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Forex Medium-Term Outlook

31 March 2017

Mizuho Bank, Ltd.
Forex Department

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Overview of Outlook

My basic understanding of USD/JPY remains unchanged since November 2016. I have been consistently expressing skepticism regarding the sustainability of USD appreciation taking place since the U.S. presidential election, because there are no solid grounds for the increase in U.S. interest rates, the main cause behind the USD appreciation trend. The adjustments in U.S. interest rates and USD, which became more marked in March, probably indicate disappointment regarding the governing abilities of the Trump administration. In this report, I have been emphasizing that, rather than focusing on the impact of a fiscal mobilization plan that is not yet certain, one would do better to worry about what has already taken place, i.e., the sharp rise in U.S. interest rates and USD. I look at the March adjustments as the consequence of an evening up of accounts by those who found their predictions of the impact of an as-yet uncertain fiscal mobilization to have possibly been wrong. Also, the FRB's hawkish stance since February could be the result of its beginning to prioritize a "politically appropriate" rather than "economically appropriate" stance. Seeing that the U.S. yield curve is beginning to flatten, it seems the markets are also conscious of this, so it is possible that the focus of attention has already shifted from the number of rate hikes to the reason for them. The current situation, with USD failing to strengthen despite hints of consecutive rate hikes, is reminiscent of the Biblical saying "we have piped unto you, and ye have not danced," and simply goes to underscore the fact that the present normalization process is unreasonable. Adjustments to the excessively strengthened USD are likely to continue to be a theme going forward.

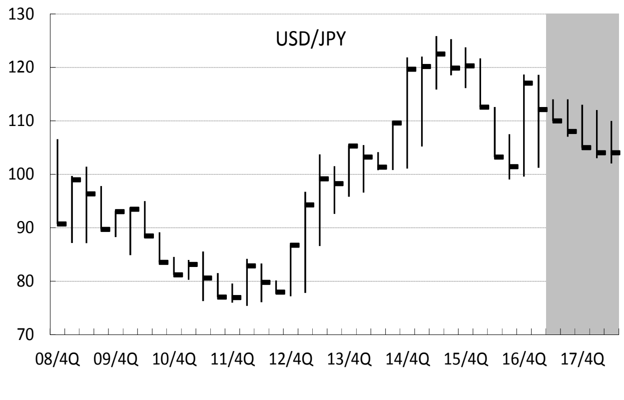
EUR in March showed a clear turnaround, due to the receding of political risks and the ECB's switch to a more hawkish stance. Elections in the Netherlands in March ended without turmoil, and the probability of a victory for far-right candidate Marine Le Pen in the French presidential elections is also reported to be declining. Again, in terms of monetary policy, the ECB is clearly switching to a more hawkish stance, suggesting that the next move is likely to be a monetary tightening rather than relaxation. This appears to be the consequence of the increasing difficulty of maintaining a system based around the solitary strength of Germany. Unless some major shock upsets plans, the ECB is expected to either maintain the *status quo* or, depending on the situation, even consider tapering off of quantitative easing (QE) or raising interest rates. Under these circumstances, if we additionally take into account the Euro area's enormous Current Account surplus, it seems prudent to forecast strength for EUR. Needless to say, the derailment of the FRB's unreasonable normalization process is also likely to give a boost to EUR. In this midst, the one reason for uncertainty seems to be the fate of the Italian general election scheduled to take place during the current forecasting period (accurately, by may 2018). There now seems a possibility of the anti-EU Five Star Movement coming to power following the election, and if this happens, EUR could weaken during the final phase of the current forecasting period.

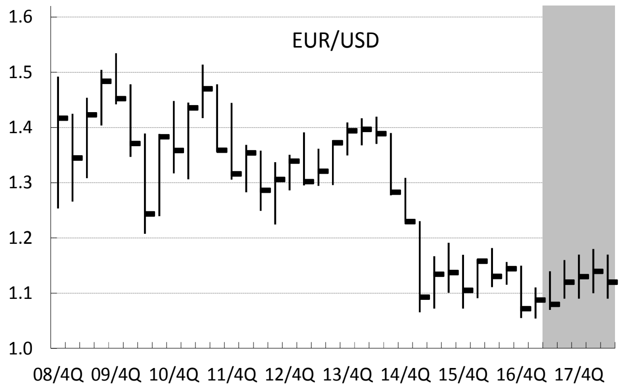
Summary Table of Forecasts

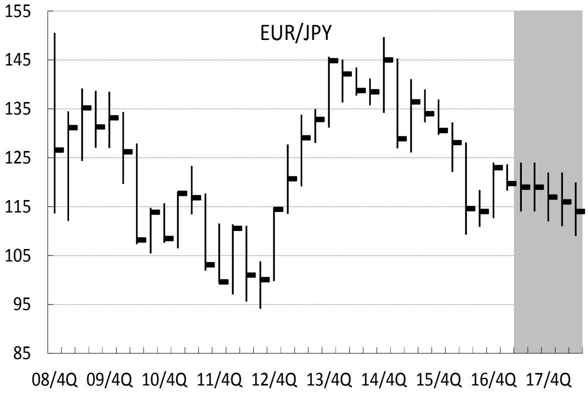
	2017 Jan-Mar (actual)	2017 Apr-Jun	Jul-Sep	Oct-Dec	2018 Jan-Mar	Apr-Jun
USD/JPY	110.11 ～ 118.60 (112.10)	107 ～ 114 (110)	106 ～ 114 (108)	103 ～ 113 (105)	102 ～ 112 (104)	100 ～ 110 (104)
EUR/USD	1.0340 ～ 1.0906 (1.0683)	1.05 ～ 1.12 (1.08)	1.07 ～ 1.14 (1.10)	1.07 ～ 1.15 (1.11)	1.08 ～ 1.16 (1.12)	1.07 ～ 1.15 (1.10)
EUR/JPY	118.25 ～ 123.71 (119.76)	114 ～ 124 (119)	114 ～ 124 (119)	112 ～ 122 (117)	111 ～ 122 (116)	109 ～ 120 (114)

(Notes) 1. Actual results released around 10am TKY time on 31 March 2017. 2. Source by Bloomberg 3. Forecast rates are quarter-end levels

Exchange Rate Trends & Forecasts







USD/JPY outlook – Receding expectations of the Trump administration

Baden-Baden G20 meeting – Preliminary match awarded to the U.S.

The recent G20 meeting was merely the preliminary match

The recent Group of Twenty (G20) meeting of foreign ministers and central bank governors held in Baden-Baden, Germany, on March 17 and 18 highlighted the increasing difficulty of arriving at agreements in the arena of international economic diplomacy amid incompatibilities between the Trump administration's "America First" policy and the principles hitherto espoused by the G20. As it had been feared, the phrase "resist all forms of protectionism" was dropped from the communiqué, and there are signs that many, if not all, of the terms insisted on by the U.S. were adopted. I say "not all" because there were some advance reports that the U.S. was keen on including phrases such as "free and fair trade" and including a mention of concern regarding currency wars in the communiqué. Needless to say, the intent of such phrases would have been to level implicit criticism at China, and their inclusion would have met with fierce resistance from that country. Nor would Japan or Germany (the current chair of the G20), which are also easy targets for finger-pointing in this regard alongside China, have acquiesced. Consequently, though the communiqué watered down its anti-protectionist stance, probably from the U.S. point of view, it was a document that fell short. In this sense, it could be said that the recent G20 meeting was like a "match drawn on account of injury." Having said that, it has also been reported that the allocation of staff, mainly in the Department of the Treasury, still remaining undecided may have contributed to the U.S. efforts falling short of full success at the G20. In this sense, perhaps the recent meeting ought to be described as merely the preliminary match.

If one had to pick a winner, it would be the U.S.

Despite the match having ended more or less on a tie, one cannot help thinking that the U.S. managed to get its own way in some senses. The deletion of language expressing the G20's firm stance against protectionism, which had always been included in its communiqué up to now, was a rather major change. Coming at it from a different direction, it is difficult to dismiss it as "not a big deal," because in that case, what was the point of including it in the communiqué to begin with. Going by the maneuvering that took place at the recent G20, it became formally clear that the U.S., led by President Trump, acknowledges its trade policies to be a form a protectionism and intends to get this acknowledged in the arena of international economic diplomacy. Breaking this down, it amounts to an expression of the intent that the U.S. will, going forward, prioritize bilateral trade relationships based on what is most appropriate for the two countries in question, rather than multilateral negotiations based on the rules of the World Trade Organization (WTO), and that it will not hesitate to adopt protectionist policies in situations that are disadvantageous to U.S. workers. Again, if reports that the U.S. wanted to include a phrase expressing concern about currency wars in the communiqué are true, that would also be a reflection of its anxieties regarding USD appreciation. Ever since the launch of the Trump administration, there has been concern that the U.S. would adopt a protectionist stance in trade policies and a currency policy stance against the appreciation of USD, and it is not insignificant from the point of view of predicting forex rates that both these stances have now been formally acknowledged.

Even if China is the target...

Just ahead of the G20 meeting, Japanese Finance Minister Taro Aso had his first meeting with U.S. Secretary of the Treasury Steven Mnuchin. At this meeting, it was reported, they concurred that sudden changes in forex rates have a negative impact on the stability of the global economy, and agreed to avoid competitive currency devaluations and to avoid making currency rates the target of policies. Avoiding competitive currency devaluation and manipulation of currency rates (to gain a competitive edge) are already forex-related guidelines observed by the G20, and the recently released G20 communiqué also mentions them. The fact that the meeting between Mr. Aso and Mr. Mnuchin ended on a positive note based on the above agreements may indicate that the Trump administration's protectionist stance as well as aversion to the strengthening of USD may be in relation to China rather than Japan.

It must be noted, however, that JPY will not go unaffected if USD/CNY undergoes a major adjustment in the direction of USD depreciation against CNY. Again, as I have said in previous issues of this report, the biggest problem in relation to China over the past two years can be described as an uncontrollable weakening of CNY due to the accelerating pace of capital outflow, and a major decline in China's foreign currency reserves as a consequence of its fight to keep CNY from slipping further. This being the case, the U.S. and Chinese interests actually coincide in wanting USD to weaken against CNY. In this scheme of things, where the U.S. is critical of China for its weak currency, perhaps the biggest loser will be Japan.

At any rate, the recent G20 meeting was the debut battle for Mr. Mnuchin – probably more of a preliminary match, given that he does not yet have a full staff. Despite this, he managed to arm-twist the G20 into making changes to its communiqué in accordance with U.S. wishes, and I would like to think about what this means and formulate my forex outlook accordingly.

U.S. monetary policies now and going forward – USD rates reminiscent of "we have piped unto you, and ye have not danced"

"Sell the fact" takes the lead

At the FOMC meeting held on March 14 and 15, the FRB decided on a rate hike for the first time in the three months since December 2016. The rate hike margin was +0.25 pp, while the much anticipated policy rate projections (dot plot) by FRB Board members and regional Federal Reserve Bank presidents (median values) indicated two more rate hikes within the year, which is the same as the projections made in December (the projections for 2018 also remained unchanged).

The staff economic projections (SEP) did not involve any majors changes since December either, with the overall assessment given at the top of the FOMC statement remaining unchanged since February. This leaves doubts as to the rationale for the FRB's switch to a more hawkish stance since February, and the recent rate hike. The results of the recent meeting were seen by many to have been more dovish than anticipated, though, because of the speculation in some quarters before the meeting that the rate hike projections for 2017 would be raised from three times to four times, and that the FRB would begin discussing a reduction of its balance sheet size. Consequently, "sell the fact" took the lead in both U.S. interest rate and forex markets, with USD being sold off as interest rates declined.

Was the FRB meeting really dovish?

The overall assessment of the economy at the start of the statement read, "Information received since the Federal Open Market Committee met in February indicates that the labor market has continued to strengthen and that economic activity has continued to expand at a moderate pace," exactly the same as the previous (February) statement. In this context, FRB Chair Janet Yellen herself said at the beginning of her press conference, "Today's decision does not represent a reassessment of the economic outlook or of the appropriate course for monetary policy," denying that the decision to raise the rates was based on any new economic or financial developments since the previous (December) meeting.

The tone of Ms. Yellen's remark gives an indication of the stance that rate hikes will continue to be justified unless something happens to warrant a major downgrading of the SEP. At her press conference, Ms. Yellen said that "changes in economic policies, including fiscal and other policies, could potentially affect the economic outlook," but then added, "Of course, it is still too early to know how these policies will unfold." Does this mean that the pace of rate hikes could even increase depending on fiscal policy developments ahead? At any rate, the clear indication of the stance that further rate hikes would be considered appropriate even if the economic outlook remains unchanged, is an important sign of what is to come. If we were to focus on this point, then it would seem that the FRB's stance may not be as dovish as the market reaction indicated, and one could say that the probability of rate hikes going forward has increased (whether this is the right thing to do is a different matter). Probing deeper into the likely reasons for the rate hike this time, the revision of the price assessment from "Inflation increased in recent quarters but is still below the Committee's 2 percent longer-run objective," to "Inflation has increased in recent quarters, moving close to the Committee's 2 percent longer-run objective" could have led to the conclusion that the time was right for a rate hike as, in addition to a state of full employment, inflation was also approaching 2%.

Could the rate hike be a "small sacrifice toward a greater cause"?

The main reason the markets considered the recent FOMC meeting to have ended on a dovish note was because the dot plot was kept unchanged from the previous (December 2016) meeting. Taking a look at the projections of FOMC members (median values), the projected interest rates at the end of 2017 and 2018 remained unchanged at 1.375% and 2.125%, respectively, suggesting no change in the number of rate hikes. Having said that, the number of FOMC members predicting 1.625% (≈ three more rate hikes, i.e., four in all for this year) for 2017 increased from three to four, which seems to suggest greater bullishness among FOMC members. It does seem as though the FOMC, based on the position that rate hikes will continue to be appropriate even if the economic assessment remains unchanged, is pushing for greater consensus in terms of going ahead with rate hikes unless something happens to warrant changing track. It is likely, therefore, that three rate hikes for this year (two more to go) are being discussed quite realistically. Given that shrinking the balance sheet is already being discussed, perhaps the rate hikes are being seen as a small sacrifice toward a greater cause.

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

FOMC Date	2017	2018	2019	Longer run
Jun-13	n.a.	n.a.	n.a.	4.00%
Sep-13	n.a.	n.a.	n.a.	4.00%
Dec-13	n.a.	n.a.	n.a.	4.00%
Mar-14	n.a.	n.a.	n.a.	4.00%
Jun-14	n.a.	n.a.	n.a.	3.75%
Sep-14	3.75%	n.a.	n.a.	3.75%
Dec-14	3.625%	n.a.	n.a.	3.75%
Mar-15	3.125%	n.a.	n.a.	3.75%
Jun-15	2.875%	n.a.	n.a.	3.75%
Sep-15	2.625%	3.313%	n.a.	3.50%
Dec-15	2.375%	3.250%	n.a.	3.50%
Mar-16	1.875%	3.000%	n.a.	3.25%
Jun-16	1.625%	2.375%	n.a.	3.00%
Sep-16	1.125%	1.875%	2.625%	2.90%
Dec-16	1.375%	2.125%	2.875%	3.00%
Mar-17	1.375%	2.125%	3.000%	3.00%

(Source) FRB

USD rates reminiscent of "we have piped unto you, and ye have not danced"

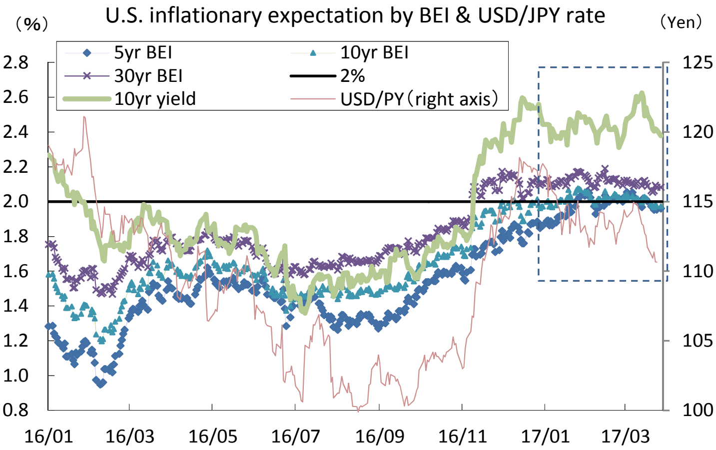
Senior FRB officials have put out strongly hawkish communications one after the other ever since Ms. Yellen's Congressional testimony on February 14, but it is not as though there have been any major improvements in U.S. economic or financial indicators since the beginning of the year. There is a sense of something not quite adding up – a reporter at the recent press conference was also insistent on knowing why the FRB had suddenly turned more hawkish in recent weeks. As rumored on the streets, it is quite likely that current FOMC members (including Ms. Yellen), nominated by Democrat party administrations, will be successively replaced by members favored by the Trump administration. If that happens, the rate hike process will probably come to a stop, as it adversely impacts the economy and asset prices (including USD). Perhaps, under these circumstances, the current FOMC members have a strong political motivation to raise the rates while they still can, so that the FRB can have more elbow-room for monetary easing at a later date. If things go as planned, it is possible that in the second half of the year, as she approaches the end of her term as FRB chair, Ms. Yellen will set in motion discussions toward reducing the size of the FRB's balance sheet as a parting gift (just as Mr. Bernanke had set the tapering process in motion). Pushing the normalization process forward based on these motives seems very risky to me. Under ordinary circumstances, it is desirable to implement a rate hike when strong economic indicators led by job data, and tight financial indicators represented by interest rates lead market participants to actively sense the need for a rate hike. This time, the markets seem to be more passive about it, as though to say, "Well, if the FRB insists that it is time...". Can a normalization process based on this kind of forcible communication really be considered justified or sustainable? I have my doubts.

However, going by the rates (and especially the bear-flattening U.S. yield curve) in March, it seems that markets are beginning to turn their focus away from the number of rate hikes to the reason behind the rate hikes. If this is true, USD movements in response to consecutive rate hikes could be limited. USD failing to strengthen despite hints of consecutive rate hikes is reminiscent of the Biblical saying "we have piped unto you, and ye have not danced," and simply goes to underscore the fact that the present normalization process is unreasonable.

How to read the languishing of U.S. inflation expectations

Incidentally, though there was a turnaround sometime during mid-March, recently, there have surfaced some discrepancies in the trend of inflation expectations, as reflected in the nominal interest rate and break-even inflation rate (BEI). Specifically, since autumn last year, during phases of an increase in USD/JPY, the nominal interest rate and BEI have also increased in tandem (see exhibit). Subsequently, following the start of this year, the nominal interest rate stopped increasing and BEI also leveled off, with USD/JPY also showing weak movement. Since February (inside the dotted square in the exhibit), however, with a clear increase in the nominal interest rate, USD/JPY has also begun to rise, but BEI remains leveled off. What could it mean when the nominal interest rate increases but BEI does not follow suit?

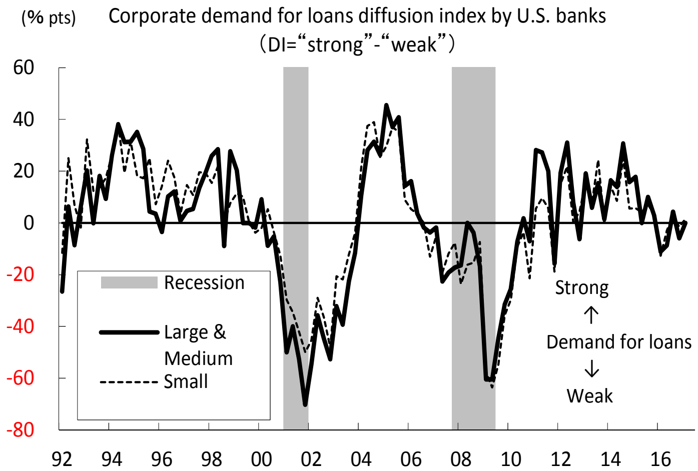
Theoretically, the equation is given as "nominal interest rate - inflation rate (or BEI) = real interest rate (or expected real interest rate)," which can be rewritten as "nominal interest rate - real interest rate (or expected real interest rate) = inflation rate (or BEI)." Given that the nominal interest rate is, in fact, rising, BEI remaining level indicates that the expected real interest rate is rising. As mentioned above, the expected inflation rate can be understood as the assumed potential growth rate of the economy, or in other words, its assumed strength. If, with economic recovery, many market participants are of the opinion that the U.S. economy is strengthening, one could allow for this interpretation. Again, given that the potential growth rate and natural interest rate suggested by the FRB's SEP and dot plot have bottomed out since last September, it is possible that the FRB also thinks this way.



(Source) Bloomberg

No signs of a recovery in economic strength

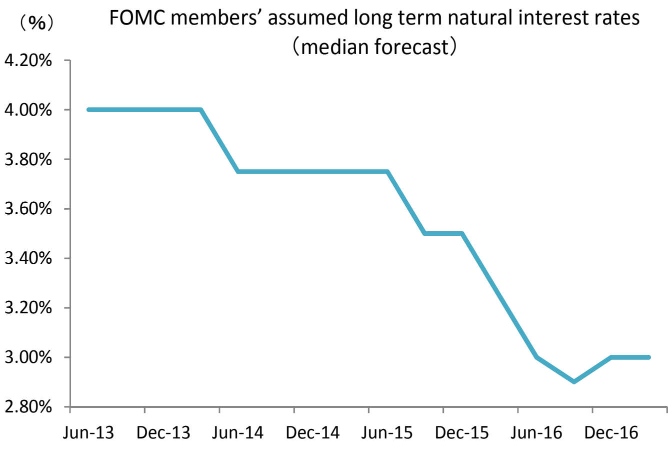
However, if one recalls that just last year, people were talking about the decline in the natural interest rate, and the theory of secular stagnation, promoted by former Treasury Secretary Larry Summers and others, was influential, one begins to wonder how prudent it is to assume that an increase in the expected inflation rate is equivalent to a recovery in U.S. economic strength. If the real economy truly begins to strengthen, we will see, for instance, a clear recovery in bank credit limits in the process of that recovery. However, going by the quarterly survey conducted by the FRB on bank lending practices, there is no sense that corporate demand for loans is tightening (see exhibit). Rather, corporate demand for loans has been weakening since mid-2014. I will refrain from reasoning about direct causal relationships here, but mid-2014 does coincide with the start of the current phase of USD appreciation, so there is some concern that corporate activity could have been dampened as a result of currency appreciation. Again, looking at the bank-side indicators (banks being the entities that actually provide these loans) regarding the demand for loans, while there has been yoy growth, this growth has not been expanding much. I, therefore, think it would be prudent not to jump to the conclusion that the increase in expected inflation rates over the past almost three months is an indication of an improvement in economic strength.



(Source)FRB

The FOMC would like to focus also on the natural interest rate and secular stagnation

In the sense that a gentle increase in the nominal interest rates, accompanied by BEI for all maturities trending close to 2%, suggests a moderate recovery of the real economy, these developments are favorable for the FRB's normalization process. As I mentioned above, however, it is only recently that the central banks of the various nations were fretting over a decline in the natural interest rate, and, in fact, FOMC members' assumed natural interest rates had been declining up to September 2016 (see exhibit). It is true, of course, that this assumed natural interest rate has since bottomed out, but taking this to mean that economic strength must obviously be improving is not something I am willing to be easily coerced into. If my



(Source) FRB

understanding regarding this issue is correct, then the expected real interest rate will peak out at some point. In a situation where the expected real interest rate is not rising, the BEI will have to begin rising in order for the nominal interest rate to continue rising steadily via the FRB's normalization process. If the BEI does not increase, theoretical questions will arise regarding the sustainability of the growth of nominal interest rates. Thinking about it this way, assessing future U.S. interest rate growth in a set with the BEI and conjecturing about its sustainability may provide a clue in terms of formulating the outlook for USD/JPY. Incidentally, since mid-March, the nominal interest rate has begun to decline, BEI remains more or less level, and USD/JPY has also been forced to readjust. Perhaps this is merely an adjustment following the excessive increase in nominal interest rates based on glib talk by President Trump and the FRB.

BOJ monetary policies now and going forward – Reminding readers of the fragility of the current framework

No effect on the markets

In the Monetary Policy Meeting it held on March 15 and 16, the BOJ decided to retain the monetary policy unchanged by a majority vote. It will continue to apply a policy rate of −0.1% and purchase Japanese government bonds so that 10-year JGB yields remain at 0%. It also retained the JPY 80 trillion a year pace at which it will purchase JGBs for the purpose of achieving its target level of the long-term interest rate. Apart from this, with regard to the purchase of assets other than JGBs, the Bank confirmed guidelines to purchase exchange-traded funds (ETFs) at an annual pace of JPY 6 trillion, and Japan real-estate investment trusts (J-REITs) at an annual pace of JPY 90 billion. It also decided to maintain its inflation overshooting commitment, i.e., to "continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner." Governor Haruhiko Kuroda's press conference had nothing controversial either, so the effect of the recent Monetary Policy Meeting on the markets can be said to have been nil.

Time to do away with the "JPY 80 trillion" specification

It was a meeting with extremely few points worth discussing, but if I were to make one comment, it would be that the specification of the sum "JPY 80 trillion" could have been deleted this time. It is widely known that if the BOJ continues its current pace of JGB purchases, it is bound to fall short of JPY 80 trillion a year, so the "JPY 80 trillion" specification is only a nominal figure. Since it is merely nominal, one might say that it makes no difference when the phrase is deleted, but deleting the numerical figure related to the pace of JGB purchases will signify the abandonment of the reflationary path that has been continuing since April 2013 both in name and in reality, and it could encourage a purchase of JPY among some types of foreign investors who base their actions on a simplistic understanding of the facts. Of course, whether this will happen or not depends on market conditions, but the timing this time (coming right after a U.S. rate hike) was rather desirable in terms of being able to safely implement withdrawal operations.

There are three more FOMC meetings with press conferences this year at which a rate hike can be expected (June, September and December) and all the BOJ meetings this year are scheduled to take place right after the aforementioned FOMC meetings. Therefore if, as the FOMC expects, there are two more rate hikes this year, there are still two more chances for the BOJ, but in fact, the fate of the rate hikes is shrouded in uncertainty. It would not be possible to be as certain of a rate hike as it was this time, which was a rare opportunity. Also, if the BOJ is worried about implementing withdrawal operations at a time when JPY is strong, it would have been safe for it to embark on the process this time.

Reminding my readers of the fragility of the current framework

As conditions are extremely comfortable for the BOJ at the present time, one tends to forget that the BOJ's current framework is, in fact, extremely fragile. At the present 110-115 USD/JPY rate, there are unlikely to be any major frictions for the Japanese economy, nor does the Trump administration seem inclined (as of the moment) to criticize extreme currency weakness at this JPY level. Since there are extreme uncertainties regarding the Trump administration's expansionary fiscal policies as of the moment, there are not many fears of JPY weakening excessively. However, with monetary austerity measures drawing attention in the U.S. and Europe, JPY has not much chance of strengthening either. Prices are also rising strongly as the effect of the yoy decline in crude oil prices fades, which gives the BOJ a chance to widely advertise its policies' effectiveness. Whether in terms of currency manipulation, which is its ulterior goal, or prices, which are the overt goal, the BOJ has absolutely no need to be front stage.

It is, however, dangerous to take this situation for granted. For instance, what would the BOJ do if JPY were to strengthen? The further expansion of the negative interest rate margin is practically difficult in view of the damage to the financial system, not to mention how severely it has been criticized ever since its introduction, especially by the household sector. Again, a policy that is unpopular with the household sector is unlikely to be welcomed by the political sector either. Does this mean the BOJ will expand quantity instead? Given that deleting the "JPY 80 trillion" numerical figure from the official statement has become the focal point of Monetary Policy Meetings, it appears that the option of re-expanding the pace of JGB purchase has, in reality, been given up. Perhaps manipulating 10-year JGB yields to be less than 0% can be considered, but this is not easy either, as it would involve an expansion of quantity. One must not forget that, following the comprehensive assessment it undertook on September 21 last year, the BOJ has been attempting to switch from quantity to interest rate operations. Incidentally, if the BOJ were to attempt an expansion of its negative interest rate margin in an attempt to counter JPY appreciation, this is thought likely to exert downward pressure on 10-year JGB yields currently pegged to 0%, and counteracting this would require a greater reduction of quantity than the BOJ would desire. An obvious reduction of quantity could then lead to JPY appreciating further in the forex markets. From this point of view, too, the hurdles against expanding the negative interest rate margin are quite high. Again, even in a scenario where the expansion of the negative interest rate margin is possible and is effective in guiding JPY weaker, there is the key problem that it would be a difficult path to adopt when taking relations with the U.S. into consideration.

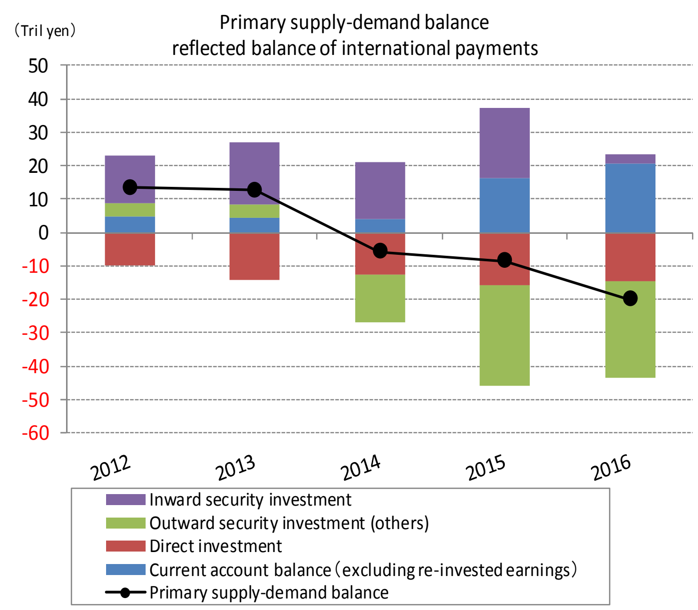
Meanwhile, countermeasures would be necessary even if JPY were to weaken. If JPY weakens beyond 120 against USD, there is concern of damage to real incomes as a result of an increase in import prices – a situation that is not welcomed by the household sector (think back to the period from the second half of 2014 through the first half of 2015). This will inevitably lower the political tolerance level for a weak JPY too. Of course, there is the option of raising the interest rates (either shrinking the negative interest rate margin or raising the target 10-year JGB yield level) to counter an unforeseen weakening of JPY, but given how stubbornly the BOJ has been working toward a +2% rate of inflation, it would be unthinkable for it in terms of its inflation overshooting commitment to switch to monetary austerity halfway through the process (of course, if the monetary base has already been expanded, it would not violate the inflation overshooting commitment, but the markets are likely to relentlessly criticize the BOJ's change in stance). At yesterday's press conference too, Mr. Kuroda commented that "We will not mechanically consider raising the interest rates just because the inflation rate reaches +1%," deterring speculation of an early rate hike in line with global trends.

In other words, the fact is that it is extremely difficult for the BOJ to undertake either monetary easing or monetary austerity, making it easy to see that the current framework of its policy operation is as fragile as glass-making. Ultimately, the best case scenario the BOJ can hope for is a continuation of the present state where there was absolutely no interest in the Monetary Policy Meeting beforehand, and the impact on the markets after the meeting was also nil. That the Kuroda BOJ, which took birth amid great fanfare four years ago, is now hoping to remain away from the limelight vividly reflects the hollowness of the unreasonable reflationary policy based on the idea that if prices were pushed up by expanding the monetary base, the desired result will follow suit.

JPY basic supply-demand situation – Constriction of foreign securities investment climate

JPY's basic supply-demand balance not in keeping with U.S. monetary policies

As U.S. monetary policies turn increasingly hawkish, the outlook for JPY basic supply-demand is likely to swing a bit toward JPY purchase. As per Japan's January Balance of Payments, which were published in March, the January Current Account surplus posted a two-and-a-half-year low, at +JPY 65.5 billion. This was mainly due to the Trade Balance posting a deficit (the first deficit in a year) as a result of exports holding back ahead of the Chinese New Year and imports increasing as crude oil prices bottomed out (note also that this was the first time in eight months, since May 2016, that the Current Account posted a yoy decrease). It is difficult to foretell the trend for the rest of 2017 based on the figures for January, though, because January tends to be affected by seasonal factors, not to mention that at this point, there is only one month of data to go by. However, it is difficult to imagine that crude oil prices this year will post as much of a yoy

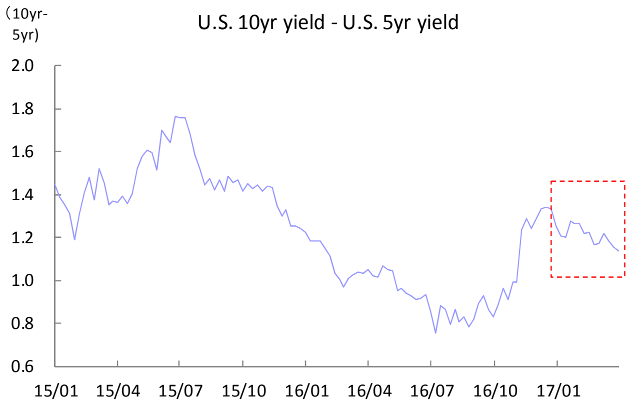


(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government

decline as they did in 2016, so one cannot expect much from the hitherto structure of "sharp fall in imports → sharp rise in trade surplus." The trade surplus may be on a decline from its peak in 2016.
Looking at the basic supply-demand balance (see exhibit), which I use as a guide in forecasting JPY rates in this report, the basic supply-demand balance for 2016 amounted to a total net sale of JPY to the tune of -20 trillion, which was almost twice that posted for the whole of 2015 (a net sale to the tune of -12 trillion). As the exhibit shows, however, these figures were not the result of an acceleration in foreign securities investment or foreign direct investment, or the shrinking of the Current Account surplus, so 2017 is likely to see a somewhat different development. Item-wise, from 2015 through 2016, foreign securities investment and foreign direct investment shrank slightly and moved, to that extent, in the direction of JPY purchase, while the Current Account surplus expanded (the yoy decline in foreign securities investment was the first in three years, since 2013). The sole reason for the expansion of the net sale of JPY in last year's JPY basic supply-demand balance was a passive one – a sharp decline in the net purchase of Japanese securities (especially Equity and investment fund shares) by foreign investors, rather than accelerated growth in Japanese investors' risk appetites.

About-turn in foreign securities investment?

As I argue in this report every month, the basic JPY supply-demand trend is decided by foreign securities investment. In this context, I have been predicting that the basic supply-demand balance in 2017 could swing toward a net purchase of JPY, based on reasons such as, (1) most institutional investors would consider anything above 110 for USD/JPY to be a high rate, and (2) the BOJ will be unable to pursue the traditional route to JPY weakness, namely "expansion in U.S.-Japan monetary policy gap → expansion in foreign securities investment → increase in USD/JPY" out of fear of criticism from President Trump. I believe this is an important point that has not faded in importance even in the face of the FRB's increasingly hawkish stance. Again, going by the bear-flattening of the U.S. yield curve (see exhibit), it seems that it is not just Japanese investors but many others also who do not believe the U.S. will be able to implement consecutive rate hikes.



(Source) Bloomberg

In addition to the above, there is another recent development that cannot be overlooked. As has been reported since last week, the Financial Services Agency is set to conduct a special investigation of Japanese regional banks, especially targeting their investment departments. It is being said that this is a move arising out of concern that Japanese banks are expanding their investment in foreign securities as an alternative to Japanese Government Bonds (JGBs), which lost their attractiveness as investment options following the introduction of negative interest rates. A number of financial institutions are thought to have suffered latent losses (and/or actual losses) as a result of the soaring of U.S. interest rates since last year, and I have repeatedly argued in this report that this may have led to the large net sale posted in Japan's foreign securities investment since November last year. There could be a number of arguments in favor of as well as against the special investigation, but if it leads to banks viewing foreign investments as risky, the climate of foreign securities investment for Japanese institutional investors will definitely become more constricted.
Going by purchasing power parity, USD/JPY is already quite high, and there has been no major change in President Trump's currency and trade policies favoring a weaker USD and greater protectionism. Add to this, the surveillance by Japan's financial supervisory bodies, and it seems obvious that Japan's foreign securities investments would find it difficult to accelerate, and could even decline. We may see an about-turn in the trend of enormous net sales of JPY in the basic JPY supply-demand balance since 2014, thanks to the shrinking of foreign securities investment, which had previously been propping up this trend.

Risks to my main scenario – Need for vigilance during mid-April

Correctness of basic premises demonstrated during March

I would like to review the risk factors related to my main forecast scenario. As I have been explaining up to this point, there has been no change to the basic perceptions underlying the forex outlook that I have been maintaining since last November. Regarding the USD appreciation seen since the U.S. presidential election, I have been arguing that—since I do not view the USD appreciation as firmly supported by the rise in U.S. interest rates that has been its main cause so far—the appreciation's sustainability is doubtful. From mid-March, there has been a conspicuous trend of adjustment in U.S. interest rates and USD exchange rates that is clearly being driven by disappointment in the Trump administration's policy implementation capabilities—the trend has strong characteristics of a correction of excessively high interest rates and excessive USD appreciation. Since last year, this report has repeatedly emphasized the point that one should be relatively less concerned about "the impossible-to-understand potential impact of fiscal stimulus measures" and relatively more concerned about "what has already happened (U.S. interest rate surge and sharp USD appreciation)." Currently, it appears the March market adjustment may well represent the ending of the effect of the mistaken inclination to focus on "the impossible-to-understand potential impact of fiscal stimulus measures."

Potential Risks to the Main Scenario

		Risk Factors	Remarks	Direction
World	①	Plaza Accord Ⅱ	・USD strength correction through international cooperation	Strong JPY Weak USD
US	②	FRB monetary policy normalization	・4 hikes/year ・Possible discussions regarding B/S reduction	Weak JPY Strong USD
US	③	Economic policy by new President	・Introduction of HIA ・Expanding government spending more than market expectation	Weak JPY Strong USD
US	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 open positions building?	Weak JPY Strong USD
Japan	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) ・Italy general election (five star movement government take over)	Strong JPY Weak USD

As I have repeatedly argued, the mere event of a country's leadership transition is not capable of bringing about a sudden seismic shift in the real economy. I have also argued that while the break-even inflation (BEI) rate (the future inflation rate expected by the markets) has remained flat since the start of this year, nominal inflation has been increasing and, theoretically, this seems to indicate that expected real interest rates (≈potential economic growth rate) are rising. However, I believe there is insufficient evidence of such a rise. Accordingly, it must be that either nominal interest rates have risen excessively or that BEI is lagging—as explained above, I have been assuming that nominal interest rates have risen excessively, and I believe that market movements during March are a corroboration of that assumption. Going forward, as expectations regarding the Trump administration diminish and the dot chart is adjusted downward, my main scenario continues to assume that the rate of decrease in the markets' anticipated inflation rate will accelerate. 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. There are almost no changes from last month's risk overview.

JPY depreciation risks – FRB pursuing "political correctness"

I will begin by overviewing JPY depreciation risk factors. The main forecast scenario anticipating a return of USD/JPY to the vicinity of 100 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). Regarding factor (3), in the case of a fiscal stimulus program huge enough to exceed market expectations, U.S. interest rates would rise sharply, inflation expectations would increase and, at the same time, there would be a possibility of a strengthening of the uptrend in USD exchange rates. If some tax system 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. However, the roughly USD1 trillion fiscal stimulus program mentioned in the presidential address to Congress in February does not seem sufficient to spur these kind of market movements.

What is the outlook regarding factor (2)? As explained last month, I have been assuming that the FRB will be capable of implementing only about one interest rate hike during 2017. Because the March interest rate hike has already been implemented, I am fundamentally expecting a hiatus in interest rate hikes, but it must be admitted that the FRB has been becoming more hawkish since February, and predicting the FRB's moves is therefore difficult. Rather than stemming from an "economically correct" response, the FRB's transition appears to reflect the beginning of an inclination to pursue a "politically correct" response. My view that the FRB will be capable of implementing only about one interest rate hike is based on the very commonplace assumptions that the economic expansion is maturing, real economic indicators show no indications of overheating, and there is only a shaky outlook for fiscal stimulus measures as the last resort hope for justifying the normalization process—these situations indicate that it is impossible to justify rate hikes as being "economically correct."

Since February, however, it has appeared that the FRB may not share these kinds of assumptions. Despite interest rate hikes' effect of promoting USD appreciation, even FRB Governor Lael Brainard (who had previously emphasized the virtues of dovish policies) has come to support rate hikes, so it is impossible not to sense that there may have been a change to the evaluation axis used for making policy management decisions. While this is no more than speculation, there appears to be a possibility that current FOMC members nominated by Democrat party administrations are anticipating their replacement by Republican party administration nominees, are concluding that they must immediately take measures while they are still in a position to take measures, and are in this sense pursuing policies that they consider politically correct. Based on President Trump's statements to date, it would appear that the Trump administration does not desire the economic tightening effects (including USD appreciation) of interest rate hikes. Accordingly, it can be expected that the person who will be nominated in 2018 to replace FRB Chair Yellen will probably be someone with a dovish tendency. Given this situation, in the case that U.S. fiscal and monetary policies were to coincide perfectly (if risk factors (2) and (3) both were to eventuate) and 3-4 interest rate hikes a year were to be implemented, then it would not be surprising to see a large divergence from the assumed forecast range of my forecast scenario, with USD/JPY surpassing 120. As already explained, however, it appears that the market's desire to proceed further with USD buying based on an emphasis on expectations of 'several' interest rate hikes is currently diminishing.

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. Currently, however, there are no signs that Japanese investors are accelerating their overseas risk taking based on betting on a continued rise in U.S. interest rates. In fact, there are conspicuous signs that the opposite trend of Japanese investors liquidating overseas assets is actually taking place. 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, and with U.S. 10-year interest rates near 2.50% and USD/JPY above 110, it may be that many investors are afraid that the value of their overseas assets may be peaking. In addition, financial supervisory authorities are strengthening their stance of viewing foreign securities investments as risky, and this is another factor likely to restrain outgoing securities investment.

Of course, there are believed to be many investors who are unable to flexibly change their fund management policies until the new fiscal year begins, so there is a possibility that there will be an acceleration of new outgoing securities investment in April and subsequently. However, since U.S. currency policies are not expected to be accepting of USD appreciation, it is advisable to recognize that it would be fundamentally difficult for such a trend to become a mainstream trend. In April, the "new economic dialogue" concept agreed on during discussions between Japanese Finance Minister Taro Aso and U.S. Vice President Mike Pence will begin to be applied, and it is possible that this concept may put discussion of monetary policies also on the table. It may well be that the Japan-U.S. interest rate gap-based JPY selling/USD buying trend will be affected by political noise.

JPY appreciation risks – Need for vigilance during mid-April

It is worth noting that the actual level of JPY appreciation risk is probably greater than that assumed by this report. As mentioned in each edition of this report in recent months, 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)). As I have repeatedly pointed out, 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 will drop, and USD/JPY will plunge as if the ladder had fallen out from under it. I believe that this is the context in which the decrease in U.S. interest rates and trend of USD depreciation seen during March have emerged. The fact that efforts to reform Obamacare have so far been fruitless may well indicate that—as feared from the beginning—the Trump administration does not have strong policy implementation capabilities.

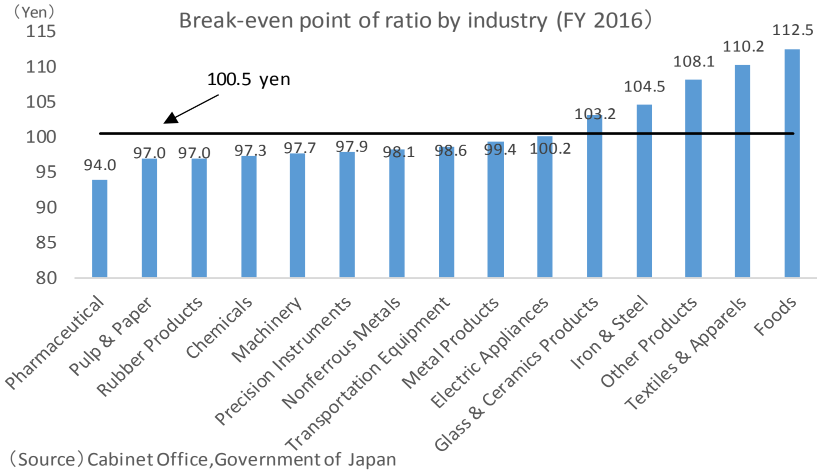
If the scope of issues considered is broadened to encompass currency policies and trade policies along with fiscal spending policies, then it is clear that it would require considerable courage to forecast USD appreciation. Looking back at President Trump's statements and actions to date, it does not at all appear likely that he will be inclined to accept USD appreciation. While Trump's protectionist stance does not require additional examination, it is worth noting that with respect to trade negotiation policy, he stated (on January 26) that – "We're going to have very, very strong controls over monetary manipulation and devaluation." Given this, it appears that the "new economic dialogue" concept will inevitably come to exert strong downward pressure on USD/JPY. At present, I am not anticipating anything akin to the bottom dropping from beneath USD/JPY during the forecast period, but, depending on the direction of U.S. trends, I do see the downside risk of USD/JPY falling below JPY100 as realistic enough to make it worth keeping in mind. This reflects my view that, if there were not any dissatisfaction with U.S.-Japan economic and financial relations, there would be no need to come up with such new approaches as the "new economic dialogue" concept. It is probably natural to expect that there may be some things that the United States will be asking for based on such approaches. It appears that the first "new economic dialogue" meeting will take place during Vice President Pence's visit to Japan in mid-April and, because this corresponds to the timing of the release of next U.S. Semiannual Report on International Economic and Exchange Rate Policies, it will be worth keeping vigilant regarding the possibility of a sharp surge of JPY appreciation at that time.

It goes without saying that the forex trend compatible with the thoroughly protectionist stance that President Trump has been demonstrating would be USD depreciation, and if the stance becomes intensified in the direction of Japan, it seems likely that, in light of JPY's strong fundamentals, JPY might immediately have to bear its putative share of the world's currency appreciation burden. When one considers such fundamentals as political stability, current account surpluses, net external assets, and price levels, JPY is an honor-list currency that is worthy of buying even if it might be with some associated regrets. Based on a comprehensive consideration of currently available information, I cannot imagine a situation in which U.S. currency and trade policies would tolerate JPY depreciation with USD/JPY at sustained levels of 120 or higher.

Problem of "adjusting over-appreciated USD" unchanged

As I have repeatedly argued, even when the FRB is seeking to hike interest rates, such associated problems as USD appreciation and turmoil in emerging country markets may preclude the hike. This "USD appreciation trap" phenomenon is 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.

In addition, as explained in a previous edition of this report, the euro area is suffering from the smoldering problem of Germany's economic overheating, and excessive currency depreciation is therefore not desirable for the euro area. Progressive EUR depreciation and the difficulties the ECB faces in undertaking policy management adjustments to an extent that would promote improvement in the German economy constitute a complex situation. Since giving due consideration to economic situations in peripheral euro area counties makes it difficult to implement a real monetary tightening, one can imagine that the ECB's frank feelings may well be – "we would like to implement monetary tightening at least with respect to forex rates." For Japan, also, the USD appreciation/JPY depreciation trend is not entirely beneficial. 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 is not welcome from the perspective of the Japanese domestic economy, where it inspires concerns about real income environment deterioration. In light of the above kinds of situations, it is apparent that when USD appreciation becomes excessive, it has to be recognized as a factor that destabilizes the global economy.



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 perhaps no longer have to make strenuous intervention efforts to sell USD and buy RMB. Moreover, USD/JPY levels in the JPY100-105 range correspond to the USD/JPY purchasing power parity level, and the Cabinet Office's questionnaire-based "Survey of Corporate Behavior" (conducted in mid-February) found that the USD/JPY level at which exporters could operate profitably was 100.5 (see graph). It thus appears that even JPY appreciation to the USD/JPY100 level would probably not have the effect of causing the Japanese economy to enter a recession. So long as Japanese stock prices are being supported by BOJ purchases of exchange-traded funds (ETFs), it would seem that the Japanese government and ruling party should not be particularly averse to excessive JPY appreciation. (Naturally, the question of whether it is correct for central banks to support stock prices is a separate issue.) 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, <u>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</u> (risk factor (1)). Looking at the political event schedule in the near future (G20 Finance Ministers and Central Bank Governors Meeting in Washington on April 17-18; G20 Leaders Summit in Hamburg on July 7-8), the possibility that forex issues will be a major topic of discussion and that strong arguments in favor of USD depreciation will be disseminated should be kept in mind. As mentioned earlier, it is noteworthy that, while the United States had not yet fully established its new bureaucratic systems at the time of the March G20 meeting, the country still showed a tough stance at the meeting. It will not be surprising if we see this situation heating up still further going forward.

Another kind of JPY appreciation risk that should not be overlooked are political risks related to Europe (risk factor (7)). The Netherlands implemented its general elections in March without disturbances, and it currently appears that Marine Le Pen, president of the far-right National Front (FN) party, is not strongly positioned to win in France's April-May presidential election. However, 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, and this appears likely to be the greatest Europe-related risk factor in 2017. Regarding the September parliamentary election in Germany, attention is being focused on whether Martin Schulz of the center-left Social Democratic Party of Germany (SPD) is capable of displacing German Chancellor Angela Merkel of the Christian Democratic Union of Germany (CDU), but few observers consider this to be a major risk event. In the case that Schulz were to win, he is seen as likely to promote expansionary fiscal policies, and there is a possibility that that would actually be considered a positive development from the perspective of market psychology.

While the above is a brief overview of the various risks related to both JPY depreciation and JPY appreciation, the biggest risk associated with preparing the forex forecast continues to be that related to the direction of the Trump administration's economic policies, particularly its currency policies. Until last month, these potential risks appeared to span a wide range of upside and downside risks, but since March it has seemed that of these two kinds of risks, it is the downside risks that have a relatively high profile. The fact that President Trump's protectionist stance harmonizes extremely poorly with a trend of USD appreciation is consistent with his image in the public eye, but situation is dangerously juxtaposed with the FRB's transition to hawkishness in pursuit of political correctness. The trends of U.S. interest rate increases and USD appreciation are not commensurate with the U.S. economy's underlying strength, and they can eventually be expected to promote economic deceleration. Overall, <u>the main problem since last year has been "how to correct excessive USD appreciation," and the situation regarding this problem has not changed at all</u>. Accordingly, I do not see a need to adjust the basic perceptions underlying my forecast of JPY appreciation and USD depreciation.

EUR Outlook – Narrow scope between consideration for Germany and consideration for the US

ECB Monetary Policies Now and Going Forward – Bullish and hawkish to a degree rarely seen in recent years

ECB showing bullishness and hawkishness to a degree rarely seen in recent years

At the March 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. The current parameters of the asset purchase programme (APP) were also maintained unchanged, and previous plans to sustain the monthly purchase amount at EUR 80 billion through the end of March and then lower the amount to EUR 60 billion during the remaining nine months of 2017 (April through December) were reconfirmed.

However, a sentence included in Governing Council Meeting statements since last April – "If warranted, to achieve its objective the Governing Council will act by using all the instruments available within its mandate" – was omitted from the latest statement, and ECB President Mario Draghi explained that the reason for the omission was – "basically, to signal that there is no longer that sense of urgency..." He went on to explain more specifically that – "that urgency that was prompted by the risks of deflation isn't there." – indicating that the omission was made in response to positive trends regarding the inflation situation, and he also note such related situations as a clear bottoming out of market-based inflation expectations. In fact, looking at five-year in five years inflation swap break-even inflation (BEI)) movements, one does find that such an evaluation is understandable. Moreover, it has been confirmed that the second round of targeted long-term refinancing operations (TLTRO2; approved last March and implemented every three months since last June) will be terminated after the last bidding round this month. (As explained below, there was no debate at all regarding schemes for protracting TLTRO2.) Looking back at the past five years, I personally cannot remember having seen such a clear increase in hawkishness on the part of the ECB GC, and I got the impression that the ECB is bullish to an extent that has been rare in recent years.

Leeway for deleting forward guidance text

By the way, although the "If warranted, to achieve its objective the Governing Council will act by using all the instruments available within its mandate" – text was omitted from the latest statement, the statement's policy rate-related forward guidance boilerplate text – "We continue to expect them [key ECB rates] to remain at present or lower levels for an extended period of time" – was retained unchanged. Draghi did admit that – "we had – not an intense – but just a cursory discussion about whether to remove the word 'lower' from the forward guidance." – however, and he gave the impression that there is a possibility that the word may be removed going forward from the next Governing Council Meeting. In light of the fact that the conflicts between 'volume' and 'interest rates' within ECB's policy management are becoming increasingly apparent, it is a generally acknowledged fact that there is little likelihood that the ECB will move further ahead with negative interest rate policies, so it can be said that the raison d'etre of the word 'lower' is diminishing. On the other hand, Draghi also explained that the reason the word was retained is – "the fact that we can't yet say that we are there with a self-sustained inflation rate."

Draghi dismissed speculation regarding schemes for protracting TLTRO2 by saying – "There was no discussion about having another TLTRO, not at all." – indicating that the loan performance-linked TILTRO funds provision scheme is finally approaching its end after being continued for about three years since 2014. The TLTRO scheme has attracted considerable attention for providing funds at negative interest rates but, excluding rush demand for the final round of bidding in March, it was not employed particularly proactively (see chart (on previous page); the huge size of funding through the first TLTRO2 bidding round reflects the refinancing of TLTRO1 transactions, so the net funding provision figures are not particularly large.) Even so, the termination of TLTRO after its regular implementation at three month intervals since June 2014 gives the impression that the ECB's easing scenario has reached the point of a major change. A reporter asked the question – "Is this tool now completely off the table? Or is it just you put it at the back and see what's going on and perhaps in the next few months it could happen? Or if you'll start tapering or exiting from the QE, it could be a good option to safeguard liquidity in the future." In response,

TLTRO2（total 4 times）

	Start (y/m/d)	Redemption (y/m/d)	Supply	Interest rate (%)	Supply amount (Bio euro)	User (Numbers of banks)
1	2016/6/29	2020/6/24	1456	0	399.3	514
2	2016/9/28	2020/9/30	1463	0	45.3	249
3	2016/12/12	2020/12/16	1456	0	62.2	200
4	2017/3/29	2021/3/24	1456	0	233.5	474
Total amount at present					**740.3**	

（Source）ECB

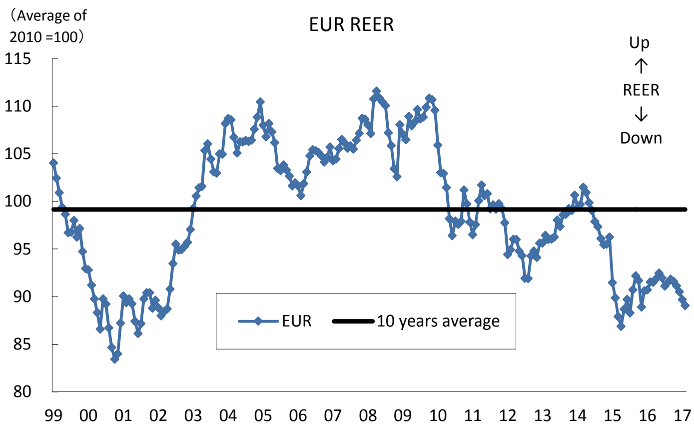
* The final borrowing interest rates will depend on interest exemption measures based on loan performance.

* However, for the first round of bidding, refinancing will be allowed for the entire outstanding loans from TLTRO1 (≈ EUR 430 billion).

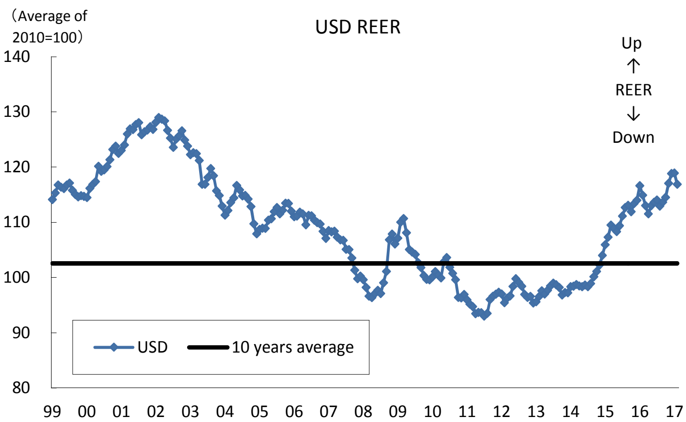
Draghi stated – "... it's potentially an instrument that could be used if the economic situation will warrant that. In other words, there is no ideological or institutional or legal obstacle to that." – not attempting to conceal the possibility that TLTRO may be revived depending on economic conditions.

Consideration for Germany and consideration for the US

Regarding such issues as the actual impending termination of TLTRO2 along with the forward guidance text that was barely retained at the last Governing Council Meeting, however, one gets the impression that there will be no major problem for the ECB even if such issues are left untouched. If there is a perception that the fundamental inflation trend is still weak, the ECB will not be considered tardy if it simply waits for the weakness to end and then reconsiders deleting the text at that point. Ultimately, it seems reasonable to assume that a key factor behind the ECB's move toward hawkish action was consideration for the "problem of Germany's singular strength" that this report has repeatedly discussed. To put it more informally, one may wildly speculate that there is a possibility that the ECB has been seeking to alleviate German unease and complaints about situations causing the German economy to overheat despite the wishes of the Germans to prevent that overheating. Apparently alluding to this situation, a reporter posed the question – "Would you say that there's more consensus today going outwards or continuing with the stimulus than there was a couple of years ago when you were going into the QE programme, because some Governing Council members have expressed doubts about whether the current level of stimulus is too strong? [*And is it for this reason that there was strong support for the hawkish aspects of this Governing Council Meeting?*]" In brief, the reporter was asking if the GC members from Germany and other economically strong countries might have had a strong influence on the debate during the Governing Council Meeting. Draghi responded by saying that it is extremely difficult to measure the degree of consensus and particularly difficult to compare the current degree of consensus to that of two or three years ago. He restricted himself to saying that the discussion at the latest meeting was "pretty consensual," but it is probably natural to speculate that the GC may have become increasingly influenced by the hawkish posture displayed by high-level German officials since February.



(Source) BIS (Note) Broad base



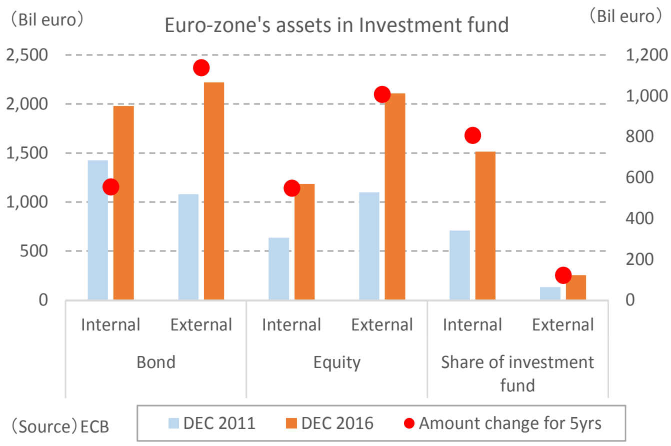
(Source) BIS (Note) Broad base

Those outside the euro area have also been considering the fact that Germany has been employing its "perpetually undervalued currency" to generate huge trade and current account surpluses. The Trump administration's criticism has been intensifying, and the situation is one in which the ECB would be likely to have scruples about casually deciding to implement additional easing. Reflecting this, a reporter asked the question – "Do you think Germany and the Euro area trade surplus reflects some kind of imbalance that could have a negative effect globally or for the Euro area?" In response, Draghi said – "The currency of Germany is the euro and the euro area's monetary policy is conducted by the ECB. The ECB is independent as laid down in the European treaties and in the Statute. The exchange rate of the euro is determined by market forces, which is consistent with the long-standing commitment of the international community to market-determined exchange rates as reiterated both at the G7 and at G20." He then went on to discuss real effective exchange rates (REERs), saying – "if we look at where the [real] effective exchange rate stands today with respect to historical average, we don't see especially that the euro is off the historical average. But the [real] effective exchange rate of the dollar is off the historical average. So it means that it's not the euro, which is the culprit for this situation [of USD appreciation]." Since Draghi did not provide detailed information on this point, it is difficult to quibble, but <u>Bank for International Settlements (BIS) REER figures indicate that both EUR and USD are considerably deviating from the long-term averages, and these figures contradict Draghi's argument (see the graphs on the previous page and above.)</u> As of February, EUR was roughly 10% below its long-term average, while USD was roughly 14% above its long-term average, so it is not impossible to understand Draghi's rationale for saying that EUR is not the only "culprit." In any case, it is apparent that the ECB is feeling anxiety about the need it now has to rebut criticism of the "excessively weak EUR" coming both from the United States as well as from Germany, within the euro area. Going forward, it can be expected that the ECB will concurrently give a greater amount of consideration to both the United States and Germany with respect to its monetary policy management, and this seems to offer a basis for arguing that there will be a diminishing likelihood of the ECB launching additional easing measures.

EUR investment fund figures – An underlying factor behind EUR depreciation

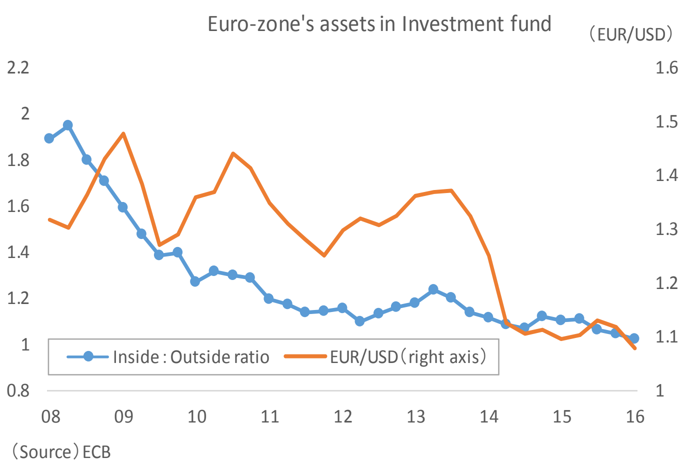
Euro area investment funds escaping the area

The 'Euro area investment fund statistics' released by the ECB on a quarterly basis indicate that investment funds are moving money to outside the euro area. Because this trend is a factor that helps explain why EUR has a heavy upside despite the euro area's huge current account surpluses, it is worth presenting a simple overview of the situation. Looking at the latest euro area investors' asset balance figures (as of the end of December 2016), one finds that euro area investment funds' total assets (assets within the euro area + assets outside the euro area) grew EUR699.0 billion yoy, to approximately EUR9,265.0 billion, the highest total asset figures since the start of this statistic's compilation in December 2008. Separately examining changes in asset levels within and outside the area, one finds that assets within the area rose EUR192.0 billion yoy, to approximately EUR4,682.0 billion, and assets outside the area increased EUR507.0 billion yoy, to approximately EUR4,583.0 billion. It is apparent that the acceleration of asset accumulation outside the area has caused asset levels within and outside the area to become roughly equal. It appears that – reflecting the protracted political and economic weakness seen within the area – the shifting of investment funds to outside the area has become a fundamental trend. The graph showing changes over five-year periods in euro area investors' assets invested in individual types of investment vehicles shows that – excluding the relatively small volume of investment fund holdings – the levels of bond and stock investment outside the area have both been considerably greater than the corresponding levels within the area. (Looking exclusively at investment outside the area, one finds that the level of investment in both bonds and stocks has roughly doubled over five years.) This seems to indicate that the majority of investors felt that looking for external investments was wiser than betting on growth within the area.



Domestic-to-foreign asset ratios and forex rates

With regard to the factors that help explain why EUR has a heavy upside despite the euro area's huge current account surpluses, it appears possible that euro area investors' moves to take risks in external investments may be offsetting current account transactions. In recent years, the EUR-USD interest rate gap has been expanding, so it is not so surprising that euro area investors' outgoing investment has been depressing EUR. The graph superimposes a comparison of euro area investment funds' internal and external asset balances on the trend in EUR/USD exchange rates. While the internal asset balance was roughly twice the external balance as of December 31, 2008, the two balances have now become roughly equivalent.



It is natural that the exchange rates (the ratio of exchange between two currencies) should reflect the sharp increase in the ratio of external to internal assets and, in fact, it does appear that there is a stable relationship between the two ratios. There appears to be a high likelihood that shifts in euro area investors' funds are an underlying factor promoting EUR depreciation.

For quite some time, I have been pointing out that the euro area's current account surpluses and chronically weak inflation outlook have much in common with Japan's history of suffering from chronic JPY appreciation[1]. Recognizing this similarity is a key basis for understanding the rationale for forecasting EUR's underlying strength, and that rationale remains unchanged at this time. In the case of JPY, during periods when institutional investors and other Japanese investors proactively sold JPY, there was a tendency to shift to a fundamental trend of JPY depreciation, and the situation regarding EUR is similar in this respect also. It goes without saying that such periods were generally those in which internal-external interest rate gaps were expanding, particularly when the Japan-U.S. interest rate gap was expanding. Currently, so long as the FRB remains stubbornly committed (even if somewhat unreasonably) to its normalization process, there is a high likelihood that investor-led trends will continue to give EUR a heavy upside, and it is probably the case at this time that the heaviness of the upside is being further increased by recent growth in euro area political risks.

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[1] Please refer to my book, "Ready for the Japanization of Eurozone, Euro and ECB," (Toyo Keizai Shinposha, 2014)