Daiwa Securities

# Forex Market View

## US pressure on Japan behind currency clause

- US wants to reduce its trade deficit with Japan
- Does it also want the yen to strengthen against the dollar to reduce its trade deficit with Japan?
- Inclusion of a currency clause risks raising pressure on Japan

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

**18 Apr-17 May: Y109.0-113.0/$ (Y111.99/$ as of 17 Apr)**

Forex Market View DSFE229

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### The US wants to reduce its trade deficit with Japan

**The US wants to reduce its trade deficit with Japan**

Following the initial Japan-US trade talks in Washington DC held over two days (April 15-16), the US Trade Representative (USTR) issued a statement as outlined below. During the talks, the US side expressed concern over its large trade deficit with Japan, indicated its desire to reduce that deficit, and said that reducing the deficit in trade in goods was an issue.

- United States Trade Representative Robert Lighthizer met with Japan's Economic Revitalization Minister Toshimitsu Motegi reaffirmed their shared goal of achieving substantive results on trade in furtherance of the joint statement issued by President Donald J. Trump and Prime Minister Shinzo Abe on September 26, 2018.
- The United States and Japan discussed trade issues involving goods, including agriculture, as well as the need to establish high standards in the area of digital trade. In addition, the United States raised its very large trade deficit with Japan – $67.6 billion in goods in 2018.
- Ambassador Lighthizer and Minister Motegi agreed that the United States and Japan will meet again in the near future to continue these talks.

**Purpose of the Japan-US trade negotiations in the US**

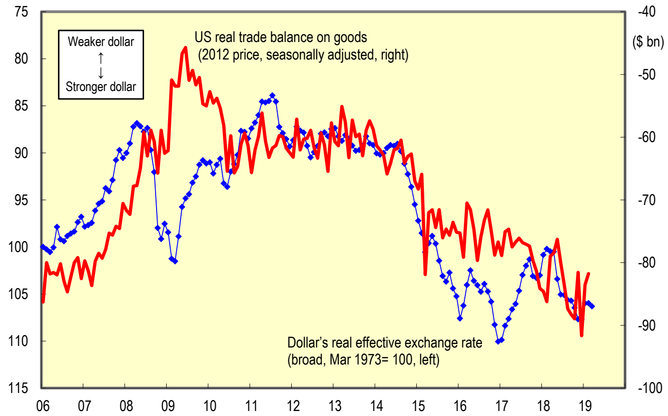
On December 21, 2018, the US announced its objectives (a list of 22 items) in negotiating the US Japan Trade Agreement (USJTA). These included, under the heading Trade in Goods: "Improve the US trade balance and reduce the trade deficit with Japan." Within Trade in Goods under the subheading Agricultural Goods: "Secure comprehensive market access for US agricultural goods in Japan by reducing or eliminating tariffs." Under the

**Chart: Objectives of USJTA Negotiations**

| | |
|---|---|
| Trade in goods | State-owned and controlled enterprises |
| Sanitary and phytosanitary measures | Competition policy |
| Customs, trade facilitation, and rules of origin | Labor |
| Technical barriers to trade | Environment |
| Good regulatory practices | Anti-corruption |
| Transparency, publication, and administration | Trade remedies |
| Trade in services, including telecommunications and financial services | Government procurement |
| Digital trade in goods and services and cross-borde | Small and medium-sized enterprises |
| Investment | Dispute settlement |
| Intellectual property | General provisions |
| Procedural fairness for pharmaceuticals and medical devices | Currency |
| | (22 items) |

*Source: United States Trade Representative, Japan External Trade Organization (JETRO); compiled by Daiwa Securities.*

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




*Source: Thomson Reuters; compiled by Daiwa Securities.*

subheading Industrial Goods: "Secure comprehensive duty-free market access for US industrial goods and strengthen disciplines to address non-tariff barriers that constrain US exports." "Secure additional provisions as necessary to obtain fair and more equitable trade in the motor vehicle sector, including provisions designed to address non-tariff barriers in Japan as well as to increase production and jobs in the US."

## Does it also want the yen to strengthen against the dollar to reduce its trade deficit with Japan?

**Will the US be satisfied with Japanese companies increasing output from their US manufacturing facilities?**

With the US having designated the agricultural sector as an area of great interest in Japan-US trade negotiations, it apparently wants to increase US agricultural exports to Japan through a lowering of Japanese tariffs (Japan maintains that the most that it can do is what it promised to do in its previous economic partnership agreement (EPA)). The US also wants to increase its exports of industrial goods to Japan through a lowering of Japan's tariffs and nontariff barriers, but one of its objectives in the automotive sector is to increase production and employment in the US. The US has apparently asked Japan's automakers to curtail exports to the US and increase their US-based production and employment. If Japan were to accommodate that request to a degree, it would reduce the US trade deficit with Japan and boost production in the US. Nevertheless, if the Japanese automakers merely raise the percentage of US demand they meet with local production at the expense of their exports, it will not affect demand for US autos. The only ways that US automakers can increase exports to Japan and raise their share of sales there are by either eliminating nontariff barriers or becoming more price competitive. If Japan's nontariff barriers are already nonexistent as Japan has been arguing, the only option left is to raise US price competitiveness through a strengthening of the yen against the dollar.

**Does it also want the yen to strengthen against the dollar to reduce its trade deficit with Japan?**

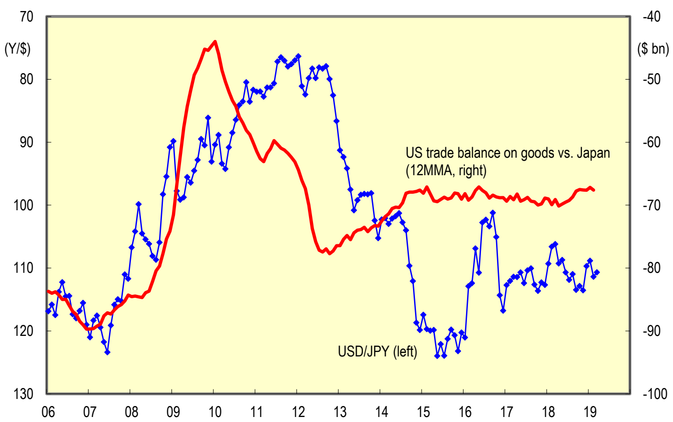
There is already a clear correlation between the dollar's real effective exchange rate and the adjusted US trade balance (excluding impacts from price fluctuations): the US trade deficit expands when the dollar strengthens and shrinks when the dollar weakens. If the US wants to shrink its trade deficit with Japan, it probably wants the yen to strengthen against the dollar. The reason that the US trade deficit with Japan did not grow despite the yen weakening considerably against the dollar from 2012 until 2015 is that Japanese companies expanded their local US production and reduced their exports from Japan (i.e., lowered US imports), not that exchange rates no longer impact Japan's trade balance. The yen's real effective exchange rate is correlated with Japan's adjusted export/import ratio (adjusted exports/adjusted imports), and that ratio tends to decline when the yen strengthens and increase when the yen weakens.

## Inclusion of a currency clause risks raising pressure on Japan

**The US seeks a currency clause in its trade agreement with Japan**

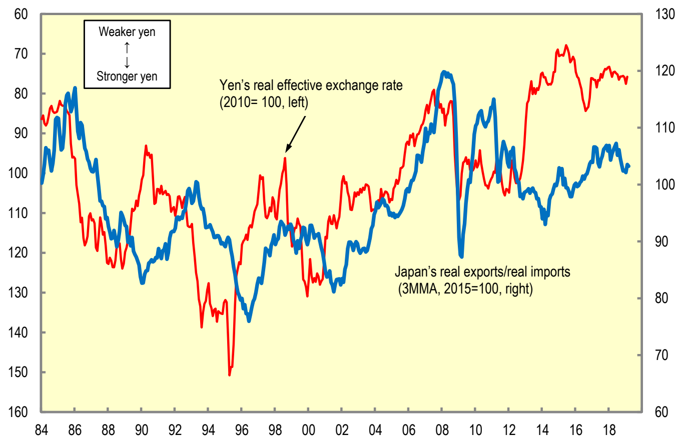
The US listed as a currency-related objective of the USJTA negotiations to "ensure that Japan avoids manipulating exchange rates in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage."

**Chart: USD/JPY and US Trade Balance vs. Japan**




*Source: Thomson Reuters; compiled by Daiwa Securities.*

**Chart: Yen's Real Effective Exchange and Japan's Real Export/import Ratio**



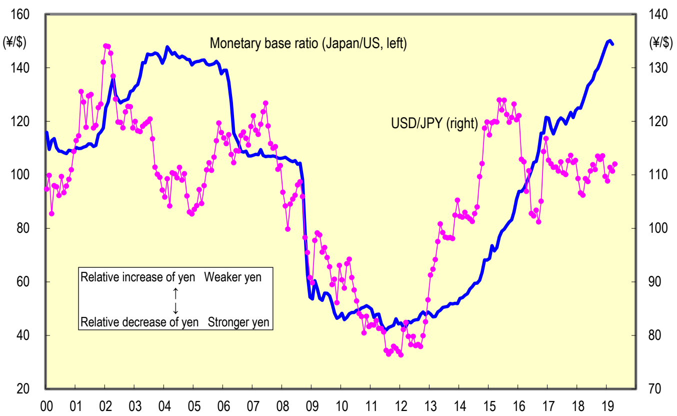

*Source: Thomson Reuters; compiled by Daiwa Securities.*

The US first used a currency clause in the United States-Mexico-Canada Agreement (USMCA) and it is trying to insert such a clause in its trade agreement with Japan. During Japan-US trade talks, the US Treasury Secretary clearly asked for a currency clause and proposed specific wording that called for its trading partner to make currency policy transparent and voluntarily restrain from competitive currency devaluations. One likely reason why the market did not react much to the Treasury Secretary's statement was that he did not make any reference to the current level of exchange rates. Another reason for the muted reaction is that the currency clause was left for discussion between Treasury Secretary Mnuchin and Finance Minister Taro Aso, without the US taking a clear stance on exchange rates.

**Inclusion of a currency clause risks raising pressure on Japan**

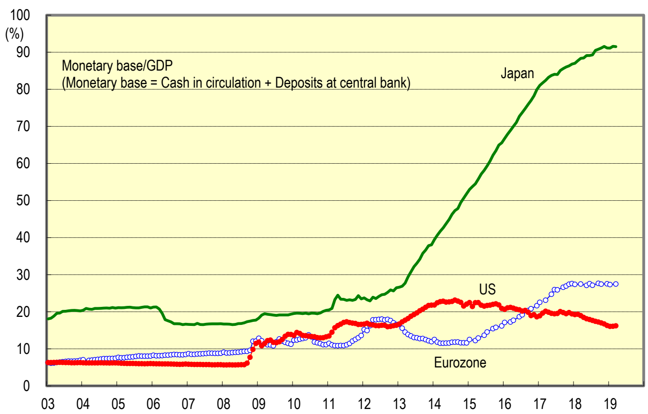
We doubt that the market thinks that the inclusion of the currency clause to prevent currency manipulation would not necessarily trigger yen appreciation. The US wants to include a currency clause in its trade agreements to force its trading partners to refrain from competitive devaluations (just as it says), but it is also probably wants to do so because if a currency clause is included and the US can argue that its trading partner is engaged in competitive currency devaluation, it makes it easier for the US to demand that it strengthen its currency. At end-January 2017, shortly after he was sworn in, President Trump said that other countries were gaining an advantage by increasing their money supply and devaluing their currencies, and that China and Japan have repeatedly devalued their currencies over the years, making the US look foolish. The monetary base for Japan, where the BOJ has stuck with its quantitative easing policy, has continued to grow relative to that of the US and now stands at over 90% of GDP. This leaves open the possibility that the US will characterize the BOJ's continued QE as currency devaluation and use that to put pressure on Japan to correct the yen's weakness. If a currency clause is included, the market will see it as raising the probability of the US putting pressure on Japan and thus as a risk of the USD/JPY declining.

**Chart: Monetary Base Ratio (Japan/US) and USD/JPY**



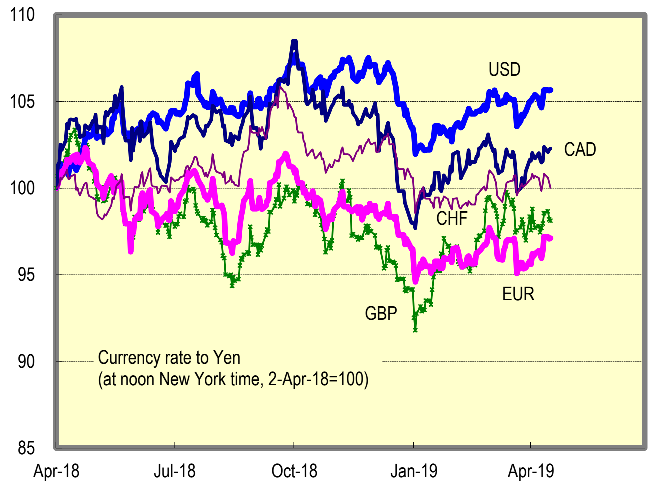

*Source: Thomson Reuters; compiled by Daiwa Securities.*

**Chart: Ratio of Monetary Base to GDP in Japan, US, and Europe**



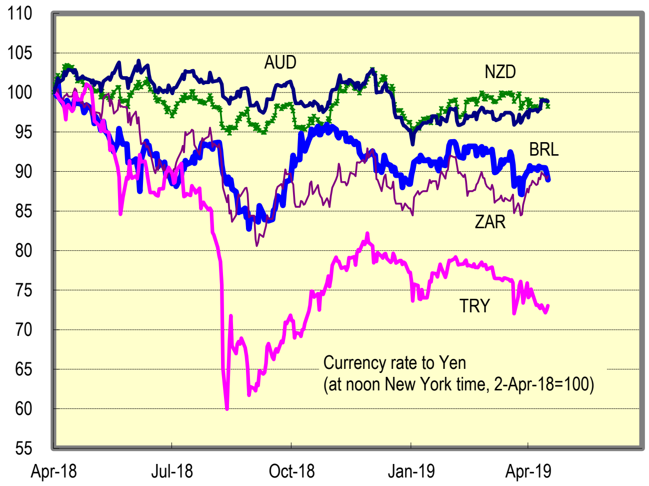

*Source: Thomson Reuters; compiled by Daiwa Securities.*

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 | | Forecast | | | | |
|---|---|---|---|---|---|---|---|
| | 31 Dec 2018 | 29 Mar 2019 | Apr-Jun 2019 | Jul-Sep 2019 | Oct-Dec 2019 | Jan-Mar 2020 | Apr-Jun 2020 |
| USD-JPY | 110.3 | 110.7 | 110.0 | 107.0 | 105.0 | 105.0 | 107.0 |
| | | | 104-113 | 104-112 | 101-110 | 101-110 | 101-110 |
| EUR-JPY | 126.3 | 124.3 | 125.5 | 121.0 | 118.0 | 118.0 | 122.0 |
| | | | 118-130 | 117-129 | 115-127 | 115-127 | 115-127 |
| AUD-JPY | 77.7 | 78.6 | 78.0 | 75.0 | 72.5 | 72.5 | 76.0 |
| | | | 81-91 | 72-81 | 70-79 | 70-79 | 70-79 |
| CAD-JPY | 81.0 | 82.8 | 82.0 | 79.5 | 77.5 | 77.5 | 80.0 |
| | | | 83-93 | 76-85 | 74-83 | 74-83 | 74-83 |
| NZD-JPY | 74.0 | 75.5 | 75.0 | 72.0 | 69.5 | 69.5 | 72.5 |
| | | | 69-78 | 69-78 | 66-75 | 66-75 | 66-75 |
| TRY-JPY | 20.9 | 20.0 | 21.0 | 19.5 | 18.5 | 18.5 | 19.8 |
| | | | 17-22 | 17-22 | 16-21 | 16-21 | 16-21 |
| ZAR-JPY | 7.7 | 7.7 | 7.9 | 7.4 | 7.0 | 7.0 | 7.6 |
| | | | 7.0-8.3 | 7.0-8.3 | 6.7-8.0 | 6.7-8.0 | 6.7-8.0 |
| BRL-JPY | 28.5 | 28.5 | 30.0 | 27.5 | 26.5 | 26.5 | 28.0 |
| | | | 26-31 | 26-31 | 25-30 | 25-30 | 25-30 |
| KRW-JPY | 9.9 | 9.7 | 9.8 | 9.4 | 9.2 | 9.2 | 9.4 |
| (100 KRW) | | | 9.1-10.1 | 9.1-10.1 | 8.8-9.8 | 8.8-9.8 | 8.8-9.8 |
| CNY-JPY | 16.1 | 16.5 | 16.5 | 15.8 | 15.3 | 15.3 | 16.0 |
| | | | 15.5-17.0 | 15.5-17.0 | 15.0-16.5 | 15.0-16.5 | 15.0-16.5 |

*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.*

# Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

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Registered Credit Rating Agencies are subject to the following regulations:
1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

**■ Credit Rating Agencies**

**[Standard & Poor's]**

**The Name of the Credit Rating Agencies group, etc**

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

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The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

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Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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**[Moody's]**

**The Name of the Credit Rating Agencies Group, etc**

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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

**How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings**

The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

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**[Fitch]**

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The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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May 2018

**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.

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The Financial Futures Association of Japan
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Type II Financial Instruments Firms Association