Market Insight **February 7, 2019**

A strong dollar in 2017, a tug-of-war in 2018 and a weak dollar in 2019

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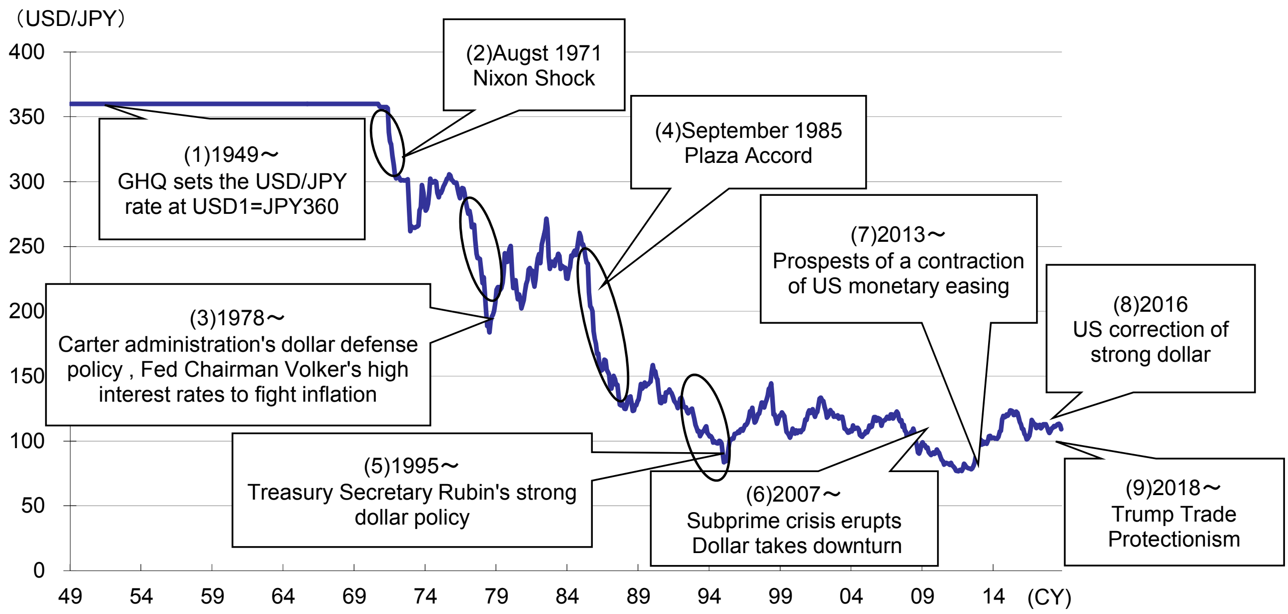
The yen has strengthened since the beginning of 2019, reaching 100 yen levels against the dollar. 2018 had the narrowest range of fluctuation in the exchange rate since the floating rate regime was introduced in 1973. Foreign currency experts are often referred to as either “strong yen proponents” or “weak yen proponents”, having a bias towards a certain foreign exchange direction. The writer does not have such a bias. However, the writer has for a long time used the analogy of a children’s game of Red Light Green Light[1] when discussing the foreign exchange markets, where change in the USD/JPY trend has historically always been dictated by ‘it’ (i.e., the US). In line with this, the writer asserted a constant strong yen in 2017 and tug-of-war situation in 2018. Today, I want to reiterate my reasons for forecasting a weak dollar in 2019. While using this analogy on numerous occasions, one such occasion was in December 2016[2]. There was a ‘Green Light’ following Trump’s success in the November 2016 US presidential election, with the renewed strong dollar policy attributed to the US monetary

[Chart 1: USD/JPY]



Source: Made by Mizuho Research Institute Ltd. (MHRI) based upon Bloomberg

[1] In the game of red light green light, when ‘It’ (i.e., the US) says red light (i.e., the US cuts interest rates) those participating in the game are unable to move (i.e., Japan is unable to hike interest rates). In the case of the foreign exchange markets, a red light indicates the US is obstructing a strong dollar, while a green light indicates the US is condoning a strong dollar.

[2] Mizuho Research Institute, *Market Insight - Trump shock and a ‘good appreciation of the dollar’* (December 20, 2016)

and fiscal policy shift. Despite a weak dollar bias due to the trade problems created by the Trump administration's "America First policy", the dollar appreciated because of US economic policy. In 2018, monetary and fiscal policies contributed to a strong dollar, like 2017, but the clear shift in focus towards trade policy under the Trump administration also exerted pressure for a weaker dollar leading to a tug-of-war between a strong and weak dollar. As a result, the range of fluctuations in the foreign exchange rates during 2018 were the lowest ever recorded. Monetary and fiscal policies have shifted in 2019, with a weakening of what had been a strong dollar policy, while the Trump administration's focus on trade policy leads to a weak dollar bias, so we forecast a weak dollar.

Chart 2 summarizes the impact on foreign exchange markets according to the Mundell-Fleming theory, a standard macro-economic theory. The text-book interpretation of the Mundell-Fleming theory suggests the policy mix of monetary tightening with ongoing US Fed interest rate hikes alongside the fiscal expansion accompanying the large tax cuts since the inauguration of the Trump administration in 2017 is a typical way to strengthen the domestic currency (i.e., it fosters a strong dollar). That is, the Trump administration's economic policy up until at least 2018 was a theoretical strong dollar policy. Our current proposition is that this could change in 2019. The increased likelihood that the Fed's stance towards hiking interest rates was put on hold at the January 30 FOMC meeting indicates a change from the upward pressure that has been exerted on the dollar up until now. On the other hand, there have been no positive factors in terms of fiscal policy, which includes the US government shutdown. There is little likelihood of additional expansion of fiscal policy and there has clearly been a shift from the conventional strong dollar.

[Chart 2: Impact of Mundell-Fleming Theory]

	GDP	Foreign exchange (domestic currency)
Monetary tightening	↓	↑ (Strong domestic currency)
Fiscal expansion	-	↑ (Strong domestic currency)

Source: Made by MHRI

[Chart 3: Direction for foreign exchange from the perspective of monetary and fiscal factors and the foreign exchange bias]

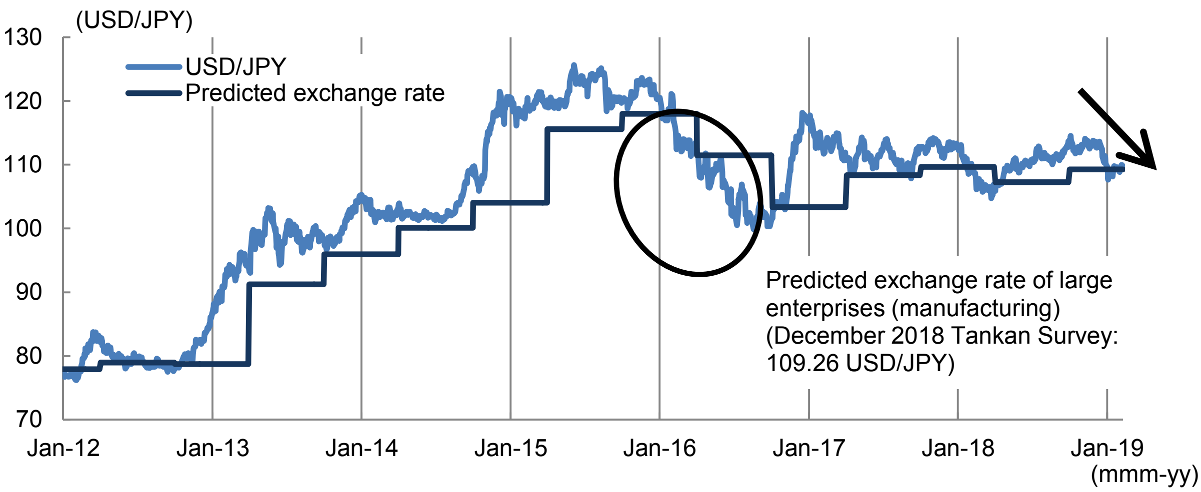
	Foreign exchange direction based on US monetary and fiscal policies	Bias due to trade even with the Trump administration's foreign exchange bias	Direction for foreign exchange
2017	Strong dollar policy	Not clear	Strong dollar
2018	Strong dollar policy	Weak dollar bias	Tug-of-war with limited fluctuations
2019	Also change in the strong dollar policy	Also a strengthening of the weak dollar bias	Weak dollar

Source: Made by MHRI

The political bias of the Trump administration means that trade issues tend to provoke uncertainty. This includes the ongoing foreign exchange issues with expectations that the Trade Agreement on Goods (TAG) in the US-Japan bilateral negotiations in 2019 will incorporate foreign exchange conditions. The history of the USD/JPY since the 1970s illustrated in **Chart 1**, which highlights the 'Red Light Green Light', indicates a weakening of the dollar when the focus has been on trade issues. The Trump administration is likely to increase pressure on trade issues this year, as there was last year, in the name of the America First policy and ahead of next year's presidential election. **Chart 3** summarizes prospective direction for foreign exchange based on monetary and fiscal factors and the US administration's foreign exchange bias.

Chart 4 illustrates the actual USD/JPY rate and the predicted exchange rate among large manufacturers. The Japanese economy was boosted by the weak yen that followed the inauguration of the Trump administration. However, the yen is once again slightly stronger than the estimated exchange rate, which inevitably causes companies to become nervous. One of the biggest risks for the Japanese economy is the risk of a strong yen originating in the US.

[Chart 4: USD/JPY and predicted exchange rate]



Note: The estimated exchange rate is the average of predicted exchange rates expected by large manufacturing enterprises in the Bank of Japan, *Short-term Economic Survey of Enterprises in Japan* (*TANKAN*)
Source: Made by MHRI based up on the Bank of Japan and Bloomberg.