Daiwa Securities

Forex Market View

Increased US protectionism puts upward pressure on yen

- Widening trade deficit is behind US protectionism
- US administration is dissatisfied with lack of decline in trade deficit with Japan
- US protectionism puts upward pressure on yen through direct pressure on Japan and risk-off moves

USD/JPY forecast range (latest: noon New York time)

14 Mar – 13 Apr: Y104.0-108.0/$ (Y106.62/$ as of 13 Mar)

Forex Market View DSFE130

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Widening trade deficit is behind US protectionism

US administration becomes more protectionist

US president Donald Trump is becoming increasingly protectionist. He signed an executive order imposing additional import tariffs on steel and aluminum. Canada and Mexico were exempted from tariffs, apparently to gain concessions for the US in the NAFTA renegotiation. It was reported that in a phone conference with Prime Minister Abe, he talked about Japan opening its market to shrink the US trade deficit with Japan. He also indicated he would instruct US Commerce Secretary Wilbur Ross to urge the EU to lower its tariffs, and to tell them that if they lower their duties on US products, the US will exempt the EU from the steel and aluminum import restrictions. Although one reason for the steel and import tariffs appears to be as part of an election strategy aimed at garnering votes in states hosting those industries, the growing trade deficit is probably also a reason why the US administration is becoming more protectionist.

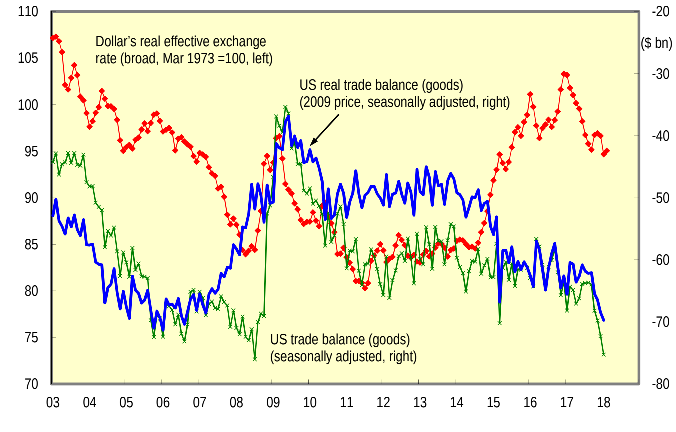
US trade deficit is growing rapidly

The US trade deficit in goods has been growing rapidly since October 2017. Although this can partly be attributed to import growth brought by rising crude oil prices, the trade deficit is growing even after adjusting for changes in prices. The output gap has been shrinking because of economic growth outstripping the potential growth rate, and there is probably an increased reliance on imports to fill the demand that domestic production cannot. On top of this you can add the tax cuts in 2018. With the government's fiscal deficit (savings deficit) growing, unless the funds surplus in the domestic private sector (saving surplus) becomes larger, the external deficit (savings deficit) will increase in size. This means an increase in the "twin deficits," the current account deficit and government budget deficit.

China is the main target for reducing the US trade deficit

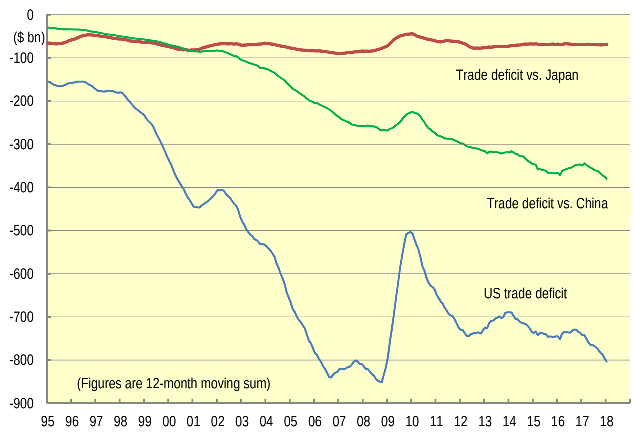
The US trade deficit (international balance of payments basis) grew $58.7 billion to $811.2 billion overall in 2017, while the US trade deficit with China, which increased $28.4 billion to $375.7 billion, is the largest.

Chart: US Nominal/Real Trade Balance and Dollar's Real Effective Exchange Rate



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US Trade Deficit and Deficit vs. Japan and China



Source: Thomson Reuters; compiled by Daiwa Securities.

The biggest challenge for US trade is reducing the trade deficit with China, and President Trump had China in mind when he proposed reciprocal taxes, including raising US tariffs to the same rate as those imposed by its trading partners. Citing the infringement of intellectual property, the US is apparently considering imposing tariffs on imports equating to as much as $60 billion, primarily on Chinese imports in the high-tech and telecom sectors. The US is raising tariffs on imports from China while demanding that China lower its import tariffs, the plan being to cut the trade deficit by reducing imports and increasing exports.

US administration is dissatisfied with lack of decline in trade deficit with Japan

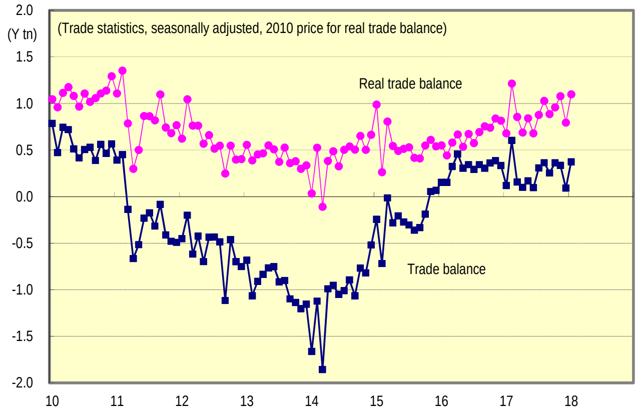
US administration is dissatisfied with lack of decline in trade deficit with Japan

The US apparently thinks that although its trade deficit with China is unusually large, it also needs to reduce its trade deficit with the EU, Japan, Korea, Canada, and Mexico. Breaking it down by trading partner, in 2017 the US had trade deficits of, starting with the largest, $375.7 billion with China, $76.2 billion with Mexico, $69.7 billion with Japan, $64.6 billion with Germany, $31.8 billion with Italy, $23.6 billion with India, $23.2 billion in Canada, and $22.6 billion with Korea. All eight of these countries meet one of the criteria in the Semiannual Report on International Economic and Exchange Rate Policies for being on the watchlist: "a trade surplus with the US of at least $20 billion." Based on all three criteria, including "a current account surplus of more than 3% of GDP" and "forex market intervention purchasing foreign currency of over 2% of GDP," the five countries that appear likely to be put on the watchlist in the 2018 report are those that were on the watchlist in the previous report issued in October 2017: China, Japan, Korea, Germany, and Switzerland. Italy's current account surplus has risen to 2.9% of its GDP, which puts it on the verge of meeting the watchlist criteria. Of the countries with which the US has the largest trade deficit, that deficit increased in 2017 with China, Canada, Mexico, and Italy, and concern over the trade deficit with Canada and Mexico is probably why the US is seeking to renegotiate NAFTA and raise the local content requirements (percentage of manufacturing inputs that must be sourced in the US). Meanwhile, the US trade deficit with Korea, India, Germany, and Japan shrank in 2017, but insufficiently so from the US perspective, and the US is apparently still unsatisfied with its deficit with Japan, which barely declined.

Japan's trade surplus with the US is 2.4x the size of its overall trade surplus

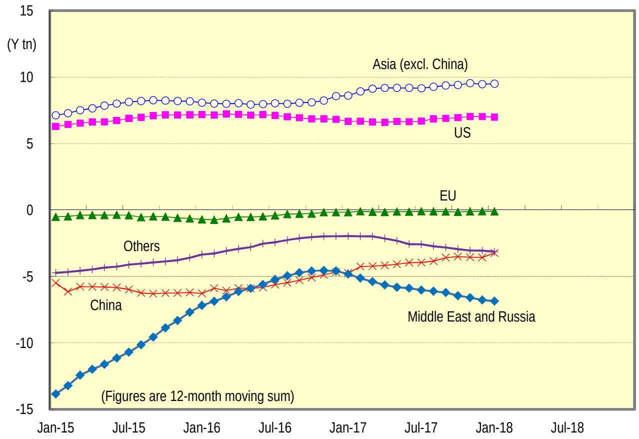
Japan's total trade surplus declined ¥1.09 trillion to ¥2.91 trillion in 2017, but this was primarily because of growth in imports brought by higher oil prices, and its trade balance adjusted for changes in prices actually improved somewhat. Although the yen has been strengthening against the dollar since mid-2015, the stronger yen has not yet had enough of an impact to cause the adjusted trade balance to worsen. Japan's nominal trade balance with the Middle East and Russia has been worsening because of rising oil prices, but that balance has been nearly unchanged with the US and the EU and has been improving with China and other Asian countries. Ranking Japan's trade surplus by trading partner, that with the US is the largest at ¥7.02 trillion (followed by Hong Kong in second place at ¥3.77 trillion and Korea in third-place at ¥2.82 trillion), a number that equates to 2.4x the size of Japan's total trade surplus.

Chart: Japan's Nominal/Real Trade Balance



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Japan's Trade Balance by Partner Nation (region)



Source: Thomson Reuters; compiled by Daiwa Securities.

US protectionism puts upward pressure on yen through direct pressure on Japan and risk-off moves

Is the US trying to improve its trade balance by devaluing its currency?

The US has long been arguing that Japan has nontariff trade barriers, and when it tries to reduce its trade deficit with Japan, it demands that Japan eliminate those barriers and opens its market. From Japan's perspective, however, it should have few nontariff barriers, and eliminating them would have a limited positive impact on the US goods and services trade deficit. If the US starts to think that its trade deficit with Japan is unlikely to shrink appreciably even if Japan makes progress in opening its market, it may try to improve that trade deficit by devaluing the dollar.

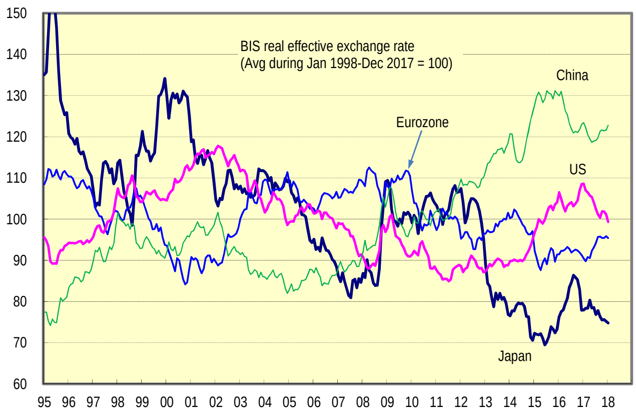
Yen's real effective exchange rate has been remarkably weak

In its Semiannual Report on International Economic and Exchange Rate Policies for April 2017, the US Treasury Department wrote that there is no evidence of the yen being excessively strong and that the yen's real effective exchange rate was about 20% cheaper than its 20-year average, but neither comment was included in the October 2017 version of the report. The yen's real effective exchange rate continued to decline in 2017, however, and as of January 2018 was about 24% weaker than its 20-year average. With most currencies within ±10% of their 20-year average, the yen's weakness is notable. Although the yen strengthened in February, its real effective exchange rate did not change much, and the US is expected to say the yen is undervalued.

US protectionism puts upward pressure on yen through direct pressure on Japan and risk-off moves

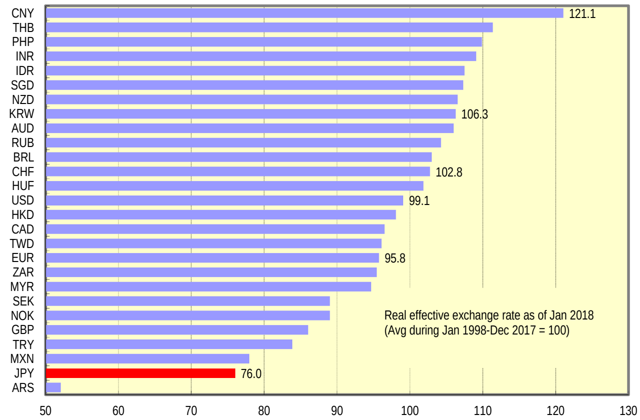
The administration clearly wants a cheaper dollar, given comments by the US Treasury Secretary that a weaker dollar is "good for the US" and "good for exports." There is a possibility that although it may refrain from making statements that could be criticized as talking down the dollar, the US may be asking Japan behind the scenes to correct the yen's weakness by tapering monetary easing. Unless US protectionism fails to bring other countries to lower their tariffs, it will strengthen the yen by way of direct pressure on Japan and risk-off moves, including because of its negative impact on the global economy.

Chart: Real Effective Exchange Rate in Japan, US, Europe, and China



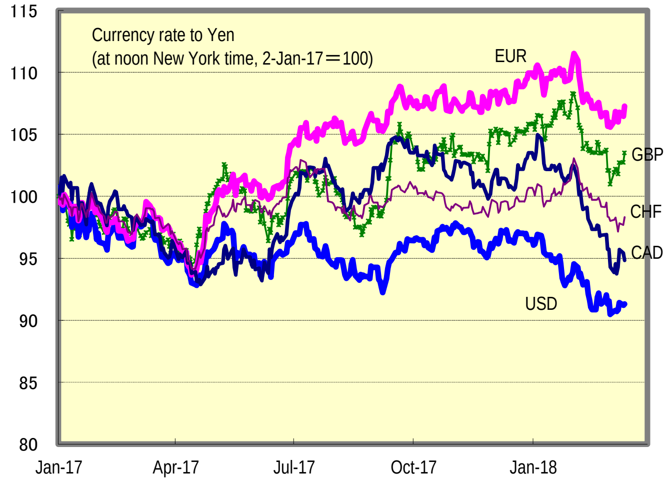
Source: BIS; compiled by Daiwa Securities.

Chart: Real Effective Exchange Rate Relative to Past 20-year Average



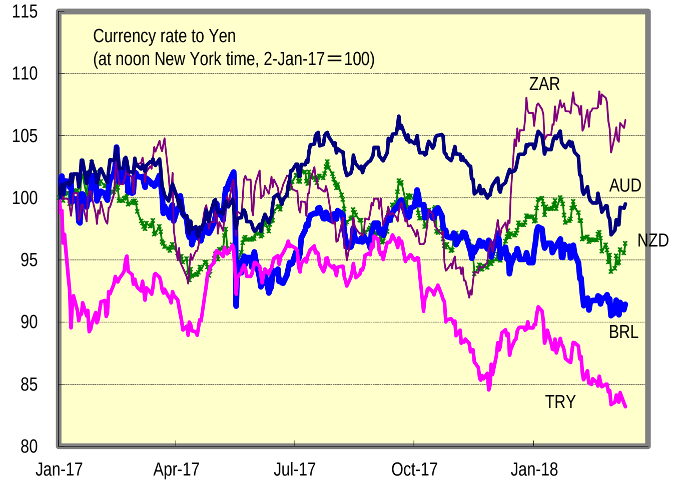
Source: BIS; compiled by Daiwa Securities.

Chart: Major Currencies/JPY FX Index



Source: Fed, Thomson Reuters; compiled by Daiwa Securities.

Chart: EM Currencies/JPY FX Index



Source: Fed, Thomson Reuters; compiled by Daiwa Securities.

Chart: Currency Exchange Rate Forecasts

	Actual 30 Sep 2017	Actual 29 Dec 2017	Forecast Jan-Mar 2018	Forecast Apr-Jun 2018	Forecast Jul-Sep 2018	Forecast Oct-Dec 2018	Forecast Jan-Mar 2019
USD-JPY	112.6	112.7	107.0	105.0	105.0	108.0	110.0
			104-114	102-112	101-111	102-112	104-114
EUR-JPY	133.1	135.2	130.5	126.0	129.5	135.0	135.5
			127-139	123-135	123-135	127-139	128-140
AUD-JPY	88.3	87.9	82.5	79.0	81.0	85.5	85.0
			80-90	76-86	76-86	79-89	80-90
CAD-JPY	90.1	89.6	82.5	79.5	81.5	85.0	85.5
			80-92	76-86	76-86	79-89	80-90
NZD-JPY	81.4	79.8	76.0	72.5	74.5	79.0	78.5
			72-82	70-80	70-80	73-83	74-84
TRY-JPY	31.7	29.7	27.5	26.8	27.7	29.2	29.0
			26-31	25-30	25-30	26-31	27-32
ZAR-JPY	8.3	9.1	8.9	8.4	8.8	9.4	9.2
			8.5-9.5	8.2-9.2	8.2-9.2	8.6-9.6	8.7-9.7
BRL-JPY	35.6	34.0	32.4	31.4	32.3	34.3	33.9
			31-35	30-35	30-35	31-36	32-37
KRW-JPY	9.8	10.6	9.8	9.5	9.8	10.2	10.2
(100 KRW)			9.6-10.7	9.2-10.2	9.2-10.2	9.5-10.5	9.6-10.6
CNY-JPY	16.9	17.3	16.6	16.0	16.3	17.0	17.1
			16.3-17.6	15.7-17.0	15.7-17.0	16.1-17.4	16.3-17.6

Source: BIS, Fed, Thomson Reuters; compiled by Daiwa Securities.
Notes: 1) Actual shows market rates at noon NY time.
2) Forecast upper row; as of quarter end, lower row; range during quarter.

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association