. the EC and Germany" scenario?

As discussed later, the situation in Europe currently attracting the most attention is the task of resolving Italian domestic banks' NPL problem and the associated issue of Italy's political fluidization. The EU has begun the full-scale implementation of bail-in rules (creditor-funded recapitalization rules) this year, and there is an ongoing confrontation between the EC, which wants government entities to rigorously implement the rules, and Italy, which wants to take special measures to allow for the use of public funds to bail out its banks. In light of what has already happened – the suicide last November of a pensioner who lost his savings invested in shares of a bank when that bank's shareholders and bondholders were forced to shoulder the burden of that bank's rescue – Italy's government is intent on using public funds to bail out problematic banks. In the case that this ambition is thwarted, it is possible that Italian prime minister Matteo Renzi would then have to relinquish his position and that he would be replaced by the leader of an anti-EU political party. The position of the EC and highly bail-out-averse Germany, on the other hand, is that extreme prudence should be exercised with regard to the approval of an exception to the new bail-in rules immediately after their implementation.

Related questions were posed at the recent press conference. For example, one reporter asked – "And do you think that some degree of public support for banks in the euro area is acceptable or indeed desirable?" Even though Italy was not specifically mentioned, it was clear that participants in the press conference were thinking about Italy. In response, Draghi said – "we have in place the rules. We have in place rules of state aid, we have the BRRD, and as I said several times, these rules contain all the flexibility to cope with exceptional circumstances. The power and the responsibility in activating these rules and in complying with these rules lies with the Commission." Draghi further articulated his position later in the press conference, saying – "public backstop is a measure that would be very useful but certainly should be agreed with the Commission according to the existing rules." To the extent discernable based on these statements, it appears that Draghi has a somewhat positive attitude toward the use of public funds to cope with crises and is hoping that the EC will bring its approach into harmony with his. If this is true, then it is possible that there may be an "ECB and Italy vs. the EC and Germany" internecine strife scenario going forward. There is a possibility that some people will be inclined to joke that Draghi's position may be associated with the fact that he is an Italian. In any case, although the recent press conference overall was concluded amid a sedate atmosphere, it may well have been "the calm before the storm."

Sense of crisis about insensitive policy management – Scattered signs of policy authorities' budding anxiety

Sense of crisis about insensitive policy management

In addition to the routine outlook regarding international economic and monetary situations this year, one gets a disturbing premonition that there may well a re-incidence of irregular market-moving factors stemming from Europe in the near future. Despite the Brexit-related developments causing rising concerns about the possibility of the EU's progressive break-up, the insensitivity of the EU's policy management to the situation is conspicuous. In my book published two years ago (July 2014), entitled "Ready for the Japanization of Eurozone, Euro and ECB," I warned against excessive emphasis on the liquidation principle, writing – "avoiding excessive hastiness in all kinds of normalization processes could be a key to at least slowing the pace of the euro area's Japanization." I expressed my doubts about the nature of new bank bankruptcy regulations requiring dogmatic emphasis on maintaining fiscal balances and on rigorous requirements that the private sector bear related burdens, but we are seeing the problematic development of both kinds of emphases in line with my concerns at this point, and one cannot help fearing that these may lead to the next flashpoints. Specifically, two situations are attracting particular attention – (1) sanctions against the fiscal budget deficits of Spain and Portugal and (2) rigorous application of bail-in restrictions regarding Italy's domestic bank crisis. It should not be overlooked that both these situations represent policy management methods with the potential for further inflaming the anti-EU sentiments stirred up during the Brexit situation.

Why insist on budget deficit sanctions at this time?

Regarding the first case, in July, there were moves to warn Spain and Portugal about financial penalties to be levied in view of those countries' fiscal budget deficits. Specifically, on July 12, the EU Economic and Financial Affairs Council (ECOFIN) ruled that Spain and Portugal failed to make sufficient efforts to reduce their budget deficits and approved the start of sanctions proceedings against the two countries. As a result, there was a prospect that the EC would propose fines (up to 0.2% of GDP), but on July 27, the sanctions were postponed on the condition that the countries present a report on additional fiscal consolidation measure by October 15. However, in the case that the additional measures proposed this autumn were too be deemed insufficient, there remains a possibility that the sanctions could be imposed, so the problem's resolution has essentially been postponed. The Stability and Growth Pact (SGP) requirement that counties to keep their fiscal deficits below 3% of GDP has already been disregarded numerous times without a single instance of sanctions, so the imposition of sanctions at this point would the a historical first.

At this stage, the EC is postponing sanctions based on political judgments, but the very fact that sanctions are being considered has a dangerous potential for further fanning the flames of anti-EU sentiment that has been rising since the Brexit referendum. Naturally, high officials of both countries have been leaking news of their dissatisfaction ever since the ECOFIN ruling. Spain's economy minister, Luis de Guindos, criticized the ruling, saying that – "It would be a paradox if sanctions were applied to a country that has the highest growth rate in Europe" – and Portugal's Prime Minister António Costa expressed similar opposition, saying – "It would be an extremely wrong, unfair decision ... It would be counter-productive too ..." Both statements are probably making the point that the imposition of sanctions would only have the problematic result of restraining economic growth. The leeway for arguing against that point is narrow at this time. In the context of the G20's efforts to promote growth, the concept that "if you are unable to implement austerity you will be fined" should be recognized as being anachronistic, and the EC's efforts to justify that concept are strange. The imposition of austerity in an environment characterized by fears of deflation is fundamentally paradoxical, and it is likely that anti-EU political parties in Spain and Portugal as well as other EU countries will leverage this situation to justify their stances.

Naturally, there may be negative repercussions if the EC is lenient with regard to the fiscal reconstruction efforts of Spain and Portugal, as such countries as Italy and Greece are encouraged to shift their policy rudders toward fiscal expansion, which would increase the risk of another financial crisis. Since none of the EU countries are able to use forex rates as means of stimulating their economies, there is no alternative for them but to use discretionary macro-economic fiscal spending, and it can be assumed that many EU countries would like to be employing those policies if they were permitted to. There is undoubtedly a medium-to-long-term risk inherent to this situation. Ultimately, the EU policy authorities have to undertake a comparative weighing of "the medium-to-long-term risk of a financial crisis" and "the short-term risk of a growing anti-EU mood," and implement their policies in accordance with the result of that comparison, but it appears at this point that the EC will make the judgment that it is more intent on avoiding the latter risk. Given that the European integration project is in an unprecedented predicament in the aftermath of Brexit – the greatest failure in the EU's history – it is clear that EU's most important priority right now is preventing a further rise in the anti-EU mood, so the EC's decision to postpone sanctions is probably appropriate. However, this same problem will have to be readdressed in October, and it will be important to monitor this situation closely.

Bail-in rule is a harsh medicine

Regarding the second situation, there is considerable concern about the question of whether Italy is permitted to use public funds to bail out its domestic banks. The question is whether the Italian banks that have fallen into difficulties can be saved with public funds (a bail out) or whether the private-sector holders of the bank's securities will be forced to bear the burden (a bail in) in line with EU rules, and there is a growing confrontation between those arguing for one or another of these alternatives. In accordance with its new Bank Recovery and Resolution Directive (BRRD), the EU has since January 1 2016 begun the uniform application of its bail-in rule, which in the event of bank bankruptcies requires the burden to be borne by the bank's private-sector shareholders and subordinated bond holders[3]. Because of this, one may ask "why apply the bail-in rule now?" and simply get the answer that "the regulations stipulate it." Still, at a time when the European integration project is on the verge of its greatest crisis, it is worth giving a bit more careful thought to the issue of what will be gained by rigorously enforcing the rule. Italy is asking the EU for a bail-in rule exemption allowing for temporary government assistance, but disregarding the BRRD so soon after its application is opposed by a Germany-led group of countries with relatively healthy economies. It has been reported that German government officials have said "there is leeway for a certain amount of compromise," but they have also been reported to have been saying that "it is desirable that a certain partial amount of loss burden be imposed on creditors." In short, while the protection of a portion of retail investors may be allowed, the fundamental position is that measures to protect all creditors from sharing in losses will not be allowed (Reuters, July 15). However, Italy is currently asking to completely avoid a bail in – in other words, it wants to prevent all creditors from bearing a loss burden – so there is a considerable gap between the two sides.

To understand this problem, there is a need to go back and review events since last November. Last November, prior to the 2016 application of the bail-in rule, several troubled regional banks in Italy were liquidated through a process that imposed losses on subordinated debt holders. It has been speculated that the reason the liquidation was undertaken prior to the 2016 application of the bail-in rule is that, if the process was begun after the bail-in rule's application, then the scope of those bearing the loss burden would not be limited to shareholders and subordinated debt holders, but would also encompass ordinary depositors with deposits exceeding EUR100,000 and holders of unsecured senior notes. The problem is that, because many individual investors in Italy purchase subordinated bonds to serve as their pension assets, the greatest victims of the aforementioned liquidation process are those Italians living on their pension assets, who were put in a very difficult situation. Then, at the end of last November, a pensioner committed suicide and left a letter saying that his bank had driven him to do that. This incident was widely reported, and the response has been the spread in Italy of a general skepticism regarding the bail-in type of liquidation method. While the circumstances probably vary from country to country, if the bail-in rule is rigorously enforced, it seems likely that similar situations may arise in other countries. Bail-in rules have been created based on a straightforward and simple view that "financial institutions should not be bailed out by tax payers." Once the rules are enforced, however, the fact that specific individuals are forced to bear loss burdens presents a risk that the bail-in approach will turn out to be perceived as a harsher medicine than the bail-out approach.

Bail-in rules may trigger the retirement of Italian PM Renzi

Another factor complicating the situation is that Italy is scheduled to hold a referendum this October regarding a constitutional amendment to reduce the power of the country's upper legislative house. It has been reported that Prime Minister Renzi has pledged to retire from his post if the referendum proposal is defeated, so the referendum is akin to a vote of confidence in the prime minister. This means that rigorous enforcement of bail-in rules may well lead to the defeat of the referendum along with the fall of the current government. Since last year, there has already been rising unhappiness among Italians regarding Italy's role as a gateway for immigration into Europe, and it appears that the use of bail-in rules to impose losses on individual investors would serve to make

General elections from 2016 to 2018

2016	OCT	Lithuania, Romania
2017	MAR	Netherland
	APR	France presidential election（first ballot）
	MAY	France presidential election（second ballot）
	JUN	France lower house
	AUG-OCT	Germany
	OCT	Luxembourg, Czech
2018	FEB	Cyprus presidential election
	APR	Hungary
	MAY	Italy general election deadline
	MAY	Belgium
	JUL	Slovenia
	SEP	Sweden
	SEP	Austria
	OCT	Latvia
	OCT	Bulgaria

（Source）By Daisuke Karakama, Mizuho Bank

[3] Designed to break the problematic chain of connection between banking crises and government debt crises, the Bank Recovery and Resolution Directive (BRRD) requires that stockholders, subordinate debt holders, and other creditors representing 8% of a bank's total balance sheet will have to be bailed-in (accept losses) before government authorities can inject public funds. This is generally referred to as the "bail-in rule."

doubly sure that the general dissatisfaction level rises still further. As the chart shows, Italian legislators' terms are scheduled to end in May 2018, but if Renzi steps down, it is possible that general elections will be held ahead of schedule. In any case, political risks are likely to be elevated during 2017, during which numerous major elections are scheduled to be held.

Currently, the Italian political party with the highest level of support is an anti-EU party, the Five Star Movement (Movimento 5 Stelle, M5S). In light of this and the recentness of the Brexit referendum, it would seem wise for the EC and other EU policy organs to exercise great prudence in considering the optimal method of enforcing the bail-in rules. (I personally consider the rigorous application of the investors' burden principle with respect to bankruptcy processes to be rife with risk, and I think there is a need to reevaluate it...)

Simply inflaming "own country vs. EU" sentiment

To the extent discernable from the above review of policy management, it appears that EU policy authorities (≈the EC) have not learned anything from the Brexit situation, or perhaps they have drawn mistaken conclusions from that situation – it must be one or the other. Just as immigration became a major issue in the U.K., it should be noted that the issue of austerity in Spain and Portugal and the issue of bail-in rules in Italy have become issues inflaming "own country vs. EU" sentiment. While fiscal austerity and bail-in may be theoretically correct policies (making them all the more troublesome), in light of the recentness of the Brexit confirmation, it must be said that moves to emphasize such policies are inept from the perspective of political strategy. Regarding austerity policies, when one adopts a long-term historical perspective on how such policies have frequently been flexibly managed, it is hard to confirm that requiring a fundamentalist approach to austerity at this point in time is rational or what the real intention is. Regarding bail-in rules, also, it is understandable that it is difficult to allow the rules to be eroded so soon after the implementation of BRRD, and yet given the impending schedule of political events in Italy, it is hard to deny that rigorously implementing the rules is likely to generate great problems.

At this time, the EU should be giving top priority to preventing a further widening of its existing wounds. Specifically, it would seem that the EU should be doing whatever it can to distract the world's attention from factors that spur discussion of the possibility of the EU's progressive break-up. It is questionable whether the EU truly has a strong commitment to doing whatever it takes to prevent a second or third country's departure from the EU. The EU does not seem sufficiently concerned about this. One should keep alert to the possibility that events around this October – including the submission of fiscal reconstruction plans by Spain and Portugal and the referendum in Italy – may become Europe-related market-moving factors that spur considerable turmoil.

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