Mizuho Bank

One MIZUHO

Forex Medium-Term Outlook

31 August 2016

Mizuho Bank, Ltd.
Forex Division

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Overview of Outlook

USD/JPY has continuously been showing signs that it may descend below 100, but it has somehow been able to keep above that level. Owing to speculators' accumulation of JPY long positions and other factors, it appears that the supply-demand environment is having the effect of making an additional JPY appreciation swing difficult. During August, a succession of statements by FRB Chair Janet Yellen and other high-level FRB officials encouraged expectations of an incipient interest rate hike, and this situation supported the level of USD/JPY. However, my fundamental forecast outlook remains unchanged. Since last year, my forecast has been centered on my expectations that "for political and economic reasons, U.S. currency and monetary policies will not be able to accept USD appreciation" and that the result will be "a trend that is more reflective of USD depreciation than of JPY appreciation." I believe that this perspective will remain valid for the next year. In fact, may well be that the FRB will boldly undertake an interest rate hike during 2016. In preparing my forecast, however, I anticipated that U.S. interest rate hikes would only begin promoting a trend of JPY depreciation if they are sustained. It is probably unrealistic to assume that consecutive interest rate hikes will be implemented despite the views of some observers who believe that the neutral level of the U.S. policy interest rate is decreasing. 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. I am continuing to expect a possibility that USD/JPY may settle down at the 90-95 level during the forecast period.

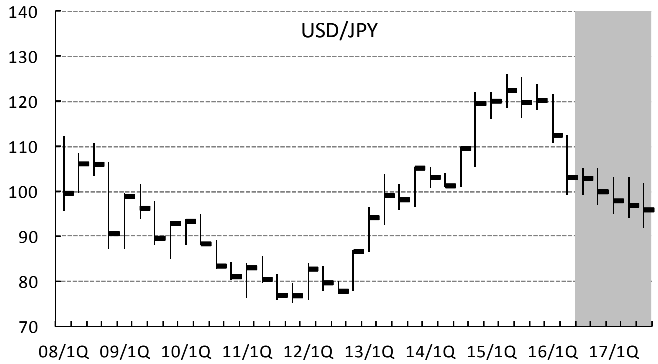
EUR has continued to be lacking in a clear-cut sense of directionality. However, the euro area's current account surplus has risen to an average monthly level of EUR20-30 billion (≈JPY2.3-3.4 trillion) since the start of 2016, and it appears certain that the area will have the world's largest current account surplus this year. Despite this, EUR shows no signs of appreciating against USD in line with that situation. If the FRB's normalization process comes to appear likely to be aborted in accordance with this article's assumptions, it would be wise to be alert for the possibility of an upswing in EUR. On the other hand, EUR upswings have already on innumerable occasions been halted by ECB easing in the past. While the direction of U.S. currency and monetary policies have overwhelming power within the floating exchange rate system, additional easing by the ECB – which overseas the only currency rivaling USD in terms of the quantity of money in circulation – may be able to counter the direction of U.S. policies to a certain extent. (A similar effort by the BOJ would be futile.) In view of the fundamentals, I believe there is a possibility that EUR/USD may return to 1.20 during the forecast period. However, given expectations of additional easing by the ECB and given such problematic situations as the Italy's crisis and October referendum and the unclear ramifications of Brexit, it seems unlikely that any resurgence in EUR/USD could be sustained to that point.

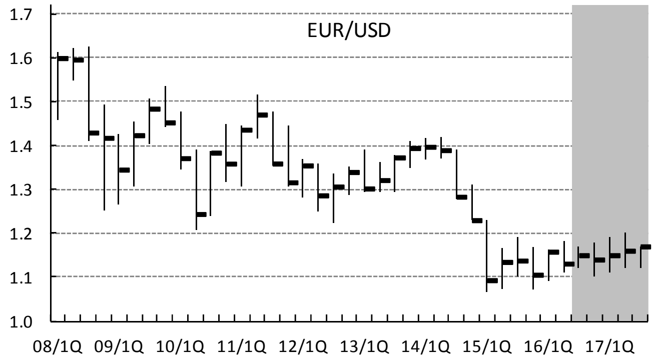
Summary Table of Forecasts

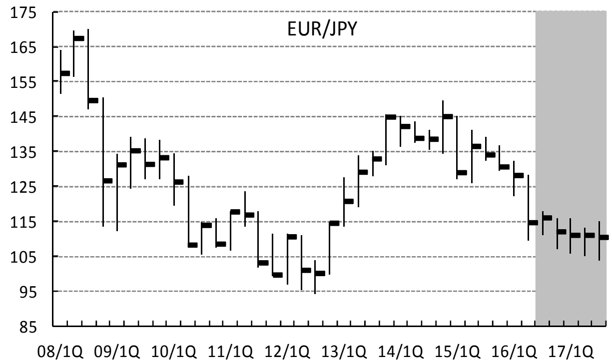
	2016 Jan-Aug (actual)	Sep	Oct-Dec	2017 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	99.00 ～ 121.70 (103.11)	99 ～ 105 (103)	97 ～ 105 (100)	95 ～ 103 (98)	94 ～ 103 (97)	92 ～ 102 (96)
EUR/USD	1.0711 ～ 1.1616 (1.1141)	1.10 ～ 1.15 (1.13)	1.08 ～ 1.16 (1.12)	1.09 ～ 1.17 (1.13)	1.10 ～ 1.18 (1.14)	1.10 ～ 1.18 (1.15)
EUR/JPY	109.30 ～ 132.45 (114.86)	111 ～ 118 (116)	107 ～ 116 (112)	106 ～ 116 (111)	105 ～ 113 (111)	104 ～ 115 (110)

(Notes) 1. Actual results released around 10am TKY time on 31 August 2016. 2. Source by Bloomberg 3. Forecast rates are quarter-end levels

Exchange Rate Trends & Forecasts





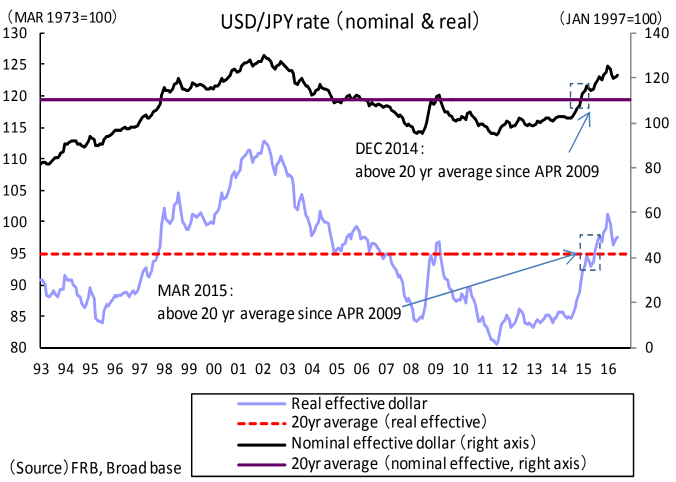


USD/JPY Outlook – What extent of USD strength reversals must be forecast

USD rates now and going forward – What issues are important and what they signify

Up to what point USD strength reversals will continue

Barely more than four months remain in 2016, so it may be time to take stock of the various issues at stake including from the standpoint of the forex outlook for the coming year. My view as of the current time is that the important issues over the next one year will not be much different from those over the past one year. Since last year, I have laid emphasis on the argument that USD strength is unlikely to be tolerated by the monetary and currency policies of the U.S. from either a political or economic standpoint – I have emphasized that the market tone is one of USD weakness rather than JPY strength. This argument is likely to remain valid next year, after the new president of the U.S. takes office. Rather, one may say that this point is unlikely to change precisely because a new president will take office, because few new administrations anywhere in the world tolerate domestic currency strength during their first year in office.

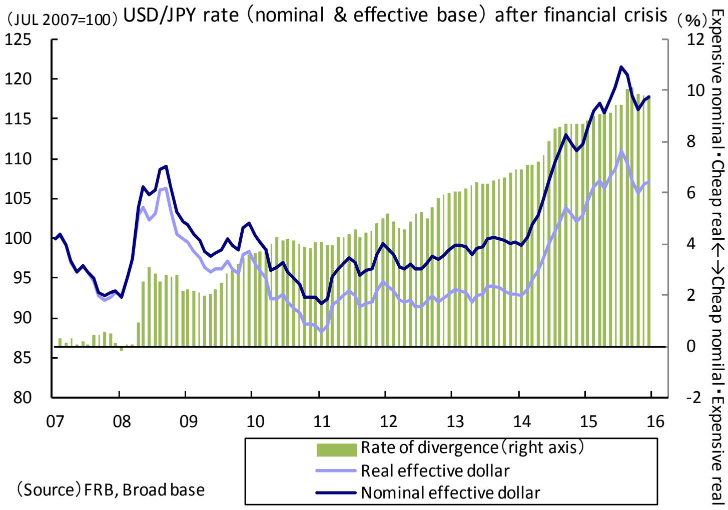


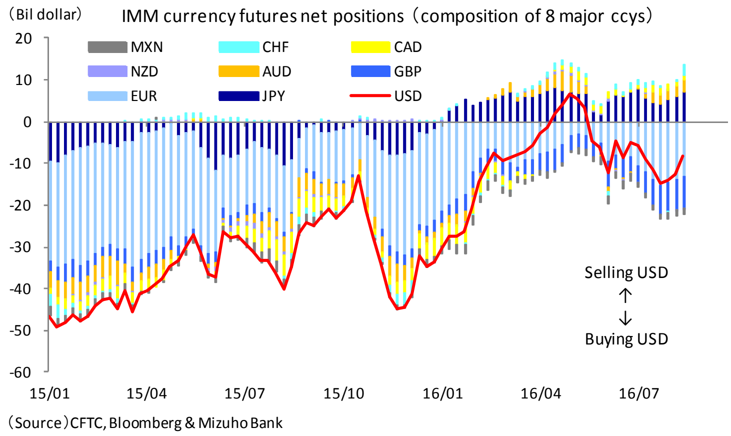
<ins>Of course, it is natural to wonder about the extent to which USD strength would have to be reversed before a turnaround can be accepted.</ins> It is a difficult question, but the usual practice is to pay attention to the divergence of the real effective exchange rate (REER) and the nominal effective exchange rate (NEER) from their long term averages. In this context, it must be said that the REER has managed to converge quite a bit toward its long-term average since the beginning of this year (see exhibit). There are, however, significant doubts as to whether the decrease is sufficient when seen in light of the steep rise since mid-2014. Meanwhile, although the NEER has peaked out since the beginning of this year, its convergence has been limited when compared with that of the REER,

rather giving a strong impression of a continued upward divergence from the long-term average. Unless both the REER and the NEER decrease and clearly fall below their long-term averages, it would be difficult to declare that the adjustments following the recent USD appreciation phase are over.

What REER and NEER divergences indicate

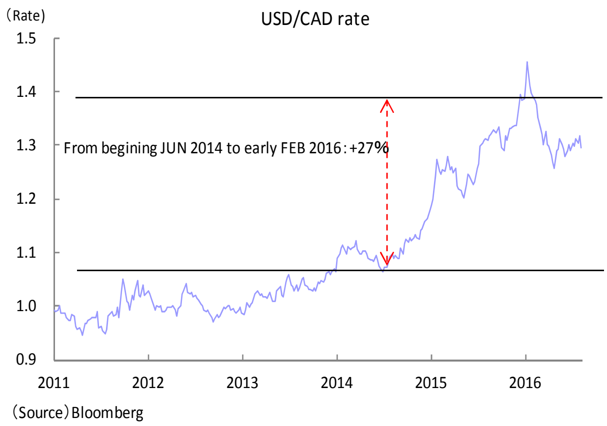
In the graph to the right, the start of the financial crisis is taken as the point of origin, REER and NEER at this point are taken to be 100, and their movements since then have been tracked against the base value. It is clear that both became increasingly divergent following the crisis, but the pace of divergence has increased particularly since 2014, when the FRB began its normalization process. The fact that both REER and NEER are diverging indicates that NEER trends have not been allowing for an adjustment of the domestic to foreign price gap (i.e., that purchasing power parity, PPP, has not been working). Looking at USD/JPY over the past one year, for instance, a rate of 120 or 125 is a divergence from the PPP of over +20%. It is precisely because such a level is so unreasonable that an adjustment has been taking place since the beginning of this year. However, the fact is that USD's NEER has remained consistently high compared with its REER, and the margin of divergence is still quite wide. In other words, even though the adjustment of USD has progressed against JPY, it has not been quite as successful in terms of REER (i.e., in comparison with its main trading partners' currencies). In short, there is still scope for USD depreciation against several currencies. In fact, looking at the speculative position trends in IMM currency futures transactions (see exhibit), USD net long positions exist against eight major currencies. USD short positions are mainly against JPY, AUD, and CHF, but because the USD long positions against EUR and GBP are extremely large, USD purchases have become deeply rooted in the forex markets overall (see exhibit). To look at it another way, if the FRB's normalization process really begins to derail, with the FOMC statement taking on a clearly dovish note, currencies like EUR and GBP could easily post large recoveries against USD. If that happens, USD could begin to be predominantly sold off in the forex markets, and one cannot rule out the possibility of JPY also becoming embroiled in this and appreciating.



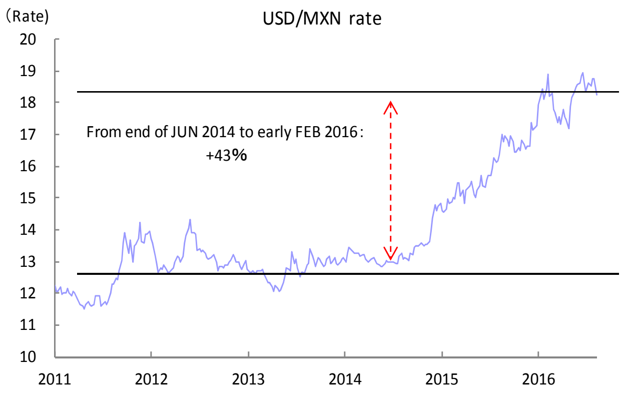


Adjustments against NAFTA currencies still halfway

In addition, the currencies of the North American Free Trade Agreement (NAFTA) member countries, CAD and MXN, are extremely important to the U.S., as these countries are some of the U.S.'s biggest trading partners. Looking at the figures for 2014, for instance, 34.1% of all U.S. exports were aimed at the NAFTA countries (Canada 19.3%, Mexico 14.8%; Source: JETRO). It is well known that U.S. automakers have a large number of factories in Canada and Mexico. The two countries also share land borders with the U.S. It is natural, then, for USD rates against these two currencies to have great political and economic significance for the U.S. The fact is, however, that USD rate adjustments against these two currencies have not progressed sufficiently. As the exhibit shows, USD has halfway recovered from its high against CAD, but remains stubbornly high against MXN.



Some say that the appreciation of USD against these two currencies may have increased the political chances for the anti-free-trade factions in the U.S. and eventually led to the Trump-Sanders phenomenon. The inclusion of Canada and Mexico in the Monitoring List in the April 2016 Semiannual Report on International Economic and Exchange Rate Policies was not entirely unrelated to this either. Even if the new administration takes a tolerant attitude toward USD strength in its currency policy, it will only be after USD adjustment against these two currencies has progressed sufficiently, and in forecasting forex rate trends, it will be important to monitor developments in this area. Amid clear signs that U.S. manufacturing sector employment has been dampened by USD strength, the most important question to ask is whether the U.S. economy and politics will tolerate a greater level of USD strength. I am not yet confident of the U.S. ability to withstand a stronger USD.



(Source) Bloomberg

JPY basic supply-demand climate – At the end of 1H of 2016

Balance of payments for 1H of 2016

In August, Japan's June Balance of Payments were released, which revealed the basic supply-demand position of JPY as of the end of 1H of 2016. The June Current Account Balance fell short of the median of market forecasts (+JPY 1.1035 trillion) at a surplus of +JPY 974.4 billion, but posted a yoy increase of +JPY 433.4 billion. With this, the current account balance for 1H of 2016 (January to June) is a surplus of +JPY 10.6257 trillion, which is a yoy increase of +2.5317 trillion. This expansion of the surplus is mainly attributable to (1) the trade balance turning positive, and (2) the shrinking of the service balance deficit (see chart). Regarding (1), this year's +JPY 2.3541 trillion is an improvement of +JPY 2.7295 trillion over the previous year's deficit of -JPY 375.4 billion, and this is the main reason behind the current account surplus expansion. However, looking at import and export trends, exports declined by -JPY 4.0916 trillion yoy, while imports decreased by -JPY 6.8208 trillion yoy, meaning that the trade surplus expansion is mainly due to the large fall in imports (needless to say, this reflects the sharp fall in crude oil prices). Given that crude oil prices have begun to fall again even as no progress is made in reversing JPY strength, this pattern of imports falling by a greater margin than exports is likely to continue, but it must be said that the sluggishness of export growth is also likely to continue against the strengthening of JPY.

Meanwhile, (2) is the result of an expansion in the travel surplus, which posted +JPY 775.9 billion this year, an improvement of +JPY 245.3 billion yoy compared with the previous year's +JPY 530.6 billion. This result is appropriate given the steady growth in the number of foreign tourists visiting Japan, but the pace of increase is clearly falling. If we also take into account JPY appreciation, it is safe to say that the improvement may be peaking out. Again, the primary income surplus, which forms the bedrock of the current account surplus has also lost some weight thanks to JPY appreciation, falling by about -JPY 827.7 billion compared with last year's +JPY 10.4406 trillion, to +JPY 9.6129 trillion this year. The Ministerial Ordinance rate used to calculate the JPY value of USD-denominated assets is always from two months earlier, which means that the appreciation of JPY starting February will be reflected in the Balance of Payments statistics starting April. To look at it another way, the USD/JPY rate of 105 or below, which became an established trend starting June, has still not begun to be reflected in the primary income balance and other Balance of Payments statistics.

Going forward, no improvement in the primary income balance is forecast, and if the travel balance stops improving, the expansion of the current account surplus will depend on the extent to which the trade surplus expands as imports shrink (and it would not really be a positive development even if the current account surplus expands through this route). Going by this report's strong-JPY outlook, it seems very likely that the basic trend going forward will be a gradual fall in the current account surplus level.

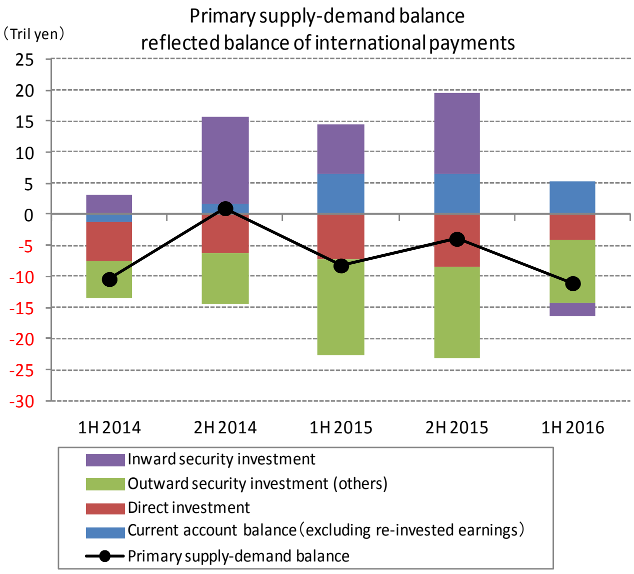
Current account & major economic figures for every first half year (unit: bil yen)

Year	Current balance	Trade balance	Export	Import	Balance on services	Travel balance	Primary income balance
1996	3,872	4,269	20,700	16,432	-3,147	-1,683	3,273
1997	5,041	5,159	23,779	18,620	-3,251	-1,708	3,759
1998	7,407	7,610	24,160	16,550	-3,137	-1,531	3,517
1999	6,376	6,943	21,932	14,989	-2,959	-1,536	3,266
2000	7,493	6,606	23,823	17,218	-2,507	-1,449	3,942
2001	5,342	4,364	23,541	19,178	-2,897	-1,489	4,362
2002	7,499	5,977	23,794	17,818	-2,586	-1,307	4,205
2003	7,403	5,434	24,797	19,364	-1,840	-1,005	4,270
2004	10,141	7,387	27,947	20,560	-2,017	-1,309	5,186
2005	9,087	5,913	29,551	23,638	-1,970	-1,327	5,745
2006	9,671	4,850	34,378	29,528	-1,639	-1,023	7,207
2007	12,699	6,749	38,546	31,797	-2,004	-990	8,731
2008	9,774	4,622	40,217	35,595	-1,984	-860	7,875
2009	5,494	1,261	22,563	21,302	-1,619	-653	6,593
2010	9,814	4,836	31,637	26,801	-1,356	-606	6,945
2011	6,127	167	30,848	30,681	-1,110	-632	7,745
2012	3,240	-1,729	31,778	33,507	-1,526	-499	7,182
2013	3,727	-3,427	33,090	36,517	-1,436	-326	9,102
2014	415	-6,252	35,692	41,944	-1,469	-66	9,277
2015	8,094	-375	37,913	38,288	-933	531	10,441
2016	10,626	2,354	33,821	31,467	-210	776	9,613

(Source) Ministry of Finance, Japan

Basic JPY supply-demand balance during 1H of 2016

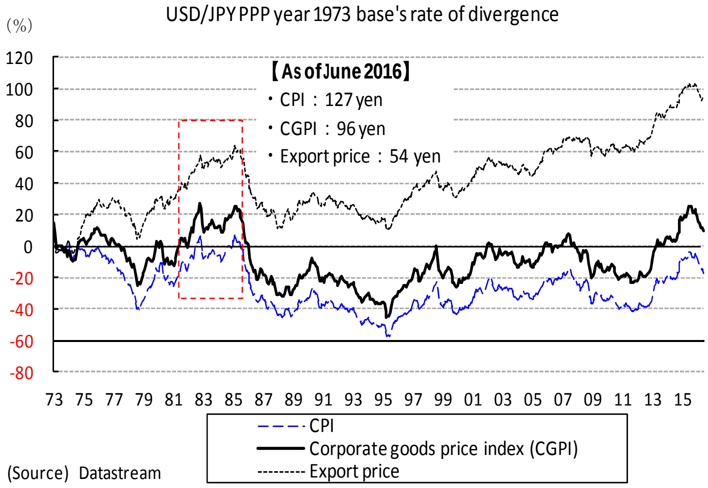
Taking this result into account, a look at the basic JPY supply-demand balance (see exhibit) that this report uses as a guideline in preparing the JPY outlook reveals a net sale of JPY for 1H of 2016 to the tune of -JPY 11 trillion or so. This is the largest net sale of JPY for a half-year period since 2013, when Abenomics became widely talked about. The continued acceleration of foreign securities investment is behind this net sale of JPY despite the aforementioned expansion in the current account surplus. This strongly reflects the present state of affairs, where JPY interest rates lowered to their limits are pushing Japanese investors to look overseas. As the exhibit shows, the JPY purchase pressure exerted by the expansion in the current account surplus is more or less offset by the JPY sale pressure exerted by foreign securities investment, causing the JPY sale pressure from foreign securities investment to become buoyant. Another feature of the current account surplus in recent years is that reinvested earnings (a component of the primary income balance), which are earnings utilized in the form of a foreign currency without being converted into JPY, are on the rise. If reinvested earnings are excluded, the JPY purchase pressure on the basic supply-demand balance would obviously increase. Of course, most foreign securities investments are hedged against forex risks, and it is precisely because of this that JPY has continued to appreciate despite the aforementioned supply-demand picture. However, a big problem in formulating future forex outlooks will be to gauge the extent to which JPY appreciation can be forecast even as the basic supply-demand balance continues to clearly indicate JPY weakness.



(Source) INDB、(Notes) Subject:including insurers, pension funds & individuals, excluding deposit taking finance institutions & goverment

Practical risks and a rough image of rate level

Each phase of the USD/JPY wave based on purchasing power parity (PPP) continues for three to four years, and as I have mentioned several times in past editions of this report, it is historically rare for the rate to surpass the range of PPP±20%[1]. Assuming that the PPP at present is around 100 yen, and taking into account that USD/JPY has historically tended to diverge on the strong-JPY side of PPP, my view remains that it would not be surprising to see USD/JPY fall below 100. However, it is difficult to say whether it would be appropriate to take our cue from past experiences and anticipate an 80-yen rate (PPP -20%) as a possible outcome in the natural course of things. My assumption at the present time in this report is that the FRB's normalization process will halt at some point, and this will cause foreign securities investment to slow down. On the other hand, we have no past experience of JPY interest rates being as low as they are right now, so this time, there does exist the risk of foreign securities investment continuing to grow without slowing down. As I often point out, this continuation (or acceleration) of foreign securities investment by Japanese investors is the biggest practical risk to this report's strong-JPY outlook.



(Source) Datastream

BOJ monetary policies now and going forward – The reasonableness of strategies should be examined as part of the comprehensive assessment

Visualizing the comprehensive assessment

At the July 29 BOJ Monetary Policy Meeting, a doubling of the purchase amount of index-linked exchange-traded funds (ETFs) was decided, but the markets are also eager to visualize the "comprehensive assessment" the Bank has declared it will conduct at its September 21 Monetary Policy Meeting. Following his meeting with Finance Minister Taro Aso on August 2, BOJ Governor Haruhiko Kuroda clarified that a comprehensive assessment does not indicate any scaling down of monetary accommodation, and will be undertaken merely to reveal the tools necessary for achieving the price stability target at the earliest. Having said that, the "tools necessary for achieving the price stability target at the earliest" do not have to involve an expansion of monetary easing. It is even possible that scaling down the present measures, which are beginning to have side effects and reach technical limits, may be "a necessary tool" for achieving the target. At any rate, the BOJ is in an awkward position right now, where it can neither admit nor deny, so certain things must remain within the realm of fantasy. In the first place, the monetary policy committee has not yet begun its assessment, so board members including Mr. Kuroda are in no position to answer any questions one may ask. Until the day of the assessment, therefore, no substantial responses can be expected.

Market consensus may be "an actual tapering"

Quantitative expansion is difficult for technical reasons, qualitative expansion was only recently implemented, and the negative interest rate has too bad a reputation – taking all this into account, if one is honest, the only conclusion from any assessment can be that the present measures need to be scaled down. Rather, if the present Quantitative and Qualitative Easing with Negative Interest Rate (QQEN) policy had really been proving effective as Mr. Kuroda says, and if there had been no limits to its expansion, an assessment would be unnecessary in the first place. The reason for deliberately undertaking an assessment is bound to be because the negative effects of the present framework are being acknowledged to some extent and an attempt is being made to treat some of the side effects that have begun to show. Any such attempt would, therefore, have to be in the direction of tapering quantity and abolishing the negative interest rate, but as it been only half a year since the introduction of the latter, abolishing it would result in a loss of face, and may be difficult. At the Jackson Hole Economic Symposium held on August 27, BOJ Governor Haruhiko Kuroda said that, thanks to new, practical policies such as the negative interest rate policy, central banks had gained more freedom to deal with various negative shocks. Going simply by remarks such as this, it would appear that he has not given up on the idea of expanding the margin of negative interest rates (rather, it seems quite likely that they may be expanded at the September and/or November meeting).

[1] Please see July 4, 2016 Market Topic titled "Phases of USD/JPY as seen from past experience – The current phase of JPY appreciation will not end in a hurry."

If so, the natural solution seems to be to cut back on the current flow-based framework of increasing the monetary base (MB) by JPY 80 trillion per year in a subtle way so as not to incur embarrassment. As already being suggested, the Bank may attempt to extricate itself from rigid purchase commitments by shifting from a strict JPY 80 trillion/year pace, to a range, such as JPY 70-90 trillion/year or JPY 50-100 trillion/year. Or, will it seek grounds for arguing that the already accumulated JPY 400 trillion worth of MBs have a monetary easing effect (in other words, shifting the discussion from a flow-based to a stock-based effect)? Regardless, it remains a fact that both the former and the latter are a kind of tapering.

Doing so will still allow the Bank to claim that the decline in interest rates shows that the measure is having the intended effect. In fact, the decline in real interest rates was emphasized as the main indication of the effectiveness of the QQE policy in the "Quantitative and Qualitative Monetary Easing: Assessment of Its Effects in the Two Years since Its Introduction" released in May last year. As far as the upcoming comprehensive assessment goes, the market's consensus forecast going forward may be "further expanding the negative interest rate margin while planning an actual tapering."

Finding the "nature of failure"

Again, with regard to the comprehensive assessment, Mr. Kuroda has clearly stated that there will be no change in the determination to achieve the 2% target at the earliest, or in the strategic framework itself. However, since he has already announced a comprehensive assessment, which is a great opportunity to bid farewell to the limitless expectations from the market, he ought to make good use of this opportunity. Now is the time to move away from perfunctory tactics such as monetary policy tools, and earnestly reexamine the feasibility and validity of the strategy of "achieving the 2% target at the earliest."

The book *The Nature of Failure – An Organizational Theory-based Analysis of the Japanese Army* (Chuko Bunko)[2], which analyzes the defeat of the Japanese army in the Pacific War to the U.S. army, points out that the Japanese army had already failed at the stage of planning its grand design (strategy) in the war. Subsequently, rather than correct its mistake and revise its strategy, it kept trying to deal with the situation by making small tactical changes, but was eventually defeated by the U.S. army, which had a superior strategy. The book concludes that "strategic failure cannot be made up for with tactics." It also points out that the Japanese army "was self-righteous when it came to receiving or interpreting information, and was bombastically and excessively idealistic in battle." The book makes the point that the Japanese army did not make an appropriate objective analysis of information available to it at each point in time.

It would be rash to apply the above analogy directly to the present situation and the BOJ's monetary policy operation. However, if the strategy itself is wrong, then it follows that the tactics (the tools for achieving the target) are also wrong. Incidentally, the complete version of the aforementioned phrase from the book is "tactical failure cannot be made up for with strategy, and strategic failure cannot be made up for with tactics." Recently, bond market participants have begun to complain that it is difficult to predict the type and amount of bonds that will be purchased under the QQEN policy. If we consider "achieving the 2% target at the earliest" to be the "strategy,"and"QQEN" to be a "tactic," the purchasing operation itself would be the "battle," and the present state of affairs seems to be "a failed tactic that is not useful in battle" (perhaps this is why a comprehensive assessment was thought necessary).

The BOJ seems to enjoy evaluating price indicators that are performing strongly (for instance, the Core CPI rather than the Aggregate CPI, the Core-Core CPI rather than the Core CPI, or depending on the situation, the University of Tokyo Daily Price Index), judging their trends or expectations to be improving according to its own convenience.

The issue that must be examined as part of the comprehensive assessment at this point is whether, in light of the decrease in the Japanese economy's potential growth rate against the backdrop of a declining population, a 2% inflation target (strategy) is, in fact, appropriate. An answer to this question would probably lead us to the "nature of failure" of the present policies, which do not seem to be succeeding. It has, however, been made clear that this point will not be touched upon at the September 21 meeting, so there seems very little likelihood that the present state or future outlook of monetary policy will change dramatically. The BOJ will probably find it easier to wage battle with revised tactics, but it is a different question altogether whether its strategy is appropriate for the Japanese economy.

[2] *The Nature of Failure – An Organizational Theory-based Analysis of the Japanese Army*, August 1991, by Ryoichi Tobe, Yoshiya Teramoto, Shinichi Kamata, Yoshio Suginoo, Tomohide Murai, and Ikujiro Nonaka.

U.S. monetary policies now and going forward – Signs of declining confidence

A possible shift to pessimism?

There were no FOMC meetings in August. In mid-August, New York Fed President William Dudley and Atlanta Fed President Dennis Lockhart made remarks that hinted at a rate hike in September, as did FRB Chair Janet Yellen in her talk at the Jackson Hole Economic Symposium (details later). Subsequently, FRB Vice Chairman Stanley Fischer also made a comment that seemed to support this idea. The July 26-27 FOMC meeting minutes, which were released 10 days before the Jackson Hole Symposium on August 17, however, were not as bullish as the aforementioned remarks or the FOMC official statement suggested. Going by the minutes, FOMC members seemed to be gradually losing confidence with regard to implementing a rate hike, leaving market participants who were already skeptical about it in an even more pessimistic mood. The reason a September rate hike is not being factored in to a very large extent despite how determined Ms. Yellen sounds could be because the idea that a rate hike will not, in the end, be possible has taken deep root in the markets.

FOMC meeting minutes – Signs of declining confidence

The July FOMC statement was clearly more bullish than the previous one and seemed to be leaning toward a rate hike, with Kansas City Fed President Esther George bringing back her rate hike proposal. The minutes of the meeting, therefore, were expected to have a rather hawkish tone. In truth, however, the minutes said, "With inflation continuing to run below the Committee's 2 percent objective, many judged that it was appropriate to wait for additional information that would allow them to evaluate the underlying momentum in economic activity and the labor market and whether inflation was continuing to rise gradually to 2 percent as expected," clearly showing that many of the members with voting rights were of the view that waiting for additional information before making a judgment would be appropriate. The minutes also contained the remark, "the Committee should wait to take another step in removing accommodation until the data on economic activity provided a greater level of confidence that economic growth was strong enough to withstand a possible downward shock to demand," but given the present global economic situation, one cannot help thinking that it will be quite a while before economic indicators provide "a greater level of confidence." The June job data was much stronger than market forecasts, and the FOMC statement's assessment of the economy and jobs was clearly more bullish than before, so this kind of policy judgment by a majority of FOMC members comes as somewhat of a surprise. It does appear as though the Committee is beginning to lose confidence in its efforts to normalize monetary policy.

A dangerous obsession with a "normal" that does not exist

As I mentioned at the start, the reason the pace of USD sales in the forex markets has recently increased is probably because the markets have begun to sense this loss of confidence within the FOMC, and market participants are increasingly switching from an optimistic to a pessimistic mood. Since the beginning of August, several U.S. economic indicators have deteriorated, and an essay titled "Monetary Policy in a Low R-star World" by San Francisco Fed President John Williams has been in the news. The essay argues that the U.S. monetary policy framework ought to be revised taking into account the natural decline in U.S. interest rates. It is an argument that supports the secular stagnation theory of Prof. Lawrence Summers and takes a position that is incompatible with the present normalization process. The recently released minutes also noted that "With neutral interest rates potentially remaining quite low, policymakers also observed that, in order to promote the Federal Reserve's policy objectives, the framework should have the capacity to supplement conventional policy accommodation with other measures when short-term nominal interest rates are near zero." In other words, the point being made is that monetary policies must take into account the fact that the true strength of the U.S. economy has deteriorated over time.

As I have said in past editions of this report, I take issue with the word "normalization" itself. In the context of normalizing monetary policy, the word "normality" probably indicates a return to the neutral federal funds rate (currently 3.00%) or the shrinking of the balance sheet to normal levels, but one has to wonder whether such a "normality" really exists. If the U.S. economy is stressed out of proportion as a result of this obsession with a normality that does not exist, it will not be just the U.S. that is forced into a difficult corner – China, which is compelled to follow in the footsteps of the U.S. in terms of currency policy, will also be in trouble. If neither the U.S. nor the Chinese economy are stable, the global economy will find itself in trouble too.

Given this global context, where USD strength is not good for anyone, it is natural for differences of opinion regarding the normalization process to emerge within the FRB as well, and for some members to even begin urging a revision of the framework. Under such circumstances, my view remains that it would be unwise to place too much stock on rate hikes being implemented, not just this year but even next year, and by extension that betting on a strong-USD scenario is dangerous.

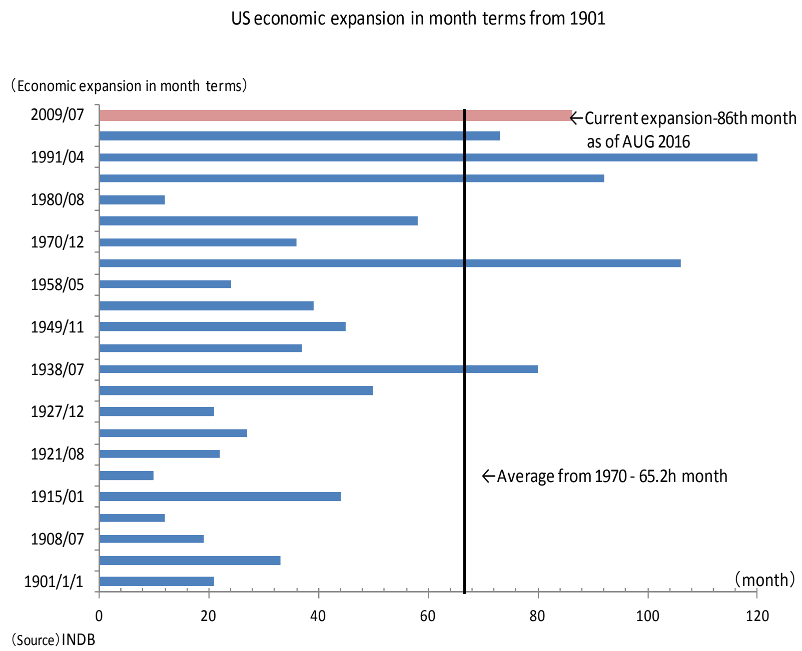
No change in JPY appreciation outlook following Jackson Hole lecture

Ms. Yellen's much anticipated talk at the Jackson Hole Symposium on August 26 was more hawkish in tone than expected, which gave rise to a USD-purchasing mood in the market. Ms. Yellen said "the case for an increase in the federal funds rate has strengthened in recent months," giving the impression that she was rather openly encouraging expectations of a rate hike in the near future. Having said that, as of the writing of this report, the probability of a rate hike at the September 20-21 FOMC meeting remains 42%, and even if we expand our sights to the December 13-14 meeting, the probability barely rises above 60%, so it does not appear as though the markets see the rate hike as a certainty. As I have said in past editions of this report, the important point when it comes to discussing the FRB's normalization process is not whether or not a rate hike will take place, but rather the result or the impact of such a rate hike. It appears that market participants are also gradually becoming aware of this fact. If one takes into account that the real effective rate of USD remains stubbornly high even after a rate hike, it does not seem sustainable. Inevitably, when it comes to preparing a forex outlook, my basic understanding that it is difficult to foresee a USD appreciation trend remains unchanged.

In her heart of hearts, Yellen bold in the short term and unsure in the long term

The topic of this year's Jackson Hole Symposium was "Designing Resilient Monetary Policy Frameworks for the Future," and Ms. Yellen's talk was conspicuously filled with hints about monetary policy limits. She even said "policymakers could have less ability to cut short-term interest rates in the future," and as an extension of this, emphasized the importance of fiscal policies. Again, as in the case of the essay by Mr. Williams, the lowering of the neutral interest rates has become a topic of discussion in various contexts, and there is deep-seated concern that we are approaching the end of the rate hike process. To summarize, it seems that in her heart of hearts, Ms. Yellen intends to raise the FF rates in the short term, but wants to avoid committing herself to any specific length of the process, so that in a pinch, the process could end after just one or two rate hikes, and fiscal policy could deal with any situation that arises subsequently. In other words, she is bold in the short term but unsure in the long term. The financial markets tend to focus excessively on whether or not there will be a rate hike at the September FOMC meeting, or within the year if taking the long view, and this results in a USD-purchasing sentiment in the market, but it is impossible to feel confident about the sustainability of such a trend.

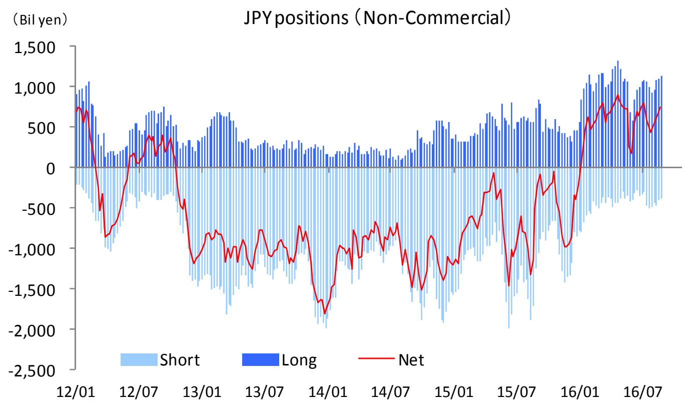
Rate hike inherently filled with contradictions



The current economic expansion phase will enter its 100th month mid-way through next year (the third largest phase of economic expansion in history even if going by data available since 1901), so it would be unwise to casually implement a rate hike, which tends to have a belated impact. This is something the FRB is likely to aware of. As mentioned above, there is a strong suspicion that the U.S. neutral interest rates are declining, and there are a number of risks scattered across the rest of the world too, in Europe, China, and other emerging economies. To begin with, given the FRB's dual mandate (employment maximization and price stability), it cannot be said that the conditions for a rate hike are being met on the price front. Why would the FRB insist on implementing rate hikes under such circumstances? Although perhaps, in its heart of hearts, the FRB wants to implement a rate hike precisely because of these circumstances. With only a short period of economic stability remaining, the FRB may feel the need to prepare for the upcoming recessionary phase of the economy. In other words, it may be in a tough spot faced with the need to arm itself with a higher rate of interest now so that there will be scope for a rate cut going forward. It wants to create elbow room for future policy operations – increasing the FF rate now so that it can cut them again in the future. In this context, it is not difficult to understand a central bank's obsession with normalization for fear of running out of policy response options in a crisis. However, it is probably not just me who feels that there is an inherent contradiction in this kind of policy response.

Implications for forex outlook

According to the IMM Currency Futures transactions as of August 23, the latest information as of the time of writing this report, the historically large JPY long position against USD continues (see exhibit). As mentioned above, a September rate hike by the FRB would come as a surprise to most market participants even after what was said at the Jackson Hole Symposium. If a rate hike is implemented under these circumstances, it is easy to imagine that JPY would weaken against a rollback in its speculative long position. As I mentioned before, Mr. Kuroda hinted at the possible expansion of the negative interest rate margin in his speech at Jackson Hole. Assuming that as of September 21, the speculative JPY long position remains at a high level, and this coincides with an expansion of the negative interest rate margin by the BOJ or a rate hike by the FRB, then it may be possible for USD/JPY to rise up to the level of 105 or so.



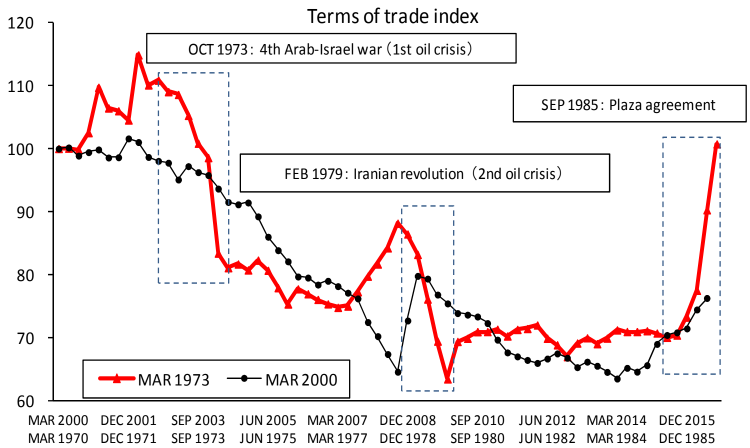
(Source) CFTC & Bloomberg

However, in formulating a forex outlook, a weak JPY trend can only be predicted if U.S. rate hikes are sustained. With the FRB itself starting to contemplate an end to the rate hike process, regardless of how high the expectations of a rate hike in the short term, my view is that in the medium to long term, the trend will be biased toward JPY strength.

Addendum – Analyzing the present state of JPY rates and the Japanese economy– Fair evaluation of the JPY appreciation/depreciation

Improvement in terms of trade since the latter half of the 1980s

Basically, JPY appreciation and the stabilization of crude oil prices at low levels have been promoting improvement in the Japanese economy's terms of trade. Given that the domestic economy has encountered supply constraints, one should prudently refrain from reflexively considering JPY appreciation to be an unmitigated negative trend. Japan also experienced sharp improvement in its terms of trade during the post-Plaza Accord period, reflecting JPY appreciation along with a coincidental drop in crude oil prices (the "reverse oil shock"), and it appears that the magnitude of those trends recently is comparable to that of the post-Plaza Accord period trends (see graph). In response to the "strong-JPY recession" triggered by the Plaza Accord, the BOJ sought to promote recovery by boldly launching large-margin monetary easing policies including a consecutive series of interest rate cuts (official discount rate reductions) from late 1985 through early 1987. There was an improving trend in real income environment against the backdrop of improvements in terms of trade while the monetary easing was launched at a time when Japan's domestic economy (differently from the current situation) had sufficient supply capacity to leverage currency depreciation as a means of accelerating exports. However many observers view that situation as having led to the subsequent formation and bursting of the bubble economy. In a speech presented in 2010, former BOJ Governor Masaaki Shirakawa said that – "It should also be noted that, the appreciation of the yen, from a longer-term perspective, has the positive effect of bringing about an improvement of the terms of trade through a decline in import prices, that is, it leads to an increase in Japan's overall real income."[3] – and he has subsequently expressed ideas along this line repeatedly.

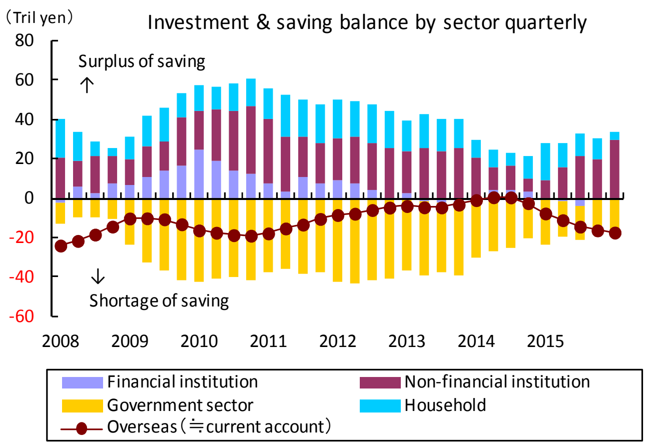


(Source) Cabinet Office, Government of Japan
(Notes) Terms of trade index-export deflator/import deflator
MAR 1973 & MAR 2000=100 and 1955-1979 are calculated on the assumption of seasonally adjusted nominal・real GDP by Karakama

[3] "Japan's Economy and Monetary Policy," Speech presented by BOJ Governor Masaaki Shirakawa at a Meeting with Business Leaders in Nagoya, November 29, 2010.

The income shift promoted by JPY depreciation

Although Shirakawa was fiercely criticized for such comments supporting JPY appreciation at a time of crisis, his ideas are worth additional consideration at this point. As already noted in the abovementioned previous edition of this publication, Japan, while facing supply constraints, had been seeking to leverage the JPY depreciation to boost exports and thereby improve conditions in its domestic economy. However, this route has been hitting road blocks. In fact, there has not been evidence of growth in the real economic pie – during the 10 quarters since 2014, negative growth has been recorded in four of them and 0% in another one – and it cannot be said that these results are commensurate with the amount of policy resources invested in the program. Although there have been signs of increase in real estate prices, those have been localized phenomena limited to central metropolitan areas. It is only with regard to stock prices that Abenomics has unmistakably produced results. Although it may be widely felt that “everyone is happy when stock prices are rising,” the actual view from the household sector is more along the lines of “we have no problem with stock prices rising, but we are not particularly happy about it either.” For example, the wealth effect theory posits that the perception of greater personal wealth promoted by rising stock prices will accelerate personal consumption, but there are probably not so many ordinary citizens who have much faith in this theory. Currency depreciation not accompanied by export volume growth merely boosts import prices and thereby elevates the consumer price index (CPI), and the associated terms of trade deterioration works to depress households’ real income. In fact, exporters have thrived during the past three years of JPY depreciation, and associated growth in tax revenues benefited the government, but there has been no conspicuous benefit for the household sector. (While there has been some nominal growth in wages, the effect cannot be said to have been positive on a real basis.) In brief, it appears that JPY depreciation has simply affected import prices in a way that boosts prices and thereby promotes a progressive shift of income from the household sector to the corporate sector along with an increase in the tax revenues the government obtains from the corporate sector.



(Source) Bank of Japan

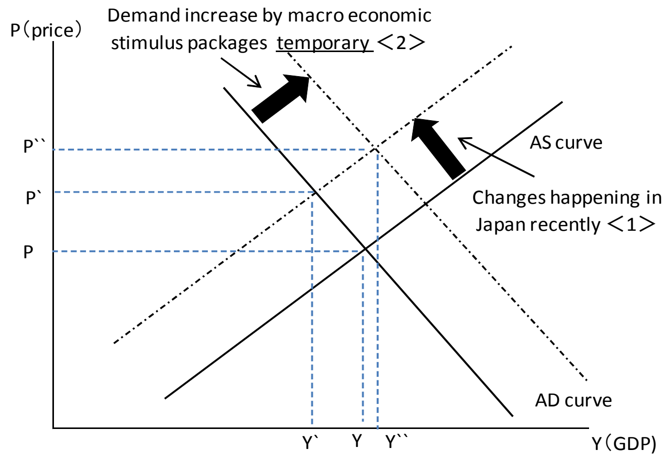
This is something that can be confirmed also by looking at the investment to savings (IS) balance, which is a necessary indicator in considering the dynamic allocation of resources in a country’s economy. Recent trends in the IS balance show a rise in excessive savings for the corporate sector accompanied by a decline in the same for the household sector. Over the past three years, the savings of Japan’s private sector have not expanded to the extent one might assume looking at the increase in revenues and profits for the corporate sector (see exhibit on previous page). It does look, therefore, that the past three years of JPY weakness have had the effect on the Japanese macroeconomic balance, of shifting income from the household sector to the corporate sector to the government sector.

This situation, with respect to the dynamic allocation of resources within the Japanese economy, can be confirmed by taking a look at trends in the investment-savings (IS) balance (see graph on the previous page). Recently, there has been growth in the corporate sector’s net saving surplus but shrinkage in the household sector’s net saving surplus. Japan’s private-sector net saving surplus has increased during the past three years, but it is clear that it has not increased to the extent that you might think if you were to focus on the expansion of corporate revenue and profit. There are ample grounds for suspecting that the main result of the past three years of JPY depreciation on macroeconomic balances within Japan has been an income transfer like the following “household sector →corporate sector →government sector”

From inflation tax increase to inflation tax reduction

Regarding monetary policy, Japan’s Qualitative and Quantitative Easing (QQE) policies including negative interest rate policies are currently undergoing comprehensive assessment, but the above analysis suggests that a principle result of JPY depreciation promoted by QQE may have merely been a mild inflation tax increase leading to improvement in the government’s fiscal budget situation. Because of Japan’s decisions to postpone its planned consumption tax rate increase twice in the past two years, its plans for launching a large supplementary budget this autumn, and other factors, progress in fiscal reconstruction has been halted. There are only three options for reducing Japan’s public debt – (1) fiscal reconstruction, (2) rapid economic growth, or (3) inflation tax. There has been no progress in (1), and given that (2) is not a problem realistically associated with public debt in most sound countries, one gets the feeling that what has been happening during the past three years corresponds to (3).

This series of events has been in line with the fundamental principles of macroeconomics. When supply constraints arise, inflationary pressure tends to increase (P→P` in the portion of the graph labeled <1>), and if demand is stimulated by means of monetary and fiscal policies, then inflation will surge upward (P`→P` in the portion of the graph labeled <2>). During this process, in the short term, GDP expands from Y to Y``, but real income is depressed by the rise of prices to P``. In the medium-to-long term, GDP ends up lower than the initial Y level, while prices end up higher than the initial P level. In general terms, JPY depreciation amid supply constraints leads to an inflation tax-type tax increase that reduces final demand, and there is a high likelihood that overall GDP will be depressed.



（Source）complied by Karakama, Mizuho Bank
（Notes）AS means aggregate supply. AD means aggregate demand

A page-two article in Nihon Keizai Shimbun morning edition on August 19th reports that it has proved impossible to prevent increases in the hourly wages of temporary employees amid the protracted labor shortage. In addition to the stable low level of crude oil prices, another factor that appears to be restraining upward movement in the CPI and other measures of consumer goods is the efforts companies have been making so far to internally absorb their rising labor costs without passing the rise through to higher selling prices. However, when the gradually rising pressures associated with this absorption process become unmanageable, then the costs will start becoming passed through to higher selling prices and inflation will commence. Because this kind of price pass-through is not the relatively sound type of price pass-through undertaken in response to economic overheating, it can be assumed that the result will be a deterioration of real income.

In any case, if JPY depreciation in recent years has by means of an inflation tax increase put downward pressure on the household sector’s real income, than JPY appreciation should logically be capable of boosting the household sector’s real income by means of an inflation tax reduction. With respect to defending households’ real income amid supply constraints, it seems, at least theoretically, that JPY appreciation is more supportive than JPY depreciation.

Risks to my main scenario – No change to the whereabouts of risks

Review of risk scenarios – No change from last month regarding concern about acceleration of Japanese outward securities investment

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. Regarding the level of USD/JPY during the next year, my main scenario anticipates a possibility that USD/JPY may settle down at the 90-95 level. The August 2016 Jackson Hole Economic Policy Symposium has increased expectations that the FRB will hike interest rates, and one gets the impression that this has prompted a preponderance of USD buying but, ultimately, the question of to what extent the U.S. will tolerate USD appreciation will be highly important. From next year, it does not at all seem likely that new presidential administration of the U.S. will stand for additional sustained USD appreciation. Regardless of how strongly the FRB desires to normalize its policies, if the country can not put up with the USD appreciation that normalization promotes, then the interest rate hikes will ultimately have to be discontinued. As noted above, speculators have accumulated substantial JPY-long positions, and it seems likely that the drawing down of those positions may be accompanied by some JPY depreciation. However, this will not affect the underlying trend. In fact, since the start of 2016, the roll-back of speculative positions has been proceeding concurrently with the recording of a succession of new lows in USD/JPY, and this kind of situation can be said to be a distinctive characteristic of long-winded JPY appreciation scenarios. Given that the new lows are being attained while the position adjustment advances, USD/JPY is positioned to effortlessly seek a succession of additional lows.

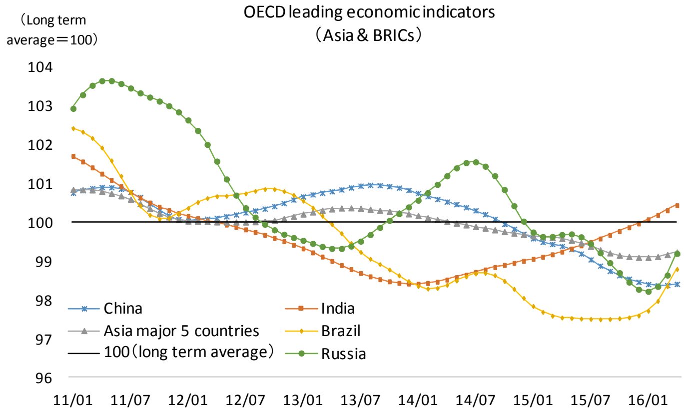
Potential Risks to the Main Scenario

		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, Clinton or Trump, Strong USD will be perceptibly capped. Focusing on new Secretary of the Treasury nomination.	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	Commotion over the breakup of the EC intensifies	・Northern Ireland and Scotland seek independence from the UK. Possible concerns about something similar happening over 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. Fundamentally, there has been no change since last month. I do not believe there has been a change in the whereabouts of risks to the main scenario during the past month. 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 – Somewhat higher risk associated with FRB normalization

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. Numerous high FRB officials made statements in August expressing their confidence in an interest-rate hike during the year, and FRB chair Yellen's August 26 speech at the Jackson Hole Economic Policy Symposium – including the sentence, "I believe the case for an increase in the federal funds rate has strengthened in recent months" – further strengthened USD buying. While only to certain extent, the FRB's policy normalization does present a perceptible risk of a JPY depreciation trend. As argued in the August 16, 2016 edition of Mizuho Market Topic, entitled "The risk scenario of a bottoming out of the global economy," the trend of recovery in the economies of emerging countries and resource exporting countries that began early this year may be significant (see graph). It quite possible that the FOMC will interpret this trend as a follow-wind factor for its interest rate hike plans.



(SOurce) OECD (Note) China, India, Indonesia, Japan & Korea

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 (5)). In his August 27 speech at the Jackson Hole Economic Policy Symposium, BOJ Governor Kuroda said – "NIRPs [negative interest rate policies] certainly provide more leeway with central banks in coping with a variety of adverse shocks as a practical monetary policy tool." – and this statement seems to hint at his readiness to introduce still-lower levels of negative interest rates. While I do not believe that BOJ policies alone are capable of reversing the JPY appreciation trend, if the BOJ policies are perfectly timed to coincide with FOMC displays of hawkishness, then there may be a possibility of a JPY weakening episode that puts USD/JPY (temporarily) outside this article's forecast range.

Overview of JPY appreciation risks – Risk of interest rate expectations becoming outdated

To repeat what I write every month, 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 U.S. economic expansion is the fourth longest in history and could become the third longest during 2017, and the "next move" officially disclosed in FOMC statements is an interest-rate hike. If the U.S. economy matures and its expansion peters out in the not so distant future, 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 August, John Williams, president of the San Francisco Fed, attracted considerable attention by arguing that there had been a drop in the level of the neutral policy rate (≈potential economic growth rate), and it is noteworthy that decreases in the neutral policy rates of the U.S. and other countries became a theme of discussion at the Jackson Hole Economic Policy Symposium that month. In fact, 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%, while three years later (June 2016) the level was 3.00%. As the underlying strength of the U.S. economy subsides and the neutral policy rate (the end point of interest-rate hikes) descends, it is important that there be renewed discussion of what should be considered normal.

Another significant JPY appreciation risk is that related to Europe (risk factor (6)). As noted in last month's edition of this article, it will be important to closely monitor Italy-related risks from this October. 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 – Surmounting the extremely challenging 1.20 level

ECB Monetary Policies Now and Going Forward – Interpreting the Account of the July ECB Governing Council Meeting

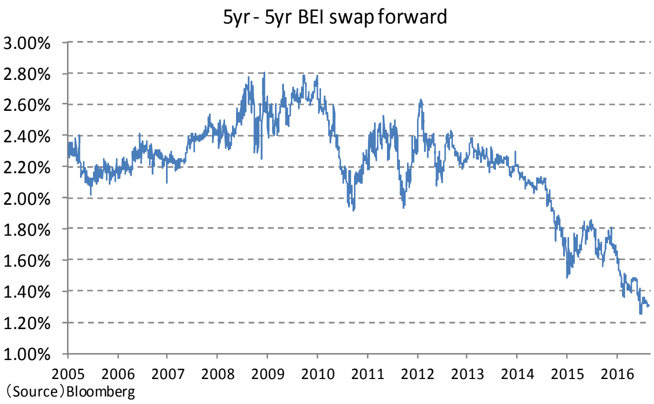
Account of the ECB Governing Council Meeting – Reasons for status quo maintenance

On August 18, the Account of the July 20-21 ECB Governing Council Meeting was released. Although that meeting did not produce any news that had much market-moving effect, at the subsequent press conference, ECB Governor Draghi said – "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." This and other Draghi comments laid the basis for expectations that additional easing will be approved at the next meeting in mid-September. The possibility of asset purchase programme (APP) parameter adjustment was the issue attracting the most attention prior to the meeting. Draghi commented about this possibility, saying that – "we concluded that we didn't have yet information to take decisions." – and the question of what kind of debate was in the background of that comment is highly interesting.

What were the background factors that led to the decision to maintain the status quo despite the fact that the meeting was held immediately after the U.K. approved Brexit? To the extent discernable from the Account, it appears that the factors included such situations as (1) the fact that the impact of the Brexit issue was not as great as had been predicted; (2) the facts that, although euro area second quarter GDP decelerated qoq, that deceleration reflected the effect of special factors, and Draghi viewed domestic demand as likely to regain its robustness (In particular, the employment situation was considered to be showing "encouraging signs.); and (3) the facts that the stability of crude oil prices was prompting progress toward a recovery in product exports and that there was the prospect of economic stabilization in such emerging countries as China, where the growth rate was accelerating in response to policy measures. Among these factors, it is clear that the complete recovery from post-Brexit referendum chaos in such principal financial markets as stock and forex market was a major factor, so one may suspect that it was factor (1) that made status quo maintenance possible. However – as argued in the August 16, 2016 edition of Mizuho Market Topic, entitled "The risk scenario of a bottoming out of the global economy" – it appears that factor (3) is impossible to ignore.

Lingering anxiety

However, the Account also includes more than a few references to factors causing concern. Regarding the inflation trend evaluations that are important bases for policy management, for example, although it had been anticipated that there would be a rise in HICP due to the diminishing base effect from the crude oil price drop, the outlook through the time of the meeting was for continued extremely low levels of price increases. Regarding inflation expectations, also, although it was possible to evaluate the expectations as being well anchored based on such surveys as the ECB Survey of Professional Forecasters (SPF), the traditionally emphasized market-based evaluation methods (such as five-year in five years inflation swap break-even inflation (BEI)) were indicating that the expectations are weak. In fact, five-year in five years inflation swap BEI is inevitably trending downward to new record low levels, and the current situation is that it is always possible that the BEI trend will be used to justify additional easing (see graph).



（Source）Bloomberg

Moreover, despite the abovementioned recognition of a positive trend in emerging country economies, it was impossible to deny that the Brexit issue will have an impact on the U.K., Europe, and other developed country economies, and the delivery routes of shocks from that impact were recognized as being highly opaque. Furthermore, the Account indicates recognition that optimistic inclinations are being quashed by such geo-political risk factors as those related to terror incidents and that there is a basis for concern that this quashing will depress economic growth rates.

Hard to predict the next move

ECB Governing Council member Peter Praet (the ECB's chief economist) summed up the situation in four points. (1) Data indicated moderate growth in the euro area economy, primarily supported by domestic demand, but the continued presence of downside risk factors pointed to the need to preserve an appropriate degree of monetary accommodation. (2) Although difficult to assess at this juncture, the outcome of the UK referendum implied the materialization of a downside risk countering the improvement in the balance of risks assessed by the Governing Council in June. (3) Despite such situations as factor (2), the responses of central banks worldwide had enabled a trend of recovery from market stress. (4) Regarding bank lending, improvement was being seen in both loan supply conditions and loan demand, but some banks had concerns about risks associated with increasing their capital. In light of these points, Praet recommended reiterating such messages as – "given prevailing uncertainties, the Governing Council would continue to monitor economic and financial market developments very closely" and "the Governing Council would safeguard the pass-through of the ECB's accommodative monetary policy to the real economy" – within the post-meeting statement, along with the message that – "When more information became available over the coming months, including the new ECB staff projections, the Governing Council would be in a better position to reassess the macroeconomic outlook."

As noted above, the meeting discussed both positive and negative perspectives, but the difficulty of understanding the Brexit impact shifted the balance of risks assessed by the Governing Council somewhat toward the downside. However, <u>there remains doubt about whether the Account provides enough information to confidently conclude that the Governing Council was predicting additional easing</u>. <u>The Account is basically saying that there is no immediate impact from Brexit although there is concern about not understanding the potential impacts going forward, and this does not appear to be a factor that would determine policy management decisions in the near future.</u> On the other hand, regarding the point that financial markets are robust despite Brexit-related stresses, one gets the impression that international financial markets in both Europe and other regions are being closely examined, and it does not seem likely that there will be a worldwide receding of concerns about Brexit-related stresses. In fact, however, the ECB, Bank of England (BOE), and FRB have all postponed their policy responses following Brexit. (Only the BOJ has taken additional easing measures.)

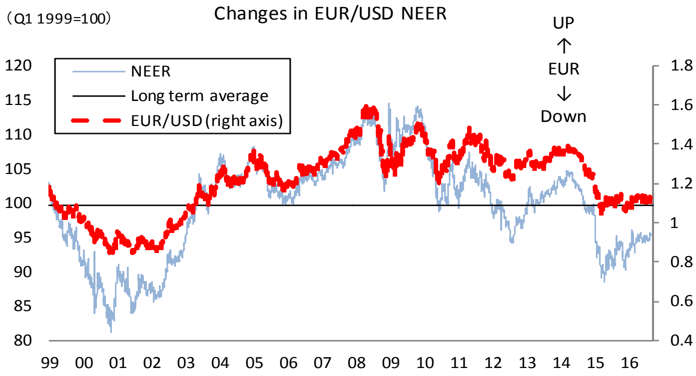
What will happen on September 8?

In light of what is known, what should we be expecting from the ECB Governing Council Meeting to be held on September 8? While I will issue a separate article previewing the meeting, it does seem possible based on the above-discussed Account that the meeting will maintain the status quo. However, <u>it is a fact that EUR has recently begun gradually strengthening, and given the weakness of HICP and inflation expectations, it may well be that the ECB will feel that it must grope toward its next move</u>. Given the tensions among Governing Council members, even if the Governing Council does decide on a next move, it seems likely that the move would be an APP parameter change, such as a repeal of the 33% rule. After that kind of precursor measure, I am anticipating the possibility that the Governing Council may move ahead with measures to expand the scale of its monthly asset purchases beginning from October. Going forward, if the Governing Council were to operate in the most standard manner, then one might anticipate the repeal of the 33% rule at the September 8 Governing Council Meeting, and a decision to expand monthly asset purchases under APP as early as the October 20 Governing Council Meeting and as late as the December 8 meeting. In particular, if EUR/USD surpasses 1.15, then there is a possibility that the ECB's efforts to restrain the rate through measures including verbal guidance may become more obvious and, in creating a EUR/USD forecast range, it is prudent to recognize that it would be extremely difficult for the rate to approach the 1.20 level.

EUR now and going forward – Expecting the market to move toward fundamentals-based levels

Strengthening surge in EUR on a nominal effective basis

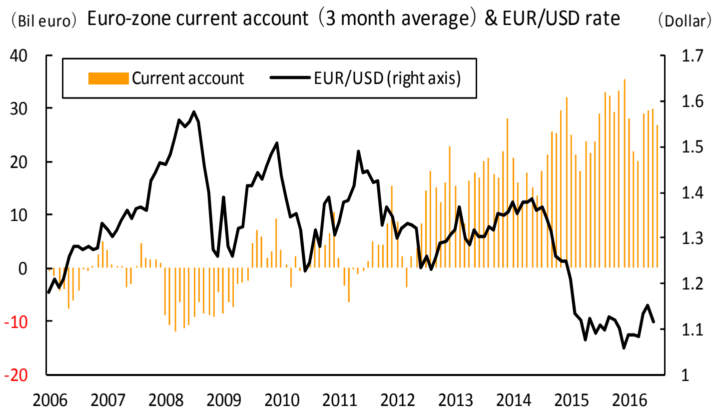
While EUR rates are being affected by the lack of clarity regarding the possibility of a U.S. interest rate hike, another aspect of the situation is that EUR is steadily strengthening – the nominal effective exchange rate (NEER) of EUR has been rising since this February. Roughly speaking, EUR's NEER began falling when negative interest rates were introduced in June 2014, and the margin of the drop peaked at about 14% in March 2015. Of course, other factors with considerable impact were at work during this period, such as the expanded asset purchase programme (APP, a quantitative expansion program) and the acceleration of the FRB's normalization process. However, at the time this article was written (August 26), the margin of decline in EUR NEER since June 2014 had shrunk to approximately 7%. In short, EUR NEER managed to regain half of the recent drop in less than one and a half years. During this period, EUR/USD has continued in the 1.05-1.15 range, displaying some characteristics of a fixed exchange rate system, but EUR's maintenance of robustness against non-USD currencies led to the EUR NEER's strengthening. One of the issues attracting the most attention with respect to the September 8 ECB Governing Council Meeting is how the strengthening of EUR will be evaluated.



(Source) Bloomberg (Notes) EU 19 countries vs G20 countries. Bold line: Q1

Movement toward fundamentals-based levels

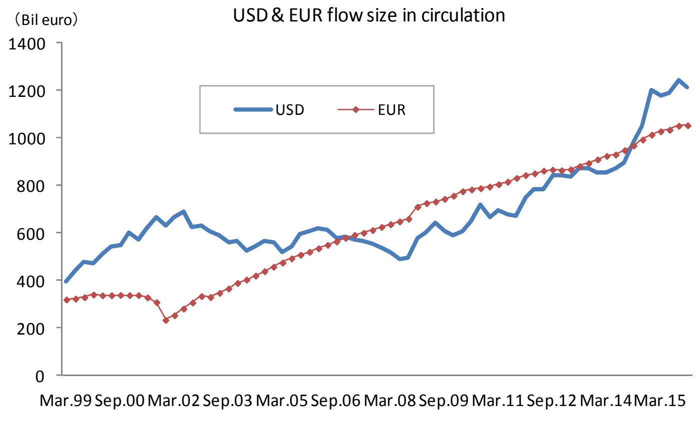
This article has long been arguing that, logically, EUR should be strengthening. The euro area is recording the world's largest current account surpluses and showing a chronic disinflationary tendency, and these are fundamental factors that can be expected to cause a currency to strengthen. However, the smooth advance of the FRB's normalization process during the past two years has provided a supportive environment for the effectiveness of the ECB's rapid-fire easing measures, resulting in EUR's steady weakening. Currently, the FRB's normalization process appears on the verge of derailing, and U.S. currency policy has begun showing a preference for USD depreciation. Regardless of how strongly its desire for EUR depreciation may be, the ECB will soon be confronted with the fact that it is not an easy task to manipulate forex rates in a manner that directly conflicts with U.S. interests. <u>As the graph shows, the euro area's current account surplus has risen to an average monthly level of EUR20-30 billion (≈JPY2.3-3.4 trillion at a rate of EUR 1 = JPY 114) since the start of 2016, but EUR shows no signs of appreciating against USD in line with that situation. Recently, one gets the impression that EUR/USD has been showing signs of gradually bottoming out.</u>



(Source) Datastream

As previously noted, it is clear that U.S. policies have overwhelming power within the floating exchange rate system. However, <u>EUR is the only currency rivaling USD in terms of the quantity of money in circulation (see graph)</u>. Looking at years since the post-financial crisis, one finds that EUR was surpassing USD in terms of the quantity of money in circulation for a protracted period.

Given that the ECB is supervising this great volume of currency, I have been getting the impression in recent years that additional easing by the ECB (but not by the BOJ) has the potential to counter the effect of U.S. policies to a certain extent. If this were not the case, it would be impossible to explain why a currency with such strong fundamentals is so resistant to strengthening. While the effects of such special factors as Brexit and frequent terrorist incidents cannot be ignored, it is still worth noting that JPY has appreciated about 20% against USD since the start of this year while EUR has appreciated only about 4% against USD during that period. Ultimately, it may be that we should be recognizing the effectiveness of the ECB's policy mix of -0.40% interest rates and quantitative expansion policies (APP).



(Source) IMF & Bloomberg (Note) Denominated in euro

Even so, however, it would be quite difficult for the ECB to completely overcome U.S. policies and engineer EUR's depreciation against USD as seen from 2014, and this is why we are currently seeing EUR edging upward against USD. Going forward, as the U.S. economy approaches the end of its cyclical expansionary period, if it becomes evident that the FRB's normalization process has been stymied, then EUR appreciation will probably be inevitable. As mentioned above, given that the ECB may be able to restrain the EUR appreciation if it goes all out to prevent it, it may be very difficult for EUR/USD to surpass 1.20 during the next year, but I believe it prudent to note that the risk of higher levels is growing. Just as USD/JPY rates have returned to levels in line with such fundamental factors as current account surpluses and purchasing power parity forex rates, I believe that there is a great potential for EUR forex rates to move toward fundamentals-based levels.

Daisuke Karakama
Chief Market Economist
Forex Division
Mizuho Bank, Ltd.
Tel: +81-3-3242-7065
daisuke.karakama@mizuho-bk.co.jp