MIZUHO

Mizuho Bank

One MIZUHO

Forex Medium-Term Outlook

1 February 2017

Mizuho Bank, Ltd.
Forex Department

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Overview of Outlook

As I have been pointing out in this report since last year, the rise of USD/JPY is being hindered by U.S. President Donald Trump's currency and trade policies. Mr. Trump's extreme inclination toward protectionism is in real conflict with the USD appreciation that has been going on over the past two and a half years, and it is natural to feel skeptical about things continuing in that direction. With USD rates at a historically high level to begin with, there is no reason for Mr. Trump, who is abnormally determined to protect his country's manufacturing industry, not to use this means to secure it. The various words and actions indicating displeasure at USD strength from the President as well as the members of his new cabinet seen during January are just the beginning. In the coming days, the authorities are likely to make more aggressive efforts to contain USD strength whenever U.S. economic indicators show signs of weakening. In the eyes of President Trump, countries with large trade surpluses with the U.S. are – in his words- "bad" in the sense of being froward, which would make China, Germany, Japan, and Mexico the "axis of frowardness." The problem is that, if one looks closely at recent developments, it becomes clear that there is very little possibility of any currency other than JPY appreciating sharply, so one cannot help feeling that JPY, inevitably the "top pick" of the lot, is going to get the short end of the stick. In reality, JPY does not have that much weight in terms of determining the real effective rate of USD, but there seems no room for righteous arguments of that kind in the present climate. My worry is that a big concern in the coming months is going to be the irrational strengthening of JPY under President Trump's watch.

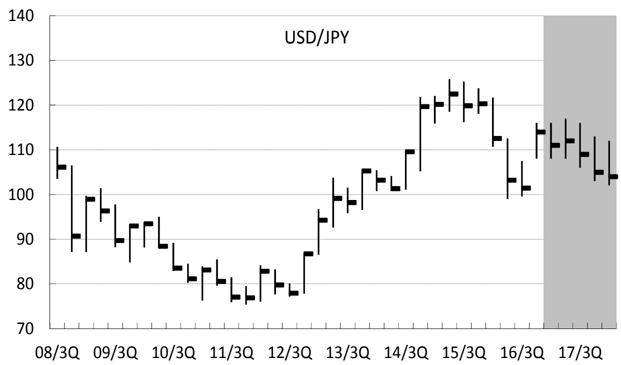
EUR has also been strengthening steadily as USD appreciation loses steam. As I have been pointing out in this report, the fact that the Euro area has the world's largest current account surplus must not be treated lightly in currency analyses – a unilateral depreciation of EUR is difficult to imagine. Again, President Trump views Germany (and the Euro area by extension) as "bad" (froward) because of its enormous trade surplus with the U.S., and given the choice, he would like to see EUR appreciate against USD. For this reason, EUR is thought unlikely to crash despite facing a number of political risks in 2017, which will constitute noise when it comes to analyzing this region's economic and financial outlooks. In the wake of Britain's exit from the EU (Brexit) and the rise of President Trump, one cannot help feeling a sense of foreboding regarding the coming year of elections in Europe – the situation allows for no complacence, with the far right candidate Marine Le Pen already reported to be leading in the French presidential election campaign, for instance. In addition to general elections scheduled for June and September in France and Germany, respectively, reports suggest that a general election is very likely in Italy within the year. The mood in none of these countries allows one to assume that these events will pass without incident, so it seems inevitable that political instabilities will weigh down EUR rates in the coming year. I predict that EUR will recover during the second half of the current forecasting period, thanks to the reactionary depreciation of USD, but it is unlikely that the recovery in 2017 will be commensurate with EUR's real strength.

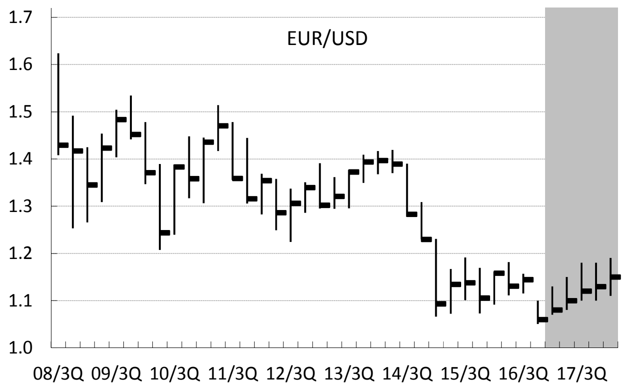
Summary Table of Forecasts

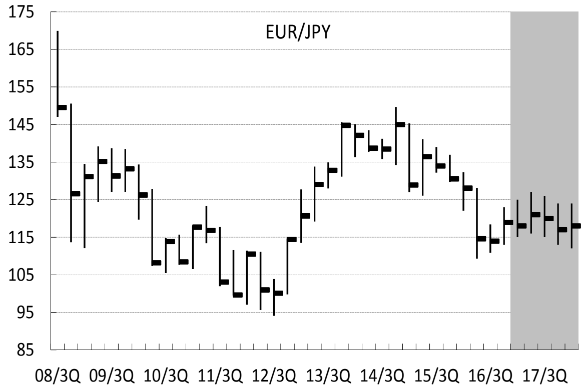
	2017 Jan (actual)	2017 Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2018 Jan-Mar
USD/JPY	112.08 ～ 118.60 (113.05)	108 ～ 116 (111)	108 ～ 117 (112)	106 ～ 116 (109)	103 ～ 113 (105)	102 ～ 112 (104)
EUR/USD	1.0340 ～ 1.0812 (1.0790)	1.05 ～ 1.11 (1.06)	1.06 ～ 1.13 (1.08)	1.08 ～ 1.16 (1.10)	1.08 ～ 1.16 (1.11)	1.09 ～ 1.17 (1.13)
EUR/JPY	120.55 ～ 123.71 (122.05)	115 ～ 125 (118)	116 ～ 127 (121)	115 ～ 126 (120)	113 ～ 124 (117)	112 ～ 124 (118)

(Notes) 1. Actual results released around 10am TKY time on 1 February 2017. 2. Source by Bloomberg 3. Forecast rates are quarter-end levels

Exchange Rate Trends & Forecasts







USD/JPY outlook – A note of caution regarding an irrational appreciation of JPY

U.S. currency and monetary policies – Is JPY part of anew so called "axis of frowardness"?

Mr. Trump's policies remain a mystery

Mr. Donald Trump has finally been inaugurated as the President of the United States, but for market participants, the specifics of most of his policies are still shrouded in a veil and a matter of considerable mystery. However, the new President's stance on currency and trade policies, which are the most important from the perspective of market participants, is quite clear. It is very easy for anyone to see that it would have been unnatural for Mr. Trump to ignore the appreciation of USD given his fiercely protectionist stance. Mr. Steven T. Mnuchin, who was nominated for the post of the U.S. Secretary of the Treasury at the U.S. Senate confirmation hearing on January 19, has commented that "the long-term strength (of USD) over long periods of time is important," but avoided presenting a short-term assessment, most likely taking into consideration the President's stance favoring a weak USD. If one's superior is in favor of currency weakness, as a subordinate, one is likely to be restrained by this in one's remarks.

The interview of President Trump featured in the Wall Street Journal in mid-January is noteworthy in that it provides many hints for formulating the forex outlook going forward. Mr. Trump not only indicated clearly that he viewed China as a currency manipulator, he even said, "Our companies can't compete with them now because our currency is too strong. And it's killing us." Mr. Trump is beginning to show a tendency to aggressively restrict other countries' currency policies, further saying at a January 26 meeting that he would include a clause preventing currency manipulation in all future bilateral trade deals. When a person making such assertions is the President of the U.S., it takes a lot of courage to aggressively continue investing in USD.

In the WSJ interview mentioned above, there were also glimpses of the risk posed by Mr. Trump's impulsiveness in the areas of currency and trade policies. He tauntingly said regarding China, "They say, 'Oh, our currency is dropping.' It's not dropping. They're doing it on purpose," This, however, is a complete factual error. China has not deliberately conducted a currency intervention, at least not since the summer of 2015. Rather, it has been frantically trying to check the rate of CNY's decline. The ≈ USD 1 trillion decline in its foreign currency reserves over the past two and a half years is proof of this, and whether or not the Chinese economy can make a soft landing as a result of its currency policies is a matter that must be paid close attention to.

In other words, China is rather at great pains to boost its currency's value – policies that would seem to be a positive from Mr. Trump's perspective – and has been criticized owing to a mistaken evaluation of the facts.

The four currencies nominated as forming the "axis of frowardness" by the new President

This risk of Mr. Trump's impulsiveness in the areas of currency and trade policies is not restricted to China. Going by his words and actions so far, the axis around which Mr. Trump assesses currency and trade policies is the size of a country's trade surplus with the U.S. Going forward, the many countries that earn a trade surplus with the U.S. are likely to be stamped with the red letters "bad," and the countries that are being pointed at as though forming an "axis of frowardness" are China, Germany, Japan and Mexico, which have the largest trade surpluses with the U.S. in that order. Of course, a trade surplus does not amount to a profit, nor does a trade deficit amount to a loss. Consequently, there is no reason to believe that a trade deficit is a bad thing. However, as is widely known, we are not dealing with someone who understands logic, so I would like to set aside a sound explanation of this issue at this point.

However, if the evaluation criterion here is the size of the trade surplus with the U.S., then Germany should be listed next to China, and taking into account the incompatibility between Mr. Trump and German Chancellor Angela Merkel, there will probably soon be a phase of confrontation between the two over the size of Germany's trade surplus with the U.S. Mr. Trump has not been hiding his anti-EU stance, saying, for instance, that the EU is merely a "vehicle for Germany," so it is difficult to imagine him establishing friendly relations with Germany. Also, if the Euro area were taken as a whole, its trade surplus with the U.S. is twice that of Germany alone, so a U.S.-Europe trade friction is likely to be as powerful a topic under Mr. Trump as a U.S.-China trade friction is.

Incidentally, in the U.S. Department of the Treasury's Semiannual Report on International Economic and Exchange Rate Policies, three criteria have been defined – (1) a significant (>USD 20 billion) bilateral trade surplus with the United States, (2) a material current account surplus (>3% of nominal GDP), and (3) engaged in persistent (>2% of nominal GDP) one-sided intervention (purchase of foreign currency, sale of own currency) in the foreign exchange market. Of these, any two must be met for a country to be placed on the Monitoring List, and if all three criteria are met, then the country is named a "currency manipulator." Mr. Trump's interest, however, lies almost entirely in criteria (1), so there may be some changes in how the criteria are defined. For instance, Mexico, which has a roughly similar sized trade surplus with the U.S. as Japan does, is likely to be newly placed on the Monitoring List (or some similar measure may be taken). Again, China has been guilty only of criterion (1) as of October last year, and the likelihood of its being removed from the Monitoring List was being pointed out, but going by China's overwhelmingly large trade surplus with the U.S. and Mr. Trump's words and actions regarding this, it may after all remain on the list. With a dispute going on regarding whether China is a "currency manipulator" or not, it seems unlikely that the U.S. currency policy stance against China will relax. At any rate, the upcoming April edition of the Semiannual Report is likely to be a more than usually important document.

No room for complacence regarding JPY, given that it is the "honor student"

Considering the situation logically, the currencies of China, Germany, Japan and Mexico, which are being treated as rivals under Mr. Trump's currency policies, are unlikely to weaken against USD. Incidentally, the countries that have the greatest weight in terms of determining USD's real effective exchange rate (REER) are China (21.7%), the Euro area (16.6%), Canada (12.9%), Mexico (12.5%), and a fair bit lower, Japan (8.0%), in that order. In other words, the countries that have been pointed at, or seem likely to be pointed at, as though being the "axis of frowardness" are all countries that have a powerful impact on USD's REER. Specifically, USD's REER increased by about +24.3% in the two and a half years since January 2014, and the largest contribution came from MXN (the Mexican Peso), at +4.6%, followed by EUR at +3.9% and CNY at +2.8%. These three currencies alone account for half the appreciation of USD over 2.5 years. Many are comparing Mr. Trump's economic policies (Trumponomics) with the economic policies of former President Ronald Reagan (Reagonomics) and are, in conclusion, predicting a second round of the Plaza Accord. If this does come about, EUR and JPY will not be the only targeted currencies – rather, the framework is likely to deliberately include MXN and CNY, because otherwise there would be no point to it.

USD NEER from JAN 2014 to DEC 2016

Countries	Share	USD vs. each ccy (%) JAN 2014 - DEC 2016	Contribution (% pts)
China	21.7	-12.8	2.8
Euro-zone	16.6	-23.5	3.9
Canada	12.9	-21.0	2.7
Mexico	12.5	-37.1	4.6
Japan	8.0	-10.0	0.8
S.Korea	3.6	-12.6	0.5
Taiwan	2.2	-7.5	0.2
Switzerland	1.5	-12.4	0.2
U.K.	3.1	-25.5	0.8
Others	39.6	-	7.9
NEER JAN2014-DEC2016	-	24.3	24.3

(Source) BIS & Bloomberg
(Notes) Currency rate of variability : from 31DEC2013 to 30DEC2016
NEER: Nominal effective exchange rate, Broad base

On the other hand, JPY has a very small weight in determining USD's REER, as mentioned earlier. In terms of its contribution to USD appreciation, it is small enough that there is no comparison with the other three currencies (in the example given above, JPY's contribution amounts to a mere +0.8 pp). Frankly, therefore, it makes no sense for JPY to be compared with the other three currencies. However, although I repeat myself, it does not appear as though a just argument would get through to President Trump. <u>Even if JPY has only a slight impact on USD rates, it is quite possible that USD/JPY may be forced down based on the simplistic logic that "JPY must appreciate because Japan's trade surplus with the U.S. cannot be forgiven."</u>

Again, of all the currencies mentioned, JPY is the "honor student," so the situation could easily exert an upward pressure on JPY. Looking at the fundamentals, the weakening of CNY, which suffers from a terrible capital outflow, and MXN, due to the weakening of the Mexican real economic momentum as a result of Trumponomics, is rational. Even in the case of EUR, though the Euro area having the world's largest current account surplus props up the currency to some extent, chronic political risks are likely to weigh the currency down during 2017. Against these, the rock-like stability of JPY is conspicuous – Japan faces few political risks, has a strong real economy, earns a large current account surplus, keeps its status as the world's largest creditor, and maintains a low level of prices. Of the four currencies that have been finger-pointed, JPY's trade surplus with USD is not especially large, and its weight in terms of contributing to USD's REER is the lowest, but <u>I feel I must caution against a possible irrational strengthening of JPY, considering the aforementioned factors, under Trumponomics.</u>

Will adjustments be made by volume or price, or both?

The first real day of the new administration was January 23, and Mr. Trump named and criticized Japan in a meeting with corporate executives, saying Japan's auto trade was "unfair." It is one thing when there are verbal attacks on Japan from the U.S. automobile industry, but it is an unusual move for the President himself to name a specific country's specific industry and level criticism at it. His timing was fortunate (unfortunate for Japan) in that the trade balance for the entire year 2016, which was announced not long after Mr. Trump's remark, posted its first surplus in six years, at +JPY 4.0741 billion. Going forward, the U.S.-Japan trade balance is very likely to affect USD/JPY, possibly resurrecting the trade balance as an economic indicator once again, and the trends must be monitored very closely. As obvious from his various remarks and actions, Mr. Trump's mindset related to U.S.-Japan relations seems to be stuck in the 1980s and 1990s. As the chart shows, even if we take the three big Japanese automakers' example, their overseas production ratio is higher than domestic, with production especially being centered in the U.S. The claim that they are depriving U.S. workers of employment opportunities through aggressive exports does not match the facts. However, this is similar to Mr. Trump calling China a "currency manipulator (intending to weaken its domestic currency)" despite the fact that China has been desperately trying to prevent the depreciation of CNY, and it may be not be possible to correct his preconceptions easily. As I mentioned at the start, Mr. Trump's central criterion for evaluation when it comes to trade deals is whether a country has a large or small trade surplus with the U.S. Regardless of what circumstances may be behind that trade surplus, it is very likely that these surpluses will be read as depriving U.S. workers of employment opportunities, and countries like China, Germany, Japan and Mexico are, therefore, very likely to be the "axis of frowardness" for Mr. Trump.

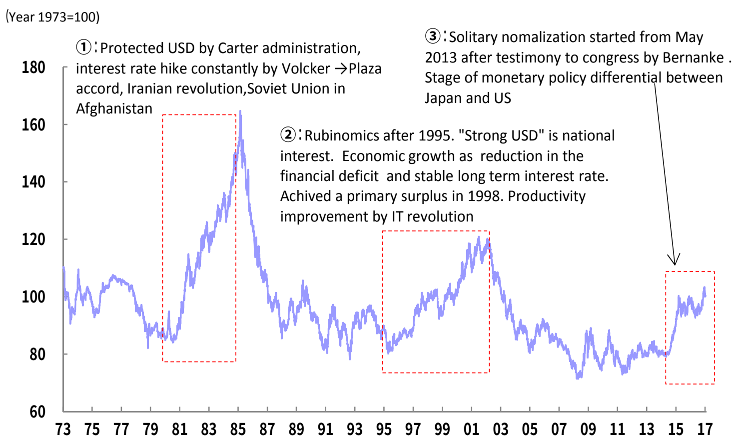
(Total production volume ratio %)

	Toyota	Nissan	Honda	Total
Japan	46.4	16.3	16.1	30.2
Overseas	53.6	83.7	83.9	69.8
North America	23.0	35.1	40.6	30.9
USA	16.0	18.0	27.3	19.4
Mexico	-	15.5	5.6	-
Canada	7.0	-	-	-
Other countries	30.6	48.6	43.4	38.9

(Notes) 1. Toyota's volume in Canada: Year 2016
2. Nissan in USA & Mexico: Year 2014
3. Honda in Mexico : Estimated value
4. Other countries: MAR 2016. - means unknown
(Source) Each companies' annual report and media report

If, irrespective of what Japan wants, its trade surplus with the U.S. is going to be progressively cut back, the outlook for the coming months becomes somewhat more predictable. There are only two ways of adjusting the trade balance – (1) by volume, and (2) by value (of course, doing both is also possible). Looking back, in the middle of the U.S.-Japan trade negotiations some decades ago, the self-imposed export control Japan undertook in 1981 was based, very conventionally, on route (1), but the 1985 Plaza Accord was based more on route (2), via forex control. Coming back to the present, Mr. Trump's attempts, starting even before his inauguration, to force companies to manufacturing in the U.S. is a move that falls under (1), while his hints at the possibility of penalties for manufacturing overseas and showing displeasure at USD strength fall under (2). Compared with route (1), which requires government-to-government negotiations and could become protracted, it is much quicker to simply make a verbal intervention in the forex market and take action via route (2). Looking at it from Mr. Trump's perspective, he inherited a strong USD even before his inauguration (see exhibit on previous page), so it makes no sense for him not to use this fact to his advantage, and if nothing else, one can say that this is at least a more straight-forward option than intervening in the management of private foreign companies.

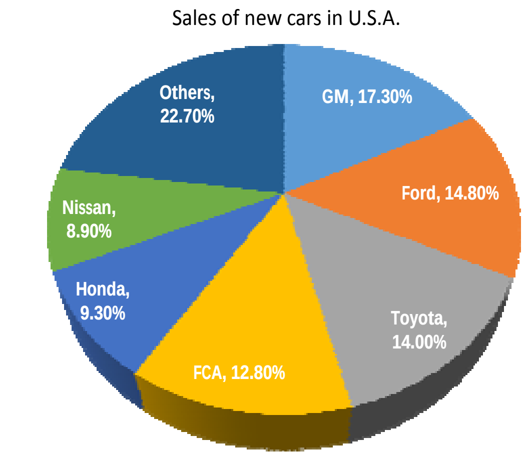
Dollar index



(Source) Bloomberg

Concerns of an irrational appreciation of JPY increase

As I have already mentioned, the topic going forward is the irrational appreciation of JPY. In terms of the absolute value of trade surplus with the U.S., Japan, at +USD 67.6 billion, trails behind Germany, at +USD 71.1 billion. Incidentally, the surplus for the entire Euro area is +USD 130.5 billion, which is even higher (please see the "Monitoring List" in the October 2016 edition of the Semiannual Report for figures). Perhaps, considering the share of vehicle sales in the U.S. market, Mr. Trump's feeling is "Japan rather than the EU" (see exhibit). However, one cannot help feeling that it is irrational to pick on Japan rather than notorious Germany, which has faltered in terms of stimulating domestic demand as a result of focusing too much on the domestic balance of finances, but has still been able to accelerate exports thanks to a "permanently cheap currency" due to the weakness of the Euro area's peripheral member countries. Every time a message is sent out from the President – the January 11 press conference, the January 14 WSJ interview, the January 20 Inaugural Address, and the January 23 meeting with corporate executives – one cannot help feeling that the probability of an irrational appreciation of JPY is increasing.

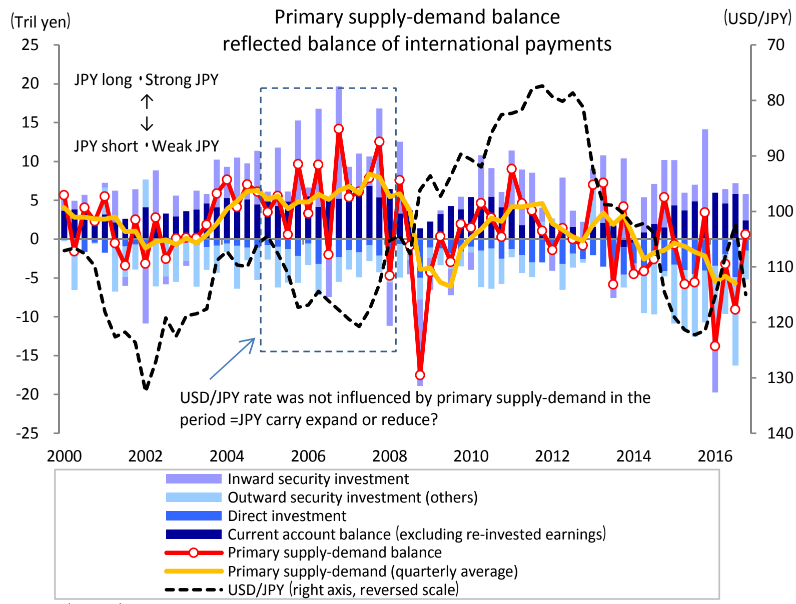


(Source) Autodata (Note) Others : including Mercedes, VW & BMW but total of these 3 companies accounts for less than 6%

Basic JPY supply-demand climate – There are concerns related to foreign securities investment too

No change in trend of JPY net sale

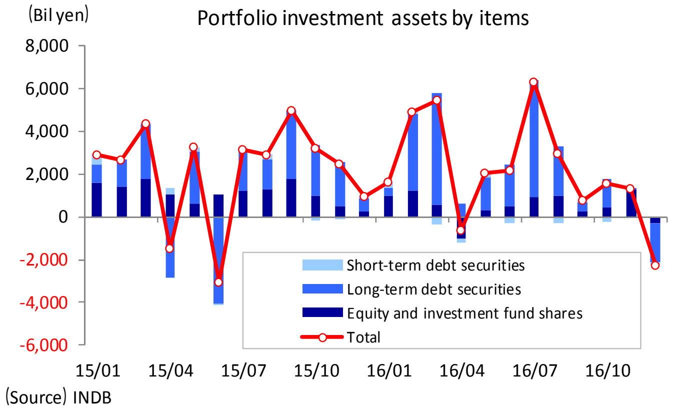
Incidentally, in the JPY market, the trend of a net sale of JPY is continuing and there are some other signs that must be heeded, so I would like to present an overview here. First of all, looking at the basic JPY supply-demand balance (see exhibit) that I use as a guideline for predicting JPY rates in this report, a total net sale of JPY worth −25.4 trillion or so was posted for January-November 2016. This is more than twice the −JPY 12 trillion or so posted for the entire year 2015. This net JPY sale continues to be driven by the foreign securities investment activities of Japanese institutional investors – a result of the trend of a widening gap between Japanese and U.S. monetary policies. As I always say, whenever I forecast a strong-JPY outlook, this "sale of JPY (purchase of foreign currency) by the Japanese" led mainly by institutional investors is an extremely large risk to that outlook. Under the BOJ's Yield Curve Control (YCC) policy, this gap between Japanese and U.S. monetary policies is semi-artificially widening, and a key point in formulating the JPY outlook will be to understand to what extent JPY strength can be offset by foreign securities investments.



(Source) Bank of Japan & INDB
(Notes) Subject: including Life insurers, pension funds & individuals, excluding banks & government sector
Bold line: primary supply-demand quarterly average but the latest is SEP-NOV

__Two causes for concern in foreign securities investment__

However, there are also two points of concern that must be noted with regard to the path of "accelerated foreign securities investment → JPY weakness." Looking at the Ministry of Finance's "International Transactions in Securities (based on reports from designated major investors)," in December, when U.S. interest rates shot up, Portfolio Investment Assets were −JPY 2.2652 trillion, the first net sale in about eight months, and the scale of the net sale the largest since June 2015. Product-category wise, Equity and investment fund shares posted −JPY 273.3 billion, Long-term debt securities posted −JPY 1.8571 trillion, while Short-term debt securities posted −JPY 134.8 billion – all posting net sales. The background to this is thought to be the damage to portfolios from the soaring of U.S. interest rates, resulting in a deterioration in risk appetite among a large number of investors. <u>Not just investors, the same is assumed to be true of business corporations as well, but there are a number of entities that do not shift their positions flexibly in response to sudden market changes, so there may have been some discrepancies between forex rates and actual capital flow during November and December.</u>



(Source) INDB

For a further increase in U.S. interest rates and a resultant acceleration of JPY sale and foreign currency purchase, one of the necessary conditions will be for the Trump Rally to be stably continuing even into the new fiscal year. However, going by Mr. Trump's words and actions so far, it does not seem that such a situation will easily come to pass. Incidentally, if the Trump Rally continues, it is thought that investors will find it easy to decide to sell JPY and purchase foreign currency, but export firms are expected to set their assumed forex rates for the new fiscal year and beyond at a level indicating greater JPY weakness than now, which will lead them to embark on selling USD and purchasing JPY. Such a move itself would work to inhibit the depreciation of JPY.

Another matter of concern: as revealed also during his press conference, Mr. Trump appears to feel something resembling animosity against trade surpluses vis-à-vis the U.S. Going by this, authorities may feel the need to exercise considerable discretion with regard to any policies that could be interpreted as guiding JPY toward a depreciation against USD. In this context, <u>one will have to closely watch how, not just currency interventions, but even the pegging of long-term interest rates to zero percent under the YCC policy will be interpreted.</u> As I discussed in a previous issue of this report too, <u>since JPY is the currency that has had the strongest response to U.S. interest rates soaring since November, the YCC policy, which is the root cause of the expanding gap between U.S. and Japanese interest rates, could be criticized as "a currency intervention in practical terms" depending on which way one looks at it.</u> It seems quite possible that such an impulsive criticism could be made, going by the lazy understanding of issues indicated by the fact of pointing a finger at countries like Japan and China while allowing Germany, the country with the world's largest current account surplus (and the second largest trade surplus vis-à-vis the U.S. after China), a free pass. The possibility of applying pressure on the FRB to do something similar to mimicking the YCC can also not be ruled out. At any rate, there is no doubt that a strong USD would be an obstacle for Mr. Trump's international trade policies.

BOJ monetary policies now and going forward – The narrow space between President Trump and the FTPL

__Monetary policy kept unchanged as expected__

At the BOJ Monetary Policy Meeting (MPM) held on January 30 and 31, the decision was made by a majority vote to keep the monetary policy unchanged. The Bank will continue to apply a short-term policy interest rate of -0.1% and keep its 10-year JGB yields pegged to zero percent or so in its financial market operations under its Qualitative and Quantitative Easing with Yield Curve Control policy. The guidelines for the purchase of JGBs with the objective of interest rate control, which were the focus of some interest, were also kept unchanged at "an annual pace of increase in the amount outstanding of its JGB holdings of about JPY80 trillion" – the JPY 80 trillion amount was neither changed nor removed, as some had been speculating.

Major outlook by BOJ policy board members (YoY %)

		Real GDP	CPI excluding fresh foods
FY 2016		1.2〜1.5 <1.4>	-0.2〜-0.1 <-0.2>
	Outlook as of OCT	0.8〜1.0 <1.0>	-0.3〜-0.1 <-0.1>
FY 2017		1.3〜1.6 <1.5>	0.8〜1.6 <1.5>
	Outlook as of OCT	1.0〜1.5 <1.3>	0.6〜1.6 <1.5>
FY 2018		1.0〜1.2 <1.1>	0.9〜1.9 <1.7>
	Outlook as of OCT	0.8〜1.0 <0.9>	0.9〜1.9 <1.7>

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

With respect to the purchase of non-JGB assets too, it was decided that the annual increase in the pace of purchase of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) would continue at JPY 6 trillion and JPY 90 billion, respectively.

Outlook Report retains the assessment of the previous edition

With Mr. Trump's excessively protectionist policies becoming more apparent, there are beginning to be signs of turbulence in the markets too, but USD/JPY has stabilized at 110 and the Nikkei Stock Average has also been maintaining a level of around JPY 19,000. As the Core Consumer Price Index (CPI), i.e., excluding fresh foods, is seen as finally rising to the +1% level this autumn, the deadline for reaching the 2% target has also been kept unchanged at "around FY 2018." Overall, therefore, the situation did not warrant any change in monetary policy. In the latest edition of the Outlook of Economic Activity and Prices (Outlook Report) published at the same time as the MPM, the projected growth rates for Real GDP were +1.4% yoy for FY 2016, +1.5% yoy for FY 2017, and +1.1% yoy for FY 2018, all of which were slightly higher compared with the previous (October 2016) edition of the report. In addition to the revision of the statistical standards, the "improvement in overseas economies and the JPY depreciation" were cited as a factor for the higher projected growth rates. The CPI Core, though being downgraded from the previous report for FY 2016 to -0.2% yoy, remained unchanged at +1.5% yoy and +1.7% yoy for FY 2017 and FY 2018, respectively. As for prices, though the report started out somewhat pessimistic, stating that "inflation expectations have remained in a weakening phase," it went on to say that "medium- to long-term inflation expectations are likely to follow an increasing trend and gradually converge to around 2 percent." Overall, the impression is that the assessment of the October 2016 edition of the report was retained, and one may even go so far as to say that the weakening of JPY as a result of the election of President Trump may have given the real Japanese economy a boost.

The risk of policy operations that may invite misunderstanding

This time, the BOJ managed to pull through, but difficult issues are accumulating. In particular, as I have repeatedly discussed in this report, <u>the key point for those who watch the BOJ's moves will be to see how skillfully it avoids stepping on the "tiger's tail."</u> As widely known, Mr. Trump said regarding future bilateral trade negotiations that "We're going to have very, very strong controls over monetary manipulation," not hiding his desire to interfere with other countries' currency policies. The unspoken understanding at G7/G20 meetings is that countries inevitably succumb to weakening their own currencies through monetary easing with the aim of stabilizing their economies, but it is not clear whether Mr. Trump will permit such fair arguments. Even at a meeting with pharmaceutical company executives at the White House on January 31, he said that "You look at what China's doing, you look at what Japan has done over the years. They play the money market, they play the devaluation market and we sit there like a bunch of dummies," and went on to express displeasure at forex rates, saying other countries "take advantage of the U.S. with their money and their money supply and devaluation" The real meaning of his latter remark is not clear, but perhaps it was pointing at monetary easing. Leave alone currency interventions, <u>it is quite suspicious what intent will be ascribed to currency weakening as a result of monetary policy operations under the Trump administration.</u>

In this connection, one feels some concern at the recent actions of the BOJ. There is a strong impression that the BOJ has skillfully managed to move away from front-stage following the Comprehensive Assessment and introduction of QQE with Yield Curve Control in September last year, and the stubborn demands for further monetary easing from the financial markets (especially the forex market) have faded. Looking back at January, however, the BOJ put off an operation that was being taken for granted, causing JPY to appreciate, but then increased the size of the operation the next day, causing JPY to depreciate. Although it was just a momentary event, it would probably be safer to avoid making any conspicuous moves in the forex markets at the present time. Of course, the BOJ would probably explain the event as changes in the size of the operation as a result of appropriate interest-rate controls. However, the reality is that the BOJ was probably concerned about JPY appreciating excessively – one must recognize that the Bank is stuck in a position where it has to dance to the tunes of the markets. <u>In reality, USD/JPY has been fluctuating based on the BOJ's operations, and if these fluctuations become too conspicuous, it could end up stepping on the "tiger's tail."</u>

Going forward, if the U.S. economic climate becomes unfavorable and the costs of protectionism become obvious[1], Mr. Trump is very likely to take a more passive approach to guiding USD lower. Such an assumption is still premature at this point, but given the BOJ's admittedly flexible stance regarding the adjustment of interest rates toward 0%, the possibility of its having to raise the level at which it pegs its long-term yields in an effort to subdue Mr. Trump's heartburn cannot be ruled out. This seems even more likely when one takes into account that, against the backdrop of extreme decline in profitability, the financial industry is eager to see a steepening of the yield curve.

[1] Even if Mr. Trump implements measures such as imposing high taxes on products from China, Mexico, or Japan, if these measures are taken to an extreme, there is bound to be retaliation from the countries in question. The U.S. has a number of employers in China, and its exports to Mexico are also high. Again, Japanese companies are already generating a lot of employment in the U.S., and the damage would not be small if this were withdrawn.

The narrow space between President Trump and the FTPL

One may recall that former FRB Chair Bernanke's visit to Japan in late Spring last year spurred lively speculation regarding the possibility of a "helicopter money" policy's implementation, causing a sudden weakening of JPY. This year, the visit to Japan of Christopher A. Sims – a professor of economics at Princeton University and winner of the Nobel Memorial Prize in Economic Sciences in 2011 – has similarly had the effect of spurring considerable discussion of the "fiscal theory of the price level" (FTPL). While this is not the place for a detailed explanation of FTPL, it can be said that the theory recognizes the limits of monetary policies and affirms the effectiveness of fiscal spending expansion for the purpose of elevating price levels[2]. While I will refrain from discussing FTPL's pros and cons, it is highly significant that the merits of using fiscal policies rather than monetary policies to promote inflation are being substantiated by a Nobel Laureate economics professor, and FTPL's affirmation by Koichi Hamada (Special Economic Adviser to Prime Minister Abe and Professor Emeritus of Economics at Yale University) is also causing the theory to be the focus of a considerable amount of attention at this time. If this situation causes FTPL to gain political support, then there is a possibility that there may be a shelving of fiscal reconstruction policies, including those involving consumption tax rate hikes. In the case that this scenario were to be realized, it seems likely that the BOJ would be forced to sustain its easing policies (with the goal of inconspicuously absorbing government bonds).

So, will Japan be forced to undertake tightening as a response to President Trump or will the country continue with easing in line with FTPL? People are anxiously waiting to see which of these timely market-moving themes determines the BOJ's policy stance but, realistically speaking, it is hard to imagine a situation in which the Japan would brazenly brandish FTPL. It appears that the most important factor from the perspective of forex rates at this time is how the BOJ will manage to weather this time period without treading on President Trump's "tiger tail," and forex market players should be closely watching to see if this weathering process is accompanied by a diminishing of the BOJ's JPY-appreciation-prevention measures.

Risks to my main scenario – Need for vigilance regarding the possibility of a second "Plaza Accord"

The world does not change so easily

Regarding the Trump Rally of rising interest rates, USD appreciation, and stock price rises seen since November, I have emphasized that rather than taking an 'offensive stance' in seeking ways to take advantage of the trend, it is important to take a 'defensive stance' based on recognition that there is due cause for concern regarding the trend's reversal. Prior to the U.S. presidential election, the declining level of the neutral policy rate (≈potential economic growth rate) in the United States (as well as other developed countries) had been a major topic of discussion, and the majority of people considered it unreasonable to assume that an endless loop of consecutive interest rate hikes accompanied by additional USD appreciation would be feasible. While it is true that the emergence of the upcoming Trump presidency is a major event, there is no need to be expecting a sudden upward jump in the U.S. potential economic growth rate. While there is now a conspicuous tendency among market players to casually use such phrases as "the rules of the game have changed" and "the world has changed," my personal view is that the world does not change so easily.

Potential Risks to the Main Scenario

		Risk Factors	Remarks	Direction
World	①	Plaza Accord II	・Correction of strong USD with international cooperation	Strong JPY Weak USD
US	②	FRB monetary policy normalization	・3 rate hike a year ・Possibility of discussion on B/S reduction	Weak JPY Strong USD
	③	Economic policy by new President	・Cycle acceleration as infrastructure investment →price up →interest rate hike →strong USD. Introduction of HIA	Weak JPY Strong USD
	④	Economic (currency) policy by new President	・Disallowing USD strength, taking explicit currency engagements ・Restraining on government spending to avoid high yield & strong USD	Strong JPY Weak USD
Japan	⑤	Risk-taking by Japanese investors	・Changing main policy from full hedging to increasing open positions?	Weak JPY Strong USD
	⑥	Japan officials strong JPY curbing	・BOJ's continuous negative interest rates expansion. ・Buying USD/JPY intervention (or rumor)	Weak JPY Strong USD
Europe	⑦	EU related fear	・France presidential election (Le Pen scenario) ・Merkel defeat	Strong JPY Weak USD

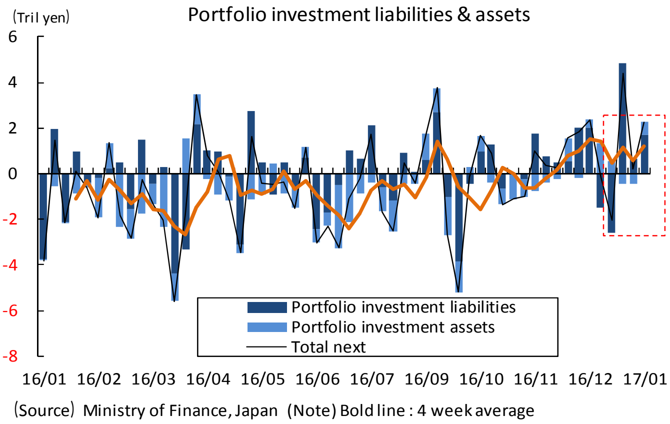
[2] However, regarding FTPL, Professor Sims argues that, since the potential losses incurred by central banks in connection with QE and similar policies are large, there is a need to give due consideration to this effect of such policies. Because all-out efforts to increase the scale of QE will pointlessly magnify this risk, he argues that, if the goal is to elevate price levels, the expansion of fiscal spending will be a more-effective means of attaining that goal.

In light of the inward oriented approach President Trump has shown since his election, it is difficult to envision a scenario in which the U.S. economy and the global economy begin heading for sustained growth. Since the election, for example, there has been an approximately 100 basis point increase in U.S. 10-year interest rates and associated rise of more than 5% in the Dollar Index. Occurring as side-effects of (the anticipation of) fiscal spending expansion, these movements can be expected to have a negative effect (whether it be large or small) on the U.S. economy during the first quarter of 2017. Consumption and investment demand for housing and other real estate assets as well as such durable consumable goods as automobiles is highly sensitive to interest rates, and these are economic sectors that can have a dominating effect on overall economic conditions. At this stage, I am anticipating that the negative effect on these sectors will become evident in the second quarter of 2017 and subsequently, and my main scenario is for a JPY appreciation/USD depreciation trend to emerge going forward. However, there naturally are risks associated with the scenario. The following is an overview of the main upside and downside risks associated with the scenario as they appear at this point. These risk factors are presented in the chart on the previous page, and the JPY appreciation risk factors are colored to differentiate them from the other risk factors.

JPY depreciation risks: It depends on the FRB's normalization process, but...

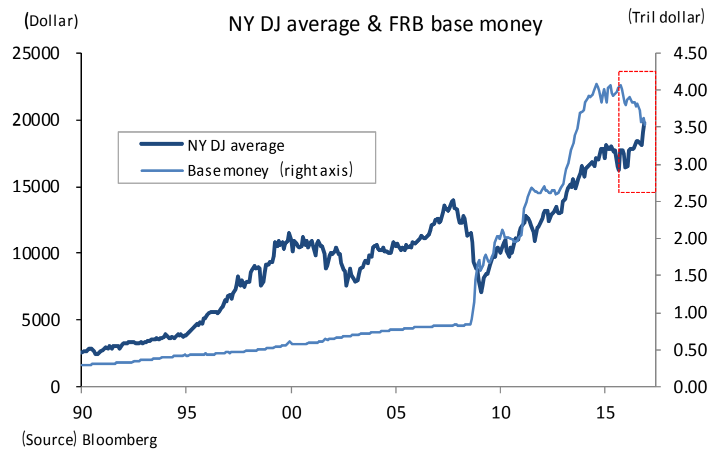
I will begin by overviewing JPY depreciation risk factors. The main forecast scenario anticipating a return of USD/JPY to the vicinity of JPY100 lists four JPY depreciation risk factors, of which the biggest risks are associated with factors (2) acceleration of the FRB's normalization process and (3) Trump administration's fiscal policies. In fact, if factor (3) turns out to have a greater effect than the markets are expecting, it would probably have the result of spurring factor (2). While I am expecting the FRB will only be able to implement about one interest rate hike during 2017, the magnitude of prospective Trump administration fiscal policies is still unclear. In the case that they are on a scale that exceeds market expectations, then there is a possibility that – amid surging U.S. interest rates and rapidly rising inflation expectations – there will be a strengthening of the USD appreciation trend. Moreover, if something along the lines of the Homeland Investment Act (HIA) passed during the Bush administration were to be instituted, USD appreciation would be promoted still further. In such a case, USD/JPY might greatly surpass this article's forecast range, and it would not be surprising to see it approaching JPY125. Of course, I personally view such a scenario as abnormal and would take the stance of recommending selling against that trend but – in light of the NY Dow Jones Industrial Average's movement into a historically record high range – it cannot be said that there is zero upside risk of the U.S. economy demonstrating unexpectedly strong fundamental strength. Given that USD has already appreciated to record high levels, however, the real economy would have to show quite a bit of strength in order to enable the FRB to boldly implement consecutive interest rate hikes. At a time when the current period of U.S. economic expansion is approaching a record length, I simply do not have the courage to muster up such an expectation.

Another JPY depreciation risk worth carefully monitoring is the risk of acceleration in the continued flow of Japanese investor's funds into foreign securities (risk factor (5)). JPY interest rates are being artificially restrained by means of the yield curve control (YCC) policy, and if the U.S. normalization process were to lead to an increase in U.S. interest rates along with a broadening of the Japan-U.S. interest rate gap, then the environment for outgoing securities investments from Japan would become even more supportive. Fundamentally speaking, it is rare that USD/JPY movements are spurred by Japan, but if Japan takes a policy path to promote it, then there is a possibility that JPY depreciation will proceed. Looking at outward securities investment since U.S. 10-year interest rates accelerated their rise to surpass 2.60% in December, however, one finds that it is actually net selling that is conspicuous (see graph). It can be inferred that this trend may be occurring because the risk tolerance levels of a large number of Japanese investors have been undermined by the rapid surge in U.S. interest rates. Moreover, it is likely that many investors are unable to flexibly change their fund management policies until the start of a new fiscal year. Furthermore, going forward, if growth in outgoing securities investment were to accelerate in response to the expansion of the Japan-U.S. interest rate gap, and if this were to cause JPY depreciation to progress, then it appears questionable whether the United States would continue to accept such a situation. There is a possibility that the situation of Japan's 0% interest rate peg causing Japan-U.S. interest rate gap expansion and thereby causing a JPY depreciation/USD depreciation trend will be characterized as "effectively constituting forex intervention" and otherwise criticized, and this possibility is coming to appear quite realistic in light of President Trump's statements and actions. As explained below, President Trump has clearly expressed his intention to strictly



(Source) Ministry of Finance, Japan (Note) Bold line : 4 week average monitor other countries' efforts to promote the depreciation of their currencies. In fact, it would appear that it is less likely than not that the BOJ will maintain its current policies.

JPY appreciation risks –U.S. Treasury Department increasingly concerned about USD appreciation



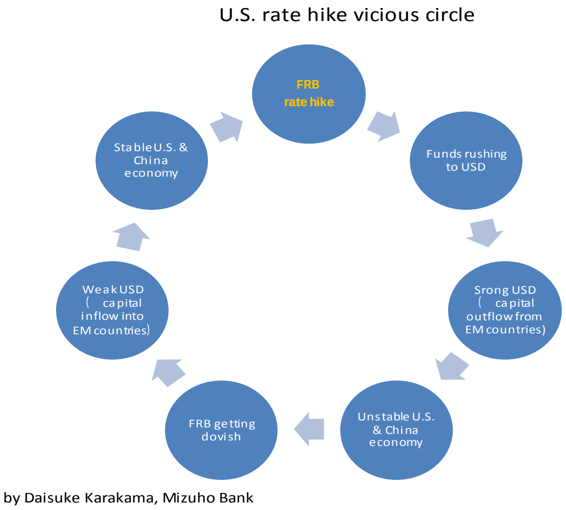
It is worth noting that the actual level of JPY appreciation risk is probably greater than that assumed by this article. As mentioned above, the Trump administration's fiscal policies' represent a risk of promoting JPY depreciation, but they also could represent a risk of promoting extremely rapid JPY appreciation (risk factor (4)). For example, the rise in U.S. interest rates since November is based on expectations of huge fiscal stimulus measures, so if the actual measures were to be on a smaller-scale than expected, it is conceivable that U.S. interest rates might drop, and JPY might inevitably surge. Moreover, the lack of a collapse in U.S. stock prices despite the FRB's ongoing normalization process probably also reflects expectations regarding upcoming fiscal stimulus measures. When this trend is exposed to the effects of a monetary tightening, a standard rule of thumb suggests that it would be natural to assume that stock prices will be depressed (see graph). It can be expected that, depending on the actual nature of the upcoming fiscal stimulus measures, adjustments will be required in U.S. stock prices, in U.S. interest rates, and, as a consequence, in USD exchange rates. If the scope of issues considered is broadened to encompass currency policies and trade policies along with fiscal spending policies, then it is clear that there is a solid basis for severe anxiety regarding the Trump administration. Looking back at President Trump's statements and actions to date, it does not at all appear likely that he will be inclined to accept sustained USD appreciation. In accordance with his promise, he has already announced his decision to withdraw from the Trans-Pacific Partnership (TPP), and he is also demonstrating a positive attitude toward renegotiating the North American Free Trade Agreement (NAFTA) and constructing a wall on the U.S. border with Mexico. Moreover, he is showing an unusual degree of tenacity in his policy of promoting manufacturing operations within the United States on the parts of both U.S.-based and foreign-based companies. Regarding his trade negotiation policy, he has stated that – "We're going to have very, very strong controls over monetary manipulation and devaluation." He has mentioned his intention to incorporate forex clauses (providing for the monitoring of currency devaluation policies) within the bilateral trade agreements to be negotiated going forward, and this is a preliminary indication of the possibility that he will be seeking arrangements to restrict other countries' currency policies. It goes without saying that the forex trend compatible with such a thoroughly protectionist stance would be USD depreciation, and it appears that President Trump's repeated brash expressions of his intentions will continue to be the most important market-moving factor for forex market players to focus on. In a newspaper interview during January, President Trump hinted at his desire to avoid USD appreciation, spurring a partial rewinding of USD appreciation in forex markets. While the statements in question were made in the context of his criticism of China, in the case that he makes a similar criticism regarding Japan, it seems likely that, in light of JPY's strong fundamentals, the trend of JPY depreciation would ineluctably fizzle out. While fiscal spending policies require time and efforts to institute, U.S. presidents have the authority to make rapid decisions regarding currency and trade policies. Given this, there are grounds for concern that a president who discusses forex issues in a manner unprecedented in history will become a locomotive of JPY appreciation.

Even if President Trump does not personally seek to directly restrain USD strength, it will be important to monitor the actions of the U.S. Treasury Department and Treasury Secretary. On March 17-18 this year, a G20 meeting will be held in Baden Baden, Germany. Looking back at events last year, one may recall that the war of words between U.S. Treasury Secretary Jack Lew and Japanese Finance Minister Taro Aso at a G20 meeting attracted considerable attention. Given that U.S. currency and trade policies will be attracting a particularly high level of attention at next year's first G20 meeting, it can be expected that the markets will be liable to react very nervously to that kind of development. Scheduled to be released in mid-April, the next U.S. Semiannual Report on International Economic and Exchange Rate Policies will also be likely to attract an extremely large amount attention with respect to whether it is designed to restrain USD appreciation or not. Even the latest edition of that report, released last October, contained rather harsh criticism of Japan, and described evaluation measures that came close to listing an additional country (Switzerland) on the Monitoring List. Although the USD appreciation surge has shown signs of moderating somewhat since the start of the year, it would seem quite reasonable to expect that the U.S. Treasury Department will become increasingly concerned about USD appreciation and unlikely to slacken its efforts to address the situation.

As the entire world moves away from liberal policies and shows signs of increasing nationalism, it seems unlikely that President Trump – who is resolutely sticking to his America First philosophy-based world perspective – will completely accept the world's current apportionment of currency appreciation. Given his temperament, it is extremely difficult to imagine such a development.

Possibility of a second Plaza Accord...

In the past, this article has frequently emphasized the "USD appreciation trap" situation – in which, even when the FRB is seeking to hike interest rates, such associated problems as USD appreciation and turmoil in emerging country markets preclude the hike (see diagram) – and this "USD appreciation trap" remains highly important. Ultimately, since the FRB is the only central bank in a position to undertake an interest rate hike, such a hike will by means of USD appreciation place a heavy burden on the U.S. real economy while also promoting capital outflows from China and other emerging countries that have the potential to foster budding risks in the international financial environment. Essentially, when USD appreciation becomes excessive, it can lead to economic destabilization in the United States and China. When the U.S. and Chinese economies are not stable, it goes without saying that the global economy is not stable.



Regarding Europe, reflecting the smoldering concerns about the possibility of a progressive dissolution if the EU, this economic instability situation is liable to promote sustained one-sided selling of EUR, the EU's highest profile symbolic manifestation. Meanwhile, the progressive USD appreciation/JPY depreciation trend does not necessarily redound entirely to Japan's benefit. When USD/JPY was stable at levels above JPY120 during the period from the latter half of 2014 through the first half of 2015, Japanese companies, households, and government units all became increasingly aware of the costs associated with JPY depreciation. (The weakness of the GDP figures recorded during that period is probably attributable to the erosion of real incomes owing to JPY depreciation's effect of increasing the cost of imported goods.) In brief, while USD appreciation (JPY depreciation) is thought to be an effective means for the BOJ to approach its inflation target, it does not seem so felicitous from the perspectives of the Japanese domestic economy, where it inspires concerns about real income environment deterioration, or the global economy, where trends are largely determined by the situations in the United States and China. In fact, when USD appreciation becomes excessive, it generates numerous types of misfortune.

In addition, USD depreciation is of course a good match for U.S. currency and trade policies under the Trump administration, and it can also be expected to rein in the emerging country market turmoil accompanying capital outflows from emerging countries. For example, China will no longer have to make strenuous intervention efforts to sell USD and buy RMB. Moreover, because USD/JPY levels in the JPY100-105 range roughly correspond to the USD/JPY purchasing power parity level and are thought to suit both exporter companies and importer companies in a balanced manner, there should be no concern that USD depreciation to the USD/JPY100-105 range will subject the Japanese economy to any serious negative impacts. (The average USD/JPY exchange rate for the entirety of 2017 predicted by enterprises as per the December 2016 BOJ Tankan survey was JPY104.9.) Because a halt to the JPY depreciation/USD appreciation trend would slacken growth in the consumer price index (CPI), it would clearly be inconvenient from the perspective of the BOJ, but it would not be a burden with respect to the global economy's stability and balance.

In this situation, if a consensus can be reached affirming that the global merits of USD depreciation exceed those of USD appreciation, then there would appear to be zero risk associated with an effort based on international cooperation to guide USD downward – an arrangement that might come to be called a second Plaza Accord or Plaza Accord II (risk factor (1)). Looking at the political event schedule in the near future, the abovementioned G20 meeting will be held from March 17-18, and the possibility that forex issues will be a major topic of discussion and that strong arguments in favor of USD depreciation will be disseminated at that forum should be kept in mind. In fact, immediately before and after the Shanghai G20 held at the end of last February, there was considerable speculation about the possibility that some sort of agreement similar to a second Plaza Accord might be or have been arranged at that meeting. It should not be forgotten that the Dollar Index as of January 2017 was at a higher level than it was at the time of the Shanghai G20 last February.

Another kind of JPY appreciation risk that should not be overlooked are political risks related to Europe (risk factor (7)). During 2017, general elections will be held in two large EU members – Germany and France – and, following the replacement of Italy's prime minister in the wake of the December referendum, there is a strong possibility that Italy will hold general elections during the year. And also approaching are the March general elections in the

Netherlands and the April-May presidential election in France. It has been reported that Marine Le Pen, president of the far-right National Front (FN) party is the leader in opinion polls forecasting the French presidential election, and such developments as reports of a financial scandal affecting a competing candidate, Francois Fillon, make it very difficult to anticipate the election results. Moreover, in the case that general elections are held in Italy, observers are beginning to see a realistic possibility that an anti-EU party – the Five Star Movement (Movimento 5 Stelle, M5S) – will come to power. In that case, there is a possibility that risk-off market conditions will emerge in light of the possibility that Italy may organize a referendum on leaving the euro area.

While the above is a brief overview of the various risks related to both JPY depreciation and JPY appreciation, it is quite apparent that the biggest risk associated with preparing the forex forecast is that related to the direction of the Trump administration's economic policies, particularly its currency policies. At this point, these potential risks span a wide range of upside and downside risks, and it would be reckless to pretend to be in a position to be prescient about which of those risks will eventuate. However, since President Trump has begun explicitly mentioning the possibility of restraining USD appreciation from an earlier date than was previously expected, it would clearly be difficult to forecast progressive JPY depreciation. President Trump's protectionist stance is becoming increasingly apparent each day, and that stance harmonizes extremely poorly with a trend of USD appreciation. I strongly recommend that these fundamental facts be kept in mind and that expectations regarding prospective forex trends be based on due consideration of their potential ramifications.

EUR Outlook ー Robust in response to USD weakening

ECB Monetary Policies Now and Going Forward - Easing environment becoming constrained

January ECB GC Meeting – Currently evaluating results

At the January ECB Governing Council Meeting, the interest rates on the main refinancing operations (MROs), the marginal lending facility (the ceiling of market interest rates), and the deposit facility (the floor of market interest rates) were all kept unchanged at 0.00%, 0.25%, and −0.40%, respectively, resulting in the interest rate corridor (difference between ceiling and floor) remaining unchanged at 0.65 pp. In addition, following a major revision of the expanded asset purchase programme (APP) parameters at the December meeting, the APP was naturally also kept as is. Plans were confirmed that call for the current EUR80 billion level of monthly asset purchases to be maintained through the end of this March and then reduced to EUR60 billion of monthly asset purchases during the nine-month period from April through the end of December. Purchases of assets with yields lower than that of the deposit facility (−0.40%) were commenced from January 13 and, for the time being it appears that, rather than proactively seeking to make additional changes, the ECB will be focusing on evaluating the effects of the recent adjustments.

Four conditions for price stability

While expectations that the January GC meeting would maintain the status quo were predominant, there was some speculation that – in response to an uptick in the Euro area Harmonised Index of Consumer Prices (HICP) and an acceleration of the CPI – ECB President Mario Draghi's tone at the press conference might become more hawkish. To the extent discernable from the Account of the December GC meeting[3], there was no discussion at all at that meeting of whether robust HICP figures might lead to a downscaling of easing measures, but questions regarding such a possible link were extremely conspicuous at the press conference. In this regard, a question was posed at the December press conference – "You've underlined that the ECB can increase the volumes and duration of the programme if developments change. Does that also mean, by contrast, if developments are better than expected, the ECB could slow purchases or cut the duration of the programme?" – and President Draghi responded, saying – "We seem to be fairly far away from any such high-class problem." In other words, his answer indicated that such developments as an unexpectedly large improvement in conditions are simply considered a 'high-class problem' and that the fundamental understanding is that such developments will not have an impact on policy judgements. The first reporter to pose questions at the January meeting persisted with that line of questioning, asking – "Is the ECB also ready to do less if it continues to outperform? I think last time you indicated this was a high-class problem. I just wondered if you had any update on that." – President Draghi briefly disposed of the question, saying – "[..] the answer is yes, it still is a high-class problem."

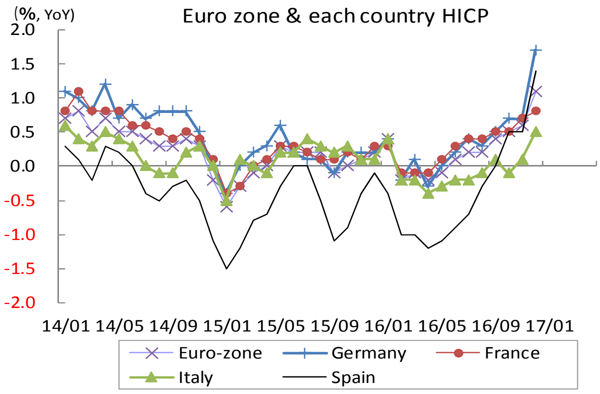
[3] Please refer to the January 16, 2017, issue of Mizuho Market Topic entitled "Preview of ECB monetary policy meeting – The real intention is 'maintaining the status quo so far as possible'".

The second reporter asked a similar question – "[...] one on the inflation again. In case it overshoots your target, for how long would you let it overshoot? Have you made up your mind for this in the Governing Council?" Draghi responded to that, saying – "Now, the answer [...] lies in what we define as our objective." – and then he described the four conditions that when satisfied will be grounds for considering the objective as attained. First, price stability (inflation rates at levels below, but close to, 2%) must be judged to persist over the medium term. Second, the situation must be 'durable' rather than 'transient'. Third, the situation must be 'self-sustained' and stable even without extraordinary monetary easing. Fourth, the situation must be realized for the whole of the euro area. While he refrained from evaluating the current situation with respect to the four conditions, it appears that President Draghi views the targets as still being quite far away.

Response to German criticism

There were also numerous questions posed at the press conference that focused on the fact that different euro area member countries are showing improvement regarding HICP and other aspects of their economic and financial environments at differing rates of speed. For example, mom HICP growth in December was +1.1% for the euro area, +1.7% for Germany, and +0.5% for Italy (see graph), so it is true that the performance gaps are beginning to become conspicuous. In this regard, there were questions about how the ECB would respond to "German critics" who view continued easing as unsuitable for Germany's situation, and President Draghi responded to such concerns by saying that – "it's too early to say." The GC unanimously agreed that movement toward improvement in GDP and various other figures indicates that the ECB's current policies should be considered to be working effectively. (In this regard, a question was posed about whether the portion of German and other members who disagreed with the December decision in December had this time for some reason changed their minds and admitted that they were previously wrong.) It was stated at the press conference that most of the recent increase in inflation rates was attributable to energy prices, but the underlying inflation pressures as well as nominal wages remained subdued. In brief, the ECB has judged that the second-round effects coming from higher inflation – which are a traditional matter of concern to the ECB – are not yet emerging. In addition, it appears that, given "the risk coming from the global uncertainty situation," the fundamental understanding of Draghi and the rest of the GC is that it is out of the question to become optimistic based on the inflation rate situation and therefore argue for monetary tightening in response. President Draghi's two answers featuring specific mentions of Germany included such repeated statements as – "The recovery of all of the Euro area is in the interests of everybody, including Germany. [...] So we have to be patient; as recovery will firm up, real rates will go up. [...] just be patient; as the recovery will firm up, real rates will go up as well. This will happen for Germany and for other countries as well." Because the Draghi-led GC does not believe that the euro area's economic situation including that of Germany is on a firm and stable recovery path, it appears that it considers it out of the question to focus on such issues as divergences among the economic performance figures for individual countries within the area.

One of the questions posed at the January press conference – "how concerned are you about increasing discrepancies between inflation rates across the Euro area? How large a gap can the ECB tolerate?" – and the underlying gist of that question was how large a gap the ECB will tolerate between Germany and the other euro area countries. This question was met with only the kind of limited responses quoted above, but it should be recognized that grilling the ECB about correcting the gaps among euro area countries' inflation rates is fundamentally inappropriate. The euro area countries' economies differ in their levels of maturity, and it is inevitable that inflation rate gaps will occur in line with those differences. For example, in the economies (particularly those of Greece and other Southern European countries) that are in the process of catching up with other euro area economies, there is a tendency for prices to become higher than the average for the area, but in the economies that are in a maturation process (particularly those of such advanced countries as Germany and France) there is a tendency for prices to be lower than the average for the area. The ECB does not consider it possible to eliminate such price gaps by means of monetary policies and has historically held the view that it is positioned only to affect the level of prices in the area as a whole. In other words, it seems that such gaps are considered "temporary" phenomena that will disappear in line with the area's progressive integration, and it appears that the ECB's view is that, rather than addressing the gaps by means of monetary policies, the gaps should be dealt with by means of structural policies and other measures within individual countries. Despite this, the fact that it is Germany – which has long tended to be relatively hawkish – that is leading the pack with respect to the increase in inflation rates, may cause obstacles going forward with respect to the consideration of additional easing measures.



(Source) Bloomberg

Increasingly constraining environment for ECB easing measures

Two questions related to President Trump were posed at the press conference. Regarding some Trump comments (in a January 14 Wall Street Journal interview) that caused USD to weaken, a reporter asked – "I wondered if you were worried about what this might mean in terms of a future currency war or perhaps about some of the other suggestions he's made about an increase in protectionism and how that might impact the Euro area." Because the press conference preceded President Trump's inauguration, Draghi made the natural response that – "really it's very early for us to comment on the to-be President Trump's statements. It's just early." (suggesting that the comments should be reserved for after actual policies become evident) – and then went on to make some conventional comments on forex rates, saying – "The exchange rates for us are not a target but they are important for price stability and growth. There is a very strong international consensus in the G20 and the G7 to refrain from competitive devaluations." However, given that President Trump upon his inauguration proceeded immediately to withdraw from the TPP and begin reevaluating North American economy's key NAFTA agreement, the degree to which he will comply with a "very strong international consensus" that is only a verbal agreement rather than a legally binding contract is questionable. Judging from the way that President Trump has personally worked to change the management strategies of global companies and even comment on the management policies of companies based in other countries, <u>it seems highly likely that if he judges that it is necessary, he will pursue thorough measures to promote USD depreciation</u>. The nature of President Trump's "America First" policy suggests that he does not consider an international perspective to be very important. The huge size of the euro area's Germany-driven trade surplus with the United States is a fully sufficient reason for President Trump to regard the euro area as a problematic rival. Given that the ECB's monetary policies have featured conspicuous currency policy characteristics since 2013, it appears quite reasonable to anticipate that the ECB will have to struggle to cope with President Trump's opposition as it considers additional easing measures going forward.

In the case that Germany's economic and financial situations continue to deviate from those of other euro area countries and that it also becomes necessary to carefully consider President Trump's perspective, <u>it seems likely that, going forward, even when the euro area faces situations that require it to consider additional easing measures, it will find that the environment for related discussions has become quite constrained</u>.

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