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Forex Medium-Term Outlook

28 April 2017

Mizuho Bank, Ltd.
Forex Department

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Overview of Outlook

My basic understanding of the outlook for USD/JPY remains unchanged since November 2016. In connection with the appreciation of USD following the election of U.S. President Donald Trump, I have been saying that there are no solid grounds for the rise in U.S. interest rates, the leading cause behind the appreciation of USD. I have, therefore, been very skeptical about the sustainability of this trend. Anxieties over the Trump administration's ability to govern, which became apparent early this year, had not been calmed even as we entered April. Some information is now available on the much-anticipated fiscal expansion program, but under a president who does not hide his preference for a weaker USD and lower interest rates, one cannot forecast a continued appreciation of USD – and this is not likely to change. I will not rule out the possibility of the FRB implementing multiple rate hikes during the current forecasting period as well as beginning to discuss reducing the size of its balance sheet, but it is a different matter whether U.S. interest rates and USD will follow along. Even if the monetary policy leans in the direction promoting a stronger USD, so long as the currency policy favors a weaker USD, it would be difficult for the currency to appreciate across the board. Dispassionately taking into account the entire policy mix of the nation, it seems likely that USD will continue resisting appreciation despite the FRB's increasingly hawkish posture (a situation reminiscent of "we have piped unto you and ye have not danced"). Japanese investors' foreign securities investment activities have begun in a rather low-key fashion this fiscal year, so JPY weakness may not receive a boost from the supply-demand side either. There are also reports rumoring the possibility of "a second Plaza Accord," something I have been talking about, so the "adjustment of the overheated USD" is likely to continue to be a major theme.

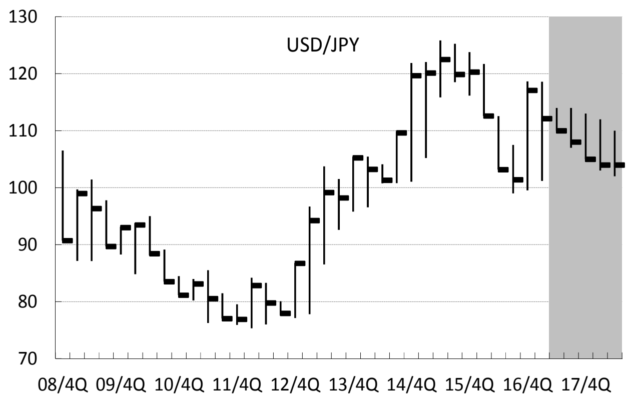
EUR has continued to strengthen as political risks fade and the ECB tilts toward a more hawkish posture. The French presidential elections, which had been considered the biggest political risk for Europe this year, passed peacefully, and speculation of the ECB lifting its accommodative monetary policy continues, so reasons for purchasing EUR are becoming more conspicuous. The end of the ECB's quantitative easing and the start of rate hikes are still quite far away, but so long as there is the possibility that the next move by the ECB could be in the direction of tightening rather than further relaxation, there is no reason why EUR, the currency of the region with the world's largest Current Account surplus, should be sold. Again, if the FRB's normalization process becomes derailed as per this report's predictions, that would further boost EUR. There are also some insecurities, though. There are plans for a snap general election in Italy during the current forecasting period, and if things continue the way they are, there is a possibility of the anti-EU Five Star Movement taking the reins of government. Whether or not this actually happens, the movement to quit the Euro is bound to gain strength through the election process. As a result, I predict that EUR will remain in the 1.05 to 1.15 range, as it has over the past two years.

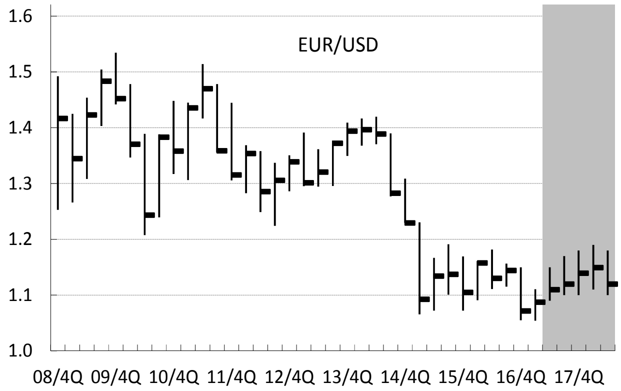
Summary Table of Forecasts

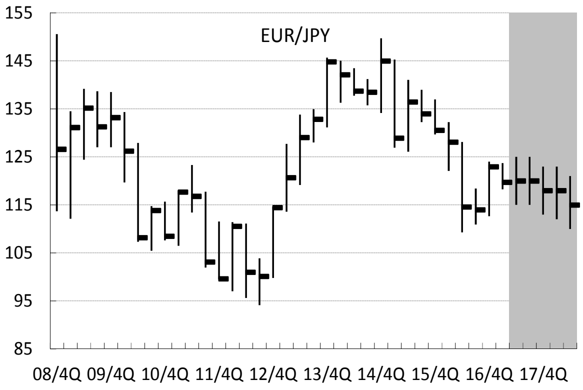
	2017 Jan-Apr (actual)	2017 May-Jun	Jul-Sep	Oct-Dec	2018 Jan-Mar	Apr-Jun
USD/JPY	108.13 ～ 118.60 (111.27)	107 ～ 114 (110)	106 ～ 114 (108)	103 ～ 113 (105)	102 ～ 112 (104)	100 ～ 110 (104)
EUR/USD	1.0340 ～ 1.0951 (1.0861)	1.07 ～ 1.13 (1.09)	1.08 ～ 1.15 (1.11)	1.08 ～ 1.16 (1.12)	1.09 ～ 1.17 (1.13)	1.08 ～ 1.16 (1.11)
EUR/JPY	114.86 ～ 123.71 (120.82)	115 ～ 125 (120)	115 ～ 125 (120)	113 ～ 123 (118)	112 ～ 123 (118)	110 ～ 121 (115)

(Notes) 1. Actual results released around 10am TKY time on 28 April 2017. 2. Source by Bloomberg 3. Forecast rates are quarter-end levels

Exchange Rate Trends & Forecasts







USD/JPY outlook – Speculation about a "second Plaza Accord" smolder

The Semiannual Report on International Economic and Exchange Rate Policies - A further boost to my weak-USD prediction

A further boost to my weak-USD prediction

The much anticipated Semiannual Report on International Economic and Exchange Rate Policies was released by the U.S. Department of the Treasury on April 14. Coming barely two days after remarks (on April 12) by President Trump that seemed to be guiding USD and U.S. interest rates lower (details to follow), there was increased speculation that the Semiannual Report would be quite radical, but the report essentially inherited the claims of the October 2016 report, and there were no major changes. Perhaps, amid rising tensions with Syria and North Korea, there was an attempt not to make waves with the currency report. Having said that, the more minute details reveal the present U.S. currency policy's basic understanding of forex rates, so the report continues to have great significance in terms of predicting forex rates. Overall, the report serves to underscore my claim that the U.S. cannot politically or economically withstand any further strengthening of USD.

No change in the six countries on the Monitoring List

The Monitoring List, which was first published exactly a year ago, is alive and well, and the countries on it remain the same as they were in October 2016 – China, Germany, Japan, South Korea, Taiwan, Switzerland (see chart). Reviewing the criteria, a country is placed on the Monitoring List when it meets any two of the following three criteria: (1) a significant bilateral trade surplus with the United States (over USD 20 billion a year), (2) a material current account surplus (over +3% of GDP), and (3) engaged in persistent one-sided intervention in the foreign exchange market (worth over +2% of GDP in a 12-month period). If a country meets all three criteria, it is declared a Currency Manipulator. China meets only criterion (1), but since its trade surplus with the U.S. is huge, it is still placed on the Monitoring List. The report declared that "Five major trading partners of the United States have met two of the three criteria" and additionally made it clear that "one major trading partner, China, constitutes a disproportionate share of the overall U.S. trade deficit." Since the main evaluation axis for the Trump administration's currency and trade policies are the size of a country's trade deficit with the U.S., China is likely to be closely monitored going forward too. What is more, the concluding line of the "Summary of Findings" section, "Treasury will closely monitor and assess the economic trends and foreign exchange policies of each of these economies," was highlighted in bold font, indicating that the six countries on the Monitoring List cannot afford to rest easy going forward.

Monitoring list 3 conditions (Highlighted countries are on the monitoring list as of APR 2017)

		Current balance		Buying USD & selling own ccy intervention
	Trade surplus vis-à-vis the U.S. (JUL 2015-JUN 2016, Bil dollar)	vs GDP (%, 2015)	Change in last 3 yrs (% pts)	vs GDP
China	**347.0**	**1.8%**	**0.2%**	**-3.9%**
Japan	**68.9**	**3.8%**	**2.9%**	**0.0%**
Germany	**64.9**	**8.3%**	**1.5%**	**-**
Mexico	63.2	-2.7%	-0.2%	-0.5%
Italy	28.5	2.8%	1.8%	-
S.Korea	**27.7**	**7.0%**	**0.8%**	**-0.5%**
India	24.3	-0.5%	2.1%	0.4%
France	15.8	-1.2%	-0.3%	-
Switzerland	**13.7**	**10.7%**	**-0.8%**	**10.0%**
Taiwan	**13.3**	**13.4%**	**3.4%**	**1.8%**
Canada	11.2	-3.3%	-0.1%	0.0%
U.K.	-1.1	-5.1%	-1.1%	0.0%
Euro-zone *	125.7	3.4%	1.2%	0.0%

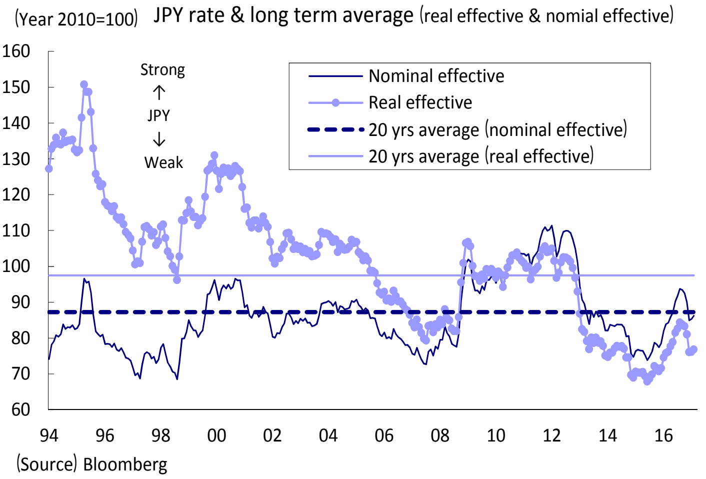
(Source) U.S. Ministry of Finance (Note) Euro zone: Estimation by U.S. Ministry of Finance

The one surprise was that Mexico was not added to the Monitoring List. As shown in the chart, Mexico's trade surplus with the U.S. is not that different from that of Japan or Germany, and given Mr. Trump's sharp rhetoric against Mexico around the time of his inauguration, it would not have been surprising to see the addition of Mexico to this list as the seventh country. Perhaps one of the reasons such a conspicuous move was not undertaken was in order to avoid further raising tensions amid the geopolitical risks mentioned at the start of this report, but as I discussed in a past issue of this report[1], Mexico is an enormous market for the U.S., and there may also have been a desire not to cause needless friction.

The report's evaluation of Japan brings relief

While the report in its entirety seems quite reasonable, the individual assessment of Japan was somewhat more noteworthy. The following are some mentions related to Japan that caught my eye:

- *Treasury is concerned by the persistence of the large bilateral trade imbalance between the United States and Japan*
- *There is little evidence that the yen is overvalued. The real effective yen is twenty percent weaker than its 20-year historical average, and the IMF's most recent assessment found the yen to be "broadly consistent with medium-term fundamentals."*



The Trump administration's stance comes through strongly in the former, but the latter is an objective point that I myself have repeatedly emphasized both in this report. It is a theoretically justified fact that the real effective exchange rate (REER) is inclined to return to average levels. In fact, the latest calculation (as of February) of JPY's REER by the Bank of International Settlements (BIS) indicates that JPY is -21.2% weaker than its long-term (20-year) average, giving the impression that there is considerable scope for an adjustment in the direction of a stronger JPY, even from a historical perspective (see exhibit). Having said that, the concluding paragraph of the section on Japan stated that "Given continued weak demand growth and exceptionally low inflation, it remains important that the authorities combat these trends using all policy levers," and also explained that there was a need for "accommodative monetary policy and flexible fiscal policy with continued implementation of structural reforms." This must come as a relief to Japanese policymakers given the great anxiety, in the run up to the U.S.-Japan economic dialog, that the BOJ's accommodative monetary policies centering on yield curve control (YCC) and its accompanying attempt to guide JPY lower would be criticized.

Again, as opposed to the previous issue of the report, the current one avoided provocative statements such as that "Japan has not intervened in the foreign exchange market in almost five years, but authorities have made persistent public statements to restrain appreciation in 2016, characterizing yen/dollar movements as "rough" and warning that they "will take firm action" if necessary," which makes it come across as less critical. Further, the discussion of whether JPY rates were "orderly" or "disorderly" (seen in the April 2016 issue of the report) also remained absent from the report[2]. All in all, except for pointing out that JPY was undervalued in REER terms, critical language regarding Japan was absent from the report, but it must be noted that there was nothing in the report to suggest support for a weak JPY either.

[1] Please see February 3, 2017 Market Topic titled "Reason why President Trump is keeping close watch on Japan – The splash-back from Japan is likely to be limited?"

[2] The April 2016 report focused on the difference in opinion between the U.S. and Japan regarding whether the soaring of JPY rates were "orderly" or "disorderly." The term "orderly" had been removed from the October 2016 report, but the report noted that "Treasury assesses that the dollar-yen foreign exchange market has been functioning smoothly," leaving the tone more or less unchanged.

Harsh evaluation of Germany

Note that the section relating to Germany is more accurately subtitled "Germany and the Euro Area." This section was titled "The Euro Area" until last time, so there seems to be an increase in the awareness that Germany is a problem. In fact, this section deliberately and clearly notes that the German Current Account surplus is "a matter of concern for Treasury." The report also notes that "there has been a considerable dispersion across members in terms of the quality of economic performance" – for instance, countries like Germany (+1.9%) and Spain (+3.2%) realized growth rates higher than the regional average of +1.7%, but countries like France (+1.2%) and Italy (+0.9%) fell short of it. This structural problem is one that I often discuss in this report myself, and the Semiannual Report has now mentioned it too.

Regarding the exchange rate, the report noted that "The real euro is currently 10 percent weaker than the monthly-average real euro since 2000. On a bilateral basis, over the same time period, the euro is 12 percent weaker against the dollar." As in the case of JPY, it was pointed out that EUR is also weaker than its long-term average in terms of REER, and the unilateral depreciation of the currency against USD in recent years was also mentioned. Against this backdrop, the report indicated awareness that "Persistent weaknesses in some of the peripheral euro area economies, including Greece, Italy, and others, have contributed to uncertainty about the resilience of the monetary union and have effectively weakened the euro over the last several years," which is true. Having said that, the report also noted that "Euro area monetary policy has had an effect as well, as easing by the ECB has opened a sizable gap in interest rates and bond yields between the United States and the Euro area," a point that offers a glimpse into the U.S. currency authorities' discontent.

The report further states that "The combination of a relatively weak currency plus weak domestic demand has led to a significant widening of the euro area's current account surplus from 0.2 percent of GDP in 2009 to 3.4 percent in 2016," further mentioning that Germany is the country leading this expansion. In particular, the following statement left an impression.

- *Germany's real effective exchange rate has depreciated by 10 percent since 2009, a shift that would be counterintuitive in light of Germany's large and persistent current account surplus but for its membership in the monetary union.*

The use of the word "counterintuitive" makes good sense here. The above statement is of the same sentiment as White House National Trade Council (NTC) Director Peter Navarro's criticism that Germany "continues to exploit other countries in the EU as well as the U.S. with an 'implicit Deutsche Mark' that is grossly undervalued," as well as the swipe by President Trump some time ago, when he said that the EU was merely a "vehicle for Germany." The report suggests that stimulating domestic demand would "help appreciate Germany's low real effective exchange rate (and) contribute to both global and euro area rebalancing," but it is not as though there are any great ideas for how to do so. This is a problem that can ultimately be solved to some extent by issuing common Euro area bonds, which would stimulate domestic demand for member states other than Germany, but as everybody knows, Germany is not in favor of this. In this connection, things may change if Martin Schulz, a more leftwing candidate than current Chancellor Angela Merkel, wins the German Federal elections this September. Mr. Schulz is also more proactive on fiscal mobilization.

Debating USD/JPY dropping to the vicinity of 90 again?

Before going into individual sections in the Semiannual Report, I have always paid attention to the section titled "The Dollar in Foreign Exchange Markets," but the report does not seem to have a section with that title this time. On the other hand, it has a subsection titled "Foreign Exchange Markets" under the section called "International Economic Trends," which may be its equivalent. This subsection included the following:

- *Treasury judges that foreign exchange markets have generally functioned smoothly, including around the U.S. election in November and increases in the Federal Reserve's policy rate corridor in both December and mid-March*

The overall tone is one of acceptance regarding the present USD rates, and it may be important that the phrase "have generally functioned smoothly" has been used to describe the FX market, including the period of rapid USD appreciation since November last year. Perhaps it indicates that an intolerable level of USD strength for the U.S. Department of the Treasury (and by extension, the Trump administration) is higher than the present level. At the very least, there seems to be a difference in temperature compared with President Trump's remark reported last week.

In the coming months, it will be worth watching to see how this difference between the opinions of the U.S. currency authorities and the stance of President Trump are resolved, but the report's description of the foreign exchange markets as "functioned smoothly" is not really at odds with Mr. Trump's assertion that USD is too strong at the moment. This strengthening of USD has been a phenomenon since June 2014, not something that began following the presidential election or the recent rate hikes. It is quite reasonable to say that the appreciation of USD over all these months needs to be adjusted. At the very least, with respect to JPY, given that the report clearly states that JPY is "twenty percent weaker than its 20-year historical average," it seems unlikely that the U.S. would take kindly to any further weakening of JPY. I would like to retain my prediction that within the year, USD/JPY will return to the 100-105 range it was in before the presidential elections.

Incidentally, a 20% adjustment of USD/JPY in the direction of a stronger JPY (from the 113 or so level it was in at the end of February) would bring the 90 level into view. This was the level I had been predicting for USD/JPY in this report since mid-year 2016, but I had to revise my prediction as a result of the Trump rally. With the fading away of the excessive expectations of the Trump administration, and the rising of geopolitical tensions, the mood to purchase JPY is rather strengthening, so I would not find it that surprising if USD/JPY were to fall to that level.

U.S. currency policies now and going forward – A review of the policy mix

The destructive force of the U.S. policy mix

In an interview with the Wall Street Journal (WSJ) on April 12, President Trump said, "I think our dollar is getting too strong, and partially that's my fault because people have confidence in me. But that's hurting – that will hurt ultimately," adding, "It is very, very hard to compete when you have a strong dollar and other countries are devaluing their currency." He also said regarding monetary policy that, "I do like a low-interest rate policy, I must be honest with you" – words that encourage guiding USD weaker through monetary policy too. Although there were several factual mistakes in his remarks, the FX market reacted by abruptly letting go of USD.

Since last year, I have persistently argued that so long as the U.S. currency and trade polices remain protectionist and biased toward a weak USD, the currency will not tend to be purchased regardless of how hawkish the FRB's messages are, and that it is impossible for non-key-currency economies such as Japan and the Euro area to stop this trend no matter what they do. Over the past five months, we have seen some groundless arguments that Mr. Trump's remarks in favor of a weak USD and protectionism are a bluff and that there is, in fact, nothing to worry about (and the associated predictions of a weak JPY trend). It has to be said that such arguments had been underestimating the destructive power of U.S. currency policies. Rarely has a market trend been so predictable in advance! Unless President Trump clearly alters his position, this phase is likely to continue.

A summary of the U.S. policy mix

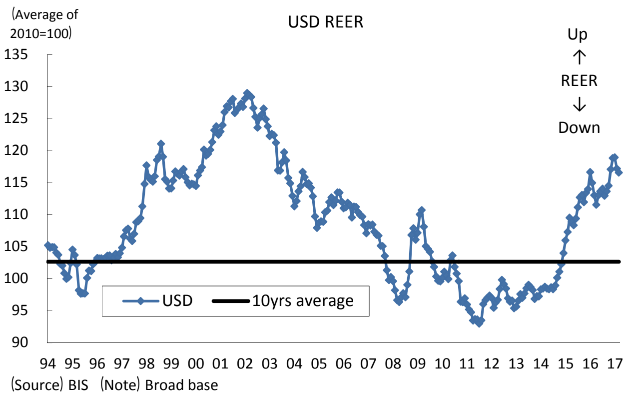
I would like to summarize the policy mix (monetary, fiscal, and currency policies) of the U.S. simply. Theoretically, there are a total of eight possible combinations of the three types of policies, but in practice, it is not possible to simultaneously have a tight monetary policy and weak domestic currency, or an accommodative monetary policy and a strong domestic policy, so when those combinations are excluded, we are left with four practical options. In other words, monetary and currency policies are the two sides of the same coin, so they have to be facing in the same direction. In this connection, a clear discrepancy has arisen in the U.S. policy mix since the inauguration of President Trump. The FRB has been solemnly continuing with its normalization process (i.e., tightening its monetary policy), implementing successive rate hikes in December last year and March this year, but USD did not strengthen following these hikes. This is largely because the U.S. currency policy, which is heavily influenced by Mr. Trump's expectations, is biased toward a weak USD. Mr. Trump has said that "the dollar is getting too strong (...) because people have confidence in me," but in fact it is the opposite. The FX market, having grasped Mr. Trump's expectations, beliefs, and true desires, are likely in fact, to be most strongly of the opinion that "buying USD is frightening." When a country's monetary and currency policies are at odds with each other, it often happens that the forex markets are more strongly conscious of the currency policy, which tends to be more influenced by politics. This is even truer when one considers the situation of FRB Chair Janet Yellen, whose retirement next year is being whispered about. In addition to all this, there was also a remark by Mr. Trump in the aforementioned interview that seemed to be in the vein of a verbal intervention in monetary policy ("I do like a low-interest rate policy, I must be honest with you"), so one can say that it is extremely natural for the supply of USD to strengthen.

Combination of policy mix

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

(Source) By Daisuke Karakama, Mizuho Bank
(Notes) × means unrealizable policy.

The outlook for the U.S. policy mix



Anticipating the developments under the Trump administration going forward, a mix of accommodative monetary policy, currency policy favoring a weak USD, and expansionary fiscal policy seems likely, which is item (1) in the chart. Ordinarily, the intention of such a policy mix would be to overcome recession or ease fears of deflation, but it is also quite harmonious with the basic stance of the Trump administration, which favors a "strong America." If a policy mix of (1) succeeds, prices and interest rates will rise, and it will be at that point that a proper monetary tightening and strengthening of USD can take place. However, it will probably take a significant weakening of USD to attain such success. Also, given that the REER of USD remains stubbornly at a 14-year high (similar levels last seen in August 2003), such a weakening would be natural (see exhibit). I also do admit that the policy mix favored by President Trump will ultimately lead to the strengthening of USD. The problem is that I do not think this is appropriate as a scenario for the coming year.

U.S. monetary policies now and going forward – The state of "we have piped unto you, and ye have not danced" continues

Minutes of the March FOMC meeting – A rate hike that could not be solidly justified when seen in terms of the FRB's dual mandate

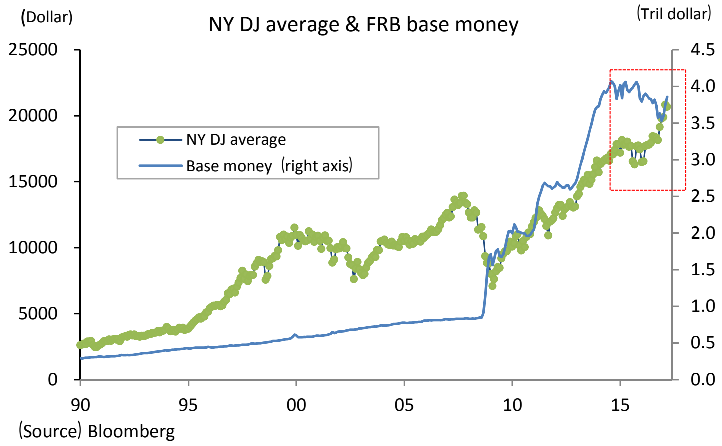
The minutes of the FOMC meeting of March 14 and 15 were published on April 5. The first rate hike in three months was implemented at this meeting, but as the remark "they judged that, even after an increase in the target range, the stance of monetary policy would remain accommodative" shows, the FRB's intention seems to be to implement successive rate hikes. This, of course, is a decision aimed at achieving the FRB's dual mandate (employment maximization and price stabilization), but with regard to employment, "nearly all participants judged that the U.S. economy was operating at or near maximum employment," so there is no doubt that the biggest reason for implementing the rate hike was the tightening of employment market conditions.

With regard to price, "in contrast, participants held different views regarding prospects for the attainment of the Committee's inflation goal." Also, "a number of participants (the most commonly held view) noted that core inflation was a useful indicator of future headline inflation, and the latest reading on 12-month core inflation suggested that it could still be some time before headline inflation reached 2 percent on a sustained basis" – in other words, there is an awareness that it could still be a while before the core inflation rate (specifically Core PCE Deflator) attains 2%. In this sense, it seems to be recognized even within the FRB that the rate hike was implemented despite the fact that only one of the two mandates (of employment maximization and price stabilization) is attainable. Perhaps this is because it was felt that under a state of maximum employment, prices would naturally rise as a result of an increase in wages and other factors. However, one has to mention that this state of maximum employment cannot really be confirmed.

Apart from this, the assessment of prices was not categorical, as the opinions were quite disparate – some expressed a more timid view that tapering of monetary accommodation should be done cautiously in order to allow prices to stably grow at around 2%, while others were more bullish, considering that an average Core PCE Deflator growth rate of +1.75% over the past 12 months indicated that the price target had been essentially achieved, and that prices would further increase toward the second half of the year. The latter faction, further, was of the view that the pace of normalization should be even higher than that indicated in the already quite bullish staff economic projections (SEP). However, as Minneapolis Fed President Neel Kashkari points out in his essay[3], the fact is that the inflation rate outlook of the SEPs over the past five years have been too optimistic overall, and one has to say that the arguments of the bullish faction lack persuasion. Taking the above into consideration, one has to say that the March rate hike did not have solid grounds when seen from the point of view of the FRB's dual mandate.

[3] Please see April 5, 2017 issue of Market Topic titled "Frank arguments against U.S. rate hikes – from Brainard to Kashkari."

Regarding the assessment that prices are too high



(Source) Bloomberg

The main point I would like to draw attention to in the recently released minutes is that there seems to be a greater convergence of views with regard to reducing the size of the balance sheet. It was also revealed that "Some participants viewed equity prices as quite high relative to standard valuation measures." Apart from this, "It was observed that prices of other risk assets, such as emerging market stocks, high-yield corporate bonds, and commercial real estate, had also risen significantly in recent months." It is true that, considering the remarkable pace at which the base money has been decreasing since 2015, one cannot help feeling that the rise in the NY Dow Jones Industrial Average has been rather too strong (see exhibit). As I have said in past issues of this report, it is natural to assume that the only reason share prices have not become volatile despite a tapering of accommodative monetary policies under conditions of lackluster recovery of the real economy is because the markets have factored in a fiscal stimulus. However, as the minutes also point out, there is unlikely to be any "meaningful fiscal stimulus" until 2018. It will be extremely important to watch closely whether the rapid rise in interest rates and USD dampens the momentum of the real economy (and share prices by extension). Having said all this, the FRB is not concerned with stabilizing share prices, so one could say that the increase in cautiousness over the soaring of risky assets itself is a factor justifying rate hikes for the FRB.

The announcement of balance sheet size reduction is likely to take place within the year, with the process beginning next Spring

As indicated boldly in the headlines, the minutes noted that "Provided that the economy continued to perform about as expected, most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the Committee's reinvestment policy would likely be appropriate later this year." Again, "Many participants emphasized that reducing the size of the balance sheet should be conducted in a passive and predictable manner." In line with what has been said all along, reducing the size of the balance sheet seems very likely to take place not by selling assets but simply by stopping reinvestments (of course, the possibility of restarting the reinvestments in the event that the economy should take a turn for the worse was also discussed). It has been suggested that Treasury securities and mortgage-backed securities (MBSs) could both be simultaneously targeted if the committee stops reinvestments. This comes as something of a surprise as it was originally thought that MBSs would be targeted first.

Apart from this, there were discussions on whether the reinvestments should be phased out or stopped all at once, and the costs and benefits of both were discussed. Some pointed out that market volatility would be higher if the reinvestments were phased out, not to mention that communications could also be difficult. On the other hand, if the reinvestments were stopped all at once, communications would be easier and the normalization process would proceed more speedily, indicating that the mood within the FOMC is in favor of ending reinvestments in one go.

It was also revealed, however, that nearly all participants agreed that "the Committee's intentions regarding reinvestment policy should be communicated to the public well in advance of an actual change," so there is no question that the markets will be given notification of the end of reinvestments well in advance. The minutes also cited the results of a survey by the System Open Market Account manager, noting that, "Survey results indicated that market participants saw a change in the FOMC's policy of reinvesting principal payments on its securities holdings as most likely to be announced in late 2017 or the first half of 2018. Most market participants anticipated that, once a change to reinvestment policy was announced, reinvestments would most likely be phased out rather than stopped all at once." To summarize, the announcement of the end to reinvestments are thought likely to take place before the end of the year, with the process actually beginning sometime next Spring. As for the manner in which the reinvestments will be stopped, phasing out is thought to be one of the options.

Dovish Neel Kashkari also in support of reducing balance sheet size

Even Mr. Kashkari, the only member of the FOMC to oppose rate hikes at the current time, proposed in his essay "Why I Dissented" that "The first step (i.e., before a rate hike) to normalizing the balance sheet, in my view, is to publish a detailed plan[4]." Having expressed the view that "I do not believe adjusting the balance sheet should be a regular policy tool," Mr. Kashkari went on to say that "The first step to normalizing the balance sheet, in my view, is to publish a detailed plan of how exactly we will shrink the balance sheet and when that roll-off will begin." He added, "I think it is imperative that we give the markets time to understand the details of the plan before it is implemented," indicating the importance of making the process of normalizing the balance sheet more predictable. On this point, his views do not differ greatly from the policies outlined in the minutes.

The important point he makes comes after that: "And while it is likely the announcement of that plan will not trigger much of a market response, we don't know that for certain. In that case, that announcement could be viewed as a substitute for a federal funds rate increase, whose magnitude is uncertain." Additionally, he states that "Once data support tightening monetary policy, I would prefer (rather than a rate hike) that the FOMC publish its plan for the balance sheet. After it has been published and the market response is understood, we can return to using the federal funds rate as our primary policy tool." This, in effect, is Mr. Kashkari's proposed outline for what the normalization process should look like. In reality, three rate hikes have already been implemented, but when it comes to balance sheet normalization, even the support of Mr. Kashkari, the only FOMC member who seems dovish right now, is likely to be gained, so the hurdles are not too high. For Ms. Yellen, who is keen to finish the normalization process before she retires, kicking off the normalization of the balance sheet could serve as a parting present. Balance sheet normalization as an alternative to rate hikes is likely to be an important point of discussion going forward (details below).

Not necessarily true that "balance sheet shrinkage ≈ USD appreciation"

In fact, it would be more reasonable to give priority to balance sheet shrinking measures rather than to interest rate hikes. As this article has repeatedly argued, another aspect of the FRB being the only central bank in a position to undertake an interest rate hike is that the FRB is also positioned to begin taking measures to shrink its balance sheet (≈ disposing of mortgage-backed securities (MBSs) and U.S. government bonds) rather than risking the possibility of an uncontrollable upsurge in interest rates. In contrast, when the global economy is picking up, individual countries' inflation rates are rising, and many central banks are taking the monetary tightening route, for those banks at that time – at least in scenarios similar to the current one – undertaking balance sheet shrinking measures is liable to be highly risky.

In addition, because balance sheet shrinking has a fundamental economic effect of elevating interest rates, one can also anticipate that launching balance sheet shrinking measures will enable a halt to interest rate hikes. In this regard, in a March 31 speech, Federal Reserve Bank of New York President William C. Dudley stated that – "because changes in [balance sheet] reinvestment policy will likely tighten financial conditions, we will have to take this into account in our interest rate decisions ... when we begin to end reinvestment, we will have to consider the implications for the appropriate short-term interest rate trajectory." – and this brings to mind the noting of movements toward crushing the yield curve. (This argument is similar to that of the abovementioned essay by Federal Reserve Bank of Minneapolis President Neel Kashkari.) Although Dudley subsequently retracted this statement, the U.S. interest rate situation has not greatly changed. If a decision on balance sheet reduction within this year is on the existing policy path, it is probably advisable to at least anticipate a high likelihood that the interest rate hike pace will decelerate.

The key question is – in contrast to the effect of federal funds (FF) rate increases – how much of a rise in home mortgage interest rates will directly result from a decision to discontinue reinvestment in MBSs. Housing investment is highly sensitive to interest rate trends and, moreover, the scope of indirect effects stemming from housing investment trends is known to be quite wide. (This reflects the fact that home purchases are accompanied by the consumption of diverse goods and services.) In the case that there was a conspicuous braking of housing investment, there is a possibility of various balance-sheet control countermeasures, such as a move to moderate the braking effect by investing a portion of the proceeds from MBS disposals in government bonds. In such a situation, although balance sheet reduction may have been commenced, the progress of such reduction could become quite slow, and it is possible that the degree of the FRB's policy hawkishness might progressively decline compared to the degree suggested by the current pace of interest rate hikes. Although balance sheet shrinking would represent a transition away from crisis response measures, it bears keeping in mind that it would not necessarily (compared to the effect of a highly likely short hiatus in interest rate hikes) turn out to be a policy that promotes USD appreciation.

In addition, as already seen, given that the U.S. currency policy is clearly averse to USD appreciation, financial markets (forex and interest rates) will not smoothly respond to FRB progress in policy normalization regardless of how far such normalization proceeds. This should be evident to those who take a look at market movements

[4] Please see footnote 3.

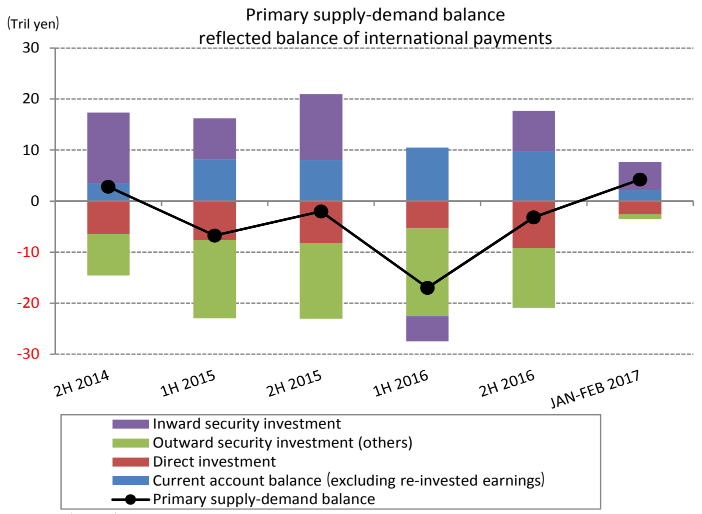
since the start of this year. It is conceivable that this situation reminiscent of "we have piped unto you and ye have not danced" may continue throughout the forecast period.

JPY basic supply-demand situation—Likely narrowing of Japan's outgoing securities investment flow

Central argument regarding the JPY basic supply-demand environment in 2017

I think it worth undertaking a fixed-point overview of the JPY-related basic supply-demand environment. Looking at Japan's February balance of payments statistics, one finds that Japan recorded a current account surplus of JPY2,813.6 billion, a record high level for February figures. This trend reflects a rebound following the Chinese lunar New Year's holiday period, however, which had an impact regarding growth in exports to China and other Asian countries. The current account figure for January was affected by the Chinese lunar New Year's holiday period, which caused an increasingly widespread trend of restrained exports, and it bears remembering that the January figure was consequentially the lowest in two and a half years. As has been explained in past editions of this article, since it is hard to imagine crude oil prices falling as much as they did in 2016, it seems unreasonable to have much confidence in a continuation of the "sharp drop in imports → sharp rise in trade surplus" pattern seen during the past year. It is highly likely that Japan's trade surplus and current account surplus will turn out to have peaked in 2016 followed by a trend of decline.

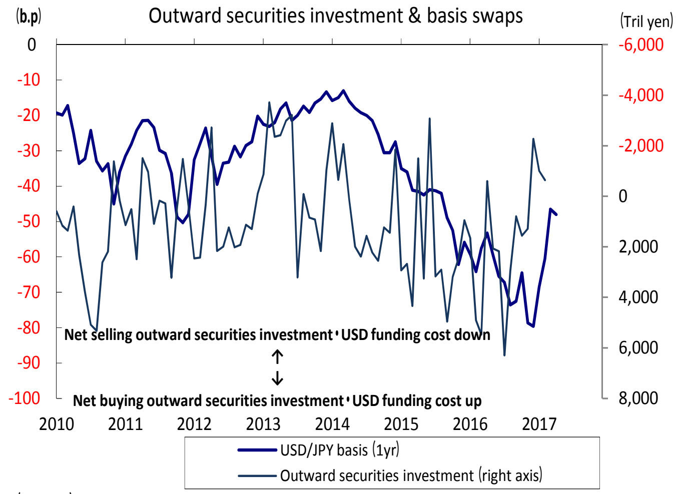
Looking at the basic supply-demand balance (hereinafter "basic supply-demand"; see graph) for JPY that this article positions as a key guiding factor for its JPY forex rate forecasts, basic supply-demand for the first two months of 2017 was characterized by approximately +JPY4.2 trillion of net JPY buying, a major change from the same period of the previous year (approximately –JPY8.6 trillion of net JPY selling). Given that the period immediately before and after President Trump's inauguration was a special period and given that the abovementioned Chinese lunar New Year's holiday period promotes greater fluctuation in current account figures during this time frame, however, one should not jump to the conclusion that net JPY buying is expanding at this point. On the other hand, as this article has repeatedly emphasized, there is a high likelihood that the "continued acceleration of Japan's outgoing securities investment against the backdrop of Japan-U.S. monetary policy gap expansion" trend seen during the past three years will reach an inflection point during fiscal 2017. It is true that the FRB's normalization process is smoothly proceeding, and the fact that discussions of balance sheet reductions seem likely during 2017 seems to indicate that the FRB's mental posture may be more hawkish in nature than the markets initially assumed. However, USD exchange rates have not shown much responsiveness to this situation. Ultimately, it appears that what market participants are focusing on is not the mere presence or absence of interest rate hikes and balance sheet reduction measures, but the 'reason' for such normalization measures. If the putative underlying economic and financial strength is truly believed in, then the market should be proceeding with USD buying. While financial market conditions since last November have been predicated on expectations of fiscal spending expansion measures by the Trump administration, such expectations appear shaky at this point. It appears that the basic supply-demand trend in 2017 will be largely determined by the relative strength of two factors – the "current account surplus shrinkage scaling back JPY buying" situation and the "outgoing securities investment shrinkage scaling back JPY selling" situation – and I am anticipating that the impact of the latter factor will be relatively strong.



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

Basis swaps, outgoing securities investment, and basic supply-demand

With respect to outgoing securities investment, USD/JPY basis swap spreads widened from mid-2014, but there has been a noteworthy trend of rapid spread tightening since the end of last year. (Spread widening boosts the USD procurement premium while spread tightening reduces the premium. See graph.) Diverse factors have been promoting spread widening – such as various kinds of regulatory responses, Japanese financial institutions' foreign currency procurement, and business companies' acquisitions of overseas businesses – but a factor said to have a comparably large effect is the rise in Japanese institutional investors' USD procurement needs that has accompanied the investors' foreign bond investment. As the graph shows, Japan's outgoing securities investment has been accumulating net buying since 2014, and associated hedging needs appear to have been a factor contributing to the basis swap spread widening. However, there has been a transition from net buying toward net selling in response to the surges in U.S. interest rates and USD that arose in connection with the Trump Rally seen since last November. Looking at weekly figures, one finds that a gradual shift to net selling was just beginning at the end of this March. (It remains too early to consider this a fundamental change in the trend, as it is likely that figures at that time reflect position adjustments routinely undertaken at the end and beginning of fiscal years.) There is an undeniable possibility that the net selling in outgoing securities investments since last November has been a factor contributing to basis swap spread tightening. Regarding recent events, it is believed that an announcement in early March that the Financial Services Agency would undertake a special study of regional banks with large foreign bond holdings has been a factor restraining foreign bond investment, and this could also be a factor contributing to basis swap spread tightening.



(Source) Bloomberg & Ministry of Finance, Japan

Regarding the impact on forex markets, there are those who make such comments on the peak basis swap spread widening period last year as – "The appeal of hedged investments in foreign bonds has been lost, but it is still difficult to hold JPY assets given the negative interest rate environment in Japan. So, a process of elimination indicates that non-hedged investments in foreign bonds will increase." Given the current trend of basis swap spread tightening, however, the need to avoid hedged investments in foreign bonds is disappearing. In addition, given that the BOJ fixation on "quantity" is being relaxed as a result of the implementation of a comprehensive assessment followed by the introduction of yield curve control (YCC) last September, Japanese institutional investors aversion to Japanese government bonds may become modest compared to last year. Of course, because the basis swap spread tightening has changed the investment environment in a way that makes it possible for investors with abundant USD holdings to obtain high yields even on negative-interest-rate Japanese government bonds, the basic supply-demand perspective emphasized by this article also suggests that a shrinking of domestic securities investment will diminish pressures promoting JPY appreciation. As shown in the graphs on the previous page, however, it is a fact that, during the past three years, basic supply-demand has been strongly influenced by the scale of outgoing securities investment. My fundamental view in this regard is that, as there appears to be a high likelihood that outgoing securities investment will be restrained during fiscal 2017, fiscal 2017 will be a year in which JPY selling become less conspicuous compared to JPY selling during the previous three years.

Risks to my main scenario – Smoldering speculation about a "second Plaza Accord"

Continued theme of USD appreciation correction

I would like to review the risk factors related to my main forecast scenario, which has remained unchanged since last November. Regarding the USD appreciation seen since the Donald Trump won 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. Moreover, President Trump made statements in April that clearly expressed his desire for USD depreciation and lower interest rates, and the high-profile U.S. Semiannual Report on International Economic and Exchange Rate Policies (IEERP) mentioned that the JPY real effective exchange rate (REER) was low compared to the long-term average level. Faced with this kind of situation, it would require quite a bit of courage to forecast JPY depreciation and USD appreciation.

As I have repeatedly argued, the mere event of a transition to a new Presidential administration is not capable of bringing about a sudden seismic shift in the real economy. Since the start of April, the break-even inflation (BEI) rate (the future inflation rate expected by the markets) has been declining along with nominal interest rates, and U.S. 10-year interest rates at one point fell below the 2.2% landmark level. Expectations from Trumponomics are not as strong as they previously were. Of course, aside from the Trumponomics issue, people are generally inclined to have positive expectations regarding the real U.S. economy's strength, and one continues to hear voices predicting JPY weakening in response to the FRB's normalization process. However, given that the U.S. government (currency policies) does not desire USD appreciation and the president himself is saying that he wants low interest rates, it is questionable whether the FRB (monetary policies) will actually move ahead with its normalization process. It of course is questionable. I believe that the key theme going forward this year will continue to center on the need for USD forex rate adjustment following three years of USD appreciation.

JPY depreciation risks – Considerable fiscal spending expansion needed to sustain JPY depreciation

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. 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. Fundamentally, there are no major changes from last month's risk overview. I will begin by overviewing JPY depreciation risk factors. It seems clear that the biggest JPY depreciation risk factors are (2) the Trump administration's fiscal policies and (3) continuation of the FRB's normalization process. It goes without saying that these two factors are inter-related, and if factor (2) turns out to have a greater effect than the markets are expecting, it would probably have the result of spurring factor (3). Given President Trump's clear aversion to USD appreciation and interest rate increases, however, it may well be more accurate to say that factor (3) will not eventuate unless factor (2) generates a positive effect that is quite strong. It is evident from developments beginning from early this year that Trump is struggling to manage the legislature, and one of his aids, who had expressed views considered extreme, has been dismissed from the President's cabinet. From a certain perspective, it appears that Trump may be gradually moving toward convergence with the mainstream elements of the Republican Party. If this is true, then it might turn out to be difficult for Trump to convince the Republican legislators, who have traditionally been opposed to fiscal expansion, to approve large-scale fiscal spending programs.

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
Others	⑧	Geopolitical risk	Korean Peninsula emergency	Strong JPY Weak USD?

In light of this, in the case that a fiscal stimulus program huge enough to exceed market expectations were to be worked out, it seems likely that U.S. interest rates would surge (following the previous trend of diminishing expectations) and that inflation expectations would once again rise. Naturally, amid such developments, a strengthening of the uptrend in USD exchange rates could be expected to ensue. 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. At least regarding the roughly USD1 trillion fiscal stimulus program mentioned in the presidential address to Congress in February, however, Trump's initiatives so far do not seem sufficient to spur these kind of market movements.

What is the outlook regarding factor (3)? As I have repeatedly argued, it appears that the FRB is more inclined to emphasize "political correctness" than "economic correctness." Inflation shows no indications of overheating, and credit-related statistics do not indicate the presence of tightness in the supply-demand relationship for funding. Ordinarily, one would not be surprised to see a hiatus in interest rate hikes, but the FOMC is continuing to forecast an additional two interest rate hikes this year. There certainly appears to be a possibility that current FOMC members nominated by Democrat party administrations – anticipating their replacement by Republican Party administration nominees – may be concluding that they must immediately take measures while they are still in a position to take measures. In this way, they may well be pursuing policies for political purposes. Amid this situation, if the economically beneficial effects of factor (2) or another unexpected follow-wind factor emerge, it seems likely that the FRB will not hesitate to implement further interest rate hikes. That would naturally be liable to lead to USD appreciation,

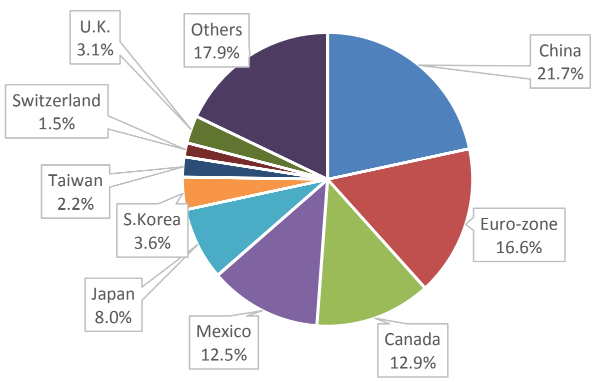
Given this situation, in the case that U.S. fiscal and monetary policies were to coincide perfectly (if risk factors (2) and (3) both were to eventuate) and 3-4 interest rate hikes a year were to be implemented (plus balance sheet reduction initiatives), then it would not be surprising to see a large divergence from the assumed forecast range of my forecast scenario, with USD/JPY going as high as 120. As one can see from looking at the U.S. interest rate market, where a bear flattening trend is firmly established, the market is less interested in the mere 'number' of hikes and relatively more interested in understanding the 'reason' in the background of the hikes. In this situation, I believe that a stimulus from fiscal spending expansion would have to be quite strong in order to provoke the "U.S. interest rate increase → USD appreciation" linkage.

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 the BOJ's YCC policy, and if the U.S. normalization process were to be accompanied by 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. However, as pointed out by this article in the past, the situation is such that it would be difficult to expect Japanese institutional investors to proactively increase their overseas risk taking activities during this fiscal year. The fact that Japanese financial supervisory authorities are strengthening their stance of viewing foreign securities investments as risky is also likely to have an effect.

JPY appreciation risks – Persistent concern regarding "a second Plaza Accord"

It is worth noting that the actual level of JPY appreciation risk is probably greater than that assumed by this report. Since last year, this article has been expressing concern about the possibility of "a second Plaza Accord" (Risk factor (1)), and some developments at the April G20 Finance Ministers and Central Bank Governors meeting in Washington D.C. appear to justify that concern. According to reports, following the G20 meeting, almost 100 Republican party affiliates and economists gathered at a meeting with the theme of promoting a new international currency deal modeled on the Plaza Accord (April 23, Nihon Keizai Shimbun*). The meeting included video speeches by Former Federal Reserve Chairman Paul Volcker and former Treasury Secretary James Baker, who played key roles in creating the accord, and was attended by Robert Mundell, a winner of the Nobel Prize in economics. Particularly noteworthy were statements by Judy Shelton – one of Trump advisors on economic issues during his presidential campaign – who said that the administration is considering the idea of a new currency agreement among major countries to ensure more stable exchange rates. The adjustment hurdles on the path toward actually concluding an agreement akin to the Plaza Accord are believed to be high, since correcting USD appreciation on an effective basis would involve not only EUR and JPY, but also RMB, CAD, and MXN (see graph). In light of the kind of reports just mentioned, however, a second Plaza Accord is a conceivable "Black Swan" development, and it would be reckless to totally dismiss it as unfeasible. In addition, the latest edition of the U.S. Semiannual Report on International Economic and Exchange Rate Policies (IEERP), released in April, contains the sentence – "Expanding trade in a way that is freer and fairer for all Americans requires that other economies avoid unfair currency practices and persistent exchange rate misalignments." The possibility that the United States would engineer a large-scale scheme to correct "persistent exchange rate misalignments" cannot be totally disregarded.

USD real effective exchange rates composition



(Source) FRB

Furthermore, 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. This should be understood to be the context in which the decrease in U.S. interest rates and the associated trend of USD depreciation seen since March have emerged. While it would be easy to interpret the trends of U.S. interest rate decline and USD depreciation from April as being associated with geopolitical risks, the fundamental fact is that confidence in Trumponomics and FRB normalization is diminishing, and the trends of U.S. interest rate decline and USD depreciation probably should be considered as reflecting the secondary and tertiary effects of that diminishing confidence.

In addition, President Trump's statement during April that USD is "getting too strong" has been has much discussed. There is cause for concern that such frankness with regard to currency and trade policies (so-called 'verbal guidance' or 'verbal intervention' aimed at FX market) is liable to be continued going forward in various interviews, tweets, and official speeches. Of course, there are probably those who will say that the consistent repetition of a given message may preclude surprises. However, Trump has recently shown a pattern of seeking to compensate for domestic political weaknesses by proactively engaging in currency and trade policies (as well as security policies) that are amenable to his authority, and it appears unlikely that this pattern will change going forward. It should be kept in mind that it is quite conceivable that the intensification of Trump's statements over time will ultimately lead to something similar to the second Plaza Accord cited as risk factor (1). In such a case, one must be prepared for the possibility that USD/JPY could easily descend to below the 100 level.

In any case, 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 there is a need to be prepared for the possibility that his position regarding Japan will be progressively intensified. Since the start of April, North Korea-related issues have brought a sudden rapprochement between the United States and China, and financial markets have been giving great attention to Trump's statements during an April 12 interview with the Wall Street Journal, in which he diametrically reversed his previous views by saying that China has not been manipulating its currency for months and that China has been seeking to prevent the weakening of RMB. In the case that Trump's general perception of USD appreciation as a serious problem has not changed (despite his absolution of China), then there is a possibility that the brunt of prospective forex-related measures may come to be focused on Japan and Germany.

Other JPY appreciation risks – North Korea-related tensions also promote JPY buying?

Among other JPY appreciation risks, it is important to note the risks related to European political situations and geopolitical risk (risk factors (7) and (8)). The first round of France's high-profile presidential election eliminated candidates other than Emmanuel Macron, a moderate running as an independent who previously served as Minister of Economy, Industry and Digital Affairs, and Marine Le Pen, president of the National Front (FN) party, and those two will advance to the second round of voting on May 7. At this point, the odds appear to greatly favor Macron, and a Macron win would dispel fears that France might move toward exiting the EU. However, the French presidential election is only one of numerous Europe-related risks. As was discussed in yesterday's edition of Mizuho Market Topic, the two euro area countries that appear to have recently avoided political turmoil – the Netherlands and France – are countries with high levels of support for EUR (see chart). Italy is scheduled to dissolve its legislature and hold general elections by May 2018, and it is noteworthy that, of the euro area's four largest countries, Italy is the one with the greatest amount of anti-EUR sentiment. The possibility that an anti-EU party – the Five Star Movement (Movimento 5 Stelle, M5S) – will come to power in Italy appears almost certain to be the greatest Europe-related risk factor in the period through next year. Of course, a risk-off mood inspired by European political situations would be likely to become an important factor contributing to JPY appreciation.

For or against the EUR ? (%)

	For	Against	Unknown
Germany	81	15	4
France	68	28	4
Italy	53	37	10
Spain	71	25	4
Netherland	77	22	1
Belgium	76	23	1
Portugal	74	23	3
Greece	68	30	2
Hungary	52	43	5

(Source) European Commision "Eurobarometer" (Autumn 2016 survey)

In addition, the incidence of JPY buying surges has been increasing since April, apparently based on the concept that geopolitical risks have been increasing since the U.S. attack on a Syrian airbase. There is a complication insofar as there is no consensus on whether increasing North Korea-related tensions, which hold the potential for spurring an attack on Japan's main islands, should be considered a factor promoting JPY buying, but the predominant view in financial markets at this time is that it promotes JPY buying. A portion of the rational for the "risk aversion promotes JPY buying" theory is based on the fact that Japan has the world's highest level of net external assets, and it is true that the net external assets situation would not be changed by a North Korean attack on Japan's main islands. In the case of an escalation to repeated attacks and ground fighting, however, it would appear prudent to keep in mind the possibility of a triple-depreciation involving concurrent declines in stock prices, JPY, and bond prices.

While the above is a brief overview of the various risks related to both JPY depreciation and JPY appreciation, <u>there is particular cause for concern regarding the possibility of a second Plaza Accord in light of the recent tendency of reports on this issue to characterize the possibility as realistic</u>. If the Trump administration continues to stumble in domestic affairs, it is probably wise to keep in mind that the extreme-case scenario is not impossible. Even leaving aside issues related to President Trump, there has been almost no change since last year with respect to the need for correcting excessive USD appreciation. Against the backdrop of the undercutting of proclivities to consume and invest by rapid interest rate increases and the strength of USD, it should be difficult to justify strong confidence in the future course of the FRB's normalization process. I continue to see no need to adjust my forecast of JPY appreciation and USD depreciation.

EUR Outlook – Natural outlook for EUR appreciation

ECB Monetary Policies Now and Going Forward – Strong possibility that the 'next move' will be one of tightening?

Confirmation of current policy path

At the April 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.

Naturally, there were several questions posed at the subsequent press conference regarding previous reports about the possibility of changing the wording of the ECB's standard forward guidance (FG) statement[5]. In response, President Draghi clearly said that there was no discussion about changing the FG wording and there was no need to discuss 'the sequencing of the exit,' such as a hike to the deposit facility rate following the end of the APP. In brief, he denied the possibility of a rate hike prior to the end of APP, which some observers had been predicting. Overall, he confirmed the current policy path.

Besides the FG-related questions, there were numerous questions about political risks, and Draghi's responses were generally along the lines of – "we discuss policies rather than politics" – and did not explain how the ECB deals with political risks. Such Draghi responses regarding the retention of the FG wording and exit sequencing were as anticipated in a recent issue of this article[6], and there were no related surprises. As a portion of related reports had inspired rising expectations that the ECB might move toward tightening, the disappointment of those expectations has prompted EUR selling.

Strong possibility that the 'next move' will be one of tightening?

Regarding the highest profile issues – FG wording and exit sequencing – reporters posed such questions as – "is there any likelihood of a change?" – and – "Is there a grey area where the interest rate could be raised before the end of the net asset purchases but after the QE has started to be wound down?" In response, President Draghi quoted a portion of a speech he presented at the ECB and Its Watchers Conference on April 6. Specifically, he said that – "our forward guidance is de facto on the entire package, not on any specific component of it." And he went on to say – " ... this guidance relates not just to the conditions under which we would withdraw stimulus ... but also to the sequence of measures we would use to do so." Essentially, <u>because the ECB does not intend to modify the FG wording at this time, it follows that there has been no change to the exit strategy, and this appears to be the position of President Draghi as well as the consensus of the Governing Council members</u>. In addition, a reporter posed the question – "... there were no discussions about raising the deposit rate at the meeting over the last two days?" – and Draghi offered the succinct response – "No." It clearly appears that a deposit rate hike is not likely for the time being.

Furthermore, at the press conference Draghi emphasized the logic of differently considering growth and inflation, saying – "The discussion focused really on the balance of risk concerning growth, not inflation." And he went on to explain the reason why there is no need at this time to change the FG wording, saying – "Your question [about the FG wording] is related to what we call easing biases [which] are actually linked to inflation [and] are meant to cope with tail risks concerning the inflation rate, not growth directly. It's quite clear that as growth perspectives improve, certainly the probability of these tail risks may go down, but we are not there yet." Draghi himself is admitting that if growth rates rise, the inflation rate tail risks will naturally decrease. Following the Governing Council Meeting, financial markets appeared to interpret the results as somewhat dovish, but, <u>so long as there is no large drop from current growth rates, it is probably natural to conclude that the 'next move' will be in the direction of tightening</u>.

By the way, a reporter asked the question – "If you were to write a headline for today's Governing Council meeting – I have my own headline – but what would be yours, from yesterday's and today's discussion, from that meeting?" Draghi responded by saying – "The headline really is this: "The risks surrounding the euro area growth outlook, while moving towards a more balanced configuration, are still tilted to the downside and relate predominantly to global factors." That's the headline. Shorter? You work it out." <u>It appears from such exchanges</u>

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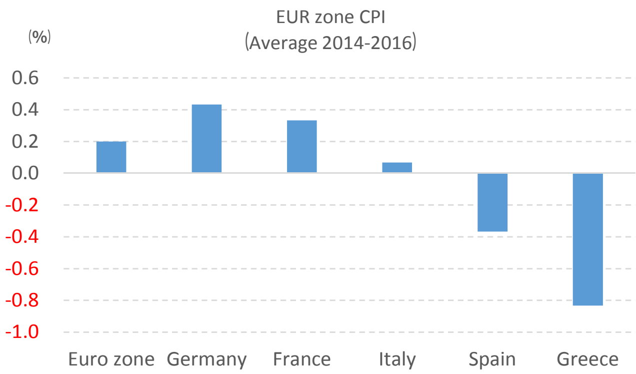
[5] The current FG wording is – "We continue to expect them to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases."

[6] Please see the April 21, 2017 Market Topic titled "Preview of ECB monetary policy meeting – Dispute regarding the handling of forward guidance" and the April 27, 2017 Market Topic titled "Preview of ECB monetary policy meeting (Part 2) – Dispute regarding the handling of forward guidance."

that, given the lessons learned since the March meeting, the Governing Council is taking pains to prevent the spread of speculation that it is hawkish, but that economic and financial situations are viewed as unmistakably moving in the direction of improvement.

Consciousness of the problem of growing intraregional disparities

This article has repeatedly argued that there is a possibility that the ECB's policy management will be greatly challenged by the situation of Germany's singular strength (see below), and there was a question posed about this issue at the press conference. Specifically, a reporter asked – "when deciding on the degree of monetary policy accommodation in the coming months, do you only look at [the euro area's] averages of growth, or also at individual countries?" – and Draghi responded – "Well, you answered it yourself: we look at [the euro area's] averages. Our mandate is not expressed in any individual country's inflation ... " This is a predictable model answer and, realistically, it is probably impossible for the central bank overseeing a unified currency area to give another kind of answer. When the contrasts between Germany and other euro area countries become even more prominent, however, it is questionable whether the ECB will be able to just continue chanting such model answers – it seems that the situation has not yet become critical enough to dictate a more-realistic response. At least regarding the past three months, there are considerable disparities apparent among the consumer price indices of the euro area's largest four countries, and the increase in disparities is even more pronounced when one considers the peripheral countries (see graph). Such disparities extend to GDP, unemployment, wages, and other kinds of statistics, and there is an undeniable possibility that the need to answer the question – "how can the disparities be addressed with a single monetary policy?" – will become increasingly urgent going forward. I believe it important to note the signs at the post-Governing Council press conferences that awareness of this problem has begun to grow.



(Source) Eurostat

Exit strategy sequence unchanged – End to negative interest rates in 2019 or later?

Since the FG statement has been maintained and there has been no change to the associated exit sequence, it can be assumed that the 'next move' will be a discontinuation of the APP. It is thought that there will be discussion of the program's current ending point (the end of December 2017) at the September Governing Council Meeting, and it is assumed to be likely that, rather than endorsing the program's sudden conclusion, the Governing Council will decide to decrease the monthly purchase amount (≈tapering) with a view to the program's eventual discontinuation. For example, if the current EUR60 billion monthly purchase amount were to be reduced by EUR10 billion each month from January 2018, the figure would be lowered to zero in six months. If APP discontinuation decisions were to be made at times when the ECB staff macroeconomic projection is revised (March, June, September, and December), then it would facilitate announcements of the next stage (≈interest rate hikes). If this potential scenario were to play out, then the earliest date of an interest rate hike might be September 2018. Based on these ideas, one gets the general image that the deposit facility interest rate will not return to positive figures until 2019 or subsequently.

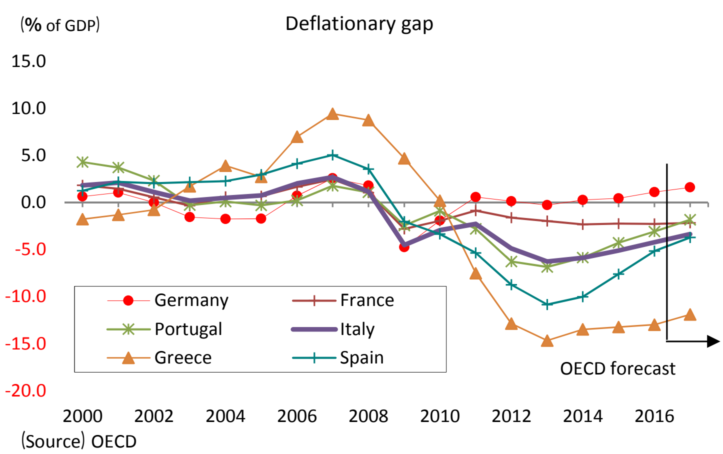
Response from forex markets – Prospective rise in EUR

From the perspective of forex markets, the FRB's interest rate hikes and balance sheet reduction and the ECB's moves toward tapering indicate that both USD and EUR are currencies headed toward monetary tightening. As can be seen from an examination of market trends since the start of 2017, however, there has not been an uptrend in USD buying despite the increasing degree of the FRB's hawkishness. U.S. interest rates' yield curve is generally tending to become flatter, and one gets the strong impression that the markets do not have confidence in the implementation of a full-scale normalization process. Given the situation reminiscent of "we have piped unto you and ye have not danced" in that USD buying has not upsurged despite the FRB's expressions of confidence in its normalization process, there is a possibility that the hints that the ECB may be prepared to begin normalization when the time is ripe will be considered relatively significant as a market-moving factor and, in fact, one gets the strong impression that recent movements in EUR/USD have been led by the ECB. Given that the euro area has the world's largest current account surpluses, it seems appropriate to anticipate that EUR/USD will begin rising before the end of this year.

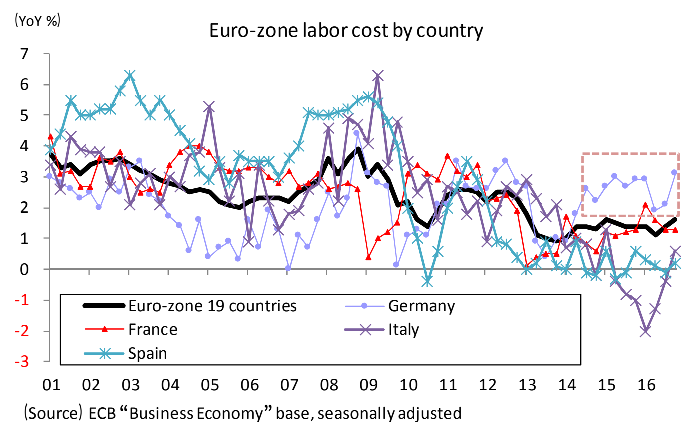
It appears to be important when forecasting forex rates, including JPY forex rates, to duly note that the "FRB normalization ≈ USD buying" pattern seen during the past three years is no longer employable as a dependable forecasting tool. While this partially reflects the downward pressure on USD stemming from the Trump administration's currency and trade policies, it is also a reaction to the persistently unidirectional trend of USD appreciation, which has gone too far. In light of the prospect of ECB normalization process beginning at a time when pushing USD upward has become difficult, it would seem apparent what the prospective trend in EUR is likely to be going forward.

The Euro area economy now and going forward – 'Underlying strength disparities' and the ECB's prospective trials

Robustness of regional disparities regarding GDP gaps



As has been argued in previous editions of this article, the problem of Germany's singular strength is gradually rising to a level at which it is too important to ignore, and it is apparent that an extreme exacerbation of the situation could make ECB monetary policy management very difficult. The graph on the right shows trends in OECD estimates of the deflationary gap[7] for Germany, France, and four Southern European countries (Portugal, Italy, Greece, and Spain.) Since 2014, Germany's deflationary gap has been eliminated and the positive margin of its deflation gap figure has been trending upward. A trend of reduction in the four Southern European countries' deflationary gap has been progressing, but it must be recognized that the disparity between their gap and Germany's remains large. Moreover, France's deflationary gap has showed a moderate expansion and has subsequently remained flat so, focusing on the trend-line alone, one might say that France's situation is actually worse than that of the four Southern European countries. The deflationary gap disparity among Euro area countries has begun significantly expanding since 2011, and this is a new phenomenon that was not seen during the first 10 years after EUR's launch.



The kind of "underlying strength disparities" situation seen in the deflationary gap figures can theoretically be expected to lead to economic temperature disparities regarding upward pressure on wages and prices over the medium-to-long term, and when those pressure disparities are evinced, it seems likely that the ECB will be confronted with a difficult scenario. If the expansion of Germany's positive GDP gap relative to other Euro area countries were to strengthen the trend of rising wages and prices in Germany, it is questionable whether the ECB would be capable of deciding to tighten its monetary policies. Looking at Euro area labor costs (see graph), one finds that Germany's trends are head and shoulders above those of other countries. (This is referring to the portion of the graph within dotted lines. Note: Portugal and Greece are excluded from the figures for the 19 Euro area countries because the sharp drops seen in their figures at one point would obfuscate the general trend line. This exclusion is essentially irrelevant to the argument regarding Germany's singular strength.) The effect of such labor cost trends is incorporated within what the ECB has traditionally referred to in its policy change-related discussions as a "second round effects," and this is an extremely important factor to consider when seeking to predict the ECB's "next move." While there may be a tendency to play down the effect of the current peaking out of HICP figures, I believe that the true direness of the situation confronting the ECB will become apparent only gradually over the medium term.

[7] When actual demand for products and service is lower than a country's potential supply capabilities for meeting such demand, the situation is referred to as a deflationary gap. (The demand-supply gap is also referred to as a recessionary gap.)

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