MIZUHO | Innovating today. Transforming tomorrow.

Forex Medium-Term Outlook

February 28, 2025

Overview of Outlook

USD/JPY showed a clear decline in February. With a sudden increase in expectations for an additional interest rate hike by the BOJ, the markets seem to be getting into the mood for placing all their bets on a BOJ rate hike. With expectations of an interest rate cut by the FED being by no means strong, are speculative moves such as placing all bets on a BOJ interest rate hike sustainable? To be honest, the risks seem high. It is true that signs of a U.S. economic slowdown began to appear in February. However, the signs could also be taken to indicate stagflation concerns, which suggests that U.S. interest rates may remain high. Is it wise to continue buying JPY on the assumption that the U.S.-Japan interest rate differential will shrink significantly during the forecast period? I think great caution is required. Speculative JPY buying is approaching the peak level seen last summer, but I expect that this position will be unwound as expectations of a BOJ interest rate hike fade, resulting in another reversal of the USD/JPY trend. Looking at the current state of the Japanese economy, inflation resulting from JPY weakness is clearly an obstacle to real growth, so a rate hike is certainly justified as a prescription for the malaise. For the time being, there also seems to be strong political backing for this. However, the political stance could quickly reverse to curbing rate hikes depending on public opinion, so the situation is still unpredictable. On the supply and demand side, household JPY selling is still robust, so even if Japan's balance of payments improves slightly, no change in the structure of excess JPY selling seems likely. Overall, there is no change in my forecast scenario regarding the risk of JPY depreciation in the second half of the current forecasting period.

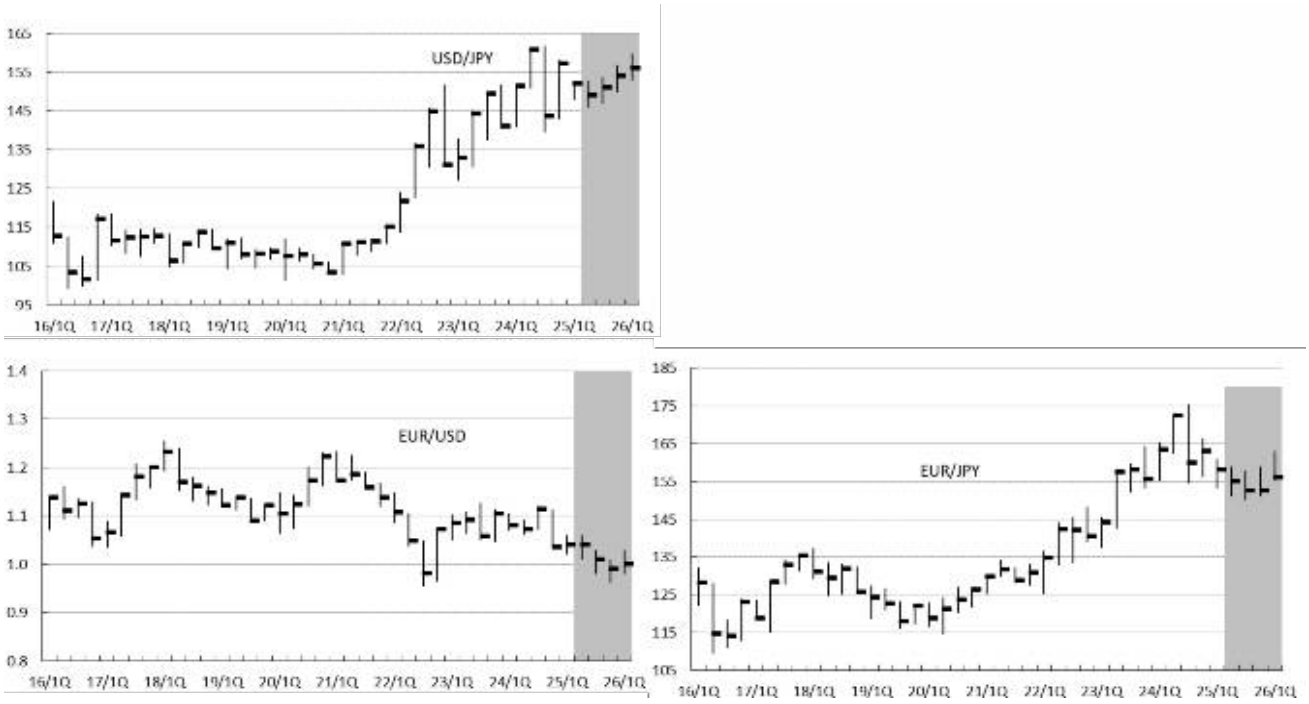
EUR remained firm in February. This was not the result of a positive evaluation of the euro area's economic and financial situation, but rather a victory by fluke amid concerns about the U.S. economy, which pushed down U.S. interest rates and triggered USD selling. The political and economic situation in the euro area remains unfavorable, and there are fears that it will inevitably import unwanted inflation as a result of the Trump administration's tariff policies and the EU's retaliatory tariffs in response. Given the current state of the regional economy, markets do expect interest rates to be cut below the neutral rate (around 2%), but the ECB may try to hold off on cuts due to concerns about EUR depreciation and the resulting rise in inflationary pressure. Ultimately, though, I expect the ECB will be forced to make an appropriate rate cut in response to deteriorating fundamentals. Further, the closely watched German federal elections ended as expected, in an outcome that poses difficulties for forming a government. Forming a coalition that can break the particularly problematic energy-policy deadlock while excluding the far-right party, which has the support of the people, seems particularly difficult. As a result, concerns about the long-term stagnation of the German economy will remain. Given the current political and economic situation, it seems unlikely that EUR can sustain a victory-by-fluke trend.

Summary Table of Forecasts

	2025 Jan-Feb (Actual)	Mar	Apr-Jun	Ju-Sep	Oct-Dec	2026 Jan-Mar
USD/JPY	148.56 ～ 158.88 (149.35)	148 ～ 153 (152)	146 ～ 153 (149)	147 ～ 154 (151)	150 ～ 157 (154)	153 ～ 160 (156)
EUR/USD	1.0125 ～ 1.0534 (1.0402)	1.02 ～ 1.06 (1.04)	1.01 ～ 1.06 (1.04)	0.98 ～ 1.03 (1.01)	0.96 ～ 1.01 (0.99)	0.98 ～ 1.03 (1.00)
EUR/JPY	155.85 ～ 164.52 (155.32)	153 ～ 161 (158)	151 ～ 159 (155)	150 ～ 158 (153)	151 ～ 159 (152)	155 ～ 163 (156)

(Notes) 1. Actual results released around 10 am TKY time on 28 February 2025. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts

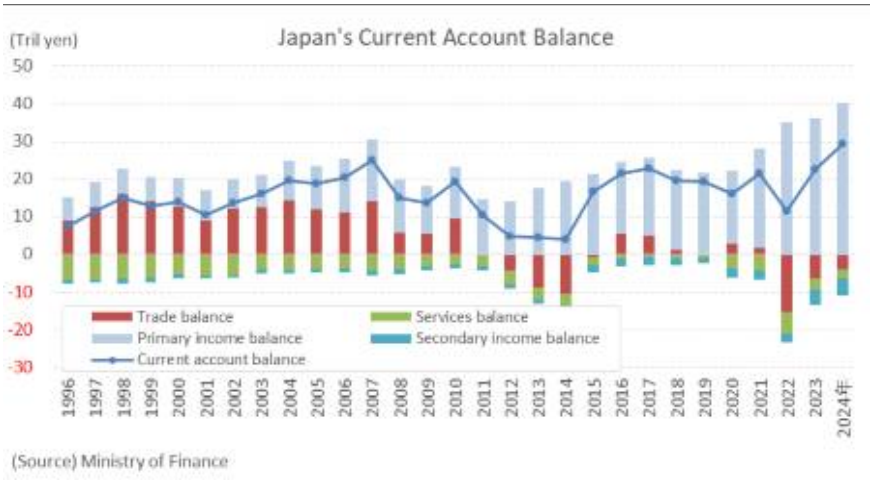


USD/JPY Outlook - JPY Appreciates Amid Risky Wholehearted Bet on BOJ Rate Hike

Supply-Demand Climate Behind JPY Rate Trend – Toward an Era of JPY10-Trillion Services Deficit

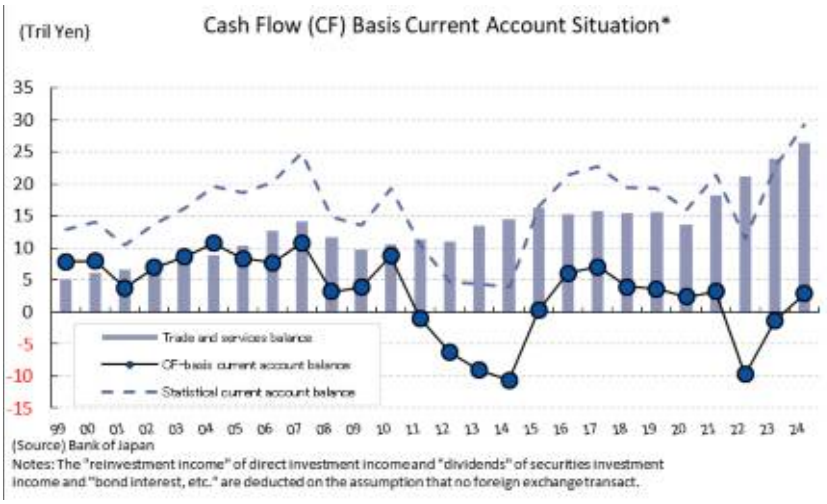
Limited Benefits for Residents of Mature Creditor Nations

Since the release of Japan's balance of payments statistics for all of 2024 on February 10 by the Ministry of Finance, I have been receiving a large number of inquiries about the current state of affairs and issues going forward. I would, therefore, like to present a summary of the issues from my perspective. In last month's edition of this report, I presented an estimate of Japan's services balance through the year 2030 based on cumulative data for January-November 2024. This time, I would like to update my estimate based on the latest figures.



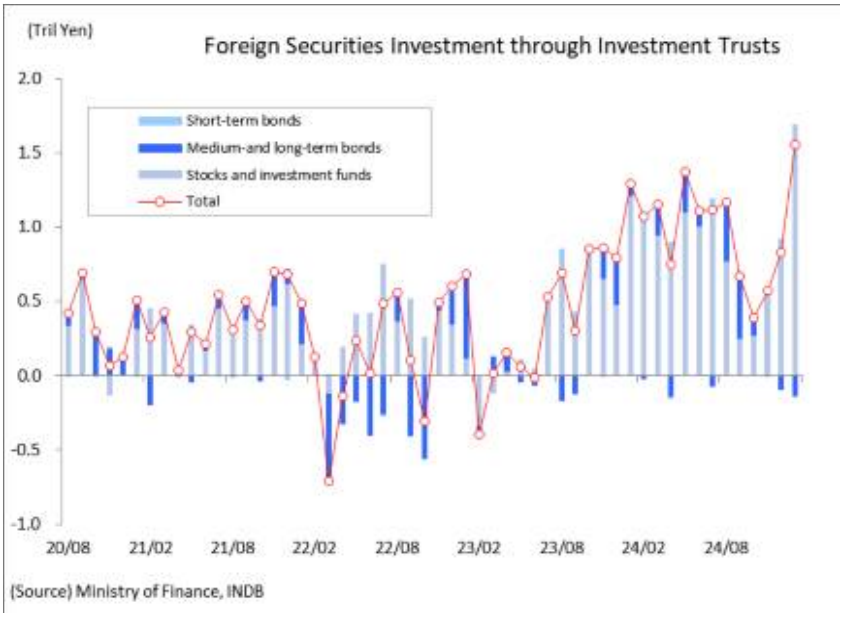
First, the current account balance for 2024 added up to +JPY29.2615 trillion, the largest since 1985, the earliest year for which current account balance statistics are available for comparison. This easily surpasses the previous largest surplus, which was for 2007 (+JPY24.949 trillion). However (see graph), while over half of the 2007 current account surplus (+JPY14.1873 trillion) was owing to the trade and services surplus, the 2024 current account surplus is entirely owing to the primary income surplus (+JPY40.2072 trillion). The 2024 trade and services deficit is the smallest deficit in the past three years, but it is still a historically large deficit (at -JPY6.5152 trillion). Incidentally, this is the first time Japan's primary income surplus has topped the +JPY40 trillion mark, making it the largest ever. It is increasingly evident that Japan has transitioned into a "mature creditor nation," earning through investment rather than trade, but the problem is that the people of Japan are unable to fully enjoy the benefits of these earnings. Since this is a point I have emphasized numerous times in this report through discussions of the current account balance on a cash-flow (CF) basis, I will refrain from going into the details this time.

Largest Ever Discrepancy Between Statistical vs. CF-Based Current Account Balance



From the perspective of whether an actual forex transaction will occur, it goes without saying that the trade and services balance is of greater importance. In this regard, it is imprudent to ignore the changes in the international balance of payments structure as the backdrop to the recent JPY depreciation. As I have repeatedly argued, by focusing on the CF-based current account balance, which is calculated by deducting flows that are likely to be reinvested in foreign currency, such as reinvested earnings and portfolio investment income, from the primary income balance, it is possible to maintain an analytical stance that is not misled by the size of the statistical surplus. As this analytical perspective has already gained acceptance in the forex market, I will refrain from explaining it here again. Please refer to my book *The Truth of JPY Weakness – Japan Masquerading as a Current Account Surplus Nation* for a more detailed discussion of this issue. As for 2024, the CF-based current account balance was roughly +JPY2.9 trillion, the first surplus in three years. Considering that it was -JPY9.7 trillion in 2022 and -JPY1.3 trillion in 2023, there is no doubt that JPY supply and demand is on the mend. However, it is also worth noting that the discrepancy between the statistical and CF-based current account balances is at its largest (approx. +JPY26.4 trillion) for 2024.

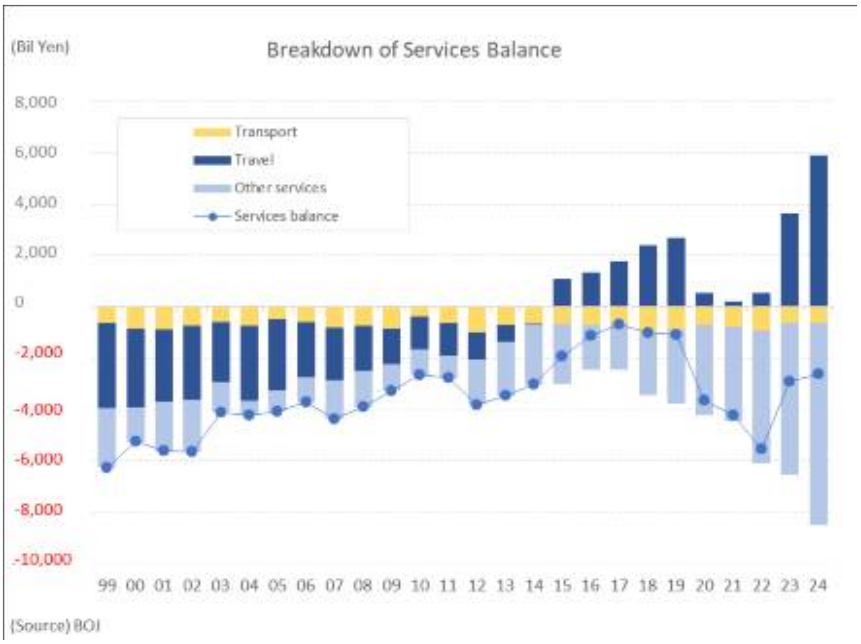
Incidentally, this discrepancy has been breaking records for four consecutive years since 2021. Although the discrepancy itself does not have a theoretical significance, the pattern is consistent with the average resident's experience, in that while corporate profits from overseas assets are on the rise owing to JPY weakness, the domestic returns (i.e., to domestic workers) are not commensurate with these profits. Of course, the inflated overseas profits are likely to be priced in as increases in the stock prices of the companies in question. In this sense, the government and ruling party's aim of making Japan an asset management nation is commendable, as the average person can enjoy the benefits of these higher share prices by investing in stocks.



In this regard, it is worth noting that the January foreign securities investment via investment trusts, which was released at the same time as the balance of payments statistics, was a record-breaking +JPY1.6 trillion or so. The strong U.S. economy and the associated high U.S. interest rates and USD are fueling JPY selling by the household sector on a scale that cancels out any improvement in JPY supply and demand in the current account balance (see graph). If the CF-based current account balance posts a surplus of about +JPY3 trillion, foreign securities investment via investment trusts due to the launch of the new NISA scheme, and foreign direct investment flows from Japan seem likely to contribute to sustaining a net sale of JPY.

Clear Structure of Digital Deficit vs. Travel Surplus Emerging

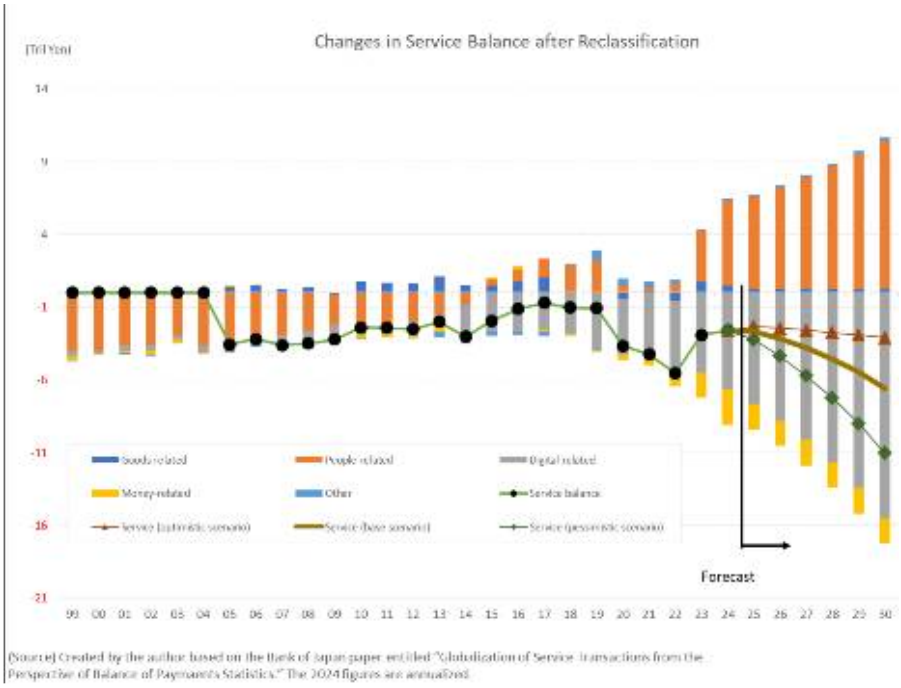
As I discussed in this report last month, Japan's international balance of payments is expected to face major changes going forward, mainly in the services balance. To be blunt, it is a question of the extent to which the growing digital deficit can be offset by the growing travel surplus in the future. The 2024 travel surplus (see graph) was an astonishing +JPY5.8973 trillion, about 1.8 times the record high of 2023 (+JPY3.6314 trillion). However, as I have explained before, the dramatic yoy growth margin was partially due to border control measures having been in place during the January-March quarter of 2023. Going forward, it will be more difficult to see such dramatic yoy increases. JPY depreciation has also peaked, and given the current state of the tourism industry, which revolves around accommodation and food services and is extremely constrained by labor supply, there may be a change in the "growing travel surplus" trend in 2025.



On the other hand, the growing digital deficit is thought to reflect demand for digital services, and there is no reason to assume a near-term reversal of the trend. The 2024 other services deficit was -JPY7.8659 trillion, of which the digital-related deficit amounted -JPY6.6507 trillion, both breaking previous records in terms of deficit size. Incidentally, the digital-related income and expenditure was -JPY2.1483 trillion in 2014, the earliest year for which this data is available, which means that the deficit has tripled in the past 10 years. Taking into account AI-related services, for which demand is likely to expand in the coming years, it seems highly likely that payments toward platform services will continue to increase.

Long-Term Simulation of Services Balance

The figure to the right shows a simple simulation I performed of the services balance up to 2030. Like last month, I have divided it into five categories, namely goods, people, digital, money, and others, as in the BOJ Review.[1] My calculations are based on the trends seen over the past three years (2022 through 2024) in each category. There are three scenarios – standard, optimistic, and pessimistic. In the standard scenario, the digital-related balance is assumed to grow at the average rate seen over the past three years, and the people-related balance is assumed to grow at a rate of +10% yoy. As it is difficult to see a clear trend in the money-related, goods-related, and other balances, I have set them to remain constant at their average levels seen over the past three years in order to eliminate arbitrariness (the money-related balance has been increasing in recent years, but I am treating it as a constant here as it has been known to fluctuate sharply. There is, however, room for discussion on this point).



(Source) Created by the author based on the Bank of Japan paper entitled "Globalization of Service Transactions from the Perspective of Balance of Payments Statistics." The 2024 figures are annualized.

The optimistic and pessimistic scenarios differ in terms of their assumptions regarding the trajectory of the people-related surplus, which centers on the travel balance. The optimistic scenario assumes that the people-related surplus will grow at a quarter of the rate for 2024 (i.e., +15.5%; this takes into account that border control measures were in place during the January-March 2023 quarter), while the pessimistic scenario assumes that the people-related

[1] Please see "Globalization of Services Trade as Seen in Balance of Payments Statistics," BOJ, August 2023

surplus will remain flat at the 2024 level. Even for an optimistic scenario, the assumption of a +15.5% yoy growth rate may be too optimistic. Meanwhile, it is debatable whether a flat level compared with 2024 can be considered pessimistic, given that the travel surplus posted nearly +JPY6 trillion in 2024. In other words, it must be noted that these are very rough assumptions.

To get straight to the point, the services deficit is expected to expand by JPY660 billion a year in the standard scenario, by JPY80 billion a year in the optimistic scenario, and by JPY1.4 trillion a year in the pessimistic scenario. At this rate, the services deficit for 2030 will be JPY6.6 trillion, JPY3.1 trillion, and JPY11 trillion, respectively, in each of these scenarios. Although the deficit is estimated to remain roughly at current levels in the optimistic scenario, the 15% yoy growth rate assumed in this scenario may, as mentioned above, be quite difficult to realize. Meanwhile, the standard and pessimistic scenarios are estimated to result in a 2.5-fold and 4-fold increase in the services deficit in 2030 compared with 2024 (approx. JPY2.6 trillion). As discussed in last month's edition of this report, it is by no means easy to realize a 10% yoy increase in the people-related surplus in the standard scenario, but even under such an assumption, the services deficit will exceed -JPY6 trillion in 2030 if the digital deficit continues to grow at a rate that is an average of the past three years. Again, despite its labeling as the pessimistic scenario, it seems quite plausible that the people-related surplus will remain flat at the 2024 level. If we assume no resolution to the structure of trade deficits, a trade and services deficit of over -JPY10 trillion could become the new normal in a pessimistic scenario. Incidentally, even in the standard scenario, a deficit of over -JPY10 trillion is within sight by the early 2030s.

Again, as mentioned briefly above, the money-related deficit (about -JPY2.4 trillion in 2024) is also expanding, having expanded by roughly four times in three years. I have taken it to be a constant in my calculations this time, but if this deficit also continues its expansion, the overall services balance will lean toward an even greater deficit.

What a JPY10-Trillion Services Deficit Era Implies

What does an over JPY10 trillion services deficit imply? Since records began, the trade and services deficit has only exceeded JPY10 trillion three times – in 2013, 2014, and 2022, all of which were years when significant JPY depreciation was widely discussed (see chart). If services deficits to the tune of JPY10 trillion become the new normal, the implications for JPY are self-evident. So far, the trade balance has determined the overall trend, but I believe we may be approaching an era of the services balance rivaling the trade balance. Of course, I am merely providing estimates based on several assumptions. My assumption for the estimates provided here is that the digital-related deficit will expand by around 15% a year, which is the average growth in deficit seen over the past three years. If, for instance, innovation plateaus and no new services are introduced, the growth in the deficit may fall to 5% or 10%. In that case, the pace of expansion of the services deficit will be somewhat limited. Moreover, it is also possible for various kinds of automation to result in a greater increase in efficiency than expected, thereby relieving some of the labor supply constraints, especially in the accommodation and food service industries. This could then lead to a continued expansion in the people-related surplus.

USD/JPY and Japan's Worst 10 Trade and Services Deficits

	Trade	Services	rade and Servic	Rate of Change of JPY Against USD (Yoy)
2022	-15.5	-5.6	**-21.1**	-13.9
2014	-10.5	-3.0	**-13.5**	-13.7
2013	-8.8	-3.5	**-12.3**	-21.4
2023	-6.5	-2.9	**-9.4**	-7.6
2012	-4.3	-3.8	**-8.1**	-12.8
2024	-3.9	-2.6	**-6.5**	-11.5
2011	-0.3	-2.8	**-3.1**	5.2
2015	-0.9	-1.9	**-2.8**	-0.4
2021	1.8	-4.2	**-2.5**	-11.5
2019	0.2	-1.1	**-0.9**	1.0

(Source) Bank of Japan, Bloomberg, *Earliest available data is for 1985

However, the pace of expansion aside, it is reasonable to assume that the demand for digital services is unlikely to decrease even if it does not increase. Meanwhile, the expansion of the travel surplus will soon reach its limit due to Japan's limited capacity to supply inbound tourism services. Incidentally, in the pessimistic scenario (flat people-related surplus), even if digital-related deficit growth slows to 10%, the services deficit will reach JPY10 trillion by 2033, and even if the former slows to 5%, the latter will still reach the JPY10-trillion level by 2040. Unless the travel surplus begins to expand again, or Japan is able to sustain a surplus in some other category, it seems quite likely that the services deficit will continue to expand, mainly due to the digital-related balance. As a result, it is highly likely that the services balance will determine the outcome of the trade and services balance in the long term. As I have discussed in my books and in previous issues of this report, the services deficit problem should be viewed in terms of its potential for future expansion rather than in terms of current figures.

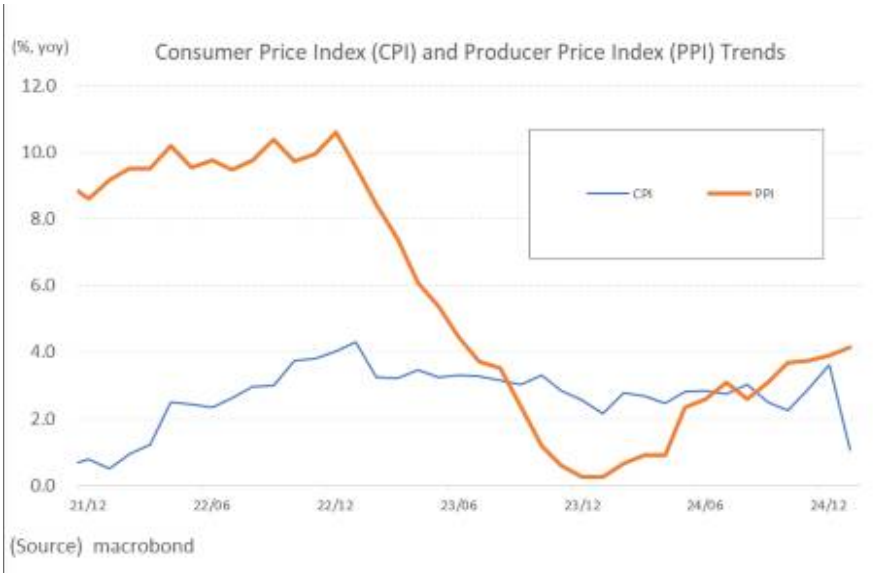
BOJ Monetary Policy Now and Going Forward: Rate Hikes Being Urged by JPY-Depreciation-Led Inflation

Inflationary Pressures Rising Upstream of the Economy

On February 18, the yield on newly issued 10-year Japanese Government Bonds (JGBs), which is an indicator of long-term interest rates, rose to 1.400%, the highest level in about 15 years since April 2010. The expectation that the

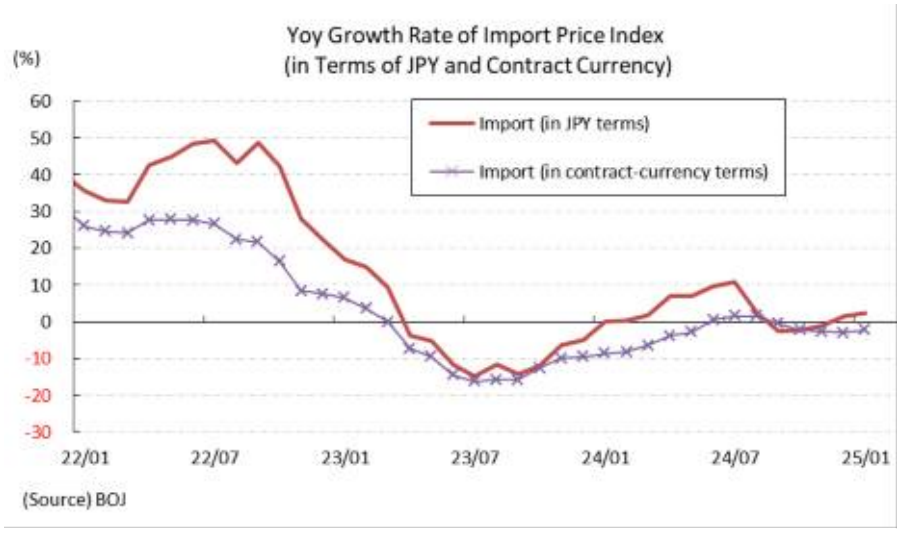
BOJ will raise interest rates in response to the JPY-depreciation-led inflation is growing day by day, and forex rates are also fluctuating strongly as market players monitor JPY interest rates. Setting aside near-term forex and interest rate trends, it is useful to understand the movement of the JPY-denominated import price index when considering the BOJ's future policy operation. No matter how big of a deal the general public or market participants think JPY weakness is, a change in monetary policy is not justified if the impact on domestic prices is limited. On the other hand, even if JPY depreciation is moderate, a yoy increase in JPY-denominated import prices will directly increase the domestic inflationary pressure, which justifies a change in monetary policy.

In this regard, Japan's January Producer Price Index (PPI) released on February 13 was interesting. Firstly, the January PPI posted +0.3% mom and +4.2% yoy growth. Especially conspicuous was the +0.3pp acceleration in the yoy grow rate compared with the previous month (December). This yoy growth rate in excess of +4% is the largest since June 2023. Cuts in the government's fuel oil subsidies has increased the positive contribution from petroleum and coal products, but the contribution of agricultural, forestry and fishery products, led by rice prices, which have remained high, is becoming impossible to ignore. As the figure shows, the PPI, which is upstream of consumer prices, has clearly been growing more strongly over the past year, and reason points to an inevitable increase in upward pressure on the downstream consumer price index (CPI) going forward.



JPY-Depreciation-Led Inflation Continues to Justify Rate Hikes

What I would like to pay greater attention to is the import price index, which was also released alongside the PPI. The import price index posted -2.2% yoy growth in contract currency terms, but +2.3% in JPY terms. The December figures were -3.0% and +1.4%, respectively, so upward pressure can be seen (see graph). More specifically, the decline in import prices in contract-currency terms has narrowed for the first time in five months, and JPY-denominated figures have posted yoy increase for the second month in a row. The main reason for this is a decrease in the negative contribution from oil, coal, and natural gas due to crude oil prices rising again since early this year. However, as far as the JPY-denominated import price index goes, the large impact from JPY weakness cannot be denied. USD/JPY was at 156.42 yen to the dollar in January (Tokyo market USD/JPY spot, monthly average as of 5 p.m., BOJ), which is just under 7% higher (JPY depreciation against USD) than the 146.59 yen to dollar level seen in January last year. Inflationary pressures via import prices as a result of JPY weakness are clearly evident at present. The BOJ is also aware of this, as evidenced by its insertion of the phrase, "(…) partly due to higher import prices stemming from factors such as the recent depreciation of the yen" in its January statement following the interest rate hike.



Incidentally, this is the first time since July-August last year that the yoy rate of change in the JPY-denominated import price index has increased for two consecutive months. In other words, the JPY-depreciation-led inflationary pressures are strong enough to remind one of the "Ueda shock" (aka "Reiwa Black Monday") following the BOJ's surprise interest rate hike. It seems like a long time ago, but around this time a year ago, negative interest rates were still in place. Perhaps it can be said that the time for a reckoning is now here.

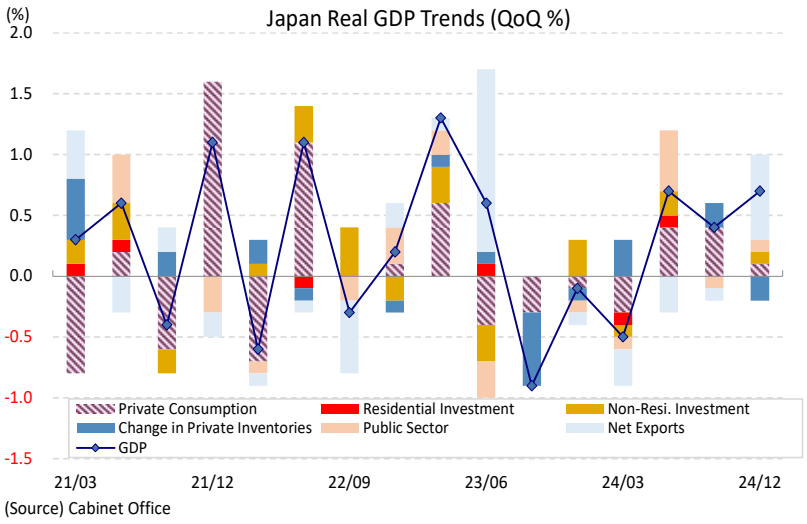
In any case, crude oil prices have stabilized since February, and it is likely that the contract-currency-denominated import price index will continue to show a clear decline. However, the JPY-denominated import price index, which is being boosted by the rise in USD/JPY with a time lag, is likely to continue posting yoy increases for the time being. The discrepancy between the falling contract-currency-denominated import price index and the rising JPY-denominated import price index is the very definition of a JPY-depreciation-led inflation, and is an important metric in estimating the

BOJ's next move. While there are no signs of a definite rate hike at present, so long as the current situation continues, a rate hike may be difficult for the BOJ's to avoid as its next move.

Japanese Economy Now and Going Forward – Inflation Tax Scars Becoming Clearer

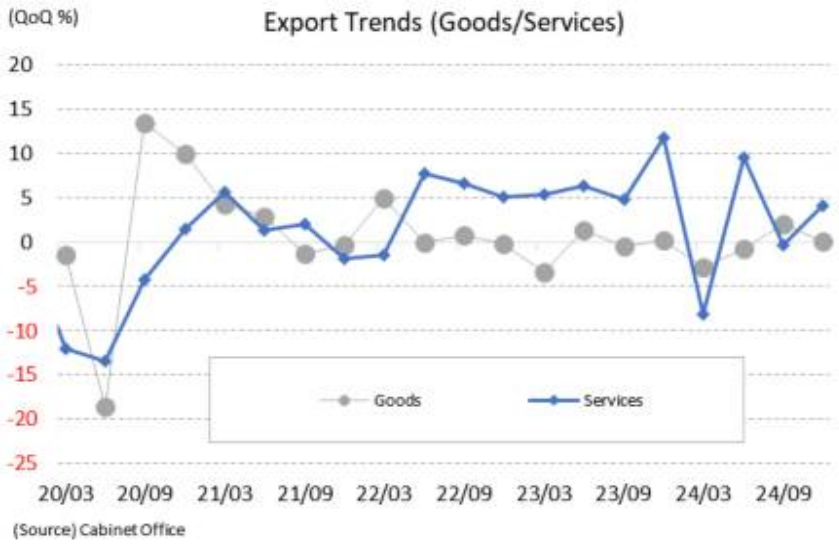
Results of a Decline in Imports

Amid rising expectations for an interest rate hike by the BOJ, the Cabinet Office announced the real gross domestic product (GDP) for the October-December 2024 quarter in February. Real GDP growth rate maintained its upward momentum at +0.7% qoq (+2.8% annualized), and +0.1% yoy for the entire year 2024 also, thereby barely managing to maintain positive growth for the fourth consecutive year. The fact that an upward momentum has been established for qoq growth is a positive development (all quarterly figures below are qoq unless otherwise stated). Again, inventory investment declined by -0.2 pp, so it should be noted that final demand (calculated by deducting private and public inventory changes from GDP) came out to +0.9%, slightly higher than the headline figure. However, based on the breakdown of the growth figures, the recent quarter's growth cannot be taken as a positive at all. In terms of contribution to the qoq growth rate, net exports were up 0.7 pp, while personal consumption (i.e., private final consumption) and capital investment were up 0.1 pp each, meaning that growth was driven almost entirely by external demand. Moreover, if we look more closely at external demand, we can see that 1) imports have declined more than exports, and 2) the only reason exports have increased is because of demand for inbound tourism.



(Source) Cabinet Office

First, regarding 1), imports in the October-December quarter were down 2.1%, turning negative for the first time in three quarters, with both goods (-2.4%) and services (-1.1%) declining. As previously reported, the October-December quarter 2024 posted record high temperatures for the time of the year, which led to lower imports of mineral fuels amid weaker demand for heating, among other factors. Of course, as other demand items show, imports are also declining due to lackluster domestic demand. This decline in imports contributed +0.5 pp to the overall growth rate, its largest ever contribution for the October-December quarter. At this point, it is already difficult to evaluate this quarter's positive growth positively, but point (2) is also important. Exports for the October-December quarter grew by +1.1%, posting the third consecutive quarter of positive growth. The export of goods barely grew, at +0.1%, but services grew significantly, at +4.1%. This is due to the export of travel services, which is driven by demand for inbound tourism. "Direct Purchases in the Domestic Market by Non-Resident Households," which is attracting attention as a proxy variable for consumption by inbound tourists, was up 4.3%, showing signs of growth amid a slump in overall personal consumption (+0.1%). Of course, taken in isolation, there is nothing wrong with this figure, given that it is statistically boosting GDP, but as explained below, there is concern that consumption by inbound tourists is crowding out consumption by Japanese residents. In other words, it is non-residents who are boosting consumption, not residents – a situation that is difficult to appreciate without reservation.



(Source) Cabinet Office

Review of Real GDP, Real GDI, and Real GNI

In terms of its absolute value, Japan's real GDP for 2024 is about JPY557 trillion, which is almost the same as in 2019 (about JPY553 trillion), before the pandemic. In other words, it can be said that there is no growth. Meanwhile, real GDI (gross domestic income) has actually decreased from about JPY551 trillion in 2019 to about JPY550 trillion in 2024. With the headlines elatedly announcing four consecutive years of positive growth, I would like to reassess GDP measurements in an effort to use the correct figures for a correct interpretation.

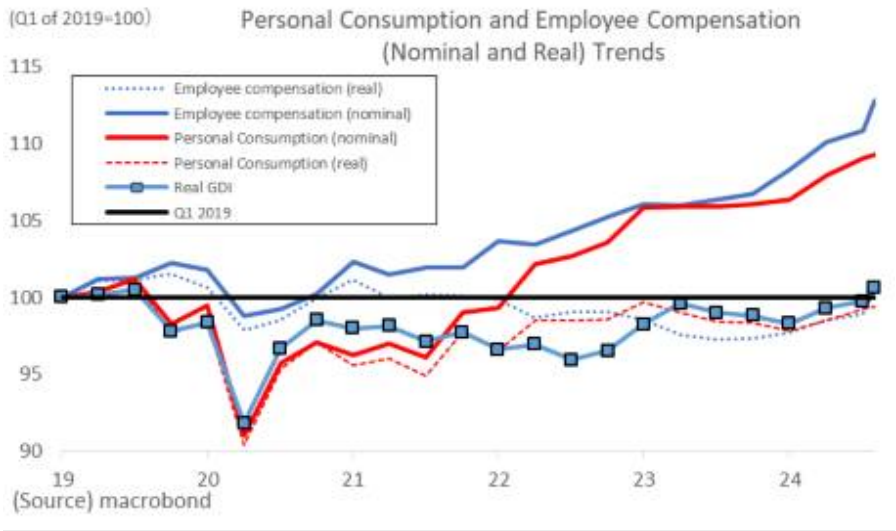
Currently, the structure of Japan's GDP statistics continue to be real GNI > real GDP > real GDI (see graph). The outflow of income from Japan due to JPY weakness and strong resource prices coinciding has been a problem since March 2022, but the headline real GDP figures do not capture it. An evaluation based on real GDI is, therefore, necessary. As the name suggests, real GDP captures a country's economic activity based on production, while real GDI captures the country's economic activity based on income. By definition, "real GDP + trading gains (or losses) = real GDI." Real GDP, which captures the quantitative changes in the economy from the production side, cannot take into account the increase or decrease in purchasing power caused by fluctuations in export/import values. So, as the chronic JPY weakness fuels import-led inflation and robs households and companies of purchasing power, the political and economic implications become significant, making it clearly more important to focus on real GDI rather than real GDP. Needless to say, Japan's real GDI lags behind its real GDP due to widening trade losses.

As I have repeatedly discussed in this report using the balance of payments statistics, the overseas income (primary income surplus) of the Japanese economy as a whole is expanding year by year. Therefore, some believe that we should focus on the GNI (gross national income), which includes income earned by overseas branches of Japanese companies, as income earned by the "people of Japan" during a certain period of time, rather than the GDP, which is the total added value of goods and services produced in Japan during a certain period of time.[2] As can be imagined from the existence of a huge primary income surplus, real GNI is much larger than real GDP, with the former being 5% larger than the latter for 2024.

However, as I have repeatedly argued in past issues of this report, I believe the GDP is a more accurate measure of the domestic economy than the GNI, as the primary income surplus is scarcely returned to the domestic market. At the very least, it can be said that real GDI may be closer to the people's perception of the economic situation than real GDP or real GNI.

Obvious Inflation Tax and Rising Political Risk

While real GDI is the closest among the GDP statistics to the household sector's perception of economic conditions, practically speaking, real employee compensation, which covers wages and bonuses, is likely to be even closer. Strictly speaking, since employee compensation includes social insurance contributions by companies (toward employee pension insurance, health insurance, employment insurance, etc.), the take-home pay is smaller than employee compensation. As shown in the figure to the right, general inflation resulting from JPY weakness via import prices acts as an inflation tax to suppress real employee compensation



[2] With the introduction of the 1993 SNA, the concept of GNP (gross national product) was abolished and GNI was newly introduced as a similar concept. The two are almost the same, but as the definition includes "income" from overseas, it was decided that the GNI should be called an income measure.

and real personal consumption, which is consistent with sluggish real GDI. It is clear, therefore, that the actual state of the real economy is almost impossible to grasp looking at nominal employee compensation and personal consumption, both of which continue to grow.
Against such a backdrop, a country's political situation becomes quite volatile, as seen from Japan's House of Representatives general elections conducted last fall. The rising prices of daily necessities, as symbolized by the recent persistently high price of rice, worsens the business confidence of the relatively poor, who have a high propensity to consume, and their anger is directed at the government and ruling party of the time. The government and ruling party struggled to perform in the lower house elections last fall, especially in urban areas. This is likely owing to the relatively higher inflation in urban areas and the greater visibility of the economic activity of foreigners, represented by foreign tourists. In fact, in areas with large demand for inbound tourism, prices, starting with goods and services that match the investment and consumption desires of tourists, are inevitably pushed up, thereby crowding out domestic consumption and investment as a result. This was visible in the recent quarter's GDP results, which revealed growth supported by non-resident rather than resident consumption. Even domestic travel has become expensive for the domestic population, not just because of increasing demand for domestic travel as an alternative to overseas travel, but also because of domestic accommodation increasingly being priced to match the purchasing power of foreigners.
Such dissatisfaction with daily life will accumulate, both directly and indirectly, as dissatisfaction with the system, and be expressed during elections. The reason why real GDP has remained almost unchanged between 2019, before the pandemic, and 2024 is probably because interest rates have continued low even as the supply-demand gap has tightened, thereby resulting in a textbook case of JPY-depreciation-led inflation and the suppression of real incomes and consumption. As people continue to suffer from the inflation tax, there may be plenty of room left for strong public sentiment against the government and ruling party to be expressed in the House of Councillors election coming up this summer.

U.S. Political/Economic Situation Now and Going Forward – A Month Since President Trump's Inauguration

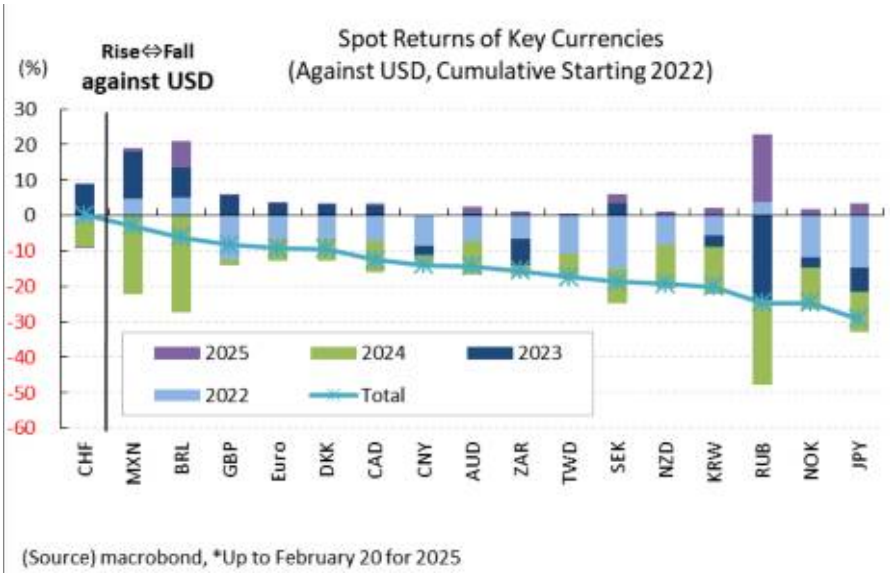
No Change in U.S. Interest Rates and USD Exchange Rates

February 20th marks the passage of exactly one month since the inauguration of the second Trump administration. President Trump took office loudly calling for the lowering of U.S. interest rates and the depreciation of USD, but in the past month, the U.S. 10-year interest rate has barely moved from around 4.5% and the U.S. 2-year interest rate has barely moved from around 4.3%. During this time, USD's nominal effective exchange rate (NEER) has declined by 1%. Looking at the spot exchange rates of G20 currencies against USD, one finds that most currencies have risen against USD, albeit by small margins. It could be said that USD has weakened very slowly, but from a more objective perspective, it is fair to say that it has remained roughly flat. In fact, considering President Trump's strong verbal intervention, it seems appropriate to say that U.S. interest rates and USD exchange rates are basically showing signs of remaining high and strong, respectively. Although the second Trump administration has been introducing and preparing to introduce a series of aggressive international trade policies, FED Chairman Powell has appeared to dismiss the impact of the current trade policies trend, simply stating at a February congressional hearing that it remains unclear at this point what kind of tariff policies will be implemented or what their impact will be and that the FED will endeavor to understand the significance of new trade policies and take appropriate monetary policy measures. President Trump has denied that FED Chairman Powell will be fired during his term, and Powell appears likely to maintain his view that the FED cannot predict policy changes and will simply adjust monetary policies in line with what does happen. Given the U.S. economy's current strength, the FED is unlikely to go along with President Trump's demands for policy revisions, so if U.S. interest rates and USD move, the movement will likely be upwards (unless there is a major crisis).

Forex and Interest Rate Trends One Month Into Second Trump Administration

	Japan 2-Year Interest Rate	Japan 10-Year Interest Rate	U.S. 2-Year Interest Rate	U.S. 10-Year Interest Rate	USD/JPY	USD's NEER
2025/1/20	0.69	1.20	4.27	4.61	155.6	110.5
2025/2/20	0.82	1.42	4.28	4.50	149.5	109.4
Difference (*)	0.14	0.22	0.01	-0.08	-3.92	-1.03

(Source) macrobond, *Rate of change shown for USD/JPY and USD's NEER

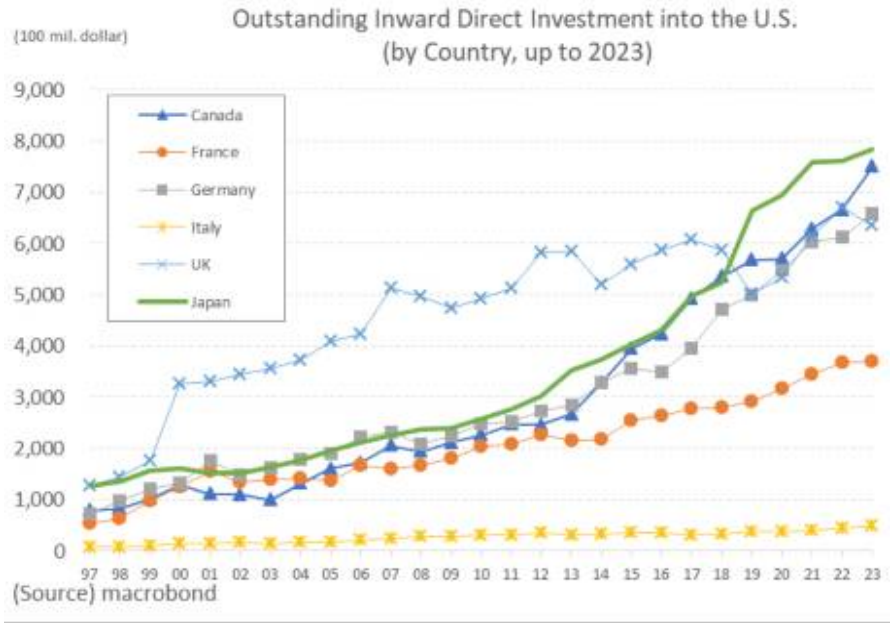


(Source) macrobond, *Up to February 20 for 2025

Japan-U.S. Summit from a Forex Supply/Demand Perspective

A Japan-U.S. summit meeting was held on February 7, at which a number of issues relating to security and the economy were discussed. Immediately after the summit, financial markets were pleased to note that Japan will not be subjected to punitive tariff measures for the time being, but as the Trump administration's upcoming tariff policies will be directed at the entire world, it seems inevitable that Japan will also be affected to a certain extent. Since the second Trump administration's inauguration, JPY has often been bought on the grounds that, compared to other major currencies, the impact on JPY of Trump's tariffs and other policies is likely to be relatively small, but is this view really well founded?

Focusing on summit meeting points that may impact forex supply/demand situations, one may note proposals to 1) raise Japan's investment balance in the United States to USD1 trillion, 2) expand Japan's imports of U.S.-produced liquefied natural gas (LNG), 3) arrange for Japan to purchase USD1 billion worth of defense equipment, and 4) clarify Japanese companies' (automobile- and IT-related) investment plans in the United States. One gets the impression that such proposals will tend to promote JPY selling rather than JPY buying. Media reports indicate that the summit meeting ended peacefully, but President Trump has made it clear that he wants to eliminate the U.S. trade deficit with Japan, and it is probably reasonable to anticipate that pressures to sell JPY will increase if the Trump administration's demands are met.



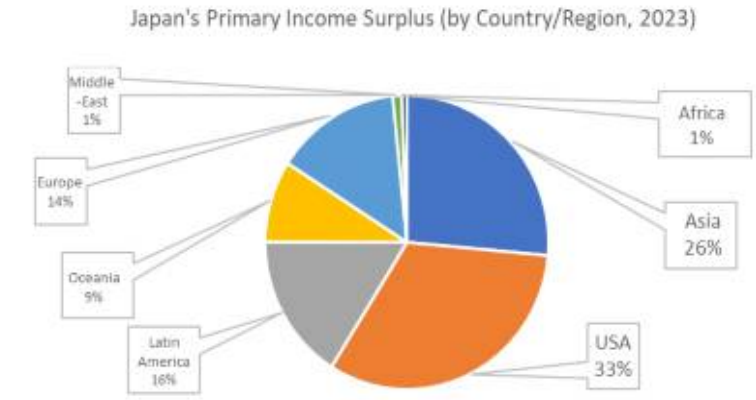
It is worth considering the scale of proposal 1), which was conspicuously prominent in headlines about the summit. As of the end of 2023 (the latest date with confirmed figures), Japan's investment balance in the United States was USD783.3 billion, so the goal is to increase that figure by about USD220 billion. This suggests that Japan has promised that Japanese companies will make direct investments entailing the selling of sufficient JPY to buy roughly USD220 billion. Over the past 10 years, the balance of Japan's foreign direct investment in the United States has increased at an average rate of about +8.5% yoy. Simply assuming that this pace is sustained from 2024 onward, the USD1 trillion target will be reached in 2026, so the level of the target does not seem overly ambitious. Moreover, as the deadline for reaching the USD1 trillion level has not been clearly stated, it does not appear that efforts to attain the level will have an acute impact on the forex market, but such efforts will definitely be a factor promoting JPY selling (see graph).

Proposal 2) will also be a factor promoting JPY selling. Confirmed figures indicate that Japan's LNG imports for the whole of 2024 amounted to about JPY6.2 trillion, of which imports from the United States totaled approximately JPY542.5 billion, or just under 9%. Currently, Australia accounts for about 40% of Japan's LNG imports, Malaysia for about 15%, and Russia for about 10%, while the United States is the fourth largest supplier. There is currently no quantitative information on when and how much US LNG exports to Japan will increase, but President Trump has said the increase will be a record high amount, so it seems safe to assume that an increase in the trillions of JPY is expected. Of course, the LNG imported from the United States can be expected to displace LNG imports from other countries, so Japan's total LNG import amount is not likely to greatly change over the medium-to-long term. However, because fuel imports are often based on long-term contracts, there is a possibility that the rise in LNG imports from the United States will lead directly to a temporary expansion of Japan's trade deficit. An expansion of mineral fuel imports (which already account for roughly a third of Japan's total imports) may have a considerable impact on Japan's trade balance.

However, Prime Minister Ishiba has noted that it is in the national interest of resource-poor Japan to have a stable supply of resources at reasonable prices, so the increased importation of U.S. LNG is ultimately likely to be viewed positively.

"Masked Surpluses" of the United States

It has been reported that details of the second Trump Administration's tariff policies will be announced from April. President Trump stated on February 18 that automobile tariff rates (of particular interest to Japan) would be "around 25%", but it has yet to be revealed which countries will be subject to the tariffs and the date from which the tariffs will be implemented. Depending on their rates and time schedules, the tariffs can be expected to definitely have a major impact on Japanese companies' management strategies and ultimately on asset prices, including stock prices.



(Source) Ministry of Finance

However, President Trump himself seems to acknowledge that his administration's tariff policies are to a great extent simply bargaining chips designed to achieve other policy objectives. As Japan has already since the summit committed to large-scale private investments in the United States and the purchase of defense equipment and natural resources from the United States, it seems reasonable to expect that, even if they are unavoidable, U.S. tariffs on Japanese imports will not be so punitive. As the above graph of the balance of U.S. inward direct investment by country/region shows, Japan has had the top balance of investment in the United States for five consecutive years. As a result, Japanese investments in the United States are also growing as a source of the primary income surpluses that support Japan's current account surpluses. Investments in the United States have been earning more than 30% of Japan's total primary income surpluses, a larger share than investments in the entire Asian region, including China (26%; see pie graph on previous page). The Japan-U.S. economic relationship has been built up in a way that is beneficial for both sides, and there are even grounds for suspecting that the benefits for the United States may be greater than those for Japan, given that the Japan's primary income surpluses does not necessarily flow back to Japan. It can be said that the United States is a country recording "masked surpluses".

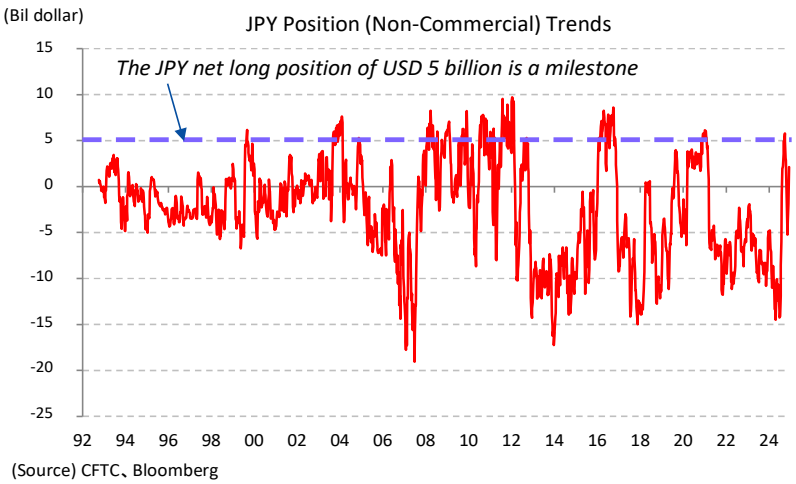
Distinguishing between Short-Term and Long-Term Perspectives

The currently available information suggests there may be some hope for a slight degree of leniency in the tariff measures imposed on Japan, but the fact remains that "new costs will be imposed" compared to previously. For example, President Trump has not hidden his concerns about Japan's automobile exports, and there is a high likelihood he will impose some kind of measure regarding those exports. Given JPY's recent depreciation, it is assumed that exports from Japan to the United States generate higher rates of return than those generated by investments in the United States. Additional tariffs will put downward pressure on corporate profits and reduce exports, thereby expanding Japan's trade deficit. As mentioned above, there has tended to be net JPY buying in the forex market since February based on a short-term perspective that U.S. tariffs may not be as impactful as previously thought, and there is a suspicion that such speculation is a major factor promoting JPY's recent appreciation. As mentioned above, however, there is no doubt that, from a long-term perspective, most of the Trump administration's prospective trade-related policies will be promoting JPY-selling. Optimal forex trading strategies should be based on due consideration of short-term and long-term perspectives separately.

Risks to My Main Scenario – Need for Caution Regarding JPY Strength Based on Prospective BOJ Rate Hikes

Speculative JPY Buying at a Worrisome level

As I have argued in the past, despite the BOJ's recent tendency to adopt policies that appear designed to defend the value of JPY, it is not very constructive to create forecasts based on careful examination of various economic and financial indicators and then consider whether a BOJ interest rate hike should be factored in. In extreme cases, such as if USD/JPY had become stable above JPY170 just before the January 23 BOJ Monetary Policy meeting, market expectations of an interest rate hike would have risen nonlinearly. At that point, it is likely that speculative JPY selling would emerge to urge an interest rate hike. If that situation occurs, a BOJ rate hike will become inevitable, as the incentive to "prevent JPY from weakening at all costs" will take priority. In late February, JPY showed a clear tendency to appreciate against USD, partly owing to hawkish comments by senior BOJ officials, and USD/JPY intermittently fell below JPY150. Looking at



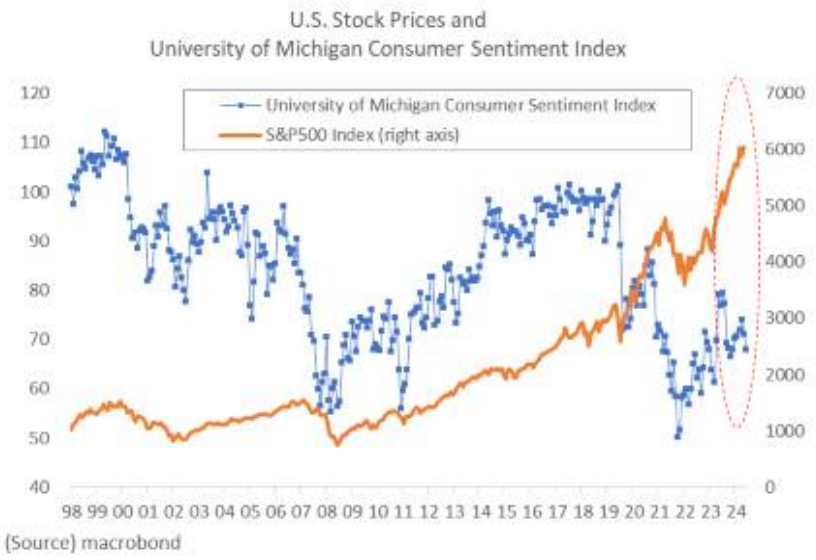
(Source) CFTC、Bloomberg

IMM currency futures positions as of February 18 (the latest figures available at the time this article was written), one finds that net long positions in JPY had risen to +USD5 billion, but it should be noted that it is historically rare for net long positions in JPY to be sustained at that level (see graph). This level of net long positions in JPY had not been reached since the end of September last year, but at that time the BOJ had implemented a surprise interest rate hike at the end of July, the U.S. July employment statistics (announced on August 2) had worsened, and there was a strong expectation that the BOJ-FED gap would be narrowing significantly. In the midst of this, for a very short time in mid-September, USD/JPY was seen to fall below the JPY140 level. The logic was that not only was the BOJ entering a period of interest rate hikes, but the FED was also finally entering a period of interest rate cuts, so JPY buying was inevitable. However, as the U.S. economy recovered and expectations of a BOJ interest rate hike vanished, the JPY appreciation trend reversed after net JPY long positions peaked out at +USD5.76 billion on September 24.

U.S. Stocks and Stagflation Concerns

First of all, the assessment of the U.S. economy is quite different now than it was then. The United States was certainly in a period of interest rate cuts then as it is now, but there is currently talk of the possibility that interest rate cuts will end in the first half of 2025 at the latest. The crucial difference between then and now is that we currently cannot expect a sustained decline in U.S. interest rates. In late February, U.S. stock prices fell sharply due to worsening financial results of major U.S. retailers and concerns about the automobile-related tariffs announced by President Trump. At present, U.S. personal consumption-related indicators are strong, and there are no major concerns, but given that tariff costs will be imposed on various goods and services in the future, the view that a slowdown in personal consumption is inevitable at some point has a strong logical basis.

As can be seen in the graph, in the very long run, the direction of U.S. stock prices and consumer sentiment has been on the same track, but the gap between the two is clearly widening at present, and it seems inevitable that U.S. stock prices will adjust accordingly. It appears highly likely that the stagnation of U.S. consumer sentiment reflects inflation concerns related to the Trump administration's tariff proposals. In the University of Michigan Consumer Sentiment Survey, for example, expectations of inflation rates a year from now soared from +3.3% to +4.3% in just one month, from January to February. It has been pointed out that that survey generates discrepancies owing to the differing perspectives of partisan groups, but the January consumer survey released by the New York FED on February 10 indicates that inflation expectations one and three years from now were flat at +3.0%, but inflation expectations five years from now were 3.0%, up 0.3 percentage point from the previous month (December), reaching their highest level in eight months, since May 2024. Although consumer survey results vary, one gets a clear impression that consumers believe that inflation rates are unlikely to fall. Despite the interest rate cuts, the difficulty in controlling inflation expectations raises concerns about the potential for stagflation, which would inevitably lead to stock price volatility.



(Source) macrobond

Questionable Reaction to JPY Appreciation

This situation is clearly exerting downward pressure on the U.S. economy, but it should be noted that it also suggests that U.S. interest rates will remain high. The increasing basis for concern about stagflation in the U.S. economy itself suggests that U.S. interest rates will remain high, and it is questionable whether this is consistent with JPY's current strength. The JPY appreciation trend seen toward the end of February is based on the interpretation that JPY interest rate changes will narrow the Japan-U.S. interest rate gap and cause JPY to appreciate against USD, and that interpretation can be said to be based exclusively on expectations of BOJ's interest rate hikes. While this view is logical, it is by no means highly probable. Paradoxically, it can also be pointed out that JPY appreciation in anticipation of an interest rate hike has led to a decline in inflation concerns and a decrease in the need for an interest rate hike. At the time this article was written, the interest rate

(Source) Bloomberg, *BOJ Monetary Policy Meeting dates used

futures market was pricing in only 0.1% of a possible BOJ interest rate hike in March, somewhat below 20% of a hike in May, and just under 50% of a hike in June, while an interest rate hike at the October meeting is 100% factored in. As a result, even looking out to the end of the year, it appears that the Japanese-U.S. policy interest rate gap is only expected to shrink by around 70 basis points (see graph), and the significance of the gap at the end of the year would actually not be much different from what it was in January. At the moment, it appears that forex market players are overthinking the situation and getting ahead of themselves in deciding to buy JPY. If the BOJ emphasizes the dissemination of dovish information amid this situation, the current increase of speculative JPY buying will be unwound, and a strong JPY selling tend is likely.

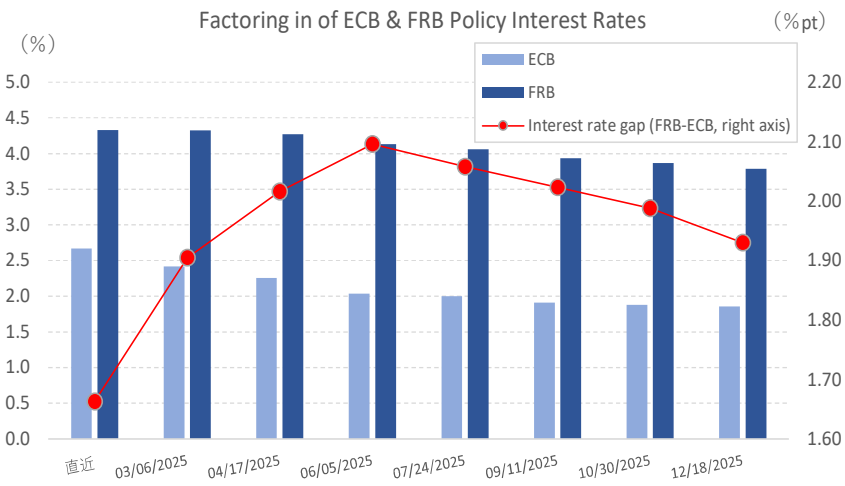
There is no doubt that the BOJ will continue its interest rate hike policy, but it is questionable whether the BOJ's policy environment has changed enough to justify the pace of JPY buying since February. Personally, I do not think the pace of JPY buying is justified. Accordingly, there appears to be an increasing need to be prepared for a market environment in which volatility increases in the direction of JPY depreciation as the accumulated speculative JPY buying is unwound.

EUR Outlook – Continued Concerns Regarding Prospective EUR Weakening to Below USD Parity

EUR Area Monetary Policies Now and Going Forward – Possibility of Euro Area-U.S. Monetary Policy Decoupling

FED-ECB Policy Decoupling

Amid growing concerns about stagflation in the U.S. economy, expectations that the FED will cut interest rates roughly twice this year are increasingly questionable. At the very least, it has become clear that there is no pressing need for large interest rate cuts at successive FOMC meetings. At present, the financial markets are factoring in about 1.6 FED rate cuts by September and about 2.2 rate cuts by December. Despite growing concerns about the U.S. economy, expectations are not high that the FED will undertake large rate cuts. On the other hand, the markets are factoring in about three ECB rate cuts by September, and about 3.2 rate cuts by December. The Europe-U.S. interest rate gap is expected to narrow during the second half of the year but remain fairly large (see graph).



(Source) Bloomberg, as of February 26, 2025
ECB Governing Council meeting dates used (assuming same month FOMC for FRB)

In this regard, an ECB Blog post published on February 5 entitled "What happens when U.S. and euro area monetary policy decouple?" has attracted attention. Since last year, this article has discussed how the Europe-U.S. disparity in economic conditions will directly lead to a ECB-FED monetary policy disparity, causing considerable EUR depreciation along with a rise in euro area inflation rates. While the ECB wants to avoid this chain of events, it is essentially unable to aggressively implement the interest rate cuts the euro area's real economy requires. I anticipate this situation will cause a decline in the euro area's domestic demand and a fall in euro area inflation rates, which will finally enable the ECB to cut interest rates in the second half of the year and thereby cause EUR to fall below parity against USD. Even at this point, I have not significantly adjusted this longstanding forecast.

Decoupling Effect Disappears over the Longer Term

Regarding this point, the ECB blog begins with a conclusion-like statement that – "Spillovers from US monetary policy initially work in the opposite direction to ECB monetary policy, but then later in the same direction." In the short term, this means that the expected development is "U.S. monetary policy tightens (≈ U.S. interest rates rise) → EUR depreciates → euro area inflation rates rise". A U.S. interest rate hike will "initially work in the opposite direction" in the sense that it will elevate euro area inflation rates. In addition, a weaker EUR will also increase exports from within the euro area to outside the region, which supports the point that the U.S. interest rate hike will "initially work in the opposite direction to ECB monetary policy" in the sense that it will boost the euro area economy. The blog also uses quantitative analysis to estimate the timing of events, stating that – "when the FED unexpectedly raises interest rates to curb inflation and economic activity, euro area inflation [induced by EUR depreciation] increases on average over the three months following the announcement." This information will be useful for those seeking to monitor, analyze, and anticipate the ECB's actions.

Regarding the long term, however, the blog post states – "Over time, however, the initial inflationary impact of higher policy rates in the US is compensated by broader disinflationary pressures. Tighter US financing conditions spill over to the euro area through global financial markets, leading to a slowdown in euro area economic activity." FED tightening will naturally suppress domestic demand in the U.S. economy, which will eventually place downward pressure on exports from the euro area to the U.S. Therefore, U.S. monetary policy actions (in this case, an interest rate hike) that "initially work in the opposite direction" will in the medium term have a suppressive effect on euro area demand similar to the effect of ECB interest rate hikes.

Examining the ECB's Actual Intentions

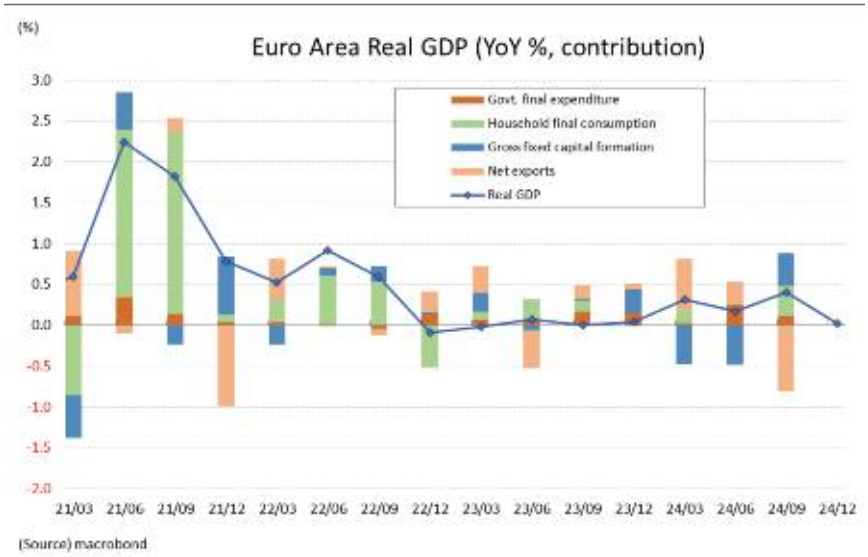
At first glance, these analyses seem to be asserting the obvious, but they also seem to convey a message about nonobvious aspects of the current situation. Since last year, the ECB has been dogged by the ideas that if it does not maintain a reasonably high interest rate level in line with the FED's, it will accelerate euro area inflation rates via EUR weakness, and that the ECB is not positioned to easily lower interest rates. As mentioned above, I also concur with those ideas. Past editions of this article have repeatedly pointed out that there is a very stable relationship between the Europe-U.S. interest rate differential and EUR/USD (see graph). This relationship suggests a basis for arguing that the ECB may be able to promote the stabilization of euro area inflation rates by aligning its policy trajectory with that of the FED. This article's view that the ECB is not positioned to easily lower interest rates is a similar albeit more-moderate assertion. The ECB blog post partially acknowledges the possibility of avoiding an ECB rate cut, stating that – "Simply mimicking a surprise move in US policy rates might avert short-term spillovers, such as higher (or lower) inflation." – but goes on to point out that – "Over the medium term, however, this would add to the tightening (or easing) impulse from abroad which, all else equal, would create risks that the ECB in turn undershoots (or overshoots) its domestic inflation target."

In other words, it appears that the ECB may be thinking that, if it endures interest rates at high levels in line with relatively strong U.S. economic conditions, it may be possible to avoid importing inflation through a weak EUR by preventing Europe-U.S. interest rate gap broadening in the short term, but in the medium to long term, the effects of mimicking U.S. interest rate rises would spread through the euro area economy, which would suffer from monetary tightening pressures along with high domestic interest rates. In short, the ECB's view may be that, even though the financial markets may generally think that it cannot lower interest rates (in light of the short-term effects of such interest rate lowering), that is not actually the case (since in the medium to long term it would be better to lower interest rates). Judging from the interest rate market's pricing, however, it is clear that the market does not expect interest rates to be lowered below the neutral rate. It will be important to see whether this view is in line with the ECB's true intentions, but since the euro area will clearly be facing inflationary pressures in the short term, I am maintaining my view that the ECB will refrain from aggressive interest rate cuts.

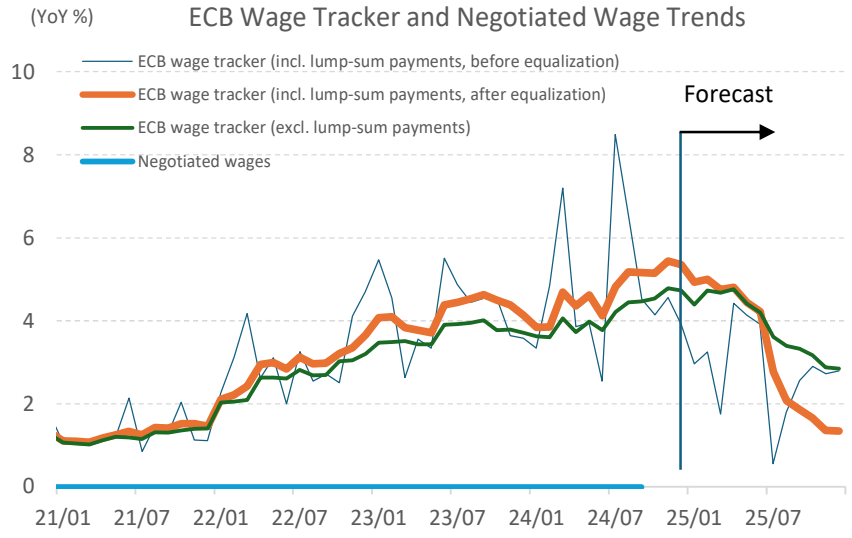
Euro Area's Economic and Financial Situation – Retaliation Against Trump Tariffs an Inflationary Factor

EU Declares Retaliation Against Trump Tariffs

In February, the Trump administration's tariff policies continued to roil the financial markets. On February 13, President Trump signed a Presidential Memorandum ordering the development of a comprehensive plan for "fair and reciprocal" trade, which includes the introduction of reciprocal tariffs. Accordingly, the government has begun reviewing imbalances among existing trade arrangements (with a particular focus on countries with large trade surpluses with the United States), and the conclusions of the review are scheduled to emerge from April. The EU has already clearly expressed its intention to retaliate against U.S. "reciprocal tariff" measures. On February 11, European Commission President von der Leyen stated, regarding the Trump administration's tariff measures on EU steel and aluminum products, that – "Unjustified tariffs on the EU will not go unanswered — they will trigger firm and proportionate countermeasures". The euro area economy is fundamentally driven by external demand (see graph above), so the impact of additional tariffs is likely to be strong. Since the sluggishness of the German economy is already presenting the euro area economy with considerable challenges, it is understandable that the EU would consider the creation of additional challenges at this time to be unacceptable. However, President von der Leyen also noted that imposing tariffs on euro area imports would naturally have the effect of elevating the region's inflation rates in the short term, putting the ECB, which is already struggling to deal with a stagflationary situation, in an even more difficult position. Updated on February 5, the ECB's wage tracker (see graph below) shows that rate wage growth in the fourth quarter of 2025 is expected to fall to +1.5% yoy, so it clearly appears that the euro area economy is seeing a deceleration of wages and price growth rates, driven by domestic demand, and this situation justifies the ECB's interest rate cut policy. The main forecast scenario that the ECB is forecasting (or hoping for) is that inflation rates will decelerate in parallel with the weakening of conditions in the real economy. However, a tit-for-tat exchange of additional tariffs will not only put downward pressure on the external demand-driven euro area economy – it will also import inflation – and there are grounds for concern that the overall effect will be similar to importing stagflation. As previous editions of this article have been arguing, the FED's efforts to terminate interest rate cuts are widening the Europe-U.S. interest rate gap and thereby promoting EUR weakness, which will promote the acceleration of euro area inflation rates and make the ECB unable to make significant interest rate cuts to stimulate the euro area economy. So the ECB is already in a difficult position, and the addition of tariff battle with the United States can be expected to further exacerbate that situation.



(Source) macrobond



(Source) ECB, macrobond

The ECB is already unable to implement interest rate reductions even if it would like to, and if significant tariffs are really imposed on the euro area from this April onwards, the difficulty of implementing interest rate reductions will become even greater. In that case, even if the ECB continues to refrain from interest rate reductions, there will be growing forex market expectations that a significant interest rate cut will eventually be necessary, and I see a high likelihood that EUR selling will prevail amid such expectations. Consequently, it remains possible that EUR will intermittently fall below parity with USD by the end of the year.

Germany's Political/Economic Situation – No Potential for Changes "Inside the Wall"

Insufficient Support for Parties "Inside the Wall"

In the German general election held on February 23, the largest opposition party, the center-right Christian Democratic Union/Christian Social Union (hereinafter referred to as CDU/CSU), came in first, ensuring its return to power for the first time since 2021. As generally expected, the far-right Alternative for Germany (AfD) party surged to second place, while the current ruling party – the center-left Social Democratic Party of Germany (SPD), led by current Chancellor Olaf Scholz – suffered a major defeat, sinking to third place. It is worth noting that this is the first time since World War II that the SPD has fallen to the position of being only Germany's third largest party, and it is fair to say that this symbolizes a tectonic shift in German politics. Looking at changes in vote shares by party since the previous general election in 2021, one finds that the share of the CDU/CSU (formerly led by former Chancellor Merkel) increased by 4.3 percentage points, to 28.5%; the share of the AfD almost doubled, to 20.8%; and the ruling SPD's share fell 9.3 percentage points, to 16.4%, its lowest share since the end of the World War II. The share of the Green Party (an environmental party that also forms part of the ruling coalition) decreased 3.1 percentage points, to 11.6%.

In light of Germany's historical experience with far-right ideology, the country's mainstream political parties have created a firewall (Brandmauer) policy that prohibits coalitions with far-right parties and, since the Merkel era, the CDU/CSU firewalls have also precluded coalitions with far-left parties. While the increasingly popular AfD is considered to be "outside the wall", however, there are limits to the combination of policies that can be realized "inside the wall". Given Germany's history, this situation is not something that people outside Germany are in a position to criticize in a superficial manner, but there will inevitably be an increasing amount of controversy about whether governing coalitions' repeated attempts to implement policies exclusively "inside the wall" (and then fail and collapse) can really be considered to duly reflect democratic election results. If it is truly impossible to form coalition government with the AfD, then it is necessary to succeed in the difficult task of forming a viable national unity cabinet exclusively "inside the wall". The ability to form such a national unity cabinet has extremely important ramifications for Germany's politics and economy.

Musk Sincerely Asserts "Only the AfD Can Save Germany"

When overviewing the principal issues Germany is facing, it is clear that Germany's biggest challenges relate to the country's energy situation and immigration and refugee situation. The next biggest issue is coping with the "debt brake[3]", but as that debt brake can sometimes be temporarily superseded in cases of exceptional circumstances, it appears to be a minor issue compared to the top two issues. This can be seen clearly by looking at changes in public opinion. At the time of the previous general election in 2021, opinion polls indicated the public considered the two most important issues to be "environmental protection and climate change" followed by "immigration and refugees". Just before the latest election, however, opinion polls indicated the public considered the two most important issues to be "immigration and refugees" followed by the "economic situation". It seems reasonable to interpret the "economic situation" issue as relating principally to the problem of rising inflation rates caused by energy issues. Leaving temporarily aside the "immigration and refugees" issue, which has long been a major concern, it is noteworthy that public interest in "environmental protection and climate change", which was once a hot topic, has fallen by half, and this suggests that it is safe to say that interest in the "economic situation" is growing in connection with the "energy" issue. It is generally understood that Germany's electric power and natural gas prices have risen quite rapidly over the past three years and that the rising prices directly reflect a political decision to abandon coal-fired power and nuclear power generation in favor of a switch to renewable energy sources that are relatively costly and unstable. In short, the German people are now seeking the restart of nuclear power plants in the area of "energy" and stricter (right-wing) policies in the area of "immigration and refugees".

Change in Issues Germans are Prioritizing (- indicates NA, see Note)

Issue	Previous election	This election	
	2021/9/1	2024/12/1	2025/1/1
Immigration/refugees	**22**	**23**	**37**
Economic conditions	7	**45**	**34**
Armed conflicts, peace, diplomacy	—	18	14
Environment/climate change	**33**	12	13
Fairness, poverty, social welfare	16	11	11
Education, schools, training	8	8	8
Pension, elderly insurance	15	6	7

(Source) Created by JETRO from infratest dimap (survey commissioned by German public broadcaster ARD)
Note: Figures are combined percentages of responses for "most important" and "second most important"

The CDU/CSU are traditional parties that advocate breaking through the current political logjam regarding these two issues, which is why they received the most votes. But the problem is that, with regard to "energy", the SPD and the Green Party (parties "inside the wall") are not in a position to approve the restart of nuclear power plants. Specifically, the SPD and the Green Party argue that the use of nuclear power is not up for discussion in Germany, which has already completed its nuclear phase-out, and they advocate the promotion of such environment-friendly products as

[3] The German Constitution provides for a "debt brake" that limits the budget deficit to 0.35% of GDP.

electric vehicles and expanding the use of hydrogen for such applications as “green steel” (manufactured without the use of fossil fuels). With regard to “immigrants and refugees”, the CDU/CSU and the SPD share, to varying degrees, a view that measures against illegal immigration should be strengthened, but the Green Party advocates that immigrants and refugees should be accepted for humanitarian reasons and measures should be taken to promote their social integration, so this is another point on which the Green Party is not able to cooperate with the traditional parties.

On the other hand, the AfD rejects all climate protection policies related to “energy” and advocates not only the restarting of nuclear power plants but also the continuation of fossil fuel power generation. It goes without saying that the AfD advocates the exclusion of “immigrants and refugees”. Regarding these two major issues, the AfD’s views are harmonious with those of the CDU/CSU (although the AfD differs from the CDU/CSU in advocating strict compliance with the debt brake). In short, the AfD is the party that seems likely to be able to reach a compromise with the CDU/CSU without friction on the issues the public is most concerned about, and the AfD’s increasing voter support in elections demonstrates that there is growing public support for such a compromise. Before the latest election, Elon Musk provoked considerable controversy by posting on X that – “only the AfD can save Germany” – and it is clear that he was quite serious and not at all joking in writing that post.

Stubborn Maintenance of “the Wall” Makes Problematic Coalition Inevitable

In reality, however, the AfD will be excluded from a prospective ruling coalition as it is considered to be “outside the wall”. The CDU/CSU, SPD, and Green Party (which are “inside the wall”) will form a coalition that is likely to be almost the same as the pre-election SPD-Green Party-FDP coalition. If one were to give top priority to measures designed to alleviate the German people’s biggest concerns, such as restarting nuclear power plants and tightening immigration policies, a coalition of the CDU/CSU, AfD, and the Liberal Democratic Party (FDP) would be inevitable. It is generally understood that it is almost impossible for the FDP (which has strong neoliberal ideology) to harmoniously reach policy compromises with the SPD and the Green Party, yet the FDP has been included in the Scholz coalition government since 2021 despite being constantly in conflict with its coalition partners. As a result of that conflict, the FDP abandoned the coalition government last November and, because that abandonment caused the FDP to lose public support and win a smaller number of parliamentary seats in the latest election, the FDP is no longer a key component of prospective coalitions.

There is considerable concern that Germany’s next coalition government will be similar to the Scholz coalition in that it includes parties that advocate disparate policy positions – parties that are unable to reach compromise agreements regarding the problems Germany’s electorate consider the most important. The CDU/CSU appear unlikely to suffer a dramatic drop in voter support, but if they set aside public concerns and form a coalition with the SPD and the Greens, it appears likely that intra-coalition strife will hamstring and/or fragment that coalition, necessitating another general election in the near future. The longer German politicians insist on maintaining a strict interpretation of “the wall” that excludes the AfD, the longer Germany’s political stalemate will last, and compliance with the debt brake is also likely to remain loose, leaving the country at a disadvantage in its efforts to respond to Trump administration trade policies. It seems that this situation in Germany will inevitably place considerable downward pressure on the euro area economy and thereby reduce the leeway for ECB policy management measures. It appears that forming a new ruling coalition in Germany may require several months, and this is one of the factors supporting my main forecast scenario, which anticipates that EUR will be chronically falling below parity with USD.

Daisuke Karakama
Chief Market Economist
Global Markets Sales & Trading Department
Mizuho Bank, Ltd.
Tel: +81-3-3242-7065
daisuke.karakama@mizuho-bk.co.jp