

# Forex Medium-Term Outlook

May 31, 2024

## Overview of Outlook

USD/JPY plunged sharply early in May due to what may have been a currency intervention, but it has subsequently inched back up to trade in the year-to-date high zone. A number of ideas are being floated for how to check JPY depreciation, but as of the present time, none of them are being taken seriously, and we seem to be in a phase of waiting patiently for the Fed to lower interest rates. Looking at Japan's monetary policy, JPY interest rates have clearly increased against the backdrop of the BOJ reducing its JPY purchase operation amounts and hawkish remarks from its governor and deputy governor, but there have been no signs of JPY strengthening against USD from the U.S.-Japan interest-rate gap perspective. If a rate hike by the BOJ were to coincide with a rate cut by the Fed, perhaps a significant correction could be expected, but unfortunately, the U.S. economy is showing no sign of slowing. We seem, therefore, to be in the very situation I most wanted to avoid – a situation where the more apparent the BOJ's currency battles get, the more they fan JPY selling in the market. Going by Japan's balance of payments so far this year, supply-demand conditions conducive to JPY selling seem to be gradually improving. The fact that JPY depreciation remains unchecked despite this suggests the possible involvement of speculative trading. If so, what are speculative traders being motivated by? While this is not yet a part of my main forecast scenario, I have the impression that debt financing (the BOJ's reluctance to raise interest rates due to concerns about higher interest rate payment on government debt) seems increasingly likely to become an issue. Indeed, given that the government's net public debt decreases as inflation rises, this is an unforeseen risk factor that needs to be monitored.

EUR remained strong in May. An ECB rate cut in June is seen as certain, but this is not being viewed with any novelty in the markets, which have been factoring it in for the past six months or so. Rather, euro area economic indicators released in April-May were conspicuously strong, with the January-March quarter negotiated wages, especially, showing stronger growth than expected. The way things are shaping up, it seems likely that even if the June rate cut goes ahead as planned, the ECB will resort to waiting and watching in July, and then contemplate the possibility of further rate cuts from September onward. EUR's strength since May is reflecting the regional economy's strength, which seems to be somewhat of an unexpected development for the ECB, which has been specifically aiming to cut rates. Going by recent words and actions of senior ECB officials, a quarterly pace of rate cuts seems most realistic. This is forecast to keep the EUR-U.S. interest rate gap level, resulting in EUR/USD jostling along without much of a sense of direction. One of the risks for the current forecast period is a forced increase in defense expenditure for euro member states if former U.S. President Donald Trump gets reelected. However, countries like Italy are already facing a fiscal squeeze, and being forced to meet NATO targets of 2% of nominal GDP could result in a downgrading of their credit ratings and cause turmoil.

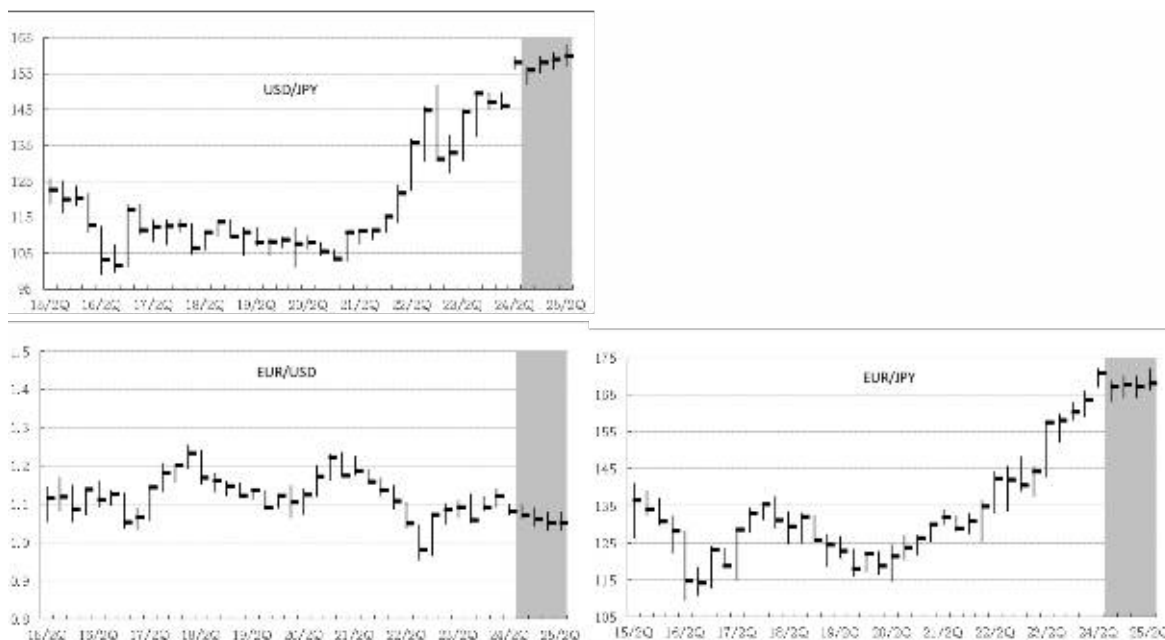
### Summary Table of Forecasts

	2024 Jan-May (actual)	2024 Jun	Jul-Sep	Oct-Dec	2025 Jan-Mar	Apr-Jun
USD/JPY	140.80 ~ 160.24 (156.74)	156 ~ 160 (158)	152 ~ 157 (156)	155 ~ 160 (158)	156 ~ 161 (159)	157 ~ 163 (160)
EUR/USD	1.0601 ~ 1.1046 (1.0832)	1.07 ~ 1.10 (1.08)	1.06 ~ 1.10 (1.07)	1.04 ~ 1.09 (1.06)	1.03 ~ 1.08 (1.05)	1.03 ~ 1.08 (1.05)
EUR/JPY	155.10 ~ 171.60 (169.77)	167 ~ 172 (171)	163 ~ 169 (167)	164 ~ 170 (167)	164 ~ 170 (167)	166 ~ 172 (168)

(Notes) 1. Actual results released around 10am TKY time on 31 MAY 2024. 2. Source by Bloomberg

3. Forecasts in parentheses are quarter-end levels.

### Exchange Rate Trends & Forecasts



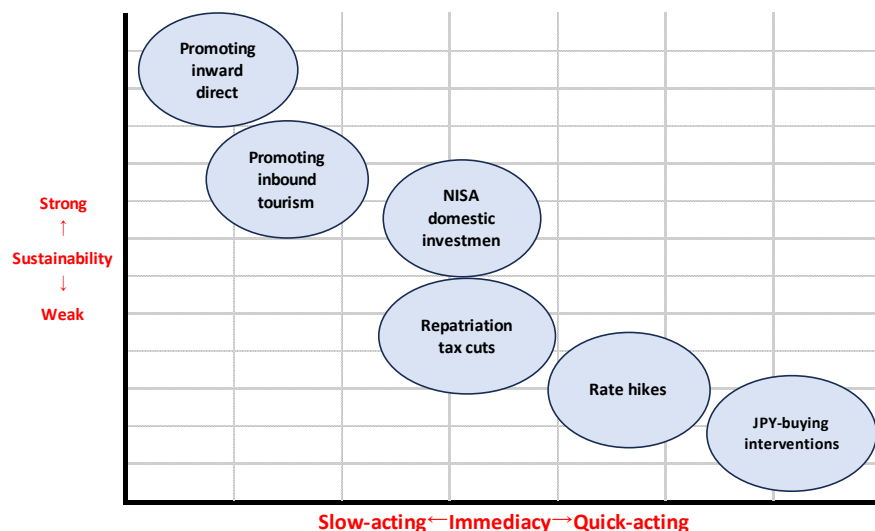
## USD/JPY Outlook – List of Ideas for Checking JPY Depreciation

### List of Ideas for Checking JPY Depreciation

#### Summary of Ideas for Checking JPY Depreciation

In May, I discussed various ideas to prevent JPY from weakening further in a series of Mizuho Market Topics reports. Since there is not enough space here to present all the ideas in their entirety, let me give you a summary. Ideas for containing JPY depreciation include (1) JPY-buying foreign exchange intervention, (2) interest rate hikes by the BOJ, (3) repatriation tax cuts, (4) the establishment of a new NISA framework for domestic investment, (5) promoting inbound tourism, and (6) promoting inward direct investment. The figure shows my evaluation of these ideas in terms of time required to take effect (immediacy) and how long the effect is expected to last (sustainability). Overall, there appears to be a tradeoff between immediacy and sustainability. For instance,

Evaluation of Ideas for Curtailing JPY Depreciation



(Source) Prepared by the author

(1) JPY-buying foreign exchange intervention and (2) interest rate hikes by the BOJ, which are monetary policies that could trigger pressure-tactics by the market, are likely to have an immediate effect, inducing momentary JPY buying, but it is difficult to say anything about rate movements following that. So long as JPY is traded under a floating exchange rate system with free movement of capital, it is essentially impossible to change the situation through discretionary currency/monetary policies alone.

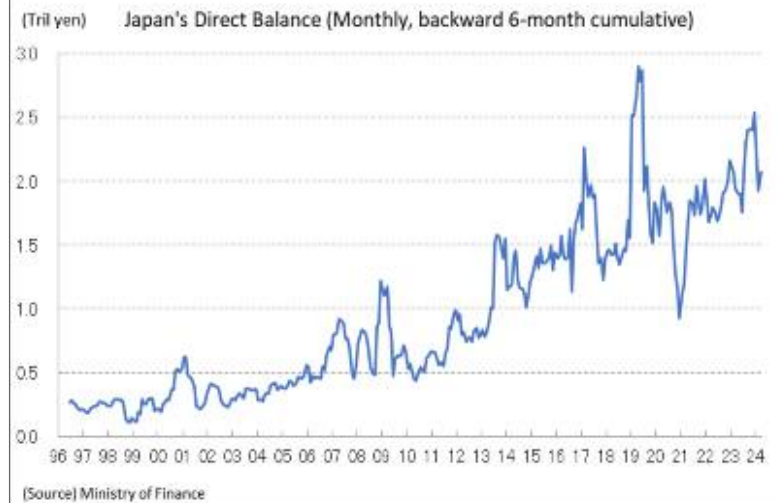
Meanwhile, (3) repatriation tax cuts and (4) the establishment of a new NISA framework for domestic investment are likely to have more sustained effect than currency/monetary policy moves, but in terms of immediacy, they are more in the “buying time” category of ideas. Having said that, I rate the establishment of a new NISA framework for domestic investment as more sustainable than repatriation tax cuts, because I believe it can attract some of the investment flow from the household sector, potentially headed for investment in overseas assets, back to Japan. Given that there is a limit to the household sector’s investment capital, it is reasonable to assume that domestic vs. overseas investment options are, to some extent, in an either-or relationship here. If so, I believe that the establishment of a new NISA domestic investment framework definitely has the potential to contain JPY selling in a sustainable manner (of course, the scale and time-frame of implementation would have to be worked out).

### *Most Orthodox Route is to Promote Inward Direct Investment*

That leaves (5) promoting inbound tourism and (6) promoting inward direct investment, but (5) has already gone beyond promotion, and some are even beginning to call for restrictions amid the possibility of supply constraints due to labor shortages unintentionally caused by over-tourism. My impression is that upside risks worth discussing are not that large.

In response to the ongoing JPY weakness, workshops and study sessions are being held in various places, and I have had the opportunity to participate in many. In most cases, participants agree that (6) promoting inward direct investment may be the best way to counter JPY weakness. With an increase in the inward direct investment balance, the number of export bases (of foreign-affiliated companies) in Japan will increase, which could cause an increase in export volume

due to JPY weakness, thereby improving the trade balance. Needless to say, this will eliminate the current problem of a structural downward pressure on JPY. This is probably the most desirable route for Japan right now. However, even assuming that this is the best route to take, it may take 10 years or more to prove effective. It was exactly about 10 years ago (see figure) that Japanese foreign direct investment began to take off, and it has resulted in the current situation of JPY weakness failing to boost exports and improve the trade balance. It is natural, therefore, to assume that a similar length of time will be required to reverse the situation. It takes years to fundamentally transform a country's currency supply and demand structure, and once we understand these new realities Japan is saddled with, we have no choice but to work with them as we explore new avenues of growth. Some lament this option of using a weak currency as the basis to link the hope of earning foreign currency to goods exports as being too close to the growth model of developing countries, but so long as JPY's real effective exchange rate (REER) remains at its lowest in half a century, the orthodox path would be to utilize the cost-related advantages of a weak currency to sell goods and services overseas.



### *Developing Country Growth Model, but With Added Challenges*

Energy and people are two issues that always crop up whenever there is an attempt to further discussions on promoting inward direct investment. The energy issue pertains to Japan's energy mix, with the restart of nuclear power plants in sight, while the people issue pertains to labor shortages. Not many foreign companies would go out of their way to choose a country with an unstable supply of electricity and labor for investment. One of the reasons Kikuyo town in Kumamoto prefecture was chosen by TSMC as an investment destination was that both of these issues were eliminated as a special circumstance.

Labor shortage is an especially large concern in Japan's case. As mentioned above, Japan may have to adopt a developing-country growth model, but most developing countries are blessed with strong population growth. In other words, Japan may be compelled to adopt a developing-country growth model, but with stricter constraints owing to its shrinking population. A question that intuitively pops up when discussing the promotion of inward direct investment is – will foreign companies be able to secure sufficient labor for their factories in Japan? Here, assuming that foreign companies choose Japan as an investment destination owing to the cost advantage, it must be pointed out that their wage levels tend to be high. As a result, it seems quite likely that these companies will be able to secure the necessary human resources. A more realistic concern is that this could result in “crowding out,” as labor shortages in other fields intensify as these factories attract most of the available supply. For example, if more regions successfully attract inward direct investment, the accommodation and restaurant sectors, where labor shortage is already an issue, could face even more serious problems. The same could be said for the nursing care sector.

If Japan chooses to go down the orthodox path of promoting inward direct investment to contain JPY depreciation, Japanese society will have to buckle down and debate the issue of accepting immigrants sometime soon. This is not an issue that can be put off forever, as the weaker JPY gets, the less attractive Japan is as a destination for immigrants. As I have argued in the past, Europe's example shows that accepting immigrants requires considerable resolve and repeated discussion. The final answer could be “no,” but it is certainly time for the government, having calmly taken into account the current difficulties Japan is facing as a result of currency depreciation, to ask the people what they think about accepting immigrants.

Historically, there is no precedent of a country having followed the trajectory of “developing country⇒ developed country⇒ developing country (with declining population),” so it is not clear to what extent Japan can overcome the headwinds simply by promoting inward direct investment. Still, there would be nothing wrong with the government/ruling party presenting it as an orthodox option to make the most of JPY weakness. However, this is something that would have to be discussed alongside major policy issues such as restarting nuclear power plants and accepting immigrants, issues that will attract great attention sooner or later.

## BOJ Monetary Policy Now and Going Forward – Currency Battles Becoming Normalized?

### *Rate Hikes, Currency Interventions, Quantitative Tightening*

On May 14, the BOJ announced that it would reduce the planned purchase amount for its regular Japanese government bond (JGB) purchase operations (of bonds with “over 5 years and up to 10 years” left to maturity) by JPY 50 billion, from JPY 475 billion as of the previous meeting on April 24 to JPY 425 billion. This was the first reduction in purchase amount since the end of yield curve control (YCC) in March. Subsequently, there were hawkish comments from the governor and deputy governor of the BOJ, and the yield on newly issued 10-year JGBs rose temporarily to the 1.10% level, the highest in about six months since November 2023. There were also brief phases of JPY appreciation against USD. While the JPY appreciation trend could not be sustained, the move is noteworthy in that it indicates the start of a quantitative tightening in addition to interest rate hikes and (suspected) JPY-buying currency interventions by the BOJ. Of course, given that the planned purchase amount for JGBs with “over five years and up to 10 years” left to maturity was set to be between JPY 400 billion and JPY 550 billion in April, the BOJ may claim that it reduced the amount because it judged that there would be no impact, but it seems reasonable to assume this was a decision intended to curb JPY’s depreciation.

On May 7, Prime Minister Fumio Kishida exchanged views with BOJ Governor Kazuo Ueda shortly after returning from a tour of several countries. Ueda’s remarks following his meeting with the prime minister – such as “the BOJ will closely monitor the JPY’s recent depreciation in managing policy” and “foreign exchange (JPY weakness) can potentially have a large impact on the economy and prices” – attracted attention. His remarks indicated a clear change of stance since his press conference following the April monetary policy meeting, when his tolerant stance toward JPY weakness met with criticism. The reduction in purchase amount came amid simmering speculation about this change in stance, revealing a growing concern over JPY weakness in the BOJ’s monetary policy operations.

### *BOJ’s Currency Policy History*

Of course, a weak currency affects general prices, and there is no doubt that the Japanese economy is currently experiencing this. When this is pointed out, some argue that corporate revenues and profits are on the rise, but this is no consolation for the household sector, which is suffering from a worsening real income environment, as it is eminently possible for strong corporate performance to coincide with a deteriorating economic outlook for households. In today’s Japan, JPY weakness has become a market phenomenon that ensures survival of the fittest, which is worrying in that it could trigger a widening of disparities. Of course, in the sense that it boosts the GDP, former BOJ Governor Haruhiko Kuroda’s repeated remarks to the effect that JPY weakness was a positive for the Japanese economy as a whole may be valid, but it is essentially inappropriate to discuss JPY weakness in black-and-white terms as good or bad. Ultimately, the problem boils down to income distribution, as I have argued in my book *Where Has the ‘Strong Yen’ Gone?* I will leave further discussion on this topic for another time, but as long as most Japanese people, led by the household sector, are averse to it, JPY weakness will be politically unacceptable, and it is worth noting that the BOJ is in a policy environment where it will be called upon to align with the political realities.

Historically, the BOJ has embarked on monetary easing during phases of JPY appreciation and stock price depreciation, which was often the case when the Fed was cutting interest rates. In such situations, the BOJ’s monetary policy was more like a currency policy taking U.S. interest rates (the Fed’s monetary policy) into account. Coming back to the present, monetary policy is being developed as a currency policy aimed at preventing JPY depreciation rather than appreciation. While the 180 degree change in policy direction in just over 10 years comes as a surprise, there is no change in the fact that currency rate trends remain enshrined as the biggest concern for the Japanese economy. Under former Governor Masaaki Shirakawa, the BOJ struggled with the battle against exchange rates from 2008 to 2012, but managed to avoid such a situation from 2013 onward.

### *Return of the BOJ’s Battle Against Exchange Rates*

Recently, however, the BOJ’s battle against exchange rates is once again attracting attention. At present, it is quite clear that the exchange rate is the key variable explaining the BOJ’s policy operation. I vividly remember Toyoo Gyoten, a former senior official of the Ministry of Finance, writing in the Nikkei Shimbun’s Economic Classroom that “in the developed world, no other nation is as sensitive to its currency’s exchange rate as Japan is. Frankly speaking, this is abnormal.” That situation has not changed, and there are no signs of it changing. In today’s Japan, every little fluctuation in JPY rates is the focus of attention in political, economic, and social spheres, and there is a growing sense that the investment of policy resources in this area is justified. Japan has traditionally had little tolerance for interest rate hikes, but now there is a growing sense that they are unavoidable.

In the first place, in light of the trilemma of international finance (see figure), it is not reasonable to expect low interest rates without JPY weakness. So, forced to choose between rising interest rates or JPY weakness over the past two years, Japan has somehow ended up choosing JPY weakness. The table shows that the BOJ has somehow managed to reconcile the mutual contradiction between (1) and (3) thus far, but amid the increasing difficulty of accepting JPY weakness since the start of 2024, it is beginning to reveal a stance of accepting some increase in interest rates. However, with U.S. interest rate cuts not progressing as expected and no significant tilt toward net JPY buying in terms of the JPY supply-demand situation, it is not clear how effective the mere stance of “accepting some increase in interest rates” can be in countering JPY depreciation. As I have said repeatedly, given the changes in JPY’s supply and demand structure, it is unclear whether JPY depreciation can be reversed with just “some” increase in interest rates.

### Trilemma of International Finance

		Adopting countries			
		U.S.	Japan	Euro area, HK, etc.	China, etc.
1	Independent monetary policy	Yes	Partial-Yes	No	Partial-Yes (*)
2	Free capital movement	Yes	Yes	Yes	No
3	Stable exchange rates	No	Partial-Yes	Yes	Partial-Yes

(Source) Prepared by the author

\*However, in the case of China, the State Council is responsible for monetary policy opera

#### Possibility of Another Rate Hike in June

Following his meeting with the prime minister on May 7, Ueda stated, “We will be closely watching to see how (JPY weakness) impacts the inflation trend.” This, combined with the recent decision to reduce JGB purchase amounts, inevitably raises expectations for another rate hike at the June 14 MPM. Even assuming there is no additional rate hike in June, Ueda is likely to adopt a strongly hawkish tone aimed at deterring JPY depreciation in his press conference following the meeting, so as not to make the same mistake as in April, when his remarks were perceived as being tolerant of JPY depreciation. Having said that, the combination of hawkish press conference and dovish policy operation will not work. Even if the BOJ manages to maintain the status quo at its June MPM, the markets are likely to turn up the pressure to raise interest rates again through speculative JPY selling ahead of the July MPM coinciding with the release of the Outlook Report (Outlook for Economic Activity and Prices). Going by BOJ Deputy Governor Shinichi Uchida’s speech (details follow), a rate hike of around +25 to +50 bps is expected going forward, regardless of the timing.

#### Focus on Debt Financing Could be Worst-Case Scenario

If we assume that the BOJ’s battle with exchange rates, as experienced during the Shirakawa era, have resumed for the first time in over 10 years, it is natural to expect that interest rates will gradually be raised going forward. Then, when a considerable number of rate hikes have been implemented, we may see a rampant rise in calculations pertaining to the increase in interest payments on government debt. This focus on debt financing at that time is a risk scenario of concern not just for forex rate trends, but also for bonds, stocks, and other JPY-denominated assets as a whole.

Recently, there has been a trend of shares being sold in line with JPY depreciation. This is due to the “(1) JPY depreciation → (2) rate hike → (3) fall in share prices” association. If debt financing becomes a topic of focus, expectations of (2) rate hikes will rise sharply, and the sharp rise in JPY interest rates and concerns surrounding the government’s debt repayment are likely to occur in a correlated manner. In such a scenario, both Japanese shares and JPY will be sold (leading to a triple depreciation trend). Of course, this is part of my risk scenario, but the possibility of this scenario playing out seems to be gradually increasing. In fact, the Japanese government’s net public debt has been declining since 2020, and some have been speculating that this is like an inflation tax imposed on the Japanese economy. If this trend gains momentum, it could encourage speculative JPY selling. I will elaborate on the discussion surrounding inflation tax in the “Risks to My Main Scenario” section below.

#### Ultimately, Labor Market is Key?

Deputy Governor Uchida’s keynote address at the international conference organized by the Institute for Monetary and Economic Studies on May 27 is instructive regarding the BOJ’s monetary policy operation in the near term. The speech stood out for its strong wording that appeared to openly commit to an interest rate hike trajectory going forward. Deputy Governor Uchida opened his speech with, “The big question is whether the current change in inflation picture means an irreversible, structural change from deflation, or just a temporary phenomenon led by global inflation.” I quote below the portions of his speech that answered this question:

- **Now it is time to answer the question I posed at the beginning of this speech. Are these trends irreversible? As I mentioned, two things are needed to change the current situation: resolving the original causes of deflation and overcoming the deflationary norm. As to the first issue, resolving the original causes of deflation, I can confidently answer “yes.” Labor market conditions have changed structurally and irreversibly.**

His reason for confidently declaring that the original cause of deflation had been eliminated was that “Labor market conditions have changed structurally and irreversibly. We cannot expect much more labor participation to come from women and seniors.” This touched upon the issue of the progressively dwindling labor supply. Uchida was less confident regarding the second point, overcoming deflationary norms (i.e., social practices and normative consciousness), saying,

“the answer is not so clear.” Here again, he stated that “The key once again is the labor market,” explaining that labor shortages were the main driving force behind overcoming social norms, which he said were “set to be dissolved.” Uchida claimed that companies’ price-setting behavior would change in response to changes in labor costs going forward. The “labor market is the key” argument was not limited to the above points in Uchida’s speech. He used that phrase multiple times, in various contexts. According to Uchida, irreversible structural changes in the labor market were the decisive factor in eliminating the cause of deflation, and the labor market once again holds the key to eliminating the social norms brought about by deflation. If so, what was the point of all the monetary easing policies over the past 25 years? Am I the only one here who finds it all a bit futile? If the confident answer to the question “Have the original causes of deflation been resolved” is “Yes, they have been resolved because of the labor shortage due to dwindling labor supply,” was there really a need for monetary policy operation that imposed such a great strain on the bond market?

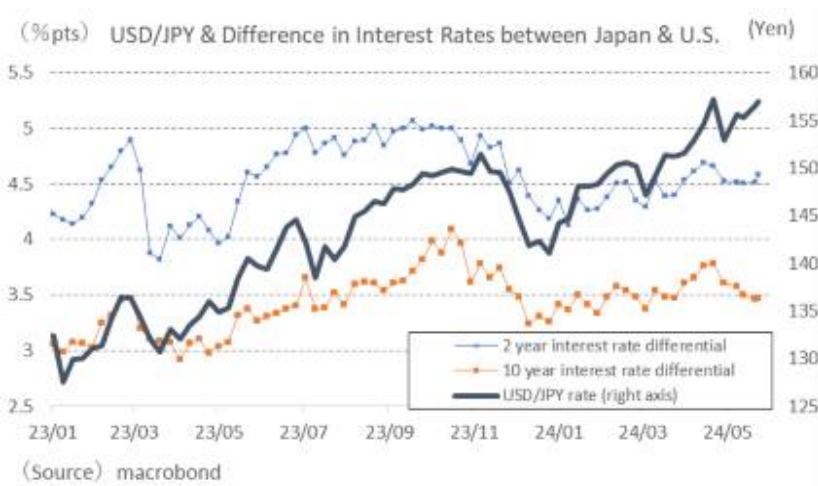
*“This time is different” Seems to Suggest Future Rate Hikes*

I will refrain from going so far as to providing a summary of past monetary policies, but judging by the concluding section of Uchida’s keynote address, the future direction of the BOJ’s policy operation appears to have been decided. On their own, the above excerpts from the speech suggest quite a hawkish tone, but let us evaluate them also taking the following into account:

- **<Abridged> Japan declared in this March that these unconventional policy tools had fulfilled their roles. We returned to a conventional monetary policy framework, aiming at a 2% price stability target through adjustments of the short-term policy rate, which means we have overcome the zero lower bound. <Abridged> the end of our battle (with deflation and the zero lower bound) is in sight.**

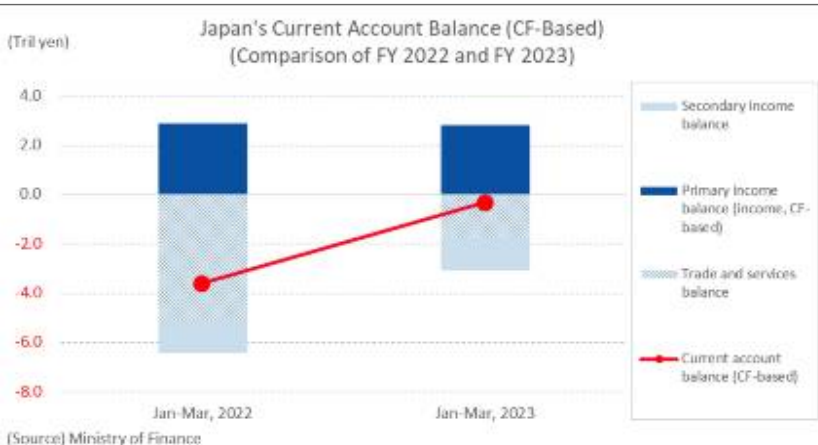
Given that Uchida went so far as to say “the end of our battle (with deflation and the zero lower bound) is in sight,” we can fully expect a rate hike of about +25 to +50 bps. Uchida further ended his speech with, “So, I would like to conclude my speech with this phrase: “This time is different,”” using a famous phrase that is mockingly used to suggest an imminent collapse of optimism in the financial markets. Uchida’s deliberate use of this phrase seems to suggest that the BOJ is confidently ready with its “next move.”

However, even though Japan’s long-term interest rates have been rising strongly in response to these communications from the BOJ, and the widening of the U.S.-Japan interest rate differential has been curbed, the upward trend in USD/JPY has not changed much (see figure). Rate hikes by the BOJ are not sufficient in themselves to eliminate the JPY short positions. It is only if they happen as a set with rate cuts by the Fed that a sufficient impetus can be gained to change the trend of speculative trading. I am not convinced by the reasoning behind the BOJ’s decision to normalize policy (structural changes in the labor market), but it seems safe to assume that the rate hike path itself will continue. However, this does not have much to do with reversing the JPY depreciation trend. Rather, it must be seen as part of an inevitable phase shift taking place against the backdrop of a transition from deflation to inflation as a result of structural changes in the labor market, and taking into account, as a matter of logic, that deflationary currencies strengthen and inflationary currencies weaken.



**JPY Supply-Demand Environment – JPY Supply-Demand Environment is Improving, But...**

*JPY Supply-Demand Climate Improving in 2024*  
 In May, Japan’s March balance of payments were released, so I would like to take stock of the JPY supply-demand climate as of the January-March quarter. News headlines are reporting in a big way about the +JPY 25.339 trillion current account surplus posted for FY 2023, the largest since 1985, when records began. My estimate of the cash-flow-based (CF-based) current account surplus is roughly +JPY 2 trillion, which is only about a tenth of the statistical surplus, but it is still a surplus. The figure on the next page compares the January-March CF-based current account balance for 2023 and 2024. Here again, a clear improvement can be confirmed. Looking at

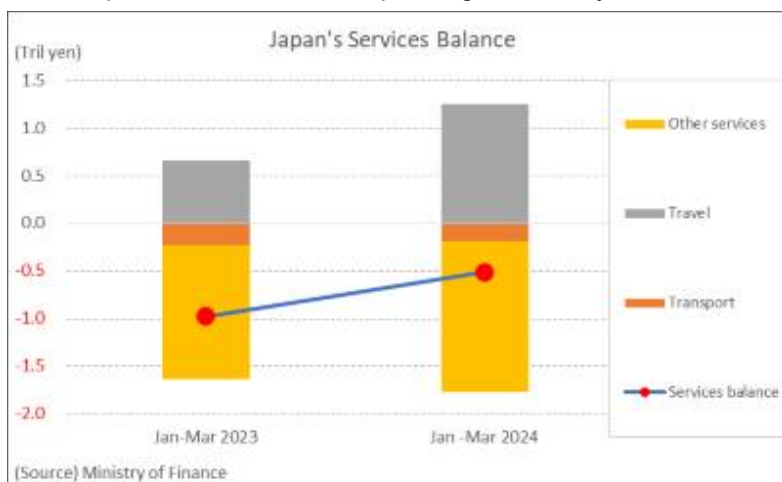


concrete figures, both 2023 and 2024 show a deficit, at about -JPY 3.6 trillion and -JPY 330 billion, respectively, but the supply and demand climate has improved to the extent of being more-or-less balanced for early 2024. Despite this, JPY has continued to fall since the beginning of the year, so there is very strong suspicion that the exchange rate is literally being led by speculative JPY selling, as the government and the Ministry of Finance have frequently been pointing out. This can also be surmised from the fact that JPY short positions in IMM currency futures trading have reached their highest level in the current phase. This may partly be due to U.S. inflation rates proving more stubborn than expected, but it cannot be denied that speculative JPY selling has also been encouraged by the view that the BOJ cannot raise interest rates out of consideration for government debt repayment.

*Two All-Time Highs Worth Mentioning*

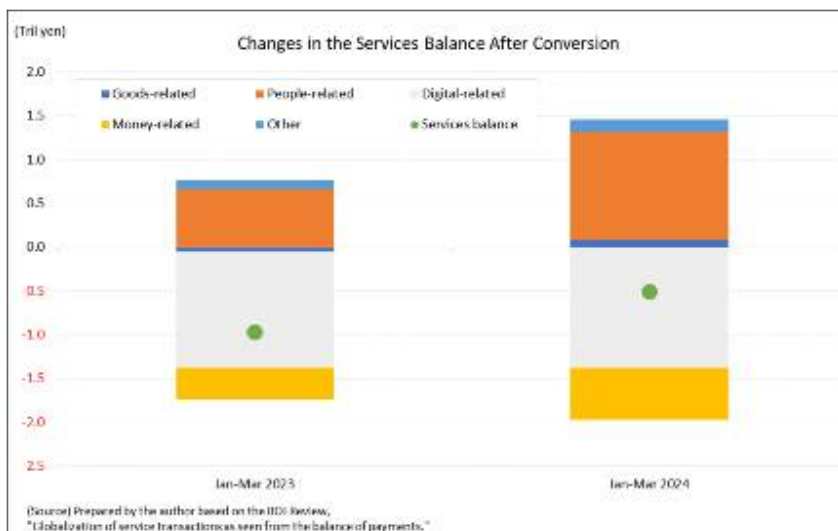
News reports have also been highlighting that Japan’s FY 2023 travel surplus, a driving force behind the current account surplus, posted an all-time high of JPY 4.2295 trillion for a fiscal year. However, as always, the services balance (of which the travel balance is a component) is still in deficit at -JPY 2.4504 trillion. Needless to say, this is the result of the other services deficit (comprising digital, consulting, reinsurance, R&D services, etc.) reaching a record high of -JPY 6.0745 trillion. Without mentioning both the all-time highs that coexist in the services balance, it would be impossible to get an accurate picture of recent developments surrounding Japan’s balance of payments. The travel surplus is the “Yang” part of Japan’s balance of payments, while the other services balance deficit (which I like to refer to as the “new era deficit”) is the “Yin” part. The concern is that the Yang part could plateau in the coming years amid supply constraints accompanying labor shortages, while the Yin part has the potential to continue expanding indefinitely.

Of course, it is good to see that the travel surplus has offset two-thirds of the new era deficit. However, it seems very likely that the new era deficit, led by digital services, will continue growing in the future. The important question is whether the travel surplus can keep up with the other services deficit in terms of the pace of expansion. Incidentally, comparing January-March quarter figures for 2023 and 2024 shows that the services deficit has shrunk from -JPY 974.6 billion to -JPY 509.3 billion, which is owing to the travel surplus doubling from +JPY 661.5 billion to +JPY 1.2957 trillion. However, a simple comparison is difficult because demand for inbound tourism was curtailed under the pretext of border control until March last year. It is from April onward that comparisons ought to be made. Moreover, the other services deficit expanded from -JPY 1.4122 trillion to -JPY 1.5828 trillion, making it difficult to ignore the question of whether the travel surplus can keep up with the other services deficit in terms of the pace of expansion.



*Money-Related Balance Posts First Deficit to Tune of JPY 2 trillion?*

Even assuming, for the sake of argument, that the digital-related deficit will continue at its current pace of about -JPY 5.5 trillion per year, the new era deficit category includes more than just digital services. As the figure shows, the money-related deficit, which includes payments made toward insurance and pension services, is also considerable. Comparing January-March quarter figures for 2023 and 2024, the digital-related balance remained flat at about -JPY 1.3 trillion, while the people-related balance, mainly led by the travel balance, doubled from about +JPY 660 billion to about +JPY 1.2 trillion (as mentioned above, this is an artefact of last year’s ‘isolationist’ policy). However, in addition to these two items, the money-related balance, which includes reinsurance premium payments made to foreign companies, has expanded by over 50% from -JPY 370 billion to -JPY 590 billion. This reflects the increase in foreign-currency-denominated insurance sales in Japan and the increase in insurance premiums due to frequent natural disasters. As with the digital-related balance, there are no plans in place for shrinking the deficit in this area.



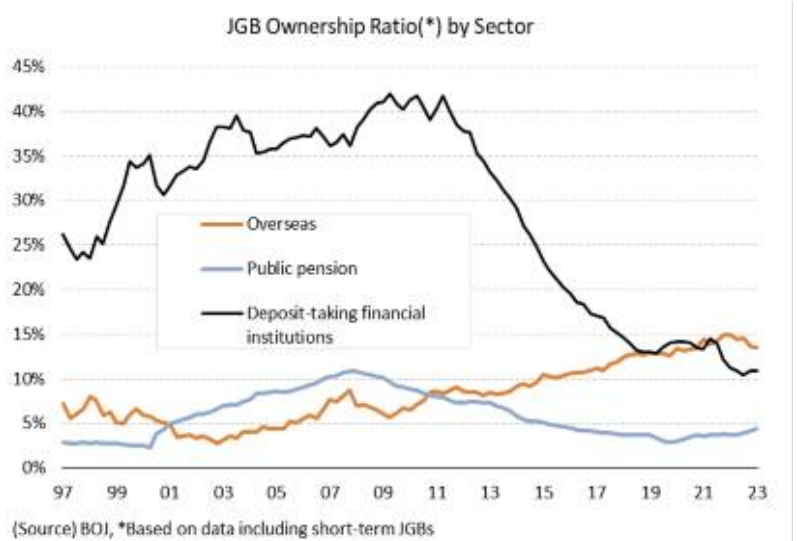
If the money-related deficit continues to grow at its current pace, it could post its first deficit to the tune of -JPY 2 trillion for the entire year. Assuming that the digital-related deficit remains at -JPY 5.5 trillion as usual, the sum of these two deficits would be -JPY 7.5 trillion. Under the current balance of payments structure, this would have to be offset as best as possible by a surplus in the labor-intensive people-related balance, which is not an easy task. I do not object to

focusing on the Yang part of the current account surplus and travel surplus. However, I do think it is wrong to exaggerate it to the extent of creating a climate where any discussion of the new era deficit (the Yin part) gets glossed over. It is important to look beyond the impact of JPY weakness and consider the expansion of the other services deficit as another problem facing the Japanese economy.

### Risks to My Main Scenario – What are the Most Threatening JPY Depreciation Risks?

#### Next Risk Factor Related to Japan’s Fiscal Financial Situation

Although it has fallen from its peak level of roughly USD/JPY160 at the beginning of May, USD/JPY is still in the JPY155-157 range, the highest sustained range seen since the beginning of the year. Most observers are pointing out that JPY’s current weakness stems primarily from such interest-rate and JPY-supply-demand factors as the height of U.S. interest rates and changes in the JPY supply-demand structure. However, I have also been receiving inquiries from overseas about whether Japan’s fiscal financial situation has the potential to be an additional JPY depreciation driver, and I think this point merits a bit of discussion. Almost 90% of Japanese government bonds are held domestically at this time so, even if Japan’s fiscal financial situation becomes perceived as a factor promoting JPY depreciation,

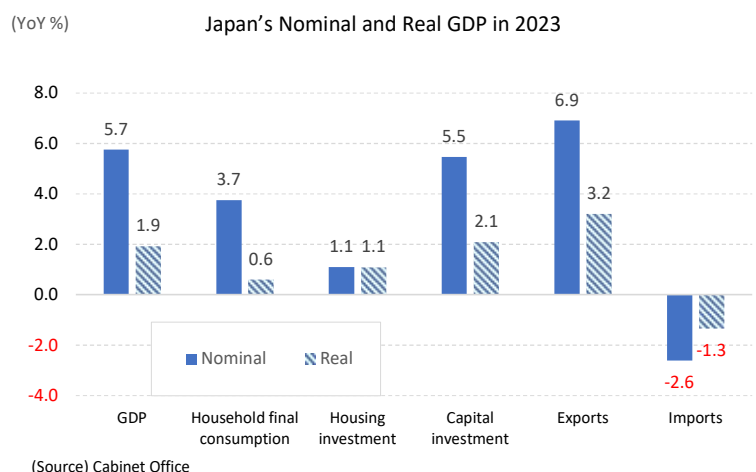


that situation appears unlikely to cause a sustained rise in JPY interest rates. However, the proportion of Japanese government bonds (including short-term government bonds) held by overseas investors exceeded 13% at the end of 2023, a considerable rise from below 5% in the early 2000s. It is apparent that the share of Japanese government bonds held domestically is slowly but surely decreasing. This decrease, combined with the recent weakening of JPY, could conceivably promote a financial market theme positing that the BOJ is fundamentally unable to raise interest rates due to the size of the government’s outstanding debt (≈ the potential need for increased government interest payments).

#### The Inflation Tax Concept

I have no way of knowing exactly what the government and the BOJ are thinking, however, as discussed below, whether intentionally or accidentally, the continued coexistence of high debt, low interest rates, and JPY depreciation appears to be putting Japanese government debt (said to be the largest in the world compared to GDP) on a course to gradually decrease. Let’s review the basic facts. There are three ways for a country’s government to rebuild its finances – 1) cutting expenditures, 2) increasing revenues, and 3) promoting inflation – and none of these are mutually incompatible, so various combinations of multiple methods are possible. In light of Japan’s current situation, one cannot help but focus attention on method 3 – promoting JPY depreciation. In extremely simple terms, it can be said that if domestic prices double, the value of money will be halved, and the value of credits and debts (including government debt) will also be halved. Let me explain in more detail. From the government’s perspective, the doubling of prices means that the household sector will use more of its financial assets to pay taxes in exchange for more-expensive goods and services. This will increase the government sector’s tax revenue and enable an accelerating reduction of the government’s debt balance. Looking at the results from the government’s perspective alone, it would appear that inflation will have improved the government sector’s ability to repay its debt.

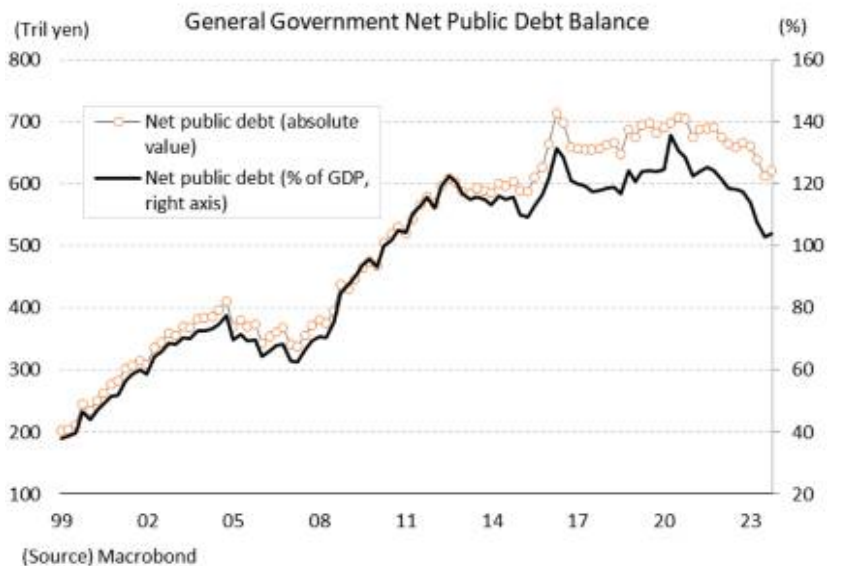
From the household sector’s perspective, however, there will be a willy-nilly decrease in disposable income, and that decrease will be used to repay government debt. That is exactly the same as an ordinary tax increase, and for this reason, the approach of reducing government debt by promoting inflation is viewed negatively as simply being an “inflation tax”. The inflation tax may result from the government’s continued avoidance of ordinary tax hikes and spending cuts understood to be quite unpopular with the public, so a particularly frightening aspect of the inflation tax is that it can proceed regardless of public opinion. Looking at the Japanese economy in 2023, one finds the nominal GDP growth rate was 5.7% but the real growth rate was only 1.9%, less than one-third of the nominal rate. This is consistent with the fact that household final consumption grew by 1.7% in nominal terms, but only 0.7% in real terms, which is almost zero growth. This can also be interpreted as indicating that the inflation tax has prevented any consumption growth in real terms (see graph).





### Increasing Signs of Inflation Tax Recognition

It has been reported that Japan's tax revenues have been on the rise in recent years, and there is a growing body of circumstantial evidence indicating that many financial market players (mainly outside Japan) are enthusiastically supportive of the onset of Japan's inflation tax. Previous editions of this column have repeatedly discussed similar points, and my view has been that, if the external shock of inflation caused by JPY depreciation and the associated rise in import prices is added to the internal shock of nominal wage increases due to labor shortages, Japan's current inflation trend is likely to be sustainable. It is noteworthy that, since 2020, the first year of the pandemic, the Japanese government's net debt has clearly peaked out both in nominal terms and as a percentage of nominal GDP (see graph). Although one cannot be completely certain that this debt level downtrend will be protracted, the downtrend



suggests that, while the BOJ may have negative reasons for not raising (or not being able to raise) interest rates (such as concerns about paying interest on government debt), there may also be positive reasons (such as anticipation that being permissive of JPY weakness will enable fiscal reconstruction to progress). This is all merely speculation, of course, given that it is impossible to accurately read the minds of those in power, but it is quite possible that those in power and other people are already becoming increasingly aware of the inflation tax phenomenon's ramifications. However, one particularly important way this situation may relate to the forex market is that, if it becomes widely believed that politicians are seeking to promote an inflation tax, forex market players may inevitably begin suspecting that the BOJ is not raising interest rates owing to the inflation tax promotion incentive, and this may cause speculative JPY selling to gain momentum. This is a risk scenario that appears unlikely at this point but, given what is currently happening, it seems to be an issue that cannot be dismissed as being completely implausible.

## EUR Outlook – Additional Confirmation of ECB Interest Rate Cut in June

### EUR Area Monetary Policies Now and Going Forward – June ECB Interest Rate Cut Certain, Subsequent Cuts Unclear

#### *June ECB Interest Rate Cut Certain, Subsequent Cuts Unclear*

While there was no ECB Governing Council meeting in May, on May 17, Nikkei published an exclusive interview with ECB Executive Board Member Isabel Schnabel (from Germany)<sup>1</sup>, and that interview is replete with information that may facilitate efforts to anticipate the ECB's prospective policy decisions. Ms Schnabel is an academic economist who is considered to be less hawkish than previous German ECB Governing Council members. There have been repeated cases of hawkish Germans with government or central bank backgrounds becoming isolated within the Governing Council and ultimately resigning before the end of their terms, and this is believed to explain why there has been a shift to nominating Germans with academic backgrounds to high-level ECB positions. Ms Schnabel had a rather hawkish tone in the interview, suggesting that the ECB will find it difficult to make many interest rate cuts, and this is thought to be the ECB consensus view rather than a German perspective.

The first question was – “The markets see a rate cut in June. How fast should things move beyond June?” – and Ms Schnabel responded that – “Depending on the incoming data and our new Eurosystem staff projections, a rate cut in June may be appropriate.” – which is in line with market expectations. However, she avoided predicting subsequent rate cuts, saying that – “[T]he path beyond June is much more uncertain. Recent data have confirmed that the last mile of disinflation is the most difficult.”

On the same day as the Nikkei interview, Reuters reported that Latvian central bank governor Mārtiņš Kazāks similarly acknowledged the possibility of a June rate cut but clearly expressed his opposition to a July rate cut. He was cited as saying that it will be much easier to make rate cut decisions at the Governing Council meetings in June, September, and December, when newly revised Eurosystem staff projections are available. In addition to these recent comments from Ms Schnabel and Governor Kazāks, it should be noted that the ECB has since the January 2024 Governing Council meeting consistently provided forward guidance suggesting that its basic stance will preclude policy changes until the end of May, when the latest staff projections enable a better understanding of trends in price and wage indicators, so it seems that the current Governing Council consensus is that a June rate is certain but no decisions have been made regarding subsequent rate cuts. The second question posed to Ms Schnabel in the Nikkei interview was – “Some of your colleagues have mentioned a rate cut in July. What's your position on this?” – and Ms Schnabel responded that – “Based on current data, a rate cut in July does not seem warranted. We should follow a cautious approach.”

#### *ECB Interest Rate Cuts “Once Every Three Months”?*

The third question in the Nikkei interview was – “[H]ow should the ECB control the speed of interest rate moves beyond summer?” – and Ms Schnabel responded that – “We are facing very high uncertainty, which has also been reflected in market expectations. We have moved from six rate cuts being priced in at the beginning of the year to around three rate cuts now. Due to this uncertainty, it is too early to say what is going to happen and we cannot pre-commit to any particular rate path.” She then mentioned two possible scenarios for the future – a scenario in which wage growth eases, the disinflation process remains on track, and the ECB will be positioned to shift to less restrictive policies, and a second scenario in which inflation remains strong owing to growth in wages and/or new supply-side shocks that disrupt the disinflationary process. Ms Schnabel described the first scenario as “the one underlying our staff projections” and, given that Governor Kazāks also mentioned the relative ease of implementing interest rate cuts when new staff projections become available, there are grounds for suspecting that the ECB may be coming to consider the ideal pace of prospective interest rate cuts to be “once every three months when new staff projections become available”.

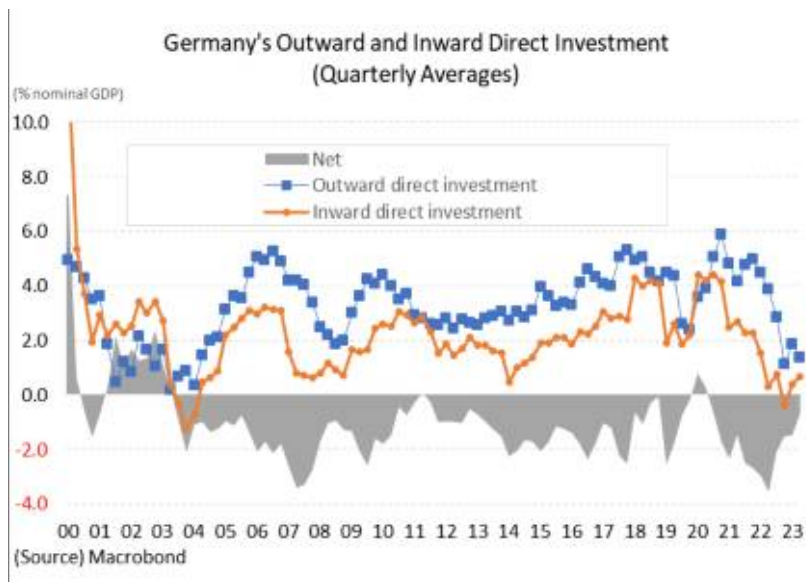
The fourth question in the Nikkei interview was – “So you want a slow pace, and to look very cautiously at the data beyond summer?” – and Ms Schnabel responded that – “We should move cautiously. We should look very carefully at the data because there is a risk of easing prematurely. And we should give ourselves sufficient time to see what is happening.” In light of this, it seems fair to say that, at least for now, the possibility of a rate cut in July is extremely low.

#### *State of German Economy Indicates Need for Better Business Model*

Later in the interview, Ms Schnabel was asked – “Could Germany, a pillar of the European economy, revert to being the “sick man of Europe” as in the late 1990s? Where do you see the European economy five years ahead?” Her response was – “The euro area is facing massive structural change. It's not just the price of energy, it's also the reliability of energy supply.” She emphasized that the energy situation has changed dramatically following the outbreak of war between Russia and Ukraine, requiring the euro area to consider “a new and improved business model”. Ms Schnabel's remarks are particularly relevant to the plight of her own country (Germany), which has been forced to rely on increasingly unstable and expensive energy sources since completing its nuclear phase-out policy.

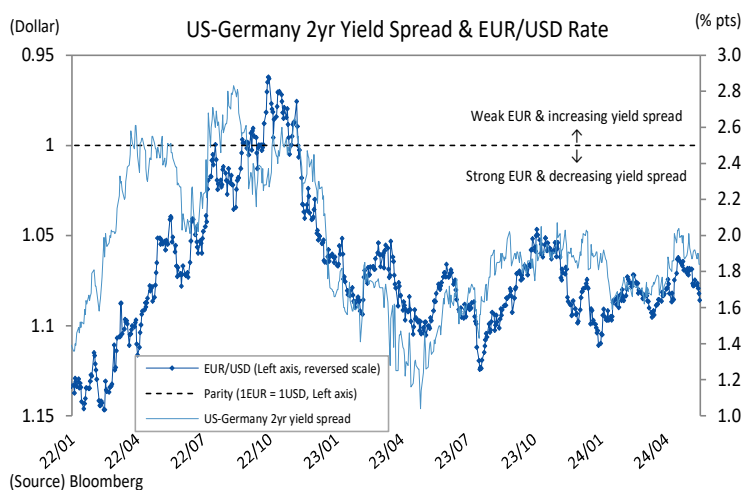
<sup>1</sup> ECB, Interview with Nikkei, “Interview with Isabel Schnabel, Member of the Executive Board of the ECB, conducted by Shogo Akagawa and Takerou Minami on 13 May 2024”. (<https://www.ecb.europa.eu/press/inter/date/2024/html/ecb.in240517~ec83fee254.en.html>)

As discussed in previous editions of this article, there are growing concerns about Germany's industrial hollowing-out process, reflected in that country's inward and outward direct investment trends (see graph). So long as it enjoys the benefits of the euro area's single currency and customs union, it is unlikely that Germany's situation will become as dire as that of Japan, from which manufacturing bases are fleeing and annual trade deficits have become chronic. But when Germany's current situation is compared to the country's 16-year golden age of economic growth under Angela Merkel-led governments, however, the country will inevitably be mocked as having reverted to being the "sick man of Europe". The prospective long-term stagnation of Germany's economy should be sufficient grounds for shifting the ECB's neutral interest rate downward, but this topic was not discussed in the interview with Ms Schnabel.



### EUR Forex Trends

The interview also touched on forex-related topics, and Ms Schnabel was asked about Japan's (presumed) foreign exchange market intervention measures, although she naturally said she couldn't comment about intervention measures or exchange rate levels. As discussed in previous editions of this article, the prospective ECB interest rate cut prior to the Fed's rate cuts is expected to weaken EUR in the future. This point was mentioned during the interview, and Ms Schnabel acknowledged that the ECB's and the Fed's policies have historically tended to move in parallel and that the correlation of policy expectations has been reflected in EUR/USD trends. Trends in the U.S.-Germany interest rate differential clearly determine EUR/USD movements (see graph on previous page), and are an important basis for forex forecasts.

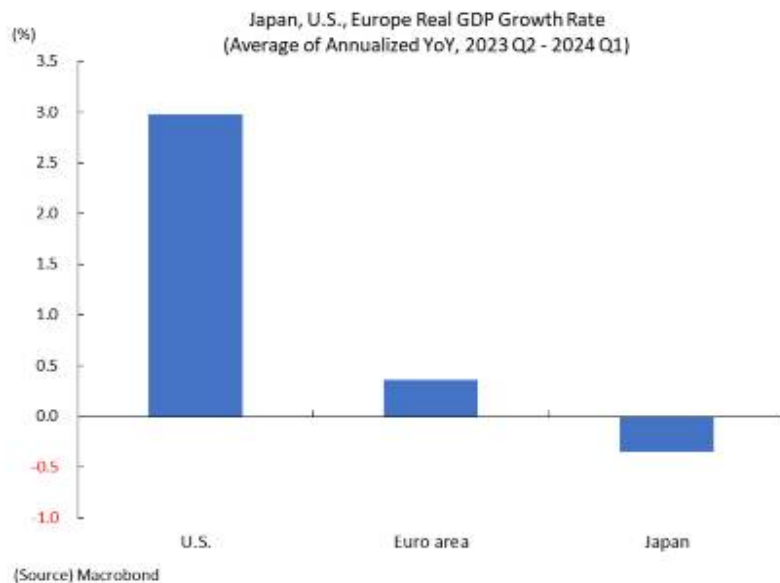


Ms Schnabel was also asked about the impact of EUR depreciation on the euro area's inflation trends and real economy, and her response was that – “We are seeing second-round effects all over the world, and they are still working their way through our economies. Services inflation plays a large role in many jurisdictions. If you look at the euro area, two-thirds of the April inflation were due to services inflation.” Without explicitly saying it, she seemed to imply that a “EUR depreciation → general rise in euro area prices → rise in euro area wage levels” process is operating. The prospective widening of the U.S.-Europe interest rate differential can be expected to push EUR/USD downward, and there is a high possibility that that trend will become a point of contention as it pushes the euro area consumer price index (HICP) growth rate upward.

## Euro Area Economy Now and Going Forward – Inconvenient Truth of Economy’s Bottoming Out

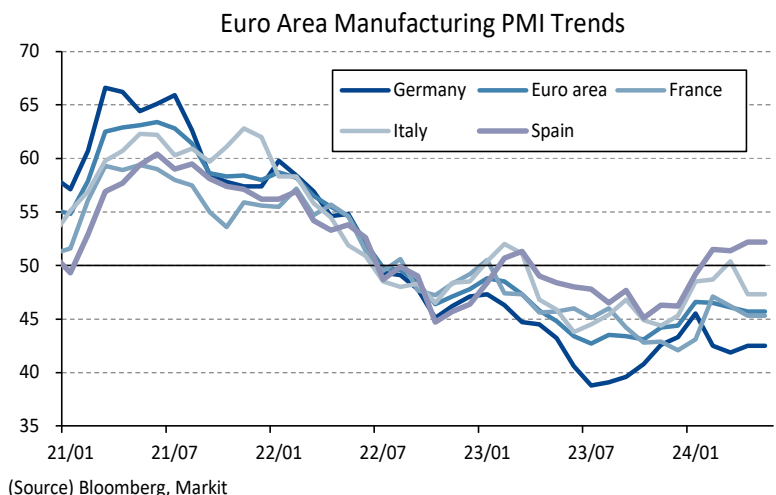
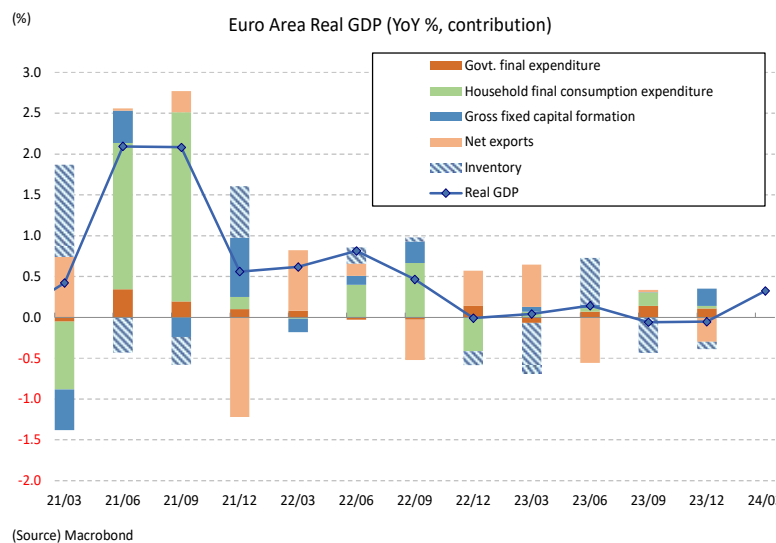
### Nothing Unnatural about ECB Rate Cut Preceding the Fed’s

Even without referencing the Schnabel interview, the available information has pretty much made it a given that the ECB will cut interest rates in June ahead of the Fed. While it is true that this decision to approve a June interest rate cut was made principally in response to the slowdown in the HICP, the ECB has also cited as a reason the fact that the euro area economy is more vulnerable than the U.S. economy. When comparing real GDP growth rates (average annualized qoq rates of change for the four quarters from the first quarter of 2023 through the first quarter of 2024), for example, one finds that the U.S. growth rate was 3.0% while the euro area’s growth rate was 0.4%. It is worth noting that Japan’s real GDP growth rate by that definition was -0.3%, even weaker than the euro area, and it should be apparent that such a weak growth rate puts the BOJ in an extremely tenuous position to further raise interest rates to restrain JPY depreciation. Returning to the comparison of Europe and the United States, the huge difference between the current states of the U.S. and euro area real economies should be clearly recognized. If you focus on inflation rates alone, you may not perceive so much of a difference, but if you emphasize the GDP growth rates, you are likely to consider it quite natural for ECB to cut interest rates before the Fed does.



### Inconvenient Truth of Economy’s Bottoming Out

However, looking at the euro area’s real GDP growth rate for the first quarter of 2024 (the preliminary figure released at the end of April), one finds that the euro area realized 0.3% qoq real GDP growth (corresponding to an annualized rate of +1.3%), regaining positive growth for the first time in three quarters (see graph). In fact, the downward revision of the euro area’s real GDP growth rate for the fourth quarter of last year from 0.0% qoq to -0.1% qoq (all GDP growth figures below are qoq unless otherwise specified) means that the euro area experienced a technical recession in the last two quarters of 2023, but it is somewhat unsettling to see that the euro area economy has bottomed out just as interest rates are about to be lowered. GDP figures by demand component have not been released, but it is noteworthy that all 20 euro area countries recorded positive growth, a pattern not seen in a long time. Particularly significant is the performance of Germany, which regained momentum to +0.2%, from -0.5% in the fourth quarter of 2023. Other countries showing accelerating growth include France (from +0.1% to +0.2%) and Italy (from +0.1% to +0.3%), and Spain also maintained a high growth rate (from +0.7% to +0.7%), so all the euro area’s four major economies recorded strong performances. The euro area economy’s bottoming out has also been reflected in monthly PMI data – although many member states are still below the 50 level (the dividing line between perceptions of economic expansion and contraction), the movements in PMI figures give the impression that the worst has passed (see graph). It is worth pointing out once again that it is difficult for a central bank to begin cutting interest rates in situations when inflation



remains at problematically high levels but the economy is already bottoming out or growing. Thus, the euro area economy's bottoming out may seem like an inconvenient truth to the ECB, which has basically committed itself to implementing a rate cut in June.

### *Will ECB Respond Calmly to Accelerating Negotiated Wage Growth?*

At the time this article was written, ECB Executive Board Member Isabel Schnabel and many other ECB officials were emphasizing a stance that “a rate cut is certain in June but no decision has been made about subsequent cuts” (although there are some officials who are calling for a rate cut in July). This may be because they are somewhat aware of the unfortunate consequences of committing to a rate cut in June. In hindsight, it seems that, because the ECB has overemphasized from January the point that “the status quo will be maintained until the end of May, when the up-to-date wage statistics become available”, the financial markets have casually factored in the idea that a rate cut will definitely occur in June.

On May 23, the ECB released the first quarter 2024 negotiated wage figures, which are an

extremely important basis for predicting the ECB's “next move”. The negotiated wage growth rate accelerated for the first time in two quarters, to +4.69% compared to the same period of 2023, and the upward deviation from the increasingly important leading indicator of advertised job wages (averaging about +4.00% in the first quarter) was also noteworthy (see graph). At this point, it appears quite unlikely that the anticipated June 6 Governing Council meeting interest rate cut will be postponed, but it seems highly likely that at the post Governing Council meeting press conference ECB President Lagarde will unambiguously deny the possibility of an additional rate cut in July. It is nevertheless likely that, at the press conference, President Lagarde will continue to emphasize that, even if a July timing is uncertain, the ECB's “next move” will be another rate cut.

This can be seen from an ECB blog post entitled “Tracking euro area wages in exceptional times” that was published on the same day as the negotiated wage statistics were released. The blog begins with the conclusion that, despite the above-mentioned movements in negotiated wages – “overall wage pressures have moderated since 2023” – and it later points out that – “Given the staggered, infrequent and decentralised nature of wage-setting in euro area countries and the relatively long duration of wage contracts (two years on average), negotiated wage growth reacts only sluggishly to changes in economic conditions and shows a high level of persistence.” Based on this conception of negotiated wage growth, the blog post's basic theory appears to be that the temporary high level of negotiated wage growth is a technically explicable phenomenon rather than a major problem. In short, the blog's message is that the accelerating rise of negotiated wages in the first quarter of 2024 is within the scope of expectations and should not affect the overall trend of the ECB's prospective interest rate cuts. More specifically, the blog's analysis is that the first quarter negotiated wage growth rate uptick reflected a drop in ad hoc one-off payments (aimed at compensating employees for the increase in inflation that was not expected when the previous wage agreements were reached) and does not indicate an uptrend in the negotiated wage growth rate.

In addition, the blog mentions that the wage tracker the ECB is currently developing suggests that wage growth will slow in 2024 and explains that data from the ECB's Survey on the Access to Finance of Enterprises (SAFE) conducted in April indicates that the wage growth rate expected by companies is also decelerating. Considered an extremely useful basis for predicting ECB decisions, the ECB's euro area wage tracker is currently only for use within the ECB – although the wage tracker is used as an important basis for the ECB Governing Council's decision-making, the wage tracker database has not been made public. However, the blog post provides important information in this regard, stating that the wagetracker data will be made publicly available on a regular basis from the second half of 2024.

### *Delicate Relationship between the ECB Blog and the ECB Governing Council*

When one calmly considers the nature of negotiated wages, the blog post's argument that the recent negotiated wage growth acceleration was a temporary phenomenon is quite persuasive. However, the fact that that the blog post's publication timing appears to have been designed to coincide with the release of first quarter negotiated wage data is somewhat more controversial. It is hard not to suspect that the blog post reflects the ECB's intention to intervene before the financial markets prematurely factor in mistaken expectations about prospective ECB decisions. Incidentally, this is not the first time that the ECB has used the ECB Blog to disseminate important information regarding policy decisions. Exactly two years previously (May 23, 2022), a blog post published in the name of President Lagarde boldly announced the early end of the Asset Purchase Programme (APP) and an accompanying interest rate hike move in July 2022, and even announced the end of negative interest rates in the third quarter of that year. It was considered extremely unusual that such important prospective changes were announced via a blog post written by the ECB President even though there was a regular Governing Council meeting scheduled to be held two weeks later. Within her blog post, President Lagarde explained her decision to use a blog post format, saying – “[A]s the expected date of interest rate lift-off draws closer, it becomes more important to clarify the path of policy normalisation that lies ahead of us – especially given the complex environment that monetary policy in the euro area is facing. This is the purpose of my blog post today.” Frankly



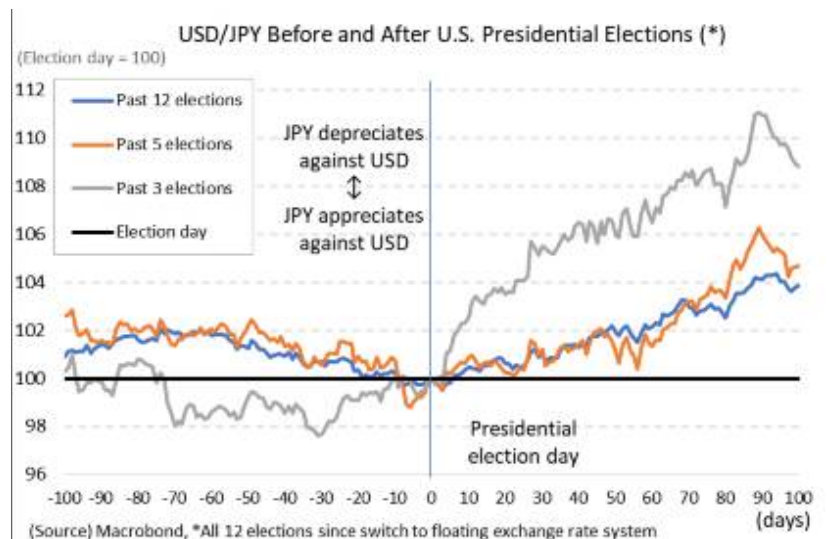
speaking, however, most people probably would argue that such information should be provided via the official Governing Council meeting's statement.

The most recent blog post is not as detailed as the post published two years ago, but it is merely a staff analysis not attributed to the ECB president, and it is also accompanied by a proviso stating that –“The views expressed in each blog entry are those of the author(s) and do not necessarily represent the views of the European Central Bank and the Eurosystem.”. Nevertheless, it has been emphasized since the beginning of the year that the first quarter negotiated wage trend will be an important basis for ECB policy management decisions made from June onwards, so that trend has attracted a lot of attention in the financial markets. It could be argued that it was kind of the ECB to publish a blog post on the day the first quarter negotiated wage trend data was announced to help people properly interpret that data, but the use of a blog post in this way also seemed to infringe on or undercut the role of the Governing Council. The blog post also mentions that the ECB wage tracker is used by the Governing Council as a basis for decision-making, so it could be argued that publishing the blog post on the same day as the Governing Council meeting would have been more appropriate. If the ECB's stance is that it will not hesitate to disseminate extremely important information through its blog even regarding matters related to Governing Council decisions, then the importance of the Governing Council will inevitably be reduced. Since President Lagarde appears committed to employing this information dissemination method, however, it will be necessary to closely monitor both the Governing Council and the blog posts as one seeks to forecast prospective ECB decisions.

## Supplement: Euro Area Risk Scenarios – Potential Debt Crisis Associated with “What If” Scenarios

### “What If” Scenarios Promote European Rapprochement with China

As the U.S. presidential election approaches, people are increasingly speculating about how that election may impact financial markets. Regarding USD/JPY, it is generally understood that, in light of past events since the transition to a floating exchange rate system, the election is likely to cause JPY to weaken and USD to strengthen (see graph). This is a fairly clear pattern that I also take into consideration when preparing my forecasts. Regarding issues other than USD/JPY, however, there are ample grounds for concern about how Europe's political and financial stances may change if Donald Trump is re-elected, so many people have begun actively pondering “what if” (what if Trump is re-elected) scenarios. More specifically, many people view Trump's re-election as a factor that could cause fundamental changes to the European security framework, and there is considerable circumstantial evidence indicating that this suspicion is probably correct. There is a wide range of related issues – for example, there have already emerged ministers in the German government who are citing a need for nuclear armaments. Rapprochement with China and increased defense spending are particularly noteworthy issues expected to attract great attention in Europe in the case of Trump's re-election.



European efforts to reestablish closer relationships with China are already becoming more proactive. Most recently, Chinese President Xi Jinping on May 6 visited Paris to participate in a meeting with French President Macron and European Commission President Ursula von der Leyen, at which President Macron stated – “The future of our continent depends very clearly on our capacity to continue to develop a balanced relationship with China” – and this statement attracted attention as a symbol of efforts to improve diplomatic relations between Europe and China. There had been considerable speculation that Xi Jinping's recent visit to Europe was intended to draw the EU – already considered generally antagonistic to Trump – into his camp, and comments made by important figures after the meeting seemed to confirm such an intention. Trump's prospective reelection is seen as an opportunity for China to drive a wedge into U.S.-European relations, while for Europe, it is seen as an opportunity to work with China to restrain the Russia-Ukraine war (and ideally bring about a ceasefire). Regarding the latter point, Commission President von der Leyen stated – “We count on China to use all its influence on Russia to end Russia's war of aggression against Ukraine.” As discussed below, one of the most important risks Europe will face if Trump is re-elected relates to a need to increase defense spending, which could exacerbate debt problems within the region. It appears that establishing closer relations with China is the approach to restraining Russia most likely to succeed.

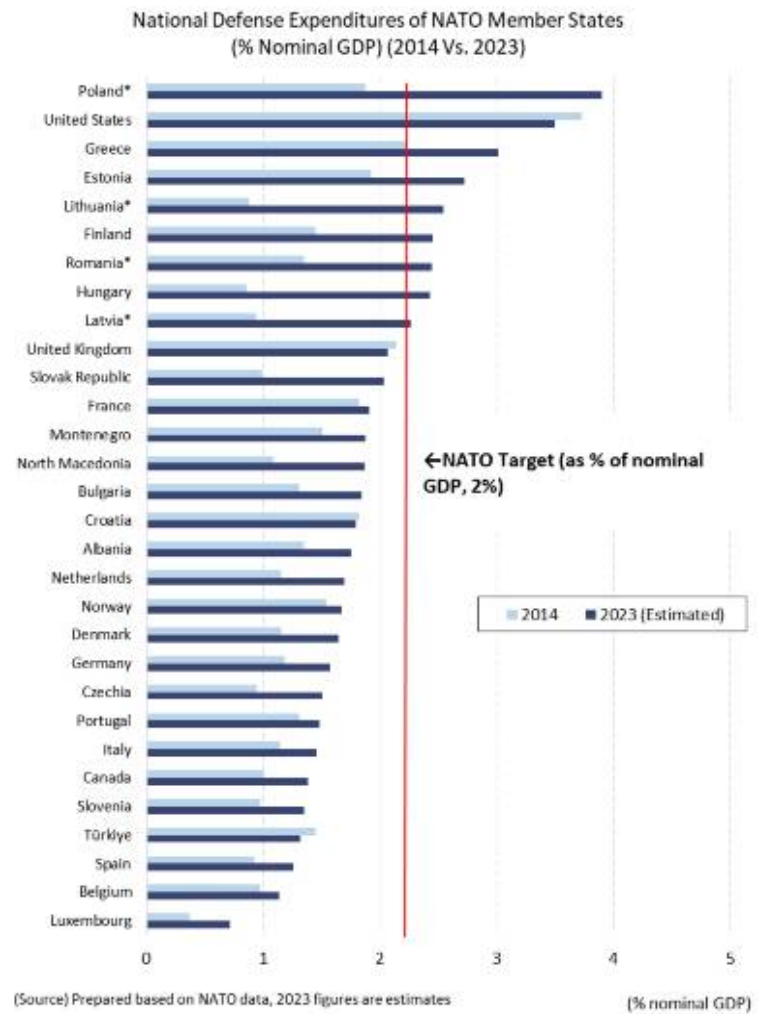
It is easy to understand Europe's view that it may benefit more from making good use of relations with China and working to curb defense spending than from dealing with Trump, who is likely to be placing strong pressures on Europe regardless of the associated costs.

### Stubborn Problem of Europe Being a “Free Rider”

From the perspective of financial markets, the issue of potential defense spending increases is worth closely monitoring. Rather than being a new situation attracting attention in the context of Trump's potential reelection, this issue arose during the President Trump's first term in office. A Trump re-election can naturally be expected to lead to trade frictions

associated with the imposition of tariffs and non-tariff barriers on trade and services transactions, but the major impact defense spending can have on a country's fiscal finances makes it equally likely to attract keen attention from financial markets. Moreover, unlike the era of the previous Trump administration, we are now in the midst of the Russia-Ukraine war, so each European country's need for defense spending is already increasing. This issue is likely to become even more of a hot topic going forward.

Since his previous term in office, Trump has repeatedly criticized European countries for not shouldering sufficient defense costs and thereby shifting the burden onto the United States. Incidentally, it has been widely reported that Trump has since 2016 made statements suggesting the United States might abandon its NATO treaty commitments and not come to the defense of those countries that do not meet the alliance's guidelines by committing 2% of GDP to military spending<sup>2</sup>. The Russia-Ukraine war that began in 2022 is expected to be protracted, and it is generally understood that the U.S. is shouldering a disproportionate share of military expenditures related to that war, so it should be clear that the impact of future Trump moves to decline to implement NATO collective defense commitments is likely to be considerably greater than similar moves during his previous term in office. The United States' defense expenditures have long exceeded 3% of its nominal GDP and, as the graph shows, the level of those expenditures as a share of GDP has not changed much over the past decade. On the other hand, such major European G7 countries as Germany, France, and Italy have never spent more than 2% of their GDP on military spending. In light of this situation, Trump has been saying that it is unacceptable for the United States to be forced to bear a disproportionate share of military spending necessitated by strife between Europe and Russia. It is worth noting that the issue of European "free riding" with respect to NATO military spending requirements has been a point of contention since the Obama administration – it is more deeply rooted than one might imagine based on reports focused on Trump's recent remarks.



### Europe's New-Normal Defense Spending Levels

Assuming that Trump will be re-elected and that he may even reduce U.S. support for Ukraine if Europe does not shoulder its fair share of the burden, European countries are likely to be forced to augment their defense spending. Already, this past February, German Chancellor Olaf Scholz declared his intention to raise Germany's defense spending to above the NATO member states' 2%-of-GDP target level. At that time, he said – "Not only the United States, but all European countries must do even more to support Ukraine." – and that can be interpreted as being designed to prepare for the situation Germany will face if Trump is re-elected. It is worth noting that German Defense Minister Boris Pistorius this past January said that Germany should prepare for the possibility that Russia might attack NATO within the next five to eight years and, in April, Bundeswehr Inspector General Carsten Breuer made a similar statement regarding the possibility of an attack within the next five to eight years. In February 2022, German Chancellor Olaf Scholz announced the creation of a special EUR100 billion fund for strengthening Germany's armed forces, and it has been made clear that this will be utilized from 2024. Germany has already increased its defense spending 44% –from EUR39.3 billion in 2014 to EUR56.6 billion in 2023 (based on real values in 2015) – and its ratio of defense spending to nominal GDP has risen from 1.19% to 1.57%. It is believed that Germany's ratio of defense spending to nominal GDP will reach 2% for the first time from 2024, when contributions from the special fund are included.

Following Germany's lead, Poland has announced plans to raise its defense spending to nominal GDP level to 3%, and Sweden and Denmark have also declared their intentions to aim for 2% levels. At a press conference on February 14th this year, NATO Secretary General Jens Stoltenberg announced that 18 of the 31 NATO member countries expect to achieve the 2% target by 2024, and he referred to this situation as being Europe's "new normal". This seems to be a quite realistic characterization.

<sup>2</sup> On February 10, 2024, at a campaign rally in South Carolina, Trump stated that during his previous term in office he was asked by a NATO member state leader if the United States would not defend member states that do not contribute adequately to military expenditures if they were attacked by Russia, to which he replied that – "No, I would not protect you. In fact, I would encourage [the Russians] to do whatever the hell they want." (<https://www.pbs.org/newshour/politics/fact-checking-trumps-comments-urging-russia-to-invade-delinquent-nato-members>)

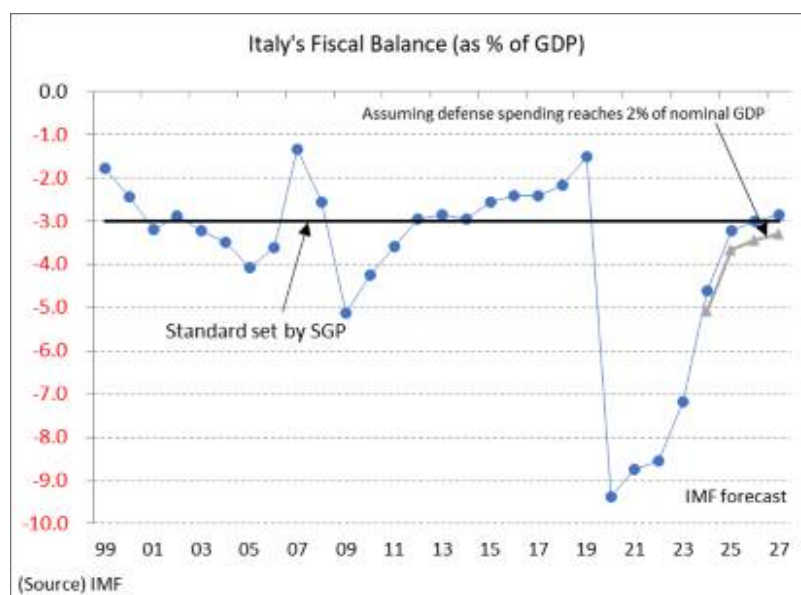
### Potential Italian Debt Crisis

It is possible that, after further assessing the situation, Trump may become less demanding about European countries' military spending levels, and it would be best if problems associated with those spending levels can be avoided, but Trump is generally acknowledged to be disinclined to back down on issues he considers important. Moreover, there is still room for U.S.-Europe antagonism over the fact that, while European countries may be belatedly approaching their 2% military spending levels, U.S. military spending levels have long been consistently above 3%. The defense spending target as a percentage of nominal GDP for individual NATO member countries set at the 2023 NATO summit was expressed as "at least 2%", so it is possible that Trump will not be satisfied with countries merely complying with the 2% minimum standard. In fact, Mark Esper, who served as Secretary of Defense in the first Trump administration, expressed concern about this point in a recent interview with the Nihon Keizai Shimbun<sup>3</sup>. The claim that Japan should shoulder the same burden as the United States seems reasonably justified, so it is quite conceivable that Trump could seek to bring Japanese military spending up to levels comparable to those of the United States.

Raising military spending to 2% of GDP in a single year is meaningless, so attention will be focused on whether countries can sustain military spending at levels above 2% throughout the all four years (2025-2028) of the prospective Trump administration. The overall amount of military spending required may well increase depending on the state of the war in Ukraine, so there is a great deal of uncertainty. If the United States were to reduce its own spending on Ukraine's defense under the next Trump administration, there are concerns that a greater share of the burden of supporting Ukraine's defense would be shifted to European countries, which is a concrete reason for forcing European countries to increase their military strength at this stage.

The problem is that there is no guarantee that all NATO countries will be financially capable to withstanding the challenges associated with increasing military spending, and the financial markets' attention is being focused on whether increased military spending may promote debt crises and other chaotic conditions. Unfortunately, the Stability and Growth Pact (SGP; the EU fiscal framework that was suspended during the COVID pandemic) is scheduled to be applied once more from 2024, so the previous SGP requirements for (1) restraining annual fiscal budget deficits to less than 3% of GDP and 2) not allowing total public debt to exceed 60% of nominal GDP have been reinstated. If countries are forced to implement additional fiscal expenditures, they may thereby violate the SGP requirements, and the European Commission's reprimanding of those countries can be expected to cause chaotic conditions in the bond market. As is often the case, Italy is likely to be the leading example of such problematic countries.

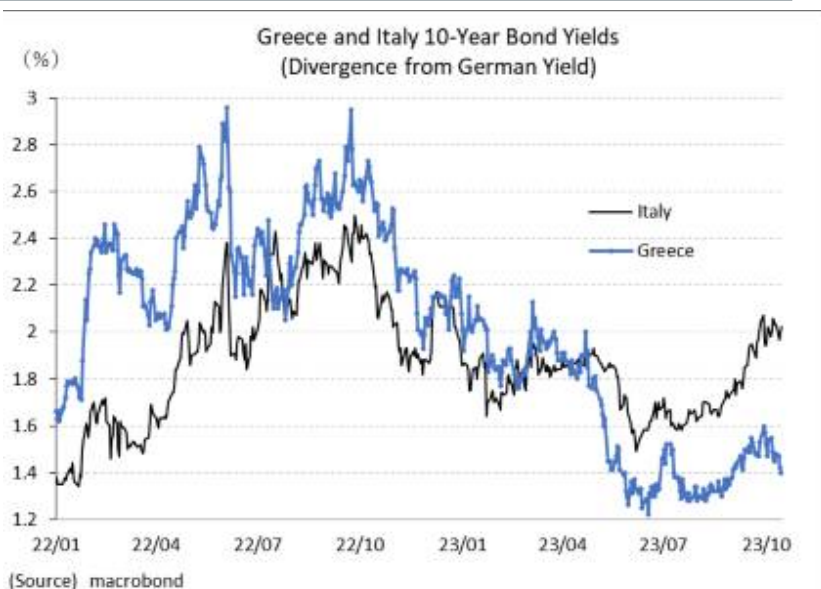
Like Germany, Italy has considerably increased its defense spending, which has risen by about 37%, from EUR20.8 billion in 2014 to EUR28.6 billion in 2023 (based on real amounts in 2015), and its ratio of defense spending to nominal GDP has also risen, from 1.14% in 2014 to 1.46% in 2023. However, Italy does not have a special fund for strengthening its armed forces like that of Germany, and it is not on track to reach the 2% military spending level. Based on NATO calculations, if Italy were to have created a defense budget corresponding to 2% of its nominal GDP in 2023, it would have needed to increase its overall spending by about EUR10 billion. Even without such additional defense spending, however, Italy's fiscal deficits have long been surpassing the SGP limits, reaching 7% in 2023, more than double the average for the 27 EU countries (approximately -3.5%; see graph on previous page), and the country is currently being subjected to fiscal discipline violation procedures by the European Commission. Although the IMF's April forecast projects a steady reduction of Italy's fiscal deficit, that deficit is expected to continue surpassing the SGP limits, amounting to 4.7% in 2024 and 3.2% in 2025.



<sup>3</sup> While praising the Kishida administration for clarifying that it will increase defense spending to 2% of nominal GDP, Esper said – "The fact that Japan is moving to increase spending to 2% is significant, but the key question is whether the former president will continue to think that 2% is sufficient." – and added that it should be noted that NATO has "changed the wording to 'at least 2%'." April 5, 2024, Nikkei Asia; "Trump could ask Japan to spend over 2% of GDP on defense".

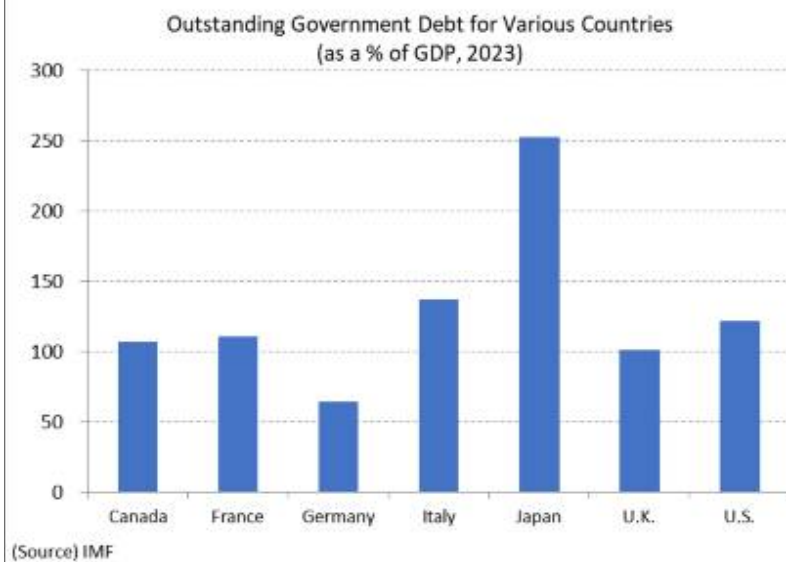


Unless the European Commission deems Trump's reelection and associated security threats be exceptional situations meriting a suspension of SGP requirements (as was done during the covid pandemic), it will not be realistic at this time to expect Italy to increase its annual fiscal spending by EUR10 billion going forward. Reflecting these circumstances, the divergence between Italian and German government bonds is already significantly larger than the divergence between Greek and German government bonds (see graph). Moreover, the maintenance of Italy's long-term issuer rating at "Baa3 (equivalent to triple B minus)" by a major U.S. rating agency last November prevented Italy from becoming the first G7 country to have its bonds downgraded to speculative grades, and that decision became a hot topic in financial markets. Currently, the outlook for the Italy's issuer rating has been raised from "negative" to "stable", but this prospective rating could also be in danger depending on Trump's actions going forward. If Italy increases its defense spending and becomes the first G7 country to have its credit rating downgraded to speculative grades, it will definitely be covered by news media as a major event with great ramifications.



### *Japan Not Immune to Similar Pressures*

The above scenarios that suggest a potential for an additional European debt crisis are based on speculation related to the likelihood of Trump's reelection, subsequent demands for increased defense spending, the reduction of U.S. aid to Ukraine, and the exacerbation of the war in Ukraine. If EU members (particularly those members that already have high levels of debt) were to be forced to increase their military spending, it is possible that Italy would become the first G7 country to have its government bonds downgraded to speculative grade, and the ECB would be forced to resolve that situation. If inflation rates remain high and the ECB does not consider itself to be positioned to lower interest rates, the ECB's policy environment would become quite restrictive. Moreover, this situation has potential ramifications with respect to Japan. If Trump's efforts to force Europe to increase defense



spending cause an Italian debt crisis, Japan may become considered to have the potential for suffering a similar crisis. Of course, since Italy and Japan have completely different government bond marketing structures, it is not appropriate to view the two countries in the same light. However, Japan has a larger government debt balance than Italy (see graph on previous page), so there will inevitably be suspicions that Japan has the potential to suffer a crisis similar to Italy's prospective crisis. Japan's Kishida administration has already approved a policy aimed at boosting the country's defense spending to 2% of GDP in fiscal 2027 but, as mentioned above, there is no guarantee that merely attaining the 2% level will be acceptable to Trump. It is also important to keep in mind the possibility that security concerns in Europe may eventually cause the "what if" speculation currently focused on Europe to encompass Japan as well. Given that fiscal financing concerns are already considered a major risk factor with the potential to vigorously promote JPY depreciation, the spread of "what if" speculation to Japan could cause a strong forex market trend, so it will be worth closely monitoring this situation going forward.

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