Mizuho Bank

# Forex Medium-Term Outlook

2 November 2016

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Forex Division

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## Overview of Outlook

Amid USD/JPY strength during October, some are beginning to forecast a weak-JPY trend through 2017, but I do not see the need to revise the main scenario of this report's forecast so far. The theme for 2017 I envisage as of the moment is "an earnest reversal of the former USD appreciation trend," with 2016 having been the starting year, i.e., the year that signaled the beginning of the end of USD appreciation. I believe that when and how many more times the FRB will implement rate hikes are trivial issues. Going by the U.S. October Semiannual Report on International Economic and Exchange Rate Policies, it is hard to believe that the U.S. currency policy would tolerate a greater level of USD strength than at present, which is in conflict with the monetary policy (FRB) normalization efforts. Under such circumstances, a spiraling situation with consecutive rate hikes and the accompanying USD appreciation is rather unreasonable. Even though USD has undergone some adjustment (weakening) against JPY, this has been offset by its strengthening against GBP, MXN and CNY, and the currency has not seen any significant weakening in real effective terms. There are uncertainties surrounding the economic policies of the new U.S. president, but in formulating forecasts, one cannot afford to ignore the fact that the reversal of USD strength is still insufficient. It is USD weakness rather than JPY strength that must be forecast. Given the current JPY interest rate climate, the foreign securities investment of Japanese investors seems worth noting as a factor exerting downward pressure on JPY, but I do not believe this pressure is sufficient to reverse forex rate trends.

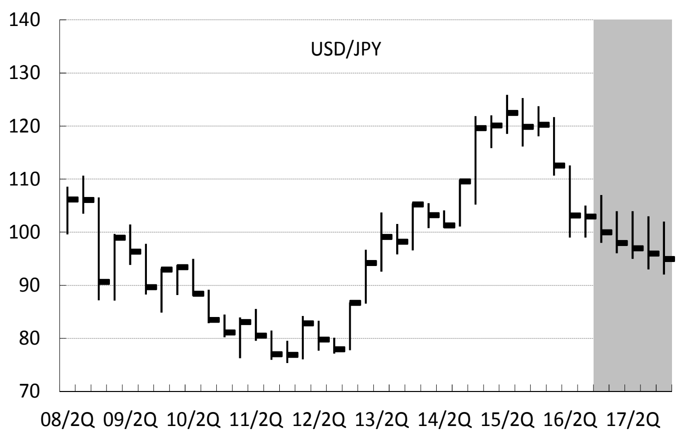
EUR continues to be somewhat weak. Amid increasing expectations of an additional monetary easing by the ECB, the numerous risk factors associated with Europe are suddenly thrown into relief – for example, concerns about the management of Germany's largest bank, the Italian constitutional referendum toward the end of the year, and Greece's financial reconstruction challenges. These factors have also been responsible for weakening EUR. However, one gets the impression there will be at best two more rate hikes by the FRB, not to mention the possibility that the normalization process could end without any further rate hikes. It is difficult, therefore, to forecast that EUR, the currency of the region with the world's largest current account surplus, will continue to weaken further. Also, even though there are increasing expectations of an additional easing, the ECB has very limited options when it comes to its "next move," so one must not rule out a disappointing turn of events. If, as I mentioned above, 2017 turns out to be the year of "an earnest reversal of the former USD appreciation trend," the other side of that coin would be strong EUR rates. The ECB is likely to want to counteract this strength of EUR through accommodative monetary policies – going by past experience, I predict that EUR would become top-heavy at around the level of 1.15 for EUR/USD.

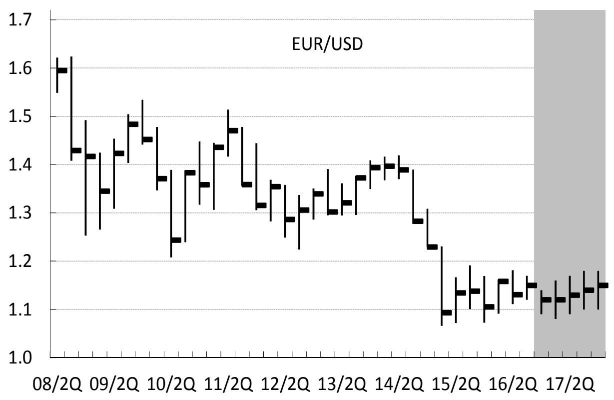
**Summary Table of Forecasts**

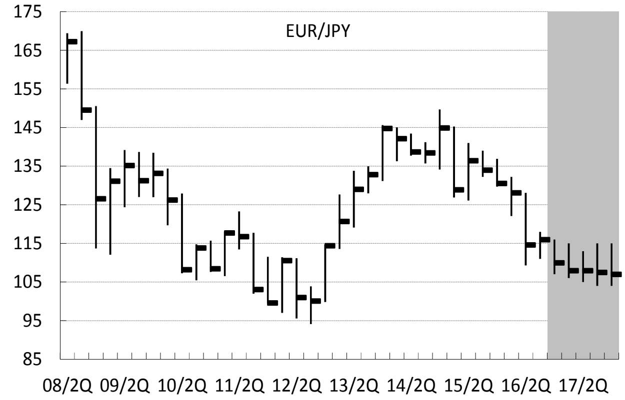
| | 2016<br>Jan-Oct (actual) | Nov-Dec | 2017<br>Jan-Mar | Apr-Jun | Jul-Sep | Oct-Dec |
|---|---|---|---|---|---|---|
| **USD/JPY** | 99.00 ～ 121.70<br>(104.06) | 98 ～ 107<br>(100) | 96 ～ 104<br>(98) | 95 ～ 104<br>(97) | 93 ～ 103<br>(96) | 92 ～ 102<br>(95) |
| **EUR/USD** | 1.0711 ～ 1.1616<br>(1.1053) | 1.07 ～ 1.12<br>(1.10) | 1.06 ～ 1.14<br>(1.10) | 1.07 ～ 1.15<br>(1.11) | 1.08 ～ 1.16<br>(1.12) | 1.08 ～ 1.16<br>(1.13) |
| **EUR/JPY** | 109.30 ～ 132.45<br>(115.04) | 107 ～ 116<br>(110) | 106 ～ 115<br>(108) | 105 ～ 113<br>(108) | 104 ～ 115<br>(108) | 104 ～ 115<br>(107) |

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

**Exchange Rate Trends & Forecasts**





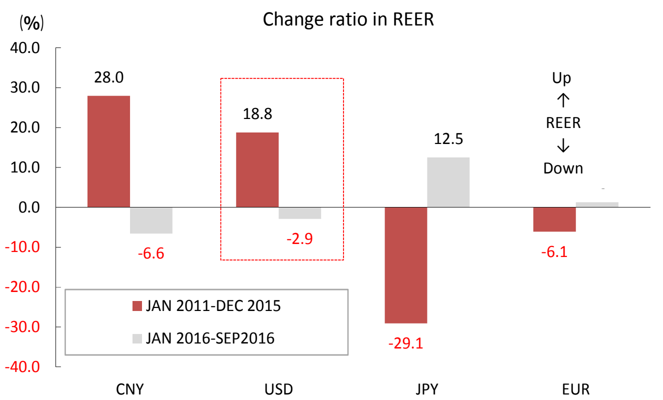




# USD/JPY outlook – Reversal of USD strength is only beginning

## USD rates now and going forward – Adjustments in real-effective USD rate will spill over into 2017

***Theme for 2017 is "an earnest reversal of the former USD appreciation trend"***

Toward the end of October, USD/JPY was strong, rising to the neighborhood of 105 at one point. I will explain the risks to my main scenario (JPY strength and USD weakness through 2017) later, but essentially, I do not feel that there is any need to change the direction of my main scenario. The theme for 2017 I envisage as of the moment is "an earnest reversal of the former USD appreciation trend," with 2016 having been the starting year, i.e., the year that signaled the beginning of the end of USD appreciation. If we use the Real Effective Exchange Rate (REER) as the measure, USD's REER increased by about +20% over the five years up to the start of the current year, but it has declined by a mere −3% since the start of this year through September (see exhibit). From the Japanese perspective, it looks as though there has been a considerable reversal of USD strength because JPY has appreciated by over 20 against USD since the beginning of the year, but that adjustment is only against JPY. USD's adjustment against other key currencies has not progressed all that much.



(Source) BIS (Note) Broad base

***Depreciation against JPY cancelled out***

Perhaps a clearer image can be obtained by looking at Nominal Effective Exchange Rates (NEER) and specific currency pairs rather than discussing the REER. First, looking at the rate of change of USD in terms of NEER (from 31 December, 2015 to 30 September 2016), it has fallen by 2.7%. The chart to the right looks at the contribution and rate of change of USD against the top currencies that contribute to its NEER. Among currencies that have strengthened against USD, JPY is at the top, with a +18.6% increase, contributing −1.5 pp to the overall decrease in USD's NEER. In other words, over half of the weakening of USD since the beginning of this year is owing to JPY strengthening. JPY is followed by KRW, which has increased +6.5% and contributed −0.2 pp, CAD, which has increased +5.4% and contributed −0.7 pp, and EUR, which has increased +3.4% and contributed −0.6 pp to USD's NEER. On the other hand, GBP is the top currency that has weakened against USD,

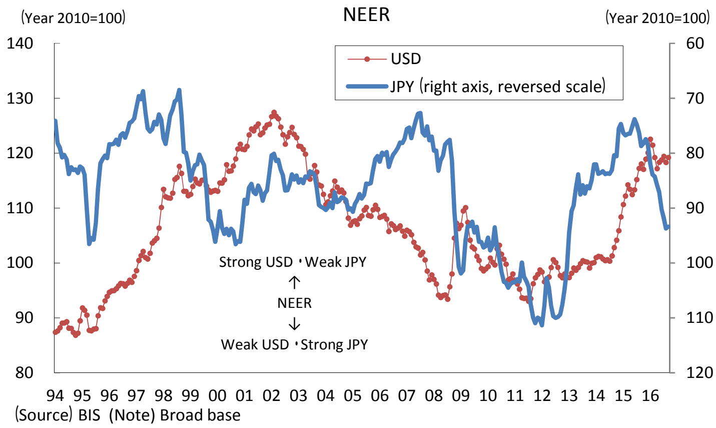
Contribution and rate of change of USD NEER JAN-SEP 2016

| Country | Share | JAN-SEP 2016 USD against each ccy (%) | Contribution (%pts) |
|---|---|---|---|
| China | 21.7 | -2.7 | 0.6 |
| Euro-zone | 16.6 | 3.4 | -0.6 |
| Canada | 12.9 | 5.4 | -0.7 |
| Mexico | 12.5 | -11.2 | 1.4 |
| Japan | 8.0 | 18.6 | -1.5 |
| S.Korea | 3.6 | 6.5 | -0.2 |
| Taiwan | 2.2 | 5.0 | -0.1 |
| Switzerland | 1.5 | 3.2 | -0.0 |
| UK | 3.1 | -12.0 | 0.4 |
| Others (residual) | 39.6 | - | -1.9 |
| JAN-SEP 2016 NEER | - | -2.7 | -2.7 |

(Source) BIS & Bloomberg. NEER: Broad base (Note) Rate of change: 31DEC 2015-30SEP2016 decreasing −12.0% and contributing +0.4 pp to USD's NEER. This is followed by MXN, which has decreased -11.2% and contributed +1.4 pp, and CNY, which has decreased −2.7% and contributed +0.6 pp to USD's NEER. As one can tell by looking at the contributions from the various currencies, USD's depreciation against JPY and CAD has been completely cancelled out by its appreciation against GBP, MXN, and CNY. Consequently, USD has not undergone much overall depreciation, leaving considerable scope for further depreciation in 2017. The biggest reason why USD has been unable to depreciate is the FRB's obstinate rate-hike stance, but Britain's withdrawal from the EU (Brexit) and the devaluation of CNY have also played a big role.

### *Could JPY depreciate alongside USD?*

Of course, given that JPY has strengthened sufficiently, it is possible that the scope for a further appreciation of JPY is limited even if the overall level of USD continues to depreciate going forward. One cannot completely rule out this possibility. In fact, going by the fundamentals (current account balance, real interest rates, etc.), the currency that really should appreciate a bit more is not JPY but EUR. However, as forex market participants know well, it is only in very rare cases that the overall value of JPY depreciates during phases when the overall value of USD is depreciating. There is a strong impression that the NEERs of USD and JPY have so far had an inverse correlation (see exhibit). Going by experience, JPY has always appreciated in phases of USD depreciation except during 2005-2007, when both USD and JPY carry trade prospered during the age of "Europhoria," when EUR rates were at their height. Unfortunately, just because JPY has strengthened significantly in advance does not mean that further appreciation will be curbed, given that USD appreciation has not yet been sufficiently reversed. This is my frank opinion regarding the outlook for 2017.



(Source) BIS (Note) Broad base

## U.S. currency policies now and going forward – No change in strict stance against Japan

### *Switzerland newly included in the Monitoring List*

The U.S. Department of Treasury's latest Semiannual Report on International Economic and Exchange Rate Policies was published on October 14. The "Monitoring List," which was introduced for the first time in the April 29 Semiannual Report, is still going strong, with Switzerland having been added as the sixth country on that list in addition to the original five – China, Germany, Japan, South Korea, and Taiwan. Any country that meets two out of the following three criteria is placed on the Monitoring List: (1) trade surplus vis-à-vis the U.S. in excess of USD 20 billion a year, (2) current account surplus worth 3% of GDP or more, (3) unilateral and continued foreign currency purchasing forex interventions worth +2% of GDP or more over a period of 12 months. A country that meets all three of the above criteria is declared a "currency manipulator." Switzerland was included in the Monitoring List this time because it met criteria (2) and (3), specifically – it has a current account surplus worth +10% of its GDP, and it has unilaterally manipulated currency worth +9.1% of its GDP (see exhibit). Given its clearly enormous (foreign currency purchasing) currency interventions for a developed country, many are likely to be surprised that Switzerland had not been on the Monitoring List so far.

3 conditions in monitoring list

| | | Current balance | | Buying USD & selling own ccy intervention |
|---|---|---|---|---|
| | Trade surplus vis-à-vis the U.S. (JUL 2015-JUN 2016, Bil dollar) | vs GDP (%, 2015) | Change in last 3 yrs (% pts) | vs GDP |
| **China** | **356.1** | **2.4%** | **0.0%** | **-5.1%** |
| **Germany** | **71.1** | **9.1%** | **2.3%** | **-** |
| **Japan** | **67.6** | **3.7%** | **2.6%** | **0.0%** |
| Mexico | 62.6 | -2.9% | -0.8% | -2.2% |
| **S.Korea** | **30.2** | **7.9%** | **2.0%** | **-1.8%** |
| Italy | 28.3 | 2.3% | 1.9% | - |
| India | 24.0 | -0.8% | 4.2% | 0.3% |
| France | 18.0 | -0.5% | 0.4% | - |
| **Taiwan** | **13.6** | **14.8%** | **5.2%** | **2.5%** |
| **Switzland** | **12.9** | **10.0%** | **-1.6%** | **9.1%** |
| Canada | 11.2 | -3.4% | 0.1% | 0.0% |
| UK | -0.3 | -5.7% | -2.0% | 0.0% |
| Euro-zone | 130.5 | 3.2% | 1.3% | 0.0% |

(Source) U.S. Ministry of Finance (Note) Euro zone: Estimation by U.S. Ministry of Finance

***China to be excluded from the Monitoring List?***

China, meanwhile, meets only criterion (1) for the evaluation period of the recent report (the four quarters through June 2016), while its (2) fell from +3% as of April this year to +2.4%, which is below the criterion level. As for (3), China implemented a domestic currency purchasing and foreign currency selling intervention worth USD 570 billion over the one year period from last August to this August, which runs in the reverse direction to that assumed in the criterion and is aimed at inducing domestic currency strength (the same is true also of South Korea, although on a different scale). If things continue as they are, it is beginning to seem likely that China could even be taken off the Monitoring List in next April's Semiannual Report. As I have mentioned in past editions of this report, China's currency policy over the past year has been to use capital regulations and currency intervention to prop up the value of a currency that would otherwise naturally decline in value. In other words, the Chinese monetary authorities are using their power to prop up a currency that would most certainly go into a free-fall if capital regulations were removed and a freely floating exchange rate system was permitted as per the wishes of the U.S., so the kind of simplistic criticism leveled at currency devaluation efforts has become unfeasible in this case. The recent report also highlighted the misunderstanding of circumstances by Republican Party presidential candidate Donald Trump, who earlier made a careless remark saying he would declare China a "currency manipulator" if he became president.

***No change in strict stance against Japan***

Following the release of the April Semiannual Report, the conflict of opinion between Japanese and U.S. authorities over whether USD/JPY market conditions were "orderly" or "disorderly" drew attention. This time, the Report refrained from using the word "orderly," but instead said "Treasury assesses that the dollar‐yen foreign exchange market has been functioning smoothly," which indicates not much change in the tone of the message. What is more, the Report also said that "Japan has not intervened in the foreign exchange market in almost five years, but authorities have made persistent public statements to restrain appreciation in 2016, characterizing yen/dollar movements as "rough" and warning that they "will take firm action" if necessary." To summarize, the U.S. Treasury Department's stance regarding JPY rates based on the above statements seems to be, "Japanese authorities are hinting at currency intervention by declaring normal functioning as "abnormal," which is unacceptable."

***Treasury Department's stance on USD depreciation is that it is merely a "reversal"***

Country-wise details tend to draw attention in the Semiannual Report, but one can also get glimpses of the Treasury Department's stance in the section "The Dollar in Foreign Exchange Markets" before the country-wise economic trends, and I always take a look at it. The main stances in this time's report can be summarized as follows:

- *USD's NEER, which had increased +6.5% during 2H of 2015, fell by −1.1% during 1H of 2016. USD has increased by +4% against developed countries' currencies. Its significant fall by −14% against JPY has been offset by its +10% rise against GBP, with almost no change being observed against EUR. USD has also not changed much against the currencies of newly emerging economies, posting only a small rise of +0.8% in NEER terms against them.*
- *Looking at movements in terms of currency pairs over the one year period through September this year, USD increased against GBP, MXN, and CNY. On the other hand, it declined against EUR, JPY, KRW, CHF, CAD, and TWD. Some of these currency movements of 2016 are reversals of trends that took place in 2015.*

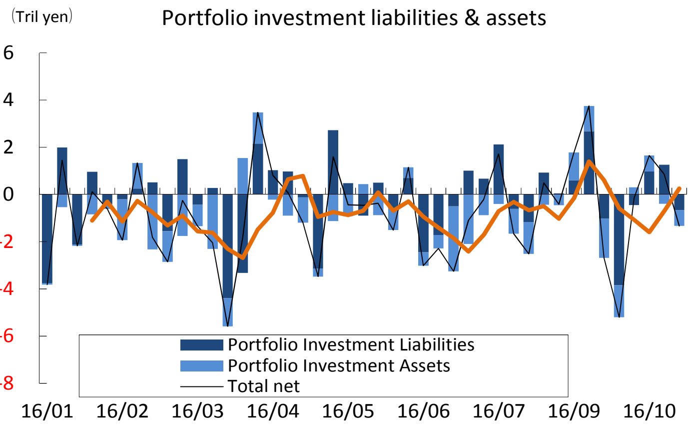
It is difficult to get a clear idea of the Treasury Department's intentions from this, but one can see that the depreciation of USD since the beginning of the year is considered to be simply a reversal of the trend prior to that – in other words, a natural development. It is true that there has not been a sufficient reversal of the sharp rise in USD rates since mid-2014, and the Treasury Department's view that the present trend is merely a part of that reversal process is quite appropriate. This basic understanding with regard to USD rates is the same as my basic understanding (which I have been emphasizing) – that the reversal of the trend of the past two years or more has only just begun. As mentioned above, factors including the FRB's obstinate rate-hike stance, the sharp depreciation of GBP, and the devaluation of CNY have prevented USD from depreciating much, and there is still plenty of scope for an adjustment.

I believe that the details of the recent Semiannual Report reaffirm this report's main scenario. Even though JPY has appreciated significantly against USD since the beginning of the year, the USD-selling trend has not yet spilled over into the broader USD market. I believe it is important to be warned that 2016 is no more than the beginning of the end of USD strength, with the real adjustment yet to come. Given that the reversal of last year's trend is still insufficient, it seems very likely, regardless of who the new president and secretary of the Treasury is, that the currency policies of the new U.S. administration will be averse to USD strength.

## Basic JPY supply and demand – The presence of realistic risks

***Capital outflow is the dominant trend***

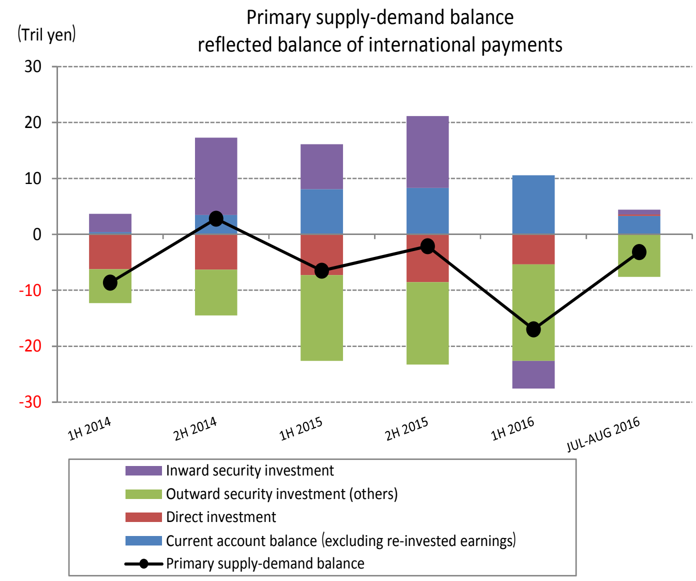
Going by the Ministry of Finance's latest release of the International Transactions in Securities as of the time of writing this report, the dominant trend since the beginning of the year has been "a net outflow of capital resulting from the combination of a net acquisition of portfolio investment assets and a net disposition of portfolio investment liabilities." In a majority of the cases, the driver of the net disposition of portfolio investment liabilities seems to be Equity and investment fund shares, and in fact, looking at the cumulative disposition amounts by category since the beginning of the year, this category is at the top (see exhibit). <u>The amount reflects the extent of decline in risk appetite among foreign investors</u>. Meanwhile, investment in Japanese Government Bonds (JGBs) has become advantageous for foreign investors holding USD amid a distortion in basis swap prices, and in fact, long-term debt securities alone have posted a significant net acquisition. In any case, netting out portfolio investment assets and portfolio investment liabilities, the basic trend is one of capital outflow, and as I will explain later, from the perspective of forex outlook, this is driving a net sale of JPY in terms of supply and demand.



(Source) Finance of Ministry, Japan

***Basic JPY supply and demand situation – The presence of realistic risks***

Looking at the latest in the basic JPY supply and demand balance I compute (see exhibit on the next page) for the purposes of this report using Japan's Balance of Payments (which includes portfolio investment assets and liabilities), 1H of 2016 posted net JPY sales of around −JPY 17 trillion, which is almost twice the −JPY 8.6 trillion worth of net sales posted for the entire year 2015. As the exhibit shows, this has been driven by a robust net acquisition of portfolio investment assets, and as seen above, is partly due to the net disposition of Equity and investment fund shares and Short-term debt securities amid the turmoil in the international financial markets since the beginning of the year (portfolio investment liabilities have posted a net disposition on a half-year basis since 2H of 2009). As is clear from the exhibit on the previous page, the large net disposition of portfolio investment liabilities in 2016 has, in many ways, determined the direction of capital flow (outflow). As of now, for the combined basic supply-demand balance for July and August, the reversal to a net acquisition of portfolio investment liabilities has added to the already large current account surplus, but portfolio investment assets do remain quite strong, resulting in a net sale of JPY worth around −JPY 3.1 trillion.



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

As I have been saying repeatedly in this report, against interest rate conditions that are extremely unfavorable for investment, it is difficult to imagine a reversal to net disposition (JPY purchase) in portfolio investment assets even in the face of a slowdown in overseas economies including the U.S. So far, such flows have mostly been executed through hedged investments, but amid an increase in USD funding costs, it seems likely that many investors will begin to consider investing in foreign securities without a hedge, which could have a significant impact on forex rates. Of course, JPY continued to strengthen during 1H despite the extremely large net acquisition of portfolio investment assets, but perhaps the reason JPY did not remain below 100 for as long as expected was because of the existence of this large net acquisition of portfolio investment assets. <u>This selling of JPY by Japanese investors will continue to be "the most realistic risk" to my JPY outlook in this report.</u>

## BOJ monetary policies now and going forward – Aiming for a “low-key” monetary policy operation

### *Aiming for a “low-key” monetary policy operation*

The monetary policy was kept unchanged at the BOJ Monetary Policy Meeting held on October 31-November 1. The decision to retain the status quo was as per market expectations, but with regard to the Consumer Price Index (CPI) 2% yoy growth target, whereas the markets were expecting a specific deadline to be withdrawn, it was merely postponed from “FY 2017” to “around FY 2018,” with the deadline remaining clearly specified. Similarly, the markets had expected the specific yearly JGB purchase target of JPY 80 trillion yen to be withdrawn, but it remained untouched. <u>One gets the impression that, by retaining the above two deadlines, the BOJ has managed to barely maintain the dignity of its reflationary stance.</u>

Major outlook by BOJ policy board members (YoY %)

| | Real GDP | CPI excluding fresh foods |
|---|---|---|
| FY 2016 | 0.8〜1.0 <1.0> | -0.3〜-0.1 <-0.1> |
| Outlook as of JUL | 0.8〜1.0 <1.0> | 0.0〜0.3 <0.1> |
| FY 2017 | 1.0〜1.5 <1.3> | 0.6〜1.6 <1.5> |
| Outlook as of JUL | 1.0〜1.5 <1.3> | 0.8〜1.8 <1.7> |
| FY 2018 | 0.8〜1.0 <0.9> | 0.9〜1.9 <1.7> |
| Outlook as of JUL | 0.8〜1.0 <0.9> | 1.0〜2.0 <1.9> |

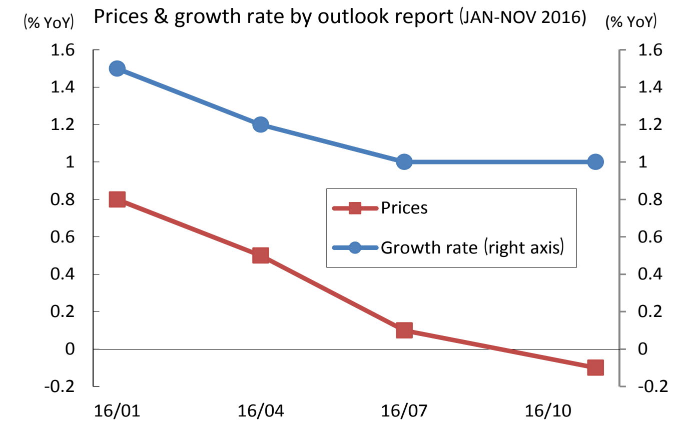
(Source) Bank of Japan

(Note) <> indicate the median estimate by policy board members

The recent postponement of deadline has made it difficult to achieve the price stability target within Governor Haruhiko Kuroda’s term in office (which is until April 2018), but this does not seem unnatural given that the September meeting decision to switch from the framework of “Quantitative and Qualitative Monetary Easing with Negative Interest Rates” to one of “Quantitative and Qualitative Monetary Easing with Yield Curve Control” was based on a long-term vision that extended beyond Mr. Kuroda’s term in office. In the first place, even if the BOJ had set itself an FY 2017 deadline for the 2% price stability target, most market participants would have found it unconvincing (although, as I will explain below, the probability of reaching +1.9% growth during FY 2018 does not seem very high either). As I have said in past editions of this report, <u>what the BOJ really wants is probably not to be front stage any more – in other words, it probably aims to conduct more low-key monetary policy operations.</u>

### *Discrepancy between growth rate and prices*

I would like to give an overview here of the recently renewed Outlook for Economic Activity and Prices (Outlook Report — see exhibit on previous page). The Core CPI (CPI excluding fresh food) outlook for FY 2016 was lowered from the +0.1% as of the previous (July) report to −0.1% this time. On a fiscal-year basis, this is the first time in four years that a negative growth rate has been predicted. The negative interest rate policy introduced with great fanfare in January this year has not been able to boost prices even after crude oil prices stopped falling, and as of the present at least, it must be seen as a policy with more disadvantages than advantages. As for the FY 2017 Core CPI outlook, it has been lowered from +1.7% to +1.5%, indicating (as mentioned above) the official abandonment of the original target of 2% for this year. <u>The price stability target had so far been postponed in half-year units (specifying 1H or 2H of the given year), but this time, it has been postponed by a whole year, indicating the BOJ’s stance of not wanting to insist on a strict deadline for achieving the price stability target.</u> Having said that, the +1.7% target for FY 2018 is still a rather optimistic one going by market predictions, so there may be speculation about another postponement starting sometime mid-year net year.




(Source) Bank of Japan

Incidentally, looking back at the four Outlook Reports (January, April, July, November) released since the beginning of 2016, the Core CPI outlook has been sharply downgraded from +0.8% → +0.5% → +0.1% → −0.1%. Meanwhile, the Real GDP outlook has been downgraded more moderately from +1.5% → +1.2% → +1.0% → +1.0% (see exhibit). Looking at a situation like this where growth remains strong despite prices not rising, I cannot help thinking that <u>the concept behind extreme reflationary policies (so long as prices rise, everything will be okay), bandied about since early 2013, are flawed after all.</u>

***No additional easing until JPY falls below 95***

Even the forex markets, which have up to now had the most impulsive reactions to the BOJ's monetary policy operations, did not move much before and following the recent BOJ Monetary Policy Meeting. It seems that price trends and additional easing decisions are no longer in correlation, so there was no increase in speculation before the recent meeting that an additional monetary easing decision would be made if the price stability target deadline was postponed. It is undoubtedly a great achievement for the BOJ that, following its "comprehensive assessment," it has successfully extricated itself from the vicious cycle of a self-fulfilling prophecy-style monetary easing urged by the markets (having said that, this "vicious cycle of a self-fulfilling prophecy-style monetary easing urged by the markets" was mainly owing to its own surprise-driven policy operation, and therefore a just retribution). In any case, going forward, the BOJ's policies will not be much of an issue in the forex markets except in the case of an extreme JPY appreciation.

Note that under the present scheme, an additional easing would probably mean an expansion of the negative interest rate margin, but this involves risks that would be very difficult to manage. Assuming that the BOJ decides to expand the negative interest rate margin, the situation is likely to unfold as follows: (1) a lowering of the short-term interest rate → (2) a lowering of the long-term interest rate → (3) a shrinking of JGB purchases in order to maintain the 0% interest rate peg. Of these, in particular, if the extent of (3) were to increase, there will very likely be an increase in those who compare this move to "tapering." If that were to happen, the worst nightmare for the BOJ would be to be sucked in to a vicious cycle of (3) a shrinking of JGB purchases in order to maintain the 0% interest rate peg → (4) speculation about tapering → (5) JPY appreciation (→ a return to (1)). In a hypothetical situation where this happens, it would be quite difficult for the BOJ to extricate itself from the mess. Also, if one envisages the unfolding of the situation to that extent, the best solution seems to be to withdraw from the commitment to a JPY 80 trillion yearly JGB purchase target as soon as possible. This is because, any strengthening of market speculation about tapering is likely to be based on a comparison with the JPY 80 trillion annual target. If the BOJ wants to prevent an acceleration from (1) to (5), the safest bet would be to first officially withdraw from the criteria that is liable to be used as a standard for comparison. In any case, the QQE with Yield Curve Control policy, as mentioned above, inherently involves the risk of inviting a vicious cycle of the above kind – it is just that the risk has not yet surfaced because both foreign economic conditions and USD/JPY rates are currently quite stable.

Going forward, given the risk of irreversibly triggering the above vicious cycle if the negative interest rate margin is expanded in an effort to contain JPY appreciation, the BOJ will have to move very cautiously when it comes to an additional easing. Under these circumstances, for an additional easing to be realistically considered, the situation would have to be considerably out of hand – in forex rate terms, it would probably be at a juncture when USD/JPY has fallen below 95, and there are concerns of it sinking to the 80 level.

## Risks to my main scenario – Factors promoting JPY appreciation relatively prominent

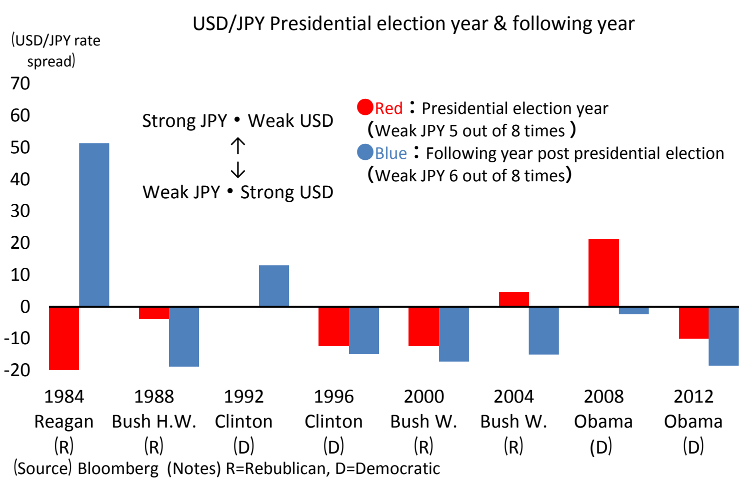
***JPY depreciation risks –New president's economic stimulus measures a factor promoting JPY depreciation?***

In light of the rise of USD/JPY past the 105 level toward the end of October, an increasing number of people are questioning the amount of risk associated with this article's forecast. However, as explained above – owing to the likelihood that the FRB's normalization process will continue to be sluggish and make no progress during 2017 and the likelihood that expectations of a rise in U.S. interest rates will progressively dissipate – I am anticipating a full-scale adjustment (USD depreciation) of the USD appreciation trend seen over the past two and a half years. When the adjustment takes place, the likelihood that JPY would independently depreciate is probably not zero, but such likelihood does not appear to be very realistic in light of the historical record. (This is just as was argued at the start of this article.) On the other hand, because it is impossible to be omniscient about future events, all forecasts are associated with risk factors with the potential to push forex rates both higher and lower than the forecast levels. These risk factors are presented in the chart, and the JPY appreciation risk factors are colored to differentiate them from the other risk factors. Since it is the JPY depreciation risk factors that are currently of concern and run directly counter to this article's main scenario, I will begin by offering a simple overview of the JPY depreciation risk factors — (1), (3), (5), and (6).

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.<br>・Economic recovery in emerging countries | Weak JPY<br>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<br>Weak USD |
| US | ③ | Economic policy by new President | ・Under Clinton, infrastructure investment→bloom→strong USD? | Weak JPY<br>Strong USD |
| US | ④ | Additional FRBs easing | ・Interest rate cut in the wake of U.S. sudden recession & QE4 pondering? | Strong JPY<br>Weak USD |
| Japan | ⑤ | Risk-taking by Japanese investors | ・Changing main policy from currency hedges to increasing open positions? | Weak JPY<br>Strong USD |
| Japan | ⑥ | Japan officials strong JPY curbing | ・BOJ's continuous negative interest rates expansion.<br>・Buying USD/JPY intervention (or rumor) | Weak JPY<br>Strong USD |
| Europe | ⑦ | EU related fear | ・Hard Brexit problem. Invoking Article 50 end of March 2017.<br>・Major elections (Germany, France, Netherlands and others) | Strong JPY<br>Weak USD |

As I have repeatedly explained, this article's main scenario is predicated on the assumption that the FRB's normalization process will not be able to withstand pressures associated with USD appreciation and will therefore be aborted. Accordingly, if the US economy or the global economy were to become stronger than anticipated and enable the FRB to implement successive interest rate hikes, then that would represent a major miscalculation. This is risk factor (1) in the chart. Certainly, as the U.S. labor market is attaining a full-employment situation and signs of budding inflation are beginning to be confirmed, there remains a logical basis for the FRB to argue for interest rate hikes. A shift to full-scale inflation requiring sharp interest rate hikes in a short time period is the scenario that the FRB would most like to avoid. However, it cannot be said that the risk of such a scenario is very high. Currently, as interest rates fall to very low levels worldwide, if the FRB were to advance with normalization, there would inevitably be a flood of funds into USD-denominated assets. The resulting across-the-board appreciation of USD against other currencies would generate economic and political pressures that the United States would not be likely to be able to withstand. Based on an examination of the content of the U.S. Treasury Department's most recent Semiannual Report on International Economic and Exchange Rate Policies, there is no evidence at all of a mood that would allow for a sustained rise in USD/JPY.




In addition, based on who may become the next U.S. president, there is reason for concern regarding risk factor (3) in the chart. Currently, the financial markets are generally considering a win by the Democratic Party candidate, Hillary Clinton, as their main forecast scenario, so attention is being focused on the effect that Clinton's economic policies would directly exert on the U.S. economy and thereby indirectly exert on the FRB's monetary policies and on forex markets. It has been reported that Clinton has drafted an infrastructure investment plan calling for USD275.0 billion of investments over five years, and if other factors are unchanged, the implementation of that plan could be expected to have an uplifting effect on the real economy. Having already been proposing interest rates hikes based on the robustness of the real economy, the FRB would consider such a development to be a godsend, and there is a possibility that this would increase the likelihood of interest rate hikes and therefore have the effect of promoting USD appreciation. Moreover, at this point in the U.S. election cycle, one often hears talk about the potential for an anomalous situation in which "a JPY depreciation/USD appreciation trend is more

likely to occur during a U.S. presidential election year and the following year," but this ultimately seems to be predicated on the assumption that new presidents will be inclined to promote economic stimulus measures, thereby boosting expectations of rising interest rates and promoting USD purchasing. Looking at the eight U.S. presidential election years since 1980, one finds that there was JPY depreciation in five of those election years (1984, 1988, 1996, 2000, and 2012) and in six of the post-election years (1989, 1997, 2001, 2005, 2009, and 2013). It does in fact appear to be true that JPY depreciation is more likely in such years (see graph).
However, this current presidential election year (barring an approximately JPY20 rise in USD/JPY during two months) seems almost certain to be a "JPY appreciation year," so the anomalous situation does not appear likely to manifest itself soon. Moreover, as I have repeatedly argued, since the global economy's sluggishness has attained a degree of severity unprecedented in recent history, regardless of how strong U.S. economic conditions may become, if the FRB were to respond to the strength by implementing interest rate hikes, then it would ultimately lead to USD appreciation that would promote the onset of a U.S. recession. FRB Governor Lael Brainard has repeatedly argued that continuing to unilaterally hike interest rates in today's world would simply cause the appreciation of one's currency in a self-destructive manner, and I personally think she is correct. Moreover, I think it wise to consider the eight U.S. presidential election years cited above to be too small a data base to justify calling the incidence of JPY depreciation years a full-fledged anomaly.

***Risk of continued Japanese outward securities investment***

Each month recently, this article has been arguing that the most realistic risk threatening the JPY appreciation outlook is risk factor (5). The miserable JPY interest rate environment is spurring an acceleration of overseas risk-taking on the parts of Japanese investors, and this has the potential for promoting greater-than-expected JPY depreciation (or preventing the progress of JPY appreciation.) It does not seem likely that there will be a large change in this situation during 2017. 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 the environment for a U.S. interest rate hike next year would be extremely harsh. 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. Even in a hypothetical case in which the FRB was actually able to increase rates, it appears that one or two hikes would be the limit of feasibility. Given that forex market movements anticipate expectations and that the interest rate hikes would only become a full-fledged factor promoting JPY selling when the interest rate hikes are sustained, it seems that tentative interest hike measures with quite apparent limits would be fundamentally incapable of becoming a full-fledged factor promoting JPY selling. From the supply-demand perspective, some people are inclined to forecast JPY weakening going forward based on expectations of a full-scale resurgence of crude oil prices that decreases Japan's trade surplus. However, it would be perilous to forecast forex rates based on an assumption that crude oil prices could recover to the high levels they maintained in the past and, even if such an unlikely event were to happen, it still must be remembered that the effect of trade and current account balances on forex rates generally is exerted only after a one year lag. It would be hard to say that there is much of a JPY depreciation risk during the forecast period (the next 12 months).
Naturally, it will be important to keep an eye on risk factor (6), in which the policy responses of the Japanese government and the BOJ (specifically, forex market intervention and additional easing) might elevate USD/JPY. I do not believe that BOJ policies alone are capable of reversing the JPY appreciation trend, but since JPY-long speculative positions remain, 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.
As explained in a recent Mizuho Market Topic[1], however, the BOJ is moving away from the limelight and appears determined to do its best to maintain the status quo. Given this and the tone of the U.S. Treasury Department's most recent Semiannual Report on International Economic and Exchange Rate Policies, it is probably not realistic to expect BOJ forex market intervention to significantly impact the main scenario. Overall, the risk of an unexpected shift to JPY depreciation does not seem very large.

[1] Please see the October 25, 2016, edition of Mizuho Market Topic entitled "Preview of BOJ monetary policy meeting – No more desire to be in the limelight.

***JPY appreciation risks – Concern that a new U.S. presidential administration may induce USD depreciation***

As I have been repeatedly arguing, it is unclear whether U.S. currency policies under a new presidential administration would permit any more than the recent amount of USD appreciation, so one cannot disregard risk factor (2). As just noted, the tone of the Semiannual Report on International Economic and Exchange Rate Policies is quite harsh, and if one were to speculate about the desired direction of USD forex rates based on that, one would have to conclude that it is more likely that USD depreciation is desired than that that USD appreciation is desired. If Clinton becomes the next president in line with most voter polling results, she is expected to implement policies that are relatively moderate and conventional compared to the policies of a President Trump. However, given the previous sharpness of USD appreciation, the fact that the adjustment during the past two years has not yet proceeded sufficiently should be kept in mind. The current period of economic expansion has become among the longest in U.S. history and, in view of signs the economy is maturing, it would not be surprising to see a strengthening of desires to guide USD downward (or to halt FRB interest rate hikes as a driver of downward guidance). The question is just how strong those desires may become, and there is probably a risk that blatant downward guidance may be pursued, as it was following President Obama's January 2010 State of the Union speech, in which he announced that his "export doubling plan" called for doubling exports and creating 2 million new jobs over a five-year period. Regarding the question of whether a President Clinton would be likely to promote JPY depreciation or JPY appreciation, the abovementioned infrastructure investment plan and other factors could be interpreted as pointing to either extreme, but my view is that there is a greater likelihood that she will seek to promote JPY appreciation.

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.

Another JPY appreciation risk that should be kept in mind is that related to Europe (risk factor (7)). In particular, U.K. Prime Minister Theresa May indicated in a speech given during October that the UK will begin the formal Brexit negotiation process by the end of March 2017, and fears that the Brexit process may have a greater-than-expected impact on financial markets caused sharp GBP depreciation in forex markets. In this way, it appears certain that Brexit-related market instability will further increase during 2017, and a growing risk-avoidance mood stemming from that instability may well become a factor promoting JPY appreciation. There are numerous other risk factors associated with Europe. For example, concerns about the management of Germany's largest bank have not yet been completely dealt with, Italy is preparing to implement a constitutional referendum (to be held on December 4), and Greece's financial reconstruction challenges are ongoing. If Italy's referendum proposal were to be rejected and 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. Regarding the simmering Greece crisis, while the country's debt restructuring issues have been put on the back burner since last year, the question of whether the debt restructuring plans are feasible or not appears likely to attract increasing attention. In addition, key EU countries (the Netherlands, France, and Germany) will be holding important governmental elections during 2017. Since the strength of right-leaning populism is growing in each country, at this time, the holding of national elections in of itself always has the potential for presenting new risk factors.

While the above is a comparative overview of risks related to both JPY depreciation and JPY appreciation, factors associated with the U.S. presidential election also have lengthening ramifications related to both JPY depreciation and JPY appreciation, and these ramifications seem to be the greatest risk factors associated with forecast preparation. (If I had to choose, I would say that the JPY appreciation risks are relatively significant.) While the Europe-related risk factors mentioned above can reasonably be called risks, many of them are quite realistic possibilities, and it should be noted that they could well become factors that promote JPY appreciation. In light of all these factors along with the state of the United States' real economy and currency and monetary policies, it appears more realistic to be concerned about the possibility of USD/JPY descending past the 95 and 90 levels than to be concerned about the possibility of USD/JPY ascending past the 110 and 115 levels.

# EUR Outlook – Shadow of potential U.S.-Europe trade frictions

## ECB monetary policies now and going forward – The direction of ECB-style comprehensive assessment

***ECB's skillful reading of market expectations***

The October ECB Governing Council meeting decided that the interest rate on the main refinancing operations (MROs), and the interest rates on the marginal lending facility and deposit facility, which are the ceiling and floor of market interest rates, would be kept unchanged at 0.00%, 0.25%, and −0.40%, respectively. This left the gap between the upper and lower interest rates, i.e., the interest rate corridor unchanged at 0.65 pp. The meeting's status quo maintenance was in line with the financial markets' expectations, but because many market players were speculating in advance of the meeting that there would be some relaxation of the expanded asset purchase programme (APP) parameters (such as the 33% rule, minimum yield of eligible assets, minimum remaining maturity of eligible assets, program expiry date, etc.), EUR appreciated sharply in forex markets immediately after the meeting results were announced. However, ECB Governor Draghi's denial of rumors about a shrinkage of the quantitative easing volume (tapering) at the post-meeting press conference along with other factors caused a return to EUR selling, and EUR has continued to be generally soft since then. Looking at the results alone, one gets the strong impression that the ECB leveraged a good understanding of market expectations to skillfully surmount the challenge.

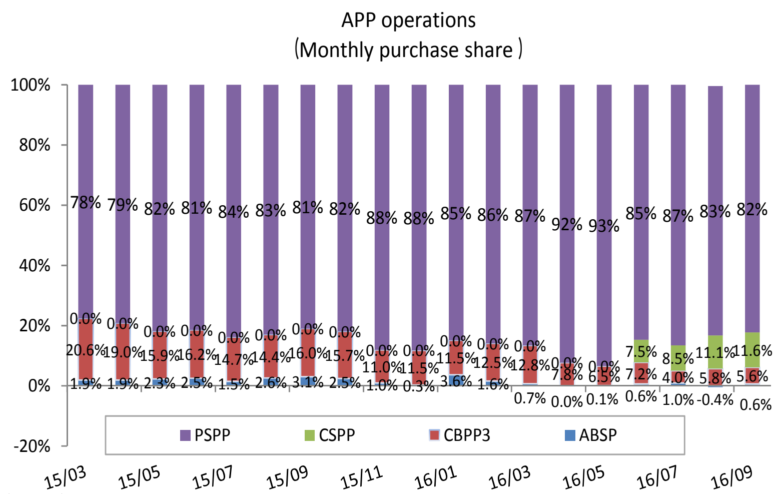
As will be explained below, one particularly noteworthy aspect of Draghi's statements at the October 20 press conference was that he repeatedly made statements akin to – "we didn't discuss tapering" – and that he thereby was able to avoid providing any sort of commitment regarding the tapering of additional easing. There is less than a half year remaining before the APP's scheduled expiry date (the end of March 2017), and when a reporter asked if there had been any discussion about extending the program, that was also met with a terse – "there was no discussion". At the September meeting, Draghi said that relevant (technical) committees had been tasked to evaluate the options that ensure a smooth implementation of the purchase program, and when he was asked in October about whether such committees had made preliminary reports, Draghi simply said – "We took stock of the ongoing technical work in the committees." (For this reason, with respect to conceivable policy options, Draghi said – "we didn't go at all in the exercise of counting views or majorities.") Draghi also said the Governing Council will take the committees' work as one of the inputs, but the Governing Council has not yet made an ultimate decision. As there was almost no information provided at the press conference, it was completed in a shorter time than usual. (They generally last about one hour.)

***Complete denial of tapering***

At the press conference, several reporters asked about the current content of reports from the technical committees to the Governing Council and requested general information about what might be considered and what definitely out of the question. On this point, Draghi limited himself to saying that Governing Council would consider reports from the committees but that the final decision would be made by Governing Council. However, he did state that – "Sometimes it's also important to say what we did not discuss, and we didn't discuss tapering or the intended horizon of our asset purchase programme." – and thereby made it clear that there were no discussions about two issues that have been major topics in the markets.

In particular, there were diverse questions about tapering. For example, one reporter insistently queried – "You just mentioned there that tapering wasn't discussed today, but do you expect it to be on the agenda six weeks from now?" Draghi provided a comprehensively negative reply, saying – "We haven't really touched on the issue at all." Regarding a sharp rise in euro area government bond yields following a Bloomberg report about the possibility of tapering, a reporter asked – "Were you surprised by the market reaction, or was it in line with your expectation?" – and Draghi responded rather sarcastically, saying – "It's very difficult to answer about my expectation of a market reaction following kind of a random statement made by somebody who didn't have any clue or information about that." Noting that the yield curve became steeper after the Bloomberg report and that that could possibly promote smooth implementation of QE, a reporter asked – "So how did the ECB profit ?" – and Draghi showed a bit of anger as he replied – "I never thought that we could profit out of sudden moves coming from unauthorised and probably uninformed sources."

### ***ECB-style comprehensive assessment***



(Source) ECB

So, what was learned about the topics of discussion at the October Governing Council meeting? In this regard, Draghi said – "we discussed scarcity [of government bonds]" – and briefly elaborated by stating – "Much of the discussion was about how to overcome scarcity [of government bonds] if that were to become a problem. It's not a problem now." Certainly, it is not a problem "now." <u>However, in the not-too-distant "future," there will come a time when the issue will definitely have to be dealt with.</u> The reason it is not a problem "now," as Draghi explained, is because of a "fortunate miscalculation" that led to corporate bond purchases proceeding more smoothly than had been expected. As the graph shows, prior to the launch of the corporate sector purchase programme (CSPP, for the purchase of corporate bonds), the public sector purchase programme (PSPP, for purchases of government bonds, public sector entity bonds, and agency and supranational bonds) accounted for somewhat less than 9% of monthly purchases. However, the CSPP's share of monthly purchases surpassed 10% in August and September, and this has moderated the challenges of making purchases via the third covered bond purchase programme (CBPP3). <u>The real situation appears to be that a portion of the government bond purchase program (regarding which there were concerns about a shortage of eligible bonds) has been replaced by the corporate bond purchases.</u>[2] Corporate bond purchases can be considered a means of buying time, and it is thought that some kind of measures may still have to be taken to deal with the impending shortage of eligible government bonds.

In light of the current and prospective situations regarding the Euro area Harmonised Index of Consumer Prices (HICP), it seems logical to consider an APP time-period extension to be tantamount to a predetermined policy route. Accordingly, what the GC currently requires is an optimal solution with respect to "an acceptable time-period extension along with an optimal parameter adjustment in line with the extension." In more concrete terms, the Governing Council is seeking to answer the following questions – "If the APP is continued as-is, at what point in time will it become incapable of achieving the goal of making EUR80 billion of monthly asset purchases?"; "How long should the APP be extended?"; and "How much parameter adjustment is necessary?". In the Governing Council meeting statement, this task is described as "evaluate the options to ensure the smooth implementation of our purchase programme (APP)." In brief, <u>the ECB Governing Council (and technical committees under the council's supervision) is currently considering how to strategically implement minor adjustments that can extend the life of the PSPP-centered APP without encountering problems</u> (with the strategic goal of boosting HICP growth to a level that is below but close to 2%). In this regard, <u>the project has the same characteristics as those of the BOJ's comprehensive assessment and, ultimately, the project is a vivid reflection of the challenges associated with "easing via the concurrent employment of negative interest rates and quantitative easing" – a policy mix with only weak sustainability.</u>

### ***Potential "next moves"***

So, what is the ECB's "next move" in December likely to be? There may be some voices in the markets anticipating that the APP monthly purchase amount will be expanded. Even if the monthly purchase amount is kept unchanged, however, simply extending the program's time period will inevitably lead to an expansion of volume. (For example, extending the program by a half year alone would entail EUR480 billion of purchases.) Since the volume limit theory is becoming increasingly prominent, it should be recognized that concurrently "expanding volume" and "extending time periods" is a highly difficult undertaking. As of this December, the APP will be scheduled to end in just three months, so it seems quite likely that priority will be given to "extending the time period," with "expanding volume" left for later consideration. However, the desire to promote expectations of greater relaxation may well lead the ECB to employ parameter adjustment as a means of heralding the "quantitative expansion" to come.

[2] Strictly speaking, a portion of the public sector entity bonds eligible for purchase via PSPP have characteristics closely akin to those of corporate bonds, and a shift of such bonds into the CSPP category may well be a significant reason for the shift of monthly purchasing share magnitude from the PSPP category to the CSPP category.

In this regard, there are many options. For example, some have noted that the ECB could reevaluate its method of allocating purchasing volumes in line with capital key shares to enable the purchasing of a greater amount of larger countries' bonds. As the common central bank of the euro area, however, the ECB can be expected to do its utmost to avoid disproportionally purchasing the bonds of specified euro area countries, so this approach is probably taboo. Then there are such possibilities as making government bonds with yields below the deposit facility interest rate (currently −0.40%) eligible for purchase or increasing the ECB's maximum holding share of individual issues (currently 33%), and some reporters have begun talking about the likelihood of the first of those two possibilities. In the present situation, it appears that the December Governing Council meeting might choose such a package of options as "extending the APP by a half year (until the end of September 2017), keeping the monthly purchase amount at EUR80 billion, but allowing for the purchase of government bonds with yields lower than that of the deposit facility."

Then again, if the deposit facility interest rate itself were to be lowered, then the groundwork for "volume expansion" would be prepared without any changes to the current system parameters. In fact, at the press conference after the most recent GC meeting, Draghi said – "We have no evidence [negative or low interest rates] actually hinder the transmission of our monetary policy." – and this view hints at the possibility of further lowering interest rates. However, given that the ECB may again face a need to further lower interest rates after a certain volume of purchases has been completed, there seems to be a high likelihood that the ECB will avoid such temporary expedient measures.

***U.S.-Europe conflict begins to be noted at the post GC meeting press conference***

This article has for quite some time been focusing on the problem of Germany's "perpetually undervalued currency" and the huge current account surpluses generated by Germany and the rest of the euro area while warning that these problems could spur trade frictions between the euro area and the United States. At this point, it is well known that there is a prominent struggle going on between the United States and Germany (Europe) regarding the treatment of large corporations, and a small but growing number of conspiracy theorists have begun speculating that the struggle may be a side effect of trade frictions.

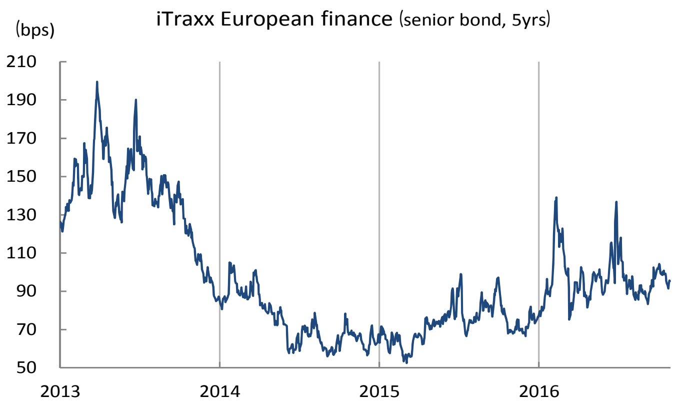
At the recent post Governing Council press conference, a reporter posed the question – "There are some people who are arguing, at least here in Europe, that what we are seeing currently is sort of an economic war between Europe, Germany and the United States, looking at all the large fines – talking about Apple, for example, or also the Deutsche Bank potential DoJ fine. What do you think? Are we here in a political game, or what do you see?" Draghi responded – "no, we are not. At least, that's my perception. We are not in a political game. All parties in doing what they do apply legislation, apply laws, apply rules. They are not acting because they are politically motivated."

It is apparent that the U.S.-Germany struggle related to large corporations has been conducted in a manner that is completely in conformity with relevant laws, and there is no clear-cut evidence that those laws are being wielded for political purposes. It is a fact, however, that comments criticizing Germany for excessively utilizing external demand against the backdrop of the structural weakness of the euro area's common currency are becoming increasingly common in international economic diplomacy. The euro area has not undertaken the integration of its member countries' fiscal policies, but there is a tacit assumption that there is a need for income transfers from the "haves (sound countries)" to the "have nots (heavily indebted countries)." To the extent that Germany continues disregarding this assumption in its policy management, it appears likely that the emergence of similar types of struggles will be increasingly liable to inspire whispered conspiracy theories, and there is concern regarding the possibility that this may cause a mood of impending strife to descend on financial markets.

## Global tail risk from "European fastidiousness" – The major German bank problem

***Temporary receding of risk-avoidance mood***

In mid-October, a risk-off mood became predominant in financial markets owing to concern that a U.S. Department of Justice proposal that Germany's largest bank pay a USD14 billion fine might destabilize the management of that bank. This situation caused a precipitous drop in the value of that bank's shares and led to a sudden intensification of the view that the bank urgently needed to increase its capital. On September 26, German new media began reporting that German Chancellor Angela Merkel had ruled out the provision of



(Source) Bloomberg

state assistance even if the bank were to be unsuccessful in increasing its capital. On September 28, reports were seen that Germany's finance ministry would not undertake rescue measures even in the case that the bank in question was unable to pay the fine demanded by the U.S. The German finance ministry announced that – "the federal government isn't preparing any rescue plans. There are no grounds for such speculation." – and the bank also denied asking for government support or hinting that it might be needed. In this way, the effects of German fastidiousness once again were felt within the euro area while also generating tension in international financial markets. This reflects the fact that Germans find it difficult to voice approval of government aid after they have consistently maintained a posture of "bail outs (government support) cannot be allowed, as bail ins (shareholders' shouldering the burden) should be emphasized" with respect to the travails of banks in other euro area countries. As the graph illustrates, concerns about Europe's financial system have clearly been rising since the start of this year.
Despite this, it seems that the fact that the German bank-related situation has generated only the current level of turmoil probably reflects the market's view that "after all, the German government would ultimately have relent and undertake a rescue." I also think that would be the case in fact. It is true that the EU bail-in rules launched from 2016 have the justifiable intention of protecting taxpayers, but it is probably a fact that in cases of serious emergencies they will prove to be ineffective and overly theoretical rules that call for excessively slow and deliberate countermeasures amid dire crises. During the course of the European debt crisis since 2010, Germany has repeatedly shown a pattern of initially refusing but ultimately compromising and taking action. It would seem that the markets' real opinion about this is that everyone would be better off if Germany would dispense with the preliminary fastidiousness and just quickly take action.

***European fastidiousness as a global tail risk***

However, as demonstrated by the approval of Brexit this year, even those things thought totally impossible do sometimes happen. In light of the characteristics of the German government – which has been widely derided as "imperialistic" in recent years – it may well be prudent to consider the recent turmoil surrounding Germany's largest bank to represent a noteworthy risk scenario. As already mentioned, the Bank Recovery and Resolution Directive (BRRD) instituted in April 2014 and implemented from January 1 of this year requires the application of bail-in rules with respect to financial institutions in the EU and European Economic Area (EEA). Germany was one of the EU member countries most strongly promoting the BRRD, and Germany's ruling party during this period has been an alliance of the Christian Democratic Union of Germany and the Christian Social Union in Bavaria (CDU/CSU). It appears that the view of the CDU/CSU is that, if they were to themselves disrespect this bail-in principle, it might cause them to lose in the federal elections slated to be held in autumn 2017. So there is a possibility that this prospect and the parties' fastidiousness about sticking to their articulated principles may cause them to refrain from providing assistance in an actual emergency.
There is also cause for concern regarding the EC's aversion to compromise its principles. Since the previously existing crisis with respect to Italian domestic banks has now been supplemented by the recent German domestic bank problem, one might think that the wisest thing for the EU to do would be to swallow its shame and devise some sort of solution to the crisis based on a one-time-only exceptional bail-out permit measure. However, even though the turmoil from the Brexit referendum result in July had not yet begun to die down, the EC was at one point considering the unprecedented move of placing sanctions on Spain and Portugal for not attaining fiscal reconstruction targets. Although the sanctions were ultimately averted, their very consideration was a shock to the markets. There is also considerable attention being focused on what the EC will decide to do regarding Italy's excessive fiscal deficit.
Amid these circumstances, one feels compelled to view the inscrutable fastidiousness of Germany and the EC as a tail risk for the global economy. Just as the impractical righteousness of this inscrutable European fastidiousness has shown a capability for spurring market turmoil, it may also be that the FRB's normalization process should be considered to be similar kind of potentially dangerous quixotic quest. It should be recognized that, because the meaning of "righteousness" has changed from the world's perspective, seeking to implement government policies based on outdated standards holds the potential for further exacerbating the existing turmoil.

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