Forex Medium-Term Outlook

31 May 2017

Mizuho Bank, Ltd.
Forex Department
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Overview of Outlook

My basic conviction on USD/JPY still remains unchanged. I have consistently expressed skepticism over the sustainability of the USD appreciation that began following the election of U.S. President Donald Trump, as there are no solid grounds for the increase in U.S. interest rates – the main argument for the recent trend. The insecurities over the Trump administration’s ability to govern, which surfaced early in the year, have further strengthened amid suspicions of a “Russiagate” scandal. An impeachment may be a rather unlikely scenario, but for some time to come, Mr. Trump is likely to have his hands too full for economic policymaking; and without a fiscal expansion, the increase in interest rates and appreciation of USD seen since November last year cannot be explained. If so, it seems reasonable, for some time to come, to forecast a return to the level seen before the presidential election. As domestic political administration is thrown into extreme confusion, foreign policies may well become easier to understand; currency and trade policies could easily become more radical, which makes it difficult to predict USD strengthening. The FRB’s normalization process should also not be taken for granted. Behind its haste to go ahead with normalization despite no sign of accelerated growth in inflation, there seems to be a desire to create more elbow room for potential future scenarios requiring the relaxation of monetary policy, but how much USD purchase could possibly accompany such a motive? Since the beginning of May, some senior FRB officials have begun to make cautionary remarks regarding rate hikes, and my prediction is that this stance will become mainstream during the current forecasting period. Japan’s basic JPY supply-demand balance is also tilted in favor of JPY purchase, so the adjustment of an overheated USD is likely to remain the topic for some time to come.

Meanwhile, EUR has been strengthening. With the receding of political risks and the ECB becoming more hawkish in its stance, the mood surrounding EUR changed considerably in May. The fact that the speculative position in IMM currency futures transactions has turned to “buy” for the first time in three years is a sign of this. The criticism of EUR weakness by German Chancellor Angela Merkel and other senior German officials also encouraged EUR purchase. The remarks can also be seen as an indirect criticism of the ECB’s accommodative monetary policies, and in this sense, they have promoted the view that the ECB is becoming more hawkish. Note that, though U.S.-German relations are not great, President Trump and Chancellor Merkel’s interests seem to be coinciding when it comes to forex rate direction. Right from the beginning, I have been saying that the turnaround in EUR rates is inevitable, given that it is the currency of the region that holds the world’s largest Current Account surplus, and I think the probability of such a scenario coming true has increased recently. Having said that, there still remain many political risks in Europe, notably the snap general election to be held in Italy within the current forecasting period, which is likely to weigh down EUR during the second half of the period. It may still be a while before EUR/USD attains the milestone 1.20 level.

Summary Table of Forecasts

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<th>2017 Jun</th>
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<td><strong>USD/JPY</strong></td>
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(Notes) 1. Actual results released around 10am TKY time on 31 May 2017. 2. Source by Bloomberg. 3. Forecast rates are quarter-end levels

Exchange Rate Trends & Forecasts
USD/JPY outlook – A choice of “volume,” “price,” or “persuasion”

The current state of U.S. currency and trade policies – Concerns of an irrational JPY appreciation continue to smolder

U.S. currency and trade policies are rather disquieting

The Group of Seven (G7) meeting of finance ministers and central bank governors held in Bari, Italy on May 12 and 13 closed with the adoption of a joint communiqué that underscored “the importance of all countries refraining from competitive (currency) devaluation” among other things. In addition to stating that “We reaffirm our existing G7 exchange rate commitments to market determined exchange rates and to consult closely in regard to actions in foreign exchange markets,” the communiqué also said, “We reaffirm that our fiscal and monetary policies have been and will remain oriented towards meeting our respective domestic objectives using domestic instruments and we will not target exchange rates for competitive purposes.” Overall, there were no major changes compared with previous communiqués, and the forex markets showed no reaction.

On the other hand, things do not appear to have improved on the trade front, which has been in focus since around the time of the President Trump’s inauguration. As with the recent G20 joint communiqué, the G7 communiqué also refrained from incorporating any expression of support for free trade or opposition to protectionism, and U.S. Secretary of the Treasury Steven Mnuchin said in a press conference following the meeting that “We don’t want to be protectionist, but we reserve our rights to be protectionists to the extent that we believe that trade is not free and fair.” “Our approach is for more balanced trade,” (Reuters, May 13), with emphasis on “we reserve our rights to be protectionists.” It is not clear exactly what “balanced trade” means, but one recalls that the statement released by the U.S. Department of Commerce (details later) along with the U.S. March trade statistics clearly called for all countries with large trade surpluses with the U.S. to work toward cutting it, and it is extremely likely that Mexico and Japan may be, especially, on the radar. Going by such words and actions, one has to say that U.S. currency and trade policies are rather disquieting, and my basic understanding continues to suggest the need to be strongly aware of the risk of JPY appreciation.

Three choices – “volume,” “price,” or “persuasion”

I would like to provide a recap of the basic points related to the Trump administration’s currency and trade policies going forward. The basic thinking of the Trump administration is that a trade deficit is a bad thing, and given that Japan is one of the main accused in connection with the U.S. trade deficit, the Japanese trade balance is faced with three choices – (1) adjust through volume, (2) adjust through price, (3) persuade the U.S. that there is no need for adjustment (that Japan’s trade surplus with the U.S. is fine as it is); of course it is also possible to make adjustments through both volume and price. In some quarters there is the optimistic view that Mr. Trump, who does not have a firm philosophy related to economic policies, may deal with Japan flexibly if he judges that the trade surplus with Japan makes sense.

Three choices faced by Japan’s trade balance

(1) Volume adjustments → Adjustments to both exports and imports
   • Self-imposed export restrictions by Japan or import restrictions imposed by the U.S., etc.

(2) Price adjustments → Adjustments to export prices, i.e., foreign exchange rates.
   • If volume remains unchanged, adjustments through price, i.e., forex rates will be demanded.

(3) Persuasion → A trade deficit is not necessarily a negative attribute.
   • Can Japan put forward a convincing argument through the U.S.-Japan economic dialogues? The Japanese side should also use its efforts so far to persuade the U.S.

Source: Daisuke Karakama, Mizuho Bank

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To be sure, the possibility of persuasion through channels such as the U.S.-Japan economic dialog cannot be ruled out. However, one has to remember that Mr. Trump, unless he sees something as making sense, is not above insisting on having his way even when it is unreasonable. A look at his recent words and actions in connection with China are revealing. Right from around the time of his inauguration, Mr. Trump had completely misunderstood the facts related to China’s currency policies, and repeatedly criticized the country’s attempts to devalue its currency, but suddenly changed his attitude when China indicated a willingness to cooperate with the U.S. on the North Korea issue, saying that China had not been a currency manipulator for some time and had rather been trying to prevent its currency from further weakening. It has been clear for the past two years that China has not been attempting to devalue its currency, but Mr. Trump refused to acknowledge this until he had a decisive reason to do so, namely the North Korean problem. With the U.S. and China getting closer, and Japan placed in a tight situation with regard to security, Japan may have to bear the brunt of U.S. frustration at both China and Japan when it comes to currency and trade policies. If the U.S. had no such intentions, why would it include the names of particular countries in the title of its statement released accompanying the trade statistics report. I do not intend to completely rule out the possibility of choice (3), but I believe the hurdles against it are extremely high.

If “volume” adjustments are rejected, “price” adjustments await (= JPY appreciation)

If persuasion proves difficult, the U.S. will definitely insist on either (1) volume or (2) price-based adjustments toward the reduction of the U.S. trade deficit. Under (1), Japan could be forced to liberalize its own markets or voluntarily impose restraint on its exports (or face import restrictions on Japanese products by the U.S.). Over a few rounds of the U.S.-Japan economic dialog, it is easy to see how the U.S. could put pressure on Japan to cut back on (1) volume by using positive-sounding phrases such as “market liberalization.” Going by the aforementioned comment by Mr. Mnuchin, and Secretary of Commerce Wilbur Ross’ comments included in the official statement released the other day, one cannot help feeling concerned that this will, indeed, happen. It is extremely important how these negotiations with the U.S. are handled. In other words, if Japan resists adjustments based on (1) volume, the U.S. strategy will be to shift to (2) price. Adjusting prices in connection with a country’s trade balance boils down to an adjustment of the currency exchange rate. For balanced trade to be achieved without making any big changes to the present export/import climate, the forex rate would have to move in the direction of a stronger JPY and weaker USD. It is widely known that, during the U.S.-Japan trade friction of the 1990s, adjustments took the form of (2) price adjustments after the (1) volume-based adjustment route ran aground. Specifically, with the U.S.-Japan trade friction becoming extremely harsh, former President Bill Clinton, while continuing to call for a volume-based adjustments including through the opening up of the Japanese market, also gave glimpses of the other option of a price-based adjustment through the appreciation of JPY. Famously, the result of the failure of volume-based adjustment negotiations was an extreme appreciation of JPY to a level surpassing 80 (79.75 to USD on April 19 1995). In terms of their real effective exchange rates (REER) over the past five years, USD and JPY as a currency pair have been one-sidedly moving in opposite directions, so even logically speaking, it would be natural to call for an adjustment of the rates. Of course, in terms of the weight of various currencies that contribute to the effective rate of USD, JPY is quite inconsequential (8.0%); the Trump administration ought to tackle currencies such as CNY (21.7%), EUR (16.6%), and MXN (12.5%) first if it really wants to weaken USD overall. However, given that the Trump administration may want to expeditiously move on currency and trade policies in an effort to make up for points lost in domestic politics, it may begin by targeting countries that seem more likely to give in, politically speaking.

Unreasonable Department of Commerce Statement

On May 4, the U.S. Department of Commerce released the March trade statistics and, unusually, a statement along with it. Such a move should also be understood within the context of increasingly obsessive U.S. trade policies. The statement also included a detailed commentary by Mr. Wilbur Ross, and I think the content was quite provocative from the perspective of forex market participants. Specifically, the Department of Commerce released a statement titled “Trade deficit with Mexico and Japan Continues to Grow at Unsustainable Rate” along with its
release of the U.S. trade statistics on May 4, clearly naming Mexico and Japan. The statement began by saying, “The trade deficit with Mexico and Japan was found to be growing at an alarming rate following the release of March 2017 U.S. International Trade in Goods and Services monthly data by the Department of Commerce,” and also contained the words “The United States can no longer sustain this inflated trade deficit with our closest trading partners” in Mr. Ross’ closing remarks.

However, one cannot help feeling that the sentiments expressed are too strong for a statement accompanying a mere monthly release of the trade statistics. Even for trade statistics, which tend to fluctuate significantly from month to month, data for the period from January to March, which includes the Chinese new year, tends to be affected by noise, so using movements (rates of change) observed during that period as an arguing point is not fair. Mr. Ross also commented that “The Trump administration is committed to rebalancing our trade relationships in order to protect American workers and businesses from lopsided trade relationships,” but a single month’s trade data is far too trivial when seen in light of the exaggerated theme of “protecting American workers.” Ultimately, I believe that such out of place comments are the result of U.S. authorities starting to prioritize achievable tasks in terms of foreign policy (including both security and economics). Such inscrutable behavior is very likely to continue going forward too.

**Strangely nice to China**

The fact that such a statement is not necessarily fair or objective is easy to see from the fact that it is strangely nice to China. Specifically, the statement offered a positive assessment of China, saying that “While China continued to be the United States largest source of trade deficit, the United States year-to-date trade deficit with China improved by 2.5 percent.” In terms of the goods and services trade, which are the statement’s target categories, this certainly is true, but if we look at the January-March period indicators for goods trade alone, U.S. imports from China have actually increased more than U.S. imports from Japan have (on the other hand, the growth of imports from Mexico are, in fact, quite large. See exhibit). Based on Mr. Trump’s words and actions so far, was it not the enormous goods trade surplus with the U.S. that was supposed to be important factor taking away American jobs? Given Mr. Trump’s efforts to induce companies to set up production bases in the U.S., it is natural to assume that the focus is on goods trade.

Looking at U.S. exports and imports from various countries, China tends to account for an overwhelming net import, much more than Japan or Germany (see exhibit). Meanwhile, Mexico is an extremely important country for U.S. exports, in other words, it is clear that Mexico is an enormous market for U.S. goods. Based on this, it is easy to see why criticizing a country based solely on the scale of its trade surplus with the U.S. is not right. At the very least, it seems that there may be some scope for protest from Mexico and Japan against a single month’s expansion of trade surplus being used as the excuse to label the relationship unsustainable. At the very least, the situation does not allow for China being overlooked.

It is being widely pointed out that Mr. Trump’s considerateness to China is in connection with the North Korean problem. The U.S. and China have suddenly come closer with the view to resolving the North Korea problem. In this context, Mr. Trump wrote on Twitter that “I explained to the President of China that a trade deal with the U.S. will be far better for them if they solve the North Korean problem!” Again, China is not even mentioned in the title line of the recent Department of Commerce statement mentioned above. Such signs were also visible in Mr. Trump’s April 12 interview with the Wall Street Journal, which jolted the forex markets. In that interview, Mr. Trump said regarding China that it had not been a currency manipulator for some time, and that it had rather been trying to prevent a further weakening of its currency, completely reversing his position from what he had been saying before then. The recent statement seems to have a political angle to it, reflecting this change of heart on the part of Mr. Trump.
The only option left is Japan (JPY)
In past issues of this report and in contributions to other journals¹, I have repeatedly emphasized that JPY, being a top-performing currency, is doomed to a fate of appreciation, and looking at the actions of the U.S. Department of Commerce described above, I cannot help feeling that my prediction is about to come true precisely. The fact is that, Japan is not in a position to take on the U.S. in any big way, amid rising security concerns. This time, the statement mentioned Mexico (an enormous market for the U.S.) as a set with Japan, but if Mexico takes some kind of countermeasure (imposing tariffs on its imports from the U.S. or raising non-tariff barriers) that affect bilateral trade relations, the U.S. may back down relatively easily. As Mexico is not even on the Monitoring List in the Semiannual Report on International Economic and Exchange Rate Policies to begin with, it is natural that the level of pressure applied on Japan and Mexico will be different.

If that happens, the two most likely targets will be, first, Japan, and then Germany (seeing that Mr. Trump’s relations with Chancellor Angela Merkel seem extremely bad), and by extension the euro area. If the indicators are objectively assessed, there is no question that the German Current Account surplus is quite far from normal, but based on a political assessment, Japan is easier to put pressure on. There is also no escaping the fact that the objectively assessed, there is no question that the German Current Account surplus is quite far from normal, but based on a political assessment, Japan is easier to put pressure on. There is also no escaping the fact that the German Current Account surplus is quite far from normal, but based on a political assessment, Japan is easier to put pressure on. There is also no escaping the fact that the German Current Account surplus is quite far from normal, but based on political assessment, Japan is easier to put pressure on. There is also no escaping the fact that the German Current Account surplus is quite far from normal, but based on political assessment, Japan is easier to put pressure on.

It is not clear whether a statement of the kind released this time by the Department of Commerce will be put out every month or every quarter, but it has become clear that the authorities will make their point using such measures once in a while. The “irrational appreciation of JPY” that I had been warning about since the beginning of the year has to conciliate Germany with an appropriate level of monetary tightening, can get away (without implementing a tighter monetary policy) by simply allowing EUR to appreciate to the upper bound of the range EUR/USD has been in over the past two years, i.e., to the vicinity of 1.15 dollars, it would probably look the other way.

Semiannual Report on International Economic and Exchange Rate Policies to begin with, it is natural that the level of pressure applied on Japan and Mexico will be different.

U.S. monetary policies now and going forward – Whether transitory or not

Markets respond to cautious language by selling USD
The minutes of the FOMC meeting of May 2 and 3, which were released on May 24, had forward-looking comments regarding the June rate hike and balance-sheet size reduction, but it also included a few cautious comments regarding the slowing down of inflation and economic activity, noting that the Committee would like to monitor these trends to see whether they were transitory. The markets reacted to the latter by selling USD. Toward the end of May, several senior FRB officials began to express caution regarding the present state of inflation and employment, and while the probability of a rate hike in June is still extremely high², a shadow has clearly been cast over the likelihood of continued rate hikes. It is extremely natural to assume that USD will not be purchased in response to a rate hike process that seems to lack sustainability.

How will the “transitory” assessment be treated in June?
The rate hike was put off at the May FOMC meeting, but the section titled Participants’ Views on Current Conditions and the Economic Outlook stated that “if economic information came in about in line with their expectations, it would soon be appropriate for the Committee to take another step in removing some policy accommodation,” reaffirming that a rate hike in June was likely as per the current policy. Also, taking into account the view among the two or three FOMC participants who do not have voting rights this year that a rate hike may take place at the May meeting, one senses that the FOMC remains quite strongly hawkish. Reading further, the Committee Policy Action section noted that “members agreed that the slowing in growth during the first quarter was likely to be transitory and continued to expect that, with gradual adjustments in the stance of monetary policy, economic activity would expand at a moderate pace.” However, economic indicators have declined significantly even after the meeting, triggering cautious statements from some senior FRB officials in recent days, so the treatment of the “transitory” assessment at the June FOMC has suddenly become the focus of attention. The first point of focus will be the May Employment Situation Summary report (to be released on June 2), following which, hard data (Retail Sales and Consumer Price Index (CPI)) will also be important to watch.

Markets shocked to hear it would be “prudent” to wait
From the beginning, a rate hike in June has been a done deal among market participants – something they have been quite sure would go through. Because of this, it came as a shock to find that voting members of the FOMC “generally judged that it would be prudent to await additional evidence indicating that the recent slowing in the pace of economic activity had been transitory before taking another step in removing accommodation,” as written in the

¹ For instance, please see my January 24, 2017 article titled “Prepare for an irrational JPY appreciation under Trump” in the Reuters Foreign Exchange Forum, and my February 8, 2017 article titled “High-performing JPY will be harassed by Trump” in the Toyo Keizai Online magazine.
² Please see the May 24, 2017 Market Topic titled “Senior FRB officials turn cautious one after the other – The sole support begins to shake.”

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section Committee Action Plan, triggering a sale of USD. Further, returning to the section Participants’ Views on Current Conditions and the Economic Outlook, the fact that several non-voting participants “noted that core PCE price inflation had been running below the Committee’s objective for overall inflation for the past eight years and that it was important to return inflation to 2 percent and that a gradual approach to tightening could help (…)” draws attention. It is true that one has to go back to 2008 to find the Core PCE Deflator trending stably above +2% (which makes “nine” years a more accurate figure; see exhibit).

To put it bluntly, such sentiments reflect the view that the FRB must not rush to hike rates when the price situation does not yet warrant it. In his essay explaining why he is against a rate hike at this time, Minneapolis Fed President Neel Kashkari wrote, “Importantly, we have said that 2 percent is a target, not a ceiling, so if we are under or over 2 percent, it should be equally concerning,” and the recently released minutes also show evidence of discussion along similar lines of thought.

**Views appear likely to converge on reducing the balance-sheet size**

With regard to the handling of the balance sheet, the proposed approach was that the caps (amount that will not be reinvested) “be raised every three months,” and the statement reported that “Nearly all policymakers expressed a favorable view of this general approach.” The statement also noted that “Nearly all policymakers indicated that as long as the economy and the path of the federal funds rate evolved as currently expected, it likely would be appropriate to begin reducing the Federal Reserve’s securities holdings this year.” This discussion is likely to be taken up again in June. It could be said, therefore, that the time has come to include the FRB’s balance-sheet size reduction in our main scenario.

The leading member of the dovish faction, Mr. Kashkari, also mentioned in his essay that the announcement of plans to shrink the balance sheet could itself trigger tighter monetary conditions and be viewed as a substitute for a federal funds rate increase, recommending that the FOMC publish its plan for the balance sheet soon. The essay itself listed all the arguments against the FOMC March rate hike, but with regard to cutting the size of the balance sheet, its position was that this should be implemented before a rate hike. Looking back, on April 7, NY Fed President William Dudley said that reducing the size of the balance now means that the FRB would have the ability to expand it again if required in the future. A month later, on May 8, San Francisco Fed President John Williams supported the idea of starting the process of trimming the balance sheet this year, so that the FRB can “have a balance sheet that quite honestly in the future we could use if it was needed in a recession.” One can see that both dovish and hawkish factions within the FOMC are coming together in support of normalizing the balance sheet as an alternative to rate hikes, or for the creation of elbow-room for future monetary relaxation.

**Can share prices, currently engaged in aerial combat, withstand the FRB’s normalization process?**

The question is, what this will result in. Going by the various comments by senior FRB officials supporting balance sheet normalization, there are hints that the overall position is that proceeding cautiously may be alright, but the fact is that there is probably a great deal of nervousness about it. For instance, on April 7, Mr. Dudley remarked that the FRB strongly wishes to reduce its holdings in an inconspicuous manner, not as a big event, but as a very small, low-key event. He said that it would probably become clear over the next few months that FRB plans to shrink its balance sheet in a very careful and cautious way. However, the introduction and tapering of QE2 and QE3 were clearly major events for the markets, with shares, forex rates, and interest rates being significantly affected. The recent strong-USD phase began in June 2014 – five months after tapering began in January 2014, and around a year after former FRB Chair Ben Bernanke announced it.

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3 Please see April 5, 2017 Market Topic titled “Direct arguments against the FRB’s rate hike – From Brainard to Kashkari.”
With USD already close to its peak strength, I think a further appreciation may be difficult, but such a move is likely to affect financial markets other than the forex markets too. For instance, there is insecurity in the share markets. While the base money supplied by the FRB has been declining dramatically since its peak in October 2015, the NY Dow Jones Industrial Average has undergone almost no adjustment — rather, it has been accelerating (see exhibit). Following the release of the March FOMC meeting minutes, it was widely reported that “some participants viewed equity prices as quite high relative to standard valuation measures,” but the Dow has risen further since then. My understanding had been that the Dow’s strength since November 2016 was the result of having factored in an expansionary fiscal policy under President Trump, but I have to say that it has become very difficult to stick with that explanation now. Could there be any real grounds for this rise in share prices?

Let me review the current situation objectively — the financial sector's liquidity (base money) has increased, no fiscal expansion to offset this seems forthcoming, and the central bank assesses equity prices as high relative to standard valuation measures. Going by the recently released minutes, it is clear that the base money may or may not fall sharply going forward, but it will definitely not rise. The nominal interest rate trend may be the one brought into direct focus with the implementation of balance sheet normalization, but I am very skeptical whether U.S. share prices, as represented by the NY Dow Jones average (which appears currently to be engaged in aerial combat), will be able to withstand the expected FRB normalization process this autumn and onward.

U.S. economy now and going forward – Sluggish inflation expectations reflect overconfidence in economy

**Sluggish inflation expectations**

As mentioned above, based on the FRB's communications, the money markets are considering it a done deal that the second rate hike this year will be implemented at the June 13-14 FOMC meeting. However, contrary to the nominal interest rate and USD rate trends, inflation expectations, rather than rise, have gradually been falling. Looking back at the various trends since the beginning of the year, both U.S. 10-year interest rates and USD/JPY have moved more or less in tandem, but the five-year, 10-year, and 30-year inflation expectation (BEI) are on clearly falling trends (see exhibit on next page). Theoretically, the equation is give by “nominal interest rate – inflation rate (or inflation expectations) = real interest rate (or expected real interest rate),” which can be re-written as “nominal interest rate – real interest rate (or expected real interest rate = inflation rate (or inflation expectations)).” In other words, if the increase in nominal interest rates we are currently seeing is correct, then the decline in inflation expectations is likely to be caused by the increase in expected real inflation. The expected real interest rate can also be thought of as the potential growth rate of the economy, or more crudely speaking, its underlying strength. The question here is, has the U.S. economy truly become stronger?

Rather than assuming that the increase in expected real interest rates implies an increase in the potential growth rate of the U.S. economy, I think it is more natural to interpret the current situation as reflecting an over-optimistic increase in nominal interest rates and accompanying appreciation of USD. As I have said in past issues of this report, there has been no conspicuous strengthening of credit-related indicators such as the demand for loans, bank lending or outstanding corporate bonds issued. Under ordinary circumstances, it is unnatural for the demand for loans not to accelerate during a phase of economic strengthening.

Further, the Core Personal Consumption Expenditure (PCE) Deflator has been in the +1.6 to +1.8% range over the past year, showing no signs of strengthening to surpass the +2.0% target. Based on this, it does not seem surprising that inflation expectations would be sluggish. To summarize, it is not that the sluggishness of inflation expectations indicates a strengthening of the expected real interest rate (economic strength), but rather that the nominal interest rate has strengthened excessively (anomalously, to put it more bluntly). Perhaps this can be rephrased to say that overconfidence in the FRB’s normalization process and President Trump’s economic policies (Trumponomics) have been significantly inflating U.S. interest rates and USD rates.
Interest rate hike ≠ rise in 10-year interest rates

Even if the FRB were to smoothly implement interest rate hikes, the simple logical consequence of nominal interest rates being pushed upward and leading to a rise in USD/JPY will not necessarily ensue. During the previous period of interest rate hikes (June 2004 through June 2006), for example, 17 hikes elevated the discount rate 425bps, from 1.00% to 5.25%, while 10-year interest rates rose only 50bps, from 4.6% to 5.1%. This time, the discount rate has been hiked in 25bp increments three times – in December 2015, December 2016, and March 2017 – raising the rate by a total of 75bps – from the 0.00-0.25% range to the 0.75-1.00% range. During this period 10-year interest rates have moved from 2.2% to 2.4%, an increase of about 20bps. In what are admittedly very rough terms, the margin of elevation of 10-year interest rates from a single hike was about 3bps (50bps/17 times) in the previous period and about 7bps (20bps/3 times) in the latter period, so it appears that the degree of sensitivity this time is relatively high.

On the other hand, the rate hikes this time have begun from a much lower level, so it is thought to be natural that the initial speed of 10-year interest rate elevation will be relatively fast. When considering the medium-to-long-term relationship between rate hikes and 10-year interest rates, however, it must be said that the sharp 80bp surge of 10-year interest rates (1.8% → 2.6%) in the period of roughly a month after President Trump’s election last November 9 was abnormal. In any case, although there is a possibility that an increasing hawkish dot chart following the June FOMC meeting will be accompanied by a progressive factoring in of rate hike expectations, it bears remembering that this will not necessarily directly lead to a rise in nominal interest rates and USD appreciation. As already has been seen, when considered in the context of low inflation expectations, it would be imprudent to take it for granted that there will be a sustained rise in nominal interest rates and USD.

Having bid adieu to May, we have already uneventfully passed by French presidential elections, which had the potential to become this year’s largest tail risk, and the concerns about the situation on the Korean peninsula have been temporarily alleviated, so USD/JPY has entered a temporary lull period. However, I believe that it would be dangerous to become distracted by such short-term changes to the extent that one underestimates the significance of the sluggishness of underlying inflation expectations. One cannot help but wonder whether the gradual decrease in U.S. inflation expectations since the start of this year is not a warning sign with regard to excessive confidence in the U.S. economy as reflected in the rises in nominal interest rates and USD.

JPY basic supply-demand situation—Considerable change in the supply-demand situation

Considerable change in the basic supply-demand environment

In light of Japan’s March international balance of payment figures, I will, as I do each month, present a fixed-point overview of the current state of the basic supply-demand balance for JPY. The March current account balance was a surplus of +JPY2,907.7 billion. The surplus for fiscal 2016 was +JPY20,199.0, the highest such level in nine years, since the +JPY24,337.6 billion surplus recorded for fiscal 2007. Moreover, the surplus for the January-March quarter alone was +JPY5,786.9 billion, the highest level in four quarters. 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 was characterized by approximately +JPY940.6 billion of net JPY buying during the first three months of 2017, and this is a complete change from the situation in the same period of last year (approximately –JPY13.8 trillion of net JPY
Outgoing securities investment slack despite historical decline in VIX

Since foreign direct investment does not greatly fluctuate in most years, if one assumes that foreign direct investment this year will be roughly the same as last year, then the outlook is for current account surpluses and outgoing securities investment to be the factors determining the nature of basic supply-demand trends. In this regard, because the view that the USD/JPY levels of above JPY110 represent peaks is shared by many institutional investors, this article has considered a trend of proactive net outgoing securities investment to be unlikely. Currently, it can probably be said that the situation is continuing to be one in which there is no major deviation from this assumption. Although there have been some temporary surges in response to Trump administration leaking scandals, the VIX© index (CBOE Volatility Index©) has been continuing to be at historically low levels. Traditionally, this situation was considered to indicate an investment environment suitable for JPY selling and foreign securities buying. Despite this situation, however, a surge in outgoing securities investment has not been forthcoming, and I would like to give some serious thought to the significance of this. Looking within Japan, one finds that the fiscal 2017 asset management plans released by major Japanese life insurance companies since the start of April do seem to indicate a desire to undertake foreign securities investments, including hedged investments, but it would appear that only a minority are inclined to proactively assume the associated forex risk at a time when USD/JPY is above JPY110. Moreover, the announcement that the Financial Services Agency would undertake a special study of regional banks focused on those banks’ asset management departments has been attracting attention, and the need to consider the possibility that overseas risk taking may attract governmental scrutiny has probably been exerting an effect.

In this situation, if there were to be a downtrend in outgoing securities investment, then there would be an increase in the relative significance of current account surpluses, which have been inflated by the low level of crude oil prices. A strengthening of this basic supply-demand trend following the January-March period appears to be creating an environment in which USD/JPY has a heavy upside. There are major changes taking place to the overall situation that prevailed during the previous three years, and it is worth seriously considering the implications of those changes regarding USD/JPY.

Risks to my main scenario – Russia-gate suspicions increasing JPY appreciation risk

Russia-gate suspicions increasing confidence in main scenario

At this point, 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. It can be said that the increase in suspicions regarding the Russia-gate situation seen since the start of May have further increased confidence in this article’s main scenario regarding this point. Although a presidential impeachment is an extreme-case risk, so long as the issue is not resolved, it is probably going to be attracting more attention than economic policies. To begin with, it is useful to review the reasons for uptrends in interest rates and USD since last November. So long as the rapid and effective implementation of an unprecedented fiscal spending expansion policy is not possible, one has a basis for expecting markets to return to their condition prior to the presidential election.

In fact, from the start of May, the Dollar Index has returned to the lowest levels seen since last November 9. This trend is a manifestation of a trend of progressively declining expectations. Just as regarding U.S. interest rates, I believe the downside risk is large. As previously explained, since mid-May, multiple high-level FRB officials have begun finding it impossible to conceal their highly dovish views and statements. Depending on the nature of
economic indicators for June and subsequent months, there is a possibility that those views may become predominant. At a time when the excessive strength of USD on a REER basis has not been eliminated, the additional factors of Russia-gate suspicions and FRB weakening suggest a need for vigilant attention to the possibility of a downward adjustment of USD. I continue to expect 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.

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. Objectively viewed, it appears that JPY appreciation risk factors are increasing more than JPY depreciation risk factors.

### 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. I will begin by overviewing JPY depreciation risk factors. As already explained, 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.

However, as noted above, the current situation is not conducive to progress in discussions of the Trump administration’s fiscal spending policies and other economic policies, so market expectations regarding factor (2) are declining considerably. In this situation, if reflation expectations can be further induced as they were last November and December, then it can be said that the upside risk is clearly large. However, it must be admitted that there is currently little basis for considering this to be a significantly relevant factor for forecasting purposes.

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<th>Potential Risks to the Main Scenario</th>
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(Source) Daisuke Karakama, Mizuho Bank

What is the outlook regarding factor (3)? To the extent discernible from high-level FRB officials’ statements during April and May, it has become impossible to conceal the FRB’s goal of proceeding with the normalization process as a means of creating elbow room for future policy operations – the normalization process cannot be said to be a policy undertaken in response to the strength of the real economy. In fact, several high-level FRB officials appear to...
be beginning to lose their confidence in the process\(^4\). Previously considered a risk scenario, the potential for balance sheet reduction this year has now been included in the main scenario category, and there has been greater progress in this regard than this article anticipated. If the FOMC’s decisions to hike the discount rate in September and December and indications that it will undertake four hikes and considerable balance sheet shrinking in 2018 actually were to become true, then USD/JPY could probably be expected to relentlessly rise.

However, if the tightening is not designed to prevent the overheating of the real economy but is a program to create shrinking in 2018 actually were to become true, then USD/JPY could probably be expected to relentlessly rise. If the FOMC's decisions to hike the discount rate in September and December and indications that it will undertake four hikes and considerable balance sheet reduction this year has now been included in the main scenario category, and there has been greater progress in this regard than this article anticipated. If the FOMC’s decisions to hike the discount rate in September and December and indications that it will undertake four hikes and considerable balance sheet shrinking in 2018 actually were to become true, then USD/JPY could probably be expected to relentlessly rise. If the discount rate is hiked in June and balance sheet reductions are begun this year, it is questionable whether such policy management will lead to U.S. bond selling and USD buying. I personally do not anticipate such U.S. bond selling and USD buying.

To summarize the above, the JPY depreciation risk is associated with concern that an effective combination of fiscal and monetary policies (the eventuation of risk factors (2) and (3)) will lead to “four interest rate hikes + balance sheet reductions” during 2017 and 2018 and with concern that the market's confidence in this scenario will become incorporated into market behavior. In this case, this article’s USD/JPY forecast range could be greatly exceeded, and it would not be surprising to see USD/JPY attain the JPY120 level. It is true that there is a possibility that the current FRB will actually implement several interest rate hikes and begin balance sheet reduction measures, but realizing market confidence in such measures will require the actual emergence of signs of overheating in the real economy and financial indicators. Mustering up such signs will require the eventuation of risk factor (2), but the outlook for that risk factor is not currently bright. In brief, what is important is not the number of interest rate hikes or the presence or absence of balance sheet reduction measures — the importance lies in the reasons for such moves. Since there is concern about the reasons — despite continued concern regarding factors (2) and (3) — the risk does not appear to have a high likelihood of eventuating.

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 (6)). 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 (The current trend of decline in the VIX indicator is another follow-wind factor for the carry trade.) The possibility that "JPY selling by Japanese" will become a contributing factor to JPY depreciation cannot be completely discounted. However, as this article has previously described, now that we are five months into 2017, Japanese investors' interest in overseas risk taking has become quite restrained, so the supply-demand situation has become quite different since last year. It seems that a full-scale eventuation of risk factor (6) is only likely at a time when risk factors (2) and (3) have eventuated, so it may be useful to consider those three risk factors as comprising a set. But of course the set cannot be said to have a high level of likelihood.

**JPY appreciation risks – JPY to bear the brunt?**

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 there continues to be risk regarding this issue. Following the April G20 Finance Ministers and Central Bank Governors meeting in Washington D.C., almost 100 Republican party affiliates and economists gathered at a meeting\(^6\) with the theme of promoting a new international currency deal modeled on the Plaza Accord (April 23, Nihon Keizai Shimbun). In the case that the United States were to desire a full-scale adjustment of USD appreciation, it would involve not only EUR and JPY, but also such currencies as RMB, CAD, and MXN that have a large weight in USD real effective exchange rates, so it would seem to clearly require some kind of treaty along the lines of a second Plaza Accord.

Even if Russia-gate eventually proves not to be a major issue, suspicions about the issue are increasing the challenges President Trump faces in domestic policy implementation, and this gives cause for concern about the possibility that he will seek to compensate for that by means of monetary, trade, and diplomatic policies that can be expected to quickly generate results. This increases concern about efforts that may be made to restrain excessive USD appreciation along the lines of those cited in risk factor (4). Along with its announcement of trade statistics in early May, the U.S. Commerce Department released a special statement (mentioned above) indicating an intent to implement policies based on a “where might is master, justice is servant” philosophy, and this will further increase

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\(^4\) Please refer to the May 24, 2017, issue of Mizuho Market Topic entitled “Series of high-level FRB officials express weaknees – Sole pillar of support begins teetering”\(^5\). 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 economics 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. While the meeting did not attract very much attention from financial markets, it would probably not be prudent to totally disregard it.
attention given to the Trump administration’s policy implementation methods going forward. For example, one wonders whether the second round of U.S.-Japan economic talks scheduled to be held this year will proceed smoothly. While the first round of talks was a kind of preliminary greeting, the second round is likely to entail the start of full-scale discussions and negotiations. While attention will be focused on the issue of whether Japan’s trade surplus with the United States should be adjusted with a focus on ‘quantities’ or ‘prices,’ if the Japan side continues to refuse ‘quantity’ measures, then there is a possibility that initiatives may be taken to implement ‘price’ adjustment measures via forex rates. In such a case, JPY would be likely to appreciate more than this article has anticipated, with USD/JPY easily descending below the USD/JPY100 level. (However, the issue of whether such a degree of JPY appreciation would actually shrink the Japan’s trade surplus with the United States to a satisfactory extent is a separate issue.)

As explained in last month’s edition of this article, North Korea-related issues have brought a sudden rapprochement between the United States and China that led President Trump to shift to making such conciliatory statements, such as 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 even in this situation it proves impossible to easily change the perception that USD strength is a problem, then there is a possibility that some other country may be forced to accept China’s share of responsibility for USD strength. Given that the Commerce Department’s statement in early May specified only Mexico and Japan as problematic with respect to trade balances, there appears to be a high likelihood that JPY will bear the brunt of whatever forex rate adjustments may be deemed requisite.

Risk balance tilted toward JPY appreciation

Regarding other JPY appreciation risks, an additional risk factor (risk factor (5)) has been added to the list of risk factors from this month to account for the risk of JPY appreciation in the case that suspicions of a “Russia-gate” scandal were to actually lead to President Trump’s impeachment. In addition, it continues to be important to be aware of the risks related to European political situations and geopolitical risk (risk factors (8) and (9)). The seriousness of risks associated with European political situations has been somewhat alleviated by the election of France’s President Macron, but Italy is scheduled to dissolve its legislature and hold general elections during the forecast period (by May 2018). 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, and international financial markets are likely to be paying very close attention to that situation.

In addition, depending on events regarding the U.S. involvement in Syria and the situation in North Korea, there is a possibility that a perception of rising geopolitical risks may prompt a surge of JPY buying, as was seen in April. While there is a certain amount of justification for believing it strange to consider increasing North Korea-related tensions as a basis for promoting JPY buying, ultimately, 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 on the fact that the strength of the international sector of Japan’s economy is generally recognized. In this regard, the external assets and liabilities statistics released by Japan’s Finance Ministry on May 26 indicate that Japan’s net external assets amounted to JPY349,112 billion, confirming Japan’s status as the country with the world’s highest level of external assets for the 26th consecutive year (see graph). Naturally, if can be expected that the markets’ mode of reaction would change in the case that the current pattern of missile test launches were to be escalated to include attacks on Japanese territory (probably a triple-depreciation involving drops in JPY and in Japanese stock and bond prices), but so long as the conflict is restricted to U.S.-North Korean diplomatic skirmishes, one can confidently characterize the situation as one that promotes JPY appreciation.

While the above is a brief overview of the various risks related to both JPY depreciation and JPY appreciation, it appears that the risk balance is tilted toward JPY appreciation. Although the likelihood that Russia-gate suspicions would actually lead to a presidential impeachment cannot be said to be high, there is clearly a possibility that increased pressure stemming from this issue might encourage the president to guide USD downward as a means of rewarding his supporters. Ultimately, it is conceivable that such a scenario could lead to the eventualization of a second Plaza Accord (risk factor (1)) and other measures to restrain excessive USD appreciation (risk factor (4)). The possibility of an unexpected trend of progressive JPY depreciation appears to be gradually diminishing.
EUR Outlook – Eliminating distortions not simple

ECB Monetary Policies Now and Going Forward – Real money EUR selling restricting the upside

**EUR long positions predominate for first time in about three years**
IMM currency futures transactions statistics indicate that the net value of EUR positions became long in May 9, 2017, for the first time in about three years – since May 6, 2014 – and that EUR long contract buying has subsequently accelerated. (As of May 23, the positions stood at +EUR8.1 billion, the highest level of EUR long contracts in about three and a half years, since October 2013.) While Emmanuel Macron’s victory in France’s presidential election directly contributed to the recent trend, the trend toward the dissolution of EUR short contracts has continued since autumn last year and recently has gradually shifted to net long contracts. While the trend is fundamentally based on the current robustness of the euro area economy, it is unquestionable that ECB policy management in response to that robustness has also been a factor promoting the avoidance of speculative EUR selling. The asset purchase programme (APP) monthly purchase amount was reduced last December from EUR80 billion to EUR60 billion (in connection with the extension of the program’s time period), and the elimination of forward guidance language since this March has begun attracting attention as a forex-related theme. It appears that the recession of political risks and the increasingly hawkish nature of monetary policies may have caused speculators to change their perspective on EUR.

**Continued capital outflow from the area**
EUR/USD has gradually recovered in step with the dissolution of speculative EUR short positions, but it has not in fact gained momentum. Regarding this situation, one may note the possibility that there may be considerable EUR selling other than speculative selling. (While it is naturally true that not all IMM currency futures transactions trends reflect speculative trends, this discussion will assume that they are for the sake of simplicity.) In other words, it appears possible that real money trends are exerting an influence. The graph (above right) shows trends in the euro area’s outgoing and incoming securities investment. It indicates that, since 2015, incoming securities investment has been sparse, but outgoing securities investment has been robust, causing a chronic net outflow of capital. Regardless of how much the ECB may have adjusted its policies in the direction of tightening, the relentless progress of the FRB’s normalization progress has prevented shrinkage of the Europe-U.S. interest rate gap. In fact, the relationship between the U.S.-Germany interest rate gap and EUR/USD has been stable (see graph; below right). In light of this situation, it appears possible that, rather than EUR selling by fleet-footed speculators, it has been real money EUR selling as reflected in international balance of payment figures that has been placing a heavy weight on EUR/USD.
Smooth accumulation of net external assets

However, the euro area as a whole recorded a 2016 current account surplus amounting to roughly JPY47 trillion or USD400 billion. When one considers that the highest level of Japan’s current account surplus occurred during the JPY bubble period year 2007 and only amounted to about JPY25 trillion, the euro area’s surplus can be recognized as exceptionally large. This kind of current account surplus and the abovementioned outgoing securities investment are causing an accumulation of net external assets, and the scale of those assets can be considered a basis for confidence in EUR. Currently, it has become a conventional pattern in financial markets that when market participants’ risk tolerance becomes undermined they respond with “risk aversion-based JPY buying,” and it has frequently been pointed out that the reason for this is that “Japan is the country with the world’s largest amount of net external assets.” As of the end of 2016, Japan had maintained that status for 26 consecutive years. However, if Germany continues recording current account surpluses greater than Japan’s, it is possible that Japan’s lead in terms of having the world’s largest amount of net external assets will progressively narrow (see graph on page 15.) I continue to maintain a basic recognition that, if one avoids being distracted by the short-term phenomenon of EUR’s weak rebound and focuses on EUR’s structural strength, then it becomes apparent that that attacking EUR by means of EUR selling is rather difficult.

The euro area economy now and going forward – Chancellor Merkel perturbed by a “peculiar economy”

Response to Merkel’s statements

On May 22, German Chancellor Angela Merkel said that – “The euro is too weak – that’s because of ECB policy – and so German products are relatively cheap. So they’re sold more.” – which attracted considerable attention and prompted a surge in EUR. In February, Chancellor Merkel made similar statements, including that – “If we still had the Deutsche Mark it would surely have a different value than the euro does at the moment. But this is an independent monetary policy over which I have no influence as German chancellor.” – and she has been showing a tendency to indirectly criticize the ECB in such statements (February 20, 2017, Bloomberg). Merkel responded to criticism of her country’s trade surplus differently three and a half years ago, however, saying – “It cannot and should not be the case that anyone tries to weaken Germany's competitiveness artificially” – and – “It would be absurd if we were to start getting German companies to cut their production or compromise the quality of their products.” – (November 22, 2013, Bloomberg). At that time, she attributed Germany’s growing trade surplus exclusively to Germany companies’ competitive strength and did not consider the surpluses inappropriate. Reviewing these statements, one gets the impression that Chancellor Merkel’s views on the forex market and trade balances have changed considerably over the past three years.

Of course, EUR/USD was at USD1.35 at the time of the previous statements (November 2013), or about 20% stronger than it is now, so it is not all that surprising that she would modify her position. Moreover, Germany’s trade surplus has grown 30% during the past three years (from EUR197.7 billion in 2013 to EUR253.1 billion in 2016), so it is natural that there would be growing concern about the imbalance. Just as Merkel said, it is impossible to deny the possibility that EUR depreciation is a factor in the background of the surplus accumulation (see graph). The key question is how the situation should be resolved. Furthermore, as President Trump becomes increasingly assertive regarding currency and trade policies, there is a possibility that Merkel is now seeking to be conciliatory. In fact, after her latest high profile statement on this topic, the Dollar Index plunged, a trend in line with Trump’s desires. On the other hand, in light of Merkel’s and Germany’s image based on various types of leaked information, it seems hard to imagine that Germany would modify its policy management owing to U.S. criticism. It bears noting that the volume of U.S. criticism of Germany is (for some reason) small compared with the volume of U.S. criticism of Japan, Mexico, and China, so it may well be that Merkel is not particularly nervous about it.
**Peculiar IS balance**

For Germany to overcome the current situation, the best solution requires proactive fiscal spending. During her most recent statement cited above (May 22), she said that one means of reducing the problematic surpluses would be to increase domestic investment, and this is a correct perception of the current situation. The chart on the right presents trends in the German economy’s investment-savings (IS) balance. It shows that all the country’s sectors – household, corporate, and government – are recording net savings surpluses, which indicates an extreme situation of insufficient domestic consumption and investment. If one compares the German IS balance with those of other advanced countries, it becomes apparent that the German IS balance is peculiar and suggests that the country’s resource distribution functions are not operating normally. In line with Merkel’s suggestion, it appears that what Germany requires is clearly more domestic investments – in other words, domestic demand stimulation. However, it is not clear whether Merkel’s recognition of the problem extends to a resolve to do what it takes to solve the problem with respect to fiscal spending. It is well known that Germany has a long tradition of dogmatic preference for austerity policies. Merkel’s statements reported on May 22 included such comments as – “I can’t force people to buy a Renault instead of a VW” – suggesting that she was focusing exclusively on private sector adjustments, and it appeared that she may not have been considering public sector-based demand stimulation measures at all. It is true that stimulating private-sector demand expansion is important, but there appears to be a lack of harmony between a desire to stimulate domestic demand on the one hand and a determination to maintain fiscal surpluses on the other hand. In this regard, there will be great amount of attention focused on whether Merkel, who now appears certain to win her fourth term in office, intends to make any major changes to her views on fiscal spending policies.

Fundamentally, Germany has a responsibility to promote euro area bonds, or eurobonds, as a scheme for realizing fiscal transfers within the area. Interest in eurobonds surged at one point but interest in the concept subsequently seems to have disappeared. However, France’s President Macron has shown keen interest in eurobonds, which can be considered an excellent means of symbolizing France-German cooperation and facilitating the EU’s re-consolidation. While it is naturally expected to face opposition from the German public, the fact that Merkel was able to surmount the severe challenges presented by the refugee reception issue indicates that successfully promoting the eurobond concept would not be impossible for her. On the other hand, if Merkel personally believes that fiscal stimulus measures are evil, then efforts to promote eurobond schemes may be doomed in advance. It will be important to see whether Merkel’s perception of the need for fiscal stimulus measures changes after Germany’s September parliamentary election.

**Fiscal mobilization is first in order of importance**

Based on her recent statements, it seems clear that Chancellor Merkel is concerned with the problems of EUR depreciation, trade surpluses, and insufficient domestic demand. At present, there is a basis for expecting that Germany will undertake some additional fiscal spending and thereby increase its imports from elsewhere in the euro area. If this takes place, it can be expected to promote improvement in the euro area economy and create leeway for the ECB to gradually shift its policies away from expansionary policies and toward the kinds of policies desired by Germany. From the start of this year, there have been sporadic incidents of comments critical of the ECB made by Merkel and other high-level German officials, but so long as other euro area countries remain insufficiently strong to cope with monetary tightening, it appears absolutely impossible for the ECB to undertake explicit tightening measures. Ultimately, it appears logical to anticipate that Germany will not focus exclusively on itself but will undertake additional fiscal spending targeting other euro area countries and perhaps even go so far as to participate in eurobond schemes and other systems designed to boost the area’s economy via fiscal transfers. By the way, it has been reported that when ECB Governor Draghi’s term expires in October 2019, Chancellor Merkel and other leading German government figures will be promoting the nomination of Bundesbank President Jens Weidmann as Draghi’s successor. However, there are numerous euro area countries requiring monetary expansion, and the appointment of a German ECB governor will not change that situation. The ECB Governing Council makes decisions on the basis of majority votes among its members and, while it is true that the governor can cast the deciding vote in the event of tied votes, barring a major change to the current situation, there appears to be little likelihood of the German positions becoming strong enough to attain tied votes. So long as the euro area economy is not growing as a whole, the ECB will remain unable to shift toward monetary tightening and, as a result,
it will be impossible to eliminate Germany’s ‘permanently undervalued currency’ problem; so it is probably wise to recognize that resolving the huge trade surplus problem is also impossible.

In order of importance, before demanding that the ECB modify its monetary policies, it seems reasonable to ask that Germany make adjustments to its concept of the ideal fiscal spending policies. Otherwise, Germany is destined to merely continue expressing its dissatisfaction with the weakness of EUR weakness and the associated trade surpluses. As a first step toward eliminating distortions created by the situation of Germany’s singular strength within the euro area, Germany itself must acquire a better recognition of the basis of those distortions.

From the perspective of forecasting EUR/USD trends, although the relationship between President Trump and Chancellor Merkel is by no means a good one, it appears extremely important for the two to find some scope for a commonality of interests, even if that scope may well be limited to the subject of the desired direction of trends in EUR/USD.

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