

Forex Medium-Term Outlook

March 31, 2025

Overview of Outlook

USD/JPY fell and bounded right back in March. In the first half of the month, JPY buying picked up on expectations of an additional interest rate hike by the BOJ, and the rate temporarily hit its lowest year-to-date level. However, amid increased financial market instability due to uncertainty surrounding the Trump administration’s tariff policies, expectations of stagnant U.S. and Japanese monetary policies strengthened, causing JPY buying in anticipation of a narrower U.S.-Japan interest-rate gap to weaken toward the second half of the month. However, even at the end of the month, speculative JPY buying driven solely by expectations of a rate hike by the BOJ remained, with IMM currency futures trading continuing to confirm the largest JPY buying in history. Needless to say, since it is speculative, this “largest JPY buying in history” is simply the other side of the coin of the “largest JPY sell-back in history,” so it has to be said that there is a huge upside risk to USD/JPY in the short term. For the time being, with the search for a trigger event taking precedence, structural discussions are likely to take a back seat. However, if a rate hike by the BOJ and a rate cut by the Fed can be expected during the April-June quarter, one can expect USD/JPY to fall after rising in the wake of the “biggest JPY sell-off in history.” The important thing is to avoid being swayed by temporary fluctuations. Trump tariffs are likely to have an inflationary effect during the July-September quarter onward, and with U.S. interest rates remaining high, USD is likely to appreciate again. In the sense that they slow down the U.S. economy, the additional tariffs could certainly have a deflationary impact, leading to lower U.S. interest rates and a weaker USD, but I do not expect this to become a trend during the current forecasting period.

EUR continued to strengthen in March. This is not due to a positive assessment of the euro area’s economy, but rather a fluke win for EUR as concerns about the U.S. economy due to the Trump administration’s tariff policies push down U.S. interest rates and promote USD selling. However, it is also true that the euro area economic and financial situations are beginning to show signs of improvement. For instance, credit-related figures have shown a clear improvement. ECB President Lagarde also mentioned that the regional economy had bottomed out, and a potential suspension of interest rate cuts was brought up at the March ECB Governing Council meeting. While it cannot be said that the regional economy is on a solid footing, it seems likely that it is over its worst, so this report’s main forecast scenario – namely the normalization of “parity breach” – seems unlikely at this point. However, I do not believe that the current situation, in which U.S. interest rates are falling rather than rising due to the uncertainty caused by Trump tariffs, is a sustainable trend. If we consider Trump tariffs to be one of the factors that will keep U.S. interest rates high at least during the current forecasting period, U.S. interest rates are likely to rise again in the latter half of the period, and EUR appreciation as a result of USD weakening may be reversed to some extent. While I believe an upward revision of the forecast range is necessary, I am not at this stage considering a revision of scenario to predict a continued EUR appreciation.

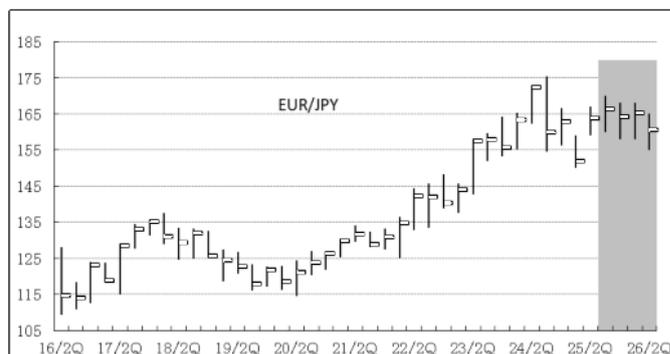
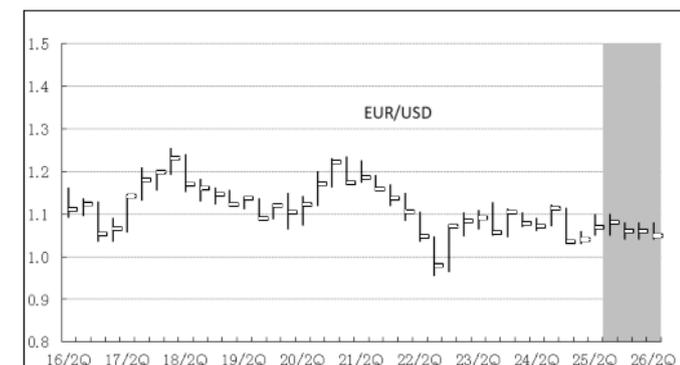
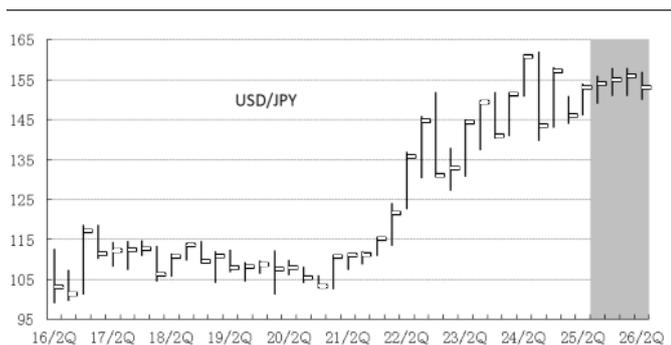
Summary Table of Forecasts

	2025				2026	
	Jan-Mar (Actual)	Apr-Jun	Ju-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	146.55 ~ 158.88 (149.30)	146 ~ 154 (153)	149 ~ 156 (154)	151 ~ 158 (155)	151 ~ 158 (156)	150 ~ 157 (153)
EUR/USD	1.0125 ~ 1.0955 (1.0841)	1.05 ~ 1.10 (1.07)	1.05 ~ 1.10 (1.08)	1.04 ~ 1.08 (1.06)	1.04 ~ 1.08 (1.06)	1.04 ~ 1.08 (1.05)
EUR/JPY	155.63 ~ 164.52 (161.86)	159 ~ 167 (164)	160 ~ 170 (166)	158 ~ 168 (164)	158 ~ 168 (165)	155 ~ 165 (161)

(Notes) 1. Actual results released around 10 am TKY time on 31 March 2025. 2. Source by Bloomberg

3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts



USD/JPY Outlook - Where is JPY Long Position Heading?

BOJ Monetary Policy Now and Going Forward – Two Prospective Outcomes of Largest JPY Long Position in History

Rate Hikes Postponed Due to Trump Tariffs

At its Monetary Policy Meeting (MPM) held on March 18-19, the BOJ decided to leave its monetary policy unchanged. The target for the policy interest rate, the uncollateralized overnight call rate, was kept at 0.5%. The fact that the statement was released before 11:30 a.m. suggests that the decision was made following a very short discussion. Policy Board members Tamura Naoki and Takata Hajime, who had been repeatedly issuing hawkish messaging, also voted in favor, and the decision was unanimous. In addition to the justifiable desire to assess the impact of the January interest rate hike, uncertainty regarding the actions of the Trump administration is likely a major factor in the inability to act. The only change this time is that the risk factors section of the statement has been revised from “developments in overseas economic activity and prices” to “evolving situation regarding trade and other policies in each jurisdiction and developments in overseas economic activity and prices under such situation.” Regarding this point, Governor Ueda stated in his press conference, “I feel that the scope of the U.S. tariff policies is expanding, and the speed of decision-making is increasing rapidly. We won’t know until April. There is a lot of uncertainty.” He did not hide the fact that uncertainties surrounding the Trump administration’s actions were in the background of this decision. This argument has been used to postpone rate hikes since last year, and the same trend is likely to continue in terms of this being the deciding factor in the BOJ’s policy operation from April onward as well.

Public Opinion Not Against Rate Hikes

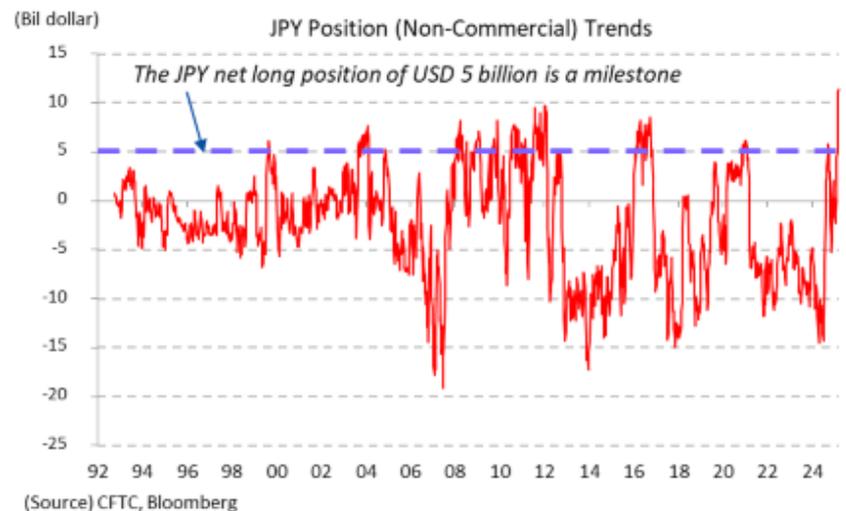
Market predictions are currently centered on the next rate hike taking place at the June 17 MPM. Since the July 31 MPM will take place after a likely defeat for the ruling party in the House of Councillors election, the thinking seems to be that it will be difficult to move forward with an interest rate hike in the midst of political turmoil. Given the undeniable likelihood of a change in government framework after the election, it would be imprudent to bet on an interest rate hike after July. However, would it not be difficult to raise interest rates at the June meeting just before the election? In terms of political hurdles, some may think that June is not much different from July. In fact, since the New BOJ Act came into force in 1998, there has been no precedent of an interest rate hike at a meeting immediately before an election. However, this view is based on a past during which Japan suffered from chronic JPY appreciation. Today, the idea of preventing JPY depreciation by raising interest rates has a positive effect on Japanese public opinion. In a periodic opinion poll (January 24-26) conducted by the Nihon Keizai Shimbun and TV Tokyo immediately following the January 24 rate hike earlier this year, a majority (54%) of respondents approved of further interest rate hikes. This would have been unthinkable in the past. Public opinion is no longer against interest rate hikes, as the hope of rate hikes preventing further JPY depreciation seems to have a more profound impact on public sentiment than various

repayment burdens that would result from a rate hike. I get a strong sense of this even when I talk to Japanese policymakers in Nagatacho and Kasumigaseki as part of work interactions.

However, such domestic circumstances are unlikely to play the deciding role in the implementation of additional rate hikes. The timing of the next rate hike depends on the Trump administration, with the end of uncertainties surrounding its actions being a necessary condition for additional rate hikes. If the political and economic situations continue as in February and March, and the financial and capital markets remain unstable, rate hikes could even be shelved. The status quo was maintained also at the FOMC meeting held immediately after the BOJ meeting, with Fed Chair Jerome Powell explaining, “we are focused on separating the signal from the noise as the outlook evolves. We do not need to be in a hurry, and are well positioned to wait for greater clarity” (details later). Monetary policy around the world is currently at a standstill, and will remain so as long as the Trump administration’s actions remain unpredictable. A necessary condition for a BOJ rate hike in June will be the end of financial and capital market turmoil caused by Trump tariffs.

Two Prospective Outcomes of Largest JPY Long Position in History

In addition to whether or not there would be a rate hike, a major concern ahead of the recent BOJ meeting was the fact that the largest ever JPY long position could be unwound if the status quo was maintained. As of March 11, one week before the meeting, the JPY position against USD in IMM currency futures transactions was +USD11.33 billion, the largest ever, and the risk of JPY depreciation due to this unwinding was attracting a lot of attention in the forex markets (see graph). In the event, BOJ Governor Kazuo Ueda emphasized in his press conference that the BOJ would continue to raise the policy interest rate if its economic and inflation projections were realized. As a result, the monetary policy status quo did not result in a JPY sell-off.



However, given that biased speculative positions remain, the prospect of sudden rate fluctuations (i.e., JPY depreciation) remains, and so does market jitteriness.

With the prospect of continued rate hikes by the Fed being by no means certain, the largest ever JPY long position remains a gamble on the sustainability of the BOJ’s rate hikes. This position is being maintained because there is a winning chance that exchange rate fluctuations (JPY appreciation/USD depreciation) will offset the negative carry. However, as mentioned above, the sustainability of the BOJ’s rate hike path ultimately depends on the Trump administration’s actions. So, will the Trump administration moderate its actions at some point? There are two possible scenarios for USD/JPY going forward.

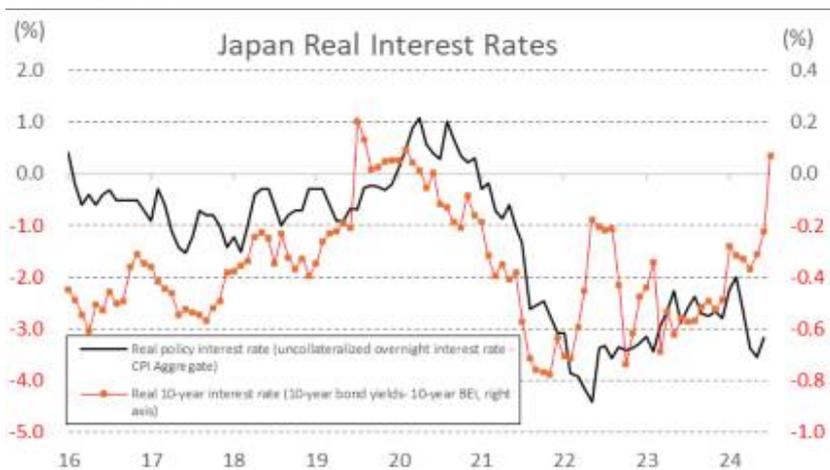
One is that measures that unnecessarily disrupt the financial and capital markets, such as additional tariffs, will be temporarily shelved ahead of the fall 2026 midterm elections. It is quite possible that, starting this fall, i.e., one year before the midterm elections, the Trump administration will decide to postpone economic policies that impose a burden on the American people. If it does, financial market uncertainties will fade, and the hurdle for the BOJ to raise interest rates will be lowered. However, the easing of downward pressure on the U.S. economy will also boost U.S. interest rates. Therefore, this scenario is based solely on the premise that the U.S.-Japan interest-rate differential will narrow based solely on an increase in the JPY interest rate.

The other scenario is that the Trump administration’s unstable behavior will continue. Before the new administration’s inauguration, analysts were speculating that additional tariffs and negotiations to increase defense spending were merely bargaining chips to extract favorable deals for the US, and that they were not serious. However, at least in the case of defense spending negotiations, they have already triggered rearmament in Europe, and one senses that Japan’s defense spending increase could be seen as “trying, but not hard enough.” As for the tariff policy, if Trump’s true intention is to return manufacturing to the U.S., as he proclaimed in his inaugural address, there is a possibility that this policy will not change and the current atmosphere will not change significantly. If so, concerns about the U.S. economy will suppress U.S. interest rates, and the BOJ will also find it difficult to raise interest rates. Therefore, this scenario is based on the premise that the U.S.-Japan interest-rate differential will narrow based solely on a decline in the U.S. interest rate.

The latter scenario is more dangerous. As suggested in the March FOMC revised Summary of Economic Projections (SEP), there are growing concerns about stagflation in the U.S., which is a decline in growth rates combined with high inflation. Powell dismisses this phenomenon as “transitory,” but one recalls the repeated use of this word following the pandemic, and that it resulted in interest rate hikes falling behind the curve. In a scenario where the Trump administration’s unstable behavior continues, it is possible that U.S. interest rates remain high while JPY interest rates are unable to rise. In such a case, not just may the U.S.-Japan interest-rate gap not shrink, it could even widen. The possibility is quite high.

Both JPY Depreciation and Interest Rate Increase Will Continue

If viewed this way, the prospects of U.S. interest rates falling and JPY interest rates rising at the same time are slender irrespective of the Trump administration's actions. To the contrary, one would do well to be prepared for a widening of the interest rate gap. In this regard, USD/JPY temporarily slipped below 140 last summer because the markets were expecting a simultaneous fall in U.S. interest rates and rise in JPY interest rates, but we are not currently in such a political or economic environment. Of course, as Ueda has also emphasized, Japan's current real interest rates are extremely low (see graph). With the discrepancy between the nominal and actual GDP growth rate being so problematic, it must be said that leaving the real interest rate at zero percent is abnormal. It should be possible to take the stance that Japan needs a rate hike regardless of the overseas environment.



(Source) macrobond, Real 10-year interest rate as of March 31

However, under the current minority government, there is a limit to how much the BOJ can continue to raise interest rates. As mentioned above, Japanese public opinion is no longer as allergic to interest rate hikes as it once was, given the just cause of curtailing JPY depreciation, but the tide will change at some point, as the burden on households accumulates. All said and done, USD/JPY is still at the 140-150 level despite having peaked. If this level continues, at some point the public could become dissatisfied with interest rate hikes alone, as they are evidently insufficient to prevent JPY from weakening. In such a situation, public demands for currency intervention rather than interest rate hikes could become louder. As a result, there is an undeniable possibility, going forward, that both JPY depreciation and interest rate increase will continue in their own ways even as real interest rates fail to turn positive.

U.S. Monetary Policy Now and Going Forward – Are Additional Tariffs Inflationary or Deflationary?

No Move Toward “Greater Clarity”

At the March 18-19 FOMC meeting, the federal funds (FF) target range was left unchanged at 4.25-4.50%, as expected by the market. The median policy rate projections by Federal Reserve Board members (the dot plot) also remained unchanged from last time (December) at 3.9%→+3.4%→+3.1% for the years 2025, 2026, and 2027, respectively (see graph). The median longer run projection (considered to be the neutral interest rate) is 3.00%, so the neutral interest rate level will be

Policy Interest Rate Outlook as of Each Year End (Median Estimate)

FOMC Date	2025	2026	2027	Longer run
Dec-23	3.625%	2.875%	—	2.500%
Mar-24	3.875%	3.125%	—	2.5625%
Jun-24	4.125%	3.125%	—	2.7500%
Sep-24	3.375%	2.875%	2.875%	2.8750%
Dec-24	3.875%	3.375%	3.125%	3.0000%
Mar-25	3.875%	3.375%	3.125%	3.0000%

(Source) FRB

reached by the end of 2027. At any rate, the projections still suggest two rate cuts this year, and in this regard the financial markets' reaction was muted. At his press conference, Powell said, “we are well positioned to wait for greater clarity,” repeating his previous statement “we do not need to be in a hurry” regarding policy changes. Like Ueda at the BOJ meeting immediately preceding, Powell noted that “uncertainty today is unusually elevated” due to the Trump administration's policies, therefore taking the position that it would be better to “wait.” In the end, both the Fed and BOJ meetings decided to defer monetary policy decisions with a view to waiting and watching the developments resulting from the Trump administration's actions.

If anything, it was decided that the FOMC would slow the pace of decline in its securities holdings by reducing the monthly redemption cap (upper limit of reduction in holdings) on Treasury securities from USD25 billion to USD5 billion, while maintaining the monthly redemption cap on agency debt and agency mortgage-backed securities at USD35 billion. Powell explained, “This action has no implications for our intended stance of monetary policy and should not affect the size of our balance sheet over the medium term,” but the financial markets will inevitably assess the move as somewhat dovish.

Interpreting the Stagflationary Revision

The revised SEP drew more attention than the dot plot (see graph). The real GDP growth rate forecast for 2025-27 has been revised downward from the previous forecast (December) to +1.7%→+1.8%→+1.8%, by -0.4pp, -0.2pp, and -0.1pp, respectively. Incidentally, given that this SEP sets the long-term growth rate at +1.8%, the assumption is that the U.S. economy will continue to sail along at cruising speed during the forecasting period. Meanwhile, the core personal consumption expenditure (PCE) deflator (hereafter “core PCE”) has been revised upward to

FRB Economic Projections (General outlook, %), *As of March 2025

	2025	2026	2027	Long-term outlook
Real GDP growth rate (As of December)	1.7 (2.1)	1.8 (2.0)	1.8 (1.9)	1.8 (1.8)
Unemployment rate (As of December)	4.4 (4.3)	4.3 (4.3)	4.2 (4.2)	4.2 (4.2)
PCE deflator rate (As of December)	2.7 (2.5)	2.2 (2.1)	2.0 (2.0)	2.0 (2.0)
PCE core inflation rate (As of December)	2.8 (2.5)	2.2 (2.2)	2.0 (2.0)	

(Source) FRB

+2.8%→+2.2%→+2.0% for the years 2025, 2026, and 2027, respectively, the forecast for 2025 having increased by +0.3pp compared with the previous forecast. In summary, the revisions indicate a significant decline in growth rate but persistently high inflation, inevitably fueling the discussion of stagflation. The “Diffusion indexes of participants’ uncertainty assessments” presented by FOMC members as part of the SEP confirm growing caution regarding all three metrics – GDP, employment, and inflation. The Fed’s basic understanding seems to be that the climate strongly suggests stagflation, but this is not the time to act, given nothing is known for certain.

Are Trump Tariffs Inflationary or Deflationary?

Predicting the next monetary policy move requires interpreting what the Trump administration’s tariff policy suggests. In this regard, Powell acknowledged that they would result in transitory price increases, and said that attempts to curtail inflation would likely slow down within the year. In other words, at least in the short term, the Trump administration’s tariff policy is inflationary, which makes it difficult to decide to lower interest rates at this time.

However, the evaluation of the tariff policy changes depending on the timeframe, with inflationary effects in the short term and deflationary effects in the medium to long term. Since monetary policy must look ahead, it is reasonable to expect the Fed to push forward with interest rate cuts based on a medium- to long-term perspective. This is consistent with what Trump posted on social media on March 19, “The Fed would be MUCH better off CUTTING RATES as U.S. Tariffs start to transition (ease!) their way into the economy. Do the right thing.”

However, the problem is that Trump’s own words and actions cannot be trusted in the first place. The Fed is well aware that the tariff policy will be inflationary in the short term and deflationary in the medium to long term. If it could be certain these policies will be implemented as currently reported, the Fed ought to make a forward-looking decision to lower interest rates. However, the Trump administration is prone to changing its mind from day to day. As long as it is not clear which countries and which goods and services will be subject to tariffs and to what extent, the Fed has no choice but to wait and see. In fact, regarding the reciprocal tariffs that are said to be announced on April 2, U.S. Treasury Secretary Scott Bessent has repeatedly given vague explanations such as, “For some countries, it could be quite low, for some countries, it could be quite high.” He has also said that each country would be given an opportunity to negotiate to avoid the “tariff wall.”

In short, nothing will be known until April 2, and even after it is known, things could change based on negotiations. Therefore, it seems likely that the status quo will continue even after the next meeting as a result of uncertainty. To decide to lower interest rates in a forward-looking manner based on the knowledge that the Trump administration’s tariff policy is deflationary is to make a firm decision to adjust policy based on the evaluation of a fluid situation from a fixed perspective. However, if Trump were to take the 2025 midterm election into account and decide against increasing the burden on the American people, his tariff policy could become mere formality. In such a scenario, lower interest rates would merely risk fueling inflation. In fact, since Powell has stated that “if there’s an inflationary impulse that’s going to go away on its own, it’s not the right policy to tighten policy because by the time you have your affect, your affect by design, you are lowering economic activity and employment, and if that’s not necessary, you don’t want to do it,” at least there is no indication that he will jump on the bandwagon of raising interest rates in response to additional tariffs. However, since the extent of additional tariffs is unknown, the Fed has no choice but to be hesitant about reducing interest rates in response to additional tariffs too. “Forward-looking interest rate cuts” are easier said than done under the Trump administration, so it is possible that the status quo will continue to be maintained owing to uncertainty after the next meeting. This is also implicitly a message to the market that interest rates cannot be lowered, which could well create a scenario in which U.S. interest rates and USD remain high.

Trump’s Policies and Their Impact on Forex Rates: Will There be No USD/JPY Pullback in 2025?*“No Winner” Tariff Policy Goes Into Effect*

In March, there was a big move with regard to the Trump administration’s tariff policy. On March 26, the president signed an executive order ordering the imposition of a 25% tariff on automobiles imported from all countries, including Japan. Since this is in addition to the existing 2.5% tariff, a total tariff of 27.5%, i.e., 11 times the current rate, will be

imposed on automobiles. On March 24, Trump further said, “We’ll be announcing some additional tariffs over the next few days, having to do with automobiles, cars, and having also to do a little bit with lumber down the road, lumber and chips,” giving the impression that this was only the first wave of Trump tariffs. The automobile tariffs will take effect on April 2, but it will probably take one or two quarters to assess their impact as confirmed by economic indicators. Trump has also stated that the auto tariffs are permanent and that “there’s no room for negotiation.” In other words, this is not a negotiating tool for getting the U.S. a better trade deal. If one assumes he was serious about what he said in his inaugural address, namely that he would make the U.S. a manufacturing superpower in the next four years, it seems likely that such measures will continue to be introduced in the future to boost production and employment in the U.S. However, both U.S. and foreign automakers are concerned that this increase in tariffs will lead to increased production costs and higher sales prices, which will ultimately lead to a decrease in sales, and this perception is probably correct. It is generally understood that, rather than just the price, the reason imported cars are so popular in the U.S. is that they are much more competitive, so logically speaking, the recently announced measures are likely to constitute a “no winner” tariff policy.

Downward Pressure Higher Than OECD Assumptions

Incidentally, the OECD Economic Outlook, released on March 17, is a useful reference for determining whether the impact of the Trump administration’s tariff policy is inflationary or deflationary. The OECD has also estimated the impact on each country’s GDP and inflation rate if the world were to negotiate the tariff rate down to 10% going forward, and the results are shown in the figure on the right. It is clear at a glance that inflation will rise and growth will fall, suggesting an intensification in stagflation. However, at the time of writing, it is already known for certain that a 20% flat tariff will be applied on Chinese imports, a 25% flat tariff on Mexican and Canadian imports, and a 25% tariff on steel, aluminum, and automobile imports from all countries. In other words, a 10% tariff rate is too modest an assumption, and one would do well to assume a much greater downward pressure than indicated by the OECD estimate. In particular, automobiles are literally the mainstay of Japanese exports, accounting for 30% of Japanese exports to the U.S. The imposition of 11 times the previous tariff rate will slash the profitability of exports to the U.S., potentially resulting in the restriction or halting of U.S. exports for models that become unprofitable. Naturally, this has a direct connection to production, employment, and other hard statistics pertaining to the Japanese economy.

Dark Clouds Over BOJ Rate Hikes Post 2026

Is there really no room for negotiation regarding the recent decision? Based on the information currently available, renegotiations seem difficult, but given the Trump administration’s proclivity to changing its policies from day to day, the situation should probably be viewed as fluid. What can be said for sure at this point is that the scope of policy operation has become even more restrictive for the BOJ. If the recently announced automobile tariffs are really a permanent measure, they will exert immense downward pressure on the Japanese economy, enough to hold back further interest rate hikes. In the long run, it is safe to say that these tariffs will have a deflationary impact not only on the U.S. economy but also on the Japanese economy.

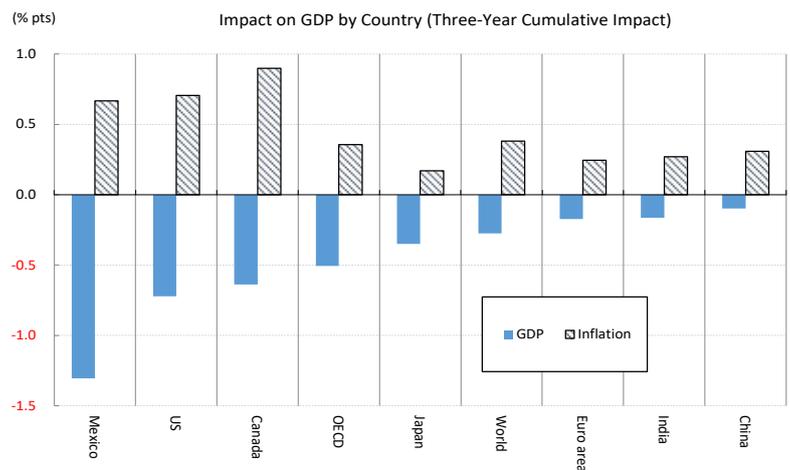
However, as suggested by the OECD

estimates above, the Trump administration’s tariff policy will push up inflation in the near term. It must be noted that the tariff policy has a two-tiered impact – inflation in the short term and deflation in the long term. Given that Japan is currently facing consumer price index (CPI) growth that outstrips Europe and the U.S., my main forecast scenario is that there will be no change in the pace of interest rate hikes, at about once every six months. However, will the BOJ be able to continue its current rate hike policy path if, from the second half of this year through 2026, the damaging impact of automobile tariffs becomes apparent in Japanese and U.S. hard economic data? I will not go so far as to say that the BOJ’s rate hike policy after 2026 faces a red light, but my impression is that it is facing a yellow light. The “tariff effect” will inevitably have to be taken into account in any serious consideration of the JPY outlook after 2026.

Risk to April-June 2025 USD/JPY Pullback

Of course, setting other countries aside, a policy that seems likely to invite great resentment domestically may not be sustainable for the Trump administration, so it is possible that some of the currently announced tariffs will be withdrawn. In that sense, there is no point finalizing predictions for after 2026 at this point. At present, the BOJ’s rate hike path is consistent with the short-term inflationary impact of the tariff policy, so, speaking only of 2025, there is no need to make major revisions to the JPY outlook from the perspective of JPY interest rates.

On the other hand, the U.S., which is the party paying the import tariffs, will be hit by significant inflationary pressure in the short term as indicated by the OECD estimates, so the Fed may implement fewer rate cuts than expected. As a result, USD/JPY is likely to remain propped up by persistently high U.S. interest rates. This is a blessing in disguise for Japanese automakers, given that the negative impact of additional tariffs will be somewhat offset by JPY weakness.



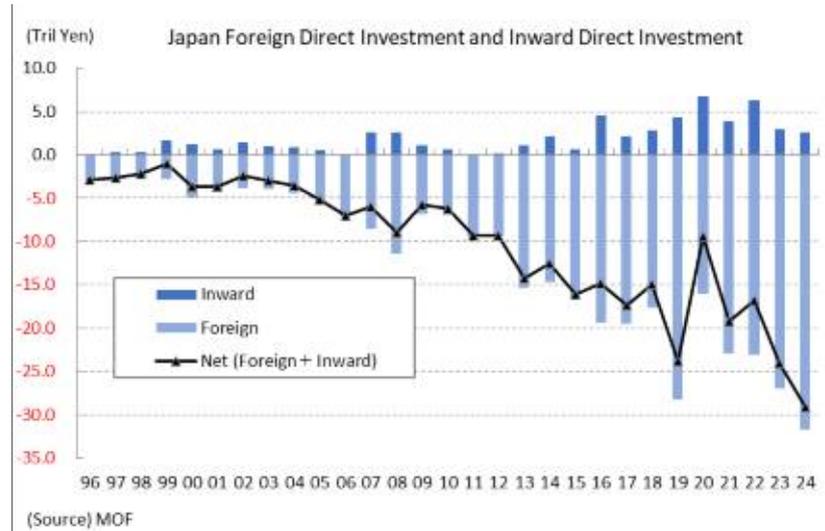
(Source) OECD, *Deviation from baseline scenario in case of 10% tariffs

This poses a risk to this report's main scenario, which has been predicting a significant pullback in USD/JPY during the April-June 2025 period.

JPY Supply-Demand Climate – Implications of Largest Ever FDI

Direct Investment, Largest Ever Net Outflow

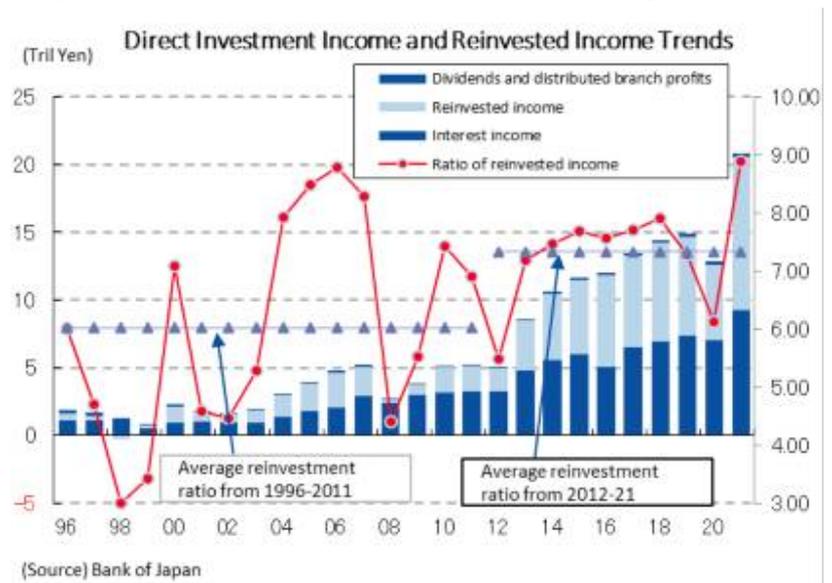
As the Balance of Payment figures for the entire year 2024 become available, I made a long-term prediction in this report last month about the possibility of the services deficit, led by the digital deficit, expanding. At that time, I naturally confirmed that the 2024 primary income surplus had posted its largest ever, hitting the +JPY40 trillion level, resulting in a current account surplus of approximately +JPY29 trillion, again the largest ever. However, I did not touch upon the important movements pertaining to the financial balance, which I would like to present here. Of particular note was direct investment. Although not widely reported, Japan's foreign direct investment (FDI) posted a total of -JPY31.6325 trillion, the largest ever, for 2024. On the other hand, inward direct investment by other countries in Japan, which is spearheaded by the government and ruling party, posted a total of only +JPY2.5648 trillion. As a result, the net direct investment (inward minus outward) capital flow was -JPY29.0677 trillion, the largest net outflow ever. Given that direct investment capital flows are outright (one-time selling/buying of JPY), this was no doubt exerting downward pressure on JPY.



The "Mask" Thickens

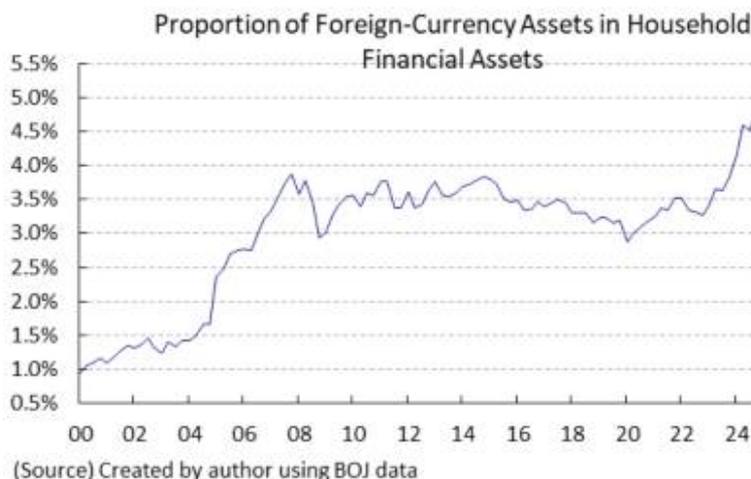
Statistically, the overseas earnings of the Japanese corporate sector through FDI result in a surplus in the primary income balance. If net FDI continues to be overwhelmingly large, the current account surplus, led by the primary income balance, will continue to be enormous in statistical terms. In fact, it will strengthen further. Japan's "mask" as a current account surplus nation – surplus in statistical terms but deficit on a cash-flow (CF) basis – will become thicker. Focusing on receipts in the primary income balance (see graph), the proportion of reinvested earnings was about 22% in 2024 and about 23% on average over the past 10 years from 2015 to 2024. This is double the average from 1999 to 2013 (about 9%).

The proportion of earnings by the Japanese economy from overseas investments that are not repatriated to the country but treated as internal reserves instead has skyrocketed, resulting in the discrepancy between the statistical vs. CF-based current account balance, i.e., the thickness of the "mask." After over three years of JPY weakness, there are cost-related benefits from JPY weakness, and the corporate sector is steadily more concerned about labor distribution in the face of extreme labor shortages, so the importance of domestic investment, including in terms of labor costs, will only increase going forward. However, this movement is not yet a major trend that can be confirmed in the balance of payments statistics as a capital inflow into Japan.



Ratio of Foreign-Currency-Denominated Assets Hit Record High

According to the BOJ's Flow of Funds Accounts (preliminary) for the October-December 2024 quarter, which was released on March 21, household financial assets as of the end of December 2024 had reached a record high of JPY2,230.3 trillion. What was particularly noteworthy this time was the expansion of household foreign currency assets, which had increased by more than 10%, from JPY98.6 trillion in the previous quarter to JPY108.8 trillion, setting a new record high. USD/JPY rose by just under 10% from around 143 to the dollar at the end of September to around 157 yen to the dollar at the end of December, so this movement is likely reflecting the impact of JPY weakness.



Composition of Japanese Household Financial Assets (as of the end of DEC 2024)

	Amount (¥trillion)	Share (%)
Total assets	2,230.3	100.0
Foreign currency nature	108.8	4.9
Foreign currency deposit	7.4	0.3
Foreign investment in securities	39.4	1.8
Investment trust	62.1	2.8
Yen character	2,121.5	95.1
Cash and deposits (excluding foreign currency deposits)	1,126.9	50.5
Government bonds, etc.	31.8	1.4
Stocks and investments	298.1	13.4
Investment trusts (excluding foreign currency portion)	79.5	3.6
Insurance and pension reserves	544.4	24.4
Deposits, etc.	40.7	1.8

Composition of Japanese Household Financial Assets (as of the end of DEC 1999)

	Amount (¥trillion)	Share (%)
Total assets	1,401.6	100.0
Foreign currency nature	12.5	0.9
Foreign currency deposit	2.9	0.2
Foreign investment in securities	4.7	0.3
Investment trust	4.9	0.3
Yen character	1,389.2	99.1
Cash and deposits (excluding foreign currency deposits)	748.1	53.4
Government bonds, etc.	51.6	3.7
Stocks and investments	138.1	9.9
Investment trusts (excluding foreign currency portion)	50.7	3.6
Insurance and pension reserves	365.5	26.1
Deposits, etc.	35.2	2.5

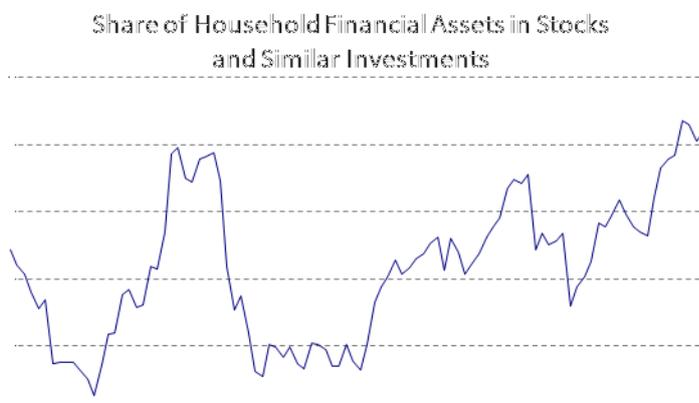
Changes from the end of DEC 1999 to the end of DEC 2024

	Amount (¥trillion)	Share (%)
Total assets	828.7	
Foreign currency nature	96.4	4.0
Foreign currency deposit	4.4	0.1
Foreign investment in securities	34.7	1.4
Investment trust	57.2	2.4
Yen character	732.3	▲ 4.0
Cash and deposits (excluding foreign currency deposits)	378.8	▲ 2.8
Government bonds, etc.	▲ 19.7	▲ 2.3
Stocks and investments	160.0	3.5
Investment trusts (excluding foreign currency portion)	28.8	▲ 0.1
Insurance and pension reserves	178.9	▲ 1.7
Deposits, etc.	5.5	▲ 0.7

The ratio of foreign-currency assets within household financial assets also rose by 0.4 pp from 4.5% in the previous quarter to 4.9% this time, also posting the highest on record (see table). Incidentally, the foreign currency assets of Japanese households were only JPY12.5 trillion at the end of December 1999, a quarter century ago, and accounted for only 0.9% of total household assets, so the balance has increased by just under nine times, and the ratio has increased over five fold. So what asset has declined instead in terms of both the outstanding balance and ratio within household financial assets? The most noticeable is JPY cash and deposits, which have increased from JPY748.1 trillion to JPY1,126.9 trillion, but fallen in terms of ratio by just under 3 pp, from 53.4% to 50.5%. The next largest decline is in government bonds, etc., which has decreased from JPY51.6 trillion to JPY31.8 trillion in terms of outstanding balance and by over half, from 3.7% to 1.4% (table on previous page), in terms of ratio of household assets.

Household Assets Adapting to Weak-Currency-Led Inflation

Incidentally, not all JPY-denominated assets have fallen in proportion. The balance of stocks and investments has more than doubled from JPY138.1 trillion to JPY298.1 trillion, and their proportion within total household assets has increased by a remarkable +3.5 pp, from 9.9% to 13.4%. In the past quarter century, stocks and investments are the only JPY-denominated assets whose proportion has increased (see graph). Meanwhile, as discussed in past issues of this report, a significant proportion of insurance and pension reserves, which still account for 24.4% (about a quarter) of household assets despite a -1.7pp decline in ratio compared to a quarter of a century ago, are suspected to be held as foreign-currency assets, in the form of foreign



(Source) Bank of Japan

currency-denominated life insurance, etc. If even just 5% (equivalent to about JPY27 trillion) of insurance and pension reserves is in foreign currency, it could easily push up the proportion of foreign currency-denominated assets by +1 pp or more, and if we assume 10% is in foreign currency, the proportion would be pushed up by +2 pp or more. While

precise calculations are difficult, it may be worth considering the possibility that the proportion of foreign-currency assets within household financial assets is already close to 10%.

To summarize, household financial assets have been rebalanced over the past quarter century by increasing foreign currency and stocks and decreasing cash and government bond holdings; this can be described as investment behavior adapted to inflation caused by the depreciation of the domestic currency. If we consider that investments have shifted to JPY cash and deposits in times of deflation and currency appreciation, and to risk assets including foreign currency in times of inflation and currency depreciation, it seems that the household sector has generally made rational asset choices, although of course, some of this can be attributed to the success of the government's policy encouraging the formation of an asset management nation.

Government on Track to Achieving Its Goal

Two days before the release of the Flow of Funds Accounts, on March 19, Japan Securities Dealers Association (JSDA) announced that purchases of stocks, investment trusts, etc., through the NISA scheme had reached at least JPY56.5 trillion. JSDA arrived at this figure by adding the cumulative purchase amount of JPY52.7 trillion by all financial institutions as of the end of 2024 to the purchase amount of JPY3.8 trillion by 10 securities companies in January and February 2025. Looking back, one recalls that, in November 2022, the then Kishida administration drew up the "Doubling Asset-based Income Plan" and set two goals at the Council of New Form of Capitalism Realization. The first goal was to "double the total number of NISA accounts (general and installment) in five years (from 17 million accounts as of June 2022 to 34 million) with the aim of doubling the number of people with investment experience." The second one was to "double the amount of NISA purchases in five years (from JPY28 trillion as of June 2022 to JPY56 trillion) with the aim of doubling investment by households." The latter goal has been achieved in just over a year.

As for the former, the number of accounts held in all financial institutions as compiled by the Financial Services Agency was only 25,604,058 as of the end of 2024, so growth is not as robust as in the case of the purchase amount, but it is not pessimistic either. Given that the number of accounts was 21,247,420 as of the end of December 2023, one can see that a total of 4,356,638 accounts were added last year. The government's target of adding 17 million accounts in five years can be realized if an average of 3.4 million accounts are added per year, so the pace of increase in 2024 is sufficient to achieve the government's target. It is obvious that the historical weakness of JPY has led to an increase in the amount of managed assets.

Conscious "Flight from Savings" by Younger Generations

Looking at the data by age group, younger generations show a conspicuous increase in desire to manage their assets.

Age group data for all of 2024 has not yet been released, but at the end of March 2014, when NISA was first launched, over half of the accounts were held by people aged 60 or older (see table). However, as of the end of September 2024, the share of accounts held by people aged 60 or older was no more than 30%. Meanwhile, during the same period, the share of accounts held by people in their 20s and 30s has risen sharply from around 10% to nearly 30%. The top share in terms of the

	Number of accounts (End of MAR 2014)	Share	Number of accounts (End of SEP2024)	Share
Total number	6,503,951	100.0%	25,086,221	100.0%
10 s			128,936	0.5%
20 s	209,144	3.2%	2,878,530	11.5%
30 s	501,895	7.7%	4,391,484	17.5%
40 s	823,581	12.7%	4,826,897	19.2%
50 s	1,078,784	16.6%	4,810,864	19.2%
60 s	1,874,228	28.8%	3,691,248	14.7%
70 s	1,490,993	22.9%	2,858,589	11.4%
80 s and above	525,326	8.1%	1,499,673	6.0%

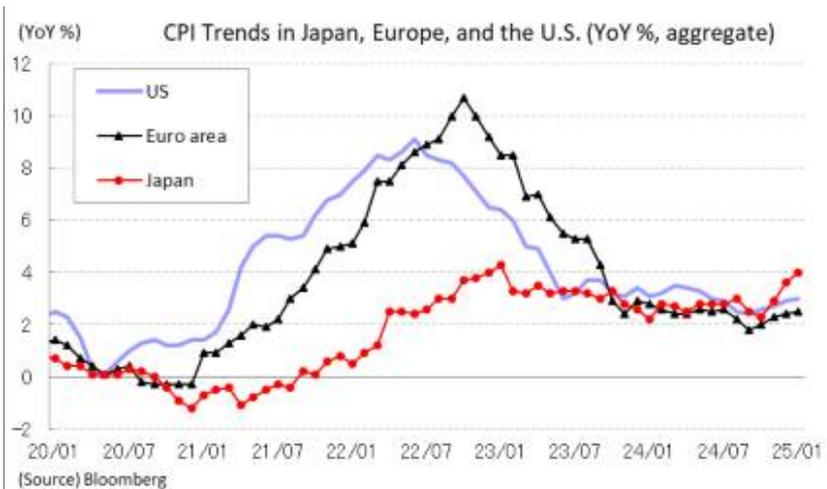
Source: Author from the Financial Services Agency

number of accounts has also shifted from those in their 60s and 70s to those in their 40s and 50s, indicating that the working generation is clearly beginning to take greater interest in asset management. Given recent trends, the working generation, especially younger people in their 20s and 30s, have no experience of the Japanese economy suffering from chronic JPY strength. Rather, they are strongly aware of the travails of JPY weakness and inflation. This experience is bound to give rise to a desire to invest in overseas assets, mainly U.S. stocks, and it cannot be denied that this may also be contributing to the present JPY weakness. There is a progression from "savings to investment," but at the same time, there is also a "flight from savings" rooted in a defensive consciousness of the risk of keeping assets in JPY. In this sense, recent asset management data hides an interesting insight regarding the current national consciousness, namely that the generation on whose shoulders the Japanese economy rests going forward has the least expectations of Japan.

Risks to My Main Scenario – Should Japan be Considered a Declining Nation?

How to Read the Markets Three Years Since the Start of the War?

February 24, 2025 marked the third anniversary of the outbreak of the Russia-Ukraine War. We can summarize Japan's economic and financial situation over the past three years as "the delay in interest rate hikes by the BOJ and rising resource prices led to increased JPY selling from both interest rate and supply-demand perspectives, importing enormous inflationary pressure and stalling real growth." Note also that, for Japan, the outbreak of the Russia-Ukraine War signaled the start of the current JPY depreciation phase. Immediately after the outbreak of the war, resource prices rose amid concerns about supply constraints due to geopolitical risks, and CPI growth rates as



high as 7-8% became the norm in Europe and the U.S. (see graph). Around this time, Japan's CPI also settled at the +2% level, and the tide of global inflation was arriving at its shores, but the then BOJ administration under Haruhiko Kuroda repeatedly proclaimed its commitment to monetary easing while making full use of fixed-price operations. There is no denying that Kuroda's repeated remarks at that time to the effect that JPY weakness was a positive for the Japanese economy as a whole led to an unnecessary widening of the U.S.-Japan interest-rate gap, which pushed JPY selling and USD buying. As I will discuss later, I do believe that the changes in supply and demand that were occurring around that time were more important on a fundamental level, but the fact that the BOJ stood out among central banks around the world in terms of its unusual policy response is also sure to have played a role.

When reviewing interest rate, exchange rate, and stock price trends over the past three years, one cannot help but feel that it was not necessarily the interest rate differential that drove JPY depreciation (see graph). It is true that, in the space of a year following the outbreak of the war (February 24, 2022 to February 24, 2023), the Japan-U.S two-year interest rate differential had more than tripled, and the 10-year interest rate differential had more than doubled. It is natural to think that this contributed greatly to USD/JPY rising rapidly by just under +20%. The problem, however, is what happened after that. USD/JPY has continued to rise since 2023, and remains persistently high with no major corrections. For example, during the subsequent year (February 24, 2023 to February 23, 2024, *February 24 being a Saturday), the two-year interest rate differential narrowed slightly while the 10-year interest rate differential remained flat, but USD/JPY still rose by over +10%. Further, during the year after that (February 23, 2024 to February 24, 2025), both the 2-year and 10-year interest rate differentials shrank significantly, but USD/JPY remained at around 150 to the dollar. No matter how one looks at it, the relationship between the interest rate differential and USD/JPY is not as definite as many market participants say it is. When JPY began to weaken three years ago, most market participants probably thought that it was simply a question of waiting it out until the Fed began to cut interest rates. As of the present, however, it is clear that even after rate cuts by the Fed and rate hikes by the BOJ to boot, JPY depreciation has still not ended. Interest rate differentials do inform the direction of USD/JPY to some extent, but it is difficult to explain JPY rate trends over the past three years solely based on them.

Changes in the Market Since Outbreak of Ukraine War

	U.S.-Japan 2-year interest-rate gap	U.S.-Japan 10-year interest-rate gap	USD/JPY	Nikkei Stock Average	Dow Jones Industrial Average	Japan trade balance (annual)
2022/2/24	1.56	1.56	115.61	25,970.82	33,223.83	-21.1
2023/2/24	4.80	3.5	136.39	27,453.48	32,816.92	-9.4
2024/2/23	4.52	3.54	150.51	39,098.68	39,131.53	-6.5
2025/2/24	3.30	2.97	149.41	38,776.94	43,461.21	-

(Source) macrobond

Significant Change in Supply And Demand Climate Over Past Three Years

If not interest-rate differentials, what must one look at? It is clear that the supply and demand structure has changed significantly over the past three years.

The trade and services deficit have been shrinking steadily, from about -JPY21.1 trillion in 2022, to about -JPY9.4 trillion in 2023, and about -JPY6.5 trillion in 2024, but these are the first, fourth, and sixth largest deficits on record, and by no means small (see graph). Incidentally, the trade and services balance immediately before the pandemic was a surplus of about +JPY1 trillion for the five-year average (2015-19), and a deficit of about -JPY2.5 trillion for the 10-year average (2010-19). It has long been my basic understanding that such changes in the supply and demand structure were what prevented a correction of the JPY depreciation trend despite the narrowing of the U.S.-Japan interest-rate differential.

Incidentally, inflation resulting from JPY depreciation during this period has pushed up general prices in Japan significantly, with the result that real GDP growth has been close to zero despite much being made of nominal GDP growth in excess of JPY600 trillion. Having already detailed this point in my report last month, I will skip it this time, but the Japanese economy since 2022 has been characterized by an income outflow from Japan due to JPY-weakness-led inflation, clearly worsening the real income climate for the people of Japan.

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

	Trade	Services	Trade and Services	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

Japan's Precariousness Revealed in High Stock Prices

As is well known, even as JPY has weakened and inflation has progressed significantly, resulting in economic stagnation, Japanese stock prices have risen sharply. Readers will also be aware that real estate and other asset prices have also risen sharply. The trend is more obvious when comparing stock price, exchange rate, and inflation trends internationally. Japanese stocks have been hit by a major correction since early March this year, but it is still a fact that they have experienced a fairly large rise over the past three years. How must we interpret this? I am worried that these high share prices are a sign that Japan's economy may be becoming more similar to that of emerging countries.

Ever since the pandemic, Japanese real estate and stock prices have been rising strongly. For example, over the three years from February 24, 2022 to February 24, 2025, the Nikkei Stock Average has risen by nearly 50% (from JPY25,970.82 to JPY38,776.94). It seems natural to view this as a textbook case of nominal asset prices rising due to inflation fueled by a weak currency. A glance at the chart on the next page shows that this phenomenon, of the stock price index of a country suffering from high inflation due to a weak currency being pushed up, is symbolic of emerging countries such as Turkey and Argentina.

Let us take a look at the top 20 major stock indexes in terms of rate of increase from March 1, 2022, just after the war broke out, to July 11, 2024, when the Nikkei Stock Average hit an all-time high (JPY42,224.02), and compare this with the rate of change of each country's currency against USD as well as the average CPI growth rate for each country during the period in question. There are a total of 18 countries, as Turkey and Japan are ranked twice in the stock index, and 15 currencies, as four euro member countries (Montenegro is an unofficial member country) are included. Japan is the only G10 member country on the list, and even among 38 OECD member countries, only five – Japan, Denmark, Greece, Hungary, and Slovenia – are on the list. It has to be said that this is a rather unusual position for Japan to be in, given that it is, in fact, a member of the G7. At the very least, the Nikkei Stock Average's rate of increase since March 2022 is extremely unusual for a developed country. Three years into the war, one can say that Japan's economic and financial conditions have changed.

	Key Global Stock Price Indices (Top 20 by Rate of Increase)	Stock Price Indices	Rate of Change If Local Currency Converted into USD	Country	CPI (*2)
1st	MERVAL	1838.93%	-88.3	Argentina	151.9
2nd	XU100	459.64%	-57.7	Turkey	61.9
3rd	XU030	441.92%	-57.7	Turkey	61.9
4th	EGX30	150.87%	-67.3	Egypt	21.8
5th	CYSMMAPA	144.97%	-2.3	Cyprus	4.8
6th	LUSEIDX	124.77%	-30.3	Zambia	11.1
7th	NGSEINDX	109.48%	-73.7	Nigeria	23.3
8th	BUX	84.88%	-6.7	Hungary	11.8
9th	KSE100	78.72%	-36.3	Pakistan	22.0
10th	BLOM	69.54%	-98.3	Lebanon	171.2
11th	LSXC	68.37%	-48.4	Laos	25.2
12th	KFX	67.60%	-2.6	Denmark	4.4
13th	ASE	66.87%	-2.3	Greece (*1)	5.4
14th	NKY	57.29%	-28.8	Japan	2.7
15th	KZKAK	54.64%	2.9	Kazakhstan	12.7
16th	TPX	54.40%	-28.8	Japan	2.7
17th	MONEX	52.69%	-2.3	Montenegro (*1)	8.6
18th	BET	48.31%	-2.9	Rumania	10.1
19th	IPSA	47.56%	-11.5	Chile	7.5
20th	SBITOP	45.10%	-2.3	Slovenia (*1)	6.3

(Source) Bloomberg. The rate of change in stock prices and currency is from March 1, 2010 to July 11, 2012.

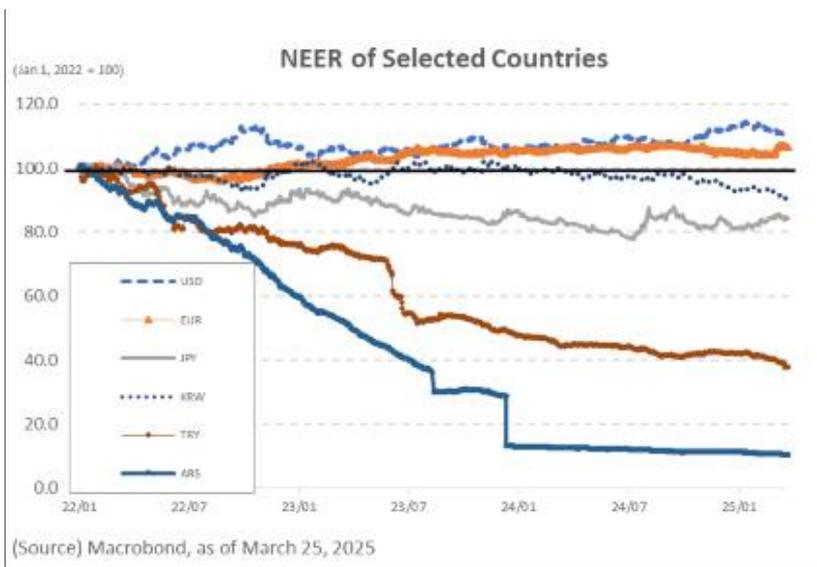
July 11, 2024 was the day when the Nikkei hit its highest level ever.

*1: Countries that use the euro. Although Montenegro is not an official EU member, it unilaterally introduced the German mark during the civil war, and it unilaterally introduced the euro at the same time as Germany.

*2: 2022-24 average.

Middle-Income or Declining Country

As one can see, 10 of the 15 currencies in the graph recorded double-digit declines against USD. The average rate of change against USD for the currencies pertaining to the top five indices (four currencies, due to the overlapping of TRY) is about -49%, which is a notable crash. The average rate of change against USD for the currencies pertaining to the top 10 indices (nine currencies) is about -51%, which, again, is large. JPY is in a similar bracket for the same period, at -29%. To repeat, this is an unusual situation to be in for a currency that enjoys a considerable status as a foreign exchange reserve currency and is the currency of a G7 member state. In terms of nominal effective exchange rate (NEER) over the past three years (see graph), JPY is far behind USD and EUR, and is even inferior to the KRW, which was weak among Asian currencies, but not as bad as TRY or ARG.



Incidentally, the average CPI growth rate of economies pertaining to the top five indices (four economies, since Turkey overlaps) is +60%, and that for the top ten indices (nine economies) is +53%, which is also quite large. Japan's CPI growth rate for the same period was +2.7%, but this is a big change considering that zero percent had been the norm for nearly 30 years.

While the above figures are only circumstantial evidence, it seems likely that in the three years since the start of the Russia-Ukraine war, the Japanese economy's problems have shifted, to some extent irreversibly, from a strong to weak currency, and from deflation to inflation. Such a transformation is closer to what is happening in developing rather than developed countries. Of course, it is clearly an exaggeration to describe Japan as a developing country, but it may be possible to call it a middle-income country, which falls between developed and emerging countries, or perhaps "declining country" would be more appropriate in that it also gives a sense of the direction in which the transformation is taking place (from developed to emerging).

Intuitively, it does seem more appropriate to say that Japan's position is gradually shifting downward from that of a developed country. At the very least, one can say that it is a gross oversimplification to explain JPY depreciation, which began three years ago, based merely on the widening U.S.-Japan interest-rate differential owing to the Fed's rate hikes. I would like to analyze the current status and future outlook of the Japanese economy and JPY while keeping my sights firmly on the bigger picture.

EUR Outlook – How to Interpret Background to EUR Strength

EUR Area Monetary Policies Now and Going Forward – Signs of an Expansionary Fiscal Policy Going Forward

Turning Point in Rate Cut Policy Path

At the ECB Governing Council meeting held on March 6, the decision was made to cut various policy interest rates by 25 basis points each for the fifth consecutive meeting. The deposit facility rate, which was closely watched by the markets, was lowered to 2.50% and is expected to enter the neutral interest rate range, which is estimated at 1.75-2.25%, following the next rate cut. In fact, the tone of the messaging is being revised to reflect this; where previously, the Account of the monetary policy said “monetary policy remains restrictive,” it has now been revised to say “monetary policy is becoming meaningfully less restrictive.” Given that it does not say “not restrictive,”

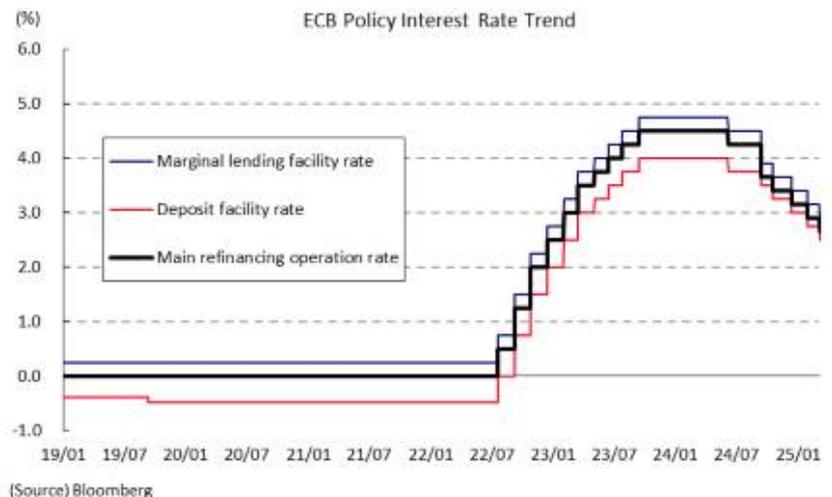
the language suggests that there is still room for interest rate cuts while also communicating a decline in the probability of rate cuts. ECB President Christine Lagarde also suggested that this change was the biggest point of the meeting (details later), so there seems no doubt that the ECB is approaching a turning point in the rate cut policy it has been pursuing since June last year (see graph).

I would like to summarize the background to the above revisions as follows: 1) the regional economy is slowing down sufficiently, 2) EUR strength as a result of USD weakness is suppressing imported inflation, and 3) there are expectations of a region-wide increase in fiscal spending. Point 3 in particular has strengthened since the inauguration of the second Trump administration, and was also a point of contention at the recent press conference by Lagarde (see below). Theoretically speaking, the move toward an expansionary fiscal policy justifies adjusting monetary policy to be more restrictive in consideration for overheating inflation, so this tone revision is logical. Lagarde did not admit this explicitly, but reality is likely to catch up going forward.

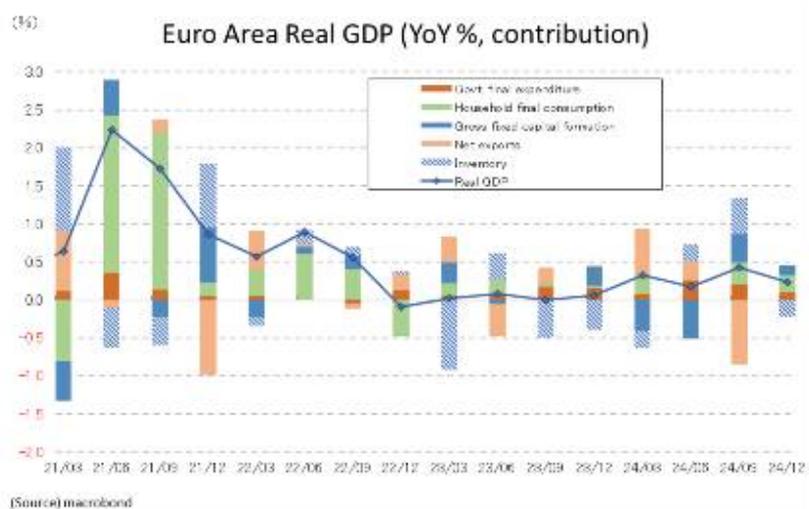
“Warm Water” and “Cold Water”

The first question from a reporter at the press conference was about the true meaning of the aforementioned messaging in the ECB Account. Specifically, the question was, “Does (the new wording) mean you could slow the pace of rate cuts now and perhaps pause in April?” In response, Lagarde frankly acknowledged the importance of the change, saying, “You very well noted that we have changed the wording. (...) It’s not just an innocuous little change, it’s a change that has a certain meaning.” She went on to describe euro area’s current situation using an analogy, “I used a comparison a few weeks ago, when we were at the G20 in South Africa, of the Cape of Good Hope, where you have warm water from the Indian Ocean and the cold water from the Atlantic – and this is really where the position is at the moment, where we have the impact of the current monetary policy decisions that we take, and have been taking, which is to cut rates. But at the same time, we still have the cold water of the Atlantic, meaning the remaining effects of decisions that we have taken over the course of time.” She said that this is what had “led us to acknowledge the fact that our monetary policy is becoming meaningfully less restrictive.”

However, she avoided committing herself in response to the question whether rate cuts would be paused in April, saying it was “data-dependent.” In fact, the second question was also about the possibility of pausing rate cuts in April, but her response was evasive as before. Lagarde went so far as to say regarding the indecisive nature of the situation, “I know some will find it frustrating, but I’m terribly sorry.” (The decision is) “data-dependent as ever.” Clever expressions used at press conferences often reappear at later dates, so it is quite possible that Lagarde might use



(Source) Bloomberg



(Source) macrobond

an expression such as “the waters have gotten warmer” to convey a change in the situation when a decision is made to halt rate cuts.

Impact of an Expansionary Fiscal Policy

As discussed below, the hottest topic in the euro area is the shift to an expansionary fiscal policy centered on defense spending. Since interest rates within the euro area have already been significantly affected, the ECB’s actions are naturally being questioned. In addition to the possibility of pausing rate cuts in April, the first reporter asked, “There’s a pretty drastic shift on the way with plans for much higher defence spending, and in Germany’s case also infrastructure. There’s been a significant market reaction as well. Could you elaborate on how the Governing Council expects this to change the economic outlook and monetary policy?” In response, Lagarde said, “I have to say that we have not been spared recent developments in the last few hours and days.” This statement acknowledged the potential impact from likely big changes in Germany’s fiscal management and the likely decision on European defense plans at the Special European Council meeting held on the same day as the Governing Council meeting (*the summit was in progress at the time of Lagarde’s press conference). However, it remains unclear when and where these infrastructure and military purchases will be made, and how their funds will be procured, so their impact is not clear at this point. While Lagarde acknowledged the importance of these purchases, she noted that their impact was yet to be understood. The developments do not appear to have been factored into the ECB staff forecasts either.

The recent staff projections for euro area real GDP growth were also downwardly revised by -0.2pp from the previous time (December 2024) to +0.9% in 2025 and +1.2% in 2026, suggesting that the boost from an expansionary fiscal policy has not been factored in (see table). While there are still many uncertainties, Lagarde argues that what can be said about these issues is that they “would be supportive to European growth at large and would be a boost to the European economy,” suggesting that there could be upward revisions to the staff projections and a corresponding slowdown or halt to interest rate cuts going forward.

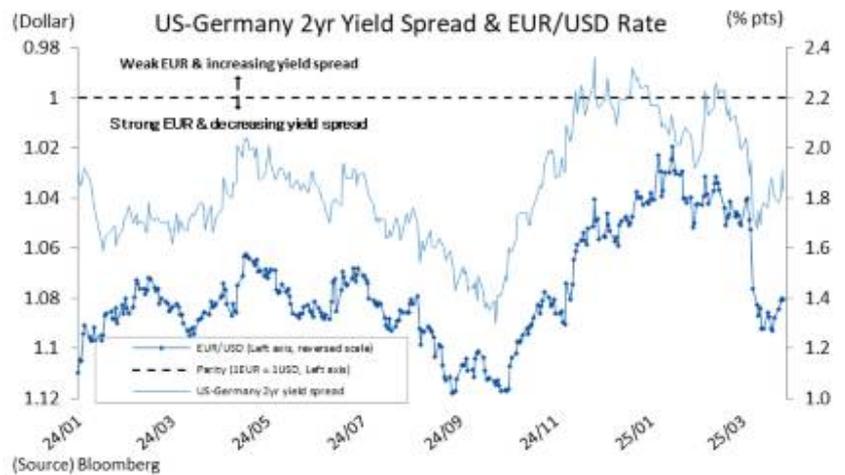
ECB Staff Macroeconomic Projections (March 2025) (%)

	2025	2026	2027
HICP	2.3	1.9	2.0
(previous: Dec 2024)	2.1	1.9	2.1
Core HICP	2.2	2.0	1.9
(previous: Dec 2024)	2.3	1.9	1.9
Real GDP	0.9	1.2	1.3
(previous: Dec 2024)	1.1	1.4	1.3

(Source) ECB, EUR/USD exchange rate for 2025-27 assumed to be 1.04. *Core excludes energy and food

The Sustainability of “EUR Appreciation as a Result of USD Depreciation”

Concerns that the Europe-U.S. interest rate gap will widen in response to the economic disparity between the U.S. and Europe, resulting in higher inflation through a weaker EUR, have been rapidly diminishing. The euro area economic and financial situations have not actually improved, but concerns about U.S. economic stagnation have pushed down U.S. interest rates and USD, resulting in EUR appreciation as a result of USD depreciation. Further, forecasts of an expansionary fiscal policy within the region have suddenly strengthened, pushing up European interest rates and narrowing the Europe-U.S. interest rate gap, thereby supporting EUR (see graph).



As mentioned in point (2) earlier, this unexpected strengthening of EUR has suppressed imported inflation, which may also have reduced the need for interest rate cuts. However, in the short term, concerns about U.S. economic stagnation are also concerns about stagflation caused mainly by the additional tariffs, so there may be significant room for debate about the sustainability of U.S. interest rate decline. If stagflation is a real threat, there is reason to be concerned about a rise in U.S. interest rates.

Currently, EUR is stronger than predicted in this report’s main scenario, but whether it will continue to rise depends largely on whether USD continues to weaken. While I may have to consider revising my forecast level for EUR upward, I see no need to revise the path itself for the purpose of this report’s outlook.

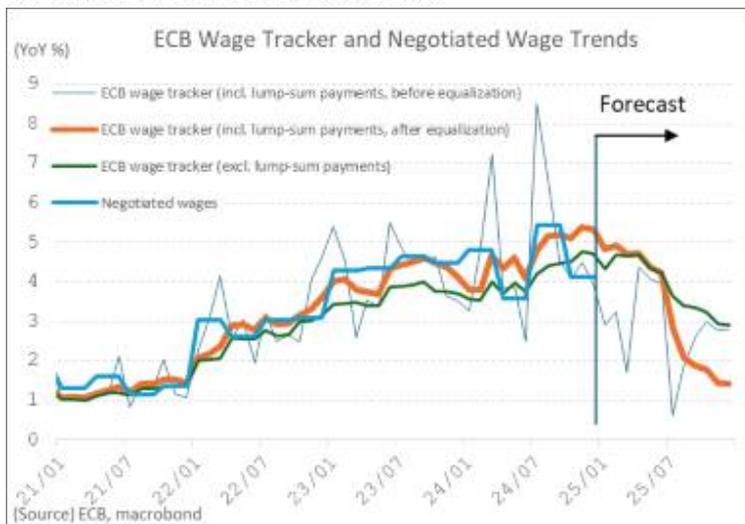
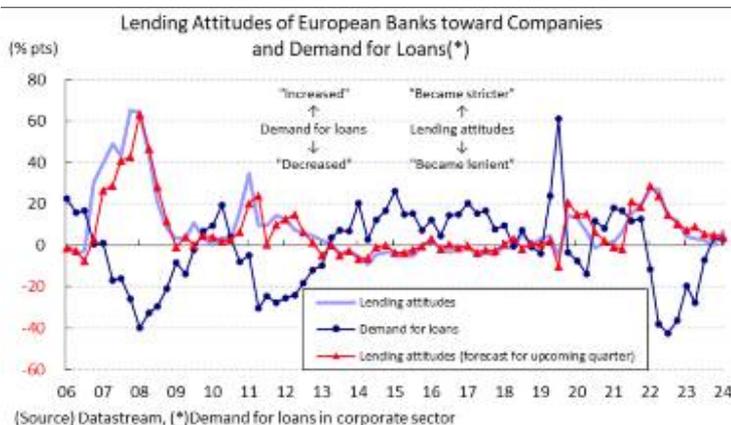
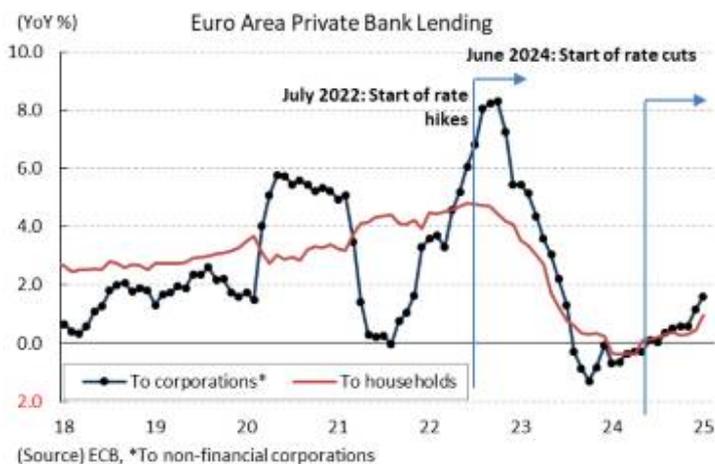
Euro Area Economic and Financial Situations – Background to EUR Strength and Existence of “Warm Water”

Considering the Background to EUR Strength

As mentioned above, EUR has been appreciating even as USD has been weakening. This is happening amid growing concerns about the U.S. economy as the Trump administration imposes additional tariffs in rapid succession, pushing down U.S. interest rates and USD. In a word, EUR has appreciated as a result of USD depreciation; as widely known, the political and economic situation in the euro area is by no means commendable. My basic understanding is that this strength of EUR due to USD weakness is not very sustainable. However, it is also true that the situation on the ground is far from this report’s main forecast scenario that parity breach would become the norm. Can one simply dismiss the current EUR strength as being driven solely by USD weakness? Is there no need to seriously reassess the region’s economic and financial conditions? Until now, I have been formulating the EUR outlook based on the premise that ECB policy interest rates lowered to the neutral interest rate (around 2%), as priced in by the financial markets, is insufficient. Current market predictions center around two more rate cuts this year, with no expectation of rates falling well below the neutral interest rate. Given the communication following the March Governing Council meeting, it is natural to assume that the ECB’s current rate cut phase will not continue for much longer. This was not something I had foreseen. EUR’s current strength may be due to USD weakness, but it could also be the result of a considerably positive assessment of the region’s economic and financial situations. There are figures that confirm this.

Warm Water Does Exist

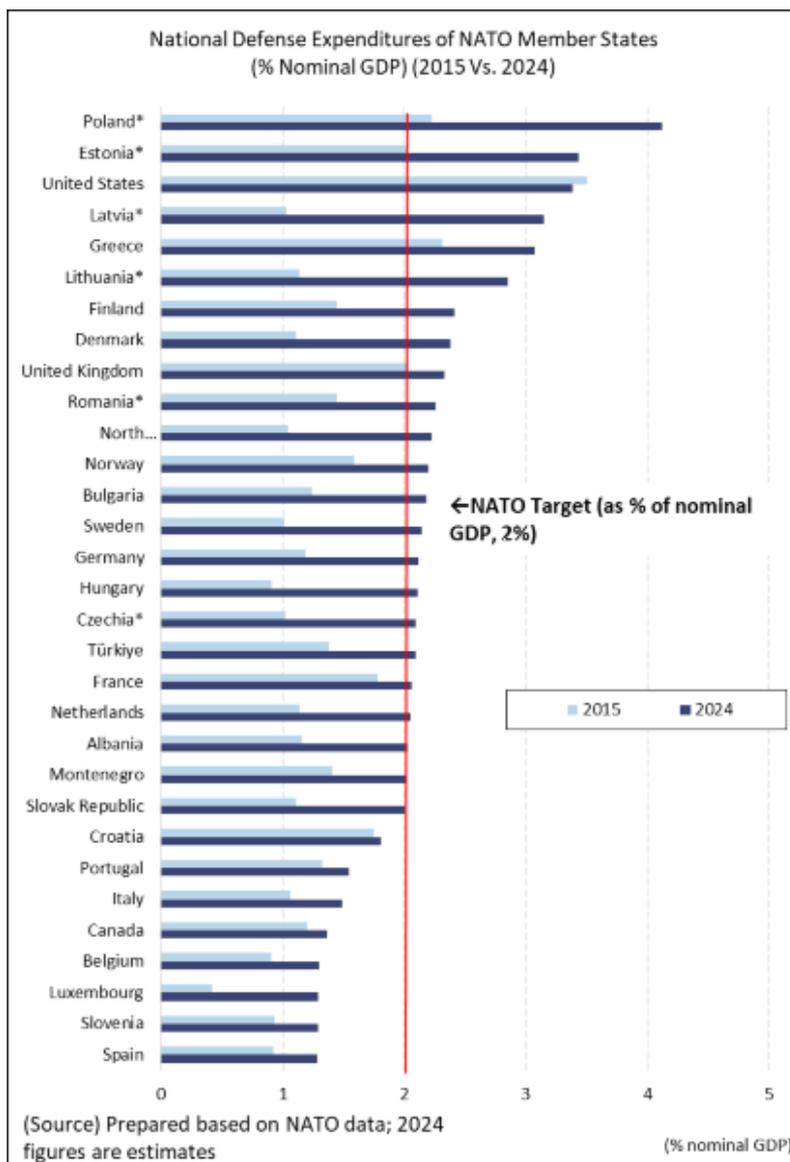
Credit-related figures, for instance, are showing signs of improvement. As mentioned above, the March Governing Council meeting hinted at a pause to rate cuts, and Lagarde likened the improving trend in the euro area economy to “warm water.” The implication was that while the “cold water” caused by the interest rate hikes remains in the system, “warm water” is also flowing into the regional economy due to the rapid interest rate cuts. However, she did not specify what economic phenomenon “warm water” referred to. According to orthodox thinking, revisions to policy interest rates are directly linked to changes in the credit environment. Is bank lending in the region, which had cooled due to interest rate hikes, recovering due to interest rate cuts? Are there signs that “warm water” is flowing into the real economy through the banking sector? As shown in the figure (top), bank lending in the region has been increasing yoy since June 2024, when interest rate cuts began, and accelerating since the beginning of this year. This trend can also be confirmed in the euro area bank lending survey (figure, center). As lending attitudes stabilize, demand for loans is also showing signs of recovery. Currently, the euro area Harmonized Index of Consumer Prices (HICP), negotiated wages, and associated wage trends are showing signs of suppression (figure, bottom). The newly developed ECB wage tracker clearly shows a slowdown in wage growth going forward through the end of 2025. I had assumed that the ECB would continue to cut interest rates in line with this. I believe that these points still hold true, but given the aforementioned revision of the Account’s wording, and Lagarde’s own acknowledgement that the change was not innocuous, my prediction as part of this report’s main forecast scenario that “continued interest rate cuts would be necessary even after the neutral interest rate had been reached” may have become less likely to come true.



EU Political/Economic Situation – Who Will Pay for Europe’s Rearmament?

U.S. Pushes for Europe’s Rearmament

Since Trump’s phone call with Russian President Vladimir Putin on February 12, concerns have grown by the day that ceasefire talks will proceed without input from the EU or Ukraine. Following the spat between Trump and Ukrainian President Volodymyr Zelenskyy at the White House on February 28, and the subsequent decision by the U.S. to suspend the provision of weapons or military intelligence to Ukraine, Europe’s self-defense instincts have suddenly kicked in. Following a telephone conference on February 12, U.S. Secretary of Defense Pete Hegseth also made pro-Russia remarks, saying, “The United States does not believe that NATO membership for Ukraine is a realistic outcome of a negotiated settlement.” He also ruled out the involvement of NATO or U.S. troops in guaranteeing Ukraine’s security following a ceasefire, saying that European troops ought to be the primary force securing a post-war Ukraine. Hegseth also stated, “The United States will no longer tolerate an imbalanced relationship,” calling for NATO allies to increase their defense spending to 5% of their nominal GDP, instead of the current 2%. 5% is a distant goal not only for Europe but for most NATO member states (see graph), but some kind of action is urgently needed from Europe. The trend was foreseen even before the inauguration of the second Trump administration, but the fact is that it is progressing faster than expected. Incidentally, Poland’s defense spending has already surpassed 4%, followed by Estonia at over 3%, so countries with a strong sense of geographical crisis are beginning to prepare. Despite being part of the same group, the sense of ownership toward defense responsibilities is completely different in different EU member states, and the Eastern European countries can be commended for facing reality head on.



Historic Attempt to ReArm Europe

The Special European Council meeting was convened on March 6 under the aforementioned circumstances. As previously reported, the summit unanimously approved the “ReArm Europe” plan proposed by President of the European Commission, Ursula von der Leyen. Initially, Viktor Orbán and Robert Fico, the prime ministers of Hungary and Slovakia, both of which import natural gas from Russia via Ukraine, were cautious about expanding military support to Ukraine, but Slovakia changed its stance to support the plan after a clause dealing with gas supply issues was added, and Hungary also eventually came around. This is a historic decision regarding the military expansion of the EU as a whole. While emphasizing that NATO will remain the basis for the collective defense of member states, EU leaders have called on EU member states that are also NATO member states to work on reaching an agreement ahead of the June 2025 NATO summit. This simply means that EU budget constraints (i.e., the Stability and Growth Pact (SGP)) will be removed, and that member states should hurry to increase defense spending. The plan, which has a maximum budget of up to EUR800 billion as per the headlines, specifically consists of the following points:

- 1. Temporarily relax fiscal discipline:** Relax EU fiscal discipline to cover defense spending, securing around EUR650 billion
- 2. Finance joint defense projects:** Provide EUR150 billion in loans for joint defense projects such as air defense systems and missile defense
- 3. Reallocate the existing EU budget:** Reallocate the existing EU budget to promote defense investment
- 4. Expand the role of the European Investment Bank (EIB):** Relax EIB lending restrictions and strengthen support for defense-related companies
- 5. Mobilize private capital:** Promote private investment in the defense sector and diversify financing

In this midst, French President Emmanuel Macron has expressed his desire to expand France's nuclear deterrent to the whole of Europe. Of course, doubts remain as to whether France can completely replace the U.S., so some are still wary about adjusting the European defense strategy along this line. However, given that France's handling of nuclear weapons rests solely on the French president's discretion, the fact that he has indicated a desire to protect Europe with French nuclear weapons is not insignificant. In any case, it is important to understand that a historic turning point has been reached in the sense that the EU as a whole has begun to move toward military expansion.

Financial Conditions Markets Focus On

As mentioned above, of the reported total of EUR800 billion, about EUR650 billion will be covered by expanding the defense budgets of member states. At this time, fiscal rules as enshrined in the SGP are expected to be shelved, and as already reported, Germany has already been trying to take a similar step. The Special meeting of the European Council Conclusions document clearly states that the Council "welcomes the intention of the Commission to recommend (...) the national escape clause under the Stability and Growth Pact (...) to facilitate significant defence spending at national level in all Member States." Member states will no longer be reprimanded by the European Commission for violating the SGP for their defense budgets. The remaining EUR150 billion are clearly stated as "defence loans" from the European Commission to member states. The funds are to be used for joint defense projects within the region, such as air defense systems and missile defense. The market will be paying attention to where the European Commission will source these funds from. In this context, there are two approaches (see table).

Feature	NextGenerationEU Bonds	SURE Bonds
Official name	NextGenerationEU Bonds	SURE Bonds
Objective	Post-COVID-19 economic recovery (long-term investments)	Reducing unemployment risk (short-term support)
Total amount issued	Up to EUR 800 billion	Up to EUR 100 billion
Duration	2021-26 (long-term)	2020-22 (short-term)
Repayment deadline	2028-58	2025-51
Nature of funding	Subsidies (free) and loans (to be repaid)	All loans (to be repaid)
Member state guarantee	Guaranteed by EU budget (new EU taxes also being considered)	Guaranteed by member states' (proportional) contributions
Political impact	A step toward EU fiscal integration	Short-term crisis response

(Source) Created by author based on data from the European Commission, etc.

The first is to follow the example of the SURE (Support to mitigate Unemployment Risks in an Emergency) program, which was adopted as an employment measure during the pandemic. Under the SURE program, the European Commission issued EU bonds (hereafter: SURE bonds) and lent funds to member states at low interest rates. The funds raised through SURE bonds are used primarily as bilateral loans, so the structure is simple: the borrowing member states repay the EU. The EU has merely loaned short-term crisis response funds, and it has no further political significance.

Another possibility is to follow the example of the NGEU (Next Generation EU) bonds issued for the purpose of economic recovery after the pandemic. NGEU bonds are backed by the EU budget, and a total of EUR750 billion worth of these bonds are scheduled to be issued by 2026. The majority of this (EUR390 billion) will be allocated to member states as "subsidies," i.e., they do not need to be repaid. Since the repayment funds for NGEU bonds will be covered by the EU's own financial resources (in other words, EU taxes), when the framework was first completed, it attracted a lot of attention as a milestone in the long-awaited fiscal integration. Naturally, NGEU bonds are based on a longer-term perspective than SURE bonds, which are mainly justified as an employment measure, and they have considerable political significance. However, these bonds are currently scheduled for issue only until 2026 and, in that sense, are like a trial measure for fiscal integration.

Second Trump Administration a "Catalyst" for European Integration

Given that the "loan" aspect has been emphasized, the recently announced defense-related funds could well follow the example of SURE bonds, but given that the plan pertains to Europe's rearmament, a procurement method like NGEU bonds, where the burden is on the EU as a whole, may be more appropriate. Even in that case, it may still remain a loan, but without ruling out the possibility of the loan being considered a subsidy in the case of member states that are financially unable to allocate a sufficient defense budget. These and other details are currently unavailable, but it is entirely conceivable that so-called euro area common bonds, like NGEU bonds, could be considered going forward. I believe that this is a move that can be evaluated positively, both in the sense that the EU has set its course in the right direction, and that a new safe asset class will be created in the financial markets. Looking back at history, it is clear that the EU has not been able to make major political decisions without the impetus of extremely urgent external pressure such as a debt crisis or a pandemic. This time, the impetus came in the form of

war. In that sense, the second Trump administration can be viewed as a “catalyst” that further promotes European integration. Whatever the reason, the EU is evolving in the right direction, with fiscal integration as its core element.

ECB to Play a Role in Risk Scenario

Of course, as readers may still remember, getting the NGEU bonds issued in the middle of the pandemic involved extremely difficult negotiations among EU member states. This time, the tentative deadline for reaching an agreement is the NATO June summit, which is not very far away. It is possible that the EU will prioritize speed of decision-making and raise funds for the EU defense budget through bonds similar to SURE bonds. The current situation is not one in which EU member states can afford to engage in internal squabbles; rather, they need to protect Ukraine and themselves from the arbitrary actions of the U.S. and Russia. Unlike other regional adjustments so far, there is a greater incentive to come together in solidarity this time.

Further, while it may be premature, there is also concern regional interest rates could be pushed up against the backdrop of growing uncertainty regarding the extent of increase in the defense budget. Just as EU member states had finally realized defense budgets worth 2% of nominal GDP, figures of 3% or even 5% are being floated, which is bound to increase pressure on the region’s bond markets. The ECB could, of course, offer a temporary lifeline as in the case of the Pandemic Emergency Purchase Program (PEPP), which it was forced into during the pandemic. While such a thing would be unlikely in the U.S., which has a large defense budget to begin with, as a risk scenario regarding the EU and EUR, I may have to factor in the possibility of the ECB becoming involved in a situation where rearmament becomes the theme.

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